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Citibank's Third Quarter 2011 Report on Law Firm Profitability: The Good News is That Cash Collections Were Up for the Quarter; The Bad News is There is a Lot More Tunnel at the End of the Tunnel

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As law firm expenses continue to rise more quickly than revenues, law firms are looking at a real hole in their buckets

Like so many of us, I [so admire and respect Citibank](#) and the leader of its law firm lending group, ably headed by Dan DiPietro. I not only look forward to Citi's quarterly reports on law firm profitability, but as so many of us do, I carefully parse through Citi's reports, since even when Citi

informs us that storm clouds are about and more are to come, it somehow manages to give the impression that the climate is balmy and sunny days are ahead.

In this regard, Citi's report for the [third quarter of 2011](#) does not disappoint. Not that Citi reports much good news nor

does it predict coming good times; but, as always, Citi, the master of euphemism, posts some important warnings in terms that seem to provide some comfort. But, the fact remains that, after performing some exegesis of Citi's most recent report, it is clear that Citi is telling us that current law firm economics are not very rosy and the coming months are foreboding.



Citi, which serves some 600 law firms and 58,000 lawyers in the United States and the United Kingdom, likes to lead with the good news and here it is: Cash collections for the third quarter were strong. The bad news: Demand for legal services continues to decline, marking the fourth quarter of consecutive decline in demand for legal services, while during the same period, expenses continued to rise, consistent with Citi's [last report](#).

Says Citi:

Cumulative growth in demand for the first nine months was 1.5 percent, down from 1.8 percent during the first six months. This indicates that growth in demand slowed to only 0.9 percent for the third quarter. This is likely a result of the slowdown in transactional work caused by the market shake-up. The slowdown has hit Am Law 50 firms (the 50 highest-grossing firms on The Am Law 100) particularly hard.

Citi went on to note that rate increases remained steady at 3.7% and realizations were strong. But a moment later, it also cautioned as follows:

Expenses, which had already risen by 4.7 percent during the first half of 2011, continued to gain momentum during the

third quarter, as they have now increased 5 percent across the industry for the first nine months of this year. This was driven by a continued increase in operating expenses—and in compensation expenses, since we saw a slight uptick in head count during the third quarter, likely due to the entry of first-year associates.

Quite obviously, where your rates are increasing by 3.7% and your expenses increasing by 5%, you are slowly losing ground. Citi acknowledged as much:

This modest increase in associate head count, combined with the slowdown in demand in the third quarter, translated into a decline in productivity gains—from 1.6 percent growth for the first six months of 2011 to 0.9 percent growth for the first nine months.



Tucked away in the middle of a following portion of its report is the most disturbing news of all in the current report, dealing with the very troubling decline in demand for future legal services and continued decline in WIP: Citi's report on WIP showed that WIP is currently at

3.6 percent for the first nine months (versus a cumulative growth rate of 6.3 percent for the first six months). *The last time we saw the third-quarter inventory growth rate slowing from the first-half rate was in 2008.* [Emphasis Added].



Citi went on to report on the winnowing down of equity partner ranks at law firms, while increasing activity in lateral hiring. Lateral partner hiring is certainly a positive sign; it signals optimism by law firm leadership and the willingness to fill in valleys of revenue decline by bringing in new partners with loyal client followings. But robust lateral partner recruiting is far from a panacea. Every lateral partner comes at a real cost, consisting of recruiting fees, where applicable, and the investment in “ramp up.” For the uninitiated, ramp up consists of that period of time which commences when the lateral partner and his professional and support staff join the firm and are fully compensated until the time that their efforts result in revenue to the law firm, a period typically lasting approximately ninety days. Thus, while successful laterals do contribute to WIP, they do add materially to the expense side, [which some firms have attempted to treat as capital costs](#). But in simple cash accounting, laterals cost money and mitigate equity partner profitability.

The reader must be mindful that

Citibank’s survey is skewed in that it is largely based on AmLaw 100 firms – “44 Am Law 1–50 firms, 36 Am Law 51–100 firms, 49 Second Hundred firms, and 54 additional firms.” Those firms at the top of this food chain are largely hiring laterals by [showering them with gold](#), not always a great idea.. Firms on the lower end of the food chain are faring much better, in our own experience. We are seeing many mid-size firms picking up quite a number of attractive top tier law firm partners, who are being squeezed out of AmLaw100 firms simply because their client bases, often quite substantial just won’t swallow the \$1,000 hourly rate level required by the top tier to feed its expense levels. The fourth quarter of every year is the season of redemption for many, as lateral candidates anxiously scour the market scooping up offers that they will formally accept as soon as the spoils of the previous year are distributed. Mid-size law firms – the “additional firms” in Citibank’s report – have actually done remarkably well these past two years and they are scooping up many of the soon to be AmLaw 100 refugees at record rates.



The continuing decline in the leverage model and decreased work available for firm lawyers also did not escape Citi’s attention:

We have recently begun highlighting in our roundtables the rising cost of leverage for law firms. Looking at the 100 most

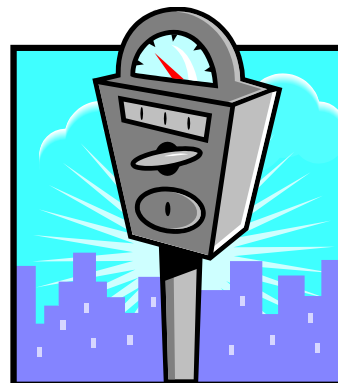
profitable firms from 2001–2010 in our database, we saw a discernable decline in the percentage of associates represented in the leverage composition and a significant growth in the income partner, counsel, and of counsel categories. The result is a much more expensive leverage model, which would be fine if these more expensive lawyers were as productive as equity partners and associates, but they are not. In looking at average annual lawyer productivity from 2001 to 2010, income partners and counsel worked about 150 hours less than equity partners and associates.



“Much more expensive leverage models” is simply a euphemism for the fact that the Cravath system continues to disappear and service partners and counsel as important profit centers are similarly withering. In other words, the old pyramid model hasn’t really disappeared; it has just been turned completely upside down.



There was also rising concern at Citi concerning the continued growth of [Alternative Fee Arrangements](#) and lowered reliance on billable hours, which Citi is concerned might result declining law firm profitability. As I have discussed in the past, AFA’s can actually enhance profitability, if properly managed, and current economic climes, with both declining demand for legal services and increased competition for those legal services require law firms to be more agile and [develop new, more efficient and more profitable models for the delivery of legal services](#).



Citibank, like everyone else,

expects an exceptionally hard push for final quarter collections. After all, following a rather difficult year of rising expenses and weakening demand, the need to boast of high PPEP is largely contingent on an extraordinarily strong squeeze in coming weeks. But as corporate clients have mightily increased their own cash management and stretched out account payable schedules, these efforts may very well be an irresistible force meeting an immovable object. [Something's got to give.](#)

My own advice is forget about [boasting about your PPP](#); instead, make the far more important investment in enhancing the firm's long term relationships with its clients.

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