THOMSON REUTERS INSTITUTE & FINANCIAL INSIGHTS

LAW FIRM FINANCIAL INDEX

Q4 2023 EXECUTIVE REPORT
ISSUED 2.12.2024

Improvement on all fronts finds law firms in familiar territory

The fourth quarter saw the law firm market improve metrics on all fronts as firms set their eyes towards a clearer 2024. The Thomson Reuters® Institute Law Firm Financial Index[1] (LFFI) rose 7 points to a score of 57. The index's rise was powered by positive movement on all the composite elements of the index, from demand and rates to productivity and expenses.

Large law firms continued to benefit from counter-cyclical[2] demand through the fourth quarter. While this demand has not brought the industry to the heights of 2021, it has managed to overcome stagnant transactional demand, as measured by hours worked, which may have finally found its nadir. A different factor that helped firms in Q4 2023 was the steady increase of worked rates over the course of the year, which reached a percentage point higher than their Q1 levels, at 6.5%, further enhancing firms' revenue.[3]

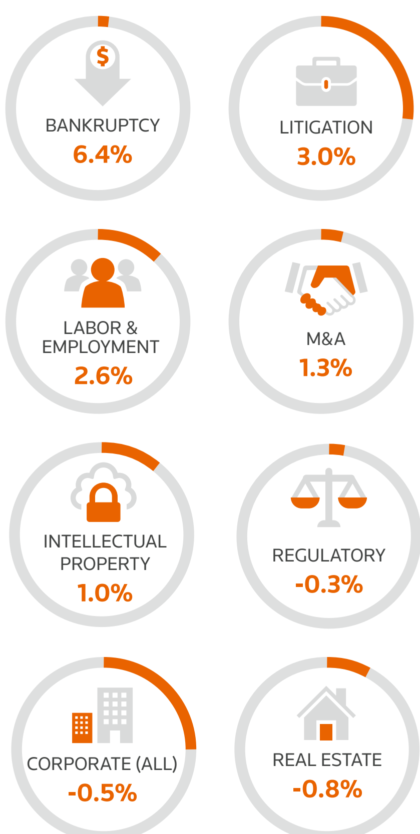
While total expenses for firms continue to grow, partially because of headcount growth and inflation, the pace continues to slow. Law firms managed to blunt a potentially major expense factor by keeping year-end bonuses and overhead expense prepayments in line with 2022, resulting in relatively little impact to firms' 2023 profitability. The new year could see a reacceleration of expenses for some firms due to higher associate pay scales, but so far this rise seems limited to those firms within the Am Law 100.

Speaking of segmentation, the Am Law 100 ended the year strong on the back of tight expense controls and high worked rate growth, yet a schism has emerged within the segment. Firms in the 51-100 range vastly outperformed the top 50 firms in terms of demand. Indeed, the difference in annual demand performance between the subsegments was its greatest since at least 2014. Mobility of demand within the Am Law 100 also seems to be a factor going into 2024, and in conjunction with the rate-increasing prestige of the entire cohort, is setting up Am Law 51-100 firms for a strong year.

Midsize firms were 2023's demand darlings, but still have their own shortcomings. Despite their regular lead in terms of demand growth for nearly every quarter — placing second in Q4 — and logging their best worked-rate growth since the financial crisis of 2008-09, Midsize law firms constantly fell behind their peers in terms of the fees worked, a proxy for revenue. Even the Am Law 100, pushed by much softer demand performance, continued to book greater fees with a fraction of the expense growth that Midsize firms incurred.

PRACTICE DEMAND GROWTH

Y/Y Change | Q4 '23 vs. Q4 '22

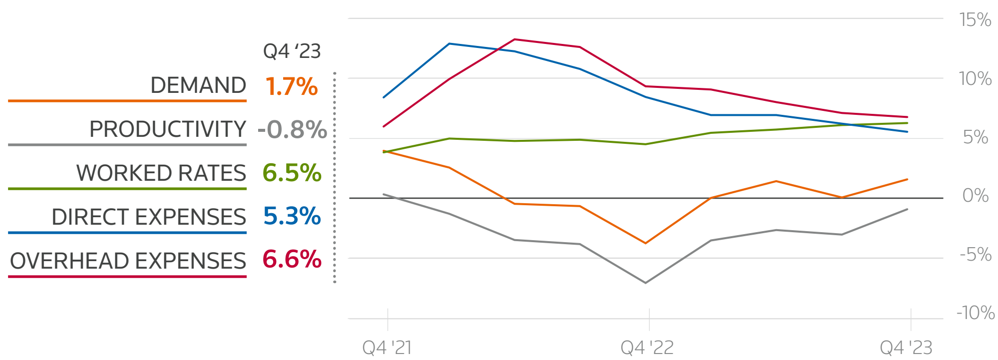


Circular band surrounding practice is equal to Proportion of Hours Worked in 2023.

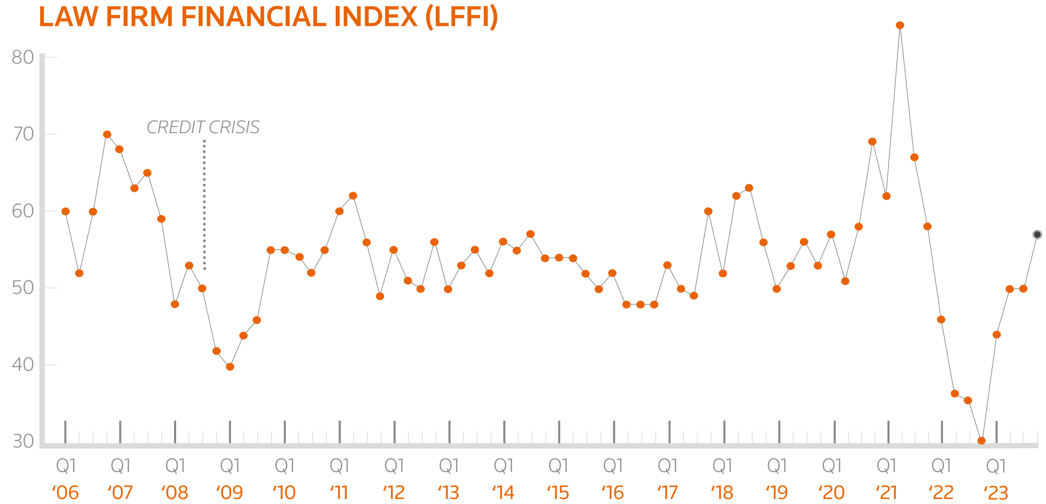
LFFI KEY FACTORS

Y/Y Change | Q4 '23 vs. Q4 '22

LFFI SCORE: 57 ↑ 7



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 succeed during periods of economic hardship and struggle in periods of economic upswing, moving counter to the business cycle.*

[3] *For more commentary on worked rates heading into 2024, check out thomsonreuters.com/en-us/posts/legal/law-firm-rates-report-2023/.*

Finally, the Am Law Second Hundred had been stuck in a sort of no-man's land for much of 2023, neither gathering the demand growth of Midsize firms nor managing the expense controls of the Am Law 100. The fourth quarter, however, saw no-man's land turn much more fertile, with the Second Hundred surging past the other segments in terms of counter-cyclical growth while containing their transactional demand contractions to a small degree. This Q4 sprint led to them passing Midsize firms in profits per equity partner (PPEP) growth by year's end.

Going into 2024, baseline effects have been washed out. For example, Q4 2023 measured against the lowest performing quarter in the LFFI's history in Q4 2022, but that quarter was also measuring against one of the Index's greatest heights in Q4 2021, effectively normalizing the playing field. For the first time in years, firms don't seem to be harried by the tumultuous rollercoaster of events seen thus far during the 2020s. In fact, law firms are returning to a period in which market benchmarks are easier to interpret and navigate.

Productivity: How important is it and how should we measure it?

Eagle-eyed readers may note that one of the key factors in the LFFI has not been mentioned yet, and it has historically been regarded as one of the most important: productivity in terms of hours worked per lawyer. On the one hand, productivity saw its smallest contraction since Q4 2021, a result that helped buoy the overall LFFI score this past quarter. On the other hand, productivity has never been as low as it is now, at least since 2005, at 115 hours per lawyer per month.

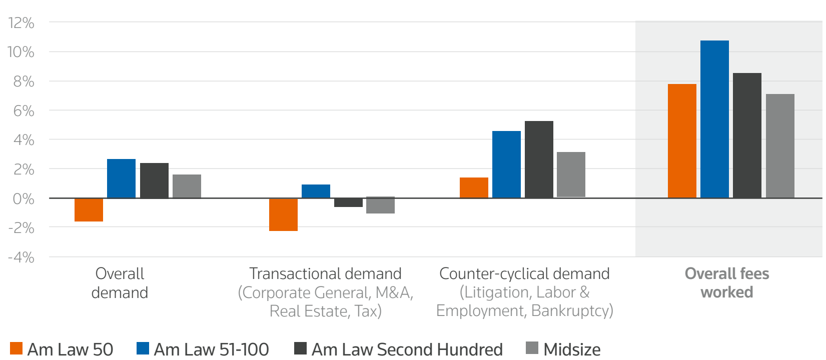
Yet we cannot unsee some of the seemingly contradictory signals. Despite lawyers routinely producing fewer billable hours over the last 10 years, associate salaries have continued to rise. Why have firms done this? One factor is that, despite a seemingly unstoppable leak in lawyer productivity, law firm profits have kept rising for most of the last decade. We see an illustration of this in the struggles of Midsize firms to turn demand into dollars compared to the Am Law 100's implacable way of raising revenue despite declining hours in 2023. Billable hours worked, the market's favored measure of demand for legal services, is simply becoming a less useful measurement.[4]

As advances in technology have allowed lawyers to put more value in their hours, reflective in ever-increasing rates, and alternate fee arrangements increasingly become inevitable, it certainly seems like the revenue that a lawyer generates is becoming detached from the number of hours they bill. While the current relationship remains important despite its cracks, the arrival of generative artificial intelligence promises to widen this detachment into a gulf. It may be time to rethink how law firms approach evaluating the performance of their lawyers and themselves alike.

This report utilizes information from the Thomson Reuters 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 the customer support ***website*** *or email* **brent.turner@thomsonreuters.com**

DEMAND AND FEES WORKED

By Segment | Q4 '23 vs. Q4 '22



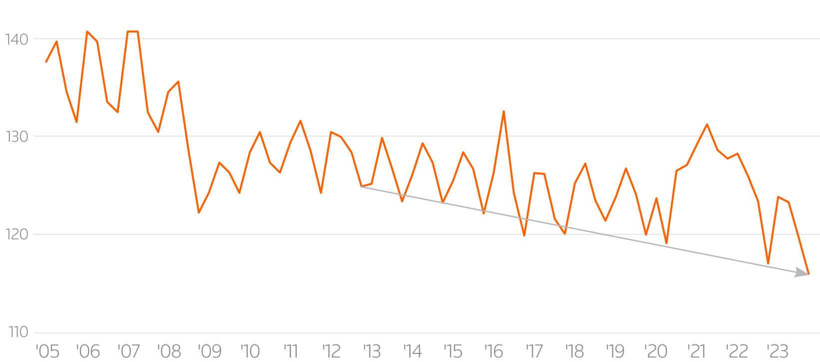
All timekeepers, billable time type; non-contingent matter

FEES WORKED GROWTH

All timekeepers, billable time type; non-contingent matters

HOURS WORKED PER LAWYER

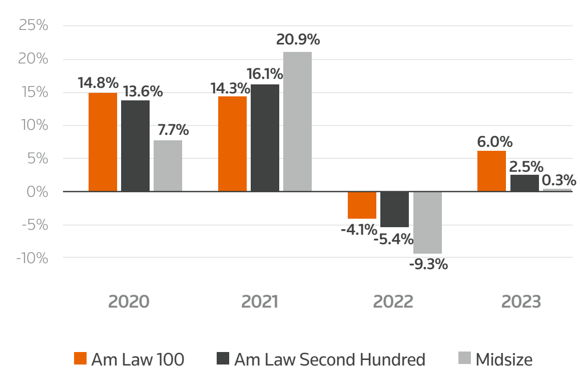
All Segments | Hours per month



All timekeepers, billable time type; non-contingent matters — All Lawyers — Trend line of Q4s since 2012

PROFIT PER EQUITY PARTNER GROWTH

By Segment | Rolling 12–Month Y/Y Change



[4] *For more commentary on productivity, check out* thomsonreuters.com/en-us/posts/legal/law-firm-productivity-metric/.

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