A perspective on the legal market
Year in review 2015/16
and what lies ahead

November 2016
Foreword

While UK Law plc continues to be a highly profitable and significant contributor to the overall economy, management teams are braced for tough times ahead. Key revenue-generating practices such as real estate, equity capital markets, mergers and acquisitions, and financial services are expected to slow down significantly.

The fact that this was happening irrespective of Brexit makes the UK’s decision in June to leave the EU even more concerning for the country’s leading business law firms. If there is one thing that lawyers dislike above everything else, it is uncertainty. But uncertainty is, for now at least, the new normal and the more progressive management teams are looking at the opportunities that this throws up rather than retreating into defensive mode while they wait for the clouds to pass.

Litigation and debt finance remain relatively buoyant while the fast-changing regulatory landscape is generating premium advisory mandates for the top players. Brexit will, of itself, create a new sector for firms to focus on, as clients, governments and regulators seek guidance on how best to navigate the complex legal challenges ahead. Increased willingness to invest in technology and agile working practices is helping firms reduce staffing and real estate costs, enabling fee earners to concentrate on more high-end matters.

Client demand for innovation in service delivery and value continues to realign firms’ business models amid changing expectations about pricing and leverage. The most successful firms remain those with a clear point of differentiation while being focused on parts of the market where they can win the most profitable, high-quality instructions. Indeed, profitable growth remains achievable for those firms proactively managing their key costs and client relationships.

Images: Gallery Stock, Getty Images

About this report

As the Head of Legal Sector at NatWest, I am delighted to share with you this report, offering my unique insights on the profession. Based on extensive research and analysis, it combines with the vast depth of knowledge and experience we have built in banking for the legal sector over many years through a dedicated team of professionals focused exclusively on the legal profession.

The UK legal sector continues to be hugely important within NatWest. We have a strong market share in the sector, and a long and proud history as bankers to the leading law firms in the UK. We continue to grow our business domestically and outside the UK through our proven commitment, actively supporting the growth and development of the UK market and the rapid globalisation of the legal sector.

I thank you for the banking business that we deliver for your firm through our dedicated and focused legal sector model. As a measure of our commitment to our legal clients, it gives me great pleasure to offer you the analysis and findings of this report.

Our focus on our clients and leadership in the sector is unwavering, and I commit to continuing to provide the legal profession with leading banking products and services, cutting-edge research and commentary on the profession. I hope you enjoy this report.

JAMES TSOLAKIS
Head of Legal Sector
Executive summary

The extent to which Brexit represents either a unique opportunity for UK business to harness entrepreneurialism or an unparalleled shock that puts the economic upturn of the past five years into reverse is the principal question for law firm management teams as ‘uncertain’ becomes the default economic outlook.

With key domestic and international markets slowing over the past year, the UK’s decision to leave the EU has come at a testing time for our top business law firms. The legal sector remains a profitable, well-hedged and robust contributor to the overall economy, but the uncertainty that the vote has caused presents law firm management teams with a conundrum.

Talk of the City of London being in the midst of an existential crisis has affected business volumes and money markets as fears take hold that the UK may lose its ‘passporting’ right to operate unrestricted throughout the EU. Many in the market predict that tens of thousands of jobs could leave the City if the UK lost access to the single market and left the EU on unfavourable terms, as employers decide to shift their headquarters to European rivals such as Paris, Frankfurt and Dublin.

On a more upbeat note for lawyers, it emerged in September that the government’s Department for Exiting the EU was already spending £33,500 a week on Brexit-related legal advice, not counting external legal advisers being brought in. A whole new Brexit industry is being created as the sheer complexity of the regulatory and legislative changes needed to support the UK’s exit from the EU becomes clearer.

Yet any kind of predictable Brexit outcome is unlikely to materialise soon. This will have relatively severe ramifications for key legal specialisms, particularly real estate, transactional and capital markets work, in the short term at least. Achieving more profit with less turnover will become a key challenge for law firms in future.

That technological innovation has enabled the delivery of cheaper, more commoditised legal services in recent years is beyond doubt. While law firms may have been slow to adopt automation, the trend towards the offshoring (and near-shoring) of routine legal services has been happening in the legal sector for over a decade. While this has led to a radical reduction in legal secretarial and other back-office support roles, new high-skilled positions have been created to lead and develop the new technologies that have taken their place. This level of investment in highly paid, non-legal positions within law firms is expected to become a major shift in capital allocation as firms navigate the next tech reality. The resulting innovation has led to swift growth in automation capabilities and contract analysis, including the spread of artificial intelligence (AI) tools into everyday law firm practice.

Indeed, with routine, commoditised work increasingly being outsourced and a lack of high-value transactional work to fill the void, law firms are experiencing sustained pressure on their margins. Despite global markets, fuelled by a mix of cheap debt and quantitative easing, roaring back into life around 2012, clients continue to aggressively seek greater value from their law firms. This has put significant pressure on profits.

With clients using fewer law firms globally, the solution for many firms has been to merge. In addition to securing increased geographic scale, access to new clients and more higher-value mandates, this route allows firms to spread their back-office costs and infrastructure across a greater number of lawyers.

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A perspective on the legal market

Mid-tier mergers

The UK’s mid-tier has also consolidated over the past five years. Following above-trend profit and revenue increases, many commentators predicted a brighter future for the UK mid-tier. This was despite intense pressure, in the aftermath of the financial crisis, from the top City firms above them and the more nimble boutiques below making inroads into their SME client bases. The high number of mid-tier mergers clearly helped improve many firms’ balance sheets, while the vastly improved financial management and pricing strategies that resulted for some have helped make the case for increased scale. Yet this was all achieved amid booming UK litigation, real estate and transactional markets.

Indeed, with markets a lot quieter this year, the mid-tier’s financial performance has been less impressive, with the best performers often those with clearly communicated strengths in a small number of practice areas, regions and industries. The future of the bloated full-service mid-tier firm does not look attractive according to recent surveys of law firm financials.

Yet as firms of all sizes focus intensely on partner and associate performance as a means of maintaining fragile profit growth, the war for talent has become a strategic battleground on both sides of the Atlantic. This has played out most tellingly at the higher end of the market, with many UK firms being forced to modify their lockstep model to compete with aggressive US rivals. Only a handful of top UK firms now operate a lockstep-only model, with many introducing above-lockstep pay for star performers.

Nonetheless, the sharp increases in associate pay on both sides of the Atlantic has come at a time when global markets are cooling significantly. Law firms are reluctant to lay off highly trained associates amid slowing transactional activity as this has historically created an even greater talent headache when markets recover. This will likely serve as a pull on law firm profits while markets remain slow.

Indeed, as a law firm’s biggest fixed cost, people management is driving a reshaping of the traditional law firm’s organisational structure. The growing use of contract lawyers and paralegals to work on specific matters is helping by alleviating the significant issue of poor lawyer utilisation during quieter periods. The cost base is gradually shifting to variable from fixed, a trend enhanced significantly by the greater use of technology and lower-cost centres to handle routine work.

Key threats

While the traditional partnership structure still dominates the legal sector, the threat posed by competitor forces is also slowly eroding profitability. Through a combination of regulatory change and ongoing transformation of buying behaviour, new and powerful entrants are capturing increased market share. Two US firms, Cahill Gordon & Reindell and Foran Glennon, have set up as alternative business structures in London while the UK’s first firm to list on the stockmarket, Gateley plc, has posted impressive first-year results. The key threat to business law firms, however, remains the Big Four accountancy firms, which are aggressively rebuilding the legal practices that were decimated by a series of accounting scandals almost 20 years ago.

The four – all of whom have alternative business structure (ABS) licences – have organised themselves on a matrix basis that crosses borders and product lines with legal services sitting among the tax, audit and industry groupings, and their multinational clients are already using them. This strategy has seen global income increase rapidly. A recent Harvard study found that if only one of the Big Four captured just 1% of the global legal market, that network would become the single largest global legal services provider. This is a worrying scenario for business law firms everywhere.

However, as we reiterate, a point of differentiation in the market, a meaningful value proposition and clearly communicated practice area and industry strengths remain key to client loyalty for law firms. The legal sector has a proven track record for coming through even the toughest economic times with strong margins intact. Yet with Brexit likely to exacerbate the already slowing business outlook, law firms will have little room for manoeuvre this time around.

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A visual summary

The headline figures showing law firms’ attitudes to recruitment, new technologies and the Brexit effect, plus two notable earnings success stories of the past year.

People

72% of law firm managers expect hiring to remain at 2014/15 levels
Source: A Perspective on the Legal Market, NatWest (2015)

68% are of the opinion that associate recruitment levels will also remain static
Source: A Perspective on the Legal Market, NatWest (2015)

72% of partners at the UK’s top 10 firms are aged 50 or under, which compares with 60% for the profession as a whole
Source: Edward Drummond (2016)

82% of law partners expect to see redundancies in the next two years
Source: Legal Week (2016)

Technology

21%

Clients developing technological solutions to previously chargeable legal advice is felt to be a threat by 21% of law firms
Source: 2016 Law Firms in Transition, Altman Weil

53%

see it as a possible threat
Source: 2016 Law Firms in Transition, Altman Weil

Brexit effects

£33,500

What the government’s Department for Exiting the European Union is spending per week on Brexit-related legal advice
Source: Department for Exiting the European Union (2016)

£5bn

The advisory bill to deal with Brexit could hit £5bn over a decade
Source: The Times (2016)

A study by Oxford Economics predicts the longer-term loss of legal revenues as a result of Brexit will be 4% per year by 2030 (£1.7bn)

£11m

The pre-tax profit of Gateley, which posted record revenues after last year’s IPO
Source: Gateley annual financial results 2015/16

Earnings

25%

PwC Legal earned £59.9m in 2015/16 – a rise of 25% on the previous financial year
Source: PwC annual financial results 2015/16

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The economic forecast

Despite investors wiping $2trn from the S&P Global Broad Market Index in the aftermath of the UK’s decision to leave the EU in June, global markets have since recovered much of the lost ground as they wait for more detail on the likely exit date. In the UK, the leave vote triggered the collapse of the pound against most other currencies. This happened markedly against the dollar, when it fell by 15% to stabilise at around $1.30, since falling further to $1.22, around 20% below its pre-referendum value.

While the weak pound has been viewed as a boost to exports in the manufacturing sector, its impact on the services-based economy that Britain relies on has been negligible. Service sectors don’t attract the demand surges that manufactured goods get when the pound depreciates. Nonetheless, the Markit/CIPS Purchasing Managers’ Index (PMI) reported that Britain’s services sector had rebounded sharply after the biggest drop on record in July following the Brexit vote. Top UK firms will, however, likely see profits fall as currency adjustments are made while their dollar-denominated rivals strengthen their fiscal hand. This is a concern for UK law firms operating globally.

Besides Brexit, volatile commodity prices; geopolitical unrest in the Middle East, Europe and Asia; a highly divisive US presidential election; and a continued economic rebalancing in China are also impacting negatively on markets. With interest rates reaching historic lows, there’s plenty of cheap debt around to drive transactional activity for those with the appropriate risk appetite. Yet the uncertain economic picture globally is undoubtedly putting a brake on investment and corporate deal volumes. All of this adds to the challenges facing UK business law firms as they deal with a potentially difficult future post Brexit.

The global forecast

Looking ahead to 2017, the Organisation for Economic Co-operation and Development (OECD) said in its June Economic Outlook: “Global growth has languished over the past eight years as OECD economies have struggled to average only 2% per year, and emerging markets have slowed, with some falling into deep recession... The global economy is set to grow by only 3.3% in 2017. Continuing the cycle of forecast optimism followed by disappointment, global growth has been marked down, by some 0.3%, for 2016 and 2017 since the November Outlook. The prolonged period of low growth has precipitated a self-fulfilling low-growth trap. Business has little incentive to invest given insufficient demand at home and, in the global economy, continued uncertainties, and a slowed pace of structural reform. In addition, although the unemployment rate in the OECD [countries] is projected to fall to 6.2% by 2017, 39 million people will still be out of work, almost 6.5 million more than before the crisis.”

In July, the International Monetary Fund said in its World Economic Outlook (WEO) Update: “The global growth forecasts for 2016 and 2017 were both marked down by 0.1 percentage points relative to the April 2016 WEO, to 3.1% and 3.4% respectively. The outlook worsens for advanced economies (down by 0.1 percentage points in 2016 and 0.2 percentage points in 2017) while it remains broadly unchanged for emerging market and developing economies.

Among advanced economies, the UK experienced the largest downward revision in forecasted growth. While growth in the first part of 2016 appears to have been slightly stronger than expected in April, the increase in uncertainty following the referendum is projected to have significantly weakened domestic demand relative to previous forecasts, with growth revised down by about 0.2% points for 2016 and by close to 1 percentage point in 2017.

In the US, first-quarter growth was weaker than expected, triggering a downward revision of 0.2 percentage points to the 2016 growth forecast. High-frequency indicators point to a pick-up in the second quarter and the rest of the year, consistent with fading headwinds from a strong US dollar and lower energy-sector investment. Brexit’s impact on the US is projected to be muted, as lower long-term interest rates and a more gradual path of monetary policy normalisation are expected to broadly offset larger corporate spreads, a stronger US dollar, and some decline in confidence.

In the euro area, growth was higher than expected at 2.2% in the first quarter, reflecting strong domestic demand. While high-frequency indicators point to some moderation ahead, the growth outlook would have been slightly revised upwards relative to April for 2016 and 2017, were it not for the fallout from the referendum. In light of the potential impact of increased uncertainty on consumer and business confidence (and potential bank stresses), 2017 growth was revised down by 0.2 percentage points relative to April, while 2016 growth is still projected to be slightly higher, given outcomes in the first half of the year. Delays in tackling legacy issues in the banking sector continue to pose downside risks to the forecast.
Big law growing pains

It's been four years since the high-water mark of global law firm expansion was reached when three cross-border mega deals involving UK firms (Norton Rose/Fulbright & Jaworski; Herbert Smith/Freehills; K&L Gates/Middletons) were announced in the space of a few months. A year later SJ Berwin joined the global major league, inking a big-ticket tie-up with Chinese-Australian firm King & Wood Mallesons, while Dentons transformed itself into the world's largest law firm through big-ticket mergers in China and the US.

Leading UK firms, realistic about long-term local growth prospects, have historically led the way in leveraging their brands into new markets to win international mandates for global clients.

The post-Lehman market for legal services contracted in line with a marked global reduction in business activity. Clients, meanwhile, with serious concerns about their profitability and share prices, began questioning law firm pricing. With routine, commoditised work increasingly being outsourced or done at paralegal level, and a lack of high-value transactional work to fill the void, law firms were experiencing sustained pressure on margins. Despite global markets, fuelled by a combination of cheap debt and quantitative easing, roaring back into life around 2012, clients continued to seek greater value from their law firms. This has put significant pressure on profits.

With clients using fewer law firms globally, the solution for many law firms has been a merger. In addition to securing increased geographic scale, access to new clients and more higher-value mandates, this route allows firms to spread their back-office costs and infrastructure across a greater number of lawyers. The key trend to emerge from the crisis, however, is that most of the significant mergers have been secured without any obligation to share profits, usually through Swiss verein structures.

This is now the preferred structure for global law firm combinations.

There are many reasons why a UK firm would wish to avoid a full merger, particularly with a US firm. Complex financial integration issues can delay even the friendliest merger discussions and can often overshadow the client-centric rationale for the deal. Full mergers also create liability issues in the UK for professional negligence claims originating elsewhere. There are also significant tax issues when structuring a full merger.

Nonetheless, analysis by Legal Business of law firm financials between 2006 and 2016 shows that firms involved in significant mergers. One example of a full merger was the Dickinson/Womble Caryle deal notably being structured as an alliance and not a merger. This performance lags behind many top-100 rivals that have grown organically.

The figures are a stark reminder that, while globalisation continues to be pushed hard by many firms in the top echelons of the market, the financial results do not necessarily support this when it comes to significant mergers.

But as dark clouds again gather over the global economy, some firms continue to pursue large-scale combinations as the fastest means of securing increased market share. In October, CMS UK, Nabarro and Olswang surprised the market with the announcement of a combination to create the sixth largest law firm in the UK by lawyer headcount and sixth largest globally by revenue. The merger is due to complete on 1 May 2017. Olswang and Nabarro will join the CMS UK LLP partnership. Cameron McKenna Nabarro Olswang LLP will comprise nearly 2,500 lawyers in the UK alone. The deal means the CMS network will now have over 1,000 partners and over 7,500 employees across 65 offices in 36 countries globally. It will have combined revenues of circa £450m in the UK and global revenues of more than £1.2bn.

CMS UK Senior Partner Penelope Warne said: “I am inspired today because we are delivering the next step to transform the legal services industry.”

This is a transformational deal not only for the three firms involved, but also for the legal sector. It will be the catalyst for further mergers and will focus greater attention on mid-tier firms that have struggled to grow revenues and profitability. With a substantially undifferentiated legal services offering, this segment of the market is likely to be under ever more margin and profitability pressure, struggle to attract and retain talent, and less competitive in winning instructions and panel appointments.

This year has also seen discussions reportedly begin between Berwin Leighton Paisner and Greenberg Traurig, Arnold & Porter and Kaye Scholer, and Bond Dickinson and Womble Carlyle. Of those, only the latter discussions have led to anything concrete happening, with the Bond Dickinson/Womble Carlyle deal notably being structured as an alliance and not a merger. Indeed, in the four years since big-ticket law firm mergers peaked, firms (Dentons aside) tend to be consolidating their existing positions as opposed to making further bet-the-firm investments. India, China and Singapore remain high on the agenda for most firms despite pricing pressures. Africa is viewed as having huge growth potential, but that is tempered by difficulties in operating in many of the key jurisdictions there. US firms in particular are piling into Latin America as local economies show impressive GDP growth and good economic relationships with Europe and the US. Latin American lawyer headcounts for US firms grew 20% in 2015 alone.

A key reason for a less active approach to expansion among UK firms in particular is an increasing gap between domestic and international profitability. Analysts at PwC estimate UK profits per partner (PPP) to be anything between 75% and 90% ahead of international PPP. This is due mainly to lower chargeable hours and a higher staff-to-fee-earner cost ratio. This situation creates a disconnect between firms needing to service clients in markets globally and the requirement to keep profitability competitive in order to attract the best legal talent.

Meanwhile, the more profitable top-tier US firms, buoyed by the strength of the dollar against most currencies, are snapping up entire teams from their UK rivals in key jurisdictions. In September, White & Case announced its hire of a 10-partner project finance team from Herbert Smith Freehills in Asia and Australia. While making targeted lateral team hires remains a cheaper option than merger, UK firms must still compete with the supreme purchasing power of US firms. Whichever way you look at it, global expansion is now more expensive for UK firms. And with the Brexit vote expected to keep sterling depressed against the dollar for some time, this scenario is unlikely to change soon.
The mid-tier squeezed (again)

Following above-trend profit and revenue increases over the past three years, many commentators predicted a brighter future for the UK mid-tier. This was despite this law firm group feeling intense pressure in the aftermath of the financial crisis from the top City firms above them, and the more nimble boutiques below, making inroads into their SME client bases.

The high number of mid-tier mergers clearly helped alleviate balance sheet issues for some, although the vastly improved financial management and pricing strategies that have occurred for many combined firms has helped make the case for increased scale. Yet this was all achieved amid booming UK litigation, real estate and deal markets. The question we posed in our report last year was how much the improving economy underpinned the mid-tier revival and how much related to having the right long-term strategy.

Less is more

Indeed, with markets a lot quieter this year, the mid-tier’s financial performance during 2015/16 has been more muted, with the more impressive growth coming from those with clearly communicated strengths in a small number of practice areas, regions and industries. This, combined with strong management teams providing a clear strategic direction and an ability to respond quickly to market changes, should be the blueprint for ambitious mid-tier firms. The future of the bloated full-service, all-singing, all-dancing mid-tier firm does not look attractive in the light of recent surveys of law firm financials.

According to Legal Business magazine’s analysis of the top 100 UK firms, average revenue in firms 26 to 50 was down 2% with average profit per lawyer down by the same margin. (It’s worth noting, though, that this was in part affected by the removal of Dentons and Squire Patton Boggs from the tables to reflect those firms shifting operations more away from the UK. This led to Osborne Clarke and Withers moving into the top 25 and being replaced in the 26 – 50 grouping with two smaller revenue firms.)

Nonetheless, average PEP rose 8% to £487,000, suggesting an unsustainable model. Either firms are cutting equity partner numbers to keep PEP artificially high or they are still cost-cutting in other areas of the business. If a firm’s lawyers are demonstrably less profitable year on year then both measures smack of short-termism.

Further analysis of the top 100 is revealing. Following above-trend profit and revenue increases over the past three years, many commentators predicted a brighter future for the UK mid-tier. This was despite this law firm group feeling intense pressure in the aftermath of the financial crisis from the top City firms above them, and the more nimble boutiques below, making inroads into their SME client bases.

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Increased competitiveness

While this may seem a worrying proposition for many law firms, the historic success of the Big Four accountancy firms (which shrank quickly from the Big Eight in the 1990s to become a quartet of highly effective, competitively priced global trusted advisers to the world’s largest companies) provides a classic model for increased scale leading to a more competitive business.

Analysis of UK mid-tier law firm mergers suggests that accountancy firms are actually better at this than law firms. Research shows that two thirds of merger discussions do not result in deal completion despite over half of the firms canvassed saying they would consider a merger. Moreover, fewer than half of mergers were deemed to be ‘successful’ with just over one fifth considered ‘unsucessful’. Indeed, after reaching a high point of 28 mergers in 2013, the numbers have gone down consistently every year since, with just two completing so far in 2016.

The number of mergers completing so far in 2016, compared with 28 in 2013
Lateral gains

As firms of all sizes focus intensely on partner and associate performance as a means of maintaining fragile profit growth, the war for talent has become a strategic battleground on both sides of the Atlantic. This has played out most ferociously at the top end of the market, with many UK firms being forced to modify their locksteps to compete with their aggressive US rivals.

The purchasing power differential, of course, got a whole lot worse for UK firms following Britain's decision to exit the EU in June, owing to the consequent collapse of sterling against the dollar.

It is against this backdrop that US firm Cravath, Swaine & Moore kickstarted a UK salary war in June, announcing a global newly qualified (NQ) rate of $180,000, equivalent to £124,000 at current exchange rates. By comparison, UK firm Clifford Chance agreed to match this rate for its associates in New York, yet will pay NQ associates in London a maximum of £85,000, far less than many of their US rivals.

Nonetheless the sharp increases in associate pay on both sides of the Atlantic come at a time when global markets are cooling significantly. Law firms are generally reluctant to lay off highly trained associates as this would create an even greater talent headache when markets recover, meaning the resultant significant drag on law firm profits will persist in the interim period.

Changing structures

Indeed, as a law firm’s greatest fixed cost, people management is driving a slow but crucial reshaping of the traditional law firm’s organisational structure. The growing use of contract lawyers and paralegals to work on specific matters is helping to alleviate the significant issue of poor lawyer utilisation during quieter periods. As recommended in my previous reports, the cost base is gradually shifting to variable from fixed, a trend enhanced significantly by a greater use of technology and lower-cost centres to handle routine work.

Firms’ demographic profiles are also undergoing significant change. According to research carried out in 2016 by recruitment company Edward Drummond, 72% of partners at the UK’s top 10 firms are aged 50 or younger, compared with 60% for the profession as a whole. This contrasts sharply with the cultural trend at US firms who find it easier to retain older, more experienced partners longer due to their propensity for merit-based, as opposed to lockstep, remuneration. Nonetheless, the tough culling practices of top City firms can serve as a boost for large regional firms that are able to snap up well-connected, highly trained partners well before they retire.

According to research by Legal Week, US firms’ lateral hiring activity has risen by 20% in 2016 to its highest level in four years. The research showed that the group of 36 predominantly US firms made a total of 110 partner-level lateral hires in 2015, compared with 90 the previous year.

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The tech imperative

Technological innovation has helped companies to deliver more commoditised legal services in recent years. Despite some hesitation to embrace such technology, the profession is starting to capitalise on the opportunities.

Law firms may have been slow to use automation, but the trend towards the offshoring (and, more recently, near-shoring) of routine tasks has been ongoing in the legal sector for over a decade. While this has led to a radical reduction in legal secretarial and other back-office support roles, new high-skilled positions have been created to lead and develop the new technologies that have taken their place. This level of investment into highly paid, non-legal positions within law firms is expected to become a major shift in capital allocation as firms navigate the next tech reality.

The resulting innovation has led to a swift growth in automation capabilities and contract analytics, including the spread of artificial intelligence (AI) tools into everyday law firm practice. A report by Jomati Consultants, ‘Civilisation 2030: The near future for law firms’, predicted that AI and robots could dominate legal service delivery within the next 15 years. While initially being used to service low-level knowledge economy work, the report predicted that “eventually each ‘bot’ would be able to do the work of a dozen low-level associates. They would not get tired. They would not seek advancement. They would not ask for pay rises. Process work would rapidly descend in cost.”

The spectre of robots replacing highly trained junior lawyers has yet to gain real intellectual traction with most law firm management teams. Moreover, when faced with business-critical commercial and legal problems, many leading corporates are understandably reluctant to look beyond their preferred human adviser, however cheap the automated option. Since the financial crisis of 2007, the amount and complexity of regulation has increased markedly, with huge consequences for companies that get it wrong.

Nonetheless, the automation of lawyers’ cognitive capabilities is already happening at a lower level, even in 2016. The increasing use of electronic discovery tools in litigation, for example, indicates that high-end document-reading software is quicker and more accurate than a lawyer when faced with searching vast amounts of evidential data. Major US law firm Winston & Straton is one of the biggest names so far to publicly adopt predictive coding technology to analyse entire sets of documentation for relevant information.

Automatic success

The academic case for the adoption of data-driven technology in the legal sector is also strong. Josh Blackman of South Texas College of Law and Michael Bommarito of Michigan State University recently built a model to predict the result of Supreme Court verdicts between 1953 and 2013 using information that was only available before the cases were decided. The model forecast 69.7% of the decisions correctly, information that if applied to forthcoming cases could theoretically provide clients in some instances with a better gauge of their claim’s likely success than a human lawyer’s prediction. A report by consultancy Altman Weil, 2016 Law Firms in Transition, found that clients’ use of technology reducing the need for lawyers and paralegals was considered a threat in 21% of law firms and a possible threat in 53% of firms. The use of virtual assistants to support clients’ own in-house functions and commoditised services, meanwhile, is becoming commonplace in many law firms, with repetitive processes currently carried out by people increasingly being replaced by self-learning AI-based algorithms.

Indeed, the very structure and seniority pricing model embedded in the vast majority of business law firms faces radical change as AI becomes more commonplace. While junior lawyers will still need to be recruited to be the client winners of the future, their charge-out rates will be subject to increased downward pressure in the early years of their careers as automated advice takes hold of more profitable work streams. This means that work opportunities for associates will become even more constrained, with firms investing in only the best talent who they perceive can generate and execute the most high-value and sophisticated work a few years down the line. This will of course also play into the client-lawyer dynamic that firms are already experiencing. Clients have historically evaluated lawyer performance as a billing concept, ie whether the end result justifies the cost. Now, smarter, more advanced tools are allowing them to analyse performance by jurisdiction, type of work, win ratio and numerous other data-driven metrics that help evaluate the value law firms are giving them.

If law firms were to adopt such measures and technology as a way of evaluating themselves then they could be on the front foot when proposing delivery models to clients as opposed to seeing entire swathes of billable income disappear because they were slow to react to the pace of technological change in the first place. In the brave new world of AI and automated delivery of legal services, truly radical thinking and investment could ultimately help generate as many technological opportunities as there are currently threats.

Fluid dynamics

While the replacement of human (billable) hours with super-efficient algorithms is a terrifying prospect for most, it may simply be symptomatic of the rapidly changing client-lawyer dynamic that firms are already experiencing. Clients have historically evaluated lawyer performance as a billing concept, ie whether the end result justifies the cost. Now, smarter, more advanced tools are allowing them to analyse performance by jurisdiction, type of work, win ratio and numerous other data-driven metrics that help evaluate the value law firms are giving them.

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The number of lawyers at major UK firms seeking to register as solicitors in Ireland so they can continue to practise unfettered in Europe post-Brexit suggests that firms are not just adopting a sanguine ‘wait and see’ policy. More than three times as many British lawyers had registered to practise in Ireland by the end of June than did over the same period last year. So far this year, 186 have already been admitted, according to the Law Society of Ireland, compared with fewer than 50 in 2015.

Dual-qualified lawyers could, for example, continue to give advice in Europe and also appear before key EU institutions such as the Court of Justice in Luxembourg. Dual qualification also ensures that legal privilege remains unaffected and clients in long-running legal matters are reassured that they will not need to seek alternative legal counsel even after the UK officially pushes the Brexit button and triggers Article 50. This is particularly important for competition and intellectual property (IP) lawyers, who regularly appear before European courts.

Beyond this, however, the UK’s future as a key global market for legal services is as uncertain as it has perhaps ever been. On a more positive note for lawyers, it emerged in September that the government’s Department for Exiting the EU was already spending £33,500 a week on Brexit-related legal advice – and that’s before external legal advisers are brought in.

The Times reported in July that extra lawyers and consultants are also being recruited and that the advisory bill to deal with Brexit could hit £5bn over a decade.

Yet there is clearly little to suggest that any kind of predictable Brexit outcome will materialise soon. Overleaf, we examine what this means for the four key legal specialisms offered by our leading business law firms: mergers and acquisitions, litigation, real estate, and finance.
Mergers and acquisitions (M&A)

While corporate deal flows have slowed significantly, particularly in the mid market, the rapid depreciation of sterling against a raft of global currencies including the US dollar has, at least, made inbound M&A a more attractive proposition for foreign corporate bargain hunters.

The announcement of the market-moving £24bn acquisition of the UK’s ARM Holdings by Japanese company Softbank shortly after the Brexit vote has helped kickstart a lacklustre market for big-ticket M&A, with corporate advisers reporting an uptick in such mandates. The announcement of further UK-targeted deals in the weeks that followed – including the £921m combination of AMC and Odeon, the £450m tie-up between Steinhoff and Poundland, and the £220m News Corp/talkSPORT merger – gives weight to this positive sentiment.

Sovereign wealth funds and private equity houses have been focusing on FTSE 250 companies, where share price falls have been more pronounced than in the FTSE 100 (where revenues tend to be overwhelmingly generated outside the UK). Active sectors here include engineering, pharmaceuticals, and also those in emerging markets that have “is the opportunity to cooperate with legal systems as they evolve and become more international”.

Nonetheless, the uncertainties thrown up by the referendum result remain concerning for UK firms as other global litigation hubs attempt to position themselves as a more dependable place in which to resolve disputes. A study by Oxford Economics has predicted the longer-term economic loss in legal revenues to be at 4% per annum by 2030 (£1.7bn.) The extent to which this happens will clearly hinge significantly upon the extent to which global businesses move their operations away from the UK to other European countries.

Litigation

The attractiveness of London as a global centre of excellence for dispute resolution is unlikely to be affected in the short term. The immense pool of top legal talent, an impartial judiciary and a legal system that has developed in tandem with the commercial necessities of international trade make London an obvious destination for all types of business litigation. London remains the number one centre for international arbitration ahead of Paris and handles four times as many arbitral disputes as New York, according to data released by research analyst TheCityUK. Indeed, disputes lawyers expect an uptick in work in the short to medium term as post-Brexit uncertainty inevitably leads to increased contractual breaches.

In an upbeat report, TheCityUK says that English Law should ensure it is “interoperable” with other jurisdictions, particularly those in emerging markets where there “is the opportunity to cooperate with legal systems as they evolve and become more international”. Nonetheless, the uncertainties thrown up by the referendum result remain concerning for UK firms as other global litigation hubs attempt to position themselves as a more dependable place in which to resolve disputes. A study by Oxford Economics has predicted the longer-term economic loss in legal revenues to be at 4% per annum by 2030 (£1.7bn.) The extent to which this happens will clearly hinge significantly upon the extent to which global businesses move their operations away from the UK to other European countries.

Real estate

Amid cooling valuations preceding the vote, particularly in London, the Brexit effect on commercial real estate was both swift and severe. The volumes of redemptions from property funds was so intense that over a dozen leading fund management groups had to suspend trading on their property funds in a bid to prevent further outflows. While many have since relaxed dealing conditions, the number of commercial property deals is expected to remain muted for the rest of the year as transactions go back to investment committees. The weak pound is acting as a stabilising factor for foreign investment but, as an asset class, UK real estate is as far from a ‘safe bet’ investment as it has been for many years.

The prospect of large multinationals signing expensive UK office leases amid all the Brexit uncertainty also remains remote. This has come at an awkward time for real estate lawyers, who have already seen volumes suffer in the buy-to-let (BTL) residential market as a result of the higher tax levies on landlords that came into force in the spring. Record low interest rates may provide a floor to a further dampening of activity here, and in the residential market generally, although a rekindling of the previously buoyant BTL market is unlikely for now.

In research carried out among almost 200 law firm partners say that real estate will be the practice area hardest hit by Brexit.

Banking and finance

As a sector, European and US banks suffered the greatest share price falls in the aftermath of the leave vote. Foreign banks base themselves in London and operate across Europe on the basis of a ‘passport’ into the other EU states. There is now huge uncertainty over whether they will need to renegotiate separate banking licences and also whether the euro clearing system will now be forced to move from London to Frankfurt or Paris. Unsurprisingly, many are making noises about relocating their headquarters away from London.

For banking lawyers, this state of affairs is a double-edged sword. A new and potentially lucrative ‘Brexit industry’ will be created in the short term where the highly complex regulatory impact of Brexit on banks and financial institutions will have to be worked through. This will provide rich pickings for lawyers at high-end firms. The sheer volume of cheap debt sloshing around the system as a result of the UK’s record low-interest-rate environment may also stimulate extra borrowings among corporate clients, leading to additional work for volume debt teams.

Investment banking work will nonetheless remain depressed as companies wait to see what happens in negotiations with the EU. This, combined with low interest rates and reduced risk appetite among clients, will hit bank sector profitability, particularly in Europe. Law firm margins, already being squeezed by banking panels and the trend towards commoditised fees, are expected to be hit still further. The market is ripe for US law firms with historic ties to the Wall Street investment banking giants to gain an advantage in London over their UK rivals.

The vote gives US banks, already growing at a faster rate than their heavily regulated European rivals, an opportunity to snatch more market share as the uncertainty surrounding Brexit continues.
The ABS factor

While the traditional law firm partnership structure still dominates the legal sector, the threat posed by competitor forces continues to slowly erode law firm profitability.

Through a combination of regulatory change and an ongoing transformation in buying behaviours, new and powerful entrants are capturing increased market share. In early 2015, Cahill, Gordon & Reindell became the first US firm to secure Alternative Business Structure (ABS) status in the UK. This represents a major step change as non-lawyer ownership is currently not allowed in the US. William Hartnett, chair of Cahill’s executive committee, said: “Our authorisation from the SRA [Solicitors Regulation Authority] enables our US and UK practices to work together more effectively and to provide a comprehensive litigation service across those key markets.”

The firm was quickly followed in setting up as an ABS by fellow US player Forrest Glennon, which focuses primarily in London on the insurance and reinsurance markets.

The biggest threat to business law firms, however, remains the Big Four accountancy firms (PwC, Deloitte, KPMG and EY) which, during the past four years in particular, have quietly yet aggressively focused resource on rebuilding the legal offerings that were decimated in the early 2000s following a series of accounting scandals. The four – all of which have ABS licences – have organised themselves on a matrix basis that crosses borders and product lines, with legal services sitting among the tax, audit and industry groupings that their multinational clients are already using. This strategy has seen income rocket globally, with PwC Legal alone earning £59.9m (£56m being UK fee income) in the last financial year, an increase of 25% on the previous year. PwC as a whole reportedly earned around £390m from legal services in 2013, plans to double by 2019 through aggressive expansion, particularly in Asia.

While the Big Four’s law firm equivalent, the Magic Circle, remain focused on premium work for their biggest clients, the accountancy giants are more than happy to provide legal services at a range of price and complexity points. A recent study by a group of Harvard academics said: “The global legal market’s projected value in 2019 is $726.2bn. If only one of the Big Four can capture even 1% that network would become the single largest global legal services provider.” A concerning scenario for business law firms everywhere.

A tale of two listings

Recent months have given the market some meaningful insight into law firm flotations, another form of ABS. AIM-listed UK law firm Gateley and Slater & Gordon, which is quoted on the Australian Stock Exchange (ASX), posted annual results in the summer showing markedly contrasting fortunes.

Gateley, which floated last year, reported record revenues up 10.2% to £67.1m for the year ended 30 June 2016. Despite turnover improving slightly to £133m, its 2015 profit of £12.03m was turned into a loss of £37m. Another £18.5m was spent reorganising its UK operations. Overall, the group made a loss, mainly due to having to make a write-down on its acquisition of controversial claims outsourcer Quindell Legal Services (now renamed Slater Gordon Solutions). The firm said: “Performance in the first half of FY16 was significantly below expectations and a performance improvement programme was commenced in the second half. The initial activity involves reorganising our legal services business to service three key client areas: fast-track personal injury, serious and specialised personal injury, and general law. Our structures, processes and technology will be optimised to ensure we are able to provide world-class services efficiently and profitably, in each of these areas.”

Traditionalists argue that the pursuit of profit from outside investors is at odds with consumer interests and a lawyer’s professional duties

More opportunities than threats

The situation at Slater & Gordon has inevitably been jumped on by traditionalists, many of whom argue that the pursuit of profit from outside investors is at odds with consumer interests and a lawyer’s professional duties. The firm famously stated ahead of its listing that investors’ financial interests were ‘tertiary’, and were behind the firm’s statutory duties to the court and professional duties to its clients. Nonetheless, its purchase of Quindell – at £637m – was almost certainly made possible by the fact that it was able to tap the capital markets.

For now, Slater & Gordon has gone from being the future of law firm innovation to a cautionary ABS tale. The firm remains positive about its future and is on a journey of restructuring to regain former glories. The fact remains, however, that the current difficulties – as demonstrated by the steadier approach of Gateley – are not necessarily a failure of ABS. The ABS environment did provide the structure that allowed it access to the funds to execute its consolidator strategy in the PI sector of the legal market. But while difficulties encountered by other ABSs such as Co-op, Parabis and AA Law have impacted negatively on additional take-up so far, many lawyers and investors currently sitting on the sidelines still see more opportunities in the low firm IPO and Big Four models than they do threats.
Conclusion

With key transactional, real estate and financial services work cooling over the past year, the UK’s decision to leave the EU came at an awkward time for the country’s leading law firms. However, the legal sector remains a robust, well-hedged and highly profitable contributor to the overall economy.

But the uncertainty that the vote has caused – which is likely to continue for some years – poses a unique conundrum for law firm management teams. Redundancies seem inevitable, at least in the short term, as firms grapple with utilisation rates and the cost of record associate salaries agreed before the referendum. If law firms are unwilling to reduce lawyer numbers for fear of being exposed if Brexit doesn’t create the economic shock predicted when Article 50 is finally triggered, then partner profit will undoubtedly be hit at many firms.

On the flip side, the availability of never-cheaper debt to fund technology, innovation, lateral hires and the organisational changes required to generate more profit with less turnover will nevertheless allow opportunities for those with the risk appetite to invest into a downturn. An intense focus on lawyer performance is likely to expose some slack in the system, but this will not be enough in itself to offset the slowdown in business spending that Brexit uncertainty is already causing.

All of this comes as new market entrants, regulatory changes, the technological revolution, and radically revised expectations about how law firms should best service clients all weigh heavily on the traditional law firm model. A point of differentiation in the market, a meaningful value proposition, and clearly communicated practice areas and industry strengths remain key to client loyalty. As a sector, UK law has a proven track record of coming through even the toughest economic times with strong margins intact.

The extent to which Britain’s leaving the EU represents a monumental opportunity for UK business, or an unprecedented shock that puts the last five years of recovery into reverse, is the key question for management teams, as ‘uncertain’ becomes the default economic outlook.

As a sector, UK law has a proven track record of coming through even the toughest economic times with strong margins intact.
Contact us

If you have any comments on the contents of this report or would like to have a discussion on any aspect of the legal profession more generally, please contact:

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