

Private Bank



2023 Client Advisory



Private Bank 

 **HILDEBRANDT**
CONSULTING LLC

This is the 15th year that Citi and Hildebrandt Consulting have issued our annual Client Advisory to the legal profession. As you navigate through this time of uncertainty and volatility, we hope that you will find our Client Advisory objective and useful.



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Part I:
The legal market
in 2022



Following the unusually strong performance seen in 2021, we entered 2022 expecting comparatively modest growth. 2022 became an increasingly challenging year for the law firm industry from one quarter to the next as a result of a macro environment marked by the Russia-Ukraine war, rolling lockdowns in China, an energy crisis, supply chain issues, rising interest rates, inflation and equity and bond market volatility.¹

INDUSTRY PERFORMANCE: 9MO'21-9MO'22

Revenue growth for the first nine months of 2022 was a modest 4.1% on average for the industry. While average lawyer rates increased by 5.8%, the modest revenue growth we saw was in large part due to the drop in demand and a longer collection cycle.

Measured against the aberrational performance seen throughout 2021, demand through the first nine months was down 1.2% as compared with the same period in 2021. We have seen demand performance in 2022 be particularly challenging for firms most dependent on M&A and capital markets work - the two most active practices in 2021. That said, while large-cap M&A deal activity has been weak, firms continue to report mid-market-cap deal work and strong private equity activity. We have also seen strong funds / investment management activity. Firms have reported a mix of experiences for their litigation practices, with some seeing growth while others are flat to down. Bankruptcy and financial restructuring has started to pick up, though not significantly at this stage. Regulatory practices have been active, as has intellectual property. Looking at the experience of different markets, we see the US outperforming others. London is weak in M&A and capital markets but funds / investment management activity remains strong, whereas Asia and Europe are generally challenged.

We have also seen the collection cycle lengthen by 3.7%. One factor driving the longer collection cycle is that law firm clients have taken longer to pay bills. This is particularly so where e-billing is involved. At the end of September 2022, we saw average inventory growth of 8%, driven in large part by 10.4% growth in accounts receivable. And with deals on hold waiting for market volatility to settle, firms are also carrying high levels of unbilled time in their inventory, up 5.8%.

For the proportion of unbilled time related to deal work, this may not be collected until market volatility settles and those deals close. The question for firms is whether that unbilled time will be recovered in 2022 or at all. Their concern is that the longer deals remain on hold, the more likely these deals will not close, causing firms to write off the unbilled time. If there is an increase in write-offs, we will likely see a decline in realization, reversing the improvement we saw in 2021 and returning to the longstanding trend of declining realization.

While total lawyer headcount has grown 4.5%, equity partner headcount increased 1.2%, resulting in leverage growth of 4.3%. With the drop in demand, this leverage growth means that firms are now carrying more lawyers at higher salaries who are comparatively less productive than we saw in 2021. To address this, we have heard anecdotally that firms have been giving tougher performance reviews in 2022. In some instances, firms have told us they are addressing performance issues that would have been addressed in 2020 but for the pandemic or in 2021 but for an atypically robust demand environment. Firms are also managing out some of the poor performers who joined their firms in 2021 in the rush to meet the surge in demand.

¹ Our analyses and projections are based on data collected from a sampling of primarily US-headquartered law firms by Citi Private Bank, as well as conversations with law firm leaders. Sources include the "Citi Annual Survey Database" of 210 US-and UK-headquartered firms, including 44 Am Law 1-50 firms, 38 Am Law 51-100 firms, 53 Am Law Second Hundred firms, and 75 additional firms; 175 firms from the "Citi Flash Survey," including 41 Am Law 1-50 firms, 37 Am Law 51-100 firms, 48 Am Law Second Hundred firms and 49 additional firms; the "Citi Law Firm Leaders Survey" of 54 large firms headquartered in the US, UK, China and India; and the "Law Firm Leaders Confidence Index" which reports the forward-looking opinions of law firm leaders from 147 firms.

Expense growth of 12.9% continued to outpace revenue growth, though we saw moderation in expense growth during the third quarter, easing some of the margin pressure seen through the first half of 2022. This is primarily due to the moderation in compensation expense growth as the war for associate talent has eased.

We also saw some moderation in operating expense growth during the third quarter. The main reason is that operating expenses ramped up in the second half of 2021, creating a higher base to compare further growth. While firms have spent comparatively more during 2022 on professional staff compensation, retreats, business development and travel, we expect this operating expense growth to further moderate through the fourth quarter.

Looking ahead to the full year results, a lot will rest on how strong fourth-quarter collections will be. Traditionally the most critical collections quarter of the year, we anticipate even greater focus on collections than usual during the final weeks of 2022 to convert as much inventory as possible into revenue.

As just one example of ways firms are seeking to improve collections by year end, we have heard anecdotally that firms are asking clients for progress payments in some transactional practices where traditionally firms are paid at the conclusion of a deal. We are also seeing some firms seek to monetize part of their inventory through the sale of receivables.

PERFORMANCE BY AM LAW SEGMENT

If we study these nine-month results by revenue size, we see that the smaller the firm, the better 2022 is likely to have been so far in terms of activity levels. In fact, most of the decline in demand has been concentrated among Am Law 1-50 firms, where demand has dropped by 1.9% on average. This segment has also seen the strongest growth in lawyer headcount - up 5.9%. As a result, the largest firms have seen the most notable drop in productivity across all segments while paying significantly higher salaries for their lawyers.

The combination of strong headcount growth and salary increases drove 15.6% growth in compensation expenses for this segment. However, even with a 7.5% productivity dip, average annualized lawyer productivity in absolute terms is 1,625 hours, similar to the average annualized lawyer productivity of 1,630 hours seen during the same period in 2019 - signaling a return to pre-pandemic levels.

Revenue growth of 3.8% for Am Law 1-50 firms trailed expense growth of 13.5%. With 8.4% growth in inventory, these firms could see an acceleration in revenue growth by year end if they are able to convert inventory into cash collections.

We have also seen a challenging demand environment for Am Law 51-100 firms, though the decline of 0.4% for the first nine months of 2022 is not as severe as we saw for the largest firms. Am Law 51-100 firms also saw comparatively stronger revenue growth than Am Law 1-50 firms (up 5.4%), but they too saw high expense growth of 12%, far outpacing revenue growth and causing margin pressure. With 8.1% inventory growth, Am Law 51-100 firms could also see an acceleration in revenue growth by year end if they are able to collect.

The Am Law Second Hundred firms and firms outside of the Am Law 200 have outperformed the largest firms in demand for the first nine months of 2022, with each segment seeing only a marginal decline. However, Am Law Second Hundred firms saw a modest 3.5% growth in revenue for the first nine months of 2022, trailing an 11.2% growth in expenses.

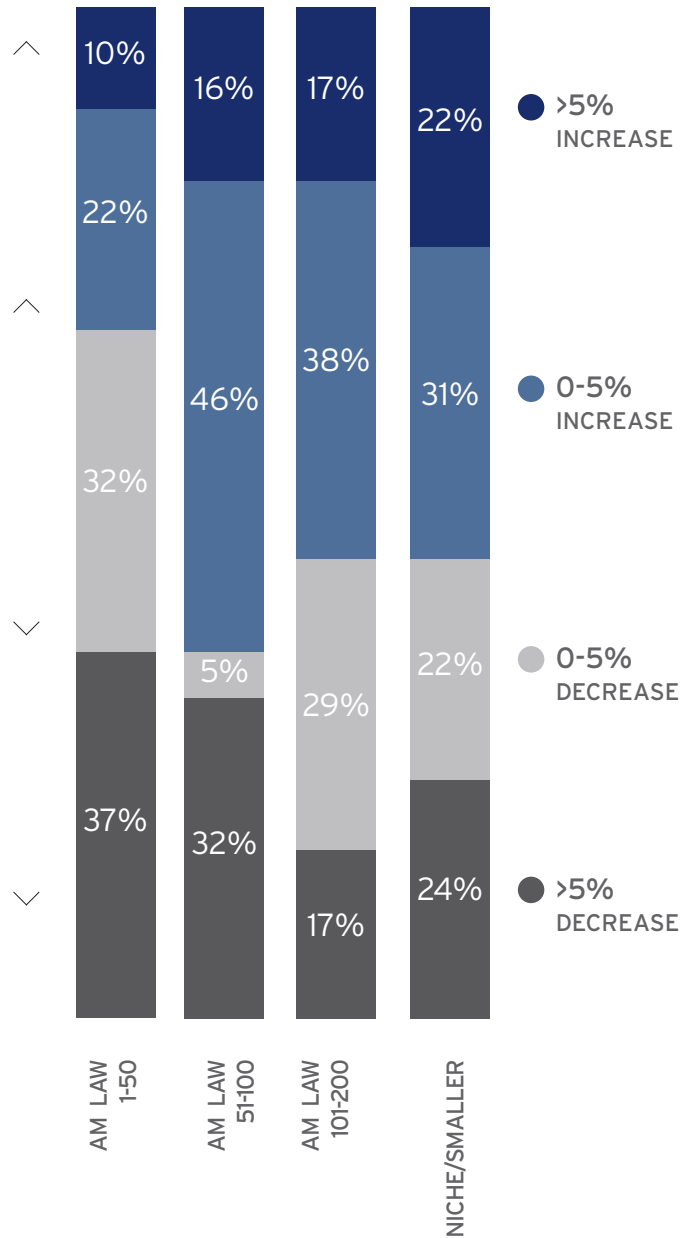
Firms outside of the Am Law 200 saw 4.5% revenue growth for the first nine months. Like the Am Law 200 segments, these firms have also experienced margin pressure, with expense growth of 12% far outpacing revenue growth.

The Am Law Second Hundred firms and firms outside of the Am Law 200 saw inventory growth of 5.9% and 4.3% respectively, placing them in a good position to accelerate revenue growth if they can collect this inventory.

DEMAND DISPERSION BY AM LAW SEGMENT: 9MO'21-9MO'22

Behind the averages, there was wide dispersion in the performance of individual law firms across all segments of the industry - FIGURE 1. The level of dispersion differs across the segments of the industry by size. In a reversal of the longstanding trend of the largest firms outperforming other segments, 69% of Am Law 1-50 firms saw a drop in demand through the first nine months of this year - in contrast to most firms in each other segment reporting demand growth. This is yet another illustration of how the drop in large-cap M&A and capital markets work disproportionately affected the largest firms in the industry in 2022.

**FIGURE 1.
DEMAND DISPERSION BY
AM LAW SEGMENT 9MO'21-9MO'22**

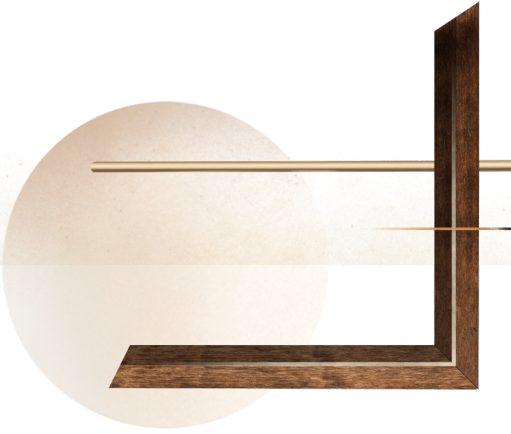


Source: Citi Flash Survey ©, Citibank, N.A., November, 2022

PERFORMANCE SINCE 2019: A BETTER MEASURE

Given the highly unusual nature of these past three years, especially 2021, we believe it is worth looking at average annual demand growth since 2019² - the last of the more “normal” years.

FIGURE 2.
INDUSTRY PERFORMANCE
9MO'19-9MO'22:
COMPOUND ANNUAL GROWTH RATE



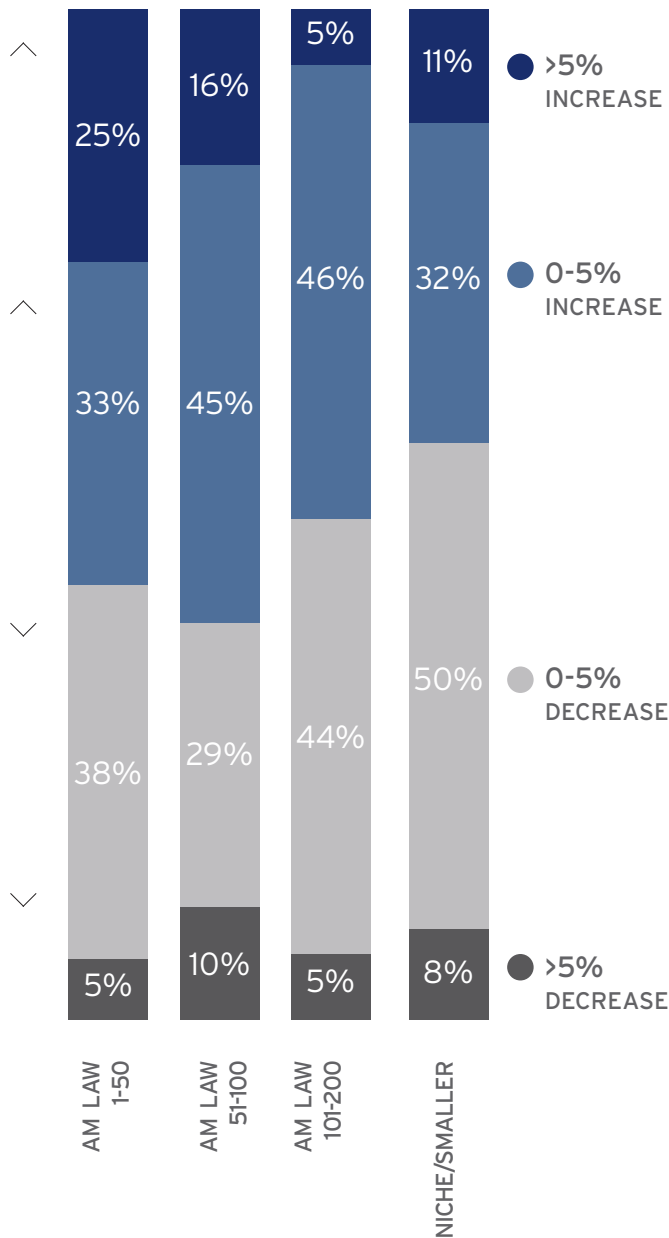
Metric	Industry
Total demand	1.8%
Revenue	7.8%
Contribution per lawyer	7.7%
Net income	9.9%
PPEP	9.9%
PPAP	6.5%

Source: Citi Flash Survey ©,
Citibank, N.A., November, 2022

The average annual industry demand growth rate during the period 9mo'19 to 9mo'22 was 1.8% - FIGURE 2 - demonstrating how well this industry has performed during these volatile pandemic years. We have also seen strong average annual revenue and profit growth over this three-year period. While there is dispersion behind the averages in demand performance over this three-year period - FIGURE 3 - we saw a majority of firms across the Am Law 200 segments reporting average annual growth in demand during this three-year period.

² This is based on the compound annual growth rate (CAGR) for the period 9mo'19-9mo'22

**FIGURE 3.
DEMAND DISPERSION BY AM
LAW SEGMENT 9MO'19-9MO'22
COMPOUND ANNUAL GROWTH RATE**



At the time of writing, all indications are that 2022 profitability will likely be lower than the aberrational results achieved in 2021 for many law firms. However, in a more reasonable analysis of performance since 2019, we would expect that the industry will report healthy average annual profitability growth over the three years since 2019.

Source: Citi Flash Survey ©, Citibank, N.A., November, 2022

Part II: Looking ahead to 2023 and beyond

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- A Growth opportunities and challenges
- B Key trends to watch in 2023



A. Growth opportunities and challenges

Looking ahead to 2023, with a recession now likely at the time of writing, law firms will face four main challenges. As we saw in the Citi Law Firm Leaders Survey conducted in mid-2022, firms are concerned about how to achieve growth in an unstable macro environment. While the aggressive war for talent we saw in 2021 has settled down, fierce competition for top talent at all levels is likely to continue as firms look for growth in a challenging market.

As firms grapple with a challenging macro environment and a competitive market for top talent, they continue to focus on how to develop an effective hybrid work model given the highly collaborative nature of legal practice.

And with inflationary pressures and the talent war driving expense pressure during 2021 and 2022, firms will need to address the rising cost of doing business. Indeed, rising costs in a slow-growth market will make it imperative for firms to implement operational efficiencies to protect their margins.

Amid these challenges, we expect that firms will continue to look for growth opportunities. In the Citi Law Firm Leaders Survey, firms described their strategy of pursuing selective growth in practices that complement what they are already best known for. This signals a focus on strategic rather than opportunistic growth. They will continue to grow their partnerships through both promotions and laterals in 2023 - and they plan to invest in lawyer talent at all levels over the next two years.

We expect 2023 to be challenging, but we note that clients need lawyers in good times and bad times. Performance in 2023 will likely depend on practice mix and footprint. The market will favor firms with a

tilt toward practices that traditionally perform well in a down cycle, such as litigation or bankruptcy and financial restructuring.

In an anticipated challenging growth environment, law firms will likely look for ways to collaborate more across practices and offices to expand their existing client relationships. This is especially an area of focus for large international law firms in response to global client demand for fewer law firms who can support their businesses across multiple jurisdictions.

Driven by a combination of client demands for more efficient legal services, growth challenges, an evolving work environment and inflationary pressures, we also expect that firms will continue to invest in ways to operate more efficiently. While most of these operational efficiency initiatives existed before the pandemic, we have seen an increased appetite for innovation and an acceleration in their adoption since 2020. We believe this trend of acceleration will continue in the coming year.

GROWTH OPPORTUNITIES AND CHALLENGES BY REGION

Based on the Citi Law Firm Leaders Survey - FIGURE 4 - the US is likely to be the major source of demand growth through 2024.

Within the US, New York is projected to be the biggest growth market, while Northern California will continue to be an increasingly larger market over the next two years, both for continued technology-related transactional activity and regulatory and litigation work. With the anticipated growth in regulatory work more broadly, Washington, DC is viewed as likely to be the third-strongest market. Firms are also expecting growth in Texas - across Dallas, Houston and increasingly Austin. And we see growing interest in Los Angeles, Chicago and Miami.

Outside of the US, firms continue to view London as a growth market. Europe will likely remain challenged, with the only exception being some optimism around Germany. Indeed, we note the recent withdrawal from Paris by some firms.

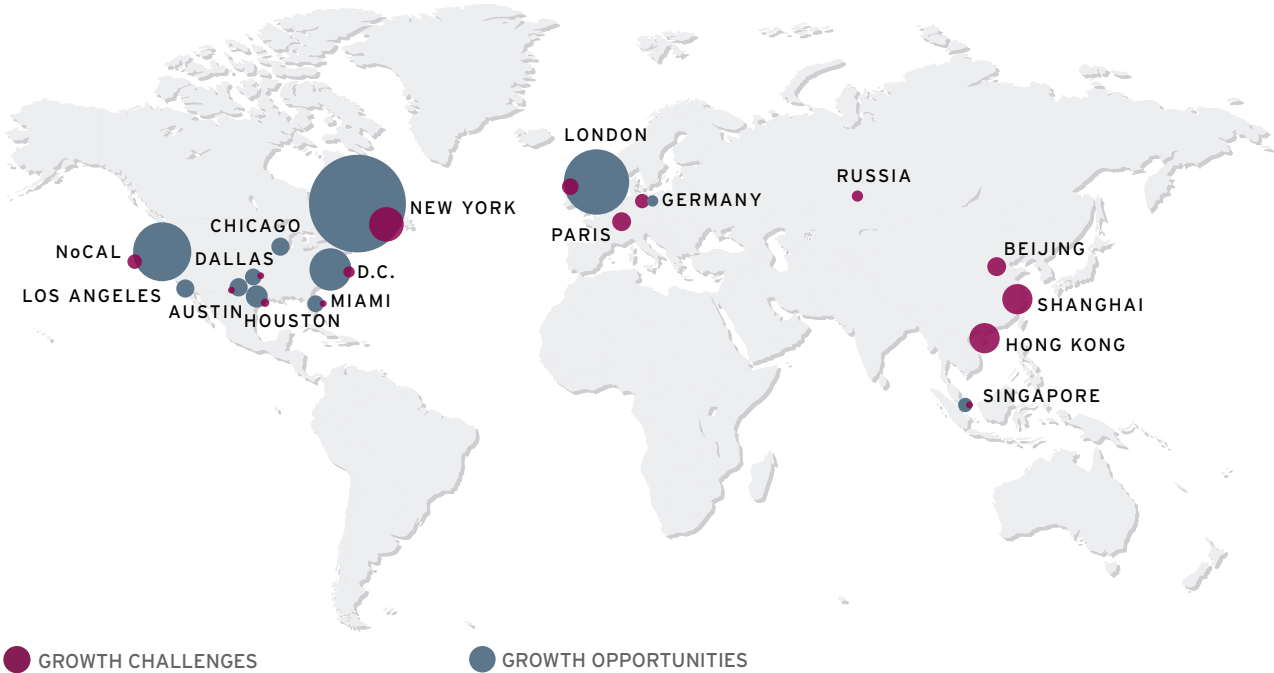
Looking to Asia, the only market where US and UK firms are betting on growth is Singapore. Indeed, in recent years, we have seen firms shift their investment there from the Hong Kong market. We have also heard firms describe how challenging it has been to operate their offices in Beijing and Shanghai throughout the pandemic, with some firms scaling back their presence in or exiting China.

While the US market has traditionally been the largest and most profitable legal market, firms have pursued international growth for many years. While we do not anticipate a widespread retreat from international markets, we would note that operating an international law firm has become more complex in recent years for several macroeconomic and geopolitical reasons. It is therefore unsurprising to see that US firms see most of the growth opportunities coming from their domestic market in the next two years.

Another challenge for international law firms is the impact of the strong US dollar and weakening of the euro, GBP and other currencies on firm revenue when foreign currencies are translated back into US dollars. This has been an issue in 2022 and will likely remain an issue into 2023, especially if currency weakness vis-à-vis the US dollar persists - viewed as highly likely at this time.

The Canadian and Australian law firms mirror some of the challenges and opportunities faced by US firms - although to a lesser degree. Indeed, Canadian firms have performed very well this year, as their transactional practices remained active. A key challenge for firms in both countries over the past two years has been the competition for their talent from US firms. Those firms recruited talent from Canadian and Australian firms to work remotely. However, that pressure should be subsiding.

FIGURE 4.
GROWTH OPPORTUNITIES AND CHALLENGES BY REGION THROUGH 2024



Source: Citi Law Firm Leaders Survey ©, Citibank, N.A., July 2022

GROWTH OPPORTUNITIES AND CHALLENGES BY PRACTICE

Looking at where growth will come from by practice area - FIGURE 5 - firms are more mixed on the outlook for their M&A/corporate/transactional and capital markets practices than we have seen in recent years. That said, they expect continued growth in private equity and funds / investment management work.

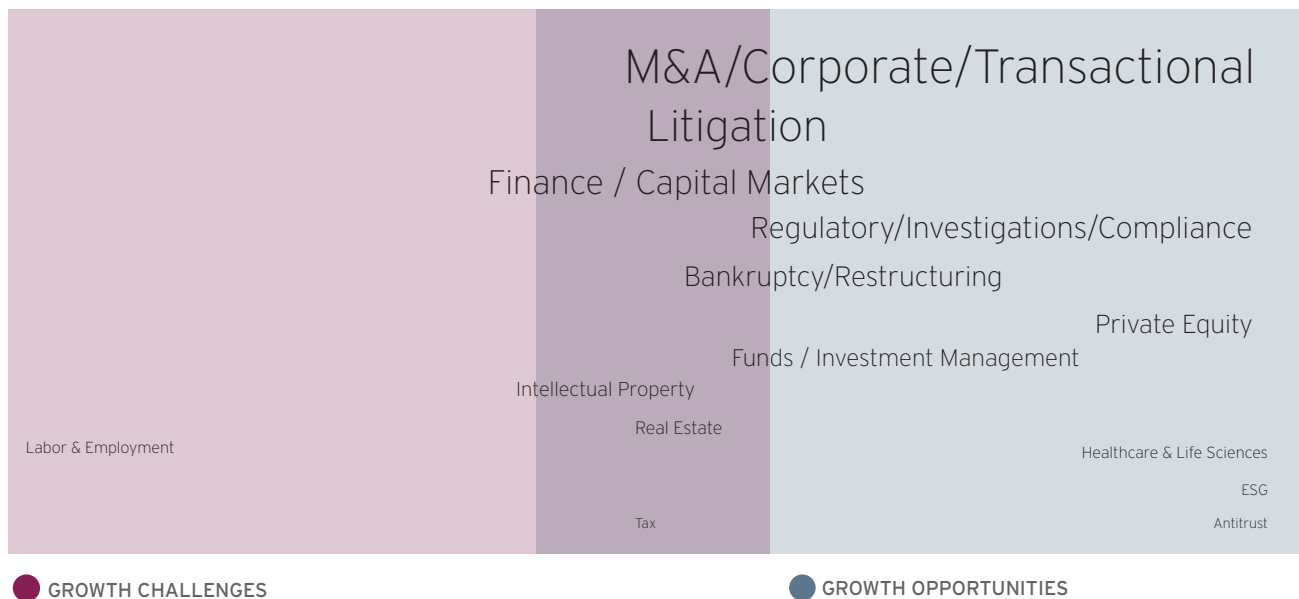
While there is a mix of views on the outlook for litigation, we see more positive sentiment than in previous years. Firms are also optimistic about growth in regulatory, investigations and compliance work and their bankruptcy and financial restructuring

practices. Though we have not yet seen the build-up in bankruptcy and financial restructuring work anticipated in the second half of 2022, we expect that this will come in 2023.

We can also expect to see growth in anti-trust and environmental, social and governance (ESG) advisory work.

Labor and employment is viewed as a challenged practice by large firms. Meanwhile, the outlook for real estate and intellectual property is mixed, with some firms reporting current and expected robust activity levels while others are less optimistic.

FIGURE 5.
GROWTH OPPORTUNITIES AND CHALLENGES BY PRACTICE THROUGH 2024



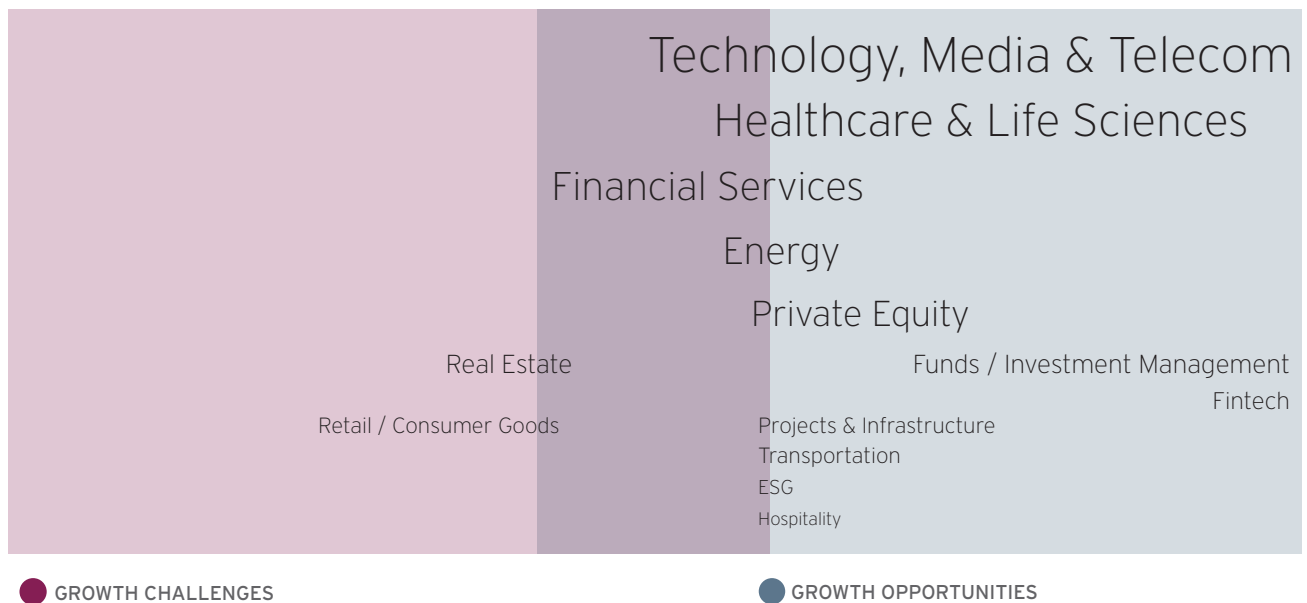
Source: Citi Law Firm Leaders Survey ©, Citibank, N.A., July 2022

GROWTH OPPORTUNITIES AND CHALLENGES BY INDUSTRY

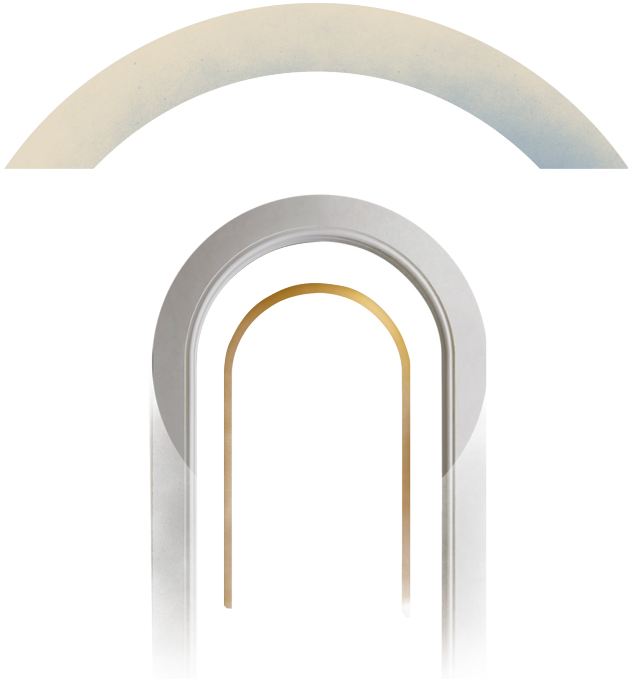
Looking at growth opportunities and challenges by industry - FIGURE 6 - the technology, media and telecommunications sector is expected to be the biggest growth driver, particularly the technology sector. Just as this sector has fueled growth in Northern California, we note that the technology centers developing in other locations in the US (e.g., New York, Southern California and Austin) and outside of the US will likely create law firm growth opportunities. Firms also expect to see growth coming from healthcare and life sciences, energy, private equity and funds / investment management clients. The outlook for financial services remains mixed, though firms are optimistic about fintech work. They also expect to see growth in projects and infrastructure, transportation, ESG and hospitality client work.

However, as we have seen in recent years, real estate and retail / consumer goods are likely to remain challenging for large firms over the next two years.

FIGURE 6.
GROWTH OPPORTUNITIES AND CHALLENGES BY INDUSTRY THROUGH 2024



Source: Citi Law Firm Leaders Survey ©, Citibank, N.A., July 2022



COMPETITION BEYOND LAW FIRMS

Outside of demand for law firm services, we expect to see the continued growth of alternative legal service providers (“ALSPs”) and Big Four legal businesses, with the latter more so outside of the US.

The Big Four have taken a range of approaches across different regions of the world and continue to face regulatory hurdles in the US. As this market segment develops, we note with interest the recent announcement of one of the Big Four to separate its audit and advisory businesses, replacing the partnership model of the advisory business (of which its legal advisory practice is a part) into a publicly traded corporate structure.

The ultimate objective is to offer an expanded and integrated range of services across legal, data analytics, process management and risk management to clients. Meanwhile, to attract lawyers from large firms, the pitch by some Big Four firms is that while the salaries they pay may be comparatively lower, the work experience they offer will be more rewarding than large law firms in other ways.

Aside from the current regulatory restrictions facing these firms in the US, we believe it will be challenging for these firms to compete with law firms for top talent if they offer a lower compensation scale.

We have seen strong growth in ALSPs in recent years, including those created by traditional law firms. As clients look for more efficient delivery of legal services in various forms - and given the continued strides being made in the development of new technology and especially artificial intelligence solutions - we expect this trajectory of strong growth to continue. In an effort to address this potential competition, we also expect to see more firms create their own ALSPs or partner with ALSPs to deliver a full range of efficient legal services to clients.

B. Key trends to watch in 2023

1. THE EVOLUTION OF THE HYBRID WORK MODEL TO A "MORE FLEXIBLE" WORK MODEL

We expect to see further development of the hybrid work model in 2023 and believe that the model will evolve to a point where it is viewed as simply a more flexible work model than we had pre-pandemic. Indeed, while the pandemic saw the emergence of the term "hybrid work model," elements of a more flexible model were already in place at some law firms prior to the pandemic, with fewer people working in the office on certain days. We expect that many versions of a more flexible work model will emerge through 2023 as firms settle on what works best for them.

Throughout most of 2022, we observed firms struggling to get people back into the office for the desired three days a week. There were numerous reasons for this: people became used to working effectively from home; the elimination of commute time translated into greater productivity and lower stress levels; fears for safety also led to a resistance to commuting, particularly in large cities, where crime rates rose; and with an ongoing pandemic, people remained concerned about their health.

Overlaying the resistance in returning to the office was the ongoing war for talent during at least the early stages of 2022. Many law firm leaders told us that they wanted people back in the office three days a week but felt that dictating stricter policies than their competitors might result in loss of talent.

As firms continue to grapple with what their work model will look like, there are three main challenges: first, how to effectively develop associates; second, how to maintain a collaborative and cohesive culture when on any given day some people are in the office while

others are working remotely; and the third challenge is around striking the right balance between giving people flexibility and meeting the needs of clients and the business.

In a profession that relies so heavily on the apprenticeship model, firms will need to find ways to adjust that model for an environment where there is reduced opportunity to identify developmental issues early on or give real-time feedback.

There is also a risk element around the quality of legal training received in a more flexible model that needs to be considered. Inadequate training of lawyers could potentially expose firms to malpractice insurance claims and higher premiums.

It will be challenging to build strong trusting relationships between partners and associates - particularly critical in the early years of practice. Firms will need to find ways to replicate the spontaneous sharing of ideas and collaboration that comes from the random encounters that occur in an office. And the fair and consistent distribution of work also potentially becomes more challenging.

We have often heard about the ease with which lawyers moved laterally in 2021 in a remote environment where they felt disconnected to their firms. It was also more challenging to integrate new hires. In adopting more flexible work models, top of mind for law firm leaders will be how to best transmit cultural norms and develop strong relationships that foster loyalty and connectedness. For some, this will mean a desire for their people to spend a set amount of time in the office; for others, it will mean asking people to be in the office on the same day.

To help reestablish a strong firm culture, we have seen law firm leaders travel extensively to their firms' offices. We have also seen firms hold retreats involving

all lawyers - not only partners - in 2022. Many have reported an uptick in office attendance following these retreats, underscoring how valuable these retreats have been to restoring a sense of community and shared purpose. We expect that firms will also continue to focus on keeping up the high level of communication across their business adopted in a fully remote environment.

For firms who want their lawyers in the office more frequently and consistently, if we enter a recession (and so long as the pandemic does not worsen), we predict that some of the struggle they experienced in 2022 will moderate. This will be as the challenging economic environment sees the broader talent war subsiding and enables leadership to be more forthright in directing people back to the office.

We have already seen signs of this, with firms increasingly becoming prescriptive in when and how often they expect their lawyers to be in the office. Whatever flexible work model law firms decide to adopt, it will be critical to balance the needs of their people with what is best for their clients and their business.

2. THE GROWTH AND RESHAPING OF LAWYER LEVERAGE

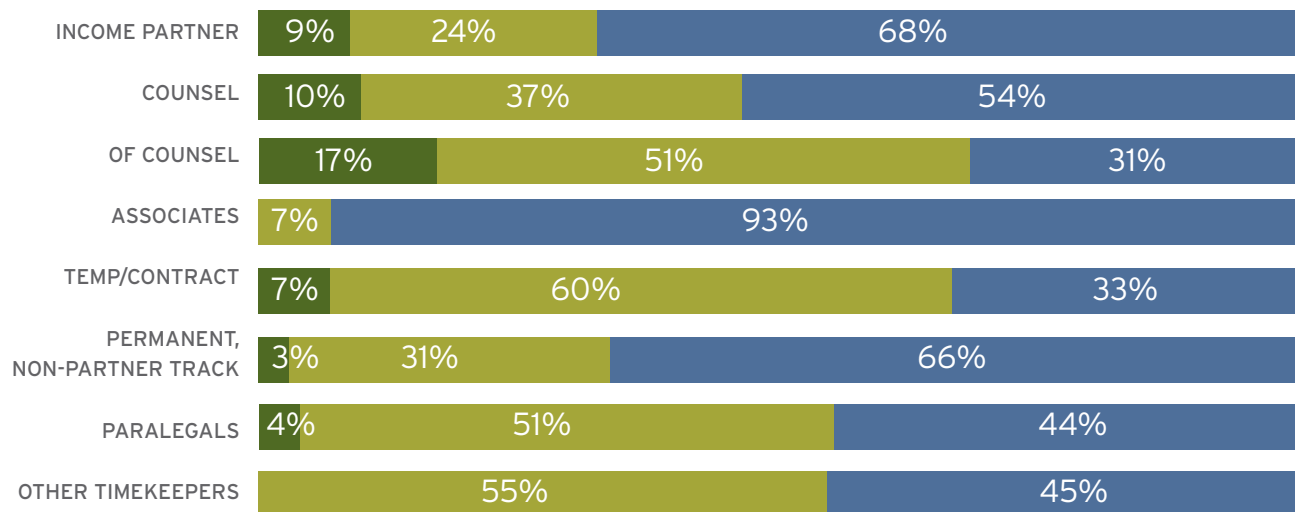
Though demand growth is likely to be challenging in 2023, large firms told us in mid-2022 that they expected to continue to increase leverage over the next two years. As the demand environment has worsened during the second half of 2022, we question the degree to which firms may have revised their leverage growth projections. That said, even if firms stay at their current leverage levels, we anticipate some reshaping of leverage to a greater emphasis on associates.

During 2016-21, we saw large firms increase their leverage by an average of 2.4% each year. During that period, large firms focused on growth among senior lawyers, with the vast majority of two-tier partnerships adding income partners. Indeed, a number of traditionally single-tier partnerships introduced the income partner category to their firms. Some of these income partners were laterals destined for full equity status if they performed well.

There was also a heavy emphasis on firms increasing their counsel ranks. Meanwhile, we saw comparatively more dispersion in how firms approached their associate headcount: 72% of large firms reported growth, while more than a quarter reported a decline.

Looking ahead, 77% of large firms projected in mid-2022 that they would increase their leverage over the next two years. As firms continue to grow their leverage, 68% of large firms with two-tier partnerships plan to add to their income partner ranks - FIGURE 7 - while almost a quarter will stay at their current levels. Looking at counsel growth projections, we can expect to see a wide range of approaches. Although 54% of large firms will continue to add to their counsel ranks, more than a third will keep them flat.

FIGURE 7.
PROJECTED LAWYER LEVERAGE GROWTH BY CATEGORY: 2024 VS. 2021



Source: Citi Law Firm Leaders Survey ©, Citibank, N.A., July 2022

● DECREASE ● REMAIN FLAT ● INCREASE

The greatest focus on growth is likely to be among associates. 93% of large firms project growth in their associate headcount through 2024.

We will watch with interest the extent to which firms add associates in the near term, given the increasingly challenging demand environment. Supporting these associate growth projections, we saw big jumps in summer associate classes in 2022, with 80% of large firms reporting comparatively larger classes than in 2021. We also saw increases in the average first-year class size for 2022 for 57% of large firms. And two-thirds of large firms project that their first-year classes will be larger in 2024 than they saw in 2022.

No doubt the increases seen in 2022 were an effort to address the high attrition rates seen in 2021, when average attrition across the total associate population was 25%. This was a jump from the 17% attrition seen

in 2020 and illustrates what we have heard from our law firm clients that some of the spike in 2021 was due to lawyers delaying their departures from 2020 to 2021. Indeed, average associate attrition during 2020 and 2021 was 21% - close to the 20% attrition seen in 2019.

Throughout 2022, we have seen attrition levels moderate for most large firms. Still, attrition was comparatively higher during the first half of 2022 than in the same period of 2021 for 30% of large firms.

Given the progressively more challenging demand environment we have seen in 2022 and are likely to see in 2023, we expect that some of the attrition pressures seen in 2021 and 2022 are likely to ease as the talent war subsides. Even in a challenging demand environment, we also believe that firms will likely continue to face competition for their top talent.

Replacing the widespread talent war seen in 2021 and in the early part of 2022, we expect that law firms will be dealing with excess capacity in the year ahead. This is not unusual in an industry where hiring decisions are made on a two-year time frame, making it hard to accurately project demand levels.

As we noted earlier, some firms have addressed current excess capacity through tougher performance reviews in 2022. As other industry commentators talk of impending layoffs, we would note that when the market rebounded from the last recession we saw firms caught short without enough associates to manage demand, causing more salary expense pressure.

3. EQUITY PARTNER GROWTH AT MORE FIRMS

In the Citi Law Firm Leaders Survey, 83% of large firms project growth in their equity partner ranks through 2024. This is a distinct shift from what we have seen over the past five years, when we saw almost even dispersion behind the firms who grew their equity partner headcount (48%) and the firms who contracted their partnerships (46%).

Among large firms, we expect growth to come mostly through promotions, followed by laterals. Indeed, we continue to see an improving rate of success for laterals. The Citi Law Firm Leaders Survey showed a success rate of 64% for the laterals who joined over the past five years - the highest rate we have ever seen and closer to the 70% success rate of promoted partners.

Firms attribute this improving success rate to better due diligence in making hiring decisions and greater focus on integrating laterals. In making those hiring decisions, we have seen the nature of lateral activity shift to include more teams and sometimes offices or entire practice groups with resulting greater success in bringing over clients and matters. We also continue to see firms use compensation, including discretionary bonuses, to attract and retain top talent.

In addition to organic and lateral partner growth, we see growing interest among larger firms in the acquisition of mid-size and smaller firms. On the other hand, we are less likely to see mergers of large firms. While these mergers are not impossible, they are typically complex and often stymied by client conflict issues.

Most merger activity is likely to be between smaller local and regional firms. During the pandemic, as many firms across the industry experienced strong performance, there was less need to merge. However, looking ahead, we expect that the twin challenges of a slow-growth environment and a higher cost structure caused by salary increases and inflation may drive consolidation among this segment of the industry. Indeed, the need to be on a larger platform to better serve clients - and to be better capitalized to afford investment in technology and other innovation - will also likely make the concept of merging an attractive proposition for these firms.

4. GREATER FOCUS ON BOTH REVENUE AND EXPENSE-RELATED OPERATIONAL EFFICIENCIES

We expect to see an even greater focus on operational efficiencies - a clear trend of the past several years that was accelerated by the pandemic. In a slow-growth, higher cost environment, it will be imperative for firms to pursue a range of both expense- and revenue-related operational efficiency initiatives. These initiatives will enable firms to deliver more efficient legal services, support a more flexible work model, reduce costs and improve revenue and margin growth.

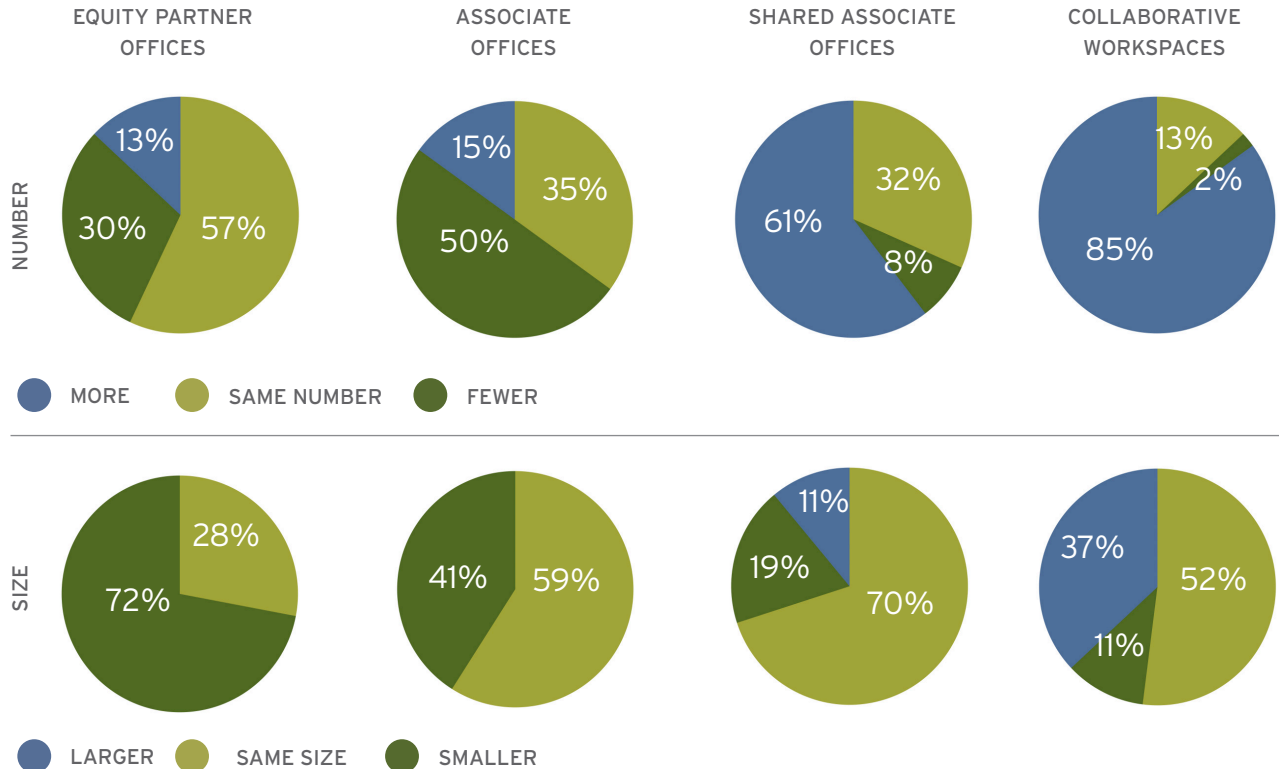
I. Rethinking space

64% of large firms project that they will reduce their space as leases come up for renewal, according to the Citi Law Firm Leaders Survey. Still, almost a quarter plan to stay at their current size. For firms with leases coming up for renewal in the near term, the biggest challenge will be how to make decisions on space while their new work models are still evolving. Firms tell us that it is hard to convince lawyers to move to a different space model, which will potentially involve smaller offices or giving up their offices altogether. Law firm leaders are concerned about hurting firm culture as well as how best to address concerns around health and confidentiality. Construction and renovation costs

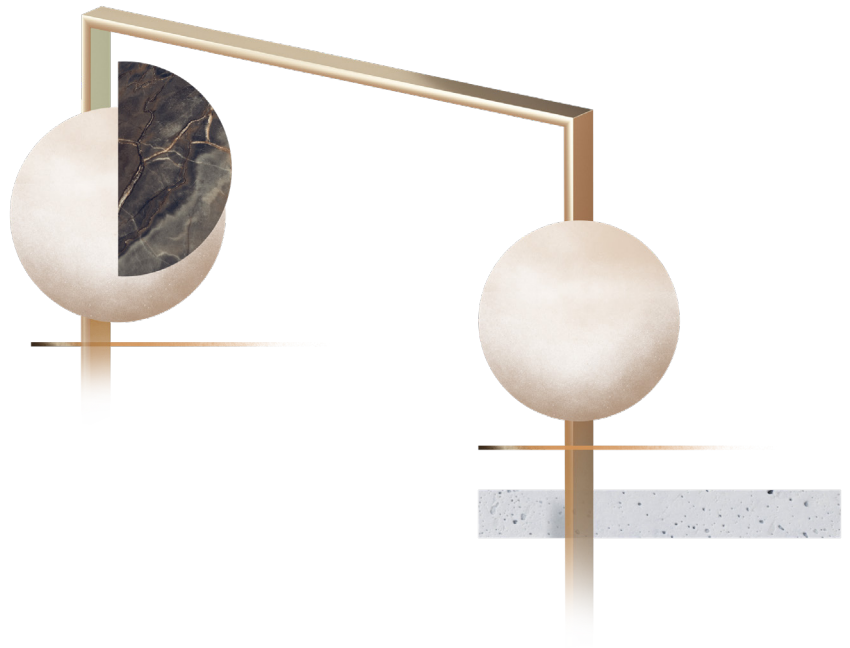
have escalated. And then there are the implementation details, including where to store client files and personal items and how to book hoteling space.

Amid these challenges, the biggest opportunity for firms is to reduce their occupancy cost - the second-biggest expense line item after salaries. For firms with the luxury of longer time horizons in making decisions on space, they will have the opportunity to better understand changing work patterns before solidifying plans. They also have time to make people more comfortable with reconfiguring space. As firms reconfigure their offices, the goal is to design a space that people want to come to, supporting focus work, collaboration and well-being.

FIGURE 8.
ASSOCIATE AND EQUITY PARTNER OFFICES: WHAT WILL HAPPEN?



Source: Citi Law Firm Leaders Survey ©, Citibank, N.A., July 2022



Equity partners are likely to keep their offices, though they will be smaller - FIGURE 8. This is a continuation of a longer trend in standardizing the size of equity partner offices. In the Citi Law Firm Leaders Survey, we saw that roughly a quarter of large firms plan to have both fewer and smaller equity partner offices.

In contrast, the number of associate offices is projected to decline for half of large firms, though offices are likely to remain at their current size. Still, 28% of large firms will reduce both the number and size of associate offices.

We also expect to see more shared associate offices. This is likely to mean associates sharing an office on any given day rather than sharing an office on alternating days. (88% of firms do not plan to share offices on alternating days.)

With the objective of making in-office days more effective, most large firms plan to add more collaborative workspaces. We are also likely to see more hoteling, though the concept of hoteling means different things to different firms and can sometimes cause a negative reaction. So far, only 30% of large firms have implemented some form of hoteling, and almost all those firms plan to increase their use of hoteling over the next two years. Of the 70% who have

not yet introduced this, 45% plan to implement it over the next two years. If that happens, we should see hoteling in some form or another used by most large firms by 2024.

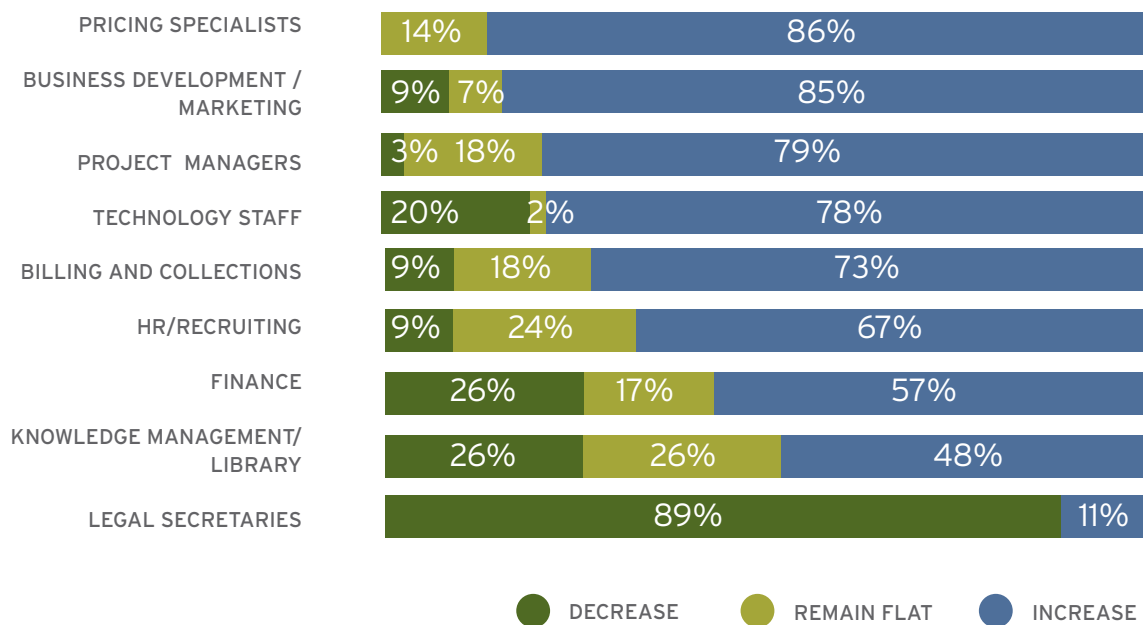
II. Redesigning the professional staff leverage model

Law firms face three main challenges relating to their professional staff leverage model. Unlike the war for top legal talent, firms are competing for top professional staff talent with other industries that might offer more flexibility and higher salaries. Meanwhile, in meeting expectations of greater flexibility, firms also need to balance this with ensuring that lawyers are adequately supported. And in the drive to reduce professional staff leverage, firms are tasked with how to do more with less.

Amid these challenges, there are many opportunities available to law firms in redesigning the professional staff leverage model. Removing the need for professional staff to be in the same physical location as the lawyers they support widens the talent pool and creates the opportunity to hire staff in lower cost locations. Creating a pool of support staff enables a more efficient allocation of work. Eliminating the need to be in the same office, or even in the office at all for certain roles, enables more flexible work arrangements, increasing employee satisfaction and retention.

We also expect to see the upskilling of the professional staff leverage model. During 2016-21, most large firms added pricing specialists, business development and marketing experts, project managers, technology professionals, and billing and collections staff - FIGURE 9. Most firms grew their HR/recruitment and finance teams too. We also saw growth in innovation and risk/conflict management roles. As firms were making these investments, 89% reduced their legal secretarial headcount.

FIGURE 9.
PROFESSIONAL STAFF LEVERAGE GROWTH BY CATEGORY:
2021 V 2016

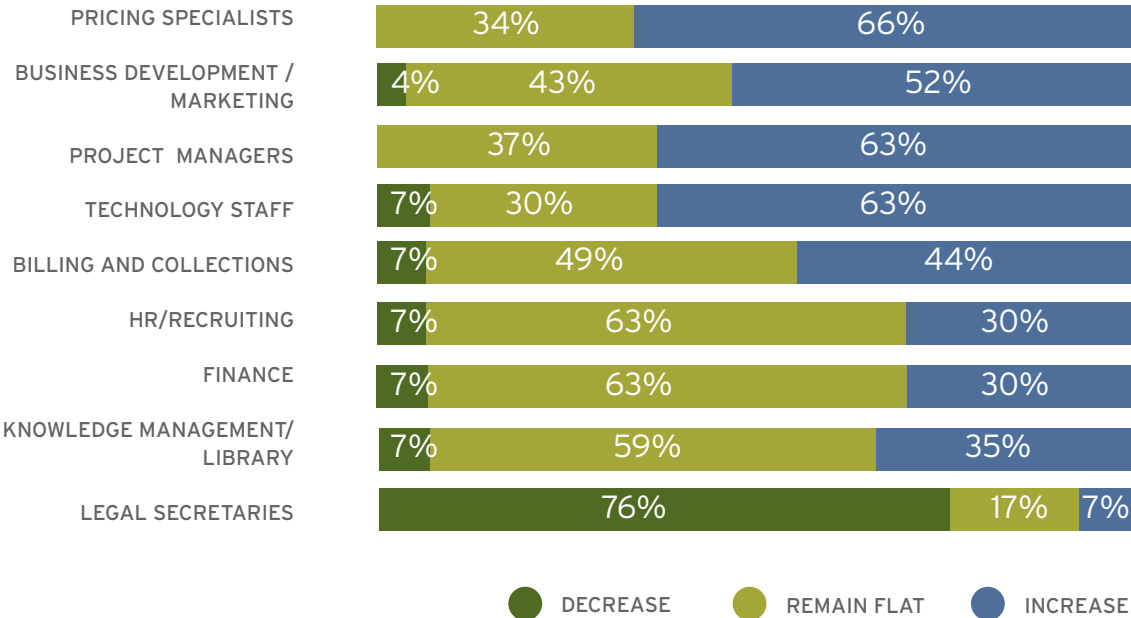


Source: Citi Law Firm Leaders Survey ©, Citibank, N.A., July 2022

Over the course of the past few years, we have witnessed a seismic shift in the composition of the professional staff leverage model of firms, accelerated by the onset of the pandemic. This is a clear trend that is projected to continue in 2023 and beyond - FIGURE 10.

Firms will continue to invest in pricing specialists, project managers, business development and technology staff. Meanwhile, the majority will continue to reduce their secretarial staffing ratios.

FIGURE 10.
PROJECTED PROFESSIONAL STAFF LEVERAGE GROWTH BY CATEGORY:
2024 V 2021



Source: Citi Law Firm Leaders Survey ©, Citibank, N.A., July 2022

As for projected net growth in total professional staff leverage, we can expect a mix of approaches. While 39% of large firms expect to see lower leverage, 33% will increase their professional staff leverage and the rest expect to remain at the same level. Even for firms projecting a decrease, we expect that the cost of professional staff leverage will rise as the composition of leverage shifts.

III. More outsourcing

Over the years, we have seen many firms open their own low-cost centers for back office functions and some legal work. We have also seen a longstanding trend of firms outsourcing office facilities. We can expect to see more outsourcing over the next two years beyond the traditional outsourcing of office facilities. Already, a small majority of large firms outsource at least some of their technology services, and this is projected to increase over the next two years. While less than a quarter of large firms currently outsource their HR, benefits, payroll, finance and procurement functions, roughly one third plan to outsource at least part of these functions over the next two years.

IV. Increased use of project management

We expect to see continued growth in the use of project management over the next two years, reflected in the 63% of large firms planning to increase their project management teams through 2024.

V. Thinking twice about business travel

With the return of business travel in 2022, law firm leaders placed a heavy emphasis on traveling between offices to strengthen firm culture as described earlier. We saw firms hold partner and all lawyer conferences and other internal events to entice people back into the office with great success. We have, nonetheless, seen firms become more selective about when to travel to clients and when to conduct meetings via videoconferencing. We anticipate that this careful approach to business travel is likely to continue in 2023.

VI. More investment in technology

As we have noted in prior reports, the technology investments made by law firms in the years leading up to the pandemic essentially enabled this industry to make a seamless transition to a fully remote environment in the space of a weekend in March 2020. Working in a fully or partially remote environment for most of the past three years, the priorities of law firms centered on information security and cybersecurity, collaboration tools (e.g., Zoom), laptops and the virtual desktop infrastructure, cloud-based technology and data centers.

Firms also invested in business-as-usual upgrades to their document management, knowledge management and financial management systems as well as Microsoft 365.

The success of the past few years has created an appetite for greater technology investment over the next two years. In 2023 and 2024, firms will continue to focus on upgrading their financial management, document management, knowledge management and client relationship management systems and implementing Microsoft 365.

We can expect to see cloud-based technology being the top priority, along with continued investment in information security / cybersecurity and data centers.

We also expect to see a greater focus on data analytics tools. These tools will enable firms to analyze the profitability and the growth potential of practices and clients more closely, based on the wealth of data residing in their existing systems. This analysis will enable firms to deliver more efficient legal services, improve profitability and inform decision making on where and how to grow.

VII. Improving realization

Realization improved in 2021, but it appears to have dipped in 2022, back to the longer trend of decline. To improve realization, firms will likely look at how to manage alternative fee arrangements (AFAs) and pre-negotiated discounting more effectively. They will also likely continue to improve the billing and collections process.

AFAs

While we do not anticipate the end of the billable hour, we note that in the Citi Law Firm Leaders Survey, large firms expected that AFAs would account for 20.5% of total 2022 revenue on average, up from 16% in 2016. The most common AFA is a fixed fee arrangement. Behind the averages, 45% of large firms estimated that AFAs would account for over 20% of revenue in 2022. A year ago, this proportion was 35% of large firms, suggesting the growing use of AFAs across large firms.

Looking ahead, 71% of large firms expect the proportion of revenue derived through AFAs to increase through 2024. That said, we have seen that firms typically project higher anticipated AFAs than are ultimately seen.

Pre-negotiated discounts

The more prevalent trend is the presence of pre-negotiated discounts. We often hear from firms that their clients start by requesting an AFA and ultimately ask for a pre-negotiated discount.

Firms project 44% of revenue to come from pre-negotiated discounted work in 2022, consistent with 2016 and 2021. Even so, 39% of large firms expect more than half of their revenue to come from pre-negotiated discounted work in 2022.

Half of the large firms surveyed expect the proportion of pre-negotiated discounted work to remain stable in the future, while 39% expect it to increase.

Looking at a common sample of large firms, roughly 64% of 2022 revenue is likely to come from either an AFA or a pre-negotiated discount.

With close to two thirds of revenue coming from either, we expect that firms will continue to focus on the efficient delivery of legal services and improving their realization.

Continued focus on improving the billing and collections process

A positive trend coming out of the pandemic was the renewed focus on billing and collections - from encouraging lawyers to record their time promptly, to sending bills out more frequently and in smaller amounts, to identifying where there may be issues in receiving client payment. For example, some firms are seeking progress payments in 2022 rather than waiting for deal completion, as described earlier in this report.

We have also seen 73% of large firms increasing their billing and collections staff over the past five years. Firms tell us that some of the headcount increases have been necessary to deal with the growing complexity of e-billing.

We expect this trend of improving billing and collections to continue in 2023. While 49% of large firms expect to keep their billing and collections staff levels in 2024 flat to 2021, 44% plan to increase their headcount.

VIII. Greater focus on cross-selling opportunities

In a slow-growth environment, a major operational efficiency opportunity is for firms to focus on doing more with existing clients. As described earlier, firms will continue to invest in their business development professionals. With this investment, and given the growth challenges ahead, we expect to see firms focus heavily on identifying and furthering the cross-selling opportunities residing in their firms.

IX. Financing growth

With the likelihood of a recession and the higher cost of operating a law firm, firm liquidity and access to capital will no doubt stay top of mind. At the onset of the pandemic in early 2020, we saw many firms

reevaluate their credit commitments from their lenders. In some instances, firms drew down fully on their lines and held cash. These drawdowns were repaid prior to year end as it became clear that 2020 would finish very differently than anticipated.

A more typical response to the onset of the pandemic was for firms to increase their committed credit facilities - often to cover three months of operating expenses. In most cases, these increases became permanent and have provided some cushion in 2022 as the collection cycle has slowed.

In light of the resizing of credit facilities in 2020 and 2021, we expect credit restructuring activity to be more modest in 2023. We expect that the emphasis will be more on how to finance investments in technology and office fit-outs to improve operating efficiency.



Conclusion

We expect that many firms will see a decline in profitability in 2022, compared to the extraordinary results of 2021. However, looking at average annual profitability growth since 2019, we believe that the law firm industry has performed very well.

Given the high likelihood of a recession in 2023, there are challenges ahead, but clients need lawyers in good times and bad. While it is hard to predict what will happen in 2023, we expect that firms with a tilt toward down cycle practices will fare better than those who are heavily dependent on M&A and capital markets practices.

In a challenging demand environment, firms will likely be dealing with excess capacity. While the level of excess capacity may be painful in the near term, experience has shown that this will correct itself when the market inevitably rebounds. And while the talent war seen in 2021 and in the early part of 2022 has settled, we expect to see lateral movement of top talent as firms look for growth opportunities from other firms.

We also expect that while the hybrid work model occupied much of the conversation through 2022, we will see the emergence of many different versions of a flexible work model as firms grapple with what is best for their people, their clients and their businesses.

Given the inflationary pressures seen in 2022, law firms now operate under a higher cost structure, making it imperative that they continue to focus on both expense- and revenue-related operational efficiencies.

Despite all these challenges facing law firms in the year ahead, we believe that, as we have seen in earlier challenging periods, the law firm industry will once again prove how resilient it is.



Credits

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