THOMSON REUTERS INSTITUTE & FINANCIAL INSIGHTS

LAW FIRM FINANCIAL INDEX

Q4 2022 EXECUTIVE REPORT
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New all-time low is not surprising, but can there be a turnaround?

The fourth quarter of 2022 saw law firms at their weakest point, year-over-year, as they measured up against the heights of Q4 2021. This mismatch resulted in the Law Firm Financial Index[1] (LFFI) dropping to a new all-time low score[2] of 30 in Q4 2022. Combined challenges to revenues, productivity, and expenses have nearly eaten through the record profit gains of 2021.

This is not surprising but is instead the logical outcome of factors which had been building for most of the year. Due to a potent combination of rising interest rates, geopolitical and economic instability, and measurements against the peak of demand in Q4 2021, transactional[3] demand faltered, resulting in overall demand contracting 3.9% year-over-year this last quarter. Overall demand has gone from growing 3.6% in Q1 2022 compared to Q1 2019 to a contraction of 0.2% in Q4 2022 vs. Q4 2019. This contraction has been tempered by the improvement of non-transactional demand, which still remains below its pre-pandemic levels.

On its own, a large demand drop wouldn't have so dampened firm profits and thus the Index's overall direction. However, the decline in demand corresponded with strong seasonal hiring on the part of law firms. This resulted in productivity contracting 7.2%, a quarterly decline equal to the depths of the pandemic lockdown. Combine this with the fact that lawyers' salaries remain historically expensive (alongside firms' efforts to enact a likewise costly return-to-office strategy) and the LFFI's drop to a new all-time low becomes more understandable.

As the Index's new all-time low suggests, the current situation is unsustainable. Yet, before panicking, we should note that there are signs of improvement on multiple fronts.

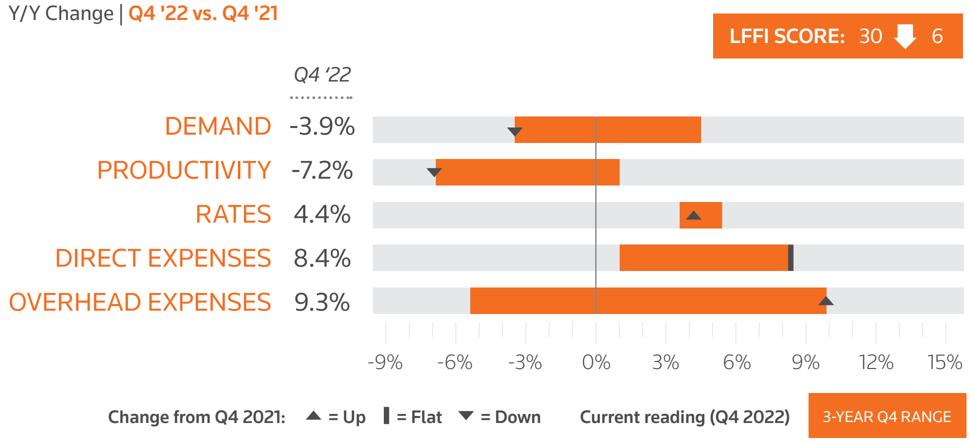
PRACTICE DEMAND GROWTH

Y/Y Change | **Q4 '22 vs. Q4 '21**

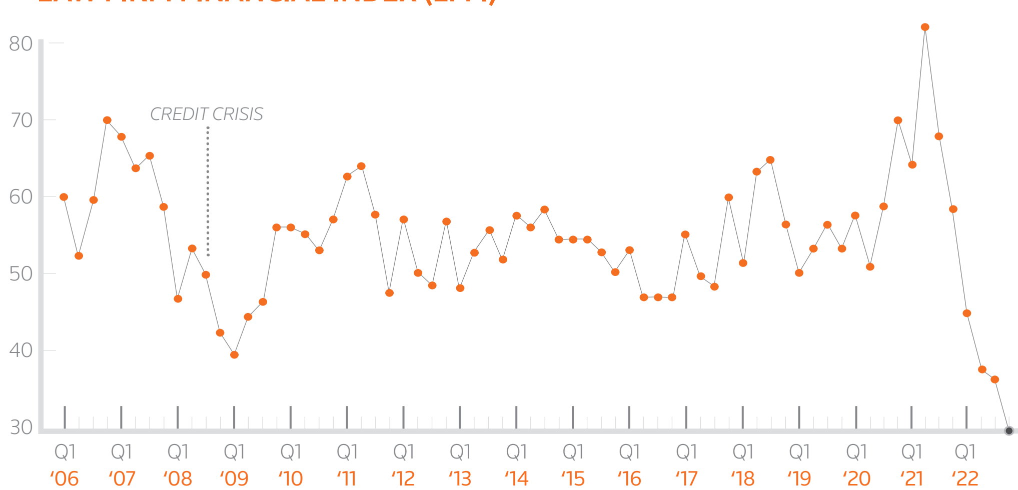
Circular band surrounding practice is equal to Proportion of Hours Worked in 2022.

LFFI KEY FACTORS

Y/Y Change | **Q4 '22 vs. Q4 '21**



LAW FIRM FINANCIAL INDEX (LFFI)



[1] *Early in 2022, 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 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.*

Can the industry right itself in 2023?

Transactional demand, while slowing compared to its heights, remained above pre-pandemic levels, with most of the contraction in demand growth year-over-year centered on Am Law 100 firms. Recent data suggests these firms may be recovering somewhat, especially with Am Law 51-100 firms outperforming all other segments in fees worked (a proxy for revenue) growth in Q4. If inflation continues to moderate and interest rates stabilize, transactional demand may find the required conditions to recover, as non-transactional demand (led by Midsize law firms) has already shown possible over the last few quarters. Continued economic instability, however, has the potential to threaten any transactional demand recovery.

Expenses showed notable signs of improvement as well, although a large part of that comes from measuring against high baselines. Direct expense[4] growth on a per-lawyer basis slowed from 10.2% in Q1 2022 to 5.7% in Q4, highlighting how the current expense growth that firms are facing is increasingly due to the higher level of on-boarding new talent, rather than salary increases. Overhead expenses per lawyer were also slowing the pace of gain, ending the quarter at 5.8% growth, although firms' return-to-office plans threaten to hamper this much needed progress.

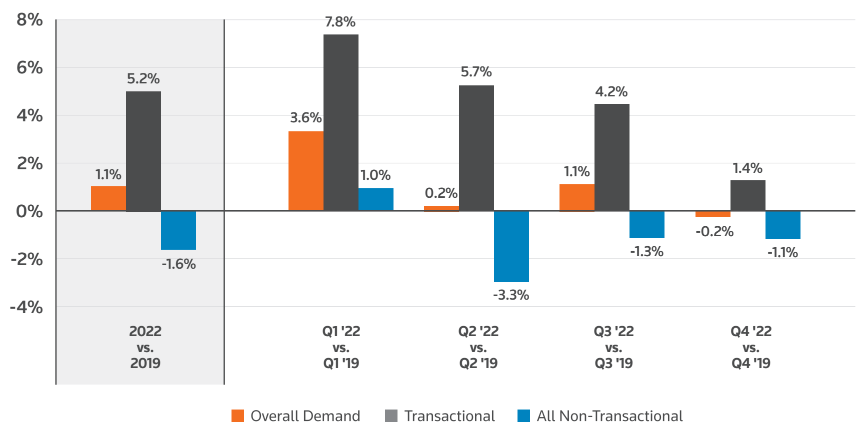
Rate growth is where signals are more mixed. The average firm's worked rate growth receded somewhat in Q4, primarily a result of volatile international work from the Am Law 100 as exchange rates fluctuated and higher-rate transactional work waned. What is more concerning is that firms' realization rates have declined across all segments over the last few quarters, defying the normal seasonal improvement trend. As firms implement new rates in 2023, which many think could be historically high, balancing realization with rate gains will be a test of firms' business savvy.

Profits declined in 2022 for the first time on an annual basis since the Global Financial Crisis. Combined with multiple ongoing issues that went so far as to pressure layoffs at some of the largest firms, it's understandable why the LFFI dropped to a new low. This was the inevitable outcome of long hiring cycles coming up against demand's rapid evaporation at a time of high-expense growth. However, there are positive signs on the horizon which indicate that firms' futures may be brighter than the LFFI score currently indicates.

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

YEAR IN REVIEW - DEMAND GROWTH VS. 2019

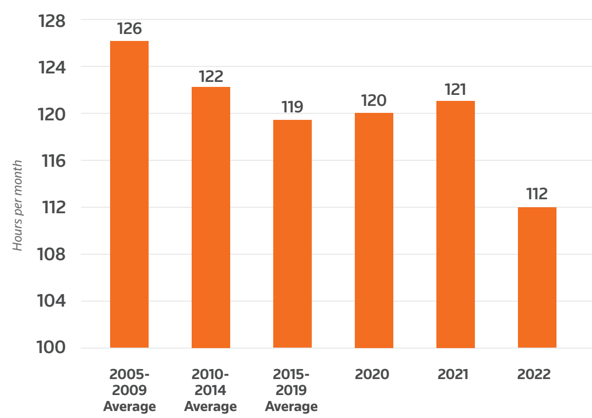
Transactional vs Non-Transactional



All timekeepers Billable time type; non-contingent matters

HOURS WORKED PER LAWYER - Q4

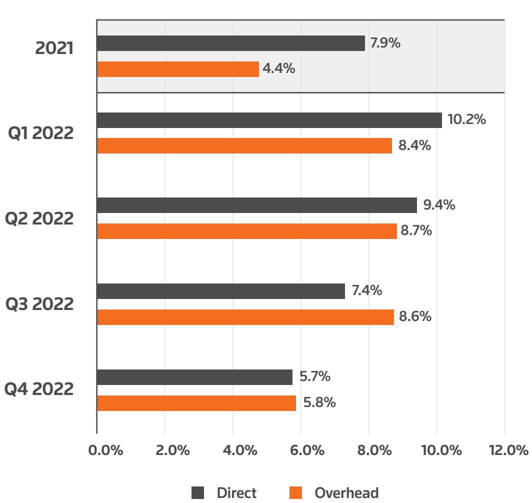
All Segments



Lawyers Billable time type; non-contingent matters

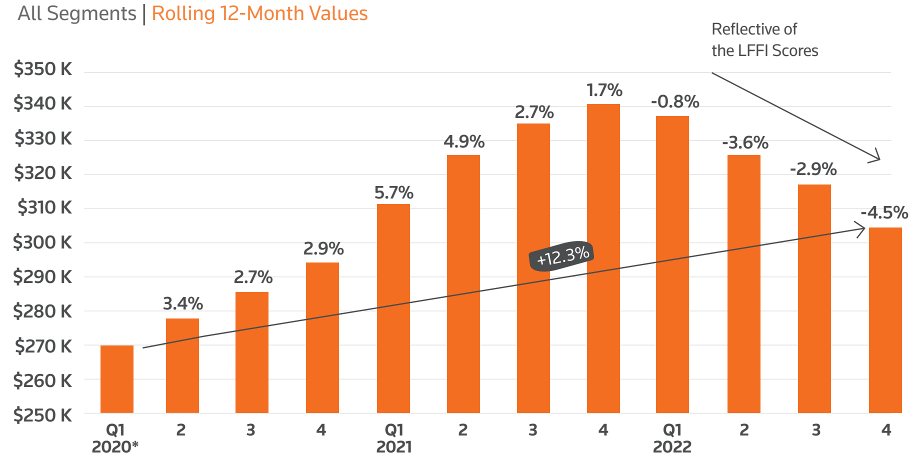
EXPENSES PER LAWYER (FTE) GROWTH

By Category | Rolling 12–Month Y/Y Change



PROFIT PER LAWYER (FTE)

All Segments | Rolling 12-Month Values



**Percentages measure change from the previous quarter's value.*

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