Crowe Horwath™

ALPMA
Australasian Legal Practice Management Association

Is your firm ready for a stronger financial future?

Crowe Horwath/ALPMA Financial Performance Benchmarking Study of Australian Law Firms

Crowe Horwath is again delighted to partner with the Australasian Legal Practice Management Association (ALPMA) to deliver the annual benchmarking study of Australian law firms' financial performance.

The study has been undertaken using Crowe Horwath's proprietary benchmarking tool, Open Measures (www.openmeasures.com.au), to benchmark the financial health of Australian law firms.

This year we have aimed to help firms anticipate their financial future. In the absence of a crystal ball at what point will you know how many more staff you require to meet new demands? Or, how many new clients can your firm take on before you run into financial stress? By asking a mix of quantitative and qualitative questions we have gained insight into the internal and external factors that influence financial strength and how firms are managing these factors to gain more financial certainty for the future.

Participant profile

The landscape is changing

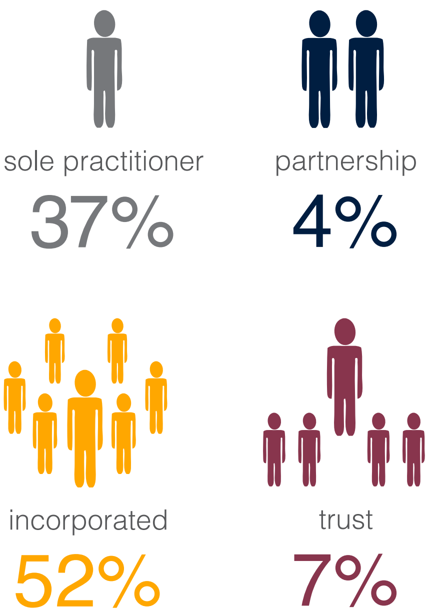
This year 99 law firms took part in the study. Law firms in every state participated, 63% of which were CBD-based.

The structure of the firms taking part shifted significantly this year, reflecting the changing nature of the industry.

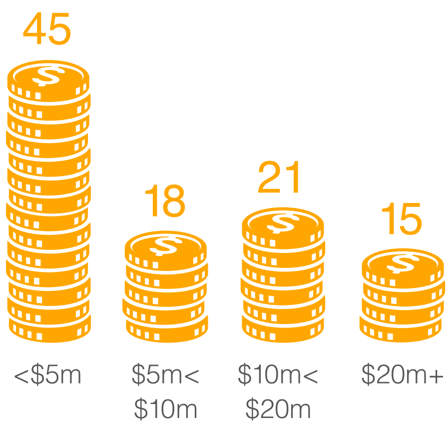
The number of partnerships participating fell from 44% to 4%, while the number of incorporated firms increased 4.8% on last year. This is consistent with the movement to incorporation and supports the proposition that an incorporated practice is now the structure of choice.

The number of sole practitioners taking part increased to 37% from 9% last year, illustrating the other industry-wide trend for lawyers to take advantage of lowering barriers to entry and establish their own firm.

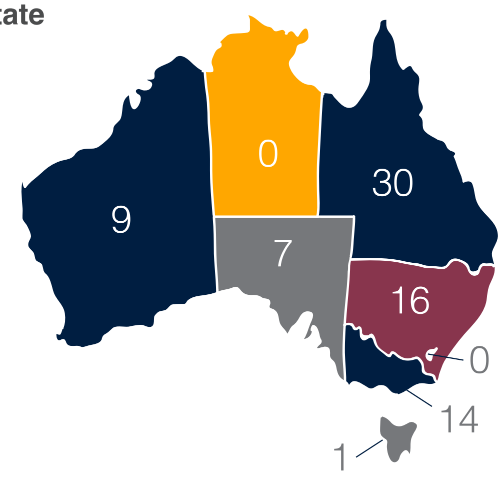
Firm structure



Firm size

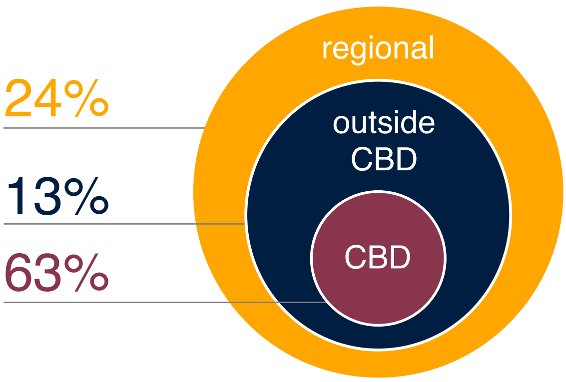


State

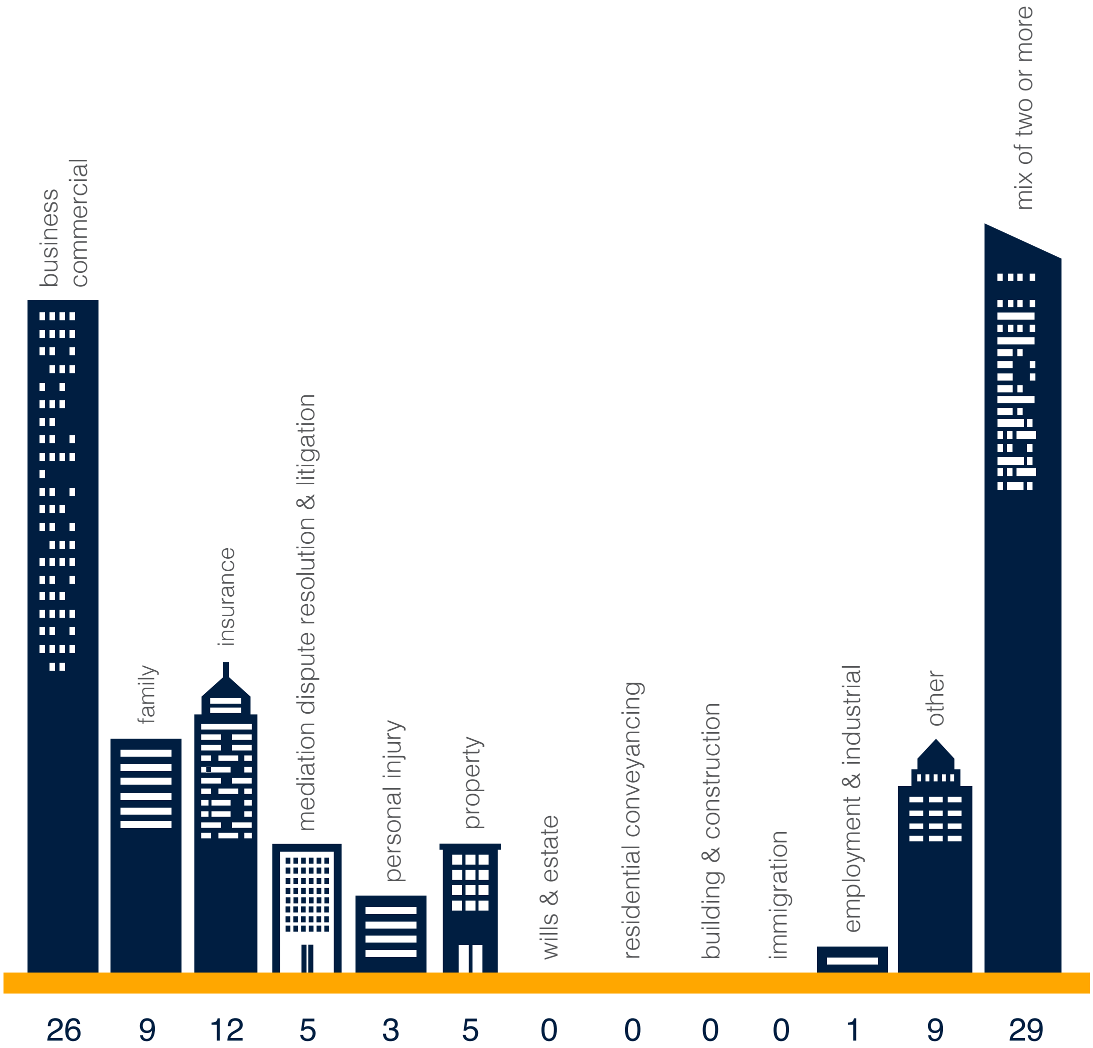


Note: in addition to the 77 Australian firms, 22 survey participants are either National or International firms

Location



Business line



Revenue – taking back control

Whilst participants commented that the business cycle remains slow, this year's study reveals a more optimistic mood.

Each firm expressed a desire to increase revenue by an average of 10.3%, compared to last year, with the larger firms aspiring to growth of just over 20%.

Even so, average revenue per partner fell among all firms, except for those in the $5m<$10m range where the average increased. Indeed, firms of all sizes are grappling with similar issues regarding revenue growth, an important factor in a firm's ability to achieve a more predictable financial future.

On a positive note, the study indicates that some firms are rising to the challenges of the economy by taking control of the internal factors affecting their ability to grow. Unlike 2013, where firms cut costs across the board, firms are now carefully choosing areas for cost savings that will create a more beneficial effect on profitability. Generally, firms are improving cash flow and there are signs that some are opening their purse strings to invest in areas they believe will facilitate growth.

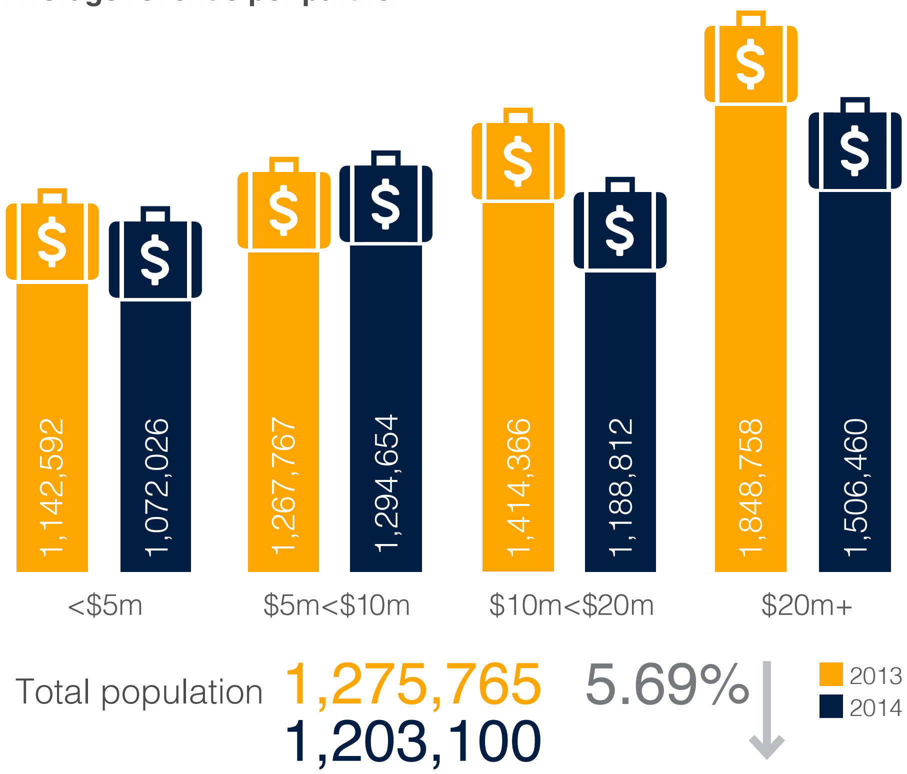
Among the internal factors described by participants as impacting growth is their ability to recruit quality lateral fee earners. Participants describe finding senior lawyers of the right calibre as a challenge, yet an essential strategy to increase revenue.

Consistent with traditional pricing methods within the professional services industry, hourly rates seem to be the predominant factor when determining fees. Being 70%, on average, of the total fee structure across all revenue bands.

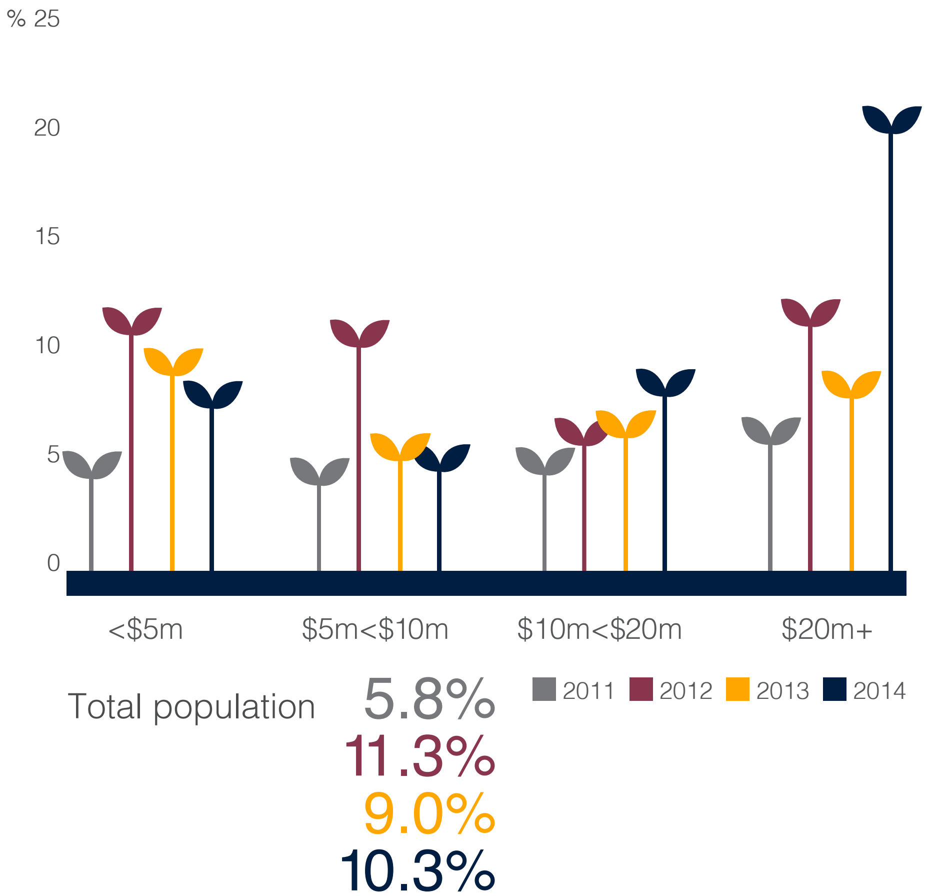
Coupled with this, participants indicated that a greater investment in marketing and business development will be forthcoming this year to support fee earners in attracting new clients, repeat and referral business, and to retain positions on client panels.

The implication of a greater focus on business development and lateral hire is more competition in what is a static marketplace for legal services. This is likely to be especially so for those larger firms aiming for more than 20% growth.

Average revenue per partner



Average growth outlook percentage



Profit – still more from less

The pursuit of leaner operations over the last few years has increased firms' gross profitability to 58.2%, almost on par with 2011, and raised firms' average profitability to 15.1% from 10.1%.

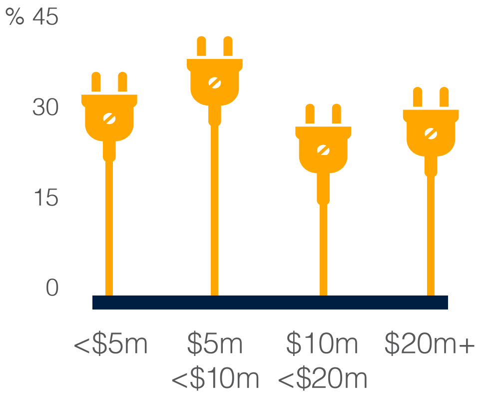
Firms with more than $20m in revenue were the most profitable, averaging close to 19%, perhaps indicating their higher revenue base and economies of scale. Average profit per partner has increased by 2.1% indicating the biggest increase in firms within the $5m<$10m range – an overall 30% increase from 2013.

The reduction in average overhead costs (excluding rent) to 36.1% as a percentage of revenue compared to 40.1% last year also demonstrates how more efficient work practices and reductions in non-essential expenditure are contributing to the more positive outlook among firms.

Despite the less gloomy atmosphere, study participants commented that lack of top line profitable work, poor productivity, underleveraging and pricing pressures are damaging profitability. The study results suggest that although firms have become more prudent in selecting where to reduce direct costs and are preparing to invest in recruitment and marketing, law firm profitability is reliant on cost savings rather than revenue growth. Consequently, there is still some way to go before firms attain greater certainty regarding their financial positions.

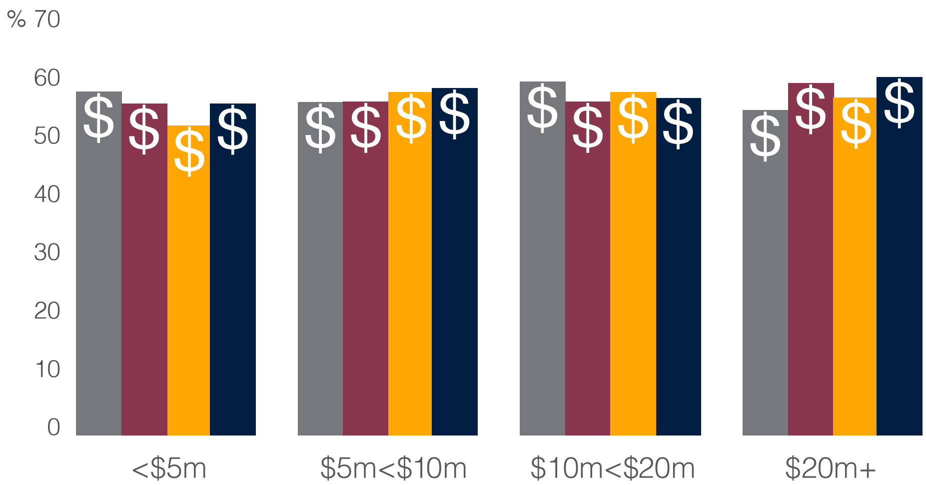
A noteworthy factor consistent through revenue sectors is that over 50% of firms are expecting to see an increase or no change in Partner/Principal remuneration. This is consistent with the growth strategy expectation for firms $20m+ in 2015. Conversely, the majority of firms <$5m expect no change.

Average O/H cost (excl. rent)



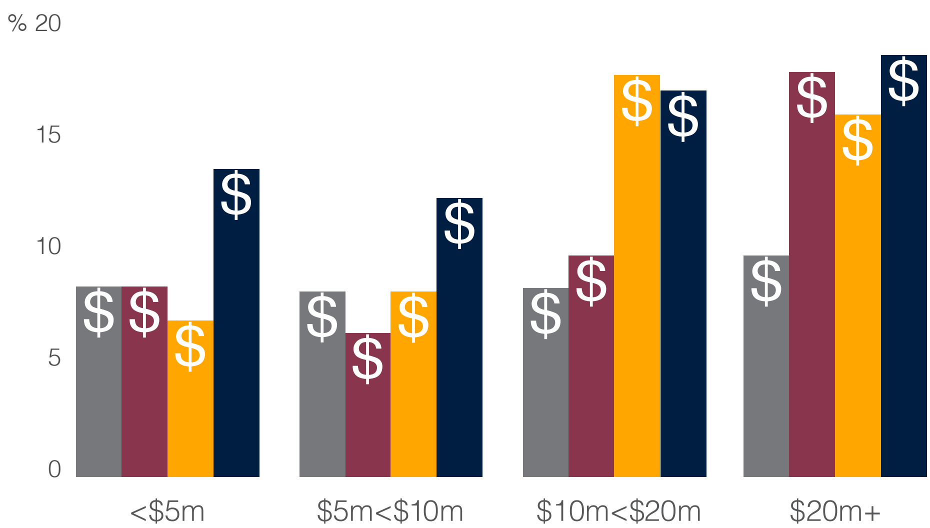
Total population 36.1%

Average GP percentage



Total population 58.7% 57.5% 55.5% 58.2%

Average profitability percentage



Total population average 8.6% 9.4% 10.1% 15.1%

Cash flowing again

All firms in the study took steps to improve profitability (particularly by increasing gross profit) during 2014 and, on average, firms were more effective in managing their cash resources, particularly those with revenues of less than $10m.

The average number of total lock-up days (debtor days + WIP days) reduced to 141, except among the largest firms ($20m+), where debtor days had shown a slight increase from last year. Although their lock-up days are lower than average – 139 days – this was an increase on last year of 15 days.

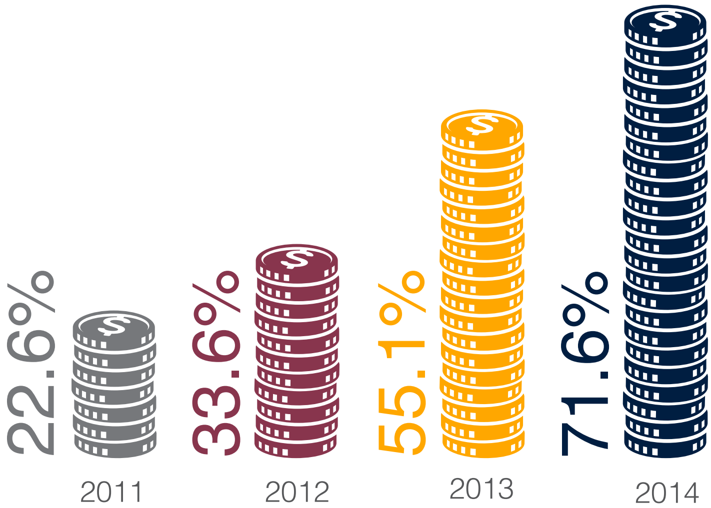
Despite study participants' comments that the business cycle is still weak – implying that clients are slow to pay – law firms' improved cash flow indicates that processes for collecting cash, and perhaps better initial engagement processes, were more influential than the economy on firms' finances during 2014. This is evidenced too by increased gross profitability, as firms take steps to improve internal operating processes.

The average ROCE has improved to 71.6%, demonstrating that firms are increasing profit with less funding. The lesser reliance on bank or partner funding may also indicate better cash flow, although to support less funding, firms have to be even more diligent in managing cash flow.

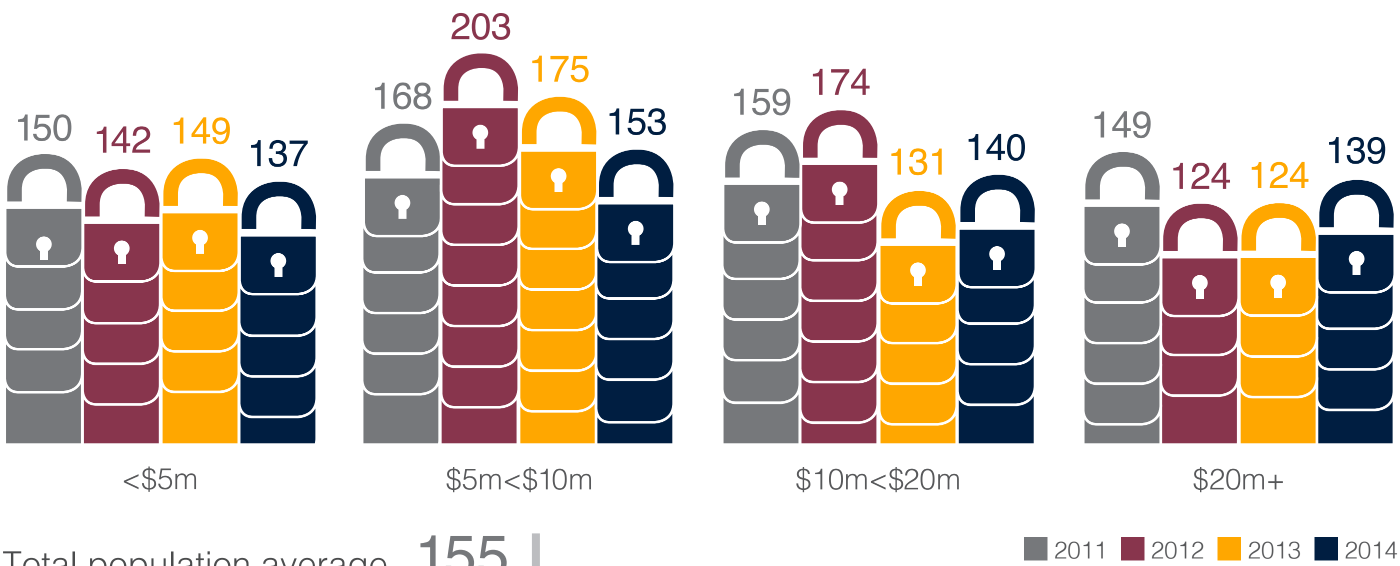
The working capital absorption rate has marginally changed from last year, consistent with lower levels of funding and improved cash flow. This is positive for assisting the firms' ability to invest in marketing and business development and quality lateral hire this year, even though increased competition may be the result.

Firms that can execute business development and good lateral hires in improving business conditions will find financial predictability increases.

Average ROCE percentage



Average lock-up days



Total population average 155 155 147 141

The Crowe Horwath Financial Resilience Index

This index allows us to better understand the relationship between revenue generated from available resources and funding.

By using this index we are able to see that although revenue per partner has dropped, law firms have increased their financial resilience over the last 12 months by a total of 0.46 (20.63%), except for those firms with revenues of more than $20m.

The index shows that in contrast to 2013, the largest firms have been drawing on more financial resources, while smaller firms (less than $20m) have improved their positions overall.

Although participants regarded the market as tough, the study indicates that firms are now choosing to face the challenge of poor revenue growth head on. Unlike 2013 and previous years when firms looked inwards, cutting costs firm-wide in reaction to poor market conditions, 2014 saw firms becoming more circumspect; choosing to reduce costs in areas that return the greatest benefit.

At the same time, firms improved cash flow and the indications are that, in some cases, smaller firms may have repaid bank or partner funding, thereby lowering their financial exposures. It may be, however, that the largest firms have chosen to invest their surplus funds in other avenues to secure their long-term financial positions.

All firms described profitable growth as a business goal. The challenge is that firms need to be in the right financial position for profitable growth. Unless a firm is aware of how its financial position aligns with its business goals, there is no certainty that the goals will be reached. Only when a firm has clarity around its financial position can financial predictability be achieved.

Overall, the aim of this index is to track the efficiency and productivity of firms over time. This is the second year that the index has been implemented and the intention is to track the trends relative to the legal industry, however this will not be possible until coming years.

Many thanks to the law firms that participated in this year's study. Your responses provide important insights and we hope that you find these helpful as your firm continues along the path to financial strength in 2015.

The Crowe Horwath Financial Resilience Index

Year	<$5m	$5m<$10m	$10m<$20m	$20m+	Total population average
2013	2.12	1.89	2.55	2.78	2.23
2014	2.88	2.47	2.64	2.47	2.69

Revenue band averages

Revenue bands	<$5m		$5m<$10m		$10m<$20m		$20m+	
	Min	Max	Min	Max	Min	Max	Min	Max
Range $m	0.59	4.86	5.19	10.00	10.29	19.03	22.69	121.22
Average of GP	56.9%		59.4%		57.7%		61.3%	
Range of average GP	33.2%	74.4%	27.5%	82.9%	45.8%	66.7%	55.6%	69.3%
Average indirect labour cost	17.6%		17.5%		15.5%		17.1%	
Average Revenue per partner $	$1,072,026		$1,294,654		$1,188,812		$1,506,460	
Average total labour cost	60.0%		57.2%		58.1%		55.7%	
Range for total labour cost	39.2%	90.3%	34.4%	87.3%	42.6%	74.5%	40.0%	65.3%
Average rent	6.2%		6.3%		6.9%		7.2%	
Average profitability	13.8%		12.5%		17.3%		18.9%	
Average O/H cost (excl. rent)	36.1%		40.7%		32.0%		34.4%	
Average IT & Communication	3.2%		2.7%		2.9%		3.6%	
Marketing and business development expenses	0.10%	0.9%	0.26%	18.0%	0.03%	5.0%	0.31%	4.0%
Average marketing and business development expenses	2.0%		4.0%		2.0%		2.0%	
Average lock up days	137		153		140		139	
Average working capital absorption	33.2%		35.3%		33.3%		34.4%	
Average ROCE	86.1%		53.3%		60.8%		65.1%	
Average growth outlook	8.9%		5.8%		9.3%		21.3%	
Crowe Horwath Financial Resilience Index	2.88		2.47		2.64		2.47	

Below is a guide to the definitions and calculations used.

Profitability

Measure	Calculation	Description
Gross Contribution %	Gross Profit Contribution / Revenue*	Gross Contribution Margin represents the percentage of revenue left after direct professional staff costs have been covered. This is an important measure as it captures the pricing of work and the productivity of staff.
Indirect Labour Cost %	Indirect Labour Cost / Revenue*	The Indirect Labour Cost percentage indicates the proportion of revenue consumed by non fee earners.
Rent % **O/H cost (excl. rent) %** **IT & Communications %**	Expense / Revenue*	The Expense percentages indicate the proportion of revenue that is allocated to provide firm occupancy, overheads and IT & Communications. These fixed expense commitment are a major cost that is required to be met from gross contribution.
Profitability %	Profit before Interest and Tax / Revenue*	Profitability % represents the operating performance of a firm expressed as a return on revenue after all expenses have been covered (except interest and tax). This is important as this is the amount allocated to the Partners to draw, and pay interest to their funding providers (usually banks).

* Revenue includes WIP movement

Working Capital

Measure	Calculation	Description
Debtor Days Lock-up	Total Debtors (x365) / Revenue	The Debtor Days Lock-up measures the number of days taken to collect outstanding debts. This is one of the most common measures of the effectiveness of cash collection processes.
WIP Days Lock-up	Total WIP (x365) / Revenue	The WIP Lock-up days measures the number of days WIP is held in a period before invoicing. It indicates the time taken to complete matters and to invoice the client.
Working Capital Absorption Rate (%)	Working Capital** / Revenue	The Working Capital Absorption Rate represents the amount invested in working capital as a percentage of revenue. This important ratio indicates the amount of cash that will be absorbed by working capital when the volume of fees increase, provided the working capital drivers remain unchanged. If the working capital absorption rate is greater than the gross contribution percentage then an increase in the volume of fees will generate negative cash flow for the business.

Performance

The Crowe Horwath Financial Resilience Index	Revenue* / (Working Capital + Non-current Assets)	The Crowe Horwath Financial Resilience Index is a measurement of how efficient the firm is – that is, how efficient the generation of revenue is from the capital employed by the firm. This measurement reflects the amount of revenue generated by each dollar of total capital employed. The major drivers are accounts receivable, WIP, accounts payable and non-current assets.
Return on Capital Employed (ROCE) (%)	Profit before Interest and Tax* / (Working Capital + Non-current Assets)	The Return on Capital Employed provides a dynamic measurement linking the operational performance in the profit and loss account with the performance in the balance sheet. It is the relationship between profitability and the total capital employed. It provides insight into the adequacy of the firm's profitability and effectiveness of working capital management.

* Revenue includes WIP movement

** Working Capital is the combination of your WIP and Debtors balances less Creditors.

Assumptions

Notional Salary

Notional Salary for Partners used in this survey for calculation purposes:

- $150,000 for Partners practising in the regional areas.
- $200,000 for Partners practising in the CBD or suburban areas.

About Crowe Horwath

Crowe Horwath Australasia is the largest provider of practical accounting, audit, tax, business and financial advice to individuals and businesses from a comprehensive network of over 100 offices.

Crowe Horwath is part of a global accounting network that delivers high quality audit, tax and advisory services in over 100 countries. We are the relationship that you can count on – large enough to offer a range of expertise and skills – and small enough to provide the personal touch.

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The relationship you can count on

About ALPMA

The Australasian Legal Practice Management Association (ALPMA) is the peak professional body for managers of law firms and legal departments in Australasia. ALPMA provides an authoritative voice on issues relevant to legal practice management.

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