

PMI REBOUNDS SLIGHTLY IN SECOND QUARTER

Demand and Rates Up, Productivity Down

Two steps forward, one step back – that expression fits the second quarter results.

The two steps forward: demand rebounded and rate growth continues to accelerate.

The one step back: productivity is dropping.

The net result was a modest three-point gain in the Thomson Reuters Peer Monitor Economic Index (PMI)¹ to 53. The growth in demand and rates combined to improve revenues. But at the same time, falling productivity and expense growth that is near recent highs continue to eat away at profitability.

While the positives outweighed the negatives, the negative factors are arguably easier to control, presenting opportunities for firms to improve second half performance.

Demand was up 0.7%, shrugging off a flat performance in the first quarter. In recent years, the market often started the year strongly, and then struggled to maintain the performance as the year wore on. The past two years have followed a different pattern – weaker first quarter demand, followed by a more robust second quarter. The strong second quarter has pulled year-to-date back into positive territory and is now up 0.3%. Worked rates rose by a strong 3.8%. Productivity, however, dropped 1.2%.

DEMAND BY PRACTICE AREAS

After a strong 2018 that saw three straight quarters of growth to finish the year, litigation has largely been treading water so far this year. After a flat first quarter, it was up 0.3% in the second quarter, and is now up 0.1% year-to-date.

However, both Am Law 100 and Second Hundred saw strong average growth in litigation, while weakness was largely in the Midsize segment. Am Law 100 was up 1.4% and is up 1.2% year-to-date, while Am Law Second Hundred rose an even stronger 2.0% and is up 2.4% year-to-date. Meanwhile, Midsize fell 2.0% and is down 2.9% year-to-date.

Transactional practices were mostly stronger in the second quarter. Corporate work rose 0.7% and is up 0.4% year-to-date. Real estate was up 2.1% and is up 0.6% year-to-date. Tax work fell 2.3% and is down 2.2% year-to-date.

Patent litigation was down 2.5% and is down 2.5% year-to-date. Patent prosecution fell 0.2% and is down 0.8% year-to-date.

Labor and employment rose 1.6% and is up 0.6% year-to-date.

Bankruptcy, which started the year strongly, retreated 1.2% but remains up 0.5% year-to-date.

PERFORMANCE BY MARKET SEGMENT

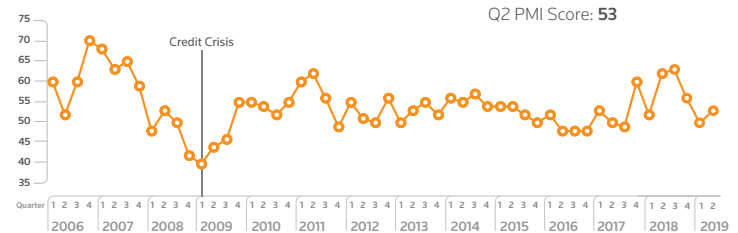
Am Law 100 continued to outpace Am Law Second Hundred and Midsize in the second quarter.

Am Law 100 had the highest demand growth, rate growth, and the best relative productivity.

Am Law 100 demand was up 1.6% and is up 1.4% year-to-date. Am Law Second Hundred gained 0.8% and is up 0.5% year-to-date.

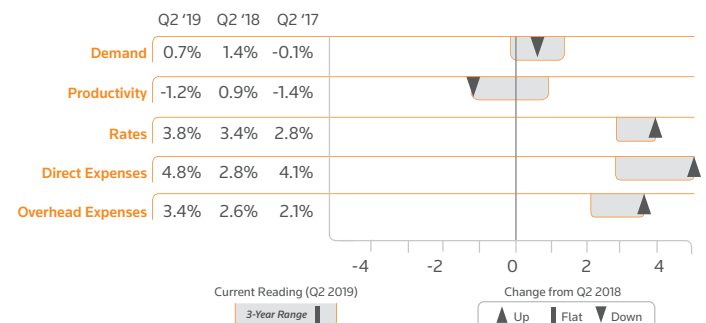
Midsize continues to struggle. It was the only segment with declining demand in the second quarter, down 0.5%, and the only segment with declining demand year-to-date, down 0.8%. Midsize has now had three consecutive quarters of falling demand, during a time when Am Law 100 and Second Hundred consistently rose.

PEER MONITOR ECONOMIC INDEX (PMI)

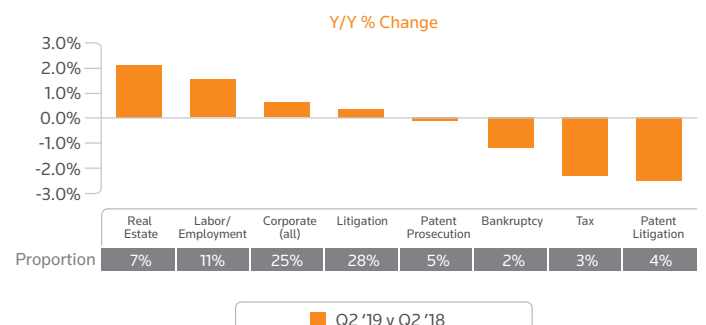


The PMI represents the relative rate of change among the major factors influencing law firm performance. These factors are tracked individually in the graph below.

PMI KEY FACTORS



DEMAND GROWTH BY PRACTICE



¹ The PMI is a composite index 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. A score exceeding 65 generally indicates a healthy operating environment.



RATES

Worked rates rose 3.8% – tying the first quarter for the strongest quarterly rate growth since 2012 – and are up 3.8% year-to-date. Am Law Second Hundred, in particular, is seeing acceleration in rates up 3.9% for the quarter and 4.0% year-to-date.

Rate growth also continues to be strong with Am Law 100, which was up 4.7% in the quarter, and is up 4.5% year-to-date.

For Midsize, rate growth was strong at the beginning of the year, but has faded a bit since then. Rates were up 2.8% in Q2 and are up 3.1% year-to-date.

For the first half of the year, all three segments are seeing rate growth that is higher than it was in the first six months of 2018. Am Law 100 is up 4.5%, compared with 4.3% last year. Am Law Second Hundred is up 4.0%, a dramatic increase over the 2.8% seen through the first six months of 2018. Midsize is up 3.1% year-to-date, compared with 2.8% a year ago.

Slightly tempering the good news of rates, however, is that collected realization against worked rates was 89.2%, down from 89.5% in Q2 2018.

Cash collections were up 3.7% – slightly below the 4.2% seen a year earlier.

EXPENSES²

While expense growth held steady in the second quarter, it bears watching as it continues to run near some of the highest levels seen over the last few years.

Direct expenses were up 4.8%, similar to Q1, which makes it one of the highest rates since 2012.

And overhead expenses rose 3.4% – one of the highest marks since 2016.

PRODUCTIVITY³

Productivity fell 1.2%, continuing the sudden reversal taking place this year.

After a lengthy string of falling productivity figures, the market finally managed a small gain in productivity last year through a combination of strong demand and disciplined restraint in headcount growth.

In less than six months, the market has now given back all of those hard-earned gains and more.

Productivity is now down 1.5% year-to-date and is down across all segments.

Am Law 100 dropped 0.9% and is down 1.4% year-to-date. Am Law Second Hundred pulled back 1.3% and is down 1.5% year-to-date. Midsize fell 1.4% and is down 1.6% year-to-date. The lone bright spot in the second quarter was Am Law 51-100, which managed to eke out a 0.1% gain, but is down 0.2% year-to-date.

With demand near last year's level, the culprit is a sharp increase in headcount taking place nearly across the board. Headcount for Am Law 100 grew 2.2% in the second quarter, Am Law Second Hundred rose 1.9%, and Midsize was up 0.9% – some of the highest levels in the last two years. The attorney replenishment ratio⁴ was 1.21, compared with 1.15 a year ago.

WHAT'S WORKING, WHAT'S NOT

Now that we're just past the halfway point of the year, there is a lot to consider.

For starters, the topline picture continues to be encouraging. Demand has recovered from a weak start to the year and is now at levels comparable to last year. And rates continue to climb, making the days of sub-three-percent rate growth recede further into the rear-view mirror.

But turning our focus forward, the road ahead becomes a little less clear. Realization may be taking another step lower after two-plus years of relative stability, taking some steam out of rate growth. Is it potentially a sign firms may be pushing the upper limits of rate increases?

Similarly, productivity is a different story than it was last year. Firms have quickly reverted into hiring mode, even though early signs are demand is not keeping pace. Was the headcount discipline just a short-term blip?

And expenses are creeping up this year. Not necessarily at an alarming rate yet, but one that suggests that keeping a close eye could be prudent. Will expenses continue moving higher?

None of these factors by themselves are reaching a level where alarm bells are being called for. But together, they may be gradually eroding profitability. And so, these questions may be increasingly front-of-mind as we make our way through the second half of the year.

For more information on the PMI, and how Peer Monitor can help your firm successfully manage through today's economy, please contact Brent Turner at **+1 651 848 8712** or brent.turner@thomsonreuters.com, or visit the Peer Monitor website [here](#).

SPECIAL FOCUS

A NEW "MIDDLE OF THE MARKET"?

At first glance, the law firm market this year is favoring the upper end of the market. The Am Law 100 segment is clearly outperforming and appears to be firing on all cylinders, leading in demand growth, rate growth, and productivity.

But while Am Law 100 is unquestionably leading the market, a closer look reveals some interesting dynamics taking place this year just outside the very top tier. A "sweet spot" is emerging in the market for certain activity.

For example, so far this year, litigation has been strongest for Am Law 51-100 and Second Hundred – both up over two percent year-to-date. Am Law 1-50 is up, but just barely at 0.3%, meanwhile Midsize is down almost three percent.

Meanwhile, Am Law 51-100 and Second Hundred are also making progress in closing the "rate growth gap" with Am Law 1-50. Am Law 1-50 rates surged a whopping 5.8% in the first half of 2018, more than two percentage points more than Am Law 51-100 and a full three percentage points more than Second Hundred.

So far this year, Am Law 1-50 is still leading the pack for rate growth. However, it's only running about one percentage point higher this year, and at the same time, Am Law 51-100 and Second Hundred are still managing to see demand growth that is on par with, or higher than, Am Law 1-50.

So while Am Law 1-50 continues to lead the market, the segment of the market from Am Law 51-200 is finding ways to grow both demand and rates, keeping their competitors at the top of the market within sight.

For further discussion on strategies, contact your Peer Monitor consultant.

² Includes both direct expenses (salaries, fringe benefits and professional fees associated with billable timekeepers) and overhead expenses (all other nondirect expenses, including staff compensation, marketing, technology, occupancy, office expenses and research)

³ Productivity is defined as hours per attorney and represents the ratio of capacity to market demand.

⁴ Attorney replenishment is the ratio of new attorneys to the firm divided by those departing. A result greater than 1 indicates growing capacity, while a result less than 1 signals a contraction.

