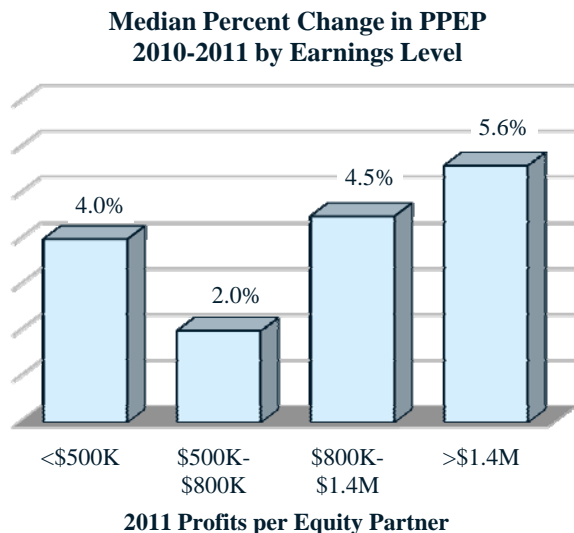


Hoffman Alvary 2011 Profitability – First Report ~ January 17, 2012 ~

Yes, the Strong Got Stronger For a first report on 2011, Hoffman Alvary polled major US law firms on their 2011 earnings, revenues and outlooks for 2012. Firms with the highest historical profits posted the largest earnings and revenue growth, but interestingly also reported the most conservative forecasts. Firms earning over \$1.4M per equity partner enjoyed a median 5.6% increase in average equity partner profits since 2010, compared with only a 2.0% rise for firms earning \$500K – \$800K. This divergence illustrates the continuing impact of the market's uneven recovery as well as some longer term shifts in work.

Respondent Firms 65 firms across the US responded to our survey over the past several days. 59 of them were able to provide year-end data. These include 28 *AmLaw 100* firms not based in New York and 23 firms in the *AmLaw Second 100*. Additional respondents include 8 regional firms with revenues falling just below the *AmLaw 200*. Respondent average profits ranged from \$3M per equity partner to less than \$500K. This report reveals the significant and widening stratification in the profession by mix of client work and by earnings. Our conclusions reflect survey responses together with our understanding of how dozens of firms fared in 2011 as they fought for market share and enhanced profits.

2011 Earnings Recovery More than 70% of the firms across all profit groups saw their average earnings improve in 2011 over 2010. As in prior economic recoveries, those who went in strong came out strong: the pre-recession highest earners with the strongest brands achieved the largest gains of the re-emerging work. This group's 5.6% median equity partner earnings (PPEP) growth includes firms with meaningful improvements



(over 15%) and some with declines. However, at this earnings level, declines generally reflect an abnormally strong 2010 (due to a contingent recovery or a very large single matter), rather than an underlying structural weakness in 2011.

Firms with average earnings of \$800K – \$1.4M have become an “upper middle class” that in 2011 saw a refreshing uptick in work and earnings. At the same time, these firms have not joined the top tier, despite profits that for most exceed their own pre-recession levels. This group held its own during the recession largely by cost-cutting; these firms may now have made their current stratum more permanent through 2011 revenue gains that outstripped those achieved by lower-earning firms.

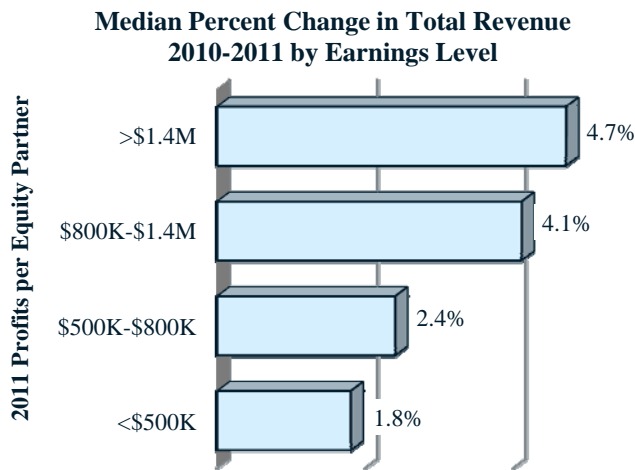
Firms in the next income bracket of \$500K – \$800K had a tougher 2011. Most did not share in the mega-litigation work arising from the financial crisis and have not yet felt much trickle-down of post-recession deal work. Adding to the strain, some have large practices in areas still in distress, including most notably middle market corporate work and real estate development. Further, some firms are feeling the pinch of softness in

specialty practices such as IP litigation, where the recovery is still widely uneven. All told, 40% of firms in this group saw average earnings decline in 2011.

When the downturn began to pummel their regional economies, secondary market firms with earnings under \$500K suffered, although generally later than capital market firms. For many, 2010 was their worst year. By 2011, some pulled through with relatively strong rates of improvement, albeit on a smaller overall earnings base than their larger firm peers. That said, performance varied widely with profits down for over one-third of this group. Given their smaller size, these firms are more vulnerable to changes in their regional economies or in the mobility of a few key clients or partners.

Market Share Changes 2011 showed a growing imbalance in the total work commanded by different sectors of the profession. The highest-earning firms enjoyed increased demand at more than two and a half times the pace of lower-earning firms, as illustrated in the chart below. The increasing concentration of market share among the highest-earning firms is even more dramatic because these firms are typically much larger than their lower-earning peers. The average firm earning more than \$800K per equity partner added \$24M in revenue in 2011 while the average respondent with earnings below \$800K added just over \$2M in revenue. The top firms achieved this revenue growth through higher rates and hours, while most lower-earning firms saw revenue growth that fell short of their 2011 billing rate increases.

Average Revenue Gain 2010-2011	
PPEP	Average Gain
>\$800K	\$24M
<\$800K	\$2M



Continuing client fee pressure suggests to some that midlevel work should be moving to smaller firms with lower rates. However, with a median revenue increase of only 1.8%, the smaller, regional firms do not appear to be enjoying a wholesale influx of midlevel work. Rather, it seems that clients are flexing their muscles to negotiate lower fees for this work from their current midsize and large firm providers. As in most industries, simply offering lower fees to attract new clients is insufficient when the incumbent provider can also compete by reducing its prices.

Implications for 2012 Given that the strongest firms both entered and emerged from the downturn ahead of the pack, this pattern accentuates the stratification among firms. The tier differences are widening, and very few firms leapfrog in either direction to join another group. Although a smaller firm can sometimes join a higher tier through a David-joins-Goliath acquisition, only the extraordinary firm can achieve this goal without a large boost from a once-in-a-generation client or set of matters.

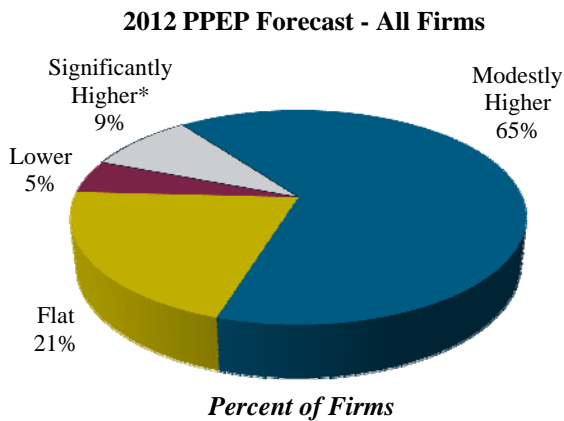
Strategic firms will recognize in 2012 an opportunity to solidify their financial and professional positions. For those in primary markets with sophisticated financial or litigation practices, this means capitalizing on these strengths and taking bold steps to expand market share, especially for high-end work. And for firms in secondary markets, this means crafting a dramatic differentiation strategy that exploits current market niches while also taking best advantage of their regional footprint and client base. Firms that invest in these

strategies now can help secure their earnings positions even if the recovery continues to fluctuate. As the scientist Louis Pasteur noted, “Fortune favors the prepared.”

While 2009 and 2010 saw alarming cuts affecting many associates and other non-partners, 2011 sharpened the focus on partner performance, compensation and tenure. We expect to see faster and more dramatic messages to both over- and under-performing partners in 2012. Some firms’ efforts to “strengthen the partnership” are tied to a drive to acquire laterals and market share and to ensure the loyalty of their strongest partners. Naturally, the pace of lateral mobility has quickened with the divergence in recovery experiences. New with this recession, though, is the number of partners holding significant management positions (and arguably greater fiduciary roles) who have jumped to other firms. We see this unfortunate trend continuing.

2012 Earnings Forecasts Most responding firms expressed cautious optimism for 2012. 74% predict modestly or significantly higher earnings; only 26% predict flat or lower earnings.

“We’ve had a great 2011, but no hubris about 2012.”



**defined as 7% or greater*

expense cuts will require structural changes. Most firms seeking higher earnings will need strategies to increase market share and also to manage their partner populations in ways that advance overall professional quality and profitability.

Headcount Growth in 2012 Two-thirds of the respondents expect modest or lower headcount growth while one-third project flat or negative growth.

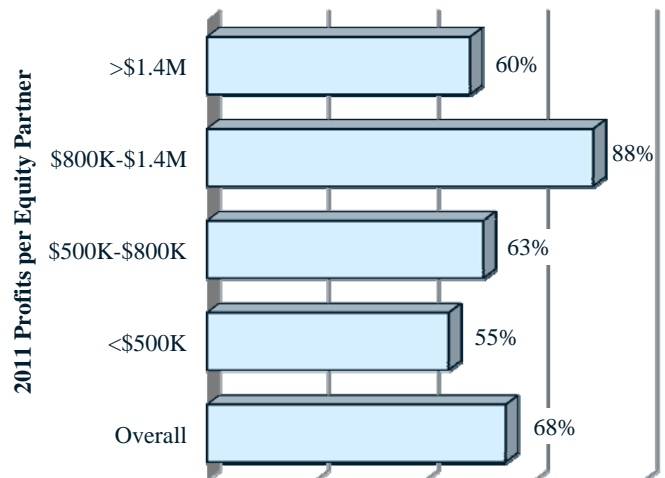
The firms earning \$800K – \$1.4M expect rosier headcount expansion: 88% predict significant or moderate net hiring, with only 12% projecting flat headcount. The highest-earning firms forecast slow growth, with 33% projecting headcount that is essentially flat and 7% projecting a decline. This

“We are growing again, but with fewer first-years and more off-tracks.”

modest forecast is consistent with the group’s relatively modest earnings projections.

The sputtering deal market in the second half of 2011, coupled with ongoing debt challenges in Europe, muted the optimism of top-earning firms. Among those earning over \$1.4M, 43% forecast flat or lower earnings in 2012 and 57% expect only modest increases; not a single respondent at this level predicts a significant earnings increase. Meanwhile, 88% of firms in the \$800K – \$1.4M earnings bracket feel more bullish and expect modest or significant improvement. Achieving major earnings improvement this year will not be easy, in large part because the next round of major

2012 Percent of Firms Forecasting Increases in Headcount by Earnings Level



The Pace of Mergers When discussing their headcount forecast, several firms mentioned either a pending merger or plans to explore a combination. Hoffman Alvary expects the strong pace of law firm mergers in 2011 to continue through 2012. International combinations were front and center in 2010 and 2011 as managing partners responded to pressure to cover greater ground in the global legal market. Possible changes in international firm ownership and the accompanying influx of new money appear poised to advance this trend. For a variety of structural and cultural reasons, international mergers present distinct challenges; we expect acceleration in the number of cross-border mergers being considered, even if very few actually close.

“We’ve not wanted a big combination, but worry about being left behind.”

At the same time, the pace of domestic consolidations continues unabated. Just as in the second half of 2011, the market in 2012 will be dominated by mergers pairing regional firms with other firms at all levels. Many firms see a merger as a well-considered means to expand geographic reach and diversify or deepen their practice mix.

Although the 2011 volatility has been unsettling, there were success stories in every earnings and size cohort. So far, 2012 suggests a continuing, if precarious, recovery.

Hoffman Alvary’s law firm consulting practice provides strategic and management consulting services to law firms prominent nationally and in their local markets. Drawing on an active client base encompassing 25,000 lawyers and 40 million billable hours, our professionals bring years of experience and an in-depth knowledge of the issues facing law firm management in today’s challenging environment.

Paula Alvary
palvary@hoffmanalvary.com

Cara Rhodes
crhodes@hoffmanalvary.com

Marie Lefton, Esq.
mlefton@hoffmanalvary.com

Brian Dies
bdies@hoffmanalvary.com

Scott Golin
sgolin@hoffmanalvary.com

Hoffman Alvary & Company LLC
Seven Wells Avenue
Newton, MA 02459
617.758.0500
hoffmanalvary.com