THOMSON REUTERS INSTITUTE

LAW FIRM FINANCIAL INDEX

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Q3 2022 EXECUTIVE REPORT
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TOUGH STRATEGIC DECISIONS AHEAD AS PROFIT FADES

The third quarter of 2022 saw the *Law Firm Financial Index*[1] (LFFI) remain at its all-time low score of 36. The continued erosion of law firm revenues from declining demand combined with elevated expense growth extended a five-quarter downturn for the Index,[2] a directional indicator of law firm profitability.

Trouble for law firms this quarter starts with the decline of transactional demand in the face of last year's boom, especially among Am Law 100 firms. Transactional[3] demand declined 2.0% for the quarter, while non-transactional demand fared somewhat better, remaining flat. Additionally, the positivity of historically high rate growth was muted by inflation, which continues to bring "real" rate growth into negative territory for the average law firm.

Even with declining revenue, seasonal hiring has continued apace, indicating law firms so far have refrained from the layoffs which defined their response to the 2007-2008 financial crisis. With fresh memories of the difficulty of rehiring talent, law firms seem willing to accept some productivity contraction in the short term; however, the large productivity contraction in Q3 weighs heavily.

Simultaneously, the large law firm industry has been undergoing an aggressive expansion of expenses, making the current wait-it-out strategy even more difficult. Direct expenses[4] are up 10.9% for the quarter, driven by law firms' continued hiring, as well as high attorney wage growth. With firms returning to the office, overhead expenses continue to climb as well, growing at 12.8%.

PRACTICE DEMAND GROWTH

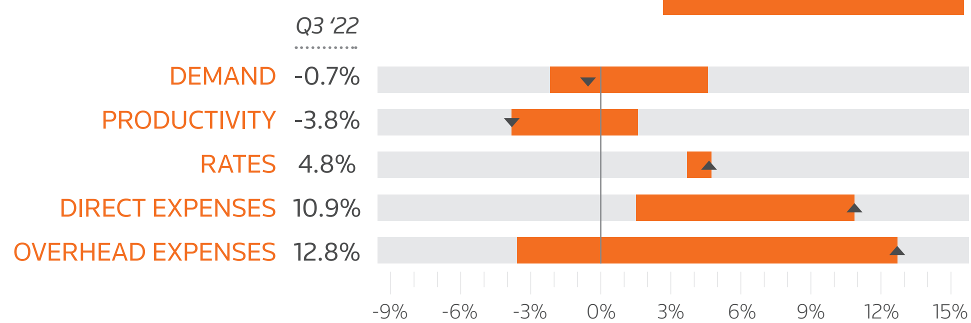
Y/Y Change | Q3 '22 vs. Q3 '21

**Circular band surrounding practice is equal to Proportion of Hours Worked in 2021.*

KEY FACTORS ANALYSIS

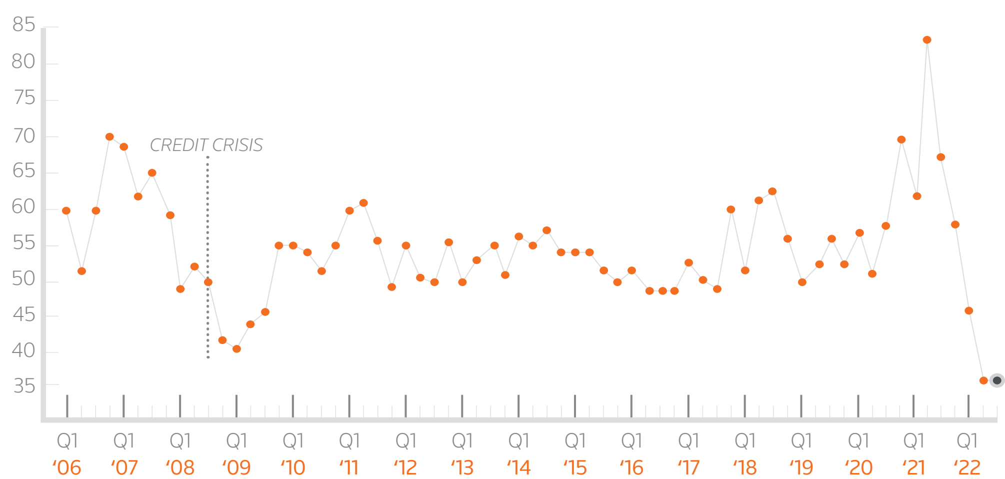
Year-Over-Year | Q3 '22 vs. Q3 '21

LFFI SCORE: ⬌ 36



Change from Q3 2021: ▲ = Up ● = Flat ▼ = Down **Current Reading (Q3 2022):** 3-Year Q3 Range

LAW FIRM FINANCIAL INDEX (LFFI)



*[1] Earlier this year, the Peer Monitor Index (PMI) was rebranded into the **Law Firm Financial Index** (LFFI). Thomson Reuters has produced the PMI for every quarter since 2006 and the new LFFI uses the same fundamental methodology to determine the index score. With this rebrand, Thomson Reuters seeks to bring new context to the findings with resources from beyond the Peer Monitor®/Financial Insights program.*

[2] The LFFI, formerly the 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.

[3] Transactional practices include corporate general, mergers & acquisitions, tax, and real estate practices.

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

The combined weight of lower demand and stubbornly higher expenses has pushed law firm profit per lawyer down 2.9% since just Q2 2022. Lawyers on average remain 17.6% more profitable than they were in the first quarter of 2020, but the gains are reversing rapidly. This is exacerbated by increasingly mobile legal demand in the market, with evidence of smaller firms seeing greater success both overall and in certain practices, suggesting that clients are now more willing to shop around. This makes it difficult for larger law firms to cut investment and improvement items that will drive efficiencies and differentiation.

Law firms are nearing an inflection point

Come Q4, law firm leaders are likely to face increasing pressure to make cuts wherever they can find them, as equity partners could be receiving annual payouts which are on pace to be considerably less, on average, than in the previous year even as inflation has eroded an additional 8.2%[5] in buying power so far this year. This will potentially place firms under immense pressure to bring expenses under control by cutting headcount, much the same as in 2008-09.

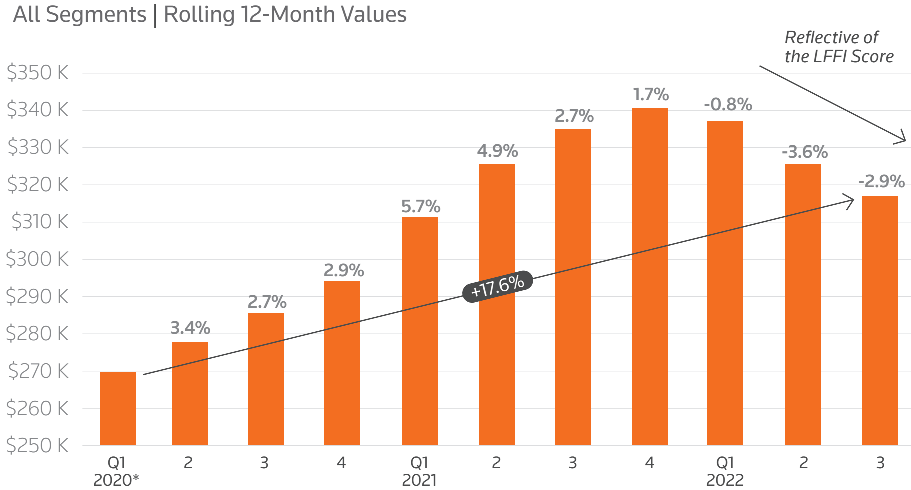
Since then however, law firms have evolved. The increasing presence of non-partner leadership has made firms more adept at strategic decision-making, with their actions during the pandemic being a good example. Those law firms that are able to retain and develop their talent, rather than jettison them, could come out of a short period of economic uncertainty stronger than their rivals. This, however, assumes that any further economic turmoil is relatively light and bearable. If it is not, these same firms will find themselves making deeper cuts than they may have originally.

So far, most law firms continue to operate in a business-as-usual environment. This quarter's LFFI score may be a prelude to the difficult decisions law firm leaders will have to make in the coming quarters.

This report utilizes information from the Peer Monitor / Financial Insights competitive intelligence platform. For additional detail on the data which underpins these reports, please contact Brent Turner at 763-326-6625. To uncover the latest granular and narrowly tailed information on the large law firm industry visit this **website** *or email* **brent.turner@thomsonreuters.com**.

PROFIT PER LAWYER (FTE)

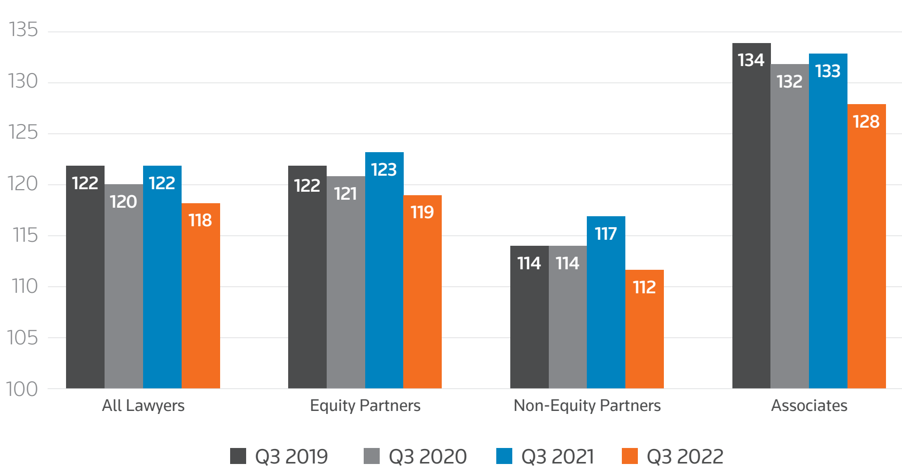
All Segments | Rolling 12-Month Values



**Percentages measures change from the previous quarters' value.*

HOURS PER LAWYER PER MONTH

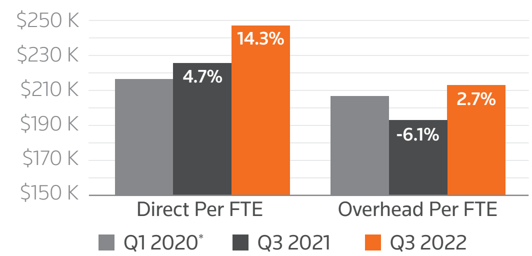
All Segments | By Title



Lawyers
Billable time type; non-contingent matters

EXPENSES PER FTE

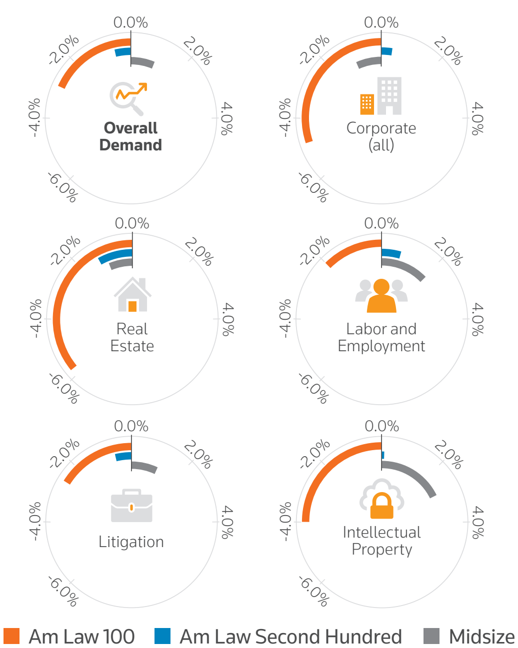
All Segments | Rolling 12-Month Values



**Percentages measure change from Q1 2020 values to show change in expenses compared to the last 12-month period preceding the pandemic.*

DEMAND GROWTH

By Segment | Y/Y Change | Q3 '22 vs. Q3 '21



All timekeepers
Billable time type; non-contingent matters

[5]*This is the Consumer Price Index headline measure of inflation for the month of September.*

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