

CommBank **Legal** **Market Pulse**

Conducted by Beaton Research + Consulting

Quarter 4 2014/15



Contents

Foreword	1
Economic outlook	2
Snapshot of survey findings	3

Firm structure

Office locations	5
Primary practice areas	5

Business conditions

Perceived performance of the Australian economy	6
Perception of business conditions – present to 2017	6
Perception of business conditions – by area	7

FY15 financial performance

Total revenue change FY14 to FY15	8
FY15 budgeted and actual revenue results	9
FY15 budgeted and actual expenses results	9
Forecast for EBIT margins in FY2016	10

Revenue predictions

Changes in revenue over the next 6 months – by location	11
Changes in revenue over the next 6 months – by practice area	12

Realised rates

Expected changes in realised rates – next 6 and 12 months	13
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Expense and profitability predictions

Changes in expenses over the next 6 months	14
Changes in staffing over the next 6 months	15
Change in operating margins over the next 6 months	16

Competition from non-traditional (alternative business model) law firms

Frequency of competition from non-traditional (alternative business model) law firms	17
Expected competition from non-traditional (alternative business model) law firms - next 12 months	17
Impact of alternative business model firms - next 12 months	18
Entry of international law firms	18
Cessation of international law firm entrants	19

Innovation at the core of sustainable growth for law firms



Marc Totaro

National Manager, Professional Services
Commonwealth Bank

Welcome to our final CommBank Legal Market Pulse for the 2014/15 financial year, conducted in partnership with Beaton Research + Consulting.

The 2014/15 financial year saw optimism generally increase amongst law firms across Australia. While this was encouraging, a backdrop of market volatility and an intensifying competitive landscape has weighed on short term sentiment in the last quarter. We saw the legal sector end the financial year with a more optimistic outlook on the Australian economy when compared to the previous quarter, with overall sentiment still remaining in negative territory. The results have been driven by a more bullish outlook amongst the top-tier compared to the mid-tier firms.

“The 2014/2015 financial year saw optimism generally increase amongst Australian law firms.”

While the view of business conditions in two years' time remains in positive territory, we saw a softening in the long-term outlook when compared to the previous quarter. This is in part being driven by increasing uncertainty and shifting market dynamics, as the economic transition to non-mining led growth continues.

While views on business confidence have been mixed, we have seen a continuing trend towards innovation in the legal sector in response to competitive challenges and the pursuit of growth.

Areas highlighted in the report across the 2014/15 financial year include a move towards adopting flexible business and staffing models, the continued move towards legal process and service outsourcing, and the utilisation of technology to improve efficiencies.

“We have seen a continuing trend towards innovation in the legal sector in response to competitive challenges and the pursuit of growth.”

We are seeing innovation in the legal sector materialise in a number of ways, with a primary driver being the limitations of further cost rationalisation in improving firm profitability. This is echoed in the report, with most firms managing to control their expenses in the final quarter of 2014/15 financial year, now tracking on or below budget.

This trend is also evident when looking at firms' continued expectation of an increase in fee earning roles, indicating major cost cutting initiatives may have run their course, as firms look again at revenue growth.

Another key trend is client demand driving the continued move towards outsourcing and offshoring of both routine tasks and lower level legal services typically undertaken by junior lawyers, and importantly an ongoing investment in automation and other technology solutions, such as e-discovery, to reduce costs.

When looking at practice areas, firms indicate no major decline in revenue forecast this quarter, with net improvements across most practice areas compared to the previous quarter. The top-tier firms forecast greatest net growth across IP, M&A and corporate advisory and insolvency and restructuring practice areas, whereas mid-tier firms forecast highest net increase across property, environment and planning, insurance and employment, workplace and OH&S.

I trust you will find this edition of the CommBank Legal Market Pulse informative and useful for your firm's planning and benchmarking. We look forward to continuing to monitor the legal industry's sentiment and performance, and sharing these insights with you.

Economic outlook



Diana Mousina

Associate Director Economics
Commonwealth Bank

The three months since our last CommBank Legal Market Pulse have seen positive developments in the Australian economic landscape. There was another rate cut from the Reserve Bank of Australia (RBA) in May, driving the cash rate down 0.25 per cent to a new low of 2 per cent. The Australian dollar also fell, taking pressure off exporters and import-competing sectors, while the Federal Budget introduced measures designed to support household and business confidence. The labour market is also looking stronger, with the unemployment rate declining a little over the past few months to its current level of 6 per cent.

Nonetheless, the growth picture remains patchy across states and industry sectors. That unevenness is reflected in a more subdued short-term outlook among legal firms in this quarter's report, with perceptions of current business conditions deteriorating. Yet the longer term outlook remains positive.

Globally, growth is looking a little stronger, although volatility will remain an issue in financial markets, continuing to influence consumer and business confidence. There is still significant uncertainty around the timing of the first US Federal Funds rate hike, the future of the Eurozone and slower growth rates in the Chinese economy.

Looking ahead, over the next two years will be the continuing transition to non-mining sources of growth, as resource investment slows. Parts of this growth transition are on track. The residential construction upturn is firmly entrenched, while consumer spending growth has lifted. Resource exports are also surging and will be a significant new source of income growth over the next two years. However, non-mining business capital expenditure remains the missing piece of the puzzle.

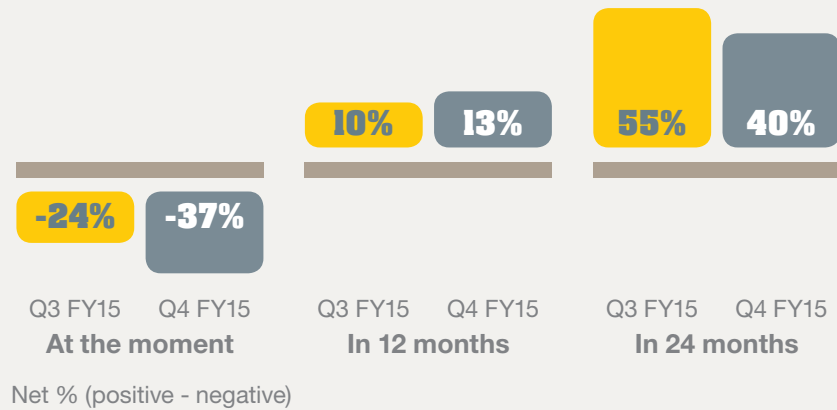
The 2015 Federal Budget's small business package may play some role in boosting investment, with a tax cut and increased depreciation allowance encouraging small businesses to make capital purchases. As a result, business confidence picked up following the Budget, although the consumer reaction has been more mixed. The challenge now is to translate improved confidence into actual spending.

The RBA rate cut reflects a more cautious outlook around the transition to stronger non-mining capex growth. On the plus side, a low-inflation environment gives the RBA the room it needs to adjust rate settings as required, especially since concerns about risks in the housing market are largely confined to Sydney. While the RBA has provided little forward guidance on the interest rate outlook, a below-trend growth and inflation outlook, coupled with concerns the unemployment rate could move higher, mean it is probably too soon to call the end of this rate-cutting cycle. Readings of key data, particularly employment data, will be central to future RBA policy deliberations.

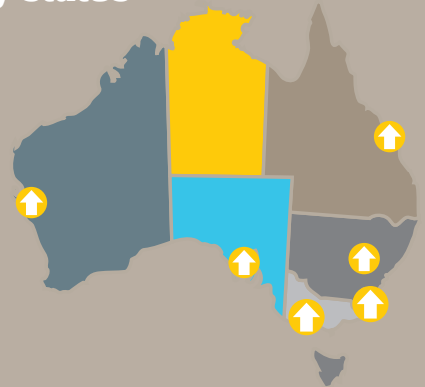
Certainly the employment outlook among law firms is mixed, judging by the results of this quarter's report. While expectations for total staff numbers have picked up over the last three months, there are wide variations across firms and staff types. On one hand, partner numbers are expected to increase, along with senior associates and junior lawyers. Yet the number of paralegals and secretarial, administrative and shared service staff are expected to decline, as firms continue to pursue efficiencies in the face of intense competition and ongoing price pressure.

Snapshot of survey findings

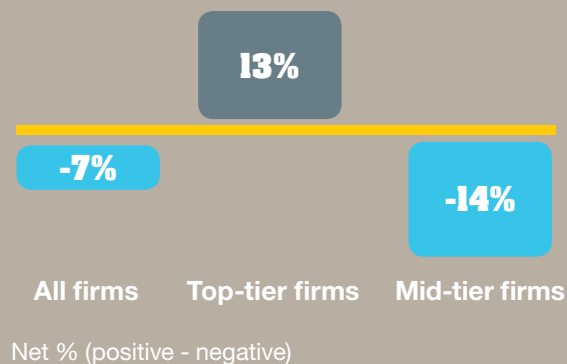
Perception of business conditions



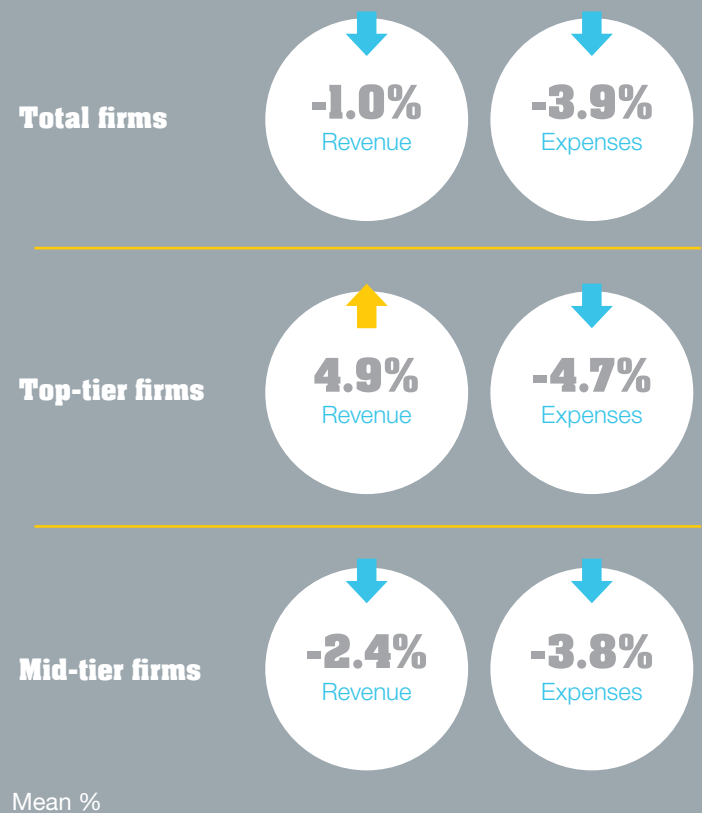
Revenue expectations by states



Perceived performance of the Australian economy over the next 12 months



Budgeted vs. actual results



Top 3 challenges for legal firms



Expected changes in realised rates

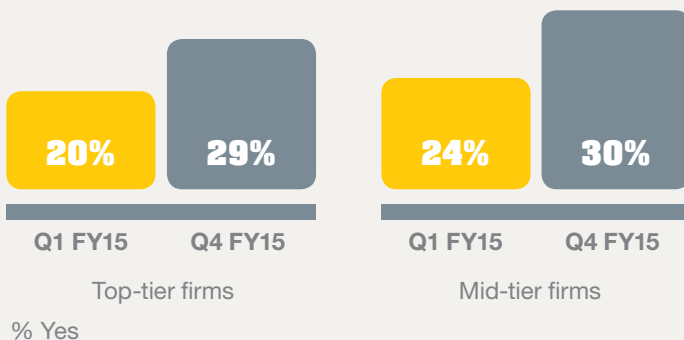


Likely cessation of international law firm entrants to Australia

50% of top-tier firms disagree

50% of mid-tier firms disagree

Increased competition from non-traditional (alternative business model) law firms



Expenses forecast

Top-tier firms



IT hardware and software
Occupancy



Marketing and business development
Staff training and development
Library and knowledge management
Professional indemnity insurance
Telecommunications

Mid-tier firms

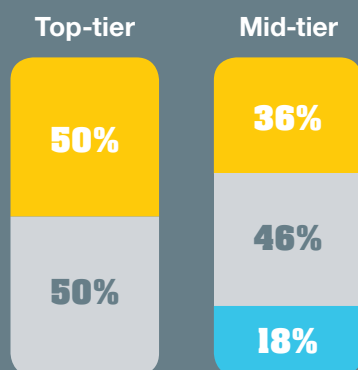


IT hardware and software
Marketing and business development
Occupancy
Staff training and development



Professional indemnity insurance
Telecommunications
Library and knowledge management

Effect of international law firm entrants on local firms



■ Positive / Very positive
■ Neutral
■ Negative / Very negative

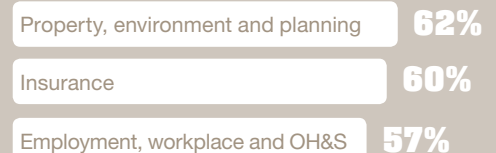
Highest revenue growth expectations – by practice area

Top-tier firms



Net % (positive - negative)

Mid-tier firms



Impact of alternative business model firms over the next 12 months

Net % (positive - negative)

+37.5%

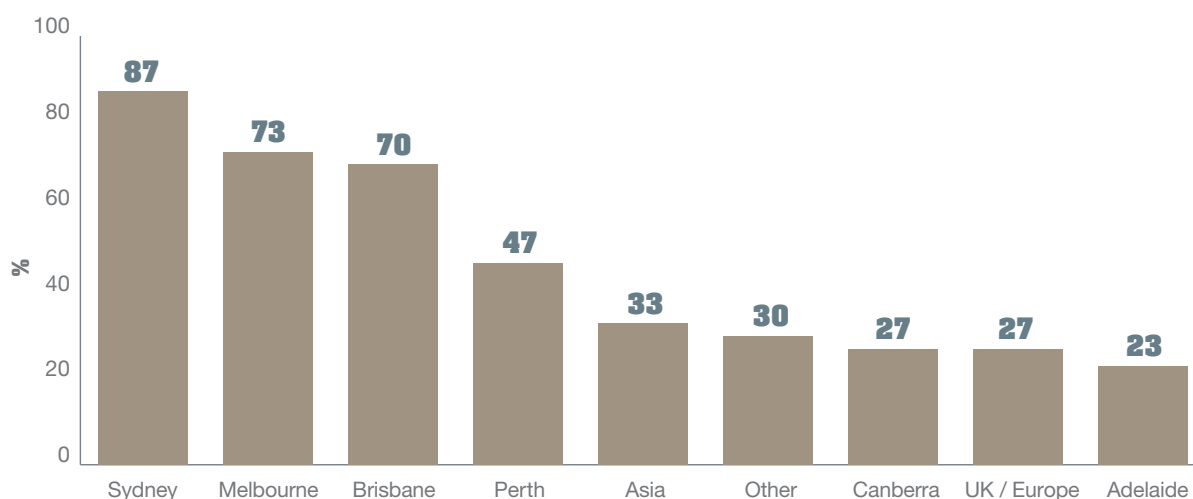
Top-tier firms

-9.1%

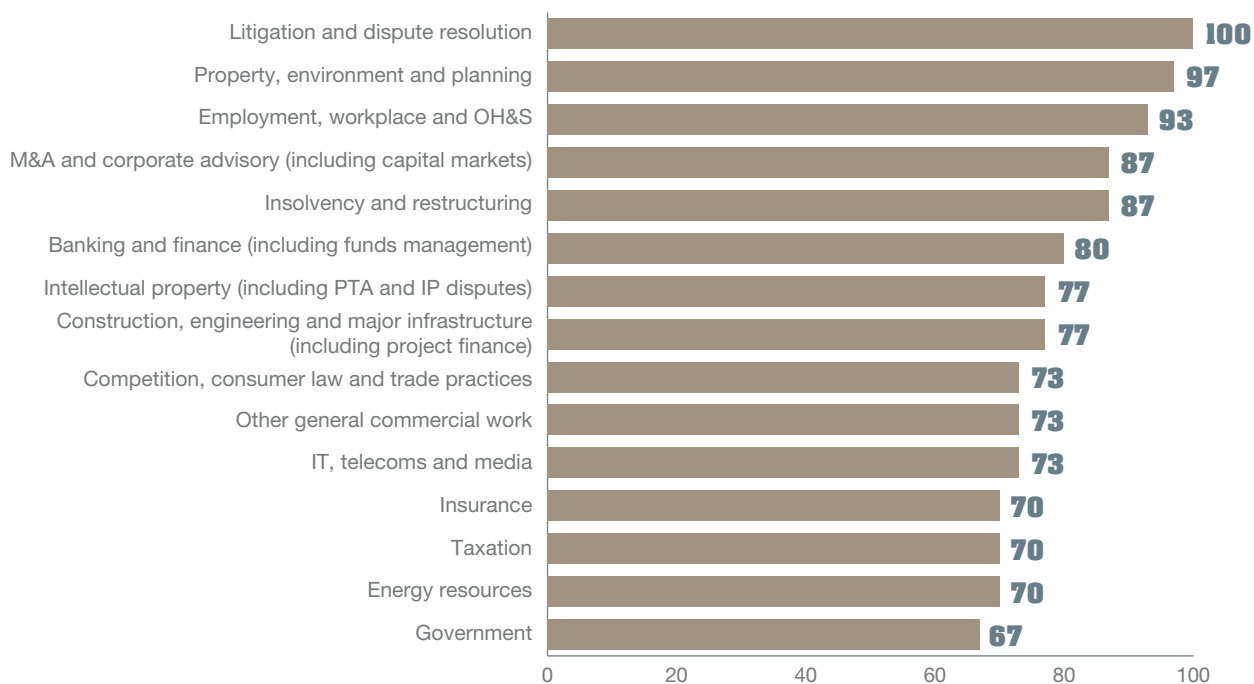
Mid-tier firms

Firm Structure

Office locations



Primary practice areas



Business conditions

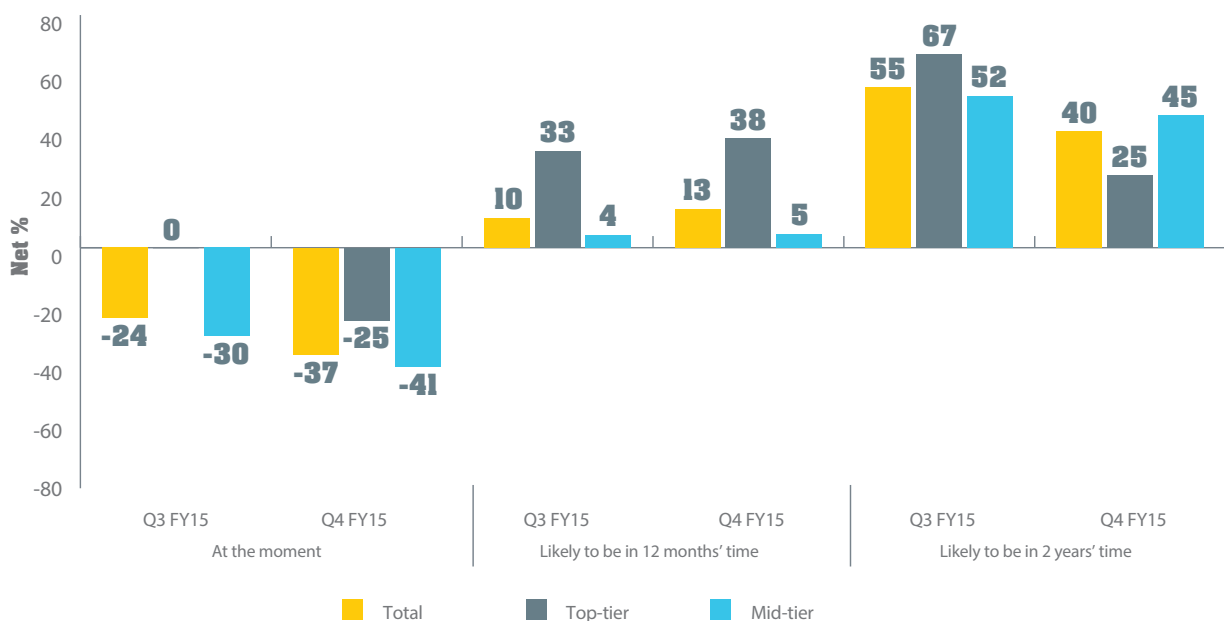
Perceived performance of the Australian economy

A greater proportion of mid-tier firms believe the Australian economy will perform negatively over the next 12 months compared to top-tier firms.



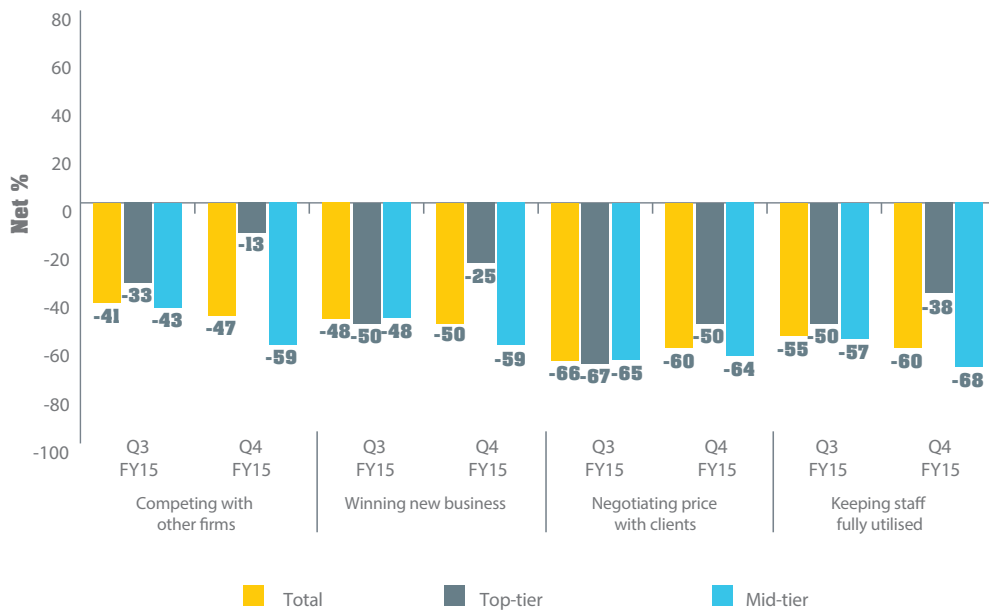
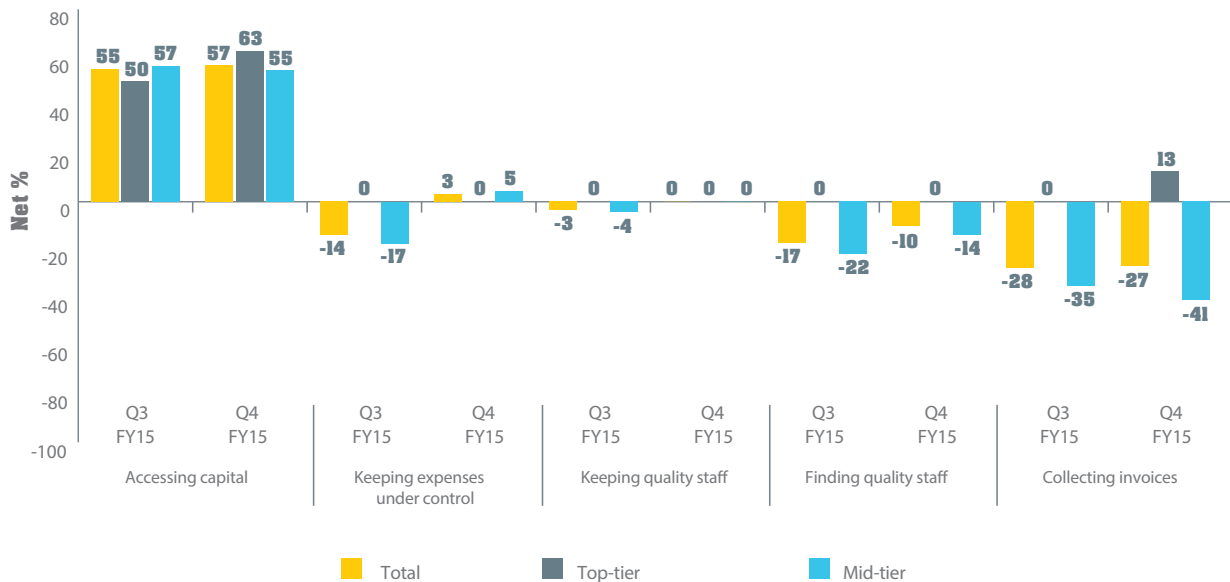
Perception of business conditions – present to 2017

Top-tier firms are less optimistic when thinking about long-term business conditions for Australian law firms.



Perception of business conditions – by area

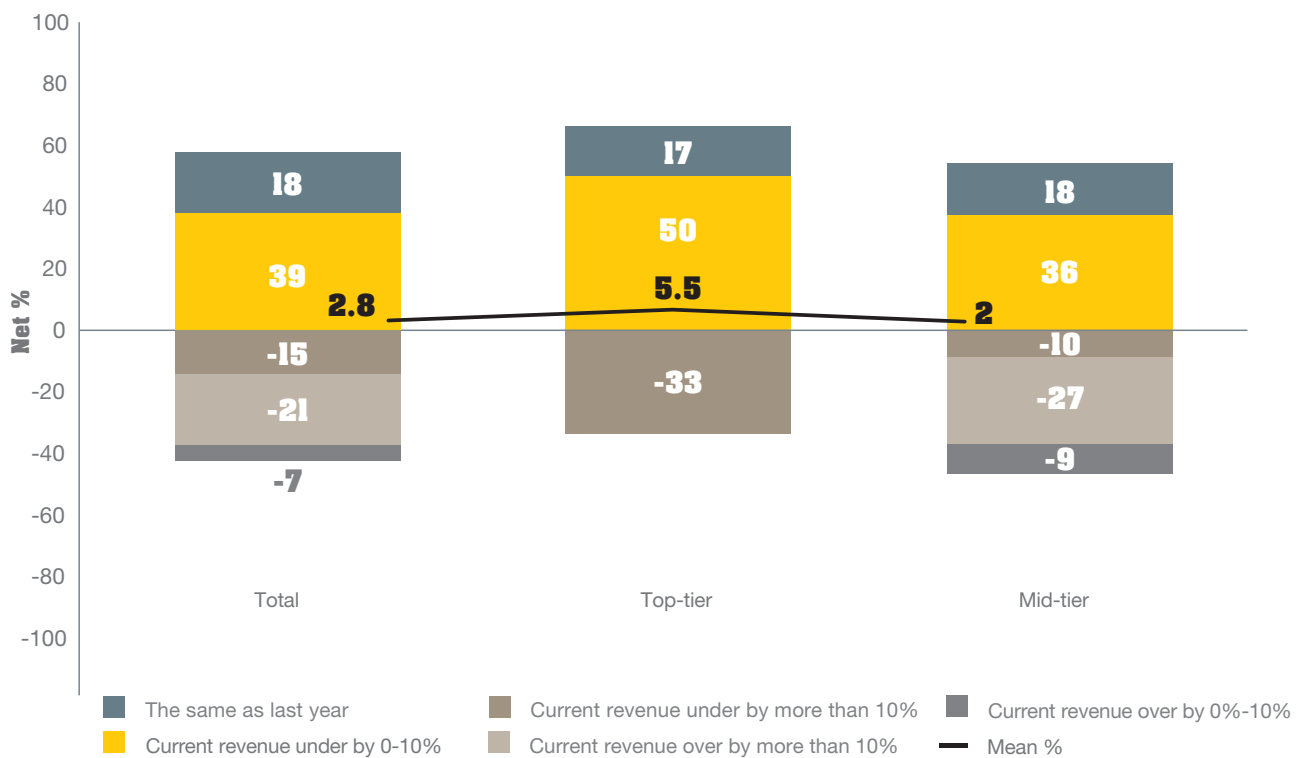
Top-tier firms find business conditions less challenging compared to the previous Q3 FY15 report, especially in the areas of competing with other firms and winning new business.



FY15 financial performance

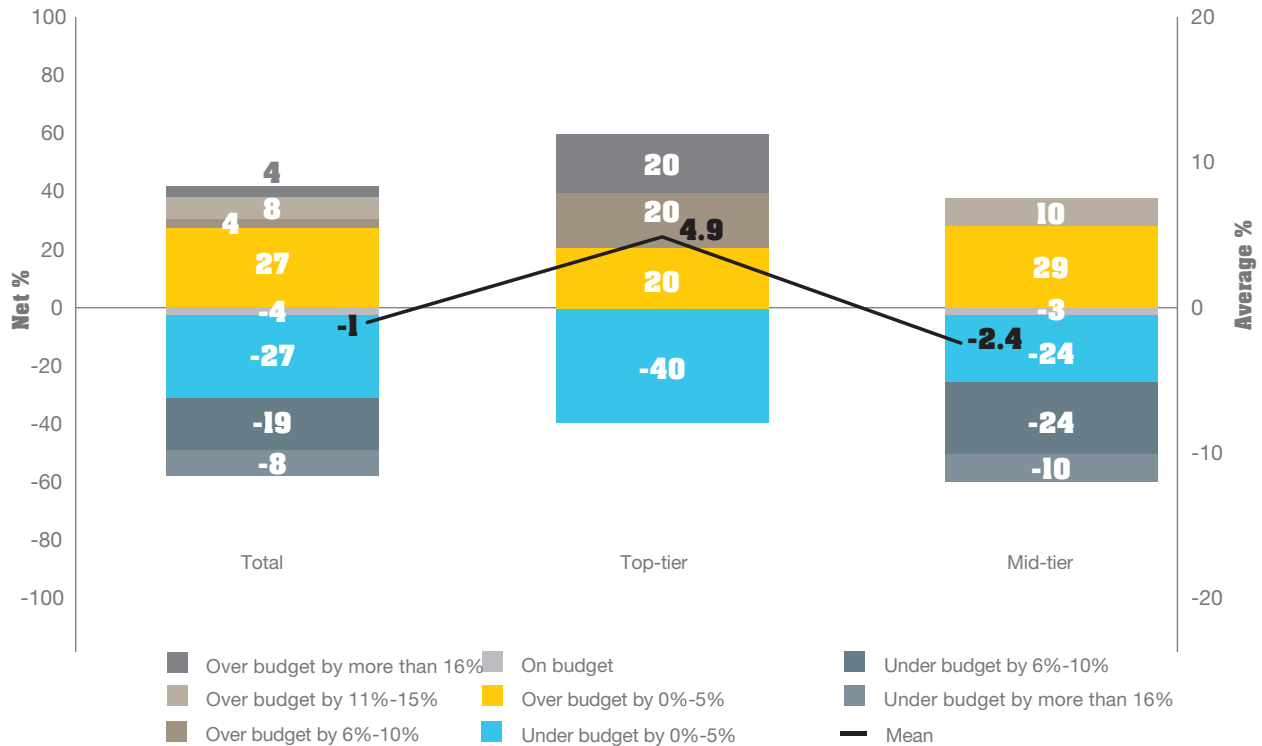
Total revenue change FY14 to FY15

Overall, current revenue for both top and mid-tier firms is slightly higher compared to this time last year.



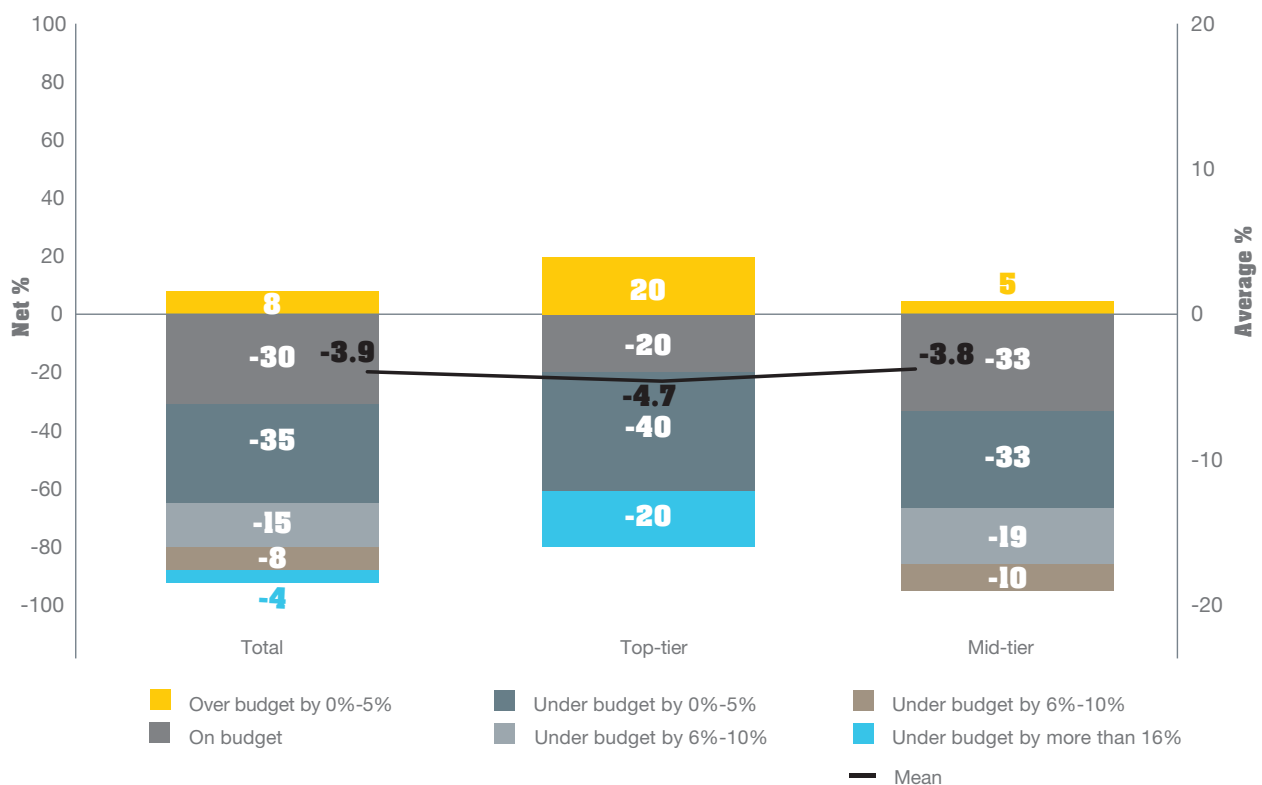
FY15 budgeted and actual revenue results

Mid-tier firms are more likely to miss their revenue budgets compared to top-tier firms.



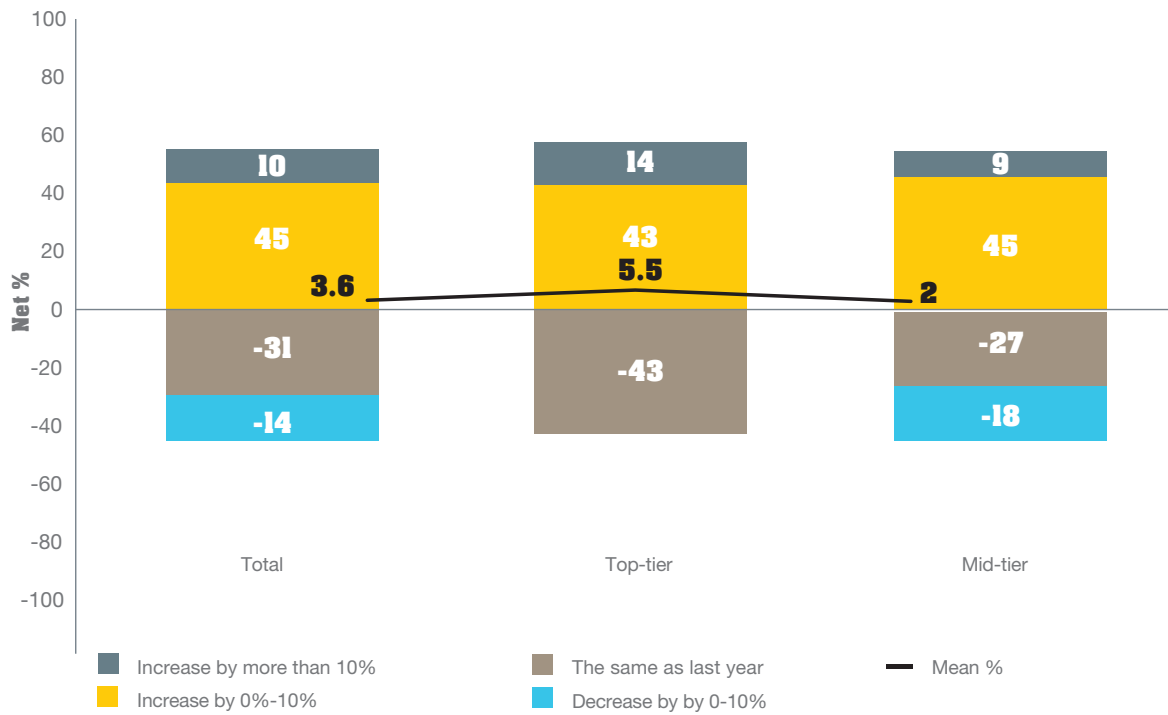
FY15 budgeted and actual expenses results

Most firms have managed to control their expenses during FY15 and are tracking on or below budget.



Forecast for EBIT margins in FY2016

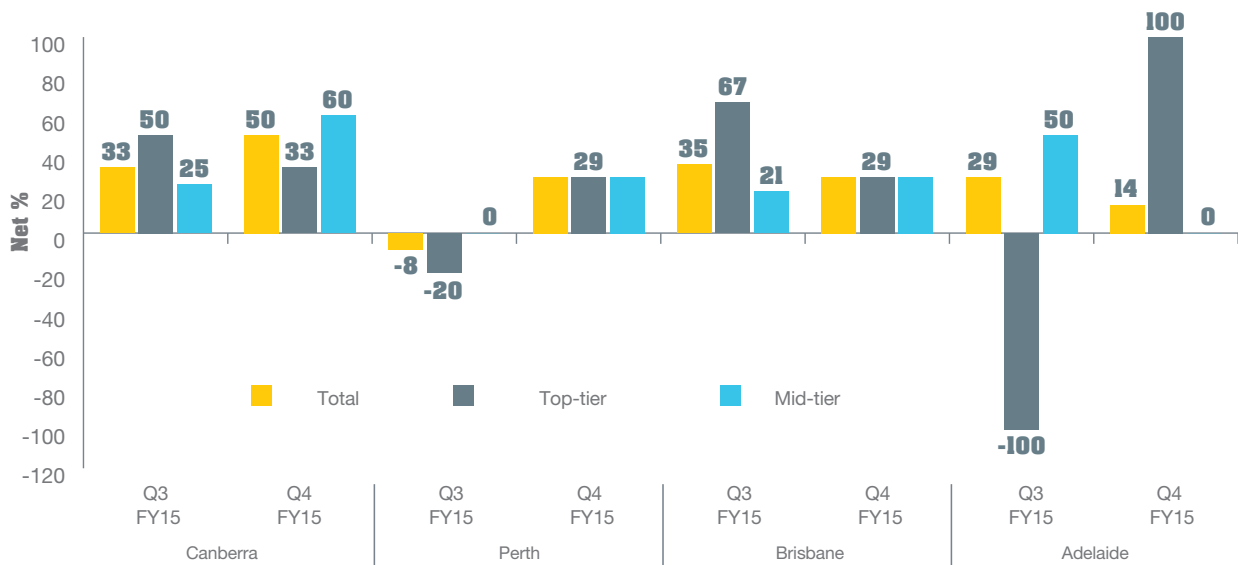
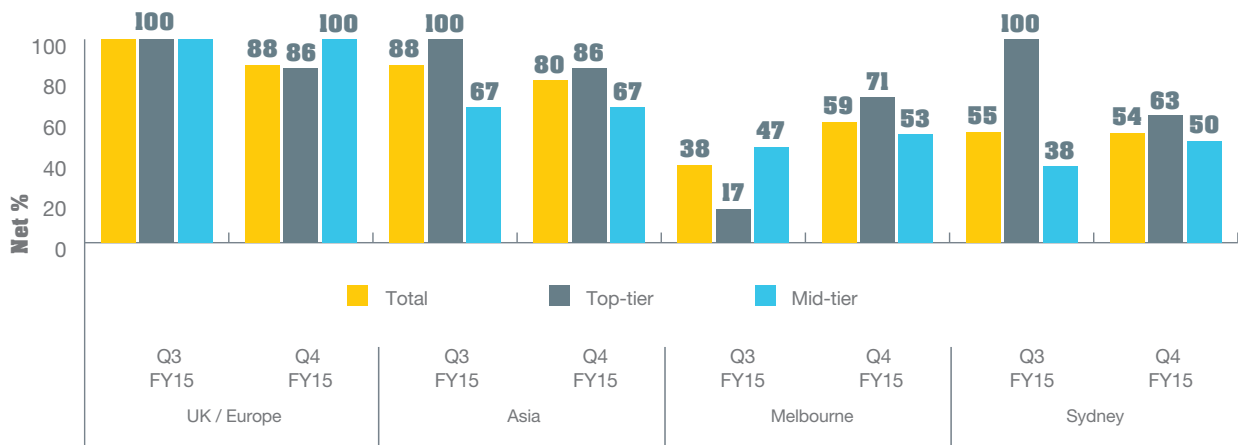
Overall, law firm leaders forecast a slight increase in EBIT margins during FY16.



Revenue predictions

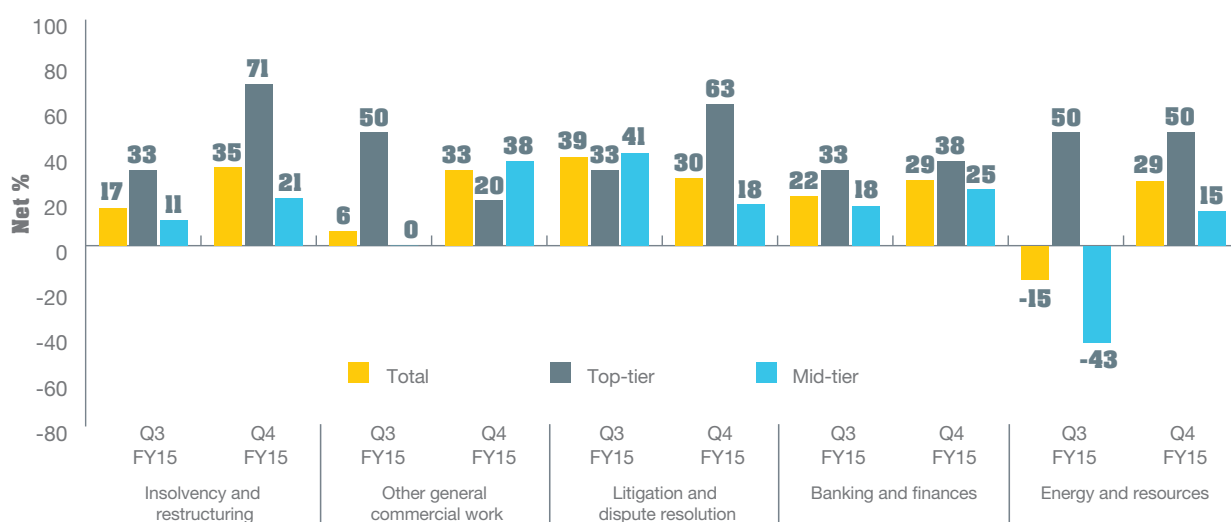
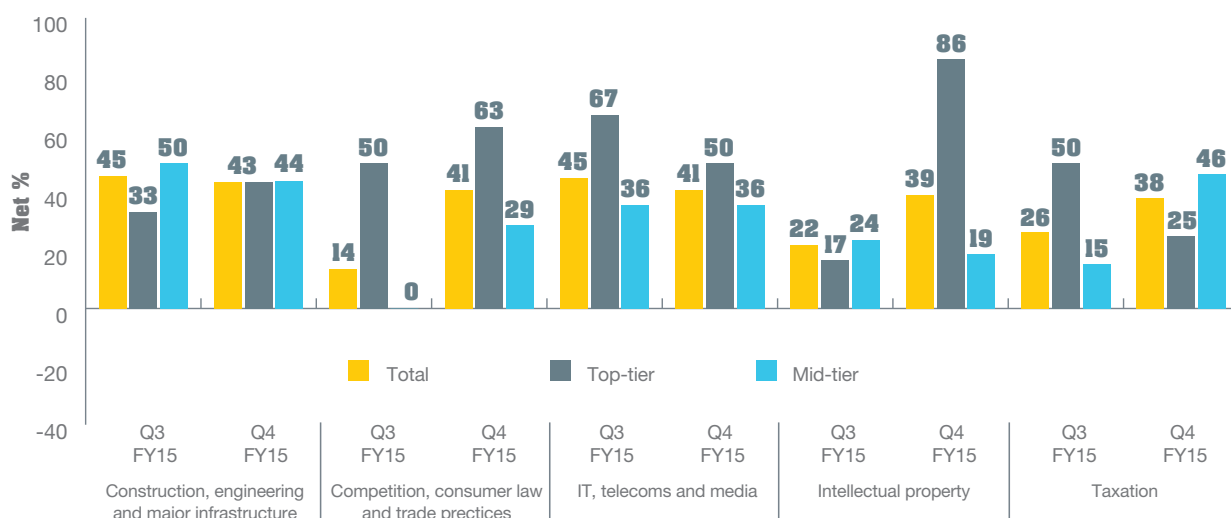
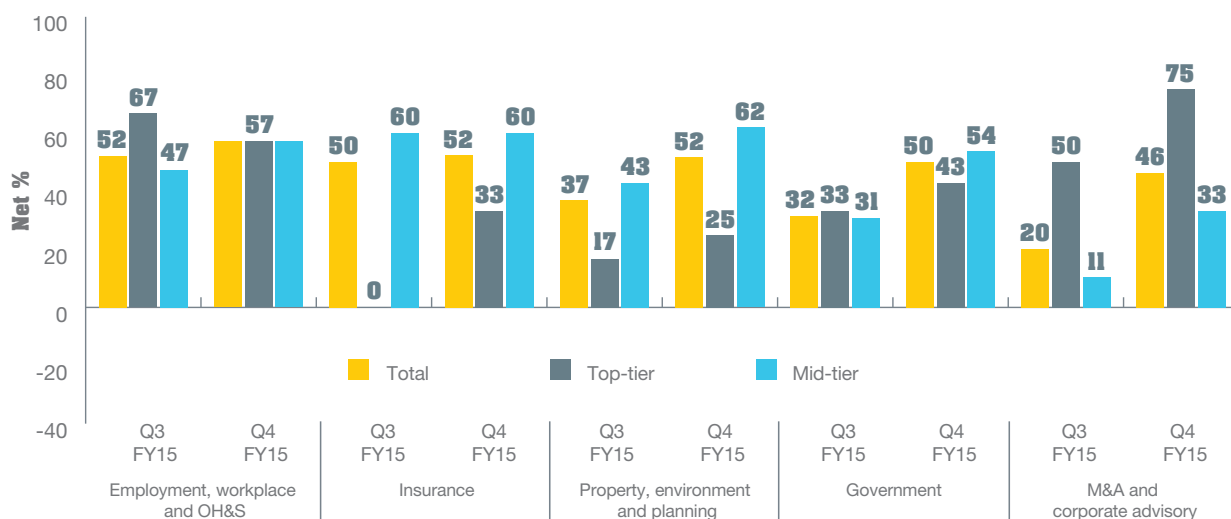
Changes in revenue over the next 6 months – by location

Melbourne and Perth based top-tier firms are the most optimistic about positive revenue changes over the next six months.



Changes in revenue over the next 6 months – by practice area

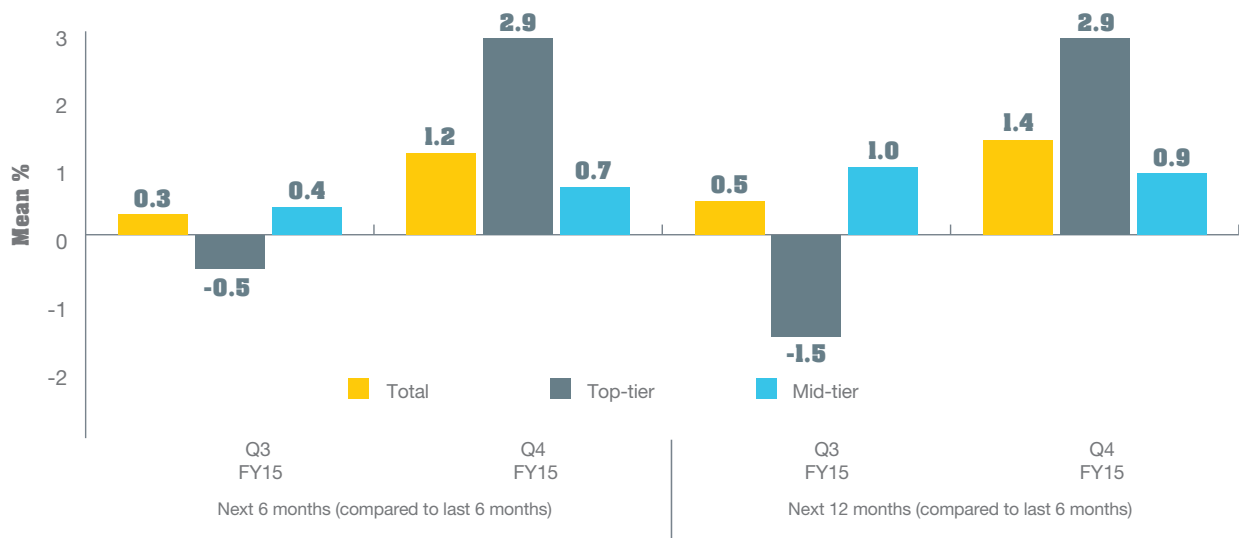
Top-tier firms are forecasting greatest net growth across IP, M&A and corporate advisory, and insolvency and restructuring practice areas. Mid-tier firms forecast highest net increase across property, environment and planning, insurance and employment, workplace and OH&S.



Realised rates

Expected changes in realised rates – next 6 and 12 months

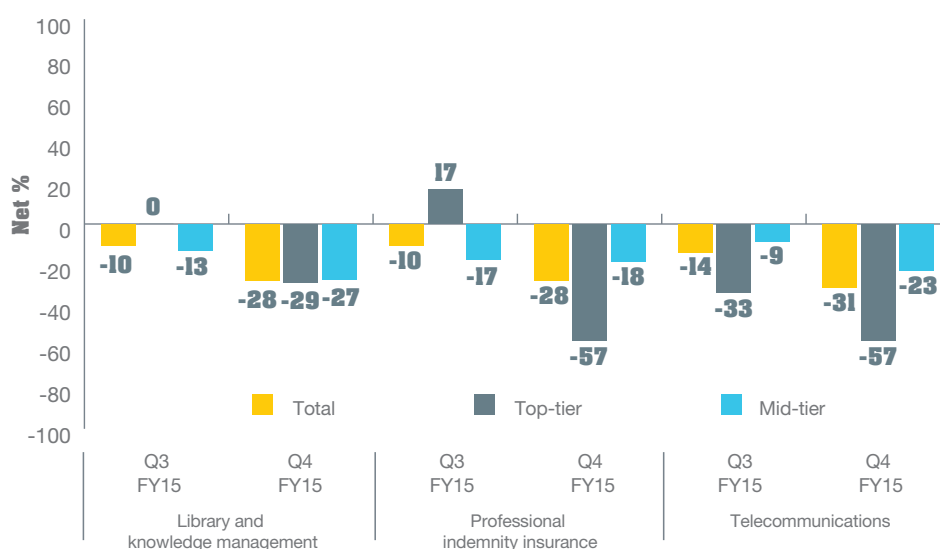
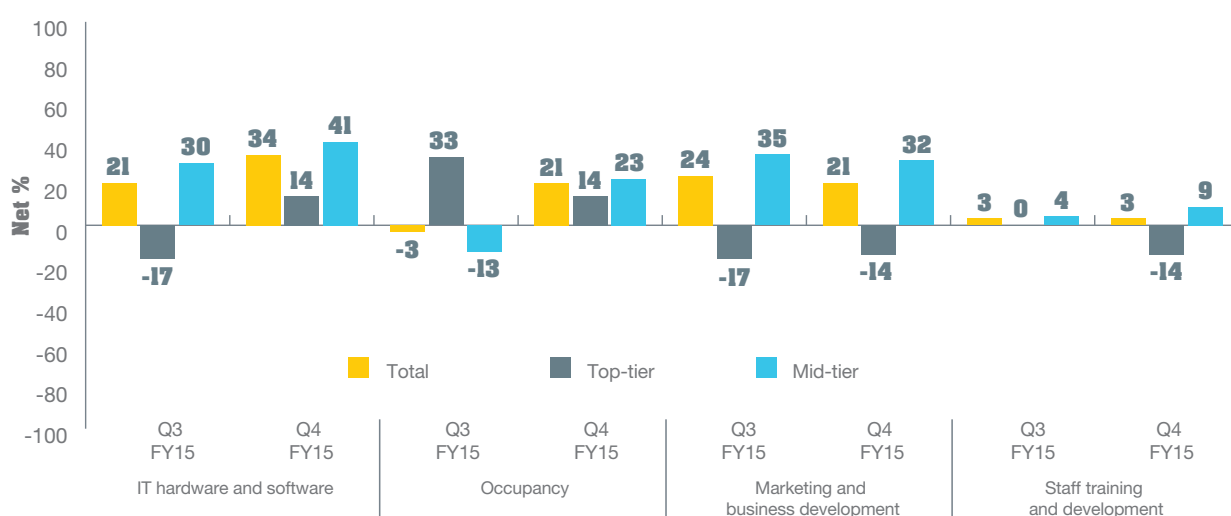
This quarter, forecast increase in realised rates is driven by top-tier firms.



Expense and profitability predictions

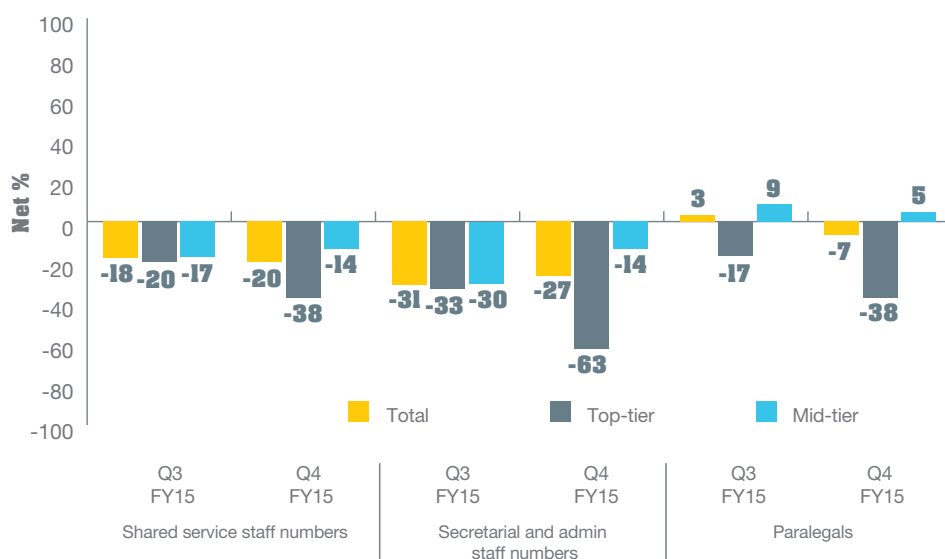
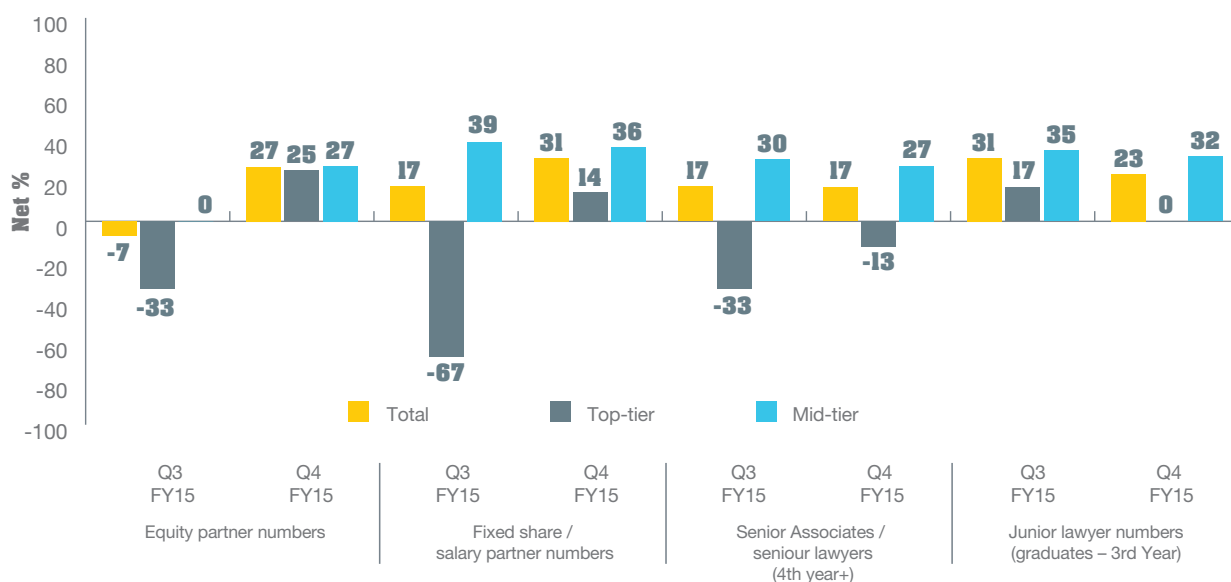
Changes in expenses over the next 6 months

Top-tier firms forecast a net decrease in expenses across all areas except IT hardware and software, and occupancy. Conversely, mid-tier firms expect expenses in IT hardware and software and occupancy areas to increase.



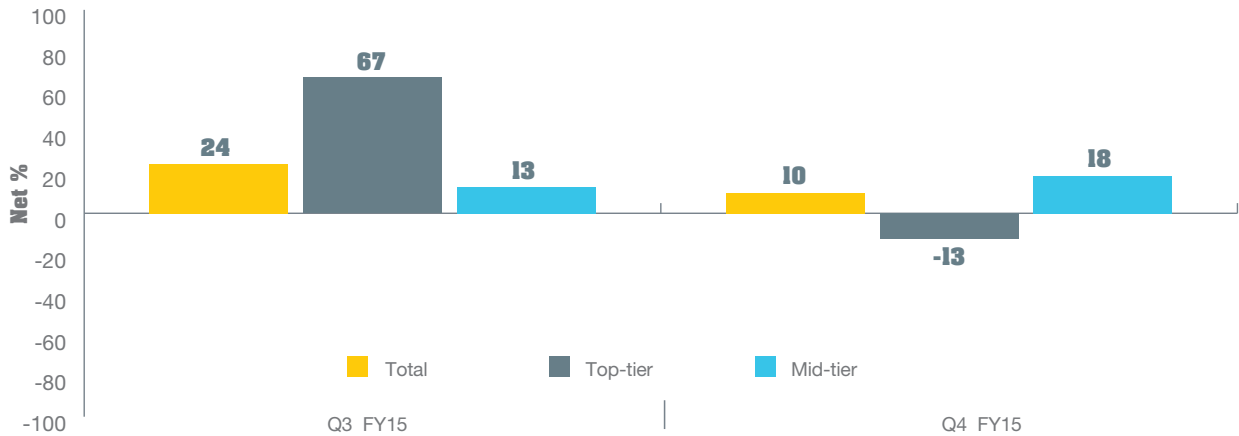
Changes in staffing over the next 6 months

Top-tier firms forecast a net increase in partner numbers and a net decrease in paralegals and non-fee earning staff.



Change in operating margins over the next 6 months

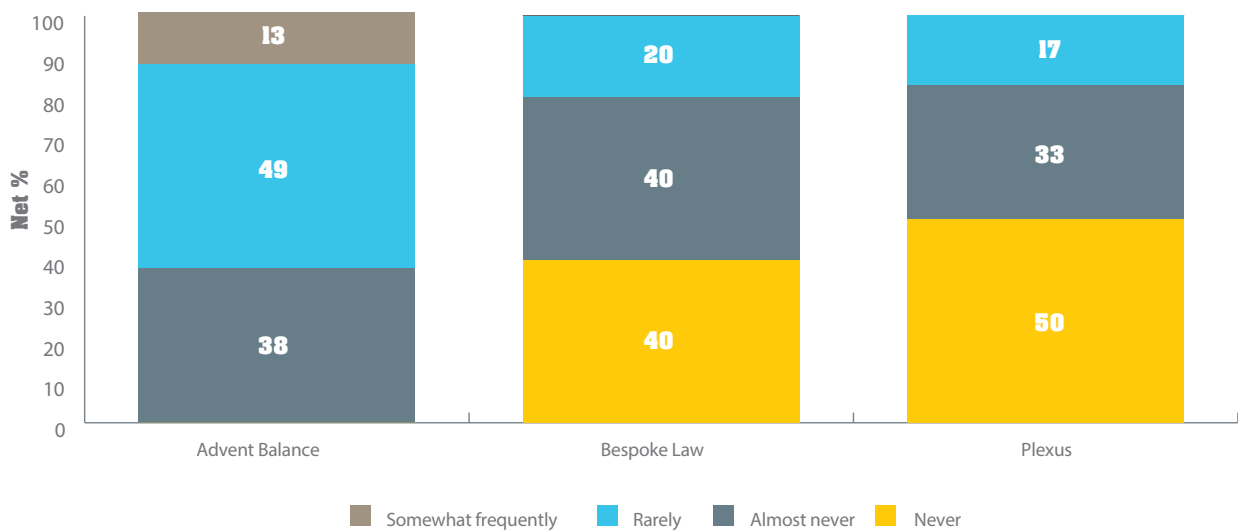
Top-tier firm leaders forecast a significant decrease in operating margins, compared to their mid-tier counterparts.



Competition from non-traditional (alternative business model) law firms

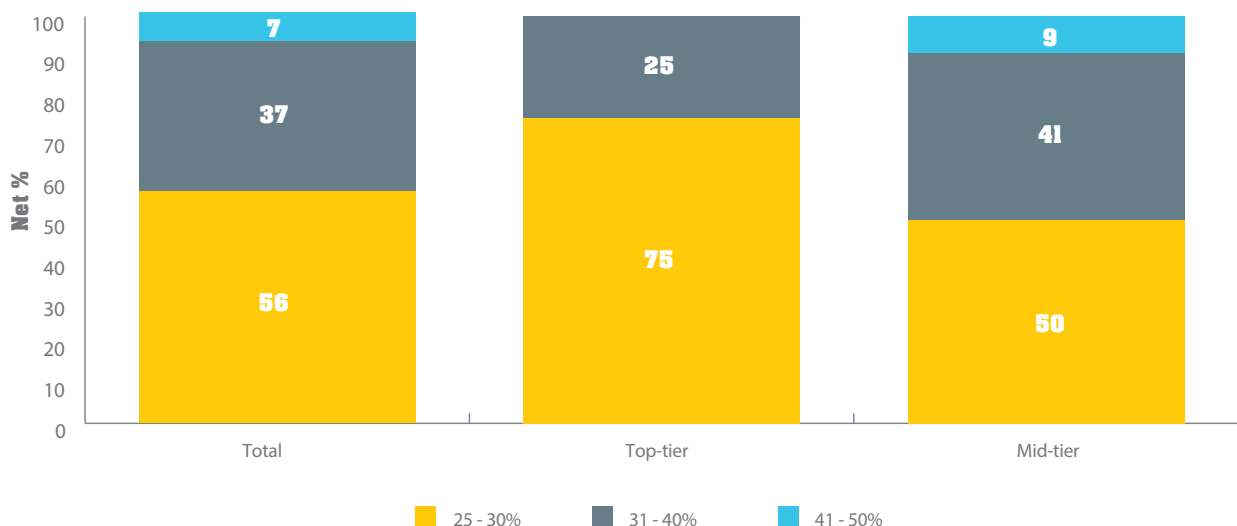
Frequency of competition from non-traditional (alternative business model) law firms

Of the three non-traditional law firms discussed with firm leaders, Advent Balance competes most frequently with traditional law firms.



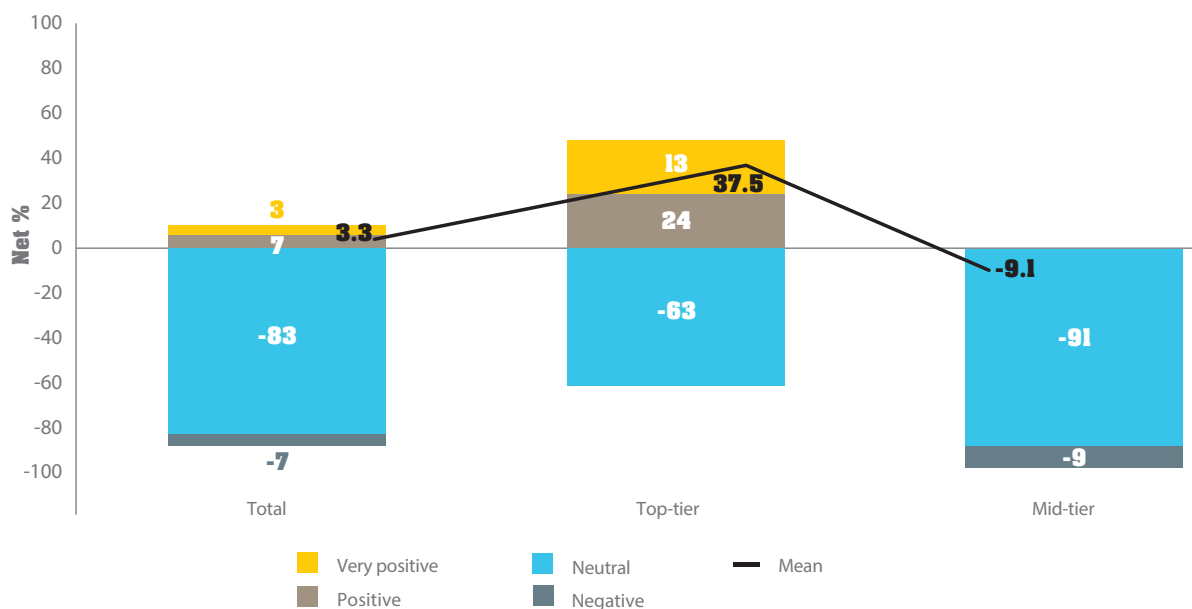
Expected competition from non-traditional (alternative business model) law firms - next 12 months

Mid-tier firms forecast a greater level of competition from alternative business model firms compared to their top-tier counterparts.



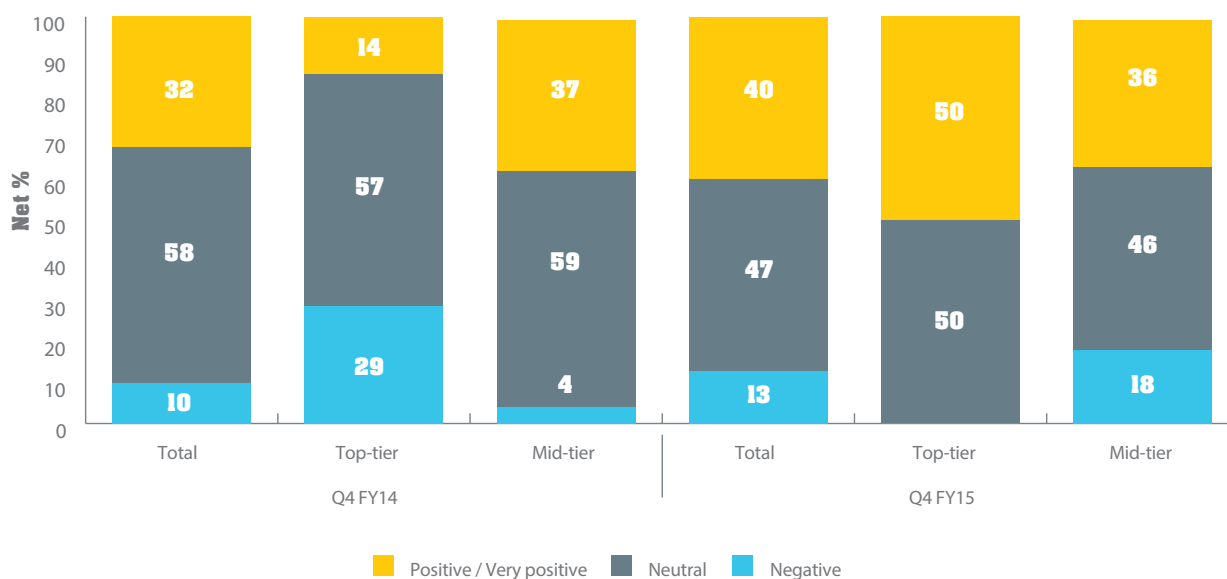
Impact of alternative business model firms - next 12 months

The majority of firms do not perceive alternative business model firms will have a great impact on their business in the next 12 months. Interestingly, one in three top-tier firms do believe alternative business model firms will have a positive impact on the Australian legal industry.



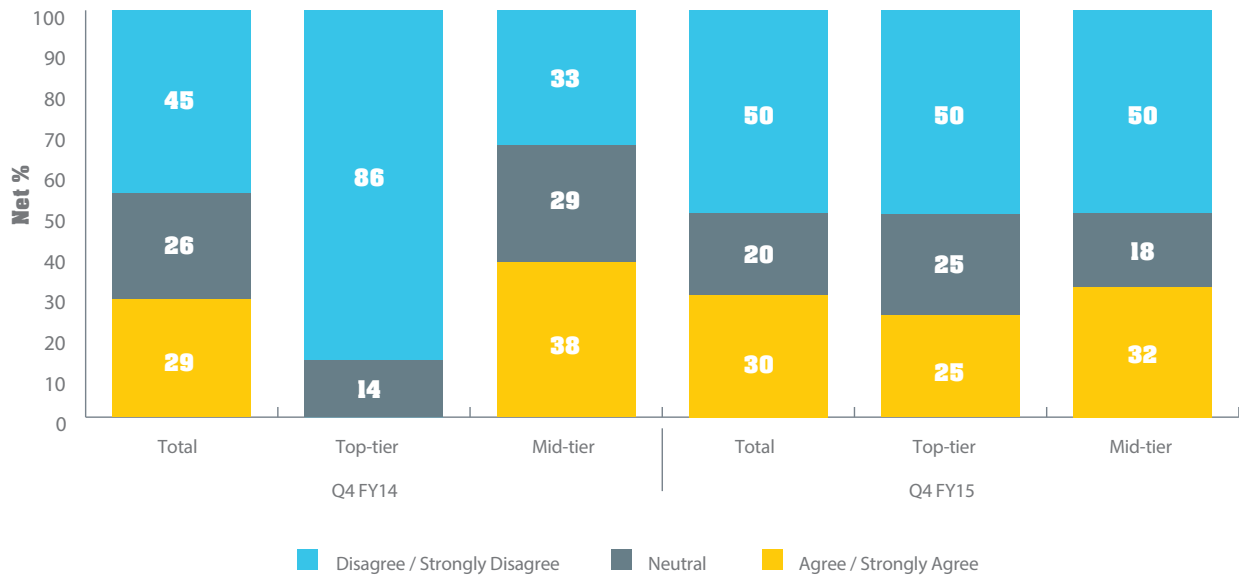
Entry of international law firms

The majority of firms do not expect international law firm entrants to have a great affect on their business. However, approximately one in five mid-tier firms view their entry to the Australian market as a threat.



Cessation of international law firm entrants

Opinions are equally divided on whether or not entry of international law firms into the Australian market will cease.



Further information

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