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Axing of partners sees top law firms increase profitability

By Bob Sherwood, Legal Correspondent

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Law firms recovered from two years of tough trading conditions with strong headline profits growth last year, but achieved the increases largely by axing more partners, according to a closely-watched industry report.

The trend for cutting partner headcount increased, with over half of the top 25 law firms cutting or "de-equitising" underperforming partners in 2004-05, up from 40 per cent the previous year.

However, the annual survey of law firms' finances by PwC, the accountants, suggests that the partner culls may have peaked, as half of the biggest 25 firms and 60 per cent of the top 100 predict a rise in partner numbers in 2006, as merger and acquisition activity increases.

Average profits per partner topped £750,000 at a handful of the top 25 firms, the survey says. But such figures can be misleading.

Alistair Rose, leader of PwC's professional partnership advisory group, said: "It's not boom time. They haven't increased the top line. The main driver of increased profits per partner has been reduced headcounts rather than an increase in absolute profits."

Overall fee income growth was generally modest, with just over a quarter of the top 25 reporting fee increases of more than 10 per cent. With profit margins remaining under pressure, the leading law firms have been forced to improve their management performance, in particular cutting costs and improving productivity.

More than 56 per cent of the top firms had staff costs of 40 per cent or less of their fee income in 2004-05, compared with just 28 per cent in 2003-04. But Mr Rose said they might struggle to keep staff costs down, as there was now "substantial pressure to raise salaries at all levels, including trainees".

The survey, an annual snapshot of law firms' financial health, says solicitors' salaries at the big firms rose by up to 7 per cent, with trainees' wages climbing an average 16 per cent. Already this year Allen & Overy and Freshfields Bruckhaus Deringer have announced significant pay rises for their non-partner lawyers, known as "associates", amid predictions of a legal pay war.

The restrictions on creating new partners in recent years have also limited career progression for senior associates at law firms. The survey says that has required the firms to offer bigger bonus schemes and a wider range of flexible benefits in an effort to retain their fee-earners. Even so, almost two-thirds of the leading firms reported turn-over of associates running at a rate of more than 15 per cent a year.

One of the headaches for law firms now is increasing the hours their lawyers work to boost productivity without causing more of what are described as "work-life balance departures".

The firms have on average increased their utilisation of associates by about 10 per cent, but they are still falling behind their targets for billable hours. For example, a newly

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qualified lawyer at an average top 25 firm would be expected to bill clients for 1,545 hours a year, or more than 6½ hours a day in a 47-week year.

The average achieved in the year to 2005 was 1,324 hours, still well short of that target, although up from just 1,180 hours in 2004.

There were also improvements for the leading firms in the performance of their international operations. Many of the top 25 have invested heavily in overseas offices as they seek to serve their multinational clients across a range of jurisdictions. So far, many have yet to see their overseas operations earn their keep.

Income from overseas operations now accounts for more than 30 per cent of fee income for almost 45 per cent of the leading group of firms. Almost half of the top 25 saw fee growth from international offices of more than 10 per cent.

The firms are also taking increasing pains to head off the potential of disastrous damages claims. More than 40 per cent of the top 25 now say they "routinely" limit their liabilities on client assignments, up from 29 per cent in last year's report. In addition, 82 per cent of firms have formalised risk management procedures.

Mr Rose said: "Overall 2005 was a strong year in profitability terms for many firms . . . However, the market remains fiercely competitive in terms of winning clients and recruiting and retaining quality staff."

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