LAW FIRM FINANCIAL INDEX

Q3 2023 EXECUTIVE REPORT
ISSUED 11.06.2023

Firms tap the brakes on September hiring, all eyes on year-end profit

In the third quarter of 2023, law firms moved to get profits in line by pulling back on hiring levels after two years of rapid headcount growth. The Thomson Reuters® Institute Law Firm Financial Index[1] (LFFI) held at its six-quarter high of 50 points as firms set themselves up to make a year-end sprint for profit growth.

The third quarter marked the point in which the Am Law 100 became the first law firm segment to return to profit growth on a rolling 12-month average. Midsize firms are also looking to climb back up, having made large improvements from their lows of only a couple quarters ago and now are performing better than the Am Law Second Hundred. Those firms, by contrast, have struggled to make improvements and seem unlikely to reach the same level of profitability as in 2022. A key factor in all firms' struggles is that expense growth, while slowing, has remained sticky. Q3 2023 marks the third consecutive year in which firms have grown direct expenses by more than 6% on a rolling 12-month average. Further, overhead expenses continue to grow rapidly despite measuring against double-digit baselines. Headcount expansion by Midsize firms and rapid rises in the Am Law Second Hundred's per-lawyer costs have been the primary causes of this growth, even as Am Law 100 firms have taken aggressive action to cool their expenses.

In light of the trouble that law firms have had in controlling expense growth, this only makes it more obvious as to why they chose to pull back on first-year associates hiring this year. Am Law firms shrank their incoming classes the most, bringing in their smallest classes since 2020. Midsize firms also brought in a smaller class than last year but to a lesser degree. Midsize firms have also been growing more aggressively in non-first year associate titles than the other segments, potentially taking the opportunity to hire talent normally reserved for Am Law firms but available now due to slower hiring and layoffs.

Even as firms hired more conservatively in the third quarter, demand remained strong, even if at first glance this may not be apparent due to a working day deficit compared with a year ago. Yet while counter-cyclical practice[2] demand has managed to keep many firms chugging along, the continued lack of a transactional practice recovery is holding others back. Average daily demand per lawyer (ADD) per full-time equivalent (FTE) encapsulates how each segment is handling the balance of supply and demand of their lawyers in the current market, which finally surpassed 2022's levels in September but remained well below that of 2021. This highlights how the relationship between productivity and profitability has always been a close one.

PRACTICE DEMAND GROWTH

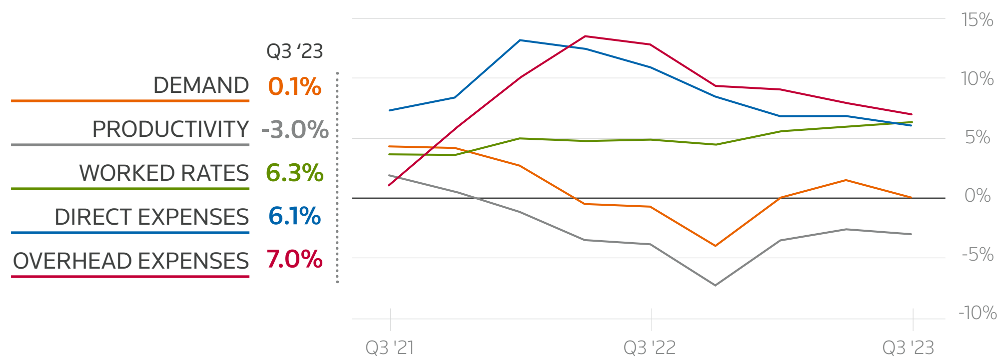
Y/Y Change | Q3 '23 vs. Q3 '22

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

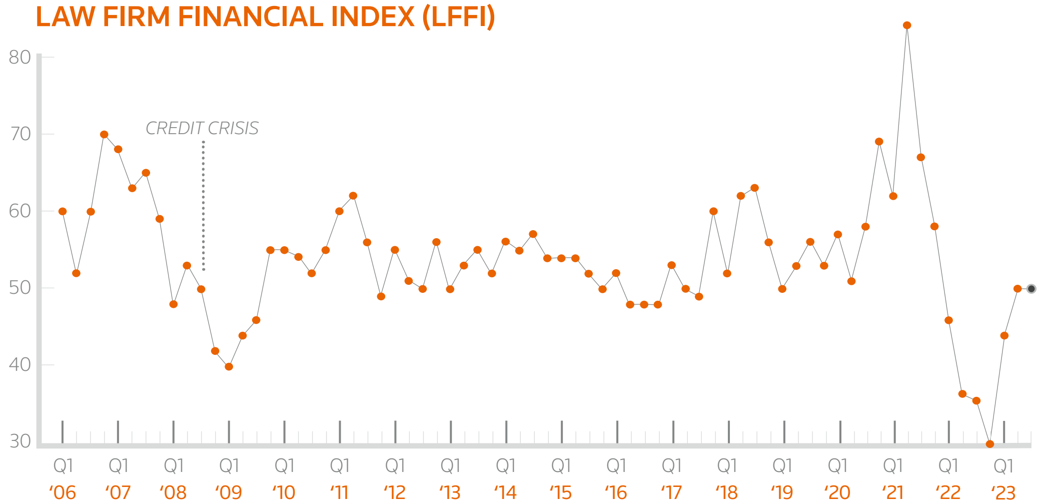
LFFI KEY FACTORS

LFFI SCORE: 50 ⟷

Y/Y Change | Q3 '23 vs. Q3 '22



LAW FIRM FINANCIAL INDEX (LFFI)



[1] 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.

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

Are divergent strategies paying dividends?

If firms are able to achieve profit growth over 2022, they will have been aided by strengthening rates. The gap between firms' worked rate growth and inflation[3] (also known as real rate growth) climbed back to historical norms after going negative in 2022. While some of this is due to slowing inflation, it is also the result of firms' worked rates atypical acceleration over the course of the year. Simply put, firms aren't necessarily raising their rates mid-year but seem to be negotiating closer to the sticker or standard rate for their work. For some firms, this may be a result of mobile demand playing out or increasing geopolitical and economic uncertainty compared to the prior quarter. Given no impactful underlying shifts in billable hours by title or practice to account for this and its widespread nature, it appears to be driven by current market dynamics between firms and clients.

As the year reaches its conclusion, there are a few factors to consider that could both give firms a boost as well as act as an impediment. In Q4 2023, firms will be measuring against the lowest baselines in the LFFI's history, which can help. On the other hand, every segment is facing a unique struggle. For all their efforts to control expenses, Am Law 100 firms are still seeing significantly lower demand. Midsize firms, for all their successes in grabbing market share over the last year, are also struggling with the expense burdens that expansion has demanded. The Second Hundred seems to have searched for greener pastures between the two, with lesser demand contraction than the Am Law 100, but ended up with more expense growth than Midsize firms, finding a sort of no-man's land instead.

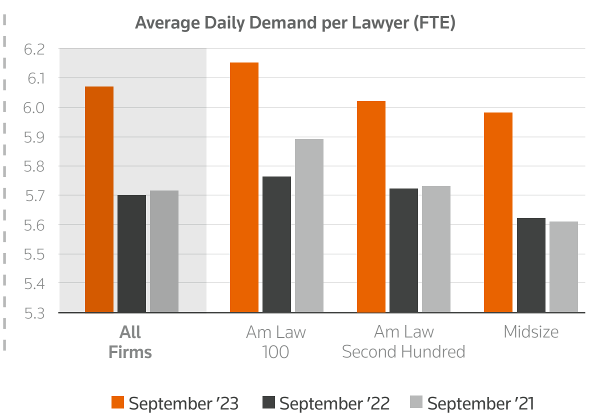
It seems apparent that the segments which made big strategic calls are seeing them pay off, be they a hard hitting of the expansion brakes or full steam ahead on growing market share. Am Law 100 firms are already slated for profit growth, with only a question of "How much?" clouding the air. Midsize firms are making a desperate sprint and if they keep their current pace up, are likely to skid into January with profits even to last year's. Unless something significant changes, partners in the Second Hundred will likely fall behind their 2022 profits. However, if anything has become obvious about 2023, it's that there can always be a twist around the next quarter.

*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***

DIVERGING STRATEGIES

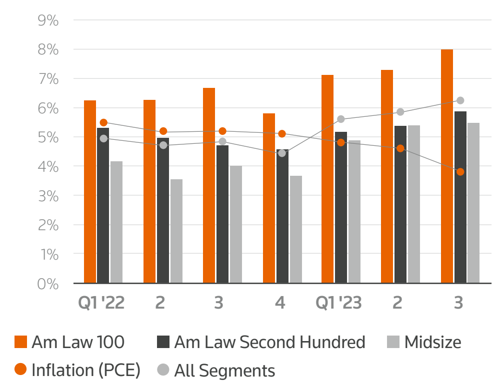
By Segment

Segment	Associate Headcount Change Sept '23 vs. Jan '23
Am Law 100	-1.3%
Am Law Second Hundred	+3.7%
Midsize	+8.2%



WORKED RATE GROWTH

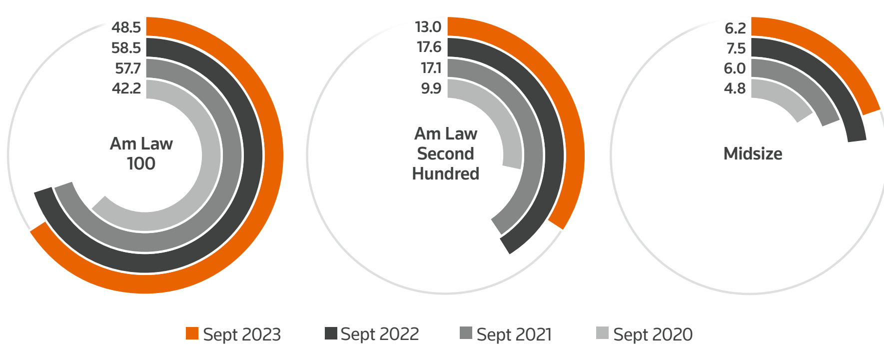
By Segment | Y/Y Change



All timekeepers, billable time type; non-contingent matters

CAUTIOUS HIRING – SEP. FIRST YEAR STAFFING DECISIONS

By Segment | Average Number of First Year Associates By Year

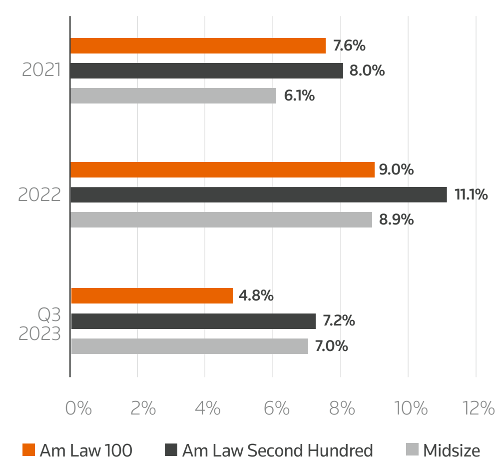


Sept 2023 vs. average of the last two Septembers

Am Law 100	Am Law Second Hundred	Midsize
-16.5%	-24.8%	-8.8%

TOTAL EXPENSE GROWTH

By Segment | Rolling 12–Month Y/Y Change



[3] For 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.

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