

PEER MONITOR INDEX

THOMSON REUTERS INSTITUTE

Q3 2021 EXECUTIVE REPORT
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Q3's BRIGHT PERFORMANCE SHADED BY COMPENSATION

The third quarter of 2021 saw the large law firm market continue its trend of recovery from last year's downturn with high marks for both demand and productivity. Also, worked rate growth continued to be healthy, and unremarkable growth in overhead expenses looked to be trending upward.

Yet, the most noteworthy feature of the quarter was the dramatic jump in law firm direct expenses,¹ a symptom of the broader market challenges relating to talent.

Despite high-water marks in demand and productivity that hit three-year Q3 highs, respectable rate performance, and only moderate growth in overhead expenses, the pronounced jump in direct expenses for the average law firm brought the Thomson Reuters® Peer Monitor Index (PMI)² back down from the stratosphere, settling in at a score of 67 for Q3, still outpacing any quarter in the previous decade.

Overall demand growth was driven by strong performances in nearly every key practice area tracked by Peer Monitor. Real estate led the way for the quarter, posting 13.2% year-over-year growth. Corporate work posted a fourth consecutive quarter of growth with a mark of 8.7%, driven again by continued strength in the M&A market, which blazed the trail by posting average growth of 9.2%. Incidentally, all three of these practices also showed strong growth compared to the marks set in Q3 2019, a measure we've been looking at throughout the course of this year due to the statistical anomaly created by the low baselines set in 2020. In contrast, litigation remains slightly below its 2019 mark, despite posting strong 2.9% average growth in Q3 this year.

Expenses dominated much of the story for Q3, however. Overhead expenses showed signs of returning to more normal levels as they moved into positive growth territory for the first time this year. The 1.1% average increase in overhead expenses was driven in particular by growth in staff compensation and technology expenses, while knowledge management & library services expenses grew by an average of 5.3%, nearly on par with the previous quarter. Office expenses continued their trend of contraction, posting a -14.1% for the quarter, as return to office plans for most law firms remained in flux.

Direct expenses, on the other hand, saw a tremendous jump to 7.2% year-over-year growth on a rolling 12-month basis, driven mainly by spikes in associate compensation. The tale of the numbers shows that the sharp increase in direct expenses growth is due largely to compensation rather than hiring as lawyer full-time equivalent (FTE) growth grew by only 2.3%. The jump in associate compensation is one indicator of what has become a global competition for talent, a trend worthy of closer examination.

PRACTICE DEMAND GROWTH

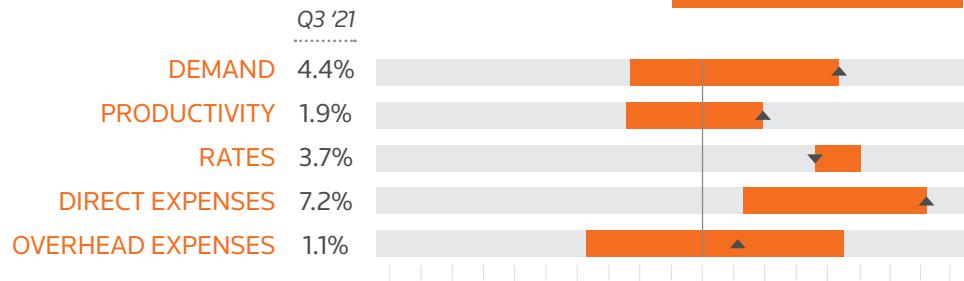
Y/Y Change | Q3 '21 vs. Q3 '20



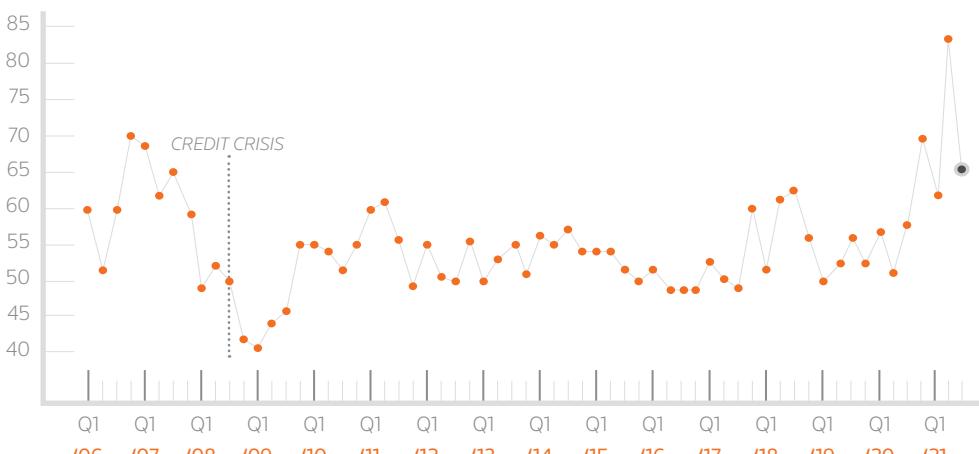
KEY FACTORS Q3 2021 ANALYSIS

Year-Over-Year | Q3 '21 vs. Q3 '20

PMI SCORE: 67



PEER MONITOR ECONOMIC INDEX (PMI)



¹For the purposes of this analysis, direct expenses consist of compensation and benefits for all attorneys who are not equity partners.

²The PMI is a composite score, representing the quarter-over-quarter change in drivers of law firm profitability, including rates, demand, productivity, and expenses. Positive factors driving firm profitability will produce a higher score.

*Circular band surrounding practice is equal to Proportion of Hours Worked in 2020.

Supply and demand applies to talent too

The general rule of supply and demand holds that if demand for a good or service increases without a corresponding increase in supply, prices will go up. That is undoubtedly a factor in the recent associate salary increases that have become almost a regular feature in the 2021 legal economy. Some law firms may also be flipping that maxim on its head, offering higher salaries as a way of creating increased talent mobility in the market, thereby putting a strain on competing firms. History has shown that law firms will make efforts to match salary scale; however, the increases in salary scale have never been as large or as frequent as they have in 2021.

We've already seen the figures related to overall average direct expense growth, but the numbers are even more noteworthy when explored on a per FTE basis. As a function of FTEs, Q3 direct expenses grew by 8.0%. At the same time, overhead per FTE was still lagging behind its 2019 mark.

Even dramatic associate salary increases, as of yet, have not helped law firms to hold onto the talent in which they are investing so heavily in recruiting. In the last 12 months, law firms saw their lawyer ranks experience nearly 14% turnover. While this turnover increase compared to 2019 might seem modest, it is equivalent to nearly 400 more lawyers leaving their firms than a normal year among our current sample of firms.

It has long been true that associate development is a potential profit sinkhole for firms, which spend hundreds of thousands of dollars per associate every year, while many of these associates operate at an effective loss for the year in terms of their collections. Increasing salaries and high turnover rates will only exacerbate this problem, absent either dramatic reductions in turnover or improvements in collections.

To further complicate matters, none of this takes into account the shifts in attitudes around how lawyers want to work in the post-pandemic economy — shorter hours, less travel, smaller billable hour requirements, etc. — nor the potential threats to headcount, particularly among law firm leadership, that could be posed by burnout and other attorney well-being considerations.

In short, law firms' competition for talent — as indicated by increasing direct expense growth — may have ignited in Q3 2021, but the situation may be only just starting to approach the boiling point.

For more information on the PMI, and how the Peer Monitor platform can provide you more granular, timely, and narrowly tailored competitive intelligence, please contact Brent Turner at **763-326-6625** or brent.turner@thomsonreuters.com, or visit the Peer Monitor website [here](#).

KEY FACTOR ANALYSIS

All Segments | Q3 '21 vs. Q3 '19



All timekeepers; Billable time type; non-contingent matters

PRACTICE DEMAND

All Segments | Q3 '21 vs. Q3 '19



All timekeepers; Billable time type; non-contingent matters

ASSOCIATE COMPENSATION GROWTH

All Segments
Rolling 12-Month Change

Q1 2021 **2.1%**

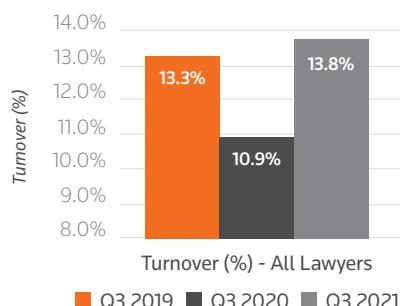
Q2 2021 **5.9%**

Q3 2021 **9.9%**

Associate Compensation Growth: Associate Compensation divided by Associate FTEs

TURNOVER

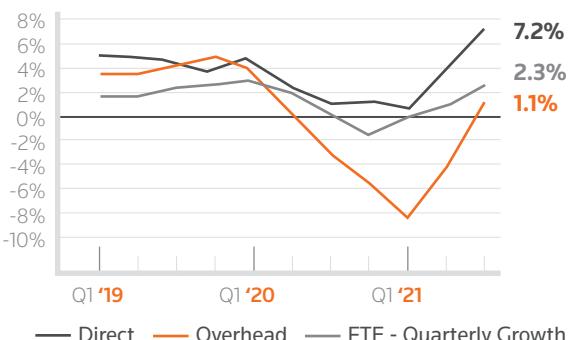
All Segments | Rolling 12-Month Values



Turnover = Lawyers who left the firm divided by the number of lawyers at beginning of the time period

EXPENSE GROWTH

Rolling 12-Month Y/Y Change



OVERHEAD HIGHLIGHTS

Rolling 12-Month Y/Y Change | Q3 '21



SUPPORT STAFF COMPENSATION
4.0%



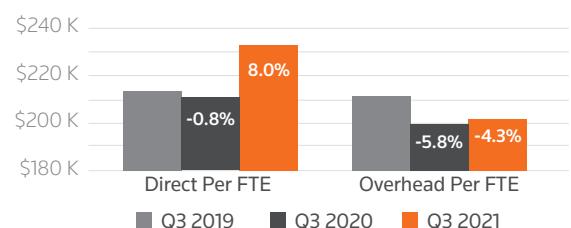
TECHNOLOGY
5.0%



KNOWLEDGE MANAGEMENT & LIBRARY SERVICES
5.3%

EXPENSES PER FTE

All Segments | Rolling 12-Month Values



*Percentages measures change from Q3 2019 values