

CommBank Legal Market Pulse

August 2017



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Key insights

Exploring new ideas in a changing market

In this edition of CommBank Legal Market Pulse, we consider how Australia's leading law firms are responding to a rapidly changing market.



Key insights

Welcome to the 2017 edition of CommBank Legal Market Pulse, an in-depth analysis of the trends shaping legal services in Australia.

This year's survey reveals a rapidly evolving legal market, driven by intensifying competitive pressures. Our research shows that top and mid-tier firms continue to feel the effects of subdued revenue growth, margin compression and increasingly demanding clients, with price negotiations and winning new business proving particularly challenging. Yet there is also good news.

Many firms believe Australia's economy is gaining momentum, helping to create better business conditions overall. In fact, our 2017 research reveals a notable improvement in perceptions of current business conditions, with the net confidence reading jumping from -24% to +20% — the first positive result for current conditions in the history of our survey.

This upsurge in confidence is not due to external factors alone. This year's survey suggests many firms are taking control of their own destinies, responding pro-actively and creatively to a changing market by exploring alternative business and pricing models, or partnering with NewLaw firms and outsourcing providers to offer greater value to clients across a range of services.

In this report, we analyse these responses with a focus on the growing impact of NewLaw and alternative business model (ABM) entrants. We also look at the growing pace of investment in digital innovation, and consider whether firms are achieving the return on investment they expect from their technology spend.

While the results are encouraging, they also show that there are still significant opportunities for firms to pursue value-creating innovations and leverage new technologies to their full advantage.

We hope you find this year's report thought-provoking, and we look forward to the opportunity to discuss our insights with you further.

Marc Totaro

National Manager, Professional Services
Business and Private Banking
Commonwealth Bank of Australia

About CommBank Legal Market Pulse

CommBank Legal Market Pulse is a wide-ranging analysis of the Australian legal sector. The report is based on a quantitative survey of CEOs, Managing Partners and other senior leaders, drawn from a cross section of the top 50 law firms around Australia. Forty law firms participated in the survey for this edition, carried out in May 2017 by beaton Research + Consulting. When results are split by tier of firm counts are shown due to small sample sizes. Where a 'don't know' response has been given it is excluded from the chart.

Business Confidence

Net percentage (positive – negative)

	September 2016	August 2017
Now	-24%	20% ↑
Next 12 months	5%	25% ↑
Next 24 months	47%	15% ↓

Profit forecasts

Percentage difference
(forecast results versus budget)

	FY16 versus FY15	FY17 versus FY16
Top-tier firms	2.4%	2.3%
Mid-tier firms	1.6%	1.1%

Top 3 business challenges

Net percentage (easy-challenging)

Negotiating price with clients	-67% ↑
Winning new business	-58% ↓
Competing with other firms	-38% ↑

Firms who see NewLaw as a competitive threat



Top-tier firms

1 out of 8

Today

4 out of 8

In 2 years

Mid-tier firms

4 out of 32

Today

8 out of 32

In 2 years

Firms adopting elements of NewLaw



Top-tier firms

7 out of 8

Mid-tier firms

17 out of 32

Firms planning to increase their investment in technology

Top-tier firms

6 out of 8

Mid-tier firms

27 out of 32

Firms outsourcing fee-earning work



Top-tier firms

2 out of 8

Today

3 out of 8

In 2 years

Refer to chart on page 13.

Mid-tier firms

11 out of 32

Today

18 out of 32

In 2 years

Refer to chart on page 13.

The state of the market

Navigating the new normal

While an improving economy has helped to buoy confidence, intensified competition and pricing pressure continue to create difficult conditions for Australia's leading law firms.



A rising economic tide

Confidence in Australia's economy continues to improve. Firms across the market appear to have benefited from heightened activity in key areas of the economy — including a rise in mergers and acquisitions, more frequent capital raisings and, at the time of our survey, renewed optimism in the wake of a well-received federal budget.

Overall, 30% of law firm leaders said they had positive expectations for the economy over the next 12 months, easily outnumbering the 5% who expressed a negative view.

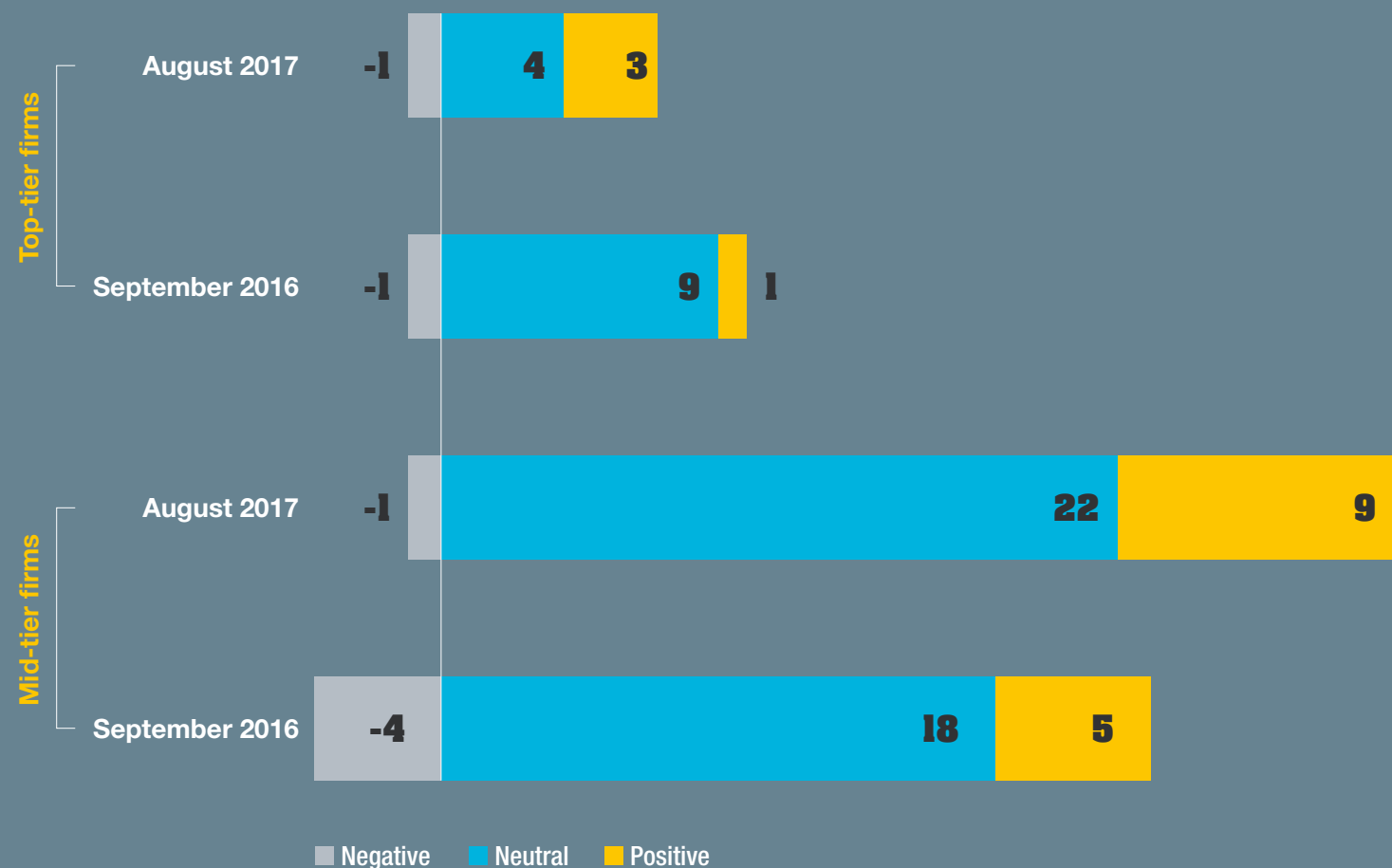
This improvement was most marked among the top-tier firms in our survey, with three out of eight forecasting better economic conditions in the year ahead. Mid-tier firms were more likely to be cautious, with 22 out of 32 expressing a neutral outlook, up from 18 in September 2016. Nonetheless, our survey suggests that law firms expect to encounter a better economic environment as they continue to adjust to the effects of ongoing structural change.

“[We have been] taking back work from accountants, particularly in the compliance sphere.”

Managing Partner
Mid-tier firm

Optimists outnumber pessimists

How do you believe the broader economy in Australia will perform over the next 12 months?



Navigating the new normal

A brightening economic situation appears to have brought better business conditions, at least for now. Thirty-eight per cent of firms in our survey rated current business conditions as positive, up from 11% a year ago. Only 18% said conditions were negative, giving a net confidence reading of 20% — the first positive reading for current conditions in the history of our survey.

Yet, at the same time, the outlook for business conditions has flattened significantly, with firms no longer confident that the future will bring better times. Perceptions of conditions in 24 months' time have fallen from a net reading of 47% in 2016, to 15% in 2017, with 28% expecting conditions to become negative.

This convergence in views on current and future conditions suggests that firms increasingly view the wide-ranging structural changes of the last few years as the new normal, rather than a temporary aberration. As a result, most expect conditions to stay steady for the foreseeable future.

That is likely to see more firms re-engineer the way they do business and experiment with alternative ideas, as they work to adapt to a changing environment.

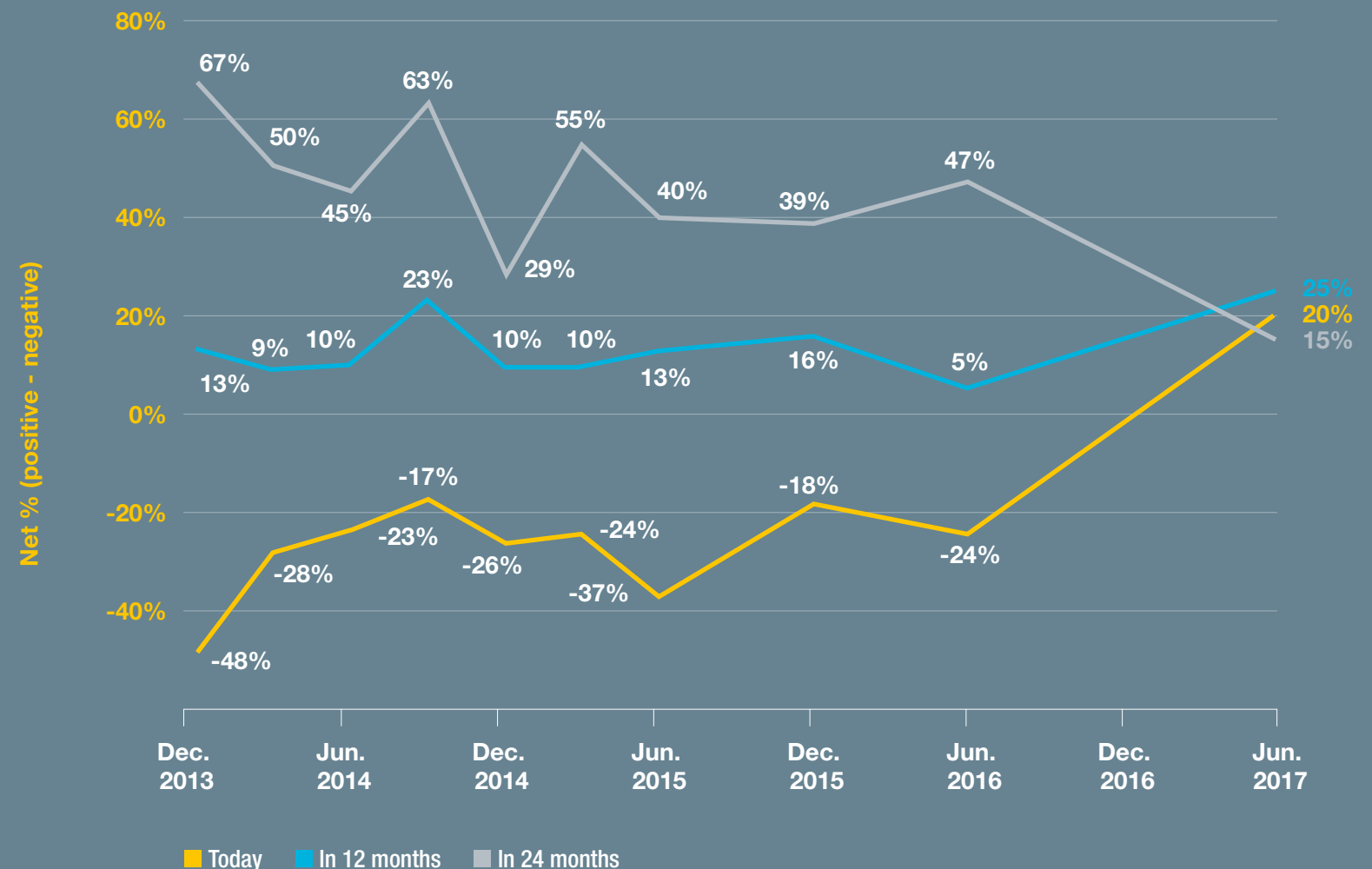
“We are well and truly in a buyers’ market and clients are looking for more value for the same price.”

COO

Top-tier firm

Set to stay steady

How do you rate overall business conditions for Australian corporate and commercial law firms?

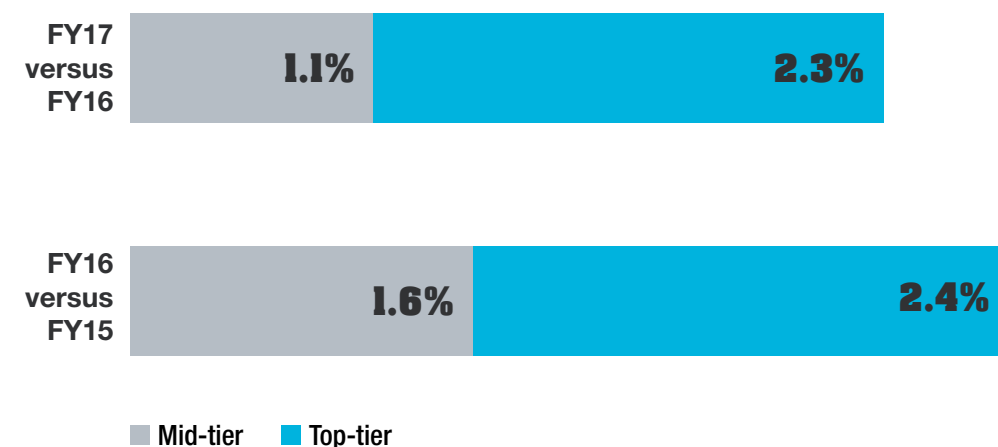


Profits edge higher

Encouragingly, firms have continued to meet and exceed their profit forecasts, although by a smaller margin than a year ago. Top-tier firms were most likely to beat budgets, forecasting an average 2.3% outperformance, compared to 1.1% among their mid-tier rivals.

Still beating budgets

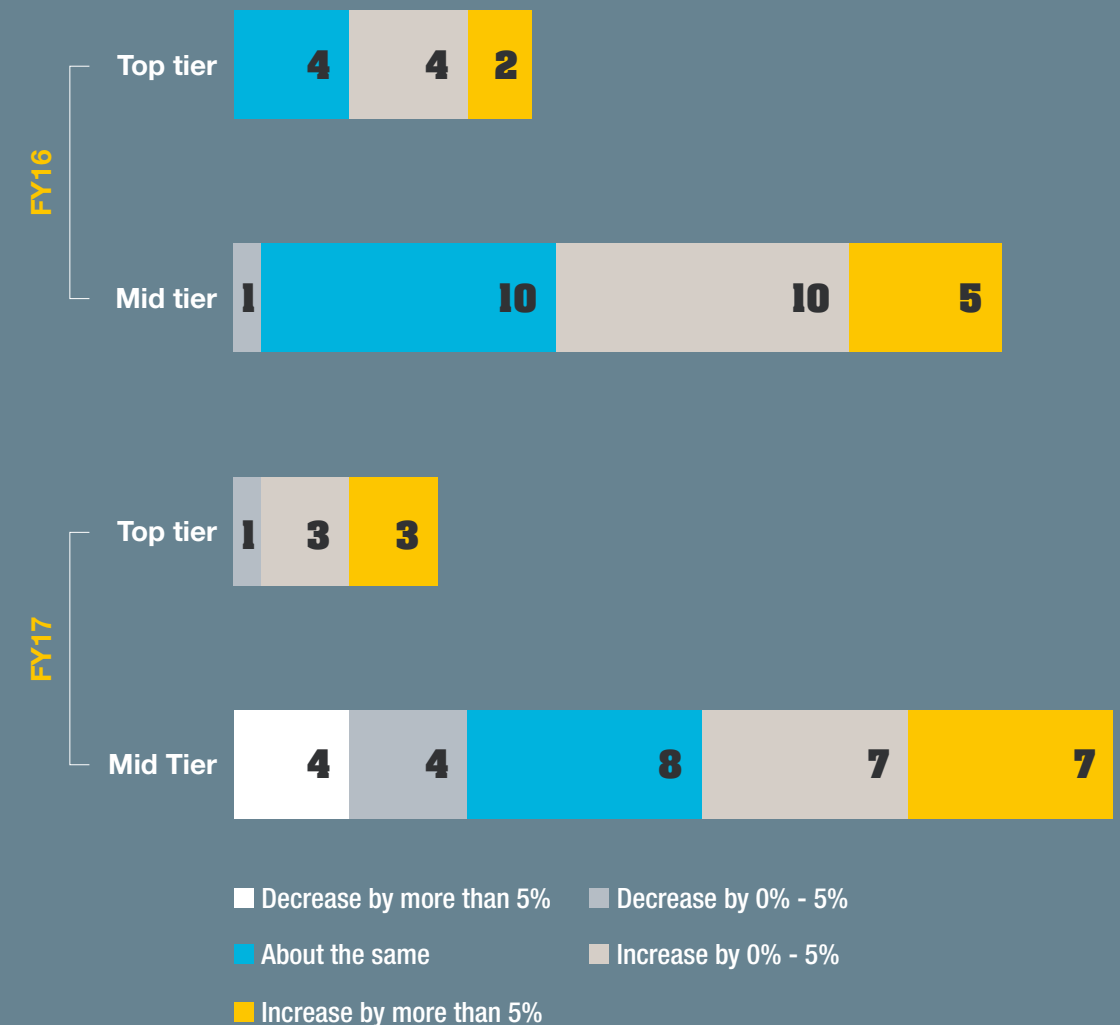
What is the difference between your firm's forecast for FY17 overall profit compared to your firm's FY16 overall profit?



However, the results of ongoing margin and pricing pressure were more in evidence when we analysed profit per equity partner (PPEP), particularly in the mid-tier. Eight out of 30 mid-tier firms said they expect their overall PPEP to fall in 2017, while 14 forecast an increase. In part, this suggests an increasing divergence between firms who have maintained PPEP by actively managing equity points, and those who have chosen to maintain their current allocations and share any declines in growth more equally. For firms in the first group, the risk is that partners with reduced participation will take their knowledge and network elsewhere, further exacerbating any decline in revenue growth.

Sharing the rewards

How do you expect your firm's overall PPEP to change from FY16 to FY17?



“The pricing power of law firms has diminished significantly. Firms are increasingly becoming price takers, with margins being squeezed.”

Managing partner
Mid-tier firm

Business challenges

Firms continue to report that a changing market has created highly challenging conditions. Negotiating price remains the number one concern, with 70% of firms saying they find it challenging or very challenging, including six out of eight top-tier firms. Feedback from survey participants suggests clients have been seeking both greater value and increased price certainty, with an increasing number of firms exploring value-based alternatives to hourly billing.

There has also been no improvement in the proportion of firms who find winning new business challenging, especially in the top tier (six out of eight firms). However, firms have become slightly more likely to say that competing with other firms is manageable (52%) or easy (5%) than challenging — suggesting that the initiatives many firms have taken to improve their competitive position are beginning to gain traction.

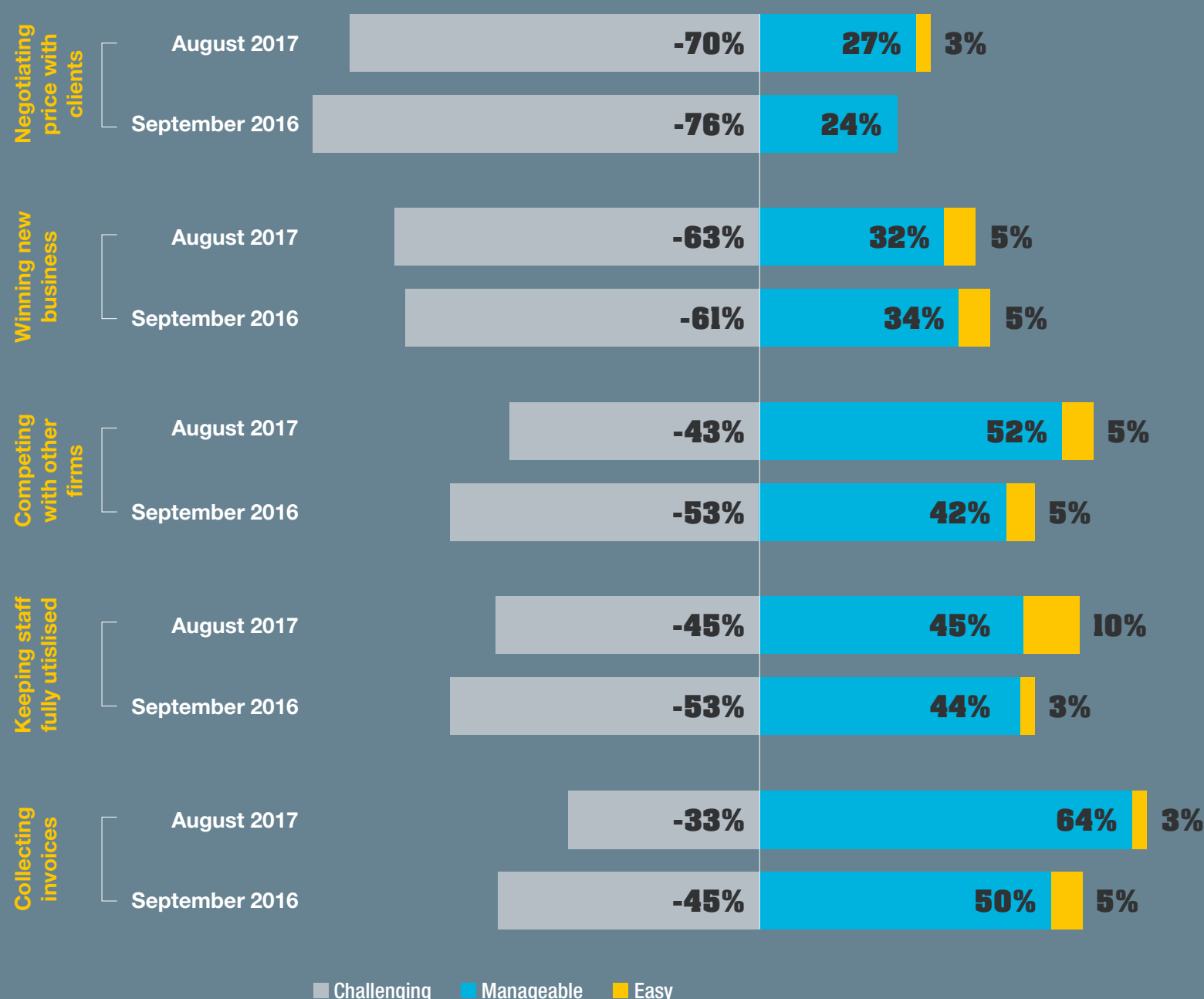
Concerns about staff utilisation have also eased, with a number of firms reducing headcount or changing their staffing mix in response to altered market conditions.

“[We have] reduced staff numbers by attrition in quieter areas and implemented redundancies in certain locations.”

CEO
Mid-tier firm

Top 5 business challenges

How would you rate each of these elements of business conditions at the moment?



Exploring alternative business models

Seeking a sustainable competitive advantage

Under pressure to reduce costs and offer clients more flexibility and value, law firms are increasingly exploring innovative new ways of working.



From BigLaw to NewLaw

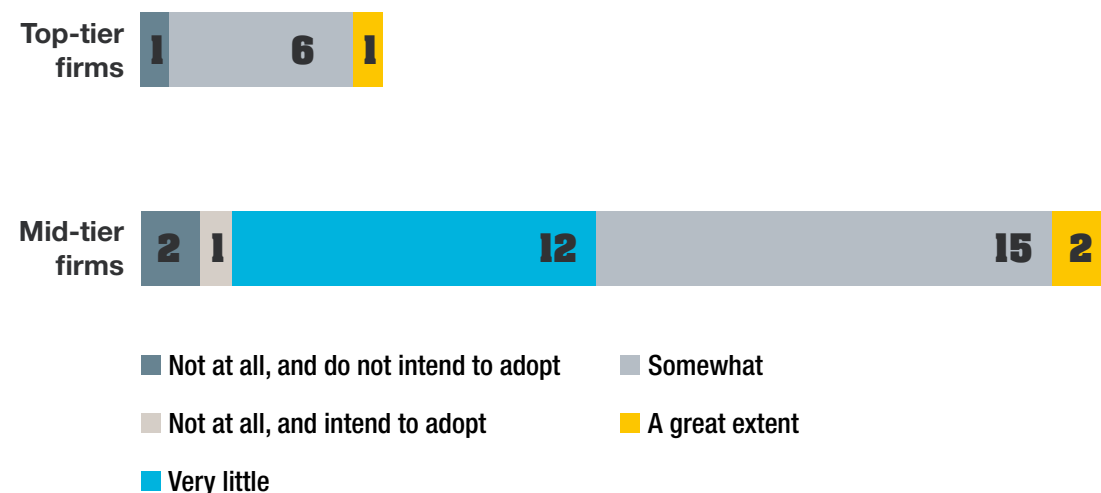
There can be no doubt that NewLaw and alternative business model (ABM) firms are a growing presence in Australia. Nonetheless, few survey participants saw them as significant rivals — at least at present. Only one in eight top-tier firms and four out of 32 mid-tier firms said NewLaw and ABM firms were a substantial threat to their market share today. However, many agreed that their impact would grow, with half of the top-tier firms in our survey saying NewLaw and ABM competitors were likely to pose a serious challenge in two years' time. In comparison, mid-tier firms were relatively relaxed, with 24 out of 32 neutral or unconcerned.

This heightened level of awareness in the top tier is symptomatic of the challenge NewLaw businesses increasingly represent to Australia's largest law firms. Technologically sophisticated, with strong brands, a growing client base and an international reach, these new entrants seem well positioned to make inroads among the institutional clientele who have previously been the top-tier's natural market.

Large firms have responded by borrowing from the NewLaw playbook, either adopting elements of their business models or collaborating with them, and thus transforming them from competitors into allies. Seven out of eight top-tier firms in our survey said they had adopted key elements of NewLaw in their own businesses, along with 17 out of 32 mid-tier firms.

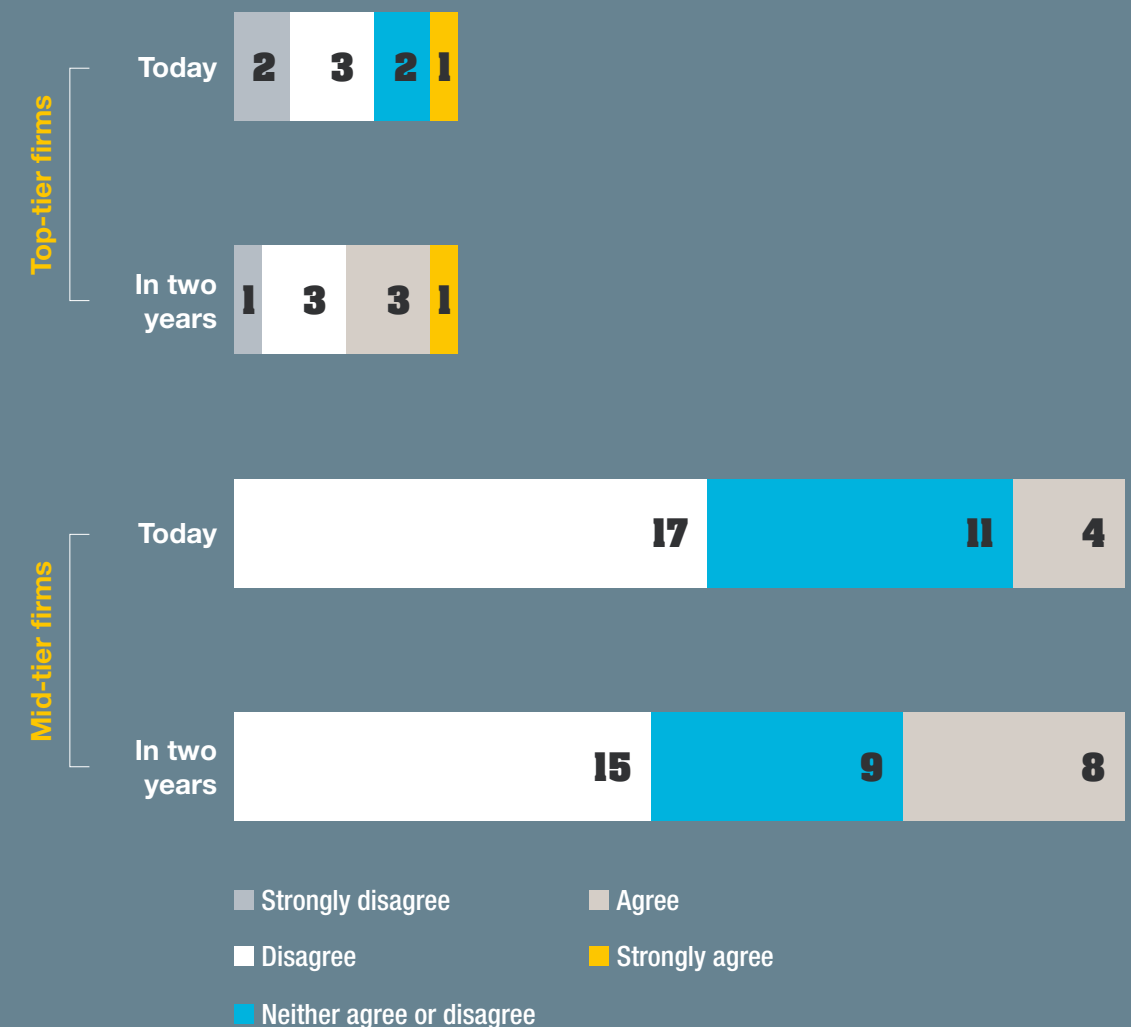
Adoption of NewLaw elements

Has your firm adopted key elements of NewLaw or ABMs?



The competitive threat

Do you agree that NewLaw and ABM firms are or will be a substantial threat to your firm's market share?



"I think the industry has definitely come to realise that [NewLaw] is an unstoppable force and will lead to major change."

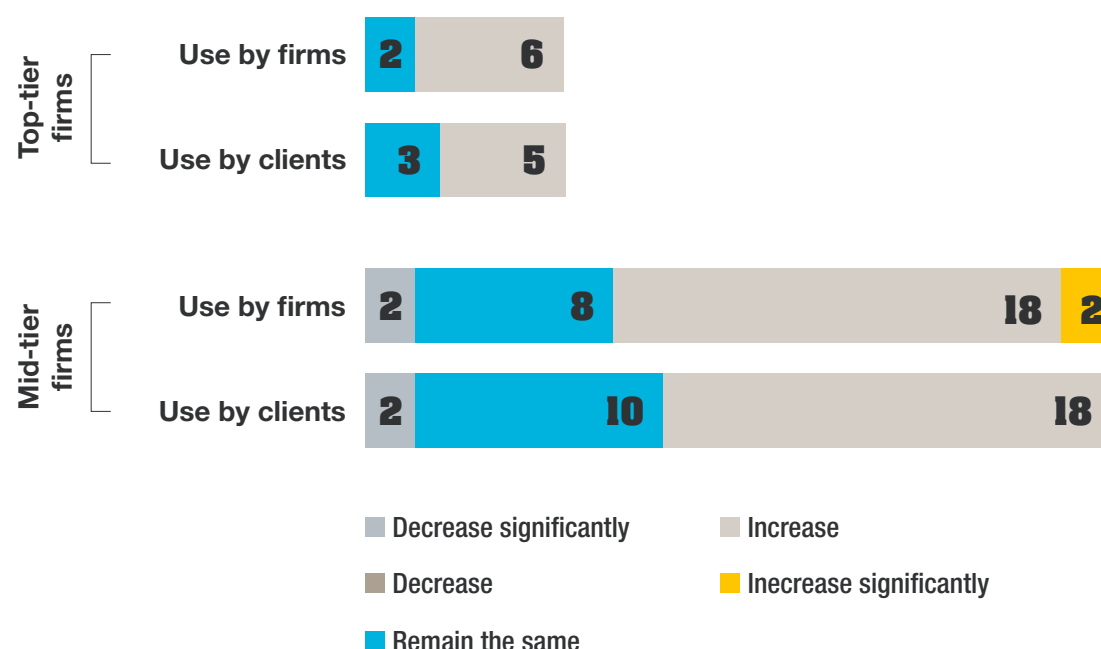
Sam Nickless
COO, Gilbert + Tobin

Outsourcing on the rise

Along with NewLaw and ABM practices, both law firms and their clients have continued to seek opportunities to reduce costs and achieve greater efficiency by outsourcing both back-room operations and lower value legal work. Twenty-six out of 40 survey participants predicted that law firms will increase their use of both Legal Process Outsourcers (LPOs) and Legal Services Outsourcers (LSOs) over the year ahead, while 23 said law firm clients will also turn to outsourcing providers in greater numbers.

Seeking lower cost solutions*

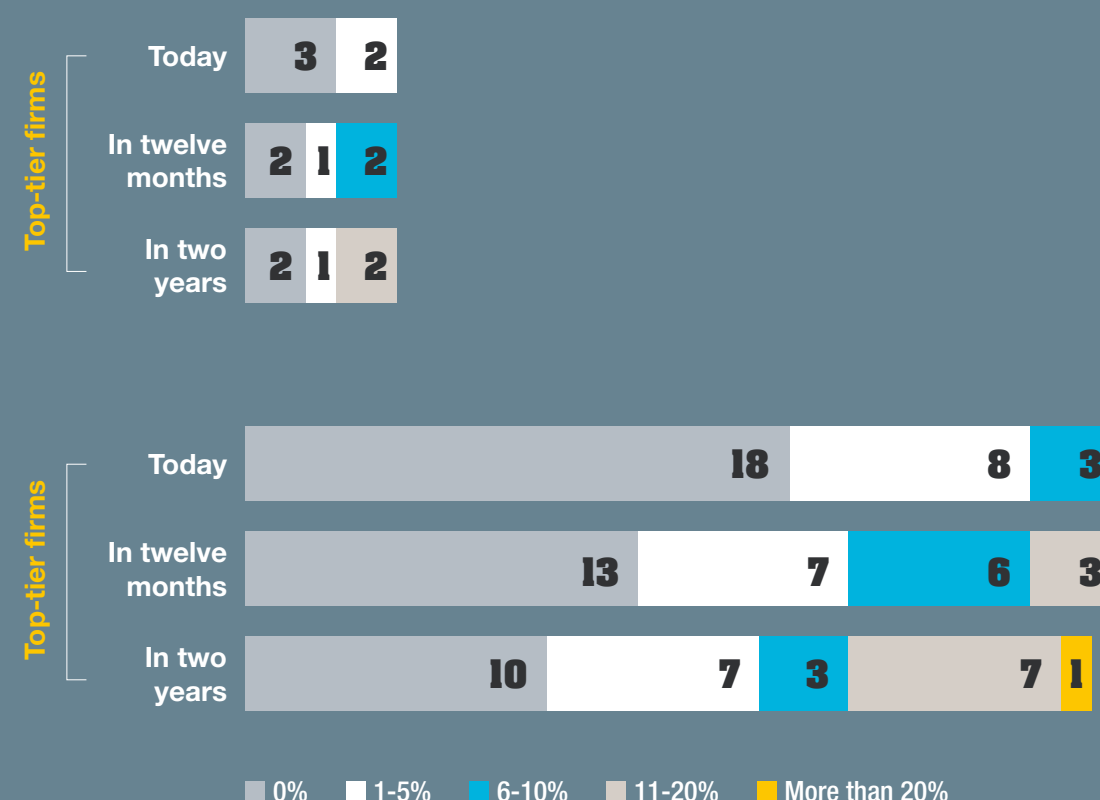
How do you think the use of LPOs and LSOs in the Australian legal market will change over the next 12 months?



As a result, firms predicted that the proportion of fee-earning work they outsource will rise over the next two years, albeit from a low base, with two out of eight top-tier firms and eight out of 32 mid-tier firms forecasting that they will outsource more than 10% of their work.

Steady growth in outsourcing*

What proportion of the fee-earning work done by your firm is outsourced to LPOs and LSOs?



"We do not want to win new work on discounted price, but know that is often where the battle is. Our new work is being scoped more stringently and priced accordingly."

Managing Partner
Mid-tier firm

*Where a 'don't know' response has been given, it has been excluded from the chart.

Who drives outsourcing?

This rise in outsourcing appears to have been driven both by law firms and their clients, with top-tier firms especially likely to feel pressure from large institutional clients to demonstrate they are exploring every avenue to deliver a more cost-effective service. Five out of eight top-tier firms said the impetus for outsourcing had come equally from firms and clients, while more than a third of the mid-tier firms in our survey (12 out of 32) believed that clients had played an equal or dominant role in the drive to outsource.

Our 2017 survey also confirmed that, used well, outsourcing can have benefits for everyone. Only one of our survey participants said they expect outsourcing to have a negative effect on their margins, while 12 out of 40 believed the impact would be positive.

These results suggest that firms have become adept at managing the outsourcing relationship to create additional value, reducing margin pressure by delivering a more flexible service at a lower overall cost.

“The outsourcing and automation of lower value, high volume work has created attractive opportunities for firms to focus on their areas of greatest expertise, where they can maximise their competitive advantage.”

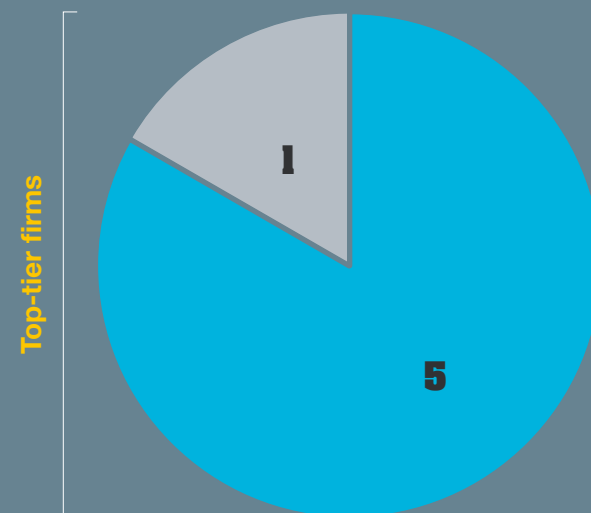
Marc Totaro

National Manager, Professional Services
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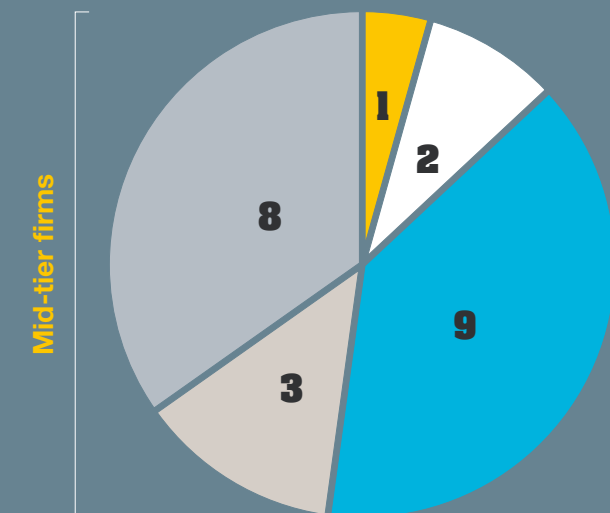
*Where a 'don't know' response has been given, it has been excluded from the chart.

Drivers of outsourcing*

Where is the impetus for outsourcing coming from?



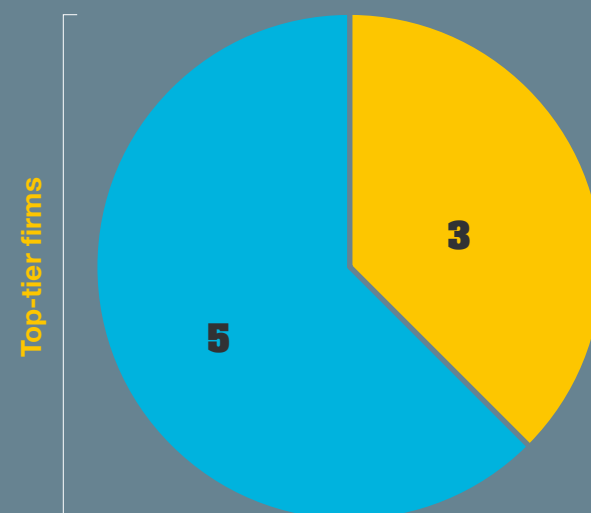
■ More firms than clients
■ Clients and firms equally



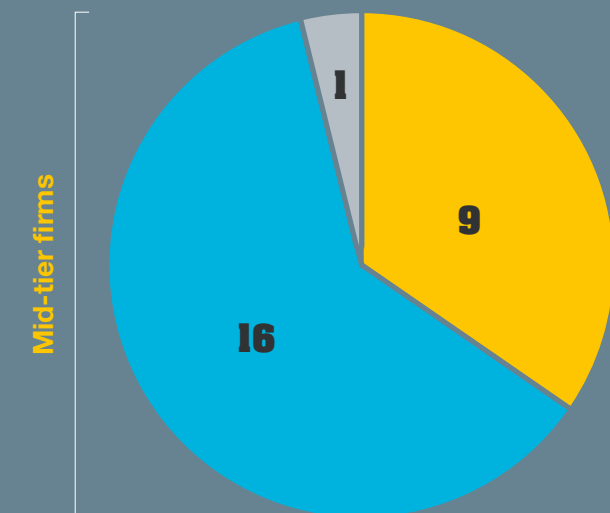
■ Mainly clients
■ Clients and firms equally
■ More often clients than firms
■ More firms than clients
■ Mainly firms

Impact on margins*

What impact on your firm's profit margin do you expect the trend towards outsourcing to have over the next 24 months?



■ Positive ■ Neutral



■ Positive ■ Neutral ■ Negative

Bidding farewell to the six-minute increment

Our survey confirms that most firms in the top and mid tiers are still strongly reliant on pricing by the billable hour for most of their revenue. Yet it also shows that they generally believe that the trend away from hourly rates and towards fixed fees or value-based pricing is set to accelerate.

Seven out of eight top-tier firms and 22 out of 32 mid-tier firms said they currently rely on hourly rates for more than 60% of their revenue. Yet a majority also indicated that they expect that proportion to fall substantially over the next two years.

Feedback from participants suggests that much of the impetus for alternative pricing models is coming from clients. We have also observed a growing tendency for firms to use fixed fees even for complex matters, including complex litigation, while still remaining profitable.

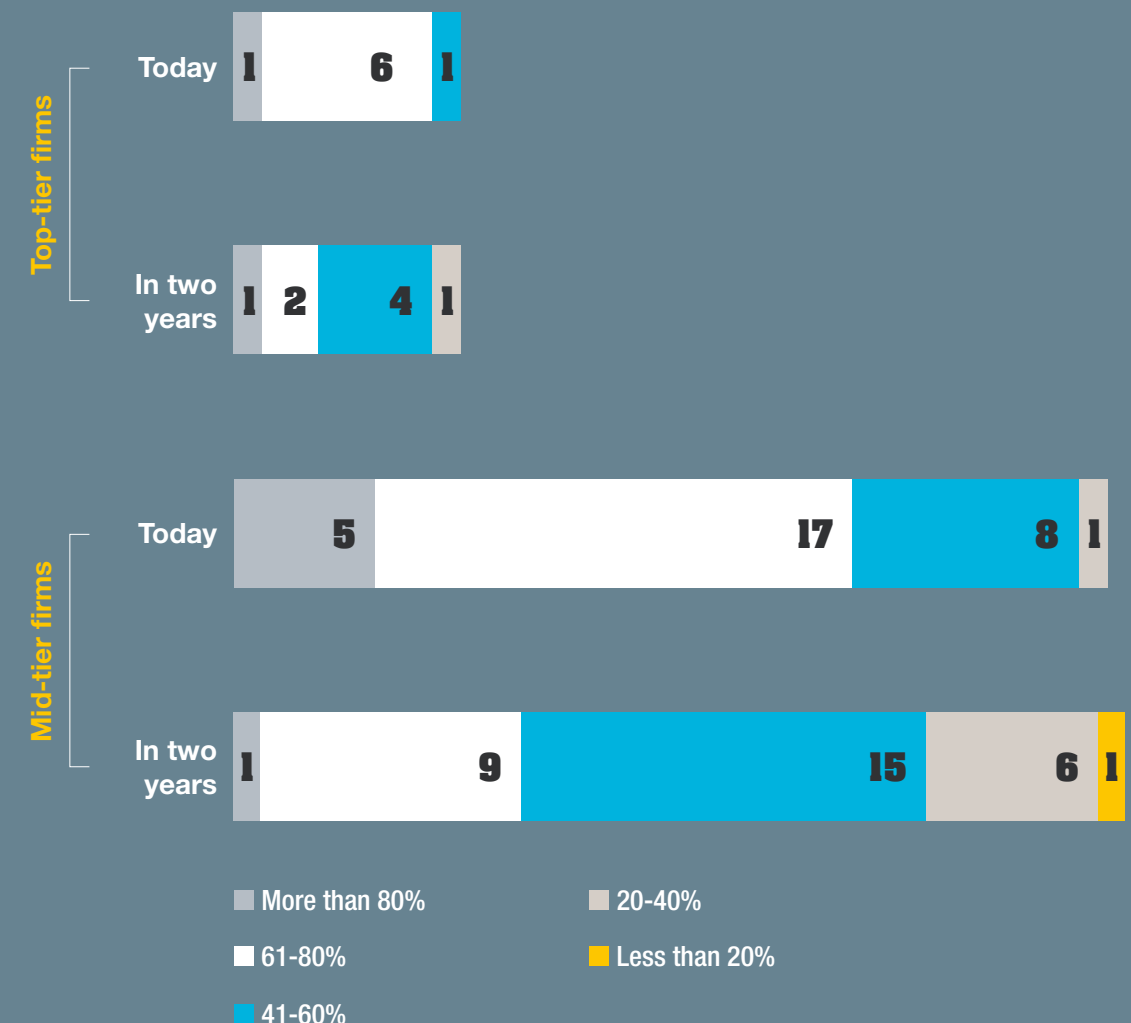
Australian firms are also beginning to catch up with their peers in the UK and US (where pricing pressures have been more intense for longer) by recruiting pricing managers and adopting more complex pricing practices underpinned by legal project management. Nonetheless, there are still significant opportunities for firms to benefit further from the efficiencies that legal project management can help to create, particularly for larger or more complex matters.

“Clients are increasingly seeking alternative pricing options.”

CEO
Top-tier firm

Alternative pricing models predicted to rise*

What proportion of your firm's total revenue comes from fees charged using an hourly rate?



“Proactive communication with all clients about pricing, and offering options tailored to their needs, is the new normal.”

Managing Partner
Top-tier firm

*Where a 'don't know' response has been given, it has been excluded from the chart.

Innovation at Gilbert + Tobin

Sam Nickless' Top 3 innovation tips

1. Start Small, think big

Nickless says the barriers to innovation have fallen as new technology has become more accessible and less expensive. "There's really no excuse not to be starting to try new ideas."

2. Change management is critical

Nickless says that, as you scale up, it's important to manage change carefully, especially as the firm's business model evolves.

3. Listen closely to your clients

Nickless believes clients expect their legal providers to innovate — and it's important to engage with them on what they are looking for as you pursue your innovation journey. "Clients are looking for new approaches to both our work and for their own in house work. The best innovations solve real problems for your clients," he says.





Sam Nickless is a Partner and the Chief Operating Officer at Gilbert + Tobin. Tasked with driving the firm's investment in technology and innovation, he is also its representative on the board of LegalVision, a NewLaw startup in which Gilbert + Tobin has a 20% stake.

Nickless believes that the pace of innovation in law is accelerating — and that client demand is the key driver.

"I think that it does start with the clients," he says. "Often, clients have priced productivity gains into their expectations before new technologies have entirely delivered results. Clients are placing pressure on law firms to ask, 'Where are we going with technology? How can we deliver better value?'"

He believes this pricing pressure will lead firms to increasingly unbundle expert advice from lower value activities.

"I think we'll see some unbundling between higher-end, more complex advice, which will remain fairly much human-expert driven for some time, and work that can be sped up and automated by the use of technology or different labour models."

While Nickless acknowledges that "labour arbitrage" — outsourcing to lower-cost locations — will continue to impact the market in the short-term, he believes the future is all about technological innovation.

"I think outsourcing has still got some part to play, but I do think it is transitional. I think some of the cost differential is narrowing. Many of the better NewLaw players who have been providers of labour arbitrage are also going to be leaders in technology, which is potentially going to offer even greater benefits."

Nickless says Gilbert + Tobin is simultaneously pursuing three different aspects of innovation: partnerships with NewLaw firms; investments in technology; and rebundling traditional legal services in unfamiliar ways.

He cites the firm's relationship with LegalVision as an illustration of the benefits a NewLaw partnership can bring. Initially focused on small and medium enterprises, LegalVision is increasingly working with Gilbert + Tobin to manage bread and butter work for large corporate clients, with a subscription-based model that offers pricing certainty to the client and guaranteed cash flow to the firm.

"It's a model where Gilbert + Tobin has set up the framework and can provide high-level guidance or escalation for very complex matters, but most of the day-to-day work is done by LegalVision. LegalVision uses their technology and their process skills to do that at an affordable rate, bringing us a part of that client's work that we probably wouldn't normally be able to service economically," he says.

Partnering with LegalVision has also allowed Gilbert + Tobin to tap into the dynamic culture of a NewLaw startup currently achieving 6–8% month on month revenue growth. "They have a founder and other key people, all with equity and all very focused on delivering great outcomes. We wanted to have that kind of culture — we didn't want to remake LegalVision as just another law firm," he says.

Meanwhile, Gilbert + Tobin is working to develop its own technological capabilities, through a specially created internal team, g+t <i>.

"They spend a lot of time looking for tasks that could be automated or made more efficient — observing lawyers and talking to lawyers about the things that they do," Nickless says. "We've started at the simple end, with basic applications, and we're moving up to some more complicated ones with the overall goal of making the delivery of legal services more productive."

Among these more sophisticated solutions is a newly patented system for automating and managing the complex process of verifying a prospectus in preparation for an initial public offering (IPO).

"It used to be a very manual process...now we have an automated way of pulling the prospectus apart, putting it into a portal and allowing it to be shared in real-time. It accelerates the whole process and adds more quality control, with cost savings we can pass on to the client," Nickless says.

The firm's other area of innovation involves unbundling and rebundling legal services in new forms to better meet evolving client needs. Often that means taking a partnership approach, where Gilbert + Tobin manages multiple providers to offer a lower cost service through a co-ordinated team.

"There have been M&A projects we've done where we've been the main client advisor and coordinator, but the due diligence review has involved machine learning, it's involved LegalVision — and in some cases, it's also had some offshore LPOs. All of those different types of resources contributing to the overall matter."

"I call that unbundling, but what we're really doing is rebundling multiple services from different providers — pulling together a total solution for the client," he says. "It's a whole new set of skills and capabilities. We've got a technology platform that helps us do that, but actually quite a few of our lawyers are getting skilled up on project management and process improvement to make that complexity work."

"That's going to be what clients are expecting of us — that we've got the best people at the right price for each task."

Investing in innovation

The search for value

As spending on new technologies continues to accelerate, firms are critically examining their return on investment to ensure they are achieving tangible results.

Focusing on technology and skill development

Despite a challenging competitive environment, firms continue to invest in innovation to create more sustainable businesses for the future. Spending on technology is set to accelerate over the next 12 months, with the proportion of firms increasing their investment in IT hardware and software rising from 55% in 2016 to 68% in 2017.

Skill development also remains a key focus. Ninety-five per cent of firms plan to maintain or increase spending on staff training in 2017. Feedback from survey participants suggests that a rising proportion of that training budget is likely to be invested in equipping legal staff to leverage new technologies more effectively, through disciplines like legal project management and process automation.

Most plan to spend more

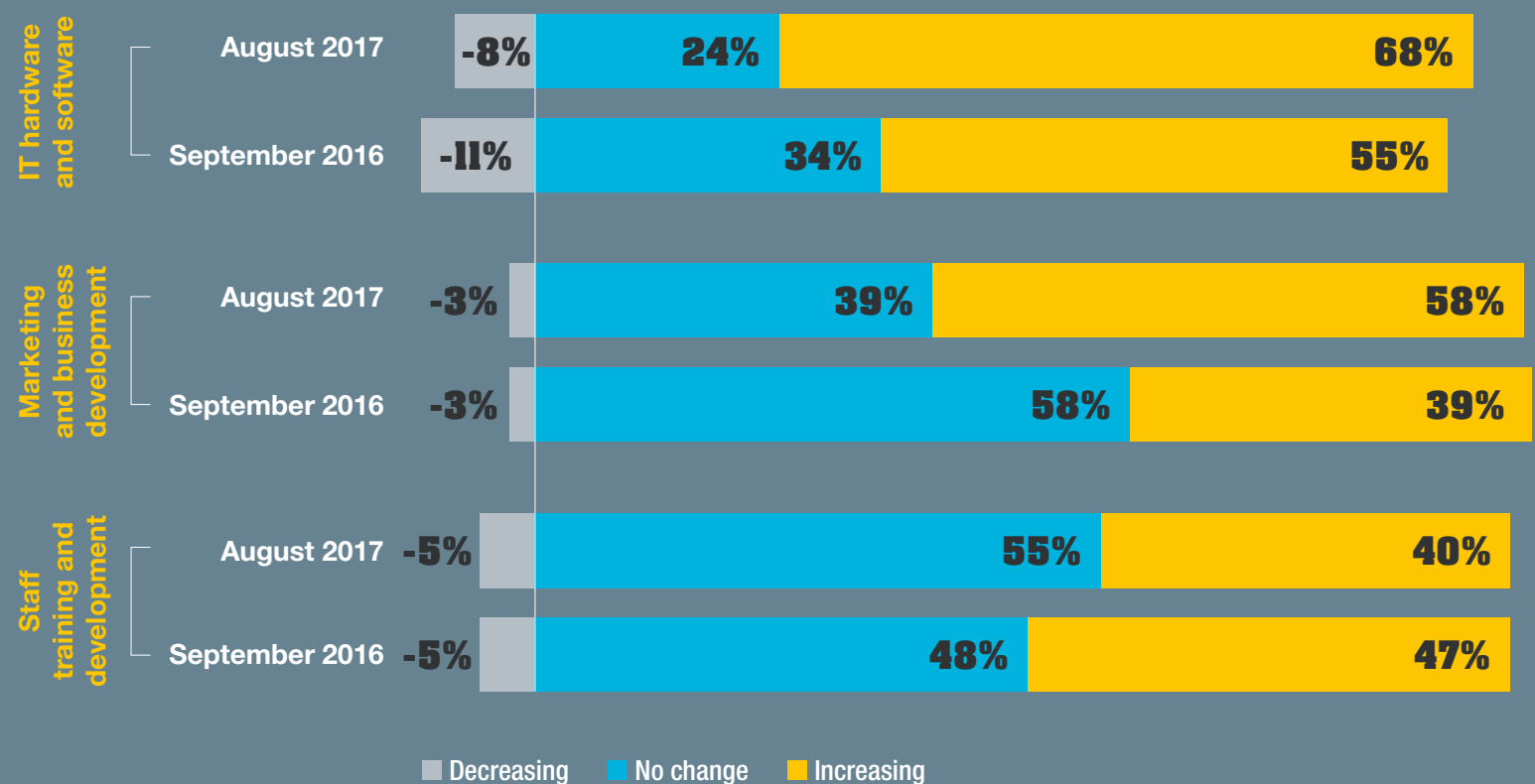
Infographic based on this data:

Firms planning to increase their investment in technology over the next 12 months:

- **Top-tier firms:** 6 out of 8
- **Mid-tier firms:** 27 out of 32

The top three areas for spending growth

What is your firm's forecast for expenses, excluding salary costs, for the next 12 months?



“We are looking at technology to automate a lot of the lower hanging fruit.”

COO
Mid-tier firm

Maximising ROI

While firms across the market are moving rapidly to adapt new technologies, not all have benefited equally from their investment. Asked to assess the return on investment (ROI) from their spending on technology, half said it was either too early to tell, or that the return had been low or negligible. Top-tier firms were most likely to be confident that their investment had generated tangible benefits, with five out of eight firms rating the return as moderate or high. In comparison, mid-tier firms were less likely to be certain that their investment had achieved the results they expected.

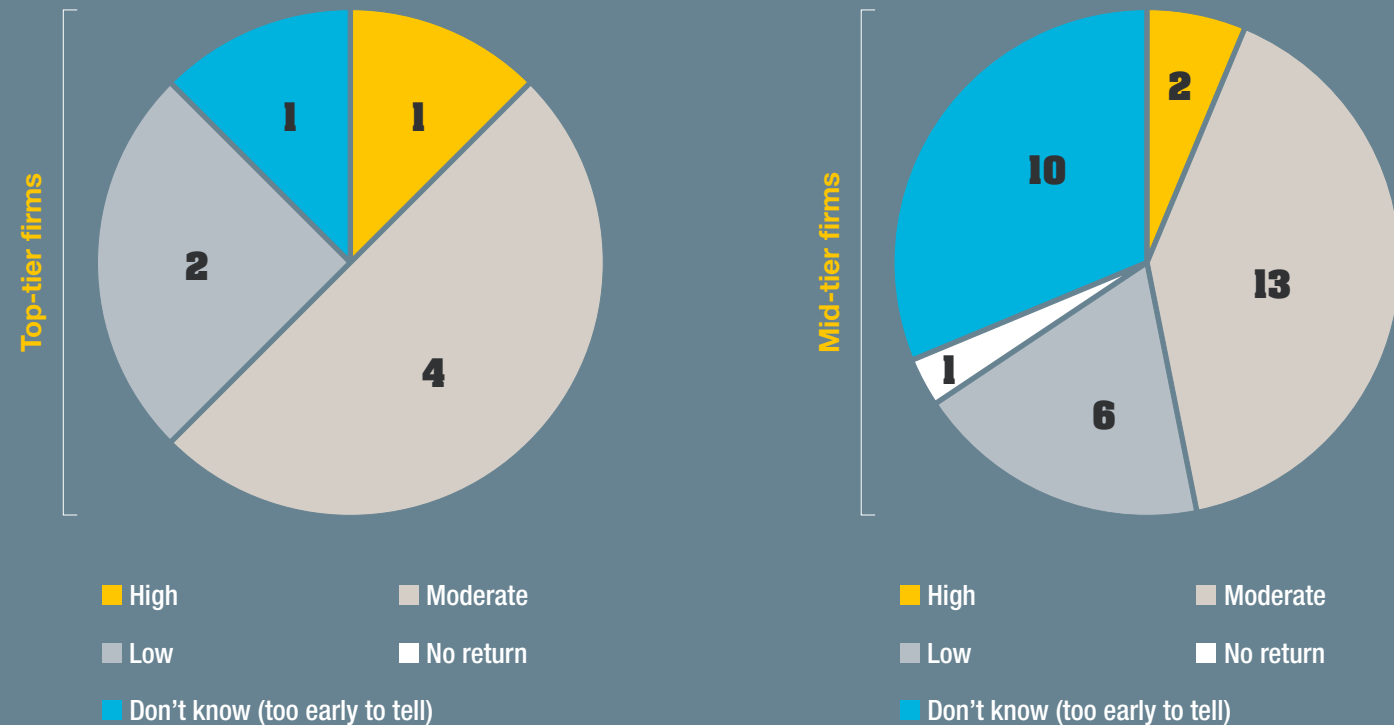
This suggests there are still untapped opportunities for Australian law firms to leverage new technologies to maximum effect — a view many survey participants shared. When we asked law firm leaders how they believe legal practices compare to other professionals in adopting new technologies, half said that law firms have been slower off the mark than their peers in other professions, while only five out of 40 participants believed they had been faster.

“Our 2017 survey reveals both a continued commitment to innovation across the legal industry, combined with a determination to ensure that this investment in technology yields genuine value for both law firms and their clients.”

Marc Totaro
National Manager, Professional Services
Business & Private Banking
Commonwealth Bank of Australia

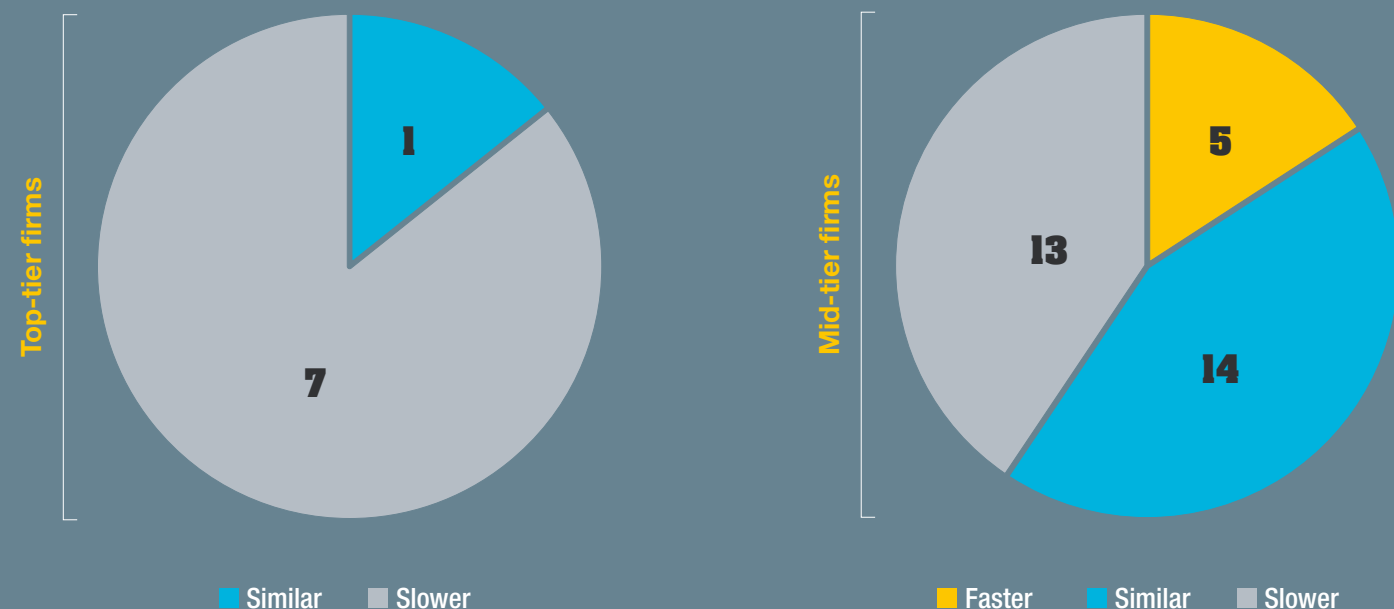
Return on investment

To what extent have you seen a return on your investment in new technology?



How the legal industry compares

Compared to other professions, how quickly do you believe law firms are adopting new technologies?



Talk to us

For further insights or information, please call your CommBank Relationship Executive.
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