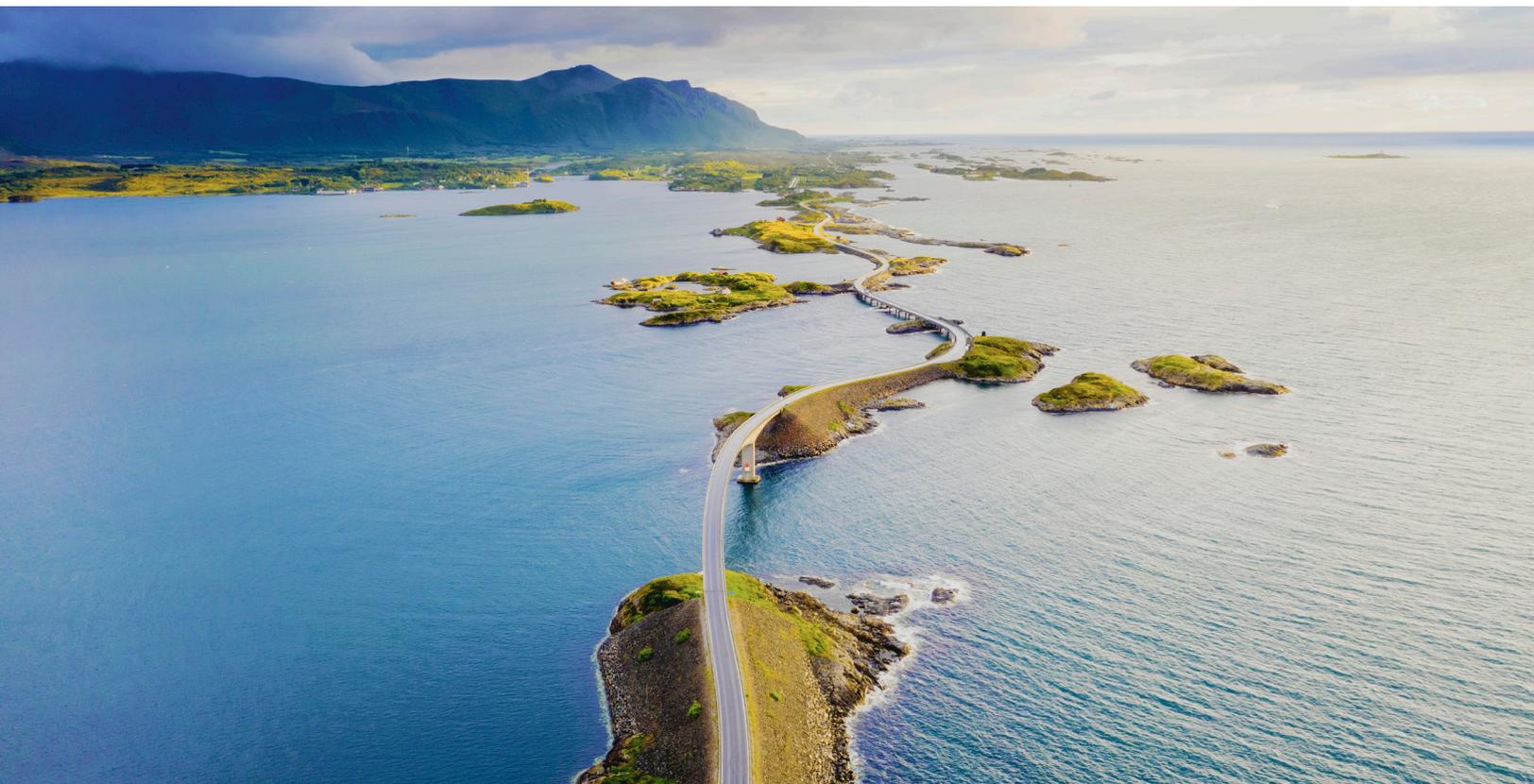


Private Bank



2022 Client Advisory



Private Bank 

 **HILDEBRANDT**
CONSULTING LLC

Executive summary

The year 2021 has been one of the strongest years on record for the law firm industry, even accounting for the aberrational base year created by the disruption of the COVID-19 pandemic. If we measure 2021 performance against a more normal 2019, the industry is still back to both demand and rate growth levels the likes of which we have not seen since 2007¹.

While some of the largest and most profitable law firms are on track to register above average demand and revenue growth, 2021 has unmistakably been a year of strong growth for all segments of the industry.

We have also seen accelerated expense growth, though driven more so by pressure on compensation expenses than the anticipated pressure on operating expenses. This compensation expense pressure was caused by the demand for law firm services outstripping the supply of lawyers, creating an acute talent war.

Meanwhile, we did not see the anticipated level of operating expense growth as many firms, especially those with a presence in large cities, delayed their return to office from the third quarter to at least November, with some delaying it until 2022.

With the strong revenue growth seen in 2021, rising expenses have so far been more than absorbed. As such, we expect to see some of the strongest net income and profit per equity partner (PPEP) results on record. In the main, challenges in 2021, and even more so for 2022, include how to successfully implement a hybrid model, win the war for talent and continue to

find ways to operate more efficiently.

Looking to 2022, we expect that strong demand levels will continue, albeit with some moderation in the growth levels compared to 2021. We would expect to see growth in demand for legal services coming especially from the technology, healthcare and life sciences, financial services, private equity, and energy and infrastructure sectors.

In terms of practice areas, we anticipate corporate/mergers and acquisitions (M&A), litigation and regulatory/investigations/compliance, finance and capital markets, and funds/investment management to be primary drivers of growth.

We expect most of the demand growth to come from the US and UK, while there is renewed optimism for some around Europe and Asia.

As firms adopt a hybrid model and start to return to a more normal world, we expect expense pressures to accelerate, coming from both continued compensation expense growth and accelerated operating expense growth, making strong revenue growth and the continued focus on operational efficiency imperative in the coming year.

Our detailed findings for 2021 and projections for 2022 are presented in this Client Advisory. We hope that you will find it to be informative. As ever, we look forward to your valuable feedback.



GRETTA RUSANOW
HEAD OF ADVISORY SERVICES
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BRAD HILDEBRANDT
CHAIRMAN
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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 213 US-and UK-headquartered firms, including 43 Am Law 1-50 firms, 40 Am Law 51-100 firms, 52 Am Law Second Hundred firms, and 78 additional firms; 173 firms from the "Citi Flash Survey", including 41 Am Law 1-50 firms, 34 Am Law 51-100 firms, 46 Am Law Second Hundred firms and 52 additional firms; the "Citi Law Firm Leaders Survey" of 56 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 145 firms.

Part I:
The legal market in 2021





It is striking how different the environment is for law firms, not just compared to last year but to the last decade, when we reflect on the first nine months of 2021. In the first three quarters, we saw an average revenue growth of 14.7% over the same period of 2020. While rates increased 6.5% and the collection cycle shortened by 2.1%, they were not the only drivers of the strong revenue growth. We also saw a return to high levels of demand growth, the likes of which we have not seen since 2007. Even if we compared the 2021 performance to a more normal 2019, we still saw performance levels akin to pre-Global Financial Crisis years.

Demand was up 6.6% at the nine-month point, driven largely by M&A, finance and capital markets, and litigation activity. However, a projected uptick in bankruptcy and restructuring largely failed to materialize. Meanwhile, real estate activity remained weak for many large firms, with the picture emerging as mixed at best.

In this strong demand growth environment, there are not enough lawyers to handle the rising tide of work, with total lawyer headcount growing just 0.7%. Indeed, productivity was up 6.1% for the first nine months, making burnout a real issue for many firms where productivity was already high. On a positive note, strong demand growth and capacity pressures have also enabled many firms to turn down work that is likely to be discounted. As such, we anticipate seeing an improvement in realization in the full-year 2021 results.

Behind the average lawyer headcount growth of 0.7%, it is important to note the wide dispersion², with 46% seeing a decline in headcount, while 54% saw growth, signaling the acute war for talent. The most consistent theme throughout all our conversations with law firm leaders in 2021 has been the severe shortage of lawyers - from young associates through to partners - to cope with the spike in demand. The competition for talent has created extraordinary compensation expense pressures - coming from spring bonuses, sign-on bonuses and the increase in base salaries adopted during the third quarter.

At the time of writing, we have already seen a number of firms announce special associate bonuses, driven by both extraordinary productivity levels for some firms as well as the war for talent. We also anticipate increases in the traditional year-end bonuses. As these bonus increases are likely to be widely adopted, we expect this to create margin pressure for firms with comparatively lower revenue growth than the more profitable firms. So far, compensation expense pressure caused by the talent war has resulted in a 14% increase in compensation expenses, and it is the primary driver of the 8% total expense growth we have seen year to date.

Meanwhile, the delay in returning to the office has led to more moderate growth in operating expenses than we anticipated, up just 3% for the first nine months. Many firms tell us that implementing a hybrid model is proving to be more challenging than operating a fully remote model. At the time of writing, we have seen the pace pick up in returning to the office and the adoption of the hybrid model. As firms return to the office and adopt a hybrid model during the fourth quarter, we expect to see expense growth accelerate through year-end.

Looking at equity partner growth trends through the first nine months, we saw an industry average of flat growth. However, the industry average belies the wide dispersion we see across the industry. So far this year, while 43% of firms have seen a contraction in equity partner headcount, 51% have seen growth, signaling the active lateral market, as well as the growing number of firms with record numbers of partner promotions. We would also note that while equity partner headcount was flat, income partner headcount grew 2.5%.

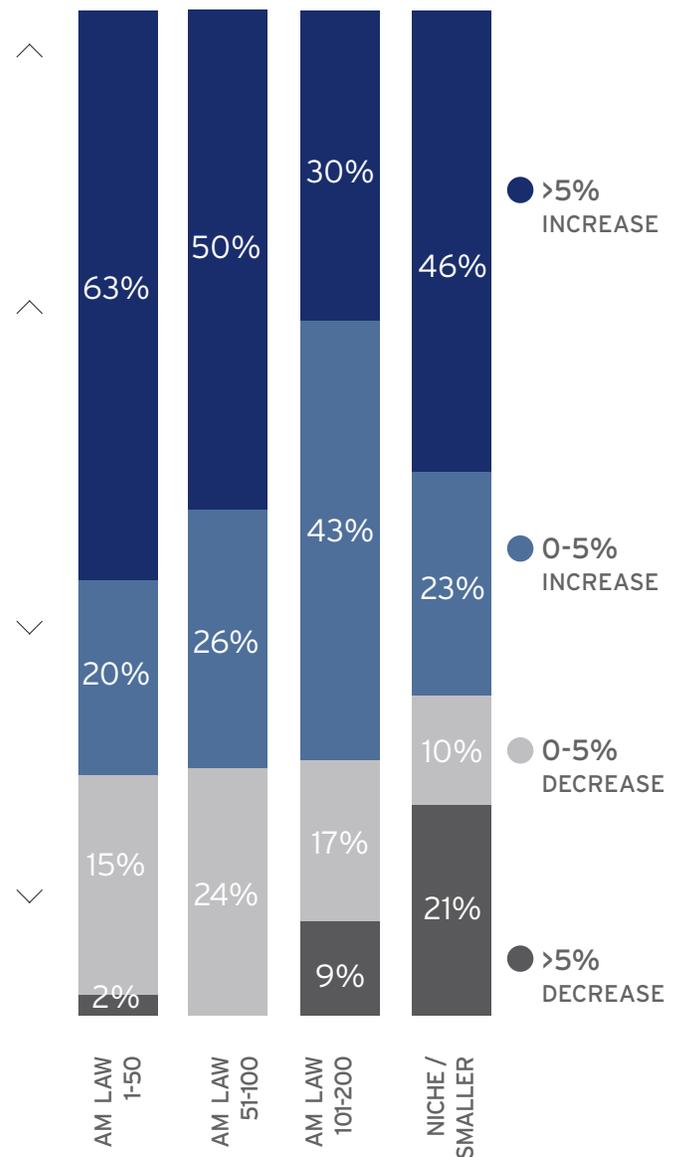
² Dispersion is defined as a near-even split between firms that saw an increase and firms that saw a decline during the period measured.

Looking to the year-end, inventory growth at the nine-month point was 12.4%, pointing to strong full-year revenue results for the industry and a solid footing for 2022. The heavy emphasis on collection efforts - one of the silver linings of the pandemic - has continued at pace in 2021 with yet greater discipline around billing and collections, resulting in a 2.1% shortening of the collection cycle through the first nine months. We expect that, for the most part, firms will continue to focus on collections through the fourth quarter, pointing to strong full-year revenue results.

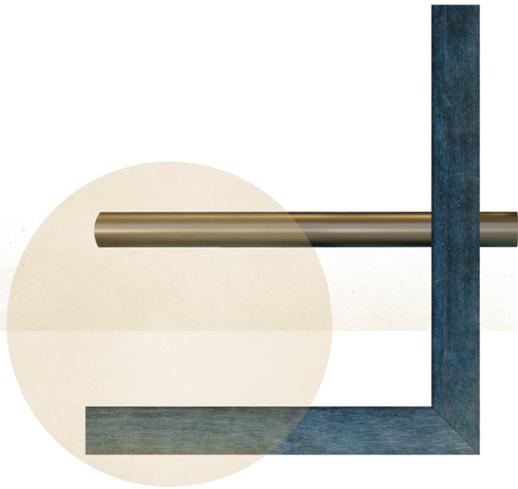
All indications suggest that the strong full-year revenue performance we expect to see will more than absorb expense increases. Overall, we expect 2021 to be one of the strongest years on record for average law firm industry PPEP growth.

If we study the results by revenue size, we note that all segments saw strong performance in 2021, unlike the broader trend during the past decade. Each segment reported solid demand growth and double-digit revenue growth through the first nine months of 2021. Just on the measure of demand, (as illustrated by chart 1), every market segment saw a majority of firms report growth. This is likely to be the result of the aberrational base year created by the disruption of COVID-19.

CHART 1. DEMAND DISPERSION BY AM LAW SEGMENT 9MO'20-9MO'21



Source: Citi Flash Survey © Citibank, N.A., October, 2021



Am Law 1-50 firms outperformed the rest of the industry, with demand growth of 8.4% and lawyer rate growth of 6.5%, driving 16.4% revenue growth. Despite some headcount growth, it was not enough to keep pace with the strong growth in demand, leading to 7.6% productivity growth - and illustrating the burnout issue so many already highly productive firms have experienced. As an illustration of the talent war's impact on expenses, this segment saw 16.5% growth in compensation expenses, driving 9.6% growth in total expenses. While Am Law 1-50 firms have experienced greater expense pressure than all other segments, their strong revenue performance through the first nine months, and the 14.5% inventory growth, positions these firms well for strong full-year revenue growth, more than absorbing this expense pressure.

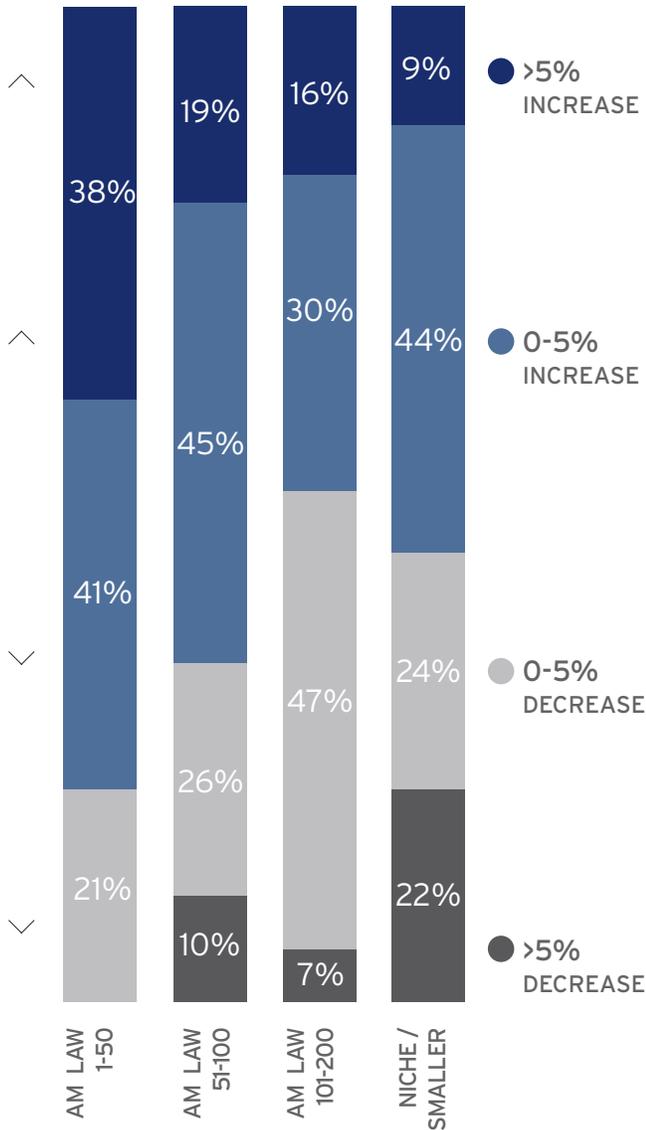
We saw strong performance by Am Law 51-100 firms, reporting demand growth of 4.4% and 10.7% revenue growth. These firms also saw comparatively moderate expense growth of 5.1%, driven largely by a 9.5% increase in compensation expenses despite just 0.2% headcount growth. This, again, illustrates the compensation expense pressure caused by the talent war. With 9.9% inventory growth, Am Law 51-100 firms, like the largest firms, are likely to see strong full-year revenue growth more than absorb expense pressure.

Am Law Second Hundred firms saw 2.5% demand growth and 10.7% revenue growth. While this demand growth trails the performance of larger firms, we would note that this is a stronger result than recent years, with a majority of firms reporting growth.

Part of why Am Law Second Hundred firms have seen strong revenue growth is a 6.6% shortening of the collection cycle, leaving them with 3.4% inventory growth for the first nine months. Like larger firms, it appears that their revenue growth will more than absorb the 5.4% growth in expenses. However, they too are dealing with strong compensation expense pressures, with compensation expenses up 8.8% despite being the only segment to report headcount contraction (-0.9%).

Firms outside of the Am Law 200 saw the strongest revenue growth (at 16.6%) across all segments, though this was partially due to the forgiveness of Paycheck Protection Program (PPP) loans, which count as revenue. If we removed those forgiven PPP loans, revenue would be up 13.6% - still a very strong result. This revenue growth was driven by solid growth in demand and rates, together with a 6.1% shortening of the collection cycle. Meanwhile, with a strong 1.7% growth in headcount, expense growth of 5.6% was largely driven by compensation expense growth. Looking ahead, even with the collection effort so far, these firms saw 9.5% inventory growth at the nine-

CHART 2. DEMAND DISPERSION BY AM LAW SEGMENT 9MO'19-9MO'21 COMPOUND ANNUAL GROWTH RATE



month point, signaling a strong year-end.

While each segment has seen a favorable demand environment this year, we would note that a comparison against 2019 performance³ creates a different picture. While there are firms who have seen average annual growth compared with the first nine months of a more normal 2019, there is greater dispersion than we see in a comparison to the first nine months of 2020. This is particularly so within the Am Law Second Hundred and niche/smaller firms (as charts 1 and 2 illustrate). This dispersion will likely continue to drive consolidation in 2022, as we discuss later in this report.

Source: Citi Flash Survey © Citibank N.A., October 2021

³ This is based on the compound annual growth rate (CAGR) for the period 9mo'19-9mo'21.

Part II: Looking ahead to 2022

CONTENTS

- A Citi Global Wealth's economic outlook
- B Law firm industry outlook for 2022
- C Key trends to watch in 2022



A. Citi Global Wealth's economic outlook

As 2022 approaches, the end of COVID-19 is coming into view with Citi Global Wealth forecasting a multi-year economic expansion. Several vaccines with high efficacy levels are now available and even pills have been successfully tested⁴. While 2021 saw a select few nations such as the US, UK, United Arab Emirates and Israel post commendable vaccination rates, we expect so-called vaccine laggards in the rest of the world to catch up.

As noted in Citi's latest economic forecasts⁵, traveling into the post-COVID world would likely see an uptick in global economic growth in 2022. However, the rate of economic growth is unlikely to be as high as 2021. Global GDP growth is currently projected to exceed 5.5% for 2021 but will likely fall below 4% in 2022 (see *table 1*). US economic growth, which outstripped global growth in recent quarters, is projected at 3.5% in 2022, down from a 2021 projection of 5.5%. The UK and European Union are also projected to have more muted growth.

	2020	2021	2022
China	2.4	8.0	4.5
US	-3.4	5.5	3.5
EU	-5.9	4.8	3.9
UK	-9.7	6.0	4.2
Global	-3.2	5.6	3.8

Table 1: Citi Global Wealth GDP Assumptions, October 21, 2021 © Citibank N.A.

China is likely to see an economic correction as well, falling from a projected 8% growth in 2021 to a forecast of 4.5%, given Beijing's need to manage its struggling domestic real estate giant Evergrande⁶ and the situation's potential spillover effect.

In the third and fourth quarters of 2021, many cyclical industries saw a rapid recovery. In the wake of this bounceback, global supply chain disruptions are roiling the delivery of goods everywhere, just as the demand for goods relative to services is peaking. Yet, looking ahead, a normalization for most of the economy is likely in 2022, especially as government stimulus wanes. Near-term shipping costs are very high but are likely to fall, and we can already see delivery times speeding up⁷.

As the economy rebalances, initial price spikes - including for services - will very likely subside in step with the unfolding of a post-COVID normalization during 2022. But holistically speaking, the pandemic has changed the global economy, perhaps forever.

⁴ Looking Through the Market Noise to 2022, CIO Strategy Bulletin, October 3, 2021 <https://www.privatebank.citibank.com/ivc/docs/quadrant/CIOBulletin100321Final.pdf>

⁵ Citi Global Wealth Investments Global Strategy | Quadrant, October 21, 2021 https://www.privatebank.citibank.com/ivc/docs/quadrant/Quadrant_October2021_final2.pdf

⁶ Citi cuts China 2022 GDP forecast to 4.9% on Evergrande spillover, Reuters, September 28, 2021 <https://www.reuters.com/world/china/citi-cuts-china-2022-gdp-forecast-49-evergrande-spillover-2021-09-28/>

⁷ Looking Through the Market Noise to 2022, CIO Strategy Bulletin, October 3, 2021 <https://www.privatebank.citibank.com/ivc/docs/quadrant/CIOBulletin100321Final.pdf>



Economic activity and investor sentiment will likely reflect this in 2022 and beyond. We see this approaching economic horizon colored by several ‘Unstoppable Trends’⁸.

The first of these is the continued shift in economic power toward Asia and the business opportunities this is likely to bring, especially as China transitions from a manufacturing-led economy to a service sector-oriented one. The second is digitization, which has taken a great leap forward during the pandemic. Our favored areas in the opportunities spectrum of digitization include e-commerce, online gaming, streaming entertainment, cybersecurity, telehealth, mobility, connected cars, factories of the future, robotic surgery and fintech.

We believe innovation in healthcare to be the third unstoppable trend. Advances made during the pandemic could prove transformative for patient care and economic activity, with medical technology, biotechnology, life sciences and pharmaceuticals leading the way. Reshaping of the real estate market is our fourth unstoppable trend, albeit one that is still in a flux, as we adjust to our new post-pandemic way of life. For commercial and residential real estate, the pandemic has created very different challenges than other crises from the past. Whereas some segments within this asset class have suffered unprecedented difficulties (e.g., hospitality and retail), others have managed to thrive (e.g., warehouses). We believe that the divergent fortunes of various segments of real estate will shape our future.

Finally, the “greening” and transformation of energy is our fifth unstoppable trend. Traditional energy use and investments suffered in the wake of the pandemic while alternative energy advanced. Despite a recent reversal in the fourth quarter of 2021 with rising near-term demand for coal, oil and natural gas, we expect further progress for renewable alternatives and energy efficiency⁹. This approaching horizon offers a multitude of opportunities for the law firm industry.

⁸ Truly Unstoppable trends perform well even during a pandemic, Citi Private Bank Mid-Year Outlook 2021, Page 18
https://www.privatebank.citibank.com/newcpb-media/media/documents/outlook/Mid_Year_Outlook_2020_FINAL.pdf

⁹ Unstoppable trends: Examining the future of energy, Office of Innovation at Citi Private Bank, September 2021,
<https://www.privatebank.citibank.com/newcpb-media/media/documents/insights/Office-of-Innovation-Examining-the-Future-of-Energy.pdf>

B. Law firm industry outlook for 2022

The positive demand environment seen in 2021 has created many opportunities for the law firm industry. The post-COVID reshaping of the global economy toward 'Unstoppable Trends' and the resulting macroeconomic climate will continue to strengthen the hands of many in the industry.

In this buoyant market, firms are focused on pursuing growth in 2022. There are two key parts to growth strategies of leading firms: first, they are planning to build on their core capabilities and do more with existing clients; and second, they are focused on selectively diversifying into other practices where it makes sense.

To grow, we expect that many firms will continue to leverage what they see as a "flight to quality" in the industry. Emphasizing the strong brand equity that they have built will enable them to attract clients, and their track record of strong financial performance in recent years, together with their platform and culture, will enable them to continue to attract top talent. We have noted this strategy among high-performing firms who have managed to grow both their PPEP and their equity partnership, further separating themselves from the rest of the industry. That said, for any firm, and even for the strongest performing firms, how to execute their growth strategy and integrate new talent will be key challenges.

The biggest challenge for firms in this extraordinary growth environment is how to win the war for talent. No longer just a war for partner talent, firms increasingly face the challenge of how to attract and retain associate talent in a fiercely competitive market, where burnout is a real issue and COVID has shifted people's mindsets around work/life balance and career aspirations.

As the law firm industry transitions to a hybrid work model, such a shift creates another challenge and we see understandable concern on the part of many firms working toward making sure it is a successful transition. Beyond addressing how best to develop associates and maintain a strong and distinctive culture, we expect to see continued focus on how to use technology to support the hybrid model. Indeed, more broadly, we expect to see continued focus on operational efficiencies to control costs and increase revenue and profitability.

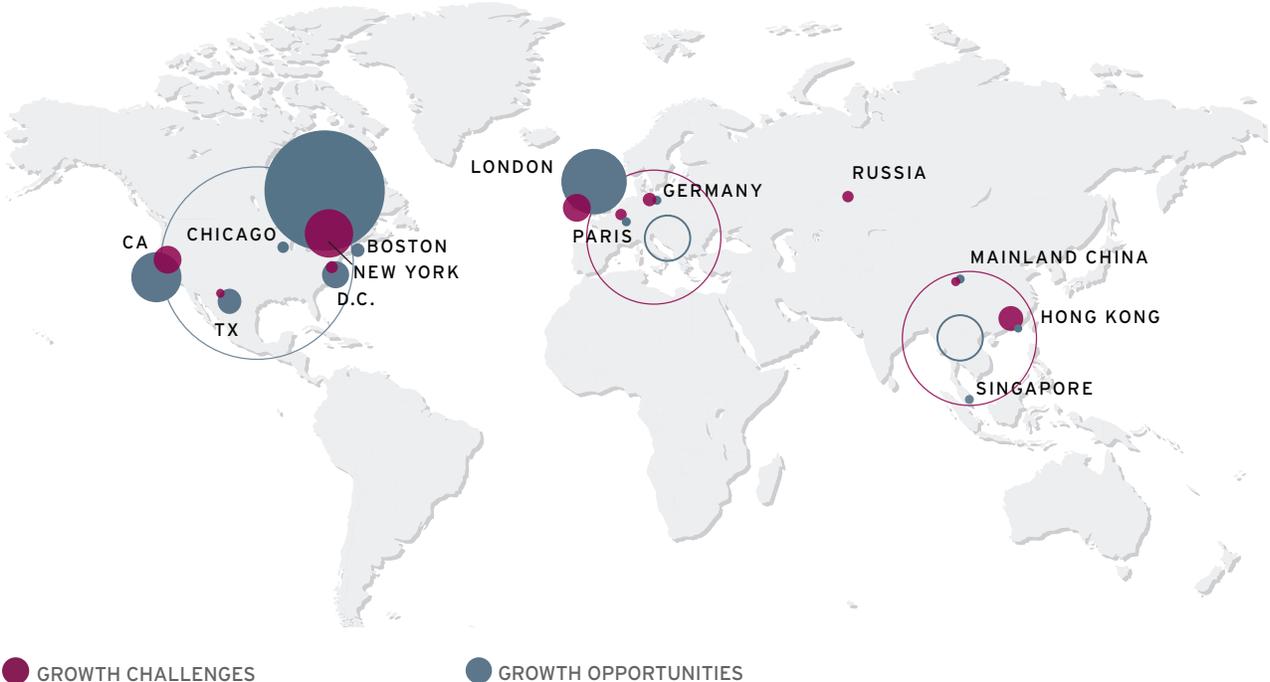
We expect that demand will continue to be strong in 2022, albeit at more modest growth levels than seen in 2021. We also anticipate accelerated expense growth, as firms return to the office in some form and we see a gradual return of travel and business development expenses, as well as rising infrastructure spending. The inevitable pressure on expenses will make the focus on revenue growth and operational efficiencies imperative.

GROWTH OPPORTUNITIES AND CHALLENGES BY REGION

Based on the Citi Law Firm Leaders Survey conducted in mid-2021 (as illustrated in chart 3), the law firm industry is betting on the US as the primary driver of demand growth in the year ahead. Yet again, the only market outside of the US marked as an area of strong growth is London, UK. Some firms have become more optimistic about their Asian and European practices, as the rest of the global economy catches up with the US. That said, more firms view these regions as challenges.

Within the US, New York is viewed as the biggest growth market, followed by Northern California, Washington DC and Texas. Chicago and Boston are also seen as growth markets. Excluding the UK, elsewhere in Europe, firms envisage some growth in France and Germany, though the challenges are greater. Moscow, Russia remains challenged too.

CHART 3. GROWTH OPPORTUNITIES AND CHALLENGES BY REGION THROUGH 2022

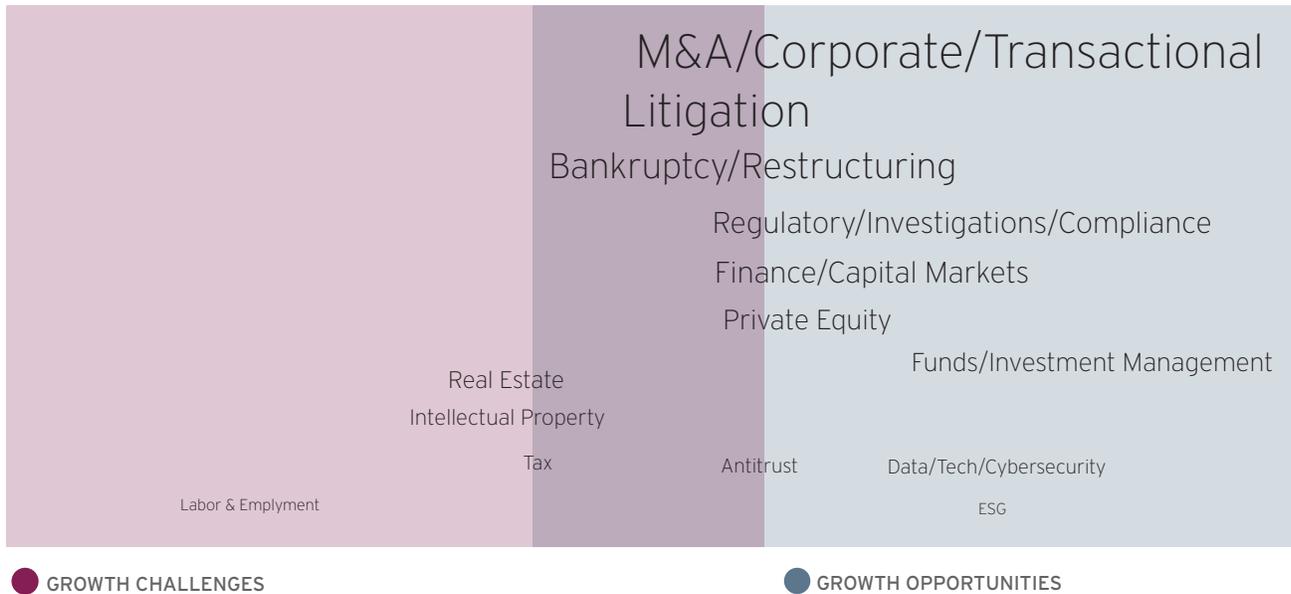


Source: Citi Law Firm Leaders Survey © Citibank, N.A., July, 2021

Optimism around Asian operations is tempered by challenges, especially in the case of China and Hong Kong. Chinese firms are growing faster than they ever have and are starting to gradually expand out of their home market. Meanwhile, Singapore has become even more of an opportunity than it was a year or two ago as its government flags the city-state’s pro-business credentials in a post-COVID world by positioning it as a technology hub. The political situation in Hong Kong is also seen to be helping the Singapore law firm industry on an upward trajectory as many firms consider shifting their regional base from the former to the latter.

Canada and Australia continue to see strong law firm performance. Meanwhile, law firms in these markets are also experiencing a talent shortage. The war for talent in Canada and Australia has a unique element, as firms face competition both within and beyond their local markets. In particular, they are seeing US firms with no local presence look to recruit talent in these markets to help address the US talent shortage.

CHART 4. GROWTH OPPORTUNITIES AND CHALLENGES BY PRACTICE THROUGH 2022



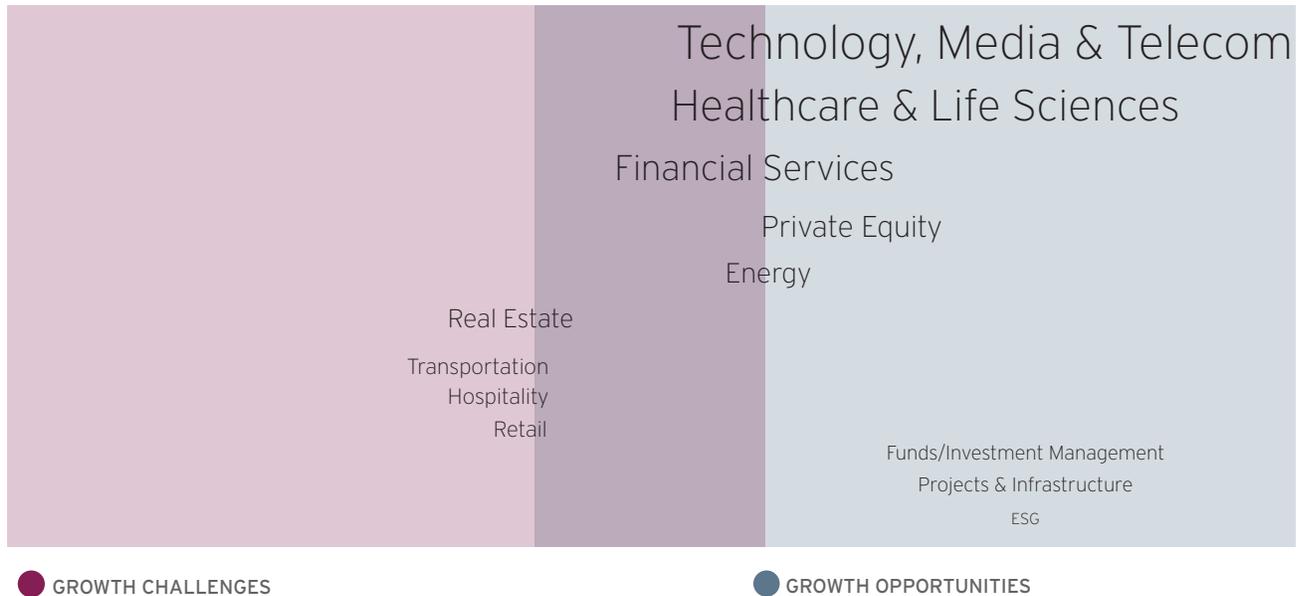
Source: Citi Law Firm Leaders Survey
© Citibank, N.A., July, 2021

Looking at where growth will come from by practice area (as illustrated in chart 4), M&A/corporate/transactional work, especially private equity-backed transactions, is seen as the largest growth driver. Firms also expect to see growth in finance/capital markets and funds/investment management. While there continues to be mixed sentiment about litigation, the majority still see it as a growth

opportunity. In addition, regulatory/investigations and compliance work are also likely to be areas of growth. Data/technology/cybersecurity and environmental, social and governance (ESG) will be practice areas to watch.

We see mixed sentiment around bankruptcy/financial restructuring, given the level of government stimulus. The more challenged markets will likely continue to be real estate, intellectual property, tax and labor and employment.

CHART 5. GROWTH OPPORTUNITIES AND CHALLENGES BY INDUSTRY THROUGH 2022



Source: Citi Law Firm Leaders Survey
© Citibank, N.A., July, 2021

Looking at growth opportunities by industry (as illustrated in chart 5), in line with trends noted over the past few years, the technology, media and telecommunications sector leads the way, with a heavy emphasis on technology sector work in a post-COVID economy. The sector is followed by healthcare and life sciences, financial services, private equity, and energy, including energy innovation and technology work.

On the other hand, real estate is likely to remain challenging for many firms. The same applies to an uncertain climate for transportation (especially aviation), hospitality and retail.

GROWTH THROUGH CONSOLIDATION

Among large firms, we forecast growth to come more through promotions and laterals than through mergers of equals or acquisitions of smaller firms. As we noted earlier, among an anticipated highly active lateral market, we believe the strongest performing firms will continue to leverage their position to attract top talent and further build scale, driving the gap between themselves and the rest of the industry. And while mergers between larger firms are more difficult, the want for larger platforms domestically and internationally may produce some surprise combinations that are currently hard to predict.

Among midsize and smaller firms, we will likely see some activity in mergers of equals and the acquisition of smaller firms.

C. Key trends to watch in 2022

1. GETTING THE HYBRID MODEL RIGHT

The most immediate challenge or opportunity, depending on how firms perceive it, is the phased return to office. The spread of the Delta variant complicated the picture in 2021, but at the time of writing, most firms had put in motion plans for at least a partial return to the office during the fourth quarter. And while in the summer of 2021, the majority of large firms were not requiring vaccination, by the fall, we saw most firms change course and make it a mandatory requirement.

In the Citi Law Firm Leaders Survey, many law firm leaders expressed a desire to have their lawyers back in the office at least three days per week, with three days being the most likely. Indeed, several firms have clearly noted that they need associates in the office at least three days per week to enable their development. For staff, the views are more mixed depending on their role in the firm.

Firms are also grappling with how to make it work when some people are in while others are remote. This gradual but steady transition from full-remote working will likely pose challenges for firms in terms of their culture and ability to develop people. How firms address these challenges will have implications for career development and talent retention, as well as possible client retention.

As firms settle on the right mix of in-office and remote work, there are three main considerations for law firm leaders: (1) what is best for the firm; (2) what is best for clients; and (3) what lawyers and staff want. Given the current talent war, the dominant consideration this year has been point (3). However, we would stress that all three considerations are important for the long-term success of any firm.



On the topic of building a strong culture under a hybrid model, firms have talked to us about the damage a fully remote environment has caused to personal relationships and a sense of belonging. This is playing out in the ease with which lawyers - from partners to associates - have moved firms during the pandemic, often with little inkling of their impending departure.

In their bid to build and maintain a strong culture in a hybrid model, firms talk about the need to be intentional. We expect that firms will continue to place a heavy emphasis on maintaining frequent and transparent communication, right through the firm and beginning with its leadership. This extends beyond formal meetings to informal check-ins. In these communications, emphasizing shared purpose, goals and values will be an important element in the drive to maintain strong, cohesive and distinctive cultures under a hybrid model. Making people feel connected, from formal social events to continued personal outreach, will also be key.

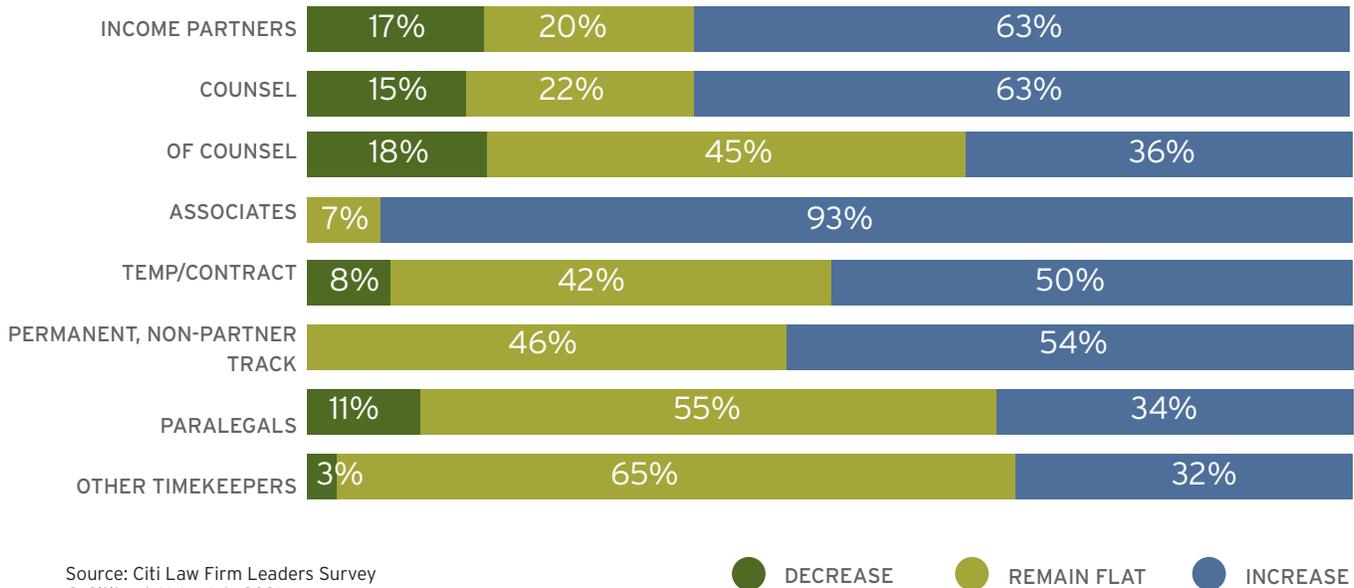
A fully remote model could not have succeeded without the technology investments firms made during the pandemic. Indeed, some firms noted that the remote environment and the dependence on technology during the pandemic actually broke down barriers. We anticipate that firms will continue to look for ways that technology can enable people who are remote and in-office to work together seamlessly.

Developing associates in a hybrid model is likely to be a huge challenge in 2022, and how to address it will be a priority for every firm. As with the attention given to maintaining a strong and cohesive culture, firms will need to be intentional in how they approach developing their people. This may involve getting partners and associates in on the same days and making time in the office focused on collaboration. Whichever way firms structure their hybrid model, their focus on how best to assign work, provide feedback, and mentor associates will be critical in getting the combination of remote and in-office work right.

2. LEVERAGE GROWTH

Growth in leverage has been one of the key industry trends over the past several years, and we expect to see this trend continue in 2022. Looking at leverage growth trends over the past five years, in the Citi Law Firm Leaders Survey, we saw a strong emphasis on increasing the number of income partners (81% of firms), counsel (73% of firms) and associates (80% of firms). Looking ahead (*as illustrated in chart 6*), we see a clear focus on associate growth, with 93% of firms planning to grow their associate headcount. And while a majority of the firms plan to increase the number of income partners and counsel, we see the proportion of firms projecting growth in these senior lawyers moderating to 63% of firms.

CHART 6. PROJECTED LEVERAGE GROWTH BY CATEGORY: 2022 VS. 2020



The focus on associate growth in 2022 makes the challenge of attracting and retaining associates even more acute. Firms have told us that the current market dynamic strongly favors the candidates. In the wake of the shift in attitudes caused by the COVID-19 pandemic, flexibility in work arrangements, promotion opportunities and potential for internal moves to a different practice area also matter, even as compensation still plays a major role in attracting talent.

On the subject of associate retention, 78% of firms reported higher attrition levels in 2021 compared with 2019 in the Citi Law Firm Leaders Survey. The primary issue remains to be burnout and trying to get associates' work/life balance right. Meanwhile, the shift in the competitive landscape in 2021 has also created opportunities for associates to move, not just to other firms, but also to inhouse positions or out of the industry altogether.

We would note that the mobility of associates is particularly easy among first- and second-year associates, whose main work experience has been via videoconferencing. In missing out on in-office work at this critical stage of their law careers, they have also missed out on developing close relationships with their colleagues, making it much easier to move to another firm. Among mid- and senior-level associates, if they are unclear on their career prospects at their current firm, they too are fair game. And in a post-COVID world, where some people want to work remotely while others prefer being in the office, firms face the challenge of how to strike the right balance of when and how frequently associates should come to the office.

3. EQUITY PARTNER GROWTH

We expect to see equity partner growth pick up steam, particularly among large firms. This is a departure from the wide dispersion seen across the industry in recent years. For example, in the Citi Law Firm Leaders Survey, while a small majority of large firms have grown their equity partner headcount over the past five years,

over 40% have seen a reduction. In a clear signal of firms' optimistic growth outlook for 2022, nearly 75% of those large firms plan to grow their equity partner headcount. As we noted earlier, this uptick is likely to come from lateral hires and internal promotions.

Examining the success rates for both over the past five years, 75% report that their promoted equity partners have been successful or very successful. It is a higher proportion than the 61% success rate for laterals, but we have learned over the years that success rates are typically higher for promotions. That is mainly because internal promotions are a known quantity and tend to be a good cultural fit.

Still, where firms have seen an improvement in the success rate of their promotions over the past five years, topping the list was better development of candidates, followed by greater scrutiny in selecting the candidates. A focus on making promotion decisions that aligned with the firm's business strategy and succession planning - with more clarity and transparency around what is expected of partners - were other notable factors.

Looking at the lateral rate of success, nearly 90% of firms told us that they have seen an improvement in their rate of success over the past five years. The main reasons for this include more structured integration and improved due diligence. Many firms have also noted that their stronger brand name and financial performance helped attract better candidates. In addition, a greater focus on strategic alignment in lateral hiring decisions and a faster hiring process have also helped attract better laterals in a hugely competitive market.

With 83% of firms reporting an increase in their equity partners being approached to move laterally over the past five years, we have also seen many firms make changes to the compensation model to retain and attract talent. Citi survey data shows that the ratio of highest to lowest compensation has expanded, from a ratio of 3.9:1 to 4.4:1¹⁰.

¹⁰ Based on an Annual Survey sample of 43 large law firms.

While some firms have made no changes, others have shifted to a more merit-based system. In addition to widening the range of equity partner compensation, firms may have enhanced the bonus pool, enabled more upward mobility of high-performing partners and placed a greater focus on practice profitability. We see the introduction of more transparency and clarity in the partner compensation process for many firms. We have also seen further modifications made to some of the few lockstep models.

Looking ahead to 2022, we are likely to see a mix in how firms approach equity partner compensation, with almost a near-even split between firms who will expand the compensation range even further or stay at levels where they are at now. We will continue to watch this split trend with interest, given the anticipated increase in lateral activity (and poaching).

4. CONTINUED FOCUS ON OPERATIONAL EFFICIENCIES

We expect to see the heightened focus on both revenue and expense-related operational efficiencies to continue in 2022. The focus on operational efficiency was one of the major factors behind the strong profitability performance that we saw across the industry in 2020 and remained an important factor in 2021.

Managing overhead expense growth was key, as was a renewed discipline around billing and collections. And technology investments firms made in recent years essentially enabled this industry to operate throughout the pandemic. We expect firms to continue looking for more operational efficiency opportunities in 2022 by focusing on the priorities discussed below.

Rethinking space: The top priority across firms is rethinking their office space. While many large firms have told us in the Citi Law Firm Leaders Survey that they plan to reduce their square footage as leases come up for renewal, around one-third are still choosing not to reduce their space, and for some, they

might even expand. In fact, we have seen a number of firms announce new offices and increase their square footage. We also saw that a majority of firms are not planning to move to lower cost locations.

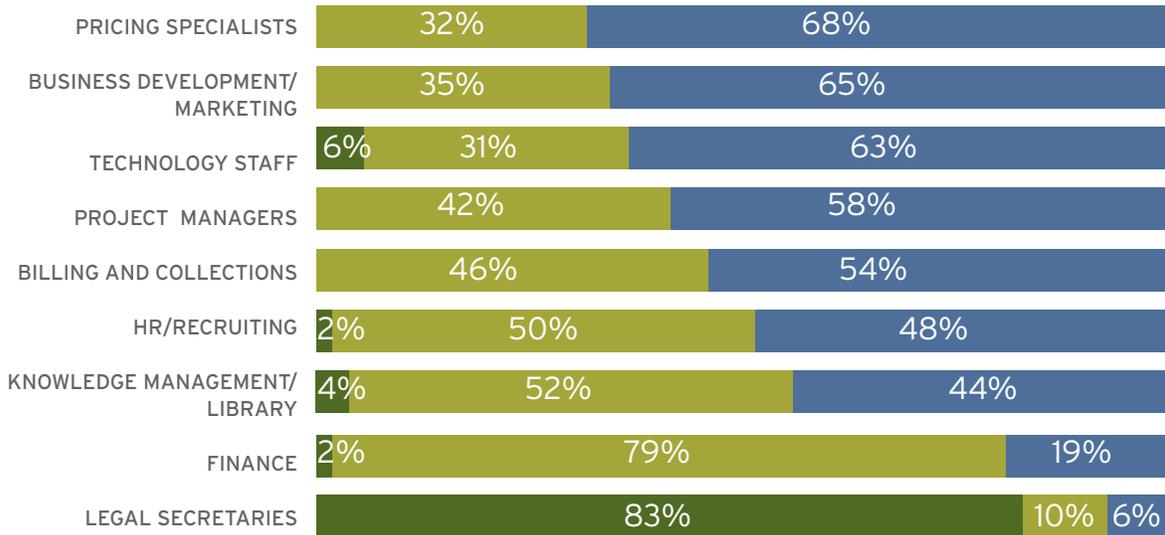
Aside from decisions around size, perhaps the biggest trend to watch will be the reconfiguration of space to encourage collaboration and make space more appealing to draw people back into the office. Our sense is that hoteling will not become a broad trend and individual offices will remain, albeit perhaps smaller. On the other hand, we expect to see larger collaborative spaces.

Deploying more technology, especially practice management tools: As we noted in our last Client Advisory¹¹, this industry could not have switched so successfully to a remote work environment had it not been for the technology investments made in recent years. We see that our clients widely acknowledge this and have a greater appetite for further investment in technology that enables their businesses to grow. Aside from continued use of videoconferencing tools, we expect to see greater investment in practice tools to help drive greater efficiency. These include systems that support knowledge management, client relationship management, billing and collections, and contribution analytics.

Reconfiguring professional staff leverage: One of the key operational efficiency trends through 2020 and 2021 has been the acceleration of a longer trend to reduce secretarial support at firms. We expect this to continue into 2022 (*as illustrated in chart 7*), delivering further expense savings to firms.

¹¹ 2021 Citi Hildebrandt Client Advisory, December 1, 2020
<https://www.privatebank.citibank.com/newcpb-media/media/documents/insights/2021-Citi-Hildebrandt-Client-Advisory.pdf>

CHART 7. PROJECTED LEVERAGE GROWTH BY STAFF CATEGORY: 2022 VS. 2020



Source: Citi Law Firm Leaders Survey
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● DECREASE ● REMAIN FLAT ● INCREASE

Meanwhile, firms are likely to see growth in pricing specialists, business development professionals and technology staff, as well as project managers and billing and collections teams. Many of these roles are likely to cost more than secretarial staff. This means that even for firms planning to reduce their overall professional staff leverage, they are likely to see an increase in the overall cost of professional staff.

Investing in business development and less travel:

Beyond investing in larger business development teams, we anticipate firms continuing to invest in business development efforts, particularly as we return to a more normal world, to support their growth strategies. That said, given that law firms were able to meet with clients through video during the pandemic, we also expect that firms will be more mindful about when they need to travel versus using videoconferencing.

5. CONTINUED GROWTH IN ALTERNATIVE FEE ARRANGEMENTS

We expect to see some growth in alternative fee arrangements (AFAs), though it is likely to remain a relatively small proportion of law firms' revenue. We saw in the Citi Law Firm Leaders Survey that during 2015 to 2020, AFAs as a proportion of revenue grew from 16.3% to 19.8%. In 2021, that proportion is projected to grow to 20.8%, with three-quarters of large firms expecting further growth in 2022.

Perhaps of greater significance, behind the averages, we see an expanding number of firms reporting more than 20% of their revenue coming from AFAs. In 2015, just 25% of large firms saw AFAs greater than 20% of revenue. By 2021, the percentage had grown to 35% of large firms. For those firms, the focus on operational efficiencies as a means of improving realization and profitability is likely to be even greater than the broader industry.

Diversity, equity and inclusion

We continue to see the law firm industry invest heavily in diversity, equity and inclusion (DEI) efforts. In 2021, Citi studied DEI efforts among a group of large law firms¹². We asked firms to report on gender, race and ethnicity levels in 2017 and 2020 to identify any shifts that have occurred since DEI reporting became more prevalent in the law firm industry. In addition to capturing diversity levels, we asked firms to describe their key DEI challenges, successes and priorities through 2022.

Our study showed increased racial and gender diversity between 2017 and 2020 across large firms, reflecting the many strides law firms have continued to make in their DEI efforts over the past few years.

Among areas of success, firms highlighted their efforts in promoting and recruiting diverse talent. For example, firms noted their mentoring initiatives designed to help retain and promote diverse talent into senior leadership roles. They have also established more committees and groups to focus on DEI at their firms.

With the continued strong focus on DEI, several firms noted their attainment of Mansfield Rule Certification¹³ as a significant milestone. On the other hand, while law firm leaders described their commitment to ensuring that DEI strategies are implemented and adopted across all levels of the firm, sentiment is mixed around how successful these efforts have been. We also saw that firms have had a mix of experiences around developing and implementing DEI metrics. And while firms have seen greater success in recruitment of diverse candidates, topping the list of challenges they face is retention of diverse talent.

Looking ahead to 2022, firms told us that their key priorities will be to continue focusing on their recruitment, mentoring, promotion and retention of diverse lawyers. They will continue to invest heavily in executing their firm DEI strategies, with DEI training a large part of their efforts. To ensure DEI remains a priority at their firms, 86% of survey participants reported that such efforts are part of the key performance indicators (KPIs) in partners' compensation review. For the 14% who said it was not explicitly stipulated as a KPI, half of those firms noted that it is still a consideration in the overall compensation review. We also heard from many law firm leaders that given increasing demands from clients for DEI metrics, firms will continue to collaborate with their clients on developing more meaningful metrics aimed at improving DEI levels.

In studying levels of diversity in 2017 and 2020 among large firms, we were particularly interested in whether there is a relationship between diversity levels and financial performance. We acknowledge that there are many factors influencing financial performance, and it would be very challenging to directly attribute strong financial performance to diversity efforts. That said, our goal was to see if there was any difference in diversity levels among higher performing firms. With this goal in mind, we studied diversity levels at the firms with the highest growth in demand during 2017-20 ("high growth firms") and compared them to the rest of the large firm sample¹⁴.

¹² 46 large firms responded to the DEI questions in the Citi Law Firm Leaders Survey.

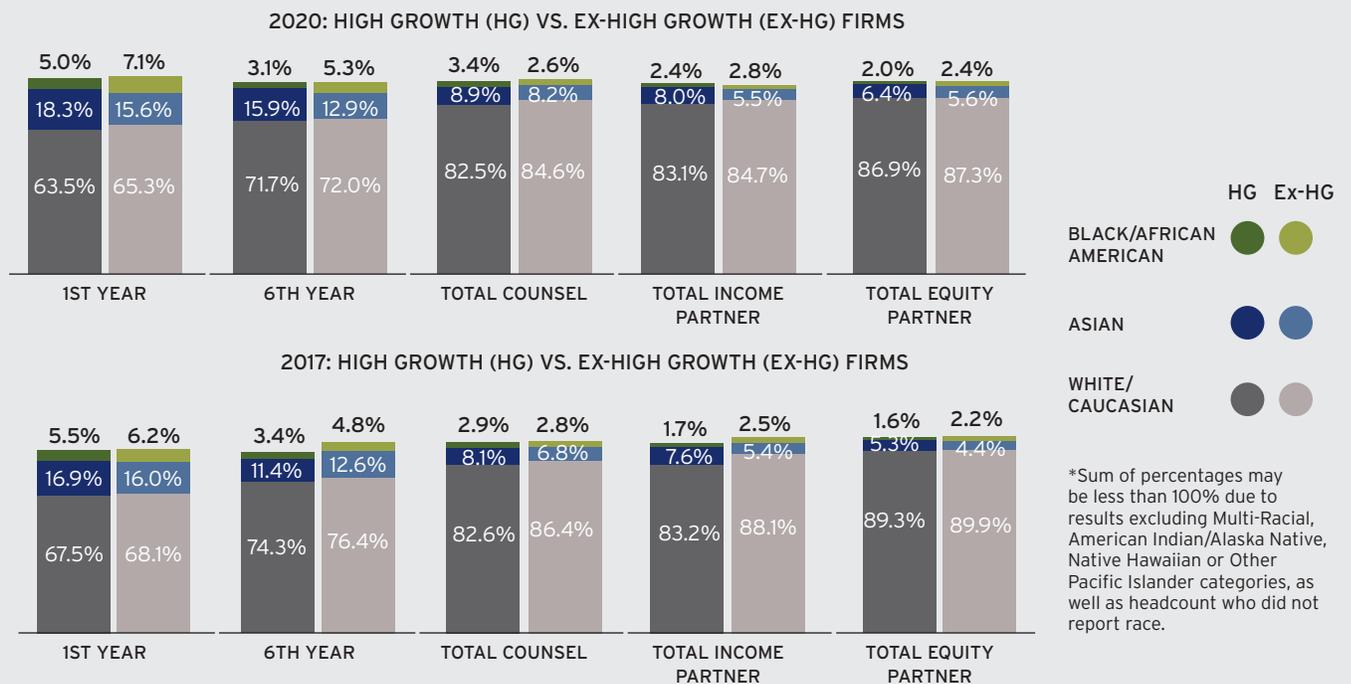
¹³ Mansfield Rule Certification measures whether law firms have affirmatively considered at least 30% women, attorneys of color, LGBTQ+ and lawyers with disabilities for leadership and governance roles, equity partner promotions, formal client pitch opportunities and senior lateral positions.

¹⁴ Using a sample of 37 Am Law 100 firms who participated in both the Annual Survey and the DEI questions in the Citi Law Firm Leaders Survey, we isolated the top quartile of firms with the highest compound annual growth rate of demand for 2016-2020 ("high growth firms") and compared their levels of diversity to the other firms ("ex-high growth firms") in the sample.

Our study showed comparatively greater gender and racial diversity among high growth firms in several areas. On gender diversity, high growth firms had a higher proportion of female counsel and income partners in 2020, having grown their female counsel and income partner ranks at a faster pace than the broader sample during 2017-20. And while they trail the broader sample in associate gender diversity, we saw comparatively stronger growth in the proportion of total female associates during 2017-20, suggesting high growth firms have become even more focused on attraction and retention of female associates. We have also seen some increase in the proportion of female equity partners, although it slightly lags the broader sample, signaling an opportunity.

Looking at racial diversity (as illustrated in chart 8), we noted that high growth firms already saw comparatively greater diversity in 2017 across their associate, counsel, income partner and equity partner ranks, as measured by lower proportions of White/Caucasian lawyers compared to the rest of the sample. This trend continued into 2020, with some further declines in the proportion of White/Caucasian lawyers evident. Among racial minorities, the primary difference was the comparatively higher proportion of Asian lawyers at high growth firms. Indeed, high growth firms continued to increase the proportion of Asian associates and income partners at a faster pace than the broader sample during that period.

CHART 8. RACIAL DIVERSITY: FROM ASSOCIATE TO EQUITY PARTNER



Source: Citi Law Firm Leaders Survey
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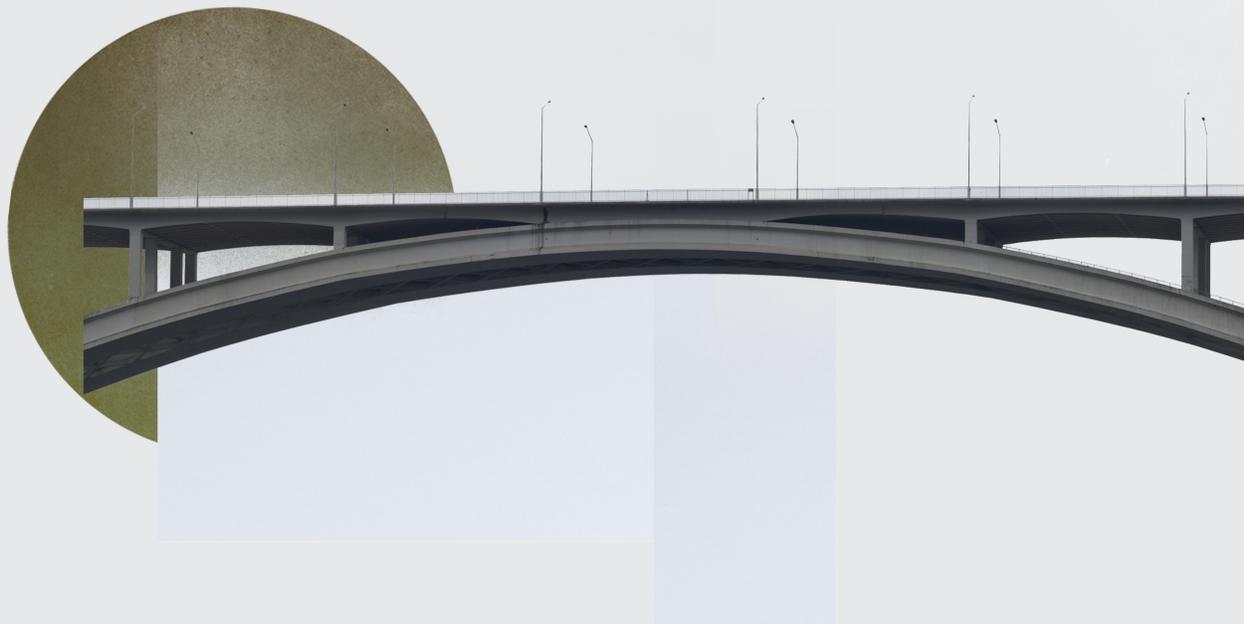
Also of note was the increase in the proportion of Asian first-year associates at high growth firms during 2017-20, signaling strong recruiting efforts by these firms, while the broader sample saw a decline. And while high growth firms trail the rest of the sample on absolute numbers of Black/African American lawyers, they saw comparatively higher growth during 2017-20 across Black/African American associates¹⁵, counsel, income partners and equity partners, narrowing the gap to the rest of the sample.

With respect to the proportion of Hispanic lawyers, we noted high growth firms trail the rest of the sample. However, they did see comparatively greater growth in their Hispanic equity partners during 2017-20. High growth firms also saw comparatively more growth in

their first-year Hispanic associates during 2017-20, indicating that recruiting was a focus.

In studying DEI this year, we would note that a big part of the challenge of recruiting diverse lawyers is the availability of diverse law graduates. A major factor in improving DEI at law firms is how to encourage minorities to enroll in law schools and see a career in law as something achievable and desirable.

Considering all that we observe about DEI in the law firm industry, it is clear that law firms are heavily invested in continuing to build on past efforts and share the common goal with clients to continue implementing more DEI in the industry.



¹⁵ Chart 8 shows the proportion of first and sixth year Black/African American associates declining during 2017-20. However, when looking at the total associate population, the proportion of Black/African American associates increases by 0.5% for the high growth firms vs. 0.4% for the ex-high growth firms.

Partner paid-in capital: positioning for growth in 2022

Law firms rely on a balanced mix of debt and equity to finance their operations. A constructive outcome of the shock of the Global Financial Crisis was an effort by many firms to restructure their balance sheets to reduce reliance on bank financing and turn increasingly to their partners to make equity investments in the firm. These efforts “de-risked” the capital structure of many firms.

	DEBT	EQUITY
SHORT-TERM FINANCING	LINE OF CREDIT	UNDISTRIBUTED INCOME
LONG-TERM FINANCING	TERM LOAN	PAID-IN CAPITAL
SOURCE OF CAPITAL	BANK	PARTNER

Table 2: Primary sources of capital for law firms
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Overall, law firms have three primary places to look for capital: partner paid-in capital, undistributed income and bank financing in the form of either term loans or lines of credit (as illustrated in table 2).

Firms source partner paid-in capital to accomplish several objectives, primarily including, but not limited to, supporting certain aspects of firm growth, providing a greater cushion in the event of a business downturn or delays in the collection cycle, and making their partners have “skin in the game,” hopefully incenting “ownership” behaviors in the partners. Indeed, we have seen several firms source capital from income partners as well as equity partners.

Our research suggests that the largest firms have moved most aggressively in recent years to raise partner paid-in capital to support many aspects of growth, ranging from investments in furniture, fixtures and equipment to laterals and practice expansion.

Firms are also projecting generational demographic changes in their equity partner populations to anticipate demands for the return of capital by retiring partners.

And as lawyer leverage has increased during the past decade, this higher leverage has increased the obligation on equity partners to support the firm with capital. Indeed, another consequence of higher leverage is that capital is sourced from a scarcer population.

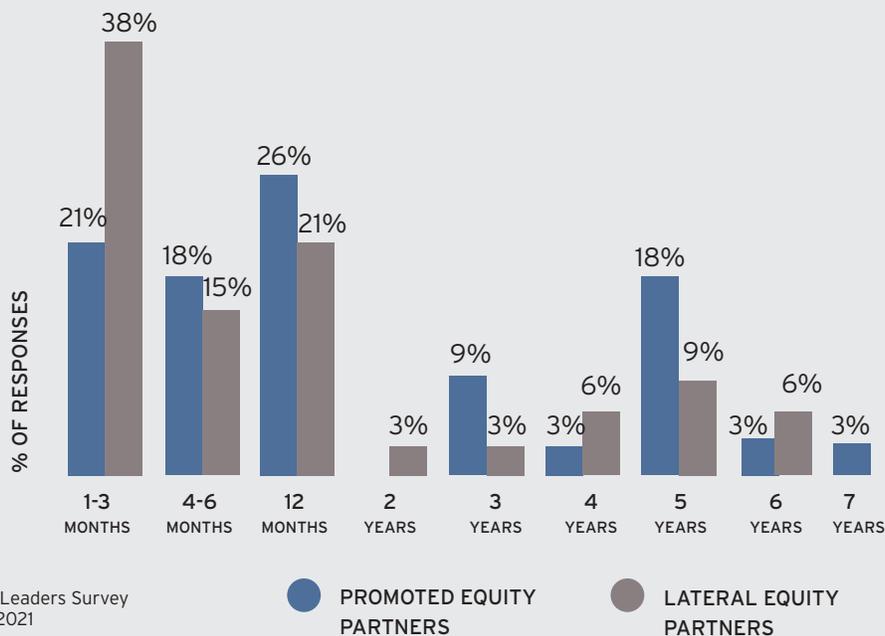
Advances in capital collected per equity partner over the past decade have continued unabated and have accelerated over the past five years. By our estimates, the industry has held partner paid-in capital to a range between 25% to 35% of net income. This metric is often referenced by firms in determining target equity partner capital levels. Available data from 2020, and anticipated 2021 net income growth, point to downward pressure on this metric, even as the dollar amounts of

capital generated have risen.

We have also seen the industry raise the ratio of partner paid-in capital to net fixed assets in anticipation of continuing investments in office space, technology and practice expansion. Fixed asset spending by the industry was rising until 2020, when the COVID-19 pandemic introduced a pause. We now see many firms examining their capital spending plans for the next three to five years to determine how much capital they need to raise for the firm they intend to be.

In addition to partner paid-in capital, we would also note that the use of undistributed income played an important role as a source of short-term capital during 2020 - as many firms deferred the release of 2019 bonuses until just ahead of the extended July 2020 tax filing date. Our research indicates that most firms have reverted back to their 2019 distribution patterns in 2021 and going forward.

CHART 9. TIME ALLOWED FOR EQUITY PARTNERS TO REACH TARGET CAPITAL POSITION



When it comes to partner paid-in capital, many firms distinguish between newly promoted equity partners and laterals. Often, laterals are expected to reach their target capital position on a timeline ahead of the newly promoted partners (as illustrated in chart 9). At other firms, some laterals may be accommodated by allowing them to roll their capital positions at the firms they have left into their destination firm as that capital is returned, easing a potential source of strain on the inbound lateral. In a “white hot” lateral market, conversations around capital policy are likely to intensify.

Conclusion

We have been publishing our Citi Hildebrandt Client Advisory for 15 years, through the good times and bad. We have historically taken the position that the law firm industry is a highly successful and stable one. The success of law firms and their ability to adjust to the global pandemic with almost lightning speed, while seeing such strong performance, illustrates this. We attribute this success both to the investments that firms have made in technology, people and client relationships and to the talent of those leading their firms.

We are optimistic about 2022, but there are challenges ahead. As we return to a more normal environment, it is unlikely that we will see the levels of profit growth recorded in 2021. We also expect to see the return of dispersion, which will likely fuel further consolidation.

As law firms adopt a hybrid model, they will need to navigate through the challenges of how to maintain a strong culture and develop their people effectively. And so long as the war for talent continues across all parts of a law firm - from professional staff to associates to partners - firms will need to balance what is best for their people with what is best for the client and the firm. We are already seeing how the views of law firms around the hybrid model are evolving, driven by the attitudes of their clients and their people. As a result, it is likely that we will see many versions of the hybrid model emerge. Only time will tell.

We also expect greater expense pressure in 2022, with the return of pressure on operating expenses as firms fully adopt a hybrid model. This will make the continued focus on operational efficiency a key priority. And so long as we are in a war for talent, compensation pressure is likely to remain. That said, while compensation goes a long way to attract and retain talent, as will remote/office flexibility, there are other important factors, such as culture, platform and career opportunities. This is best illustrated in the outperformance of certain firms in every segment of

the market, who have built strong brands, cultures and platforms, enabling those firms to attract the best talent and clients and further strengthen their market position.

We hope you find our report to be helpful. We thank you for your continued support and wish you all the best for 2022.



Credits

This publication is co-authored by Citi Private Bank and Hildebrandt Consulting.

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