

Layoffs and counter-cyclical practices split law firms' recovery

A combination of historic rate increases, expense growth slowing, and the rise of counter-cyclical practice areas helped law firms snap a year-and-a-half streak of decline. While still in historically low territory, the *Law Firm Financial Index (LFFI)* rose 14 points to a score¹ of 44 in Q1 2023.

It's not necessarily surprising that the *LFFI* is rebounding from its all-time low score, set in Q4 2022. The fourth quarter measured up against some of the highest baselines in recent history while simultaneously feeling the brunt of a demand downturn. The first quarter of this year was more advantageous, with every major practice performing far better than in Q4 2022. However, the continued emergence of macroeconomic counter-cyclical practices² in recent quarters cannot be ignored. These practices were led by litigation and labor & employment, with bankruptcy seeing its best quarter since the beginning of the pandemic. If common wisdom holds, current law firm billables point toward a recessionary cycle.

Worked rate growth for firms also reached new historic heights, with Am Law 100 firms putting together the highest worked rate growth in the history of the Index, finally edging out the record 7.0% growth seen before the Global Financial Crisis (GFC). Am Law Second Hundred and Midsize firms are also at historic highs, allowing the average law firm to raise rates by 5.5%, nudging just above core inflation,³ and securing the Index's recovery.

What is surprising is the divergent nature of the recovery, with firms in the Am Law 100 finding a very different set of challenges and strengths compared to Midsize firms, which have continued to grow demand at the fastest rate for three consecutive quarters. The demand growth among Midsize firms is derived from strength in counter-cyclical practices overall and better relative performance in transactional areas, which are contracting. Midsize firms, however, continue to struggle with high expense growth, partially the result of historic hiring. These firms grew their lawyer count by 4.9% compared to Q1 2022, more than 1 percentage point faster than any quarter for the segment over the last 10 years, while Am Law firms' headcount grew less than 3.5%.

PRACTICE DEMAND GROWTH

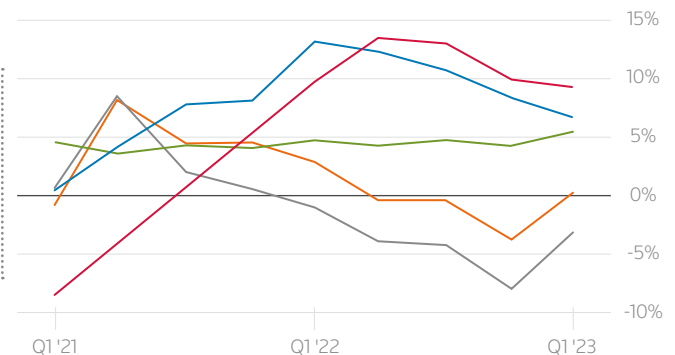
Y/Y Change | Q1 '23 vs. Q1 '22



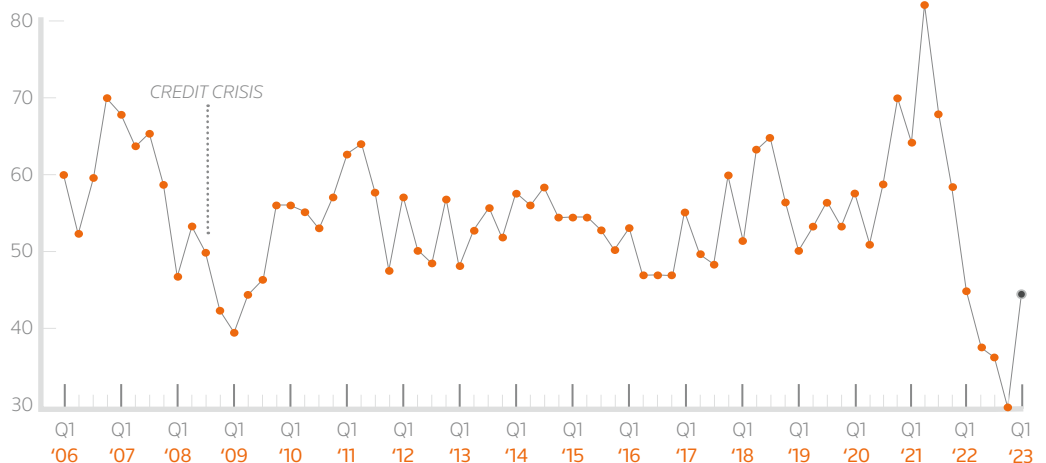
LFFI KEY FACTORS

Y/Y Change | Q1 '23 vs. Q1 '22

DEMAND	0.1%
PRODUCTIVITY	-3.5%
RATES	5.5%
DIRECT EXPENSES	6.8%
OVERHEAD EXPENSES	9.1%



LAW FIRM FINANCIAL INDEX (LFFI)



¹The 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.

²Counter-cyclical practices are those that succeed during periods of economic hardship and struggle in periods of economic upswing, moving counter to the business cycle.

³For these purposes, we use the PCE Core inflation measure (Personal Consumption Expenditures Excluding Food and Energy) both because it is the standard inflation measurement of the Federal Reserve and because we believe it is the most reliable indicator of the rate of inflation experienced by law firms.

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

Am Law 100 firms are facing challenges in a steep reversal to Midsize, experiencing the largest demand decline of all tracked segments, primarily driven by significant shortfall among the Top 50. These firms, however, have found new strength and are driving the recent trend of slowing expenses, which also relieves pressure off the *LFFI* score. Layoffs in Q1 appear to be more widespread among the Am Law 100 but still remain relatively shallow. Combined with other cost-cutting measures, Am Law 100 expenses are slowing dramatically, especially on the direct expense⁴ side compared to the previous 12 months. It should be noted that the Am Law Second Hundred sits in the middle in terms of demand and rate growth, however that segment is seeing similar hardships as Midsize firms with direct expenses, which is an unenviable position.

Lines in the sand

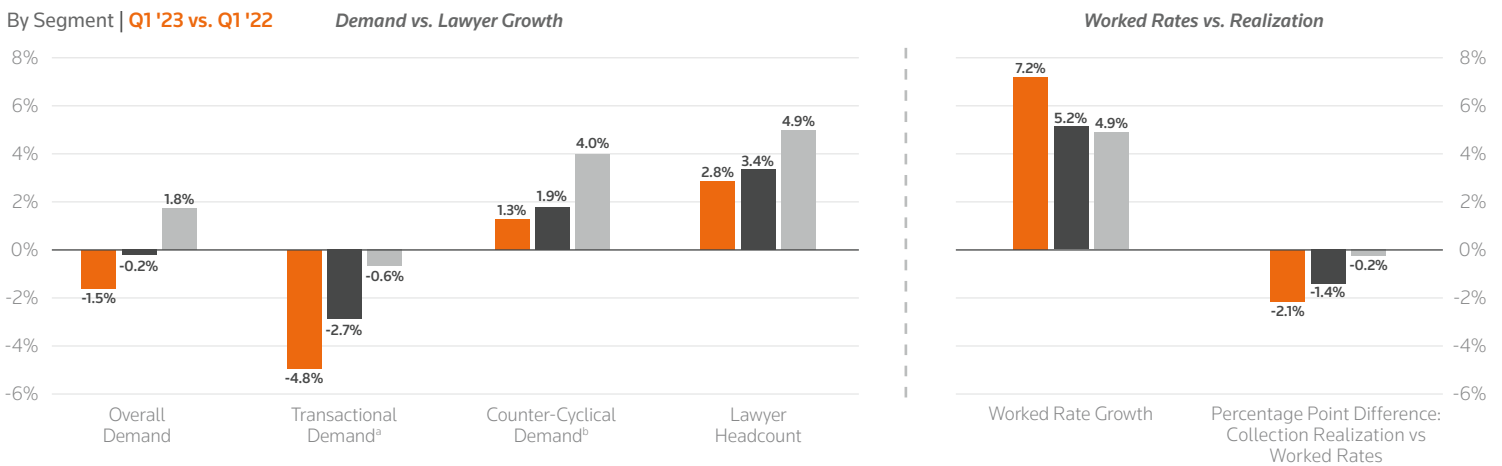
This bifurcated recovery, with two ends of the industry experiencing such contrasting revivals, highlights the precarious state of the legal industry as every strength is seemingly accompanied by a drawback. Am Law 100 firms' worked rate growth has been enough to overcome some of its demand shortfalls, but realization against worked (agreed) rates has declined significantly more than the other segments — potentially the result of clients pushing back against such aggressive increases. Midsize firms' great expansion in headcount surpassed their best-in-class demand growth, keeping the all-firm average productivity contraction to just 3.5%. This marks four quarters in a row where productivity declined more than 3%, a streak not even close to being rivaled since the GFC.

Law firms have by no means recovered from the downwards spiral that sent the *LFFI* to Q4 2022's all-time low, but at least firms now have some metrics headed in the right direction. Working to their advantage is the fact that going forward, firms will be measured against lesser baselines. The rise of counter-cyclical practices, however, is a red flag for economic stability in 2023.

The challenges that Am Law 100 and Midsize firms face seem daunting; however the current trends in terms of hiring and expenses may outline how these law firm leaders view their future prospects. Given the Am Law 100 firms' decision to enact layoffs and Midsize firms' strategic call to hire despite great costs, it seems each segment has drawn lines in the sand respective of how they may believe they will perform in the coming months and years.

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

A BIFURCATED RECOVERY – ALL STRENGTHS HAVE A DRAWBACK



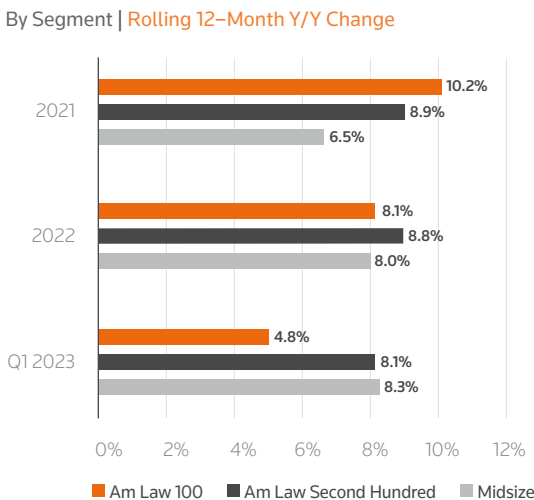
^a Transactional Practices = Corporate General, M&A, Real Estate, Tax

^b Counter-Cyclical Practices = Litigation, Labor & Employment, Bankruptcy

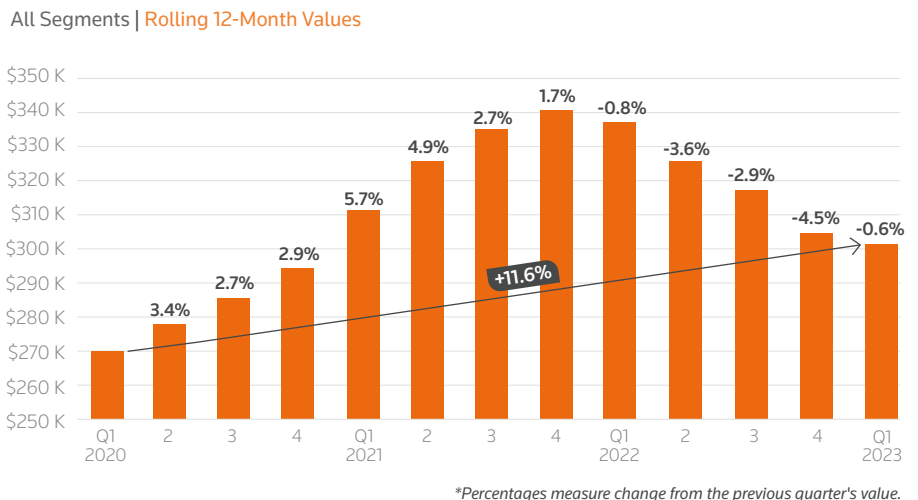
■ Am Law 100 ■ Am Law Second Hundred ■ Midsize

*All timekeepers, billable time type; non-contingent matters

DIRECT EXPENSE GROWTH



PROFIT PER LAWYER (FTE)



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