

The Law Society's Law Management Section

Financial Benchmarking Survey 2019



In association with Hazlewoods LLP



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Foreword

I am delighted to write the introduction for the 2019 Law Management Section Financial Benchmarking Survey.

This year, 210 firms participated – our highest number for many years – making the LMS Survey one of the largest of its kind in England and Wales.

The combined turnover of firms involved amounts to over £1.1bn. We can confidently say that the LMS Financial Benchmarking Survey continues to increase in importance as a valuable tool for all law firm managers, enabling them to benchmark results against a wide range of other law firms.

The team behind the survey have worked to improve the layout and formulation of the results. The design is aimed at making the survey user-friendly and easy to understand. Many of the charts contain results over two years.

I would strongly encourage firms who are not members of LMS to look at our website and consider joining the section; and for those LMS member firms who have not yet joined in the survey, hopefully next

year you will be encouraged enough to do so, making the results stronger than ever.

A huge thank you to Andy Harris and everyone at the accountancy practice Hazlewoods, for their hard work in pulling together and compiling all of the survey results. Thanks also to Andrew Otterburn for his efforts throughout the year, and to Clive Black, Helen Lee and Steve King at the Law Society for their invaluable assistance.

More thanks also go to Lloyds Bank Commercial Banking for their sponsorship of the survey, and to Paul McCluskey from Lloyds for his support and encouragement.

Final thanks go to all who have taken the time to participate in the survey, which makes the report possible.

I hope that you find this year's survey useful in improving the profitability of your practice. Please keep a look out for the survey later in the year, so that you can include your statistics in next year's report.



Ann Harrison

Chair, Law Management Section Executive Committee
Chairwoman, Stephenson Solicitors LLP
April 2019

About the Law Management Section

The Law Management Section (LMS) is the community for partners, leaders and practice managers in legal businesses. Established in 1998, the Section provides law firm managers with support, advice and opportunities to network and share best practice with peers.

It provides practical guidance, information and support on the full range of practice management disciplines, including HR, finance, marketing, IT, business development, client care, quality and risk.

The comprehensive range of services and benefits includes:

- *Managing for Success* quarterly magazine;
- regular *Law Management* e-newsletter;
- website featuring news and events, members-only discussion forum, downloadable documents, secure payment facility and suggested links;

- national and regional events programme covering all management disciplines;
- the *LMS Financial Benchmarking Survey*;
- toolkits on internet policies, mergers, legal aid, risk management, HR and business development;
- networking opportunities;
- representation on the Council of the Law Society; and
- discounts on a range of events, texts and training packages.

Membership is open to solicitors; those concerned or involved in the management of a legal practice / department (whether as HR, IT or marketing manager); or those habitually or frequently involved in the supply of services to legal practices which relate to the financing or management of such practices.

New Corporate Membership

Individual membership costs £199, but you can now take advantage of even greater savings with our new corporate membership deal. For only £200 more than the cost for an individual member, your firm can nominate up to six individuals in their organisation who will all receive the full benefits of being a member of the Law Management Section.

For more information, visit

www.lawsociety.org.uk/lawmanagement

email: MSadmin@lawsociety.org.uk

telephone: 0207 320 5804

About Hazlewoods LLP

The *LMS Financial Benchmarking Survey* is written and produced by the Legal Team of Hazlewoods LLP.

Hazlewoods is a Top 30 accountancy practice with a niche specialism in advising the legal profession, and we have a dedicated team of 28 individuals who focus only on this.

We are retained by over 140 practices countrywide on a recurring basis, and advise at least 30 others each year on projects such as practice strategy, new practice start-ups, mergers, practice sales, structure advice and implementation, external equity investment, breaking away from larger firms and dealings with the SRA. The scope of our service goes far beyond the normal compliance based services provided by the majority of other accountancy practices, and we have a tremendous range of contacts in the sector. See more at www.hazlewoods.co.uk/sectors/legal-accountants.aspx

This is the 10th year that we have compiled the LMS Financial Benchmarking Survey. Over this period, our experience and understanding of the sector have enabled us to develop and constantly refine the questionnaires, and interpret the results.

Should you have questions about anything at all in it, we would be delighted to hear from you (legal@hazlewoods.co.uk)

We would like to thank all practices that took the time to complete and return the questionnaires, and we hope that you find the report both interesting and useful in your practice.



About Lloyds Bank Commercial Banking

I am encouraged by the results which once again show that the sector is resilient and continuing to thrive against a backdrop of challenging headwinds.

The pressure of continued sector reform, coupled with the uncertainty as the UK prepares for Brexit, pose many questions for firms.

However, most pressing issues lie closer to home, with many firms combatting important challenges such as succession planning, viable exit strategies for partners and cybercrime.

To deal with pressures on income, it is crucial that firms keep a tight control on costs and work with fee earners to improve their time recording, billing and cash collection. Results from this year's survey indicate firms are having some success with this.

Almost all types of work are experiencing growth and this is again evidenced by the ninth consecutive year of improvement.

Encouraging too is the reduction in lock-up, however I am still concerned by the number of firms across the sector that continue to allow partners' drawings to exceed profits. Succession is a major issue and this

practice not only weakens the financial strength of the firm - thus potentially discouraging a prospective investor - but it also means practices are less likely to be able to sustain a healthy future. I encourage all managing partners to take a hard stance against this culture.

At Lloyds Bank Commercial Banking, we work closely with solicitors to provide funding and support that meets the specific needs of their businesses. Our specialist managers are Lexcel-trained; understand practice management standards; and know the opportunities and threats that face the profession.

They are also trained in the SRA Accounts Rules to ensure we complete the housekeeping processes correctly.

We are proud to have been voted 'Bank of the Year' by Finance Directors in the FDs' Excellence Awards for 13 consecutive years. Our 'through the cycle' approach to lending has allowed us to continue to support viable firms through difficult times. Since 2011, we have grown net lending to SMEs by 31 per cent while the market has contracted by 11 per cent.

Lloyds Bank Commercial Banking is proud to sponsor the Annual LMS Financial Benchmarking Survey. It is the most in-depth of its kind and an invaluable tool for law firm owners and managers to understand best practice and to make the right business decisions. I am certain that firms who seek out and use external comparators will continue to be successful, irrespective of new market entrants.

Paul McCluskey

UK Head of Professional Practices, SME Banking
Lloyds Bank Commercial Banking

www.lloydsbank.com/solicitors



Introduction

Members of the Law Society's Law Management Section (LMS) are represented in law firms across England and Wales. For the past 18 years, the LMS has produced the annual LMS Financial Benchmarking Survey with the active participation of that membership, and the recent growth in support from the wider legal practice community. The survey is widely regarded as one of the leading annual health check reports for smaller and mid-sized practices.

This report is unique in providing detailed accounting and business metrics collected directly from over 200 solicitor firms across England Wales, allowing those firms and others – particularly from the mid-market – to benchmark their performance against peers and to an extent over time.

As in previous years, all participants provided two years' data, i.e. the most recent accounting period and the previous one, which has allowed us to compare two years' results on a true like for like basis.

210 practices from across England and Wales, concentrated in the mid-market, with a combined turnover of over £1.1billion have taken part in this year's survey. Participants included over a quarter of firms ranked 101 to 200 based on revenue. We anticipate that most of the participants' income will relate to domestic work. For reference, in 2016-17, total domestic turnover for all firms in England and Wales was £23.9billion, although over half of this amount was earned by the 100 largest firms, which are not the subject of this survey.

Many of the charts throughout this report include the results for two accounting years. Most charts include three figures for each turnover band; the lower quartile, median and upper quartile. The results for 2018 are shown as columns and numbers, and the like-for-like results for 2017 are shown as a dash, i.e. - .

Participants are analysed in more detail in section 3.

In a small number of instances, either participants were not able to provide us with full comparative

data, or the sample size was insufficient to allow the findings to be meaningful in relation to the wider population of firms. Where necessary, we have taken account of this in the charts shown and statistics quoted. In general, we have provided results for categories where at least 30 practices responded to the survey.

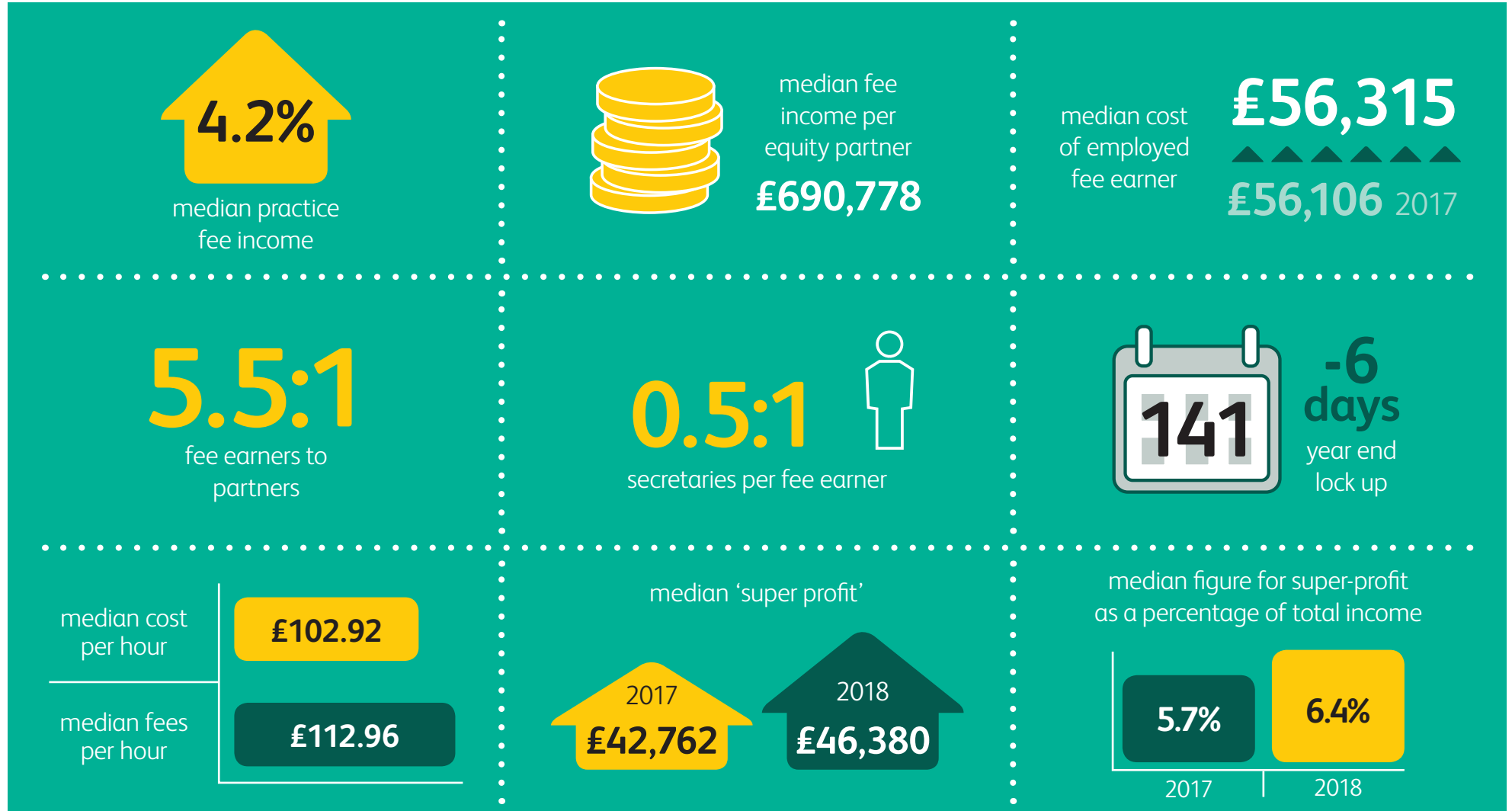
We consider that the response rates that we have seen for this voluntary survey are good, compared to other financial surveys of professional firms. There was a good participation amongst mid-sized and larger firms, but an under-representation of smaller firms, and we do not survey the very largest firms (many of which are global operations). The overall results should not be taken as being representative of the profession as a whole. The sample is self-selecting, and this may introduce bias into the results in a manner that is not directly quantifiable.

For ease, throughout this report we refer to the owners of the practices as Equity Partners.

2.

Summary of findings

Key headlines in this year's survey (explanations for all of these will follow later):



- Median increase in practice fee income of 4.2%. Most work types have seen an increase.
- Median fee income per equity partner of £690,778 (2017: £648,877).
- The median cost of a fee earner, including fixed share partners and notional salaries for equity partners, was £56,315 per fee earner, compared to £56,106 in 2017.
- The ratio of fee earners to equity partners remained steady, at 5.5 to 1.
- The number of secretaries per fee earner fell very slightly, to 0.5 to 1 (2017: 0.56 to 1). The number of all other support staff per fee earner remained the same, at 0.40 to 1.
- The median spend on non-salary overheads per fee earner was £36,415 compared with £36,521 in 2017, and as a proportion of fee income non-salary overheads dropped slightly, to 29.5% (2017: 30.4%)
- Total year end lock up days (WIP and debtors combined) fell by 6 days to 141 days.
- Median equity partner capital (combined total of capital account, current account and tax reserves) down by 3% to £210,301.
- 16% of participants reported partners' total drawings (including income tax) exceeding profits in both 2018 and 2017, in line with last year.
- The median hourly cost of a fee earner (based on 1,100 chargeable hours per year) is £102.92, compared to median hourly fees per fee earner of £112.96

Median net profit per equity partner (before notional salary) for participating practices has increased again, up from £149,546 in 2017 to £151,613 this year – a rise of 1.4%. This is the ninth year in a row that survey participants have seen increased net profits.

When we adjust the net profit figure to include a cost for equity partners, and also notional interest on partner capital, the median 'super-profit' for the year was £46,380, compared to £42,762 in 2017. 25% of participants reported a 'super-loss' for the year.

The median super-profit percentage for participants in the survey was 6.4% of total income, compared to 5.7% in 2017.

3.

Participants

210 practices from across England and Wales, comprising 16,000 partners and employees, took part in this year's survey. The fee income of all participants totals £1.11bn - an average of £5.3m per practice - and combined net profits of £243m.

Once again, we have categorised practices based on turnover. The turnover bands and the number of participants in each band are shown in the table below. In a change from last year, the lower turnover band now covers firms with income of up to £2million.

The total number of practices in England and Wales in each band is also shown.

Turnover band	Total number of practices	Number of participating practices	%
<Up to £2million	8,195	64	0.8%
£2million to under £5million	653	72	11.0%
£5million to under £10million	261	44	16.9%
£10million to under £35million	195	30	15.4%
£35million+	112	-	-
No turnover data available	36	-	-
Total	9,452	210	2.2%

Participants included over a quarter of firms ranked 101 to 200 based on revenue. There was a good participation amongst firms with a turnover greater than £5million, and an under-participation of firms with turnover below £2million.

The locations of the participants are as follows:

Region	Number of participating practices
Eastern	10
Greater London	31
Midlands	44
North East	17
North West	27
South East	28
South West	41
Wales	8
Yorkshire	4
Total	210

80% of participants traded as either an LLP or limited company. This is significantly higher than the equivalent percentages for all solicitor firms, and contains a greater share of LLPs, at 51%. According to SRA statistics, 46% of practices were operating as a limited company, and 15% were operating as an LLP at 31 December 2018.

This difference between the survey participants and the sector as a whole reflects the fact that a greater proportion of mid-sized firms have taken part this year.

The SRA's statistics show that the number of limited companies has increased by 585 in the last two years, with very little change in the total number of practices.

Figure 3.1: Financial year end of participating practices

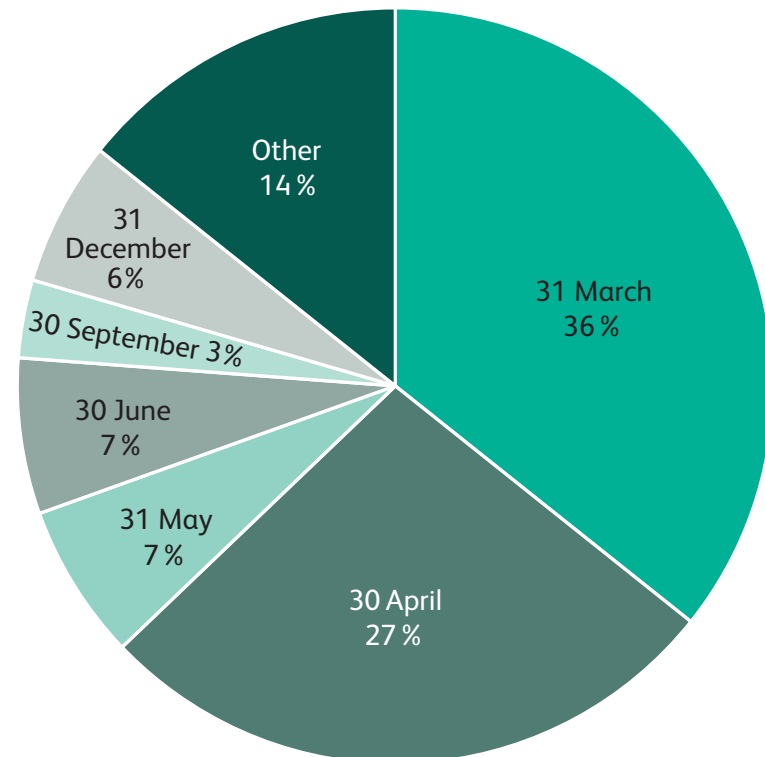


Figure 3.2: Type of participating practices (self-defined)

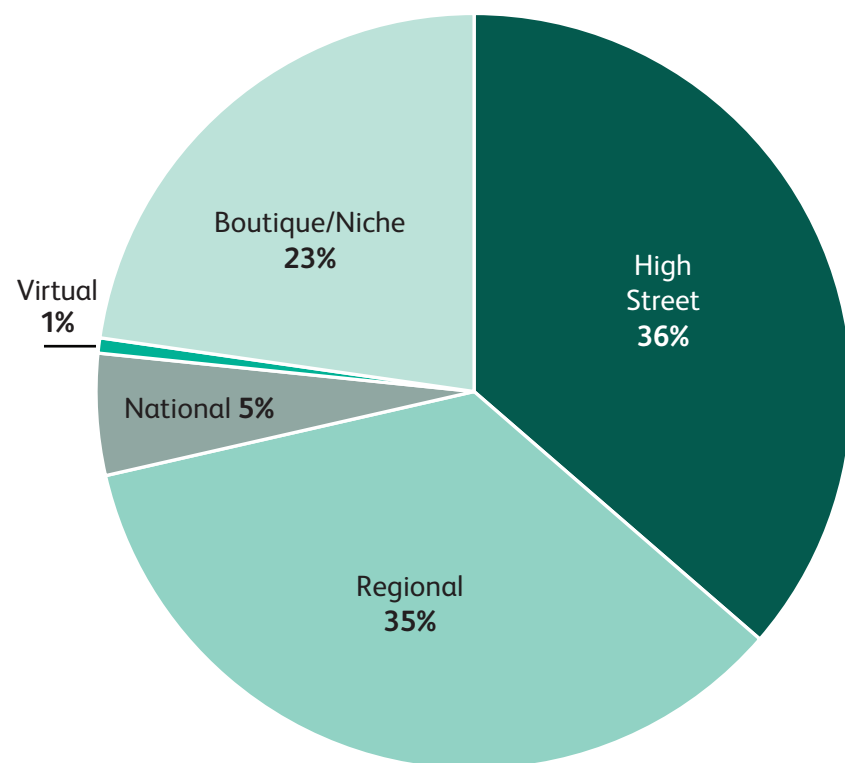
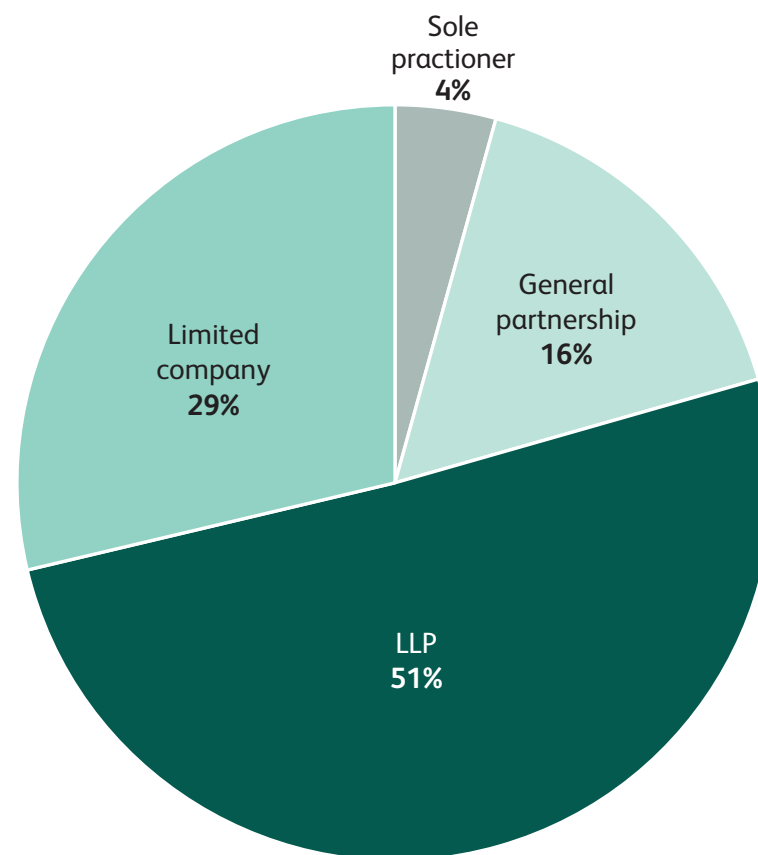
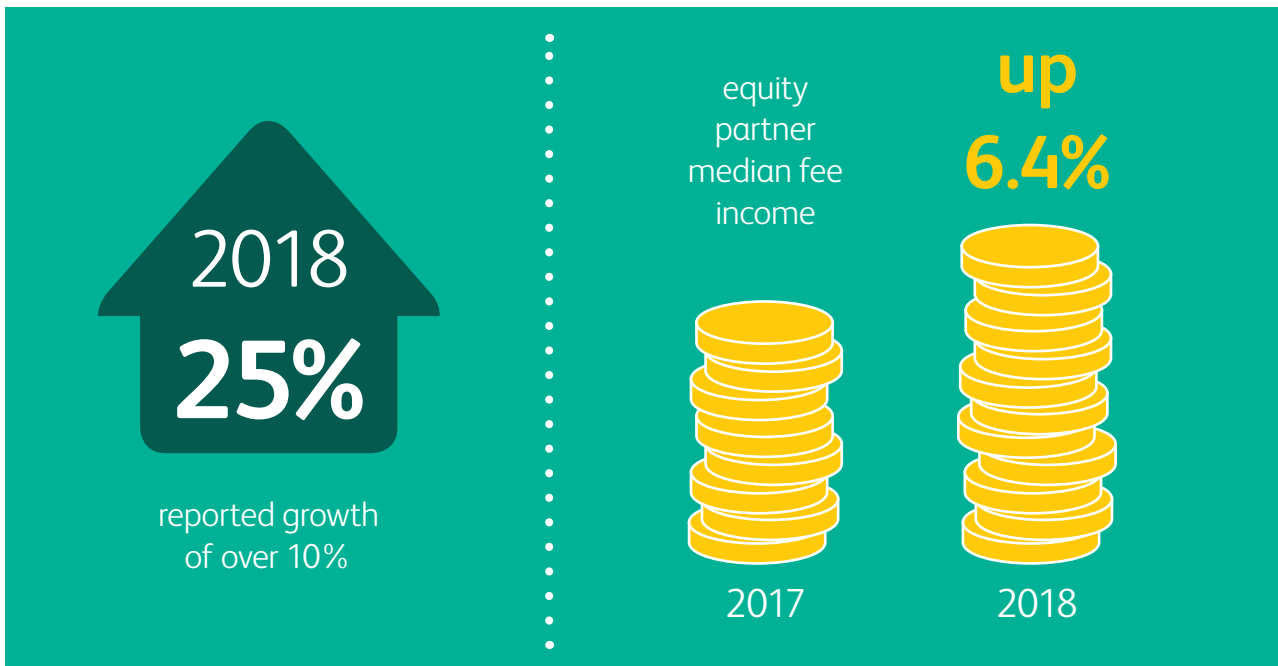


Figure 3.3: Structure of participating practices



We start our analysis by reviewing income growth. We have measured income performance by equity partner, by individual fee earner and by specialism. We also reveal the effects on revenue from changing the gearing in a practice; that is the ratio of fee earners to equity partners.



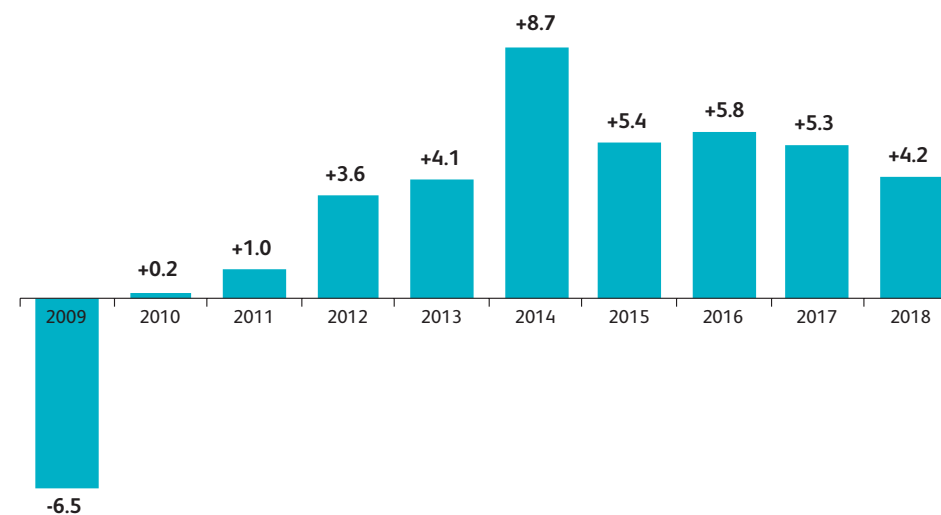
Key points are:

- 71% of the participants in the survey reported year-on-year fee growth in 2018, with a quarter seeing growth of over 10%. Smaller practices in the survey saw a wider range of fee change than other turnover groups, as shown in Figure 4.1, possibly due to the fact that a modest increase in £ terms can represent a large proportion of overall fees for those practices.
- This is the ninth consecutive year that we have reported a median fee increase, although it should be noted that the composition of the sample across those nine years will have varied. Across the last five years we have reported an average median increase of 5.9%, so when compared against RPI inflation (currently at 2.7%), participants have experienced strong growth in real terms.
- Participants reported a median fee income per equity partner of £690,778 compared to £648,877 in 2017 – an increase of 6.4% - although smaller firms in the survey generally saw much lower results.
- In general, most work types are experiencing growth, although for many practices this has slowed significantly in recent months.

Figure 4.1: Change in fee income compared to previous year's fee income (%)

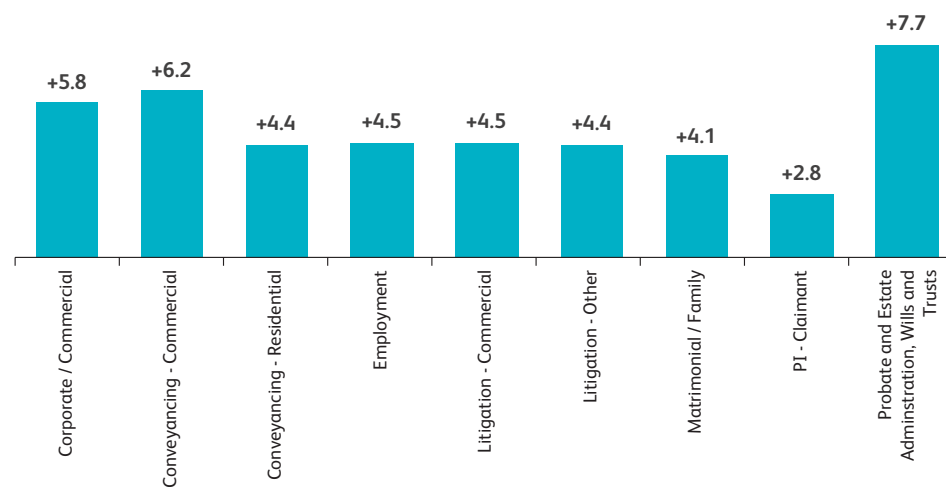


Figure 4.2: Median changes in fee income over the last 10 years (%)



4. Fee income

Figure 4.3: Change in fee income compared to previous year's fee income by specialism (%) (median figure only)

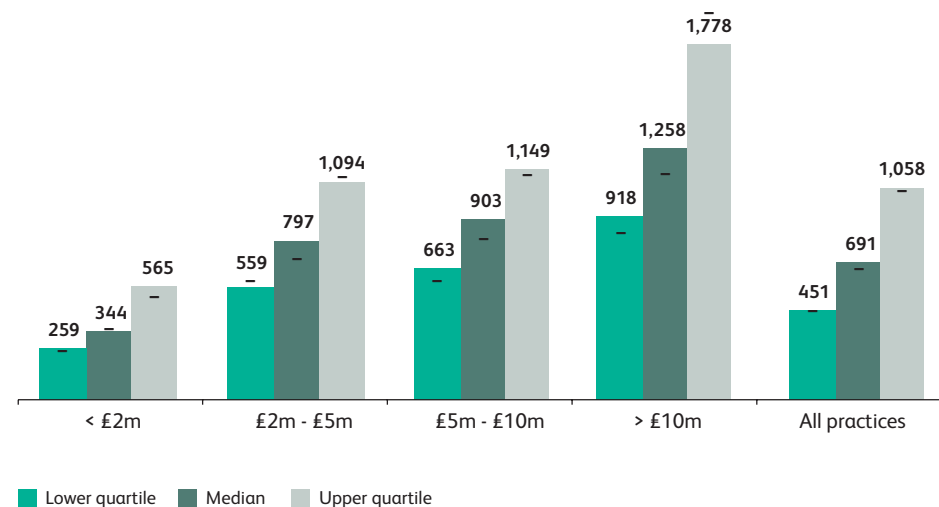


Equity partner performance

The majority of participants in the survey reported minimal change to the number of partners between 2017 and 2018. The total number of equity partners in participating practices fell by just 0.9%, from 1,269 to 1,258.

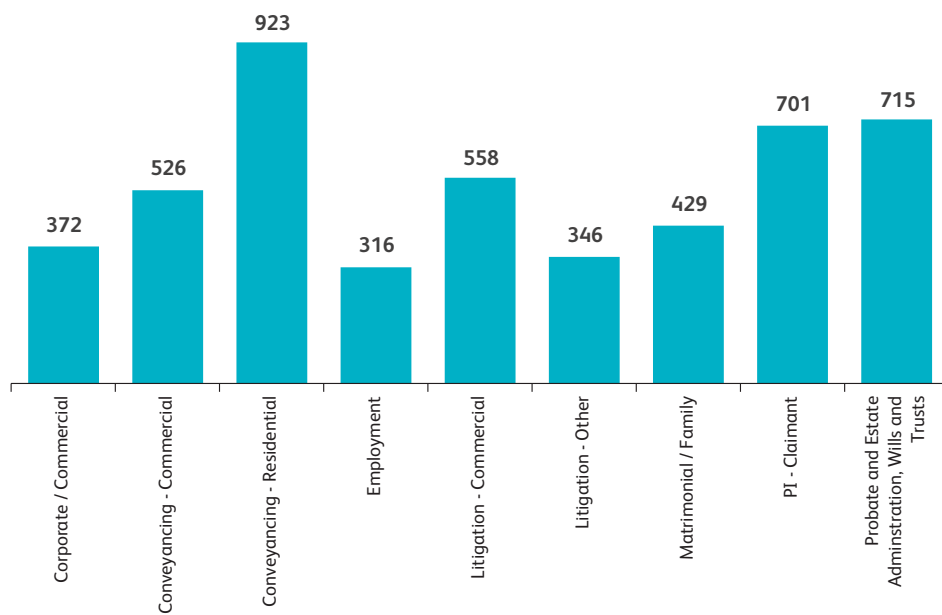
For most practices, the growth shown in Figure 4.1 has resulted from increased fee income per equity partner, rather than an increase in partner numbers. All but the smallest practices show a rise in fee income per equity partner, with a median growth of 6.4%.

Figure 4.4: Fee income per equity partner (£'000)



4. Fee income

Figure 4.5: Fee income per equity partner by specialism (£'000) (median figure only)



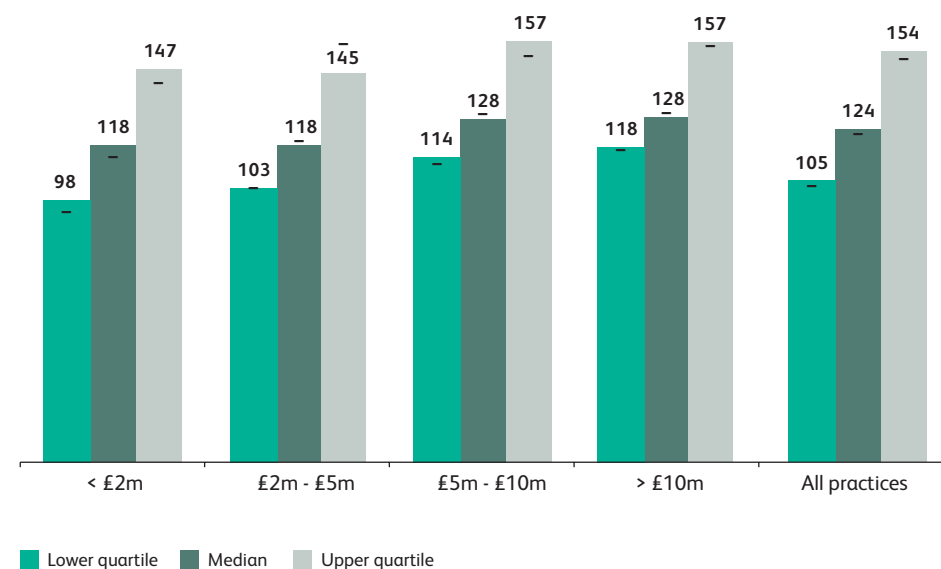
Income by individual fee earner



Key points here are as follows:

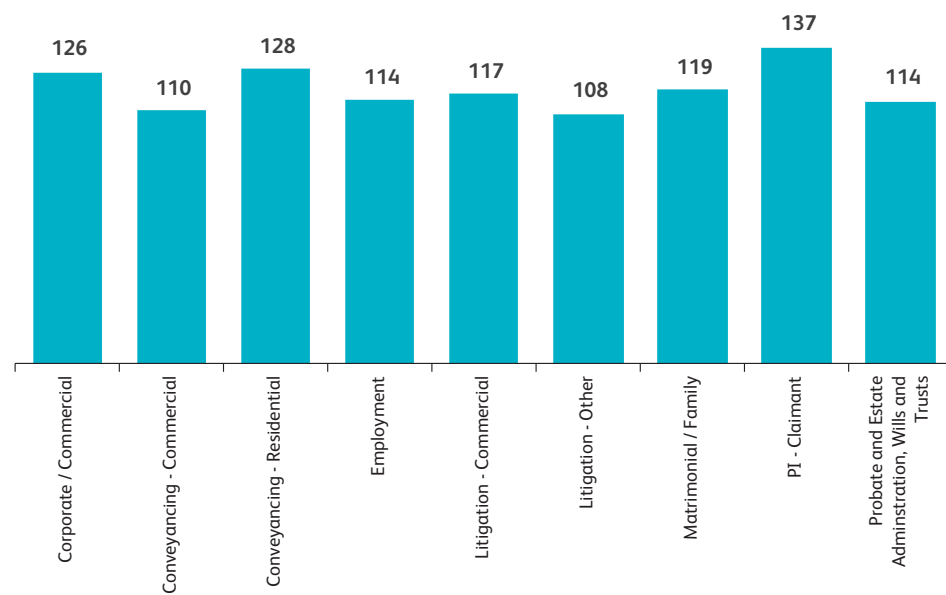
- The total number of fee earners for participating practices was 8,404, compared to 8,130 in those same practices in 2017, a 3.3% increase.
- Average fees per fee earner were £124,253, compared to £122,621 in 2017, a growth of 1.3%.
- The growth in the number of fee earners is good news, as it demonstrates that partners in most practices are optimistic about the future. The increase in average fees per fee earner is also good news, as it shows that new fee earners recruited during the year are being productive and generating chargeable work in line with their peers. Existing fee earners are recovering more of their chargeable time, or have been able to increase their chargeable rates.

Figure 4.6: Fee income per fee earner (£'000)



4. Fee income

Figure 4.7: Fee income per fee earner by specialism (£'000) (median figure only)



Fee earner gearing

Fee earner gearing (the ratio of fee earners to equity partners) is a key indicator, not only as an absolute measure, but also as a trend over time. In improving economic conditions, the ratio of fee earners to equity partners tends to increase as practices grow, with the opposite happening in times of recession.

This is certainly true in our surveys. Back in 2009, when we first carried out the LMS survey, the median ratio was 4:1, and the general economic climate was fairly bleak. Practices took steps to contain overheads. Since then, we have seen a steady rise in fee income, and the gearing ratio has gradually crept up to 5.5:1.

In our calculations we have included equity partners in the number of fee earners (unless they are non-lawyer managers). For example, if a practice comprises two equity partners and three other fee earners then the ratio is 2.5:1 (i.e. five divided by two).

As shown on the chart overleaf, fee earner gearing can vary quite significantly by work type. Residential conveyancing and personal injury claimant teams in particular often have a higher than average ratio, whereas the ratio tends to be lower in areas such as employment and litigation.

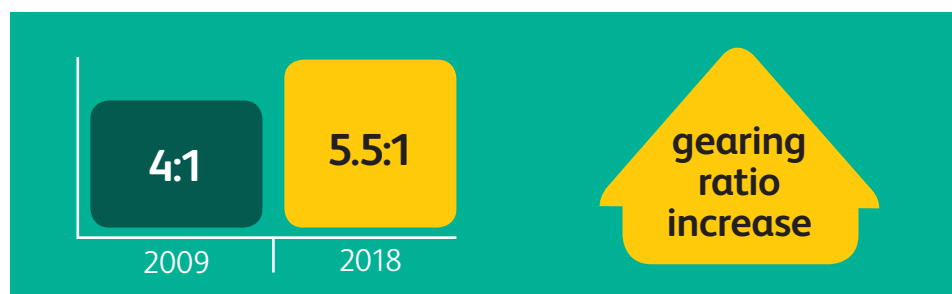
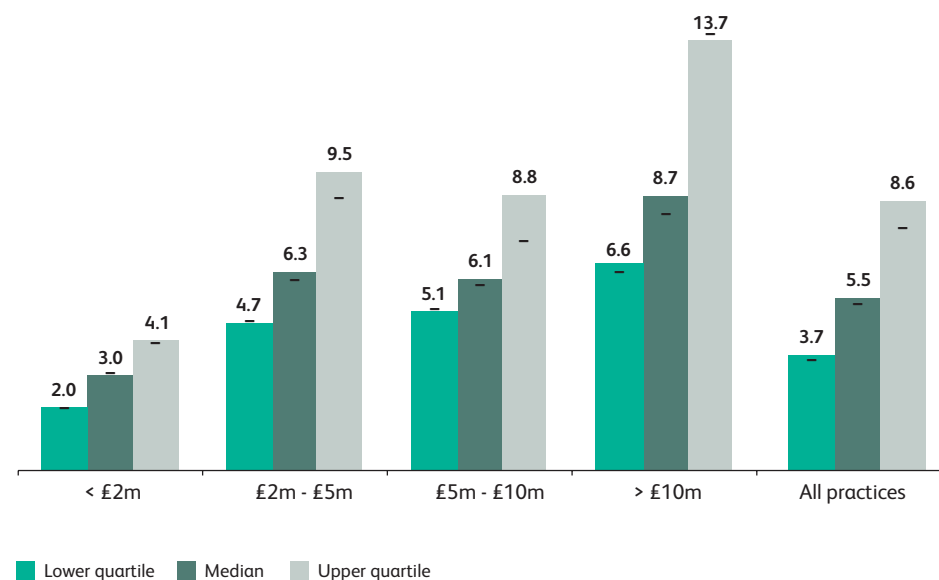
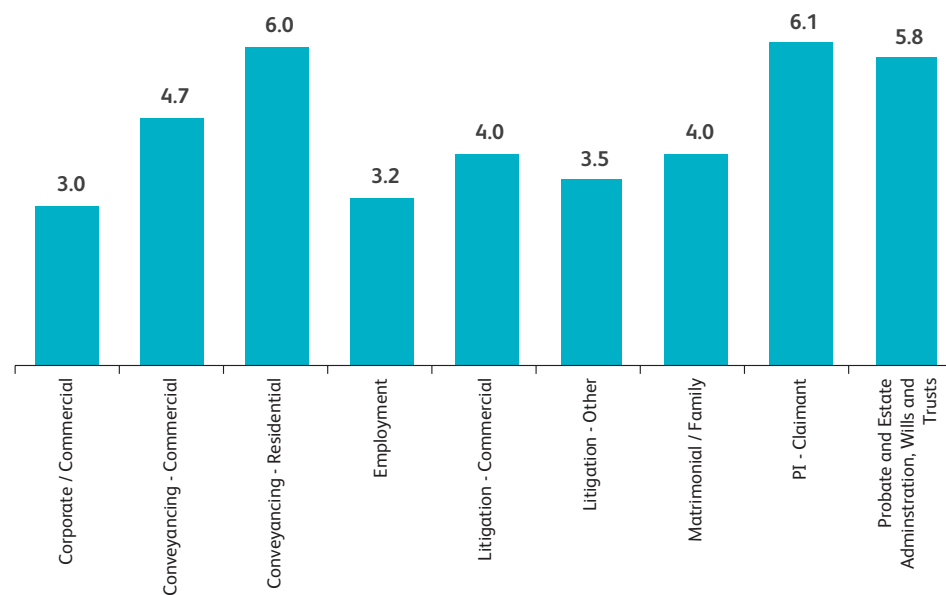


Figure 4.8: Number of fee earners per equity partner



4. Fee income

Figure 4.9: Number of fee earners per equity partner by specialism (median figure only)



Fee earners

People represent the primary cost of all legal practices. The total costs are broken down into three principal categories:

- Equity partners
- Fee earners
- Support staff

Figure 5.1 compares the total cost of these people against fee income. This includes notional salaries for equity partners, which we have set at a level of the highest employed fee earner's salary for the size of practice, plus 15%, to reflect Employer's NIC and pension contributions.

The median 2018 total is 64.5%, compared to 64.2% in 2017. The consistency in margin indicates that staff costs have risen in line with fee income. More people are being recruited, and salaries are rising, but fees are increasing to cover the additional cost.

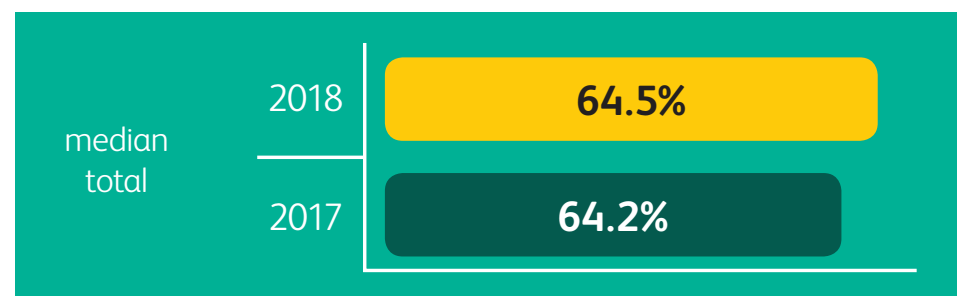
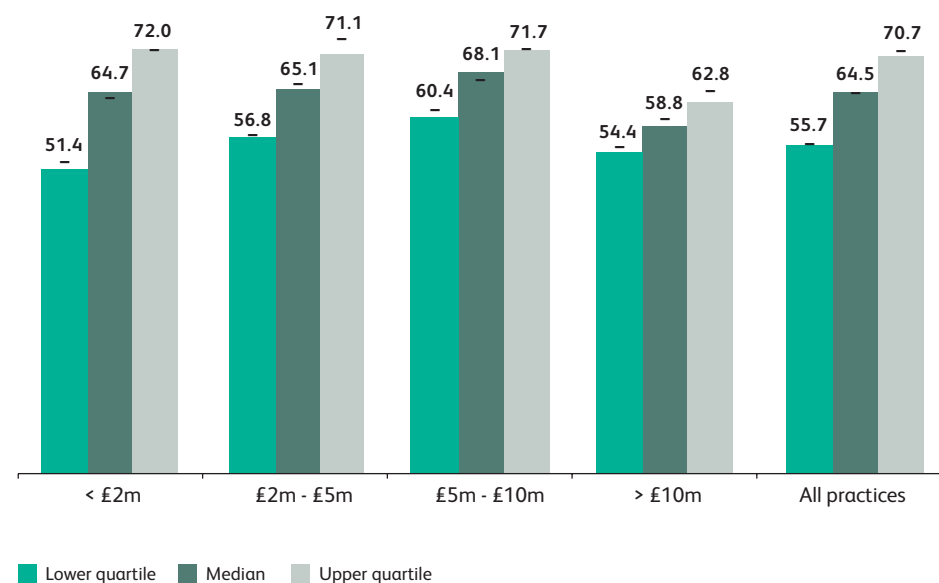


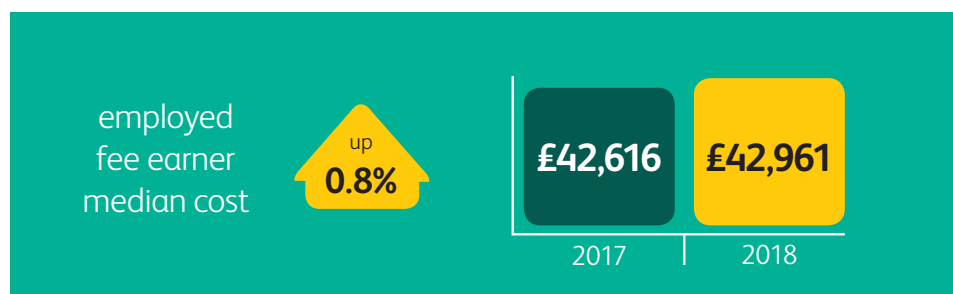
Figure 5.1: Total salary costs, including notional salaries, as a percentage of fee income (%)



5. Employment costs

Employment costs – employed fee earners

Having established the contribution margin, we can now look in more detail at how much practices are actually spending on their employees. In Figure 5.2 we include salaries, fixed share partners, consultants, temporary staff and all usual payroll and pension costs. However, no redundancy or recruitment costs are included here, or any notional salaries for equity partners.



Key findings are:

- Expenditure on fee earners as a percentage of fee income is very consistent for most practices, across all turnover bands.
- The median cost of an employed fee earner increased by 0.8%, from £42,616 in 2017 to £42,961.
- The average fee earner cost is not consistent across practice size, and rises in line with practice revenues. Practices with the highest fee income are generally employing more expensive staff, as shown by the notional salaries detailed in section 6.

Figure 5.2: Expenditure on employed fee earners as a percentage of fee income (%)

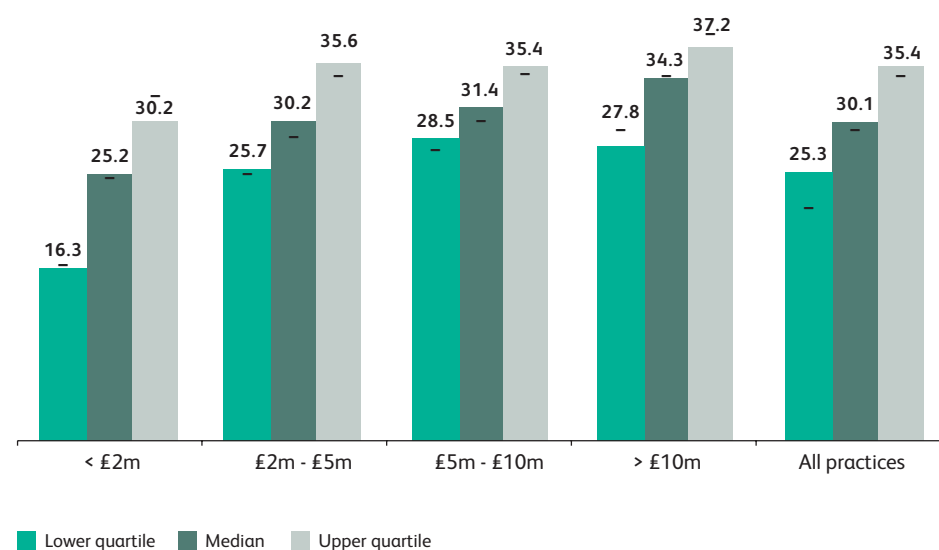
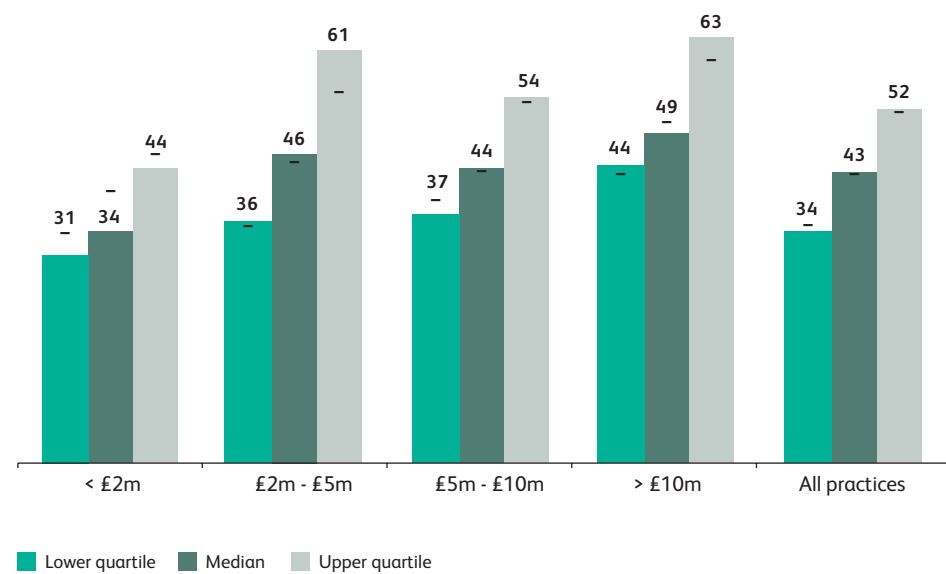


Figure 5.3: Cost per employed fee earner (excluding notional salaries for equity partners)
(£'000)



5. Employment costs

Employment costs – all fee earners, including equity partners

Building on the results in Figure 5.3, we now show the cost per fee earner, including a notional salary cost for equity partners. This graph shows the “true” cost of a fee earner in the practice, combining employee salaries, fixed share partners, consultants, temporary staff and normal payroll and pension costs, and a notional cost for the equity partners.

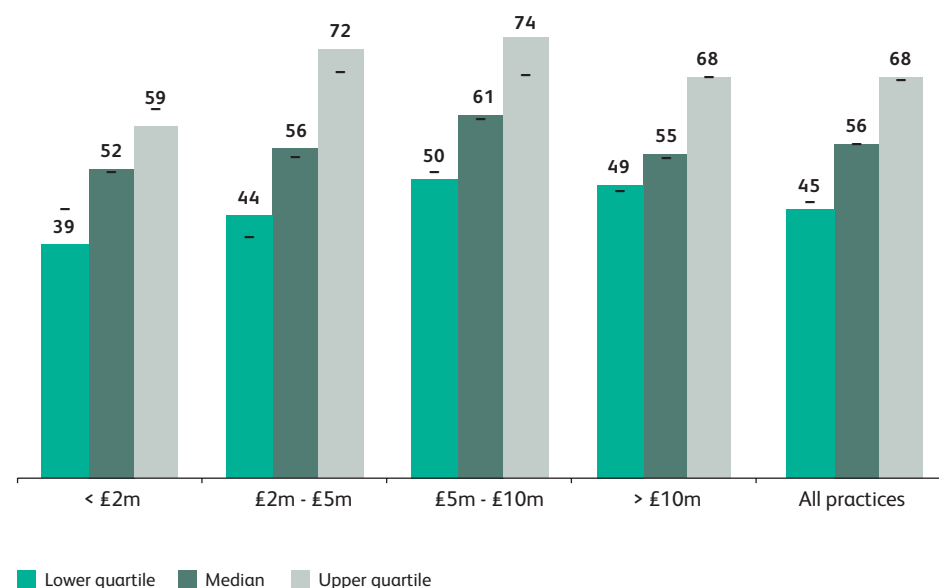
Notional salaries are based on the highest fee earner salary for the turnover band, plus an extra 15%, partly to reflect the costs that would have been incurred if the equity partners had been employed.

When equity partners are included, the median ‘true’ cost of a fee earner increases to £56,315, up slightly from £56,106 in 2017.

Notional salary rates are shown on Figure 6.4. The median notional salary across all turnover bands is just under £87,000, although notional salaries for the larger practices in the survey are considerably higher than this.

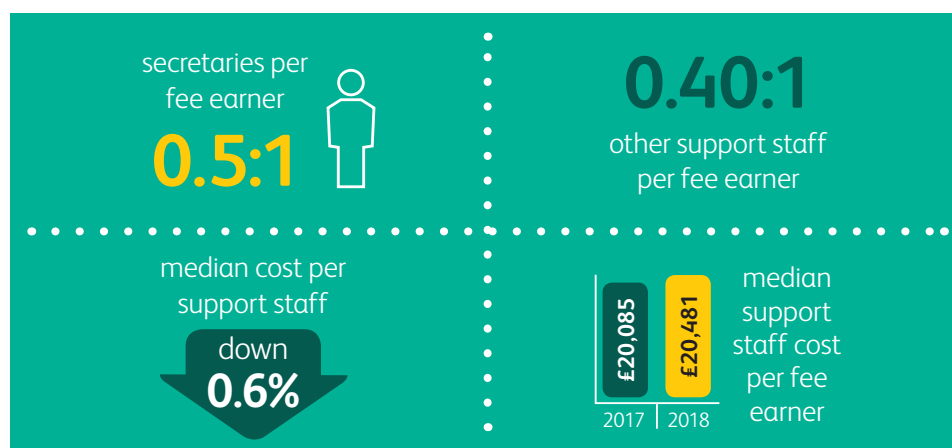


Figure 5.4: Cost per fee earner (including notional salaries for equity partners) (£'000)



Employment costs - support staff

In terms of actual head count, the total number of people employed in a non-fee earning capacity by practices in our survey was 7,540 in 2018, compared to 7,258 in 2017. That's a rise of 3.9%.



Within that total we looked in more detail at their specific roles and identified the following statistics:

- The number of secretaries per fee earner fell very slightly, from 0.56 to 1 to 0.5 to 1. If we look back ten years ago, the same ratio was 0.77 secretaries per fee earner.
- The number of other support staff per fee earner (accounts, administration, marketing, receptionists, IT, etc.) remained almost unchanged at 0.40 to 1.
- The median cost per member of support staff (including secretaries) fell from £22,998 in 2017 to £22,850
- The median support staff cost per fee earner, including secretarial support, was £20,481 in 2018, compared to £20,085 in 2017 – an increase of 2.0%.

Figure 5.5: Expenditure on support staff as a percentage of fee income (%)



5. Employment costs

Figure 5.6: Cost per support staff member (£'000)

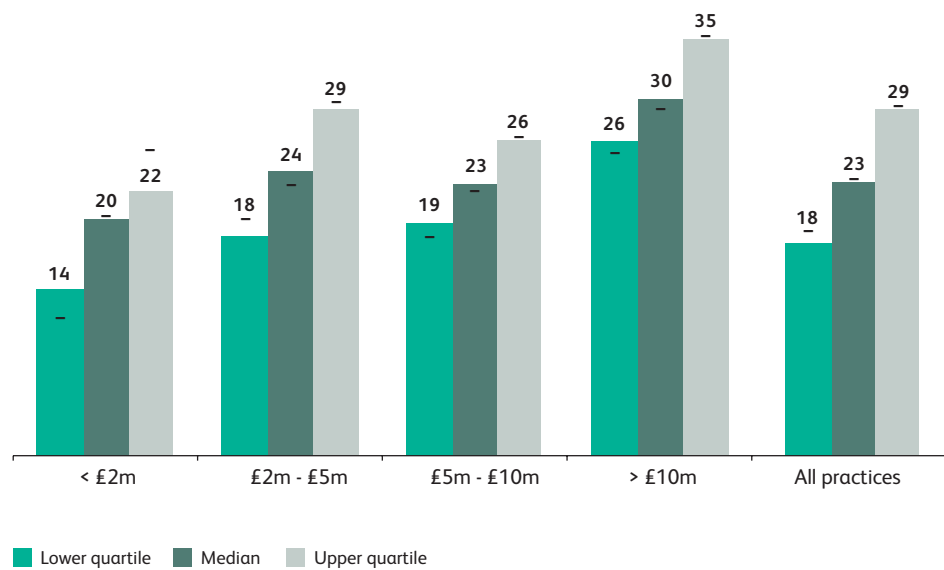


Figure 5.7: Number of secretaries per fee earner



Figure 5.8: Number of other support staff per fee earner

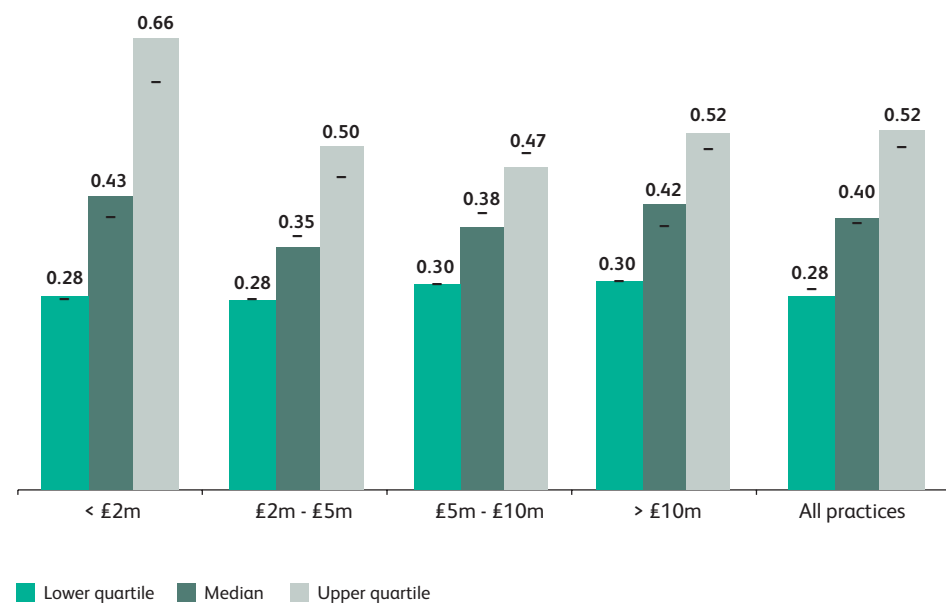
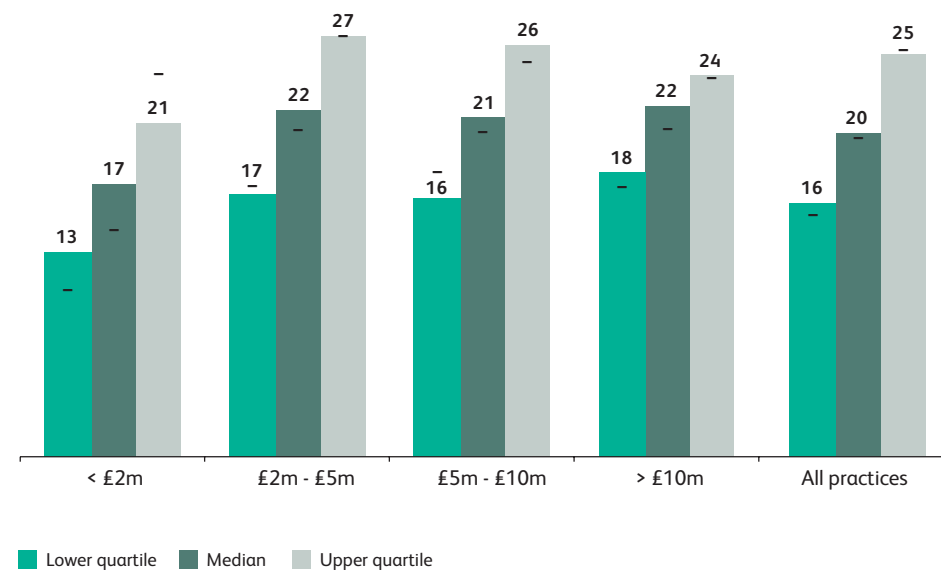
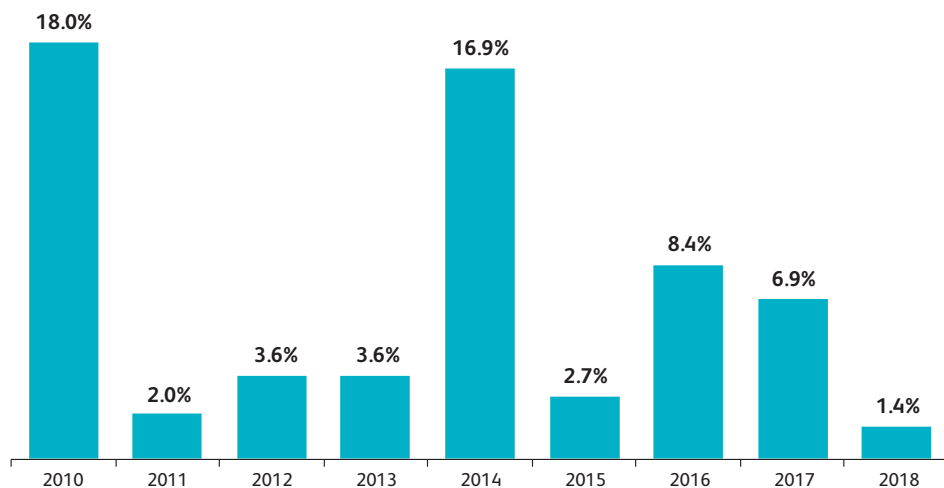


Figure 5.9: Cost of support staff per fee earner (£'000)



The reported median profit per equity partner (PEP) for participants has grown every year since 2010, as shown in the graph below. Again, it should be noted that the composition of the sample across those nine years will have varied.

Median increases in PEP (%)



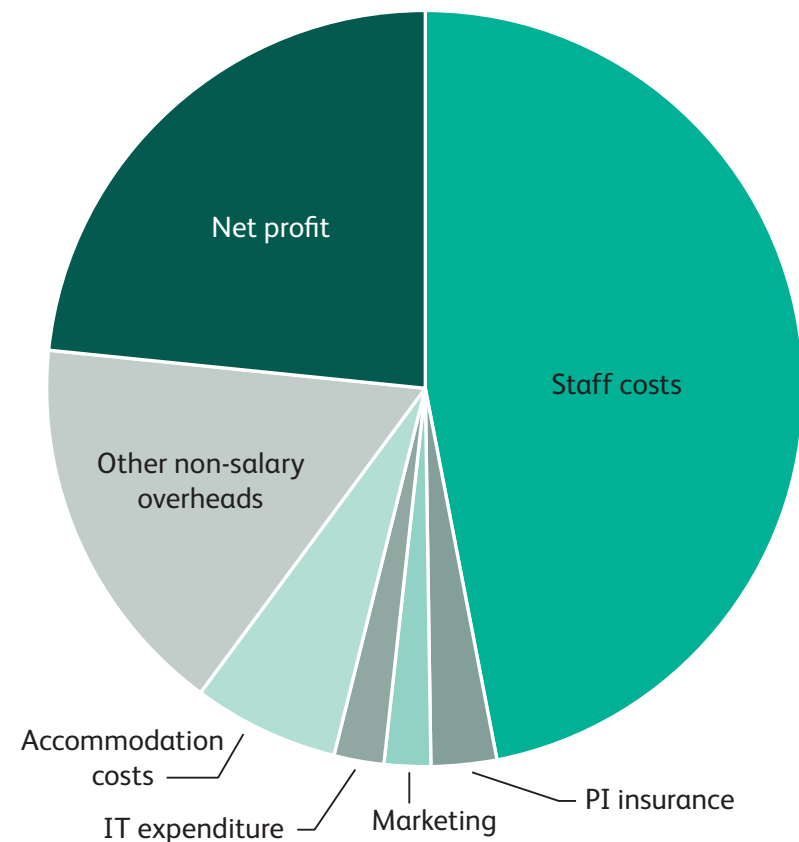
The trend continued in 2018, as median profits per equity partner have increased by 1.4%, from £149,546 to £151,613.

The net profit margin has also increased, from a median of 21.7% to 23.2%, mainly as a result of increased fee income.

Almost a third of fee income is spent on non-salary overheads. The median amount per fee earner is £36,415, compared to £36,521 in 2017. We have looked in detail at expenditure on specific costs such as professional indemnity insurance cover, marketing and accommodation costs. When expressed as a proportion of income, there has been little variation from 2017. Practices are focusing on fixed costs, and seem resistant to price increases.

For many years, the general rule of thumb for staff costs, non-salary overheads and profit compared to income was 33%:33%:33%, but this ratio is no longer appropriate for the majority of practices, mainly as a result of increasing staff costs. If we combine the findings in sections 5 and 6 of this survey, we arrive at the proportions shown on the pie chart below.

Overheads and profitability as a proportion of fee income



The pie chart does not include equity partner notional salaries.

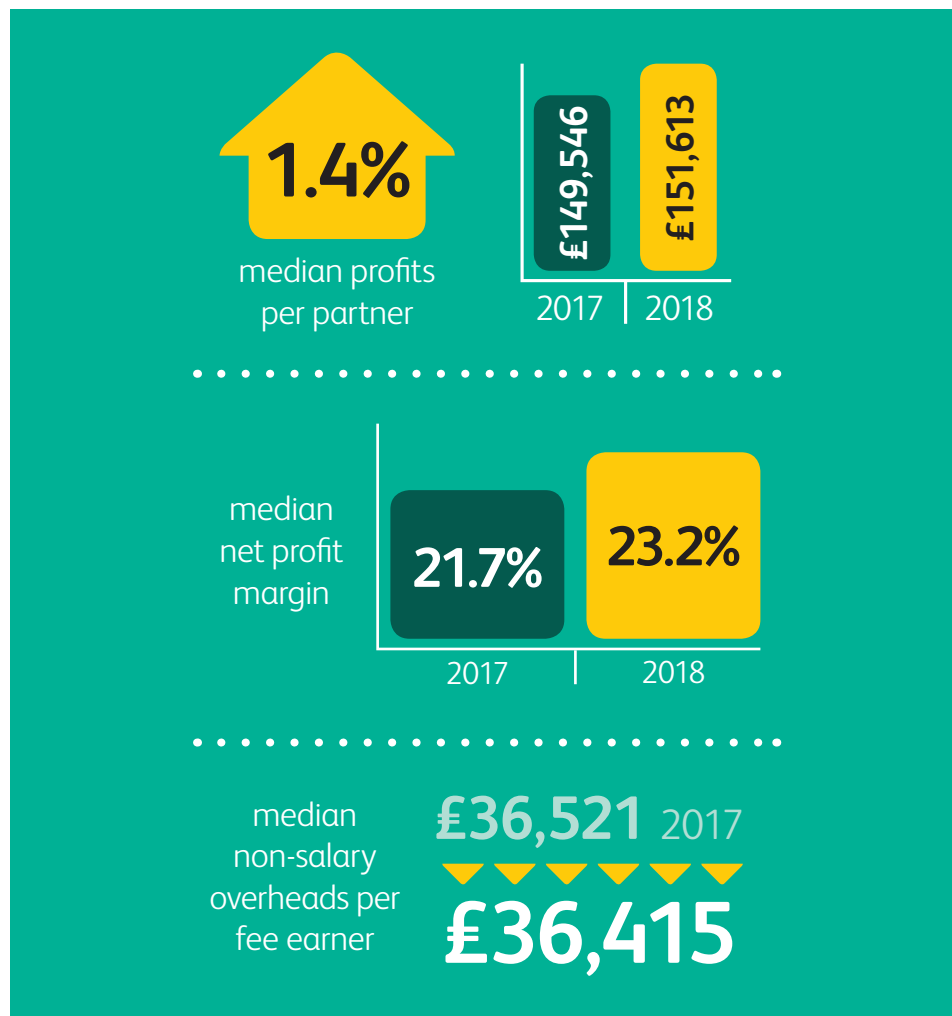
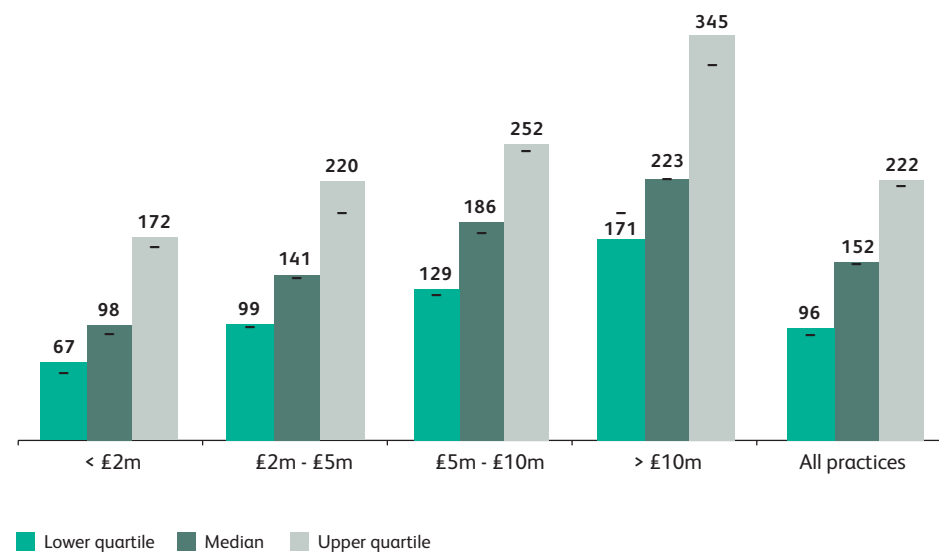


Figure 6.1: Profit per equity partner (£'000)



6. Profitability

Figure 6.2: Profit per fee earner (£'000)

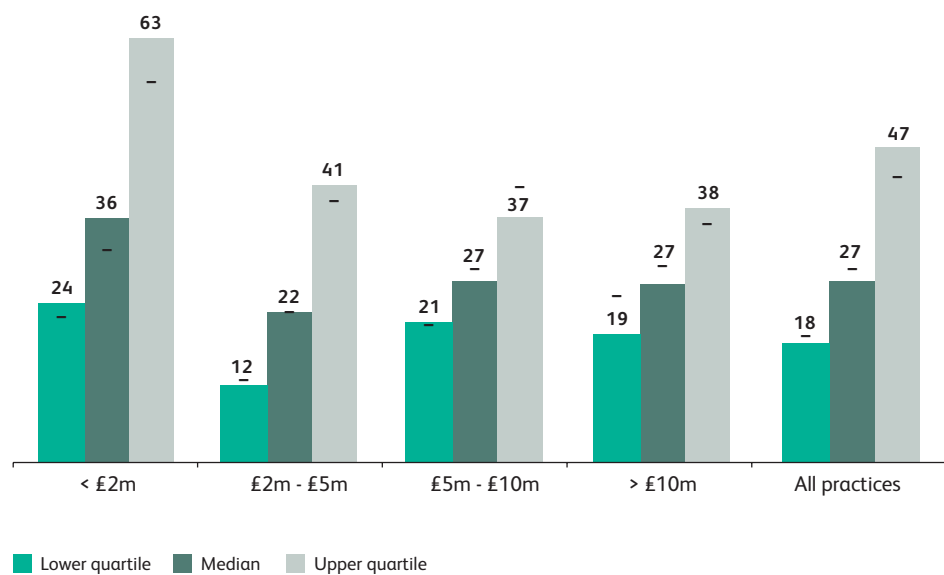
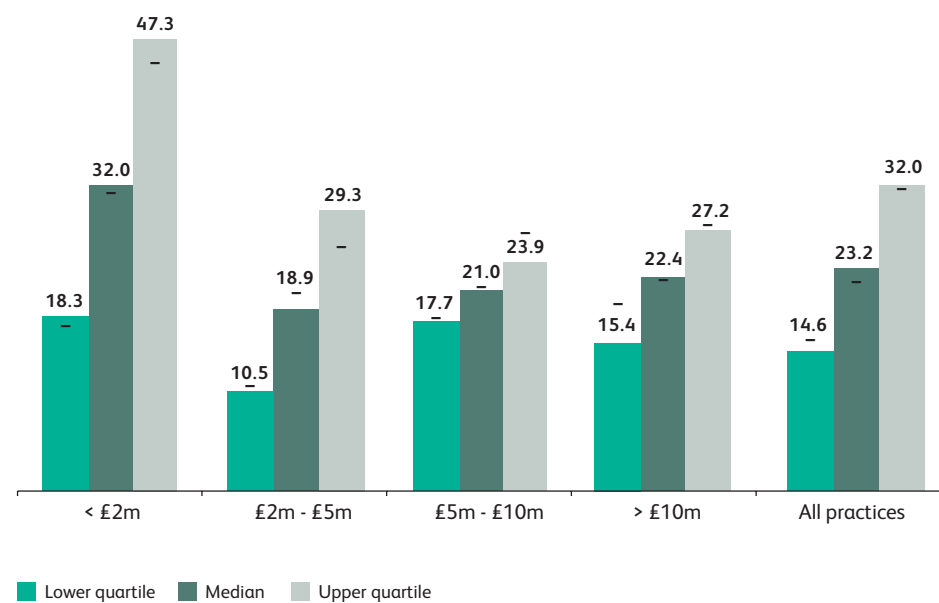


Figure 6.3: Profit as a percentage of total income (%)



Profitability – return on investment, i.e. super-profit

As owners of a practice, equity partners expect to be rewarded for the salary equivalent for work that they do, and they also require a return for the capital invested in the practice and an additional “super-profit” for the risk and liabilities of running the practice. We refer to these as notional salary, notional interest and super-profit.

As noted above, equity partner notional salaries have been calculated based on practices’ highest fee earner salary plus an extra 15%.

Notional interest is set at 3% of partner capital.

Super-profits are simply the net profit less notional salaries and notional interest.

In Figure 6.4 we show the “super-profit” per equity partner. In 2018, the median ‘super profit’ was £46,380, compared to £42,762 in 2017.

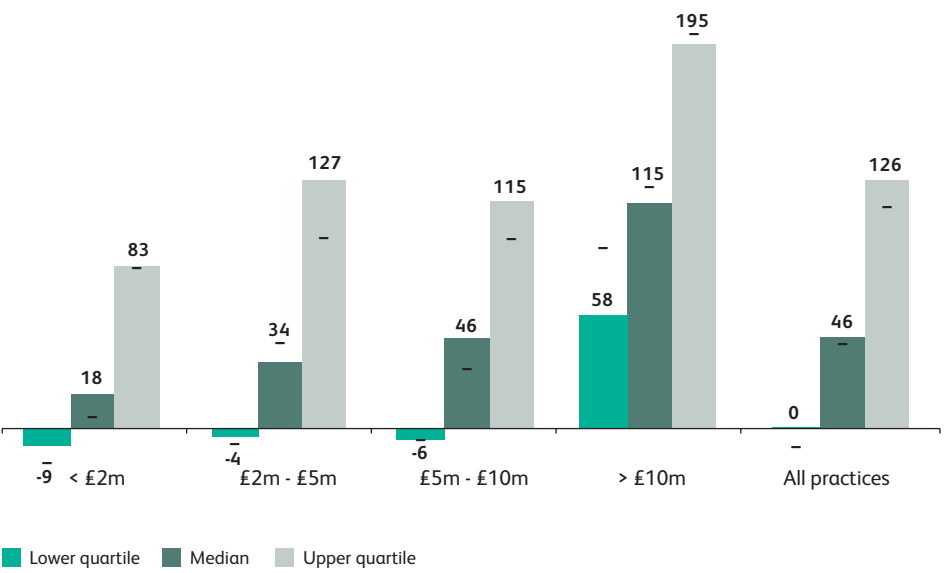
The median figure for super-profit as a percentage of total income has also increased, from 5.7% last year to 6.4%.

The notional salaries used for each size of practice are shown below the Figure on the right. As we noted in section 5, the larger the practice, the higher the notional salary. Mid-sized practices have been forced to pay higher salaries, in order to both retain and attract senior fee earners.

Super-profits per fee earner have remained consistent, at a median figure of £7,691 in 2018 compared to £7,960 in 2017.

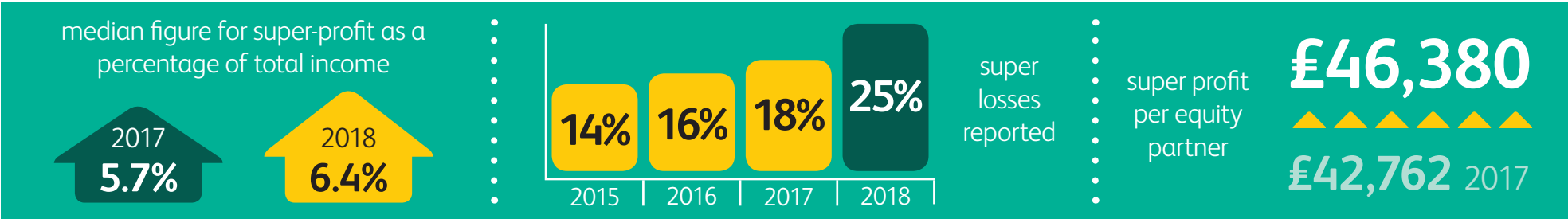
This year, a quarter of practices in our survey reported a super loss. This appears to be a growing trend amongst smaller practices, with 14% reporting losses in 2015, 16% in 2016 and 18% in 2017.

Figure 6.4: Super-profit per equity partner (£’000)



Notional salaries

2018	56	89	96	147	87
2017	58	85	95	140	85



6. Profitability

Figure 6.5: Super-profit per fee earner (£'000)

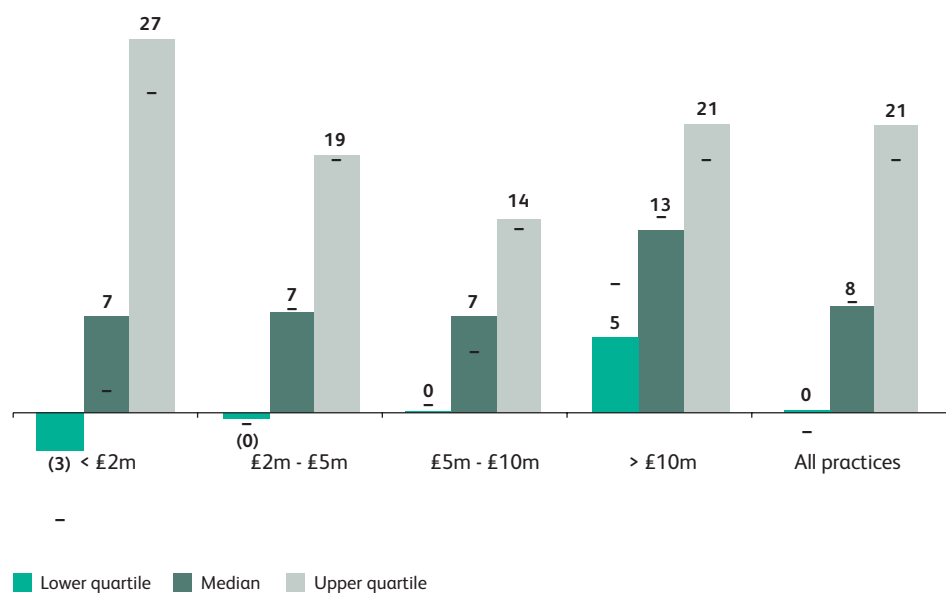
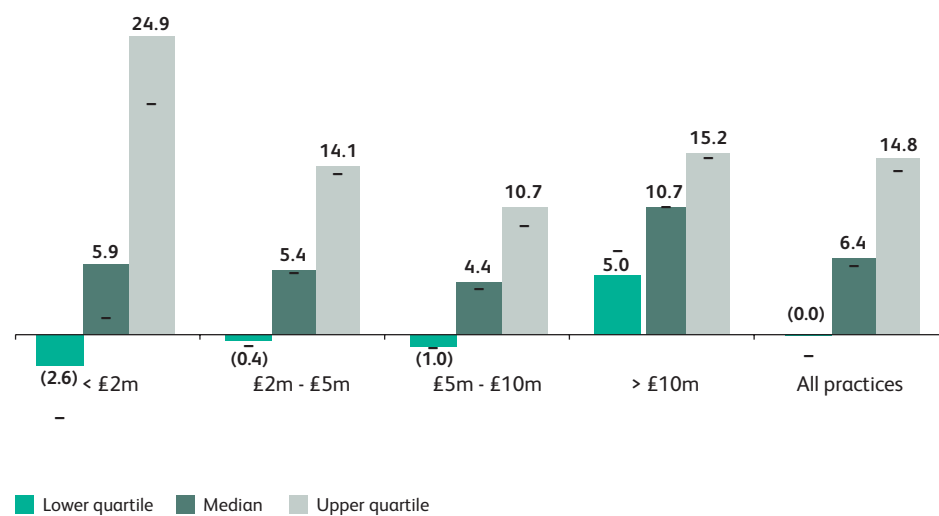


Figure 6.6: Super-profit as a percentage of total income (%)



Return on capital employed (ROCE)

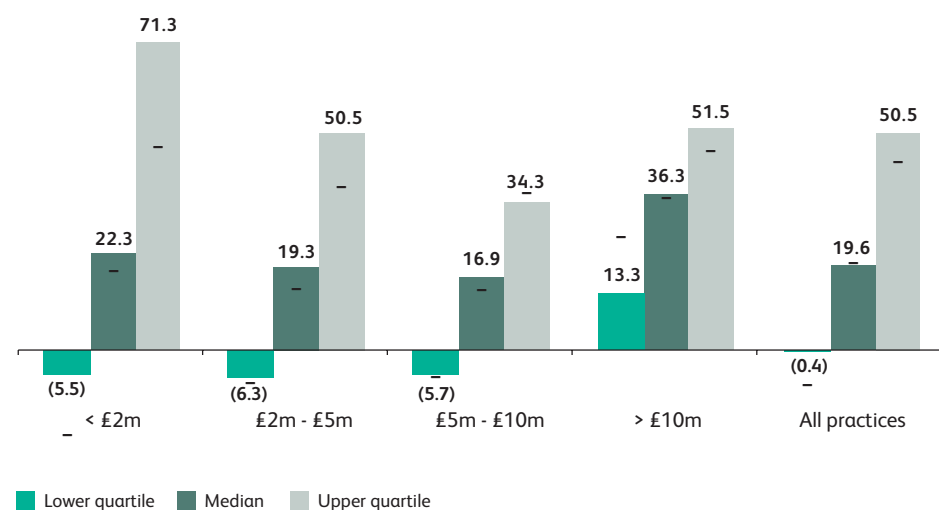
ROCE is a measure of the returns made by a practice on the resources available to it. For a legal practice, ROCE is measured in terms of super-profits as a percentage of partner capital. We use super-profit, as this takes account of notional salaries for partners, and also notional interest on partners' capital.

The results show a median ROCE of 19.6% for 2018, compared to 20.2% in 2017.

Practices looking to attract new partners will be more successful with higher levels of ROCE. Potential investors or acquirers will pay more when a practice is achieving ROCE in line with the best performers in their size category.

The chart on this page shows that a number of the smaller practices in the survey experienced a negative ROCE, which is a result of super-losses reported at Figure 6.4.

Figure 6.7: Return on Capital Employed (super-profit as a percentage of partner capital) (%)



6. Profitability

Non salary overheads

The graphs over the new few pages reveal that practices have continued to work hard to control their overheads, with non-salary overheads either falling or remaining consistent across all size of practice.

Figure 6.8: Non-salary overheads as a percentage of fee income (%)

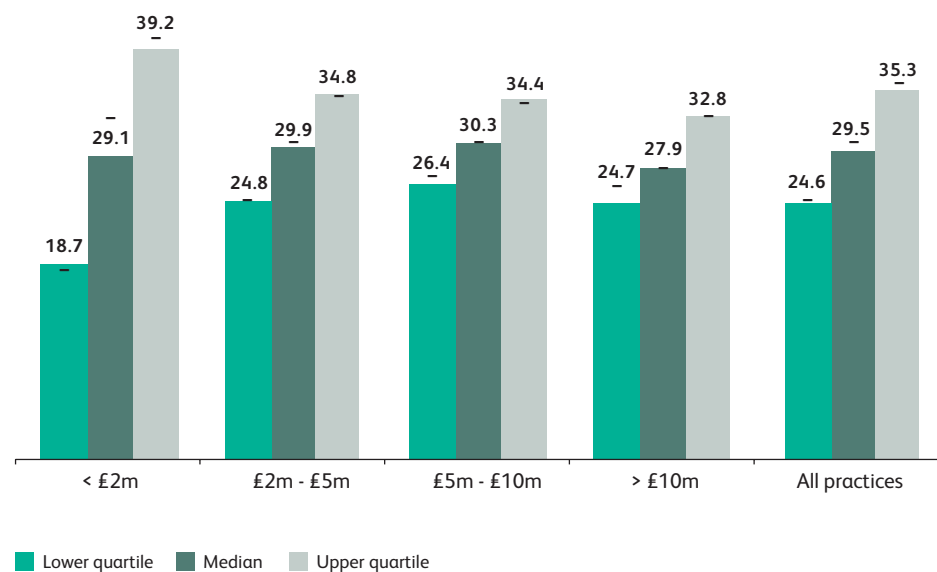
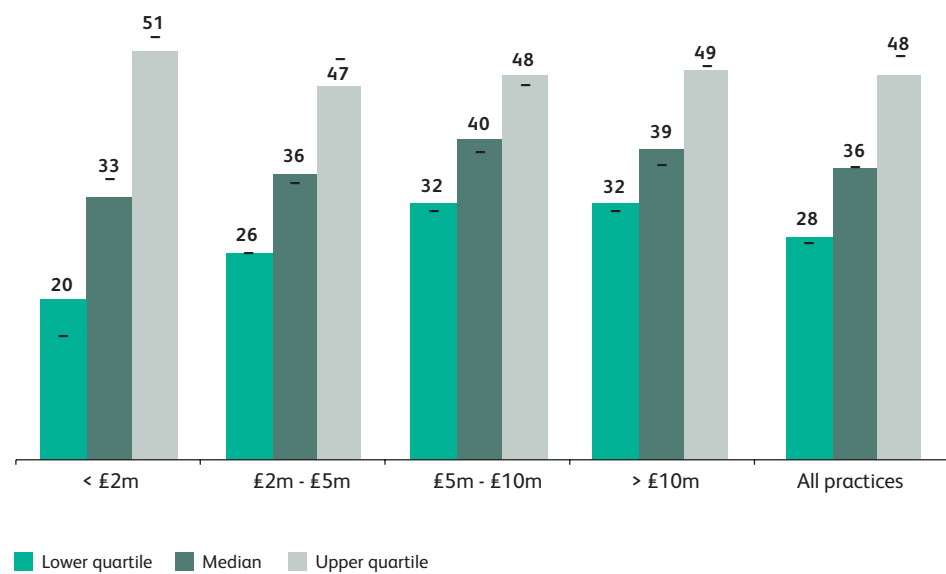
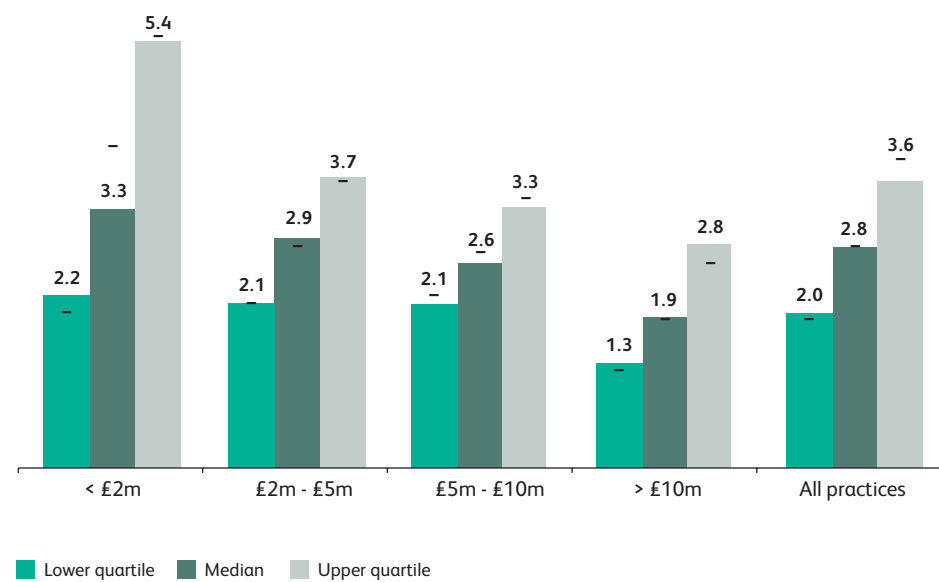


Figure 6.9: Non-salary overheads per fee earner (£'000)**Figure 6.10:** PI insurance premium expenditure as a percentage of fee income (%)

6. Profitability

Figure 6.11: Marketing expenditure (including staff costs) as a percentage of fee income (%)

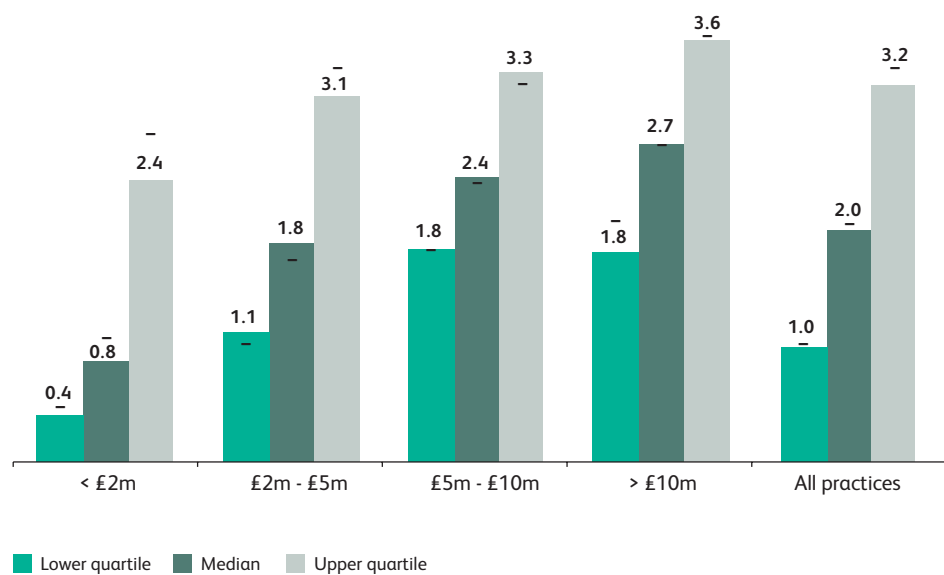
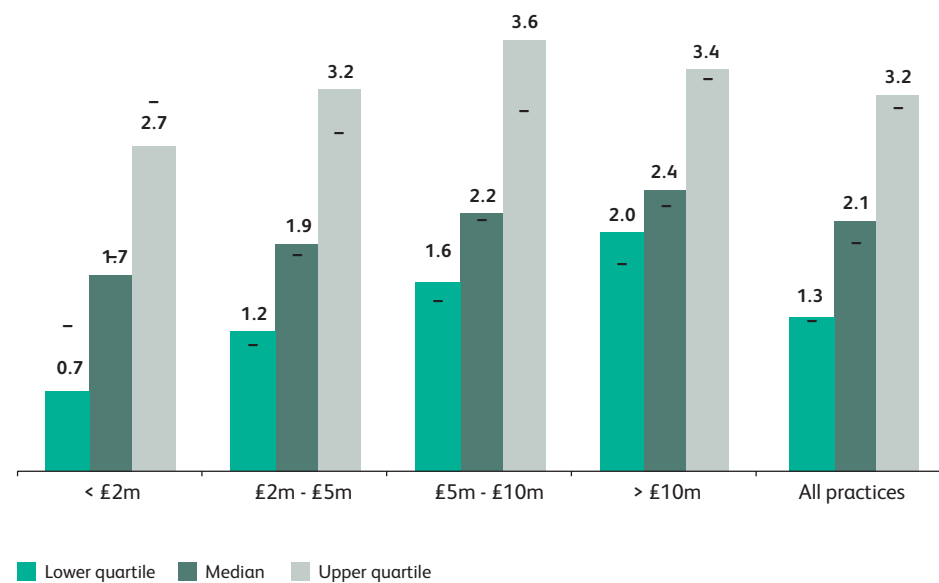


Figure 6.12: IT expenditure (including IT support, IT consultants and cloud-based storage) as a percentage of fee income (%)



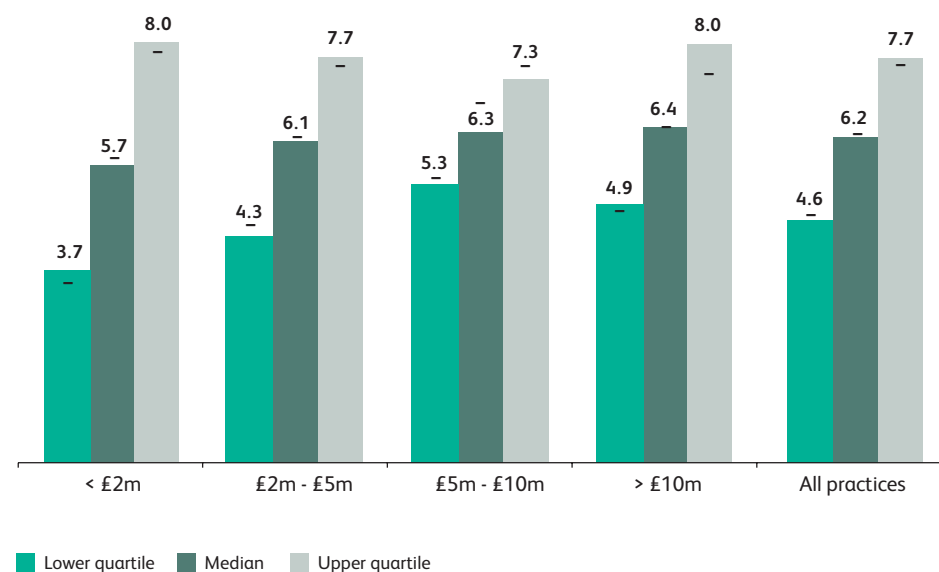
Accommodation costs

After staff-related costs, accommodation costs are usually the next largest expense for any practice. The results here show a median spend on accommodation costs of 6.2% of fee income, in line with the previous year.

Many practices are paying more than this though, either due to prime locations (e.g. those in city centres or brand new offices) or as a result of surplus office space, or both.

A few practices in the survey pay a reduced rent on their premises, either because the property is owned by the principals or former principals of the practice, or because they have managed to negotiate reduced rent with their landlords. Where this is the case, those practices have provided us with a current market rental value, so that the results shown are as if on a third party basis.

Figure 6.13: Accommodation costs as a percentage of fee income (%)

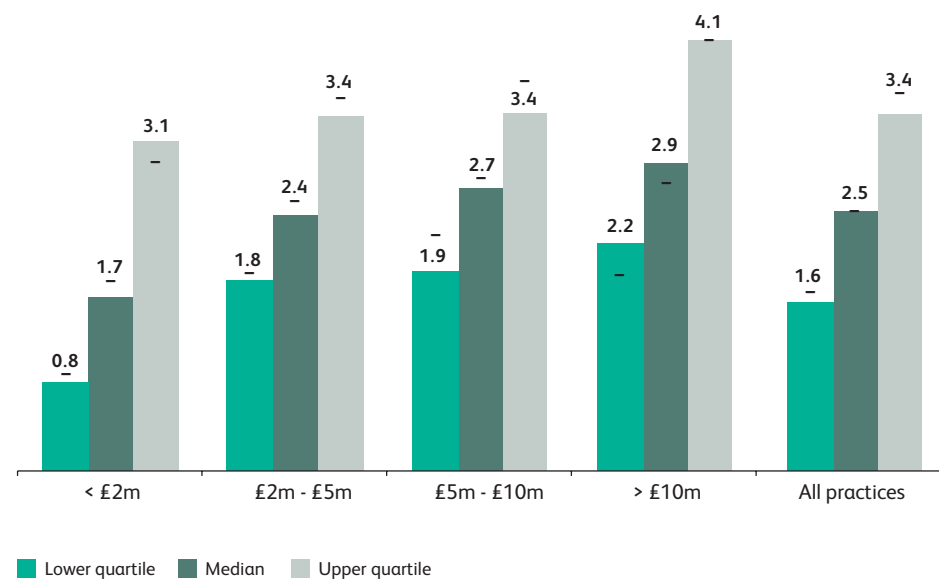


6. Profitability

Figure 6.14: Premises rental payments as a percentage of fee income (%)



Figure 6.15: Other premises costs (rates, light and heat and maintenance) as a percentage of fee income (%)



Characteristics of the most profitable practices

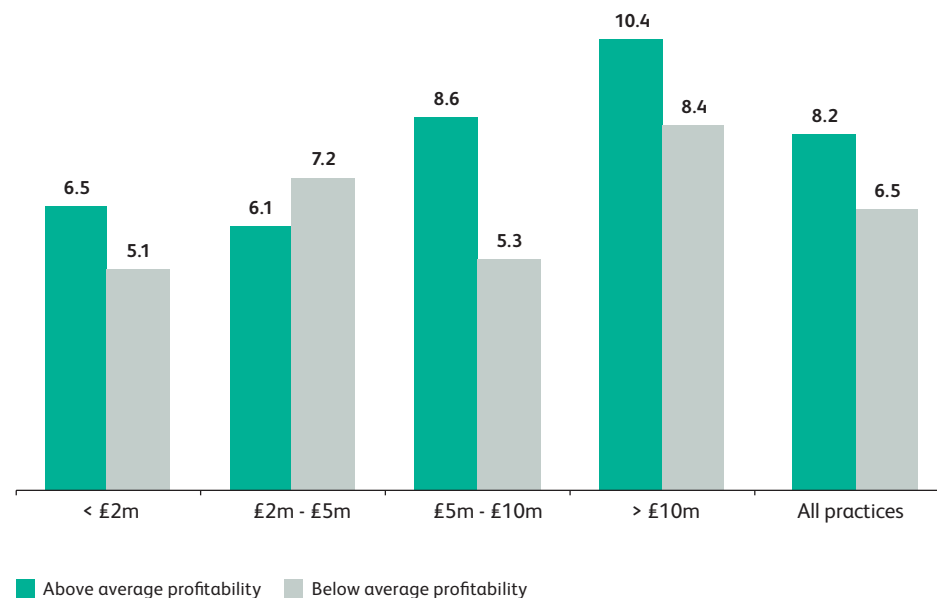
In this section we examine the characteristics of the practices that achieved above-average levels of profitability in this year's survey, and compare them against the same characteristics of the practices that achieved lower than average levels of profitability. We have focused on four key areas:

- Fee earner gearing;
- Fee income per equity partner;
- Total salary costs, including notional salaries for equity partners;
- Non-salary overheads.

The figures shown in the following charts have been calculated by separating all participants into two groups: those with net profit per partner above the median shown in Figure 6.1, and those with net profit per partner below the median, in each turnover band. We then reanalyzed these two groups, to calculate new median figures.

The four Figures in this section show two bars for each turnover band. The bars on the left are the figures for the practices with above-average levels of profitability, and the bars on the right are for the practices with lower than average levels of profitability.

Figure 7.1: Fee earner gearing (median figure only)



7. Characteristics of the most profitable practices

Figure 7.2: Fee income per equity partner (£'000) (median figure only)

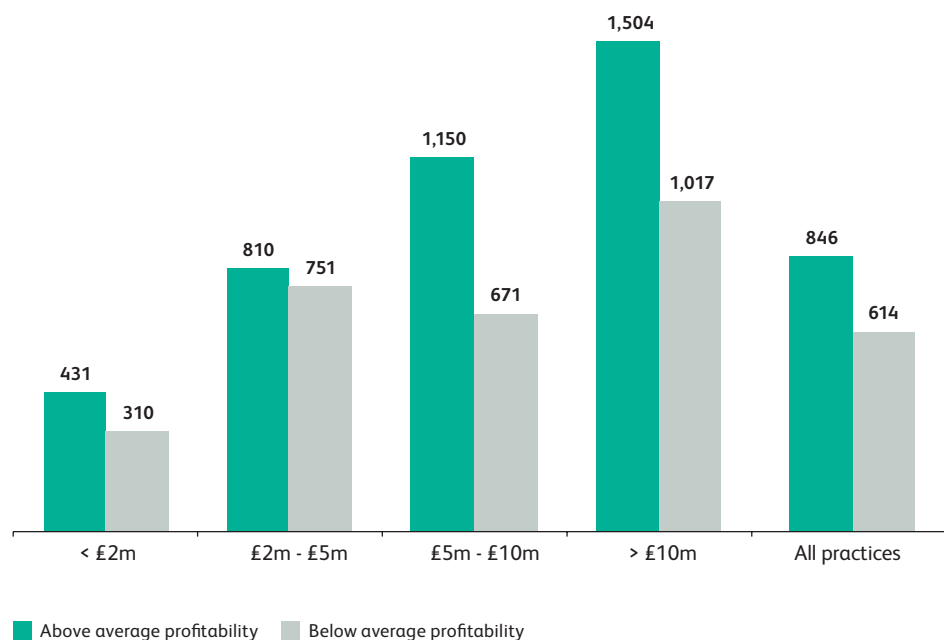


Figure 7.3: Total salary costs, including notional salaries, as a percentage of fee income (median figure only)

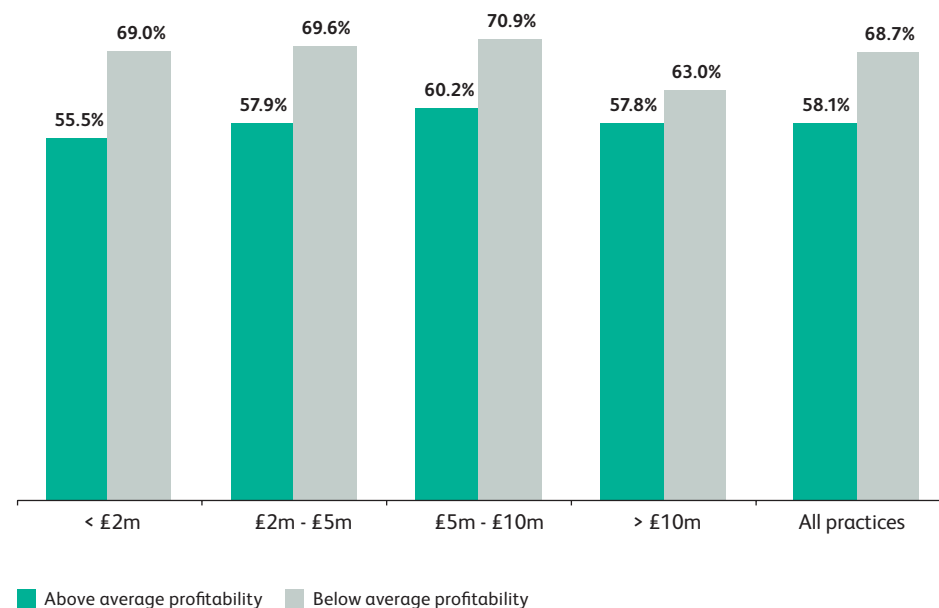
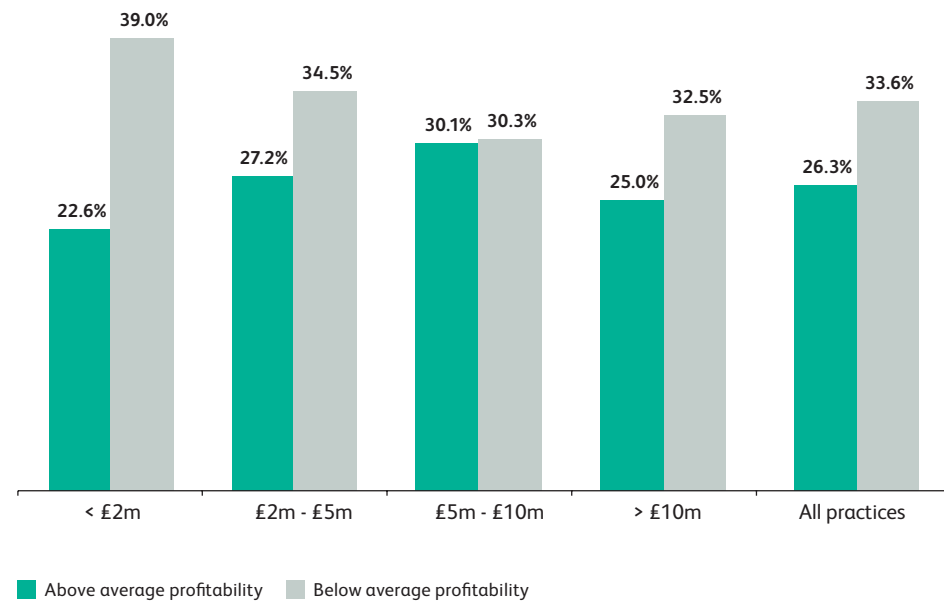


Figure 7.4: Non-salary overheads as a percentage of fee income (median figure only)



8.

Working Capital

It is always difficult to conclude on trends on working capital management in a survey of legal practices, as lock up varies so dramatically in differing areas of law.

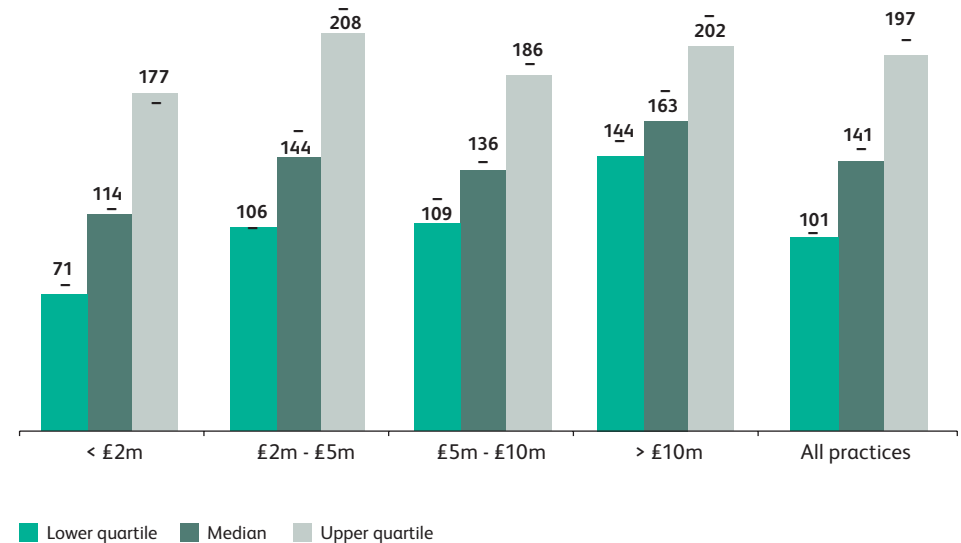
However, the median number of days lock up has fallen by about 4% between 2017 and 2018, and we have seen reductions in both WIP and debtor days, both of which are good news. We must remember that our data is collected for balances at the year-end date only, which may not be reflective of a full twelve-month period.

A 4% reduction in lock up will make a significant difference to cash flow. For a practice with turnover of £5m, this would free up £82k of cash.

As a matter of general good procedure, practices need to ensure that they continue to focus on reducing lock up where at all possible, as high lock up can not only lead to adverse cash flow issues but often also leads to increased bad debt exposure too.



Figure 8.1: Total lock up (days)

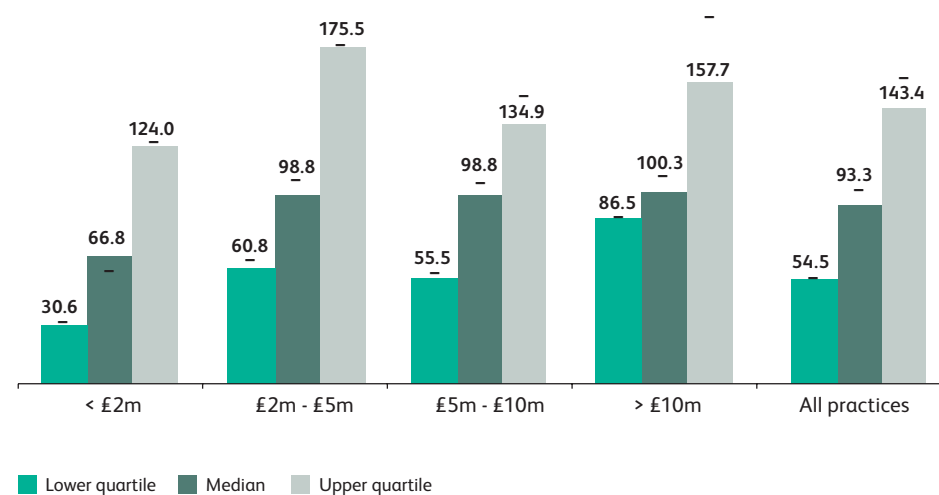


WIP days

WIP days have been calculated based on total WIP per participants' time records, as opposed to the figure included in their accounts, as for many practices the figure in the accounts does not include large amounts of contingent WIP.

The survey shows a reduction in WIP days across most turnover bands, with a median of 93 days, compared to 100 days in 2017.

Figure 8.2: WIP days (days)



8. Working capital

Debtor days

As per last year, the survey shows very little change in debtor days between 2017 and 2018. Our own experience is one where:

- Fee earner training on managing lock-up can make a huge difference.
- Increased effort continues to be directed at pre-billing client communication and cash collection, resulting in fairly quick realisation of current invoices.
- Small changes to standard practice, such as raising bills as soon as the work is complete, can make a big difference to lock-up. Moving away from billing at month-end to billing across the month can also result in clients paying a full month earlier.
- Many practices continue to carry large amounts of unbilled disbursements, and often do not ask for money on account of them, even in areas where you would have thought it was straightforward for them to do so, e.g. property work.

The SRA plans to introduce new Accounts Rules later this year. Under the new Rules, some practices will be able to hold money received on account of fees and disbursements in their office account, even if the work has not been carried out. Also, practices that hold money on account of disbursements in their client account will in future need to raise an invoice before they can reimburse themselves for any disbursements paid from office account. Under the current Rules, a bill is not required for disbursements.

It will be interesting to see how these changes impact on debtor days in next year's survey.

Figure 8.3: Debtor days (days)

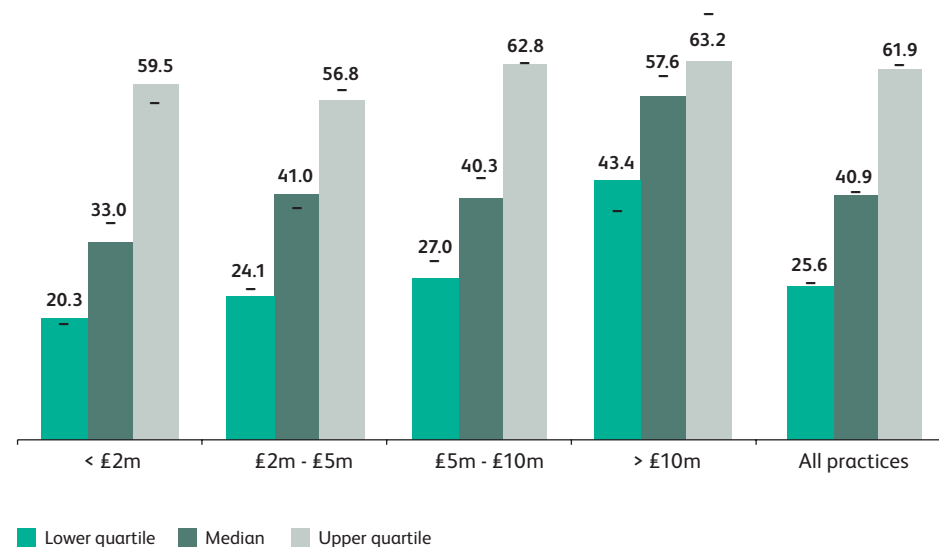
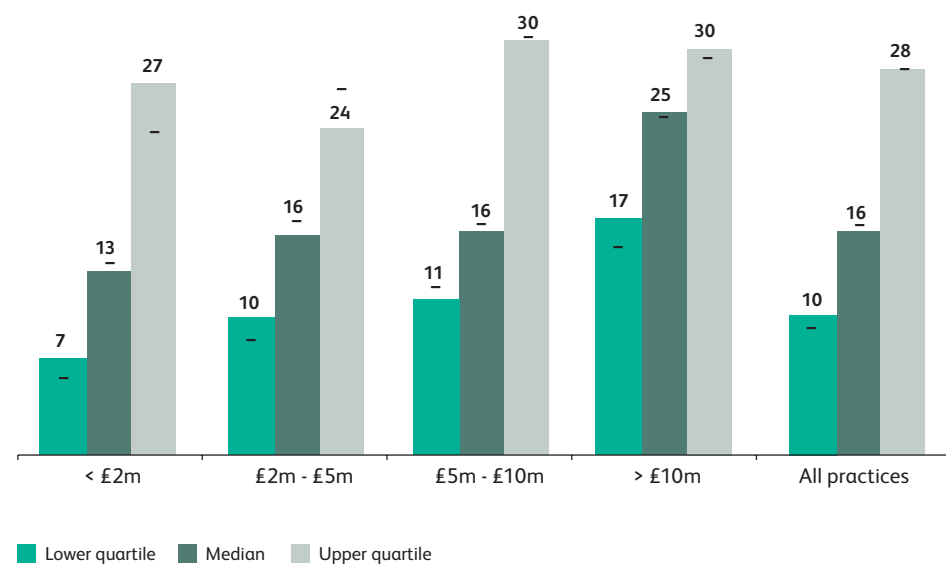


Figure 8.4: Debtors per fee earner (£'000)

8. Working capital

Working capital – equity partner funding

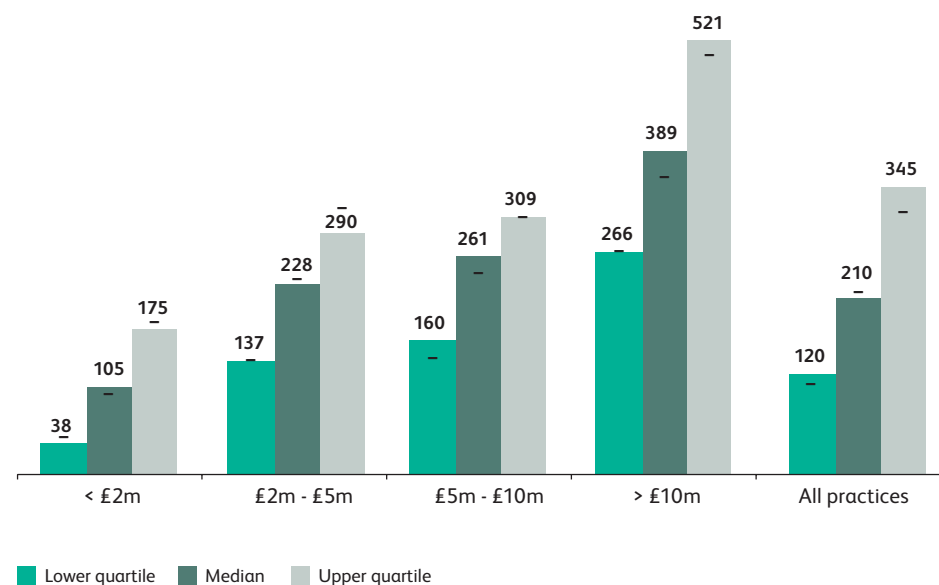
Equity partner capital in a partnership or LLP is the total combination of capital account, current account and tax reserves. In a limited company, capital comprises share capital and retained profits.

The participants in this year's survey reported a median 3% reduction in partner capital in 2018, which is the first drop that we have seen for several years.

The median balance has fallen from £216,702 in 2017 to £210,301.



Figure 8.5: Partners' account balances per equity partner (£'000)



Bank and other borrowings

Two thirds of participants reported a positive office account balance at their most recent accounting date. The median office account balance across all participants was £85,000, with all but the largest turnover bands reporting a positive median balance.

Fewer than one in five participants reported that they operated with no overdraft or borrowings at all. For those firms that had bank borrowings and/or a bank overdraft, the median amount owed per equity partner was £57,455.

Finally, approximately half of the participants had non-bank borrowings such as hire purchase or finance agreements. The median amount per equity partner was £22,666.

It is important to bear in mind that these are very much a snap-shot of the position at participants' accounting dates, and may not be reflective of the position over a 12 month period.

Figure 8.6: Year-end office account bank balance (£'000)

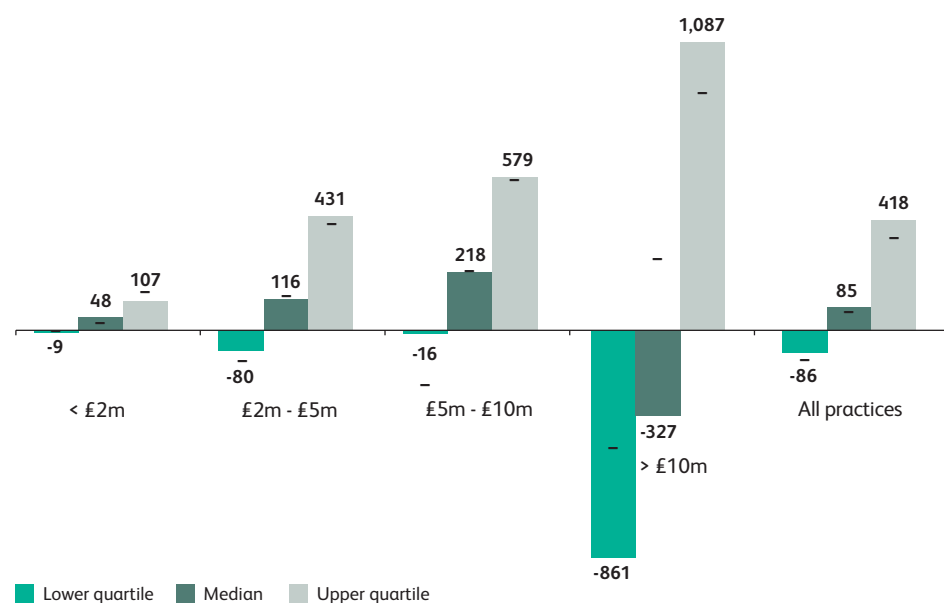
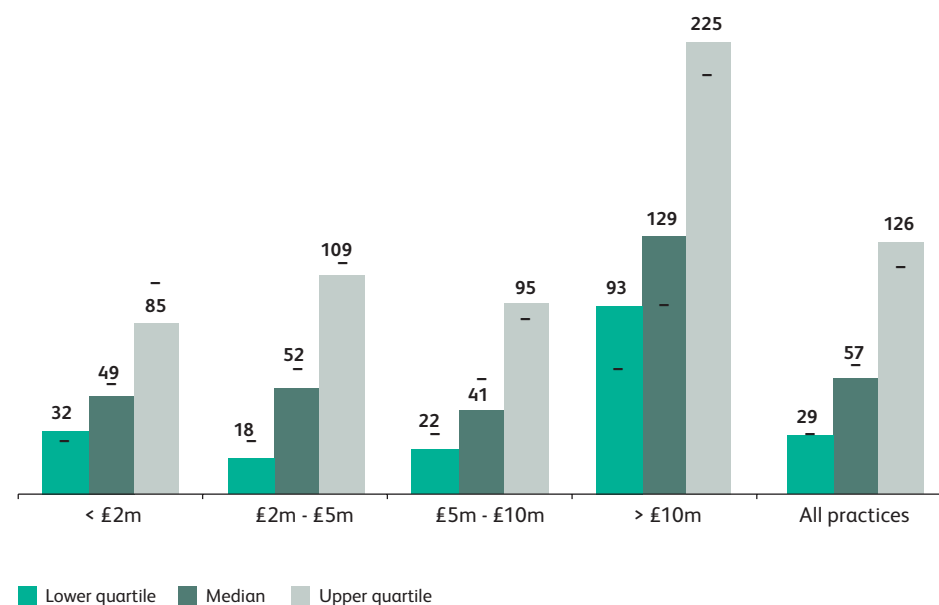
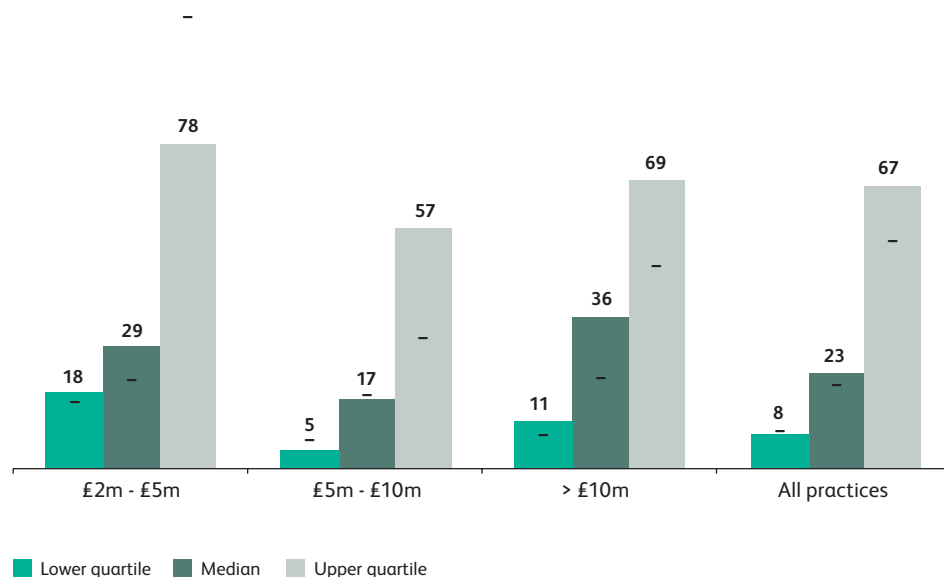


Figure 8.7: Bank borrowings per equity partner (£'000)



8. Working capital

Figure 8.8: Other borrowings per equity partner (£'000)



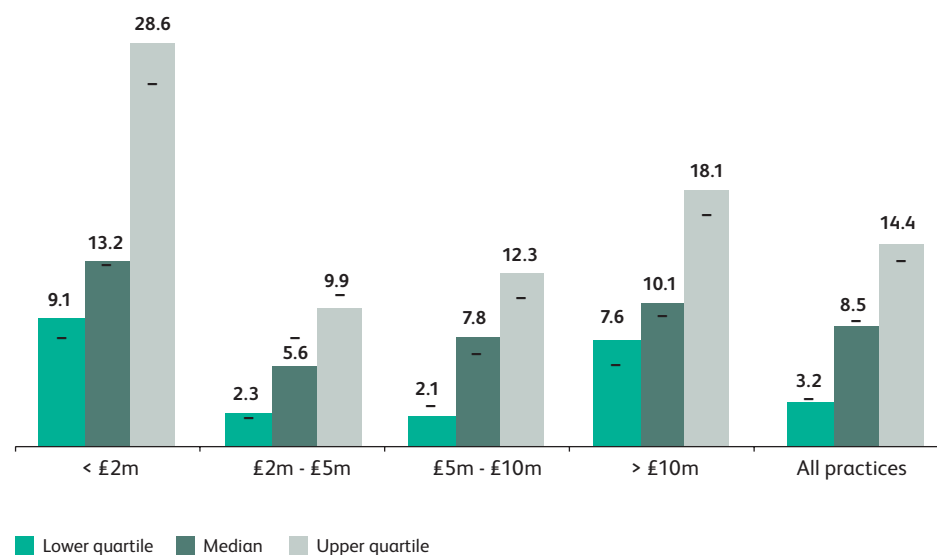
Banks' attitude to lending

Banks continue to view the legal sector positively, although there is an increasing reluctance to lend to practices specialising in areas such as personal injury work.

As per last year, we have seen considerable levels of new lending, secured by a debenture over the practice only, where practice performance and debt to equity ratios support it.

Many banks pay close attention to the ratio of borrowings to fee income when assessing ability to make repayments, and it is pleasing to see a median of 8.5% for the practices in the survey, compared to 8.8% a year ago.

Figure 8.9: Bank borrowings as a percentage of fee income (%)



In 2015, the SRA began risk-assessing practices based on selected figures from their annual accounts. The three warning indicators identified by the SRA were:

- Drawings in excess of profits.
- Borrowings in excess of net assets, i.e. net liabilities.
- Borrowings over a certain (undefined) level.

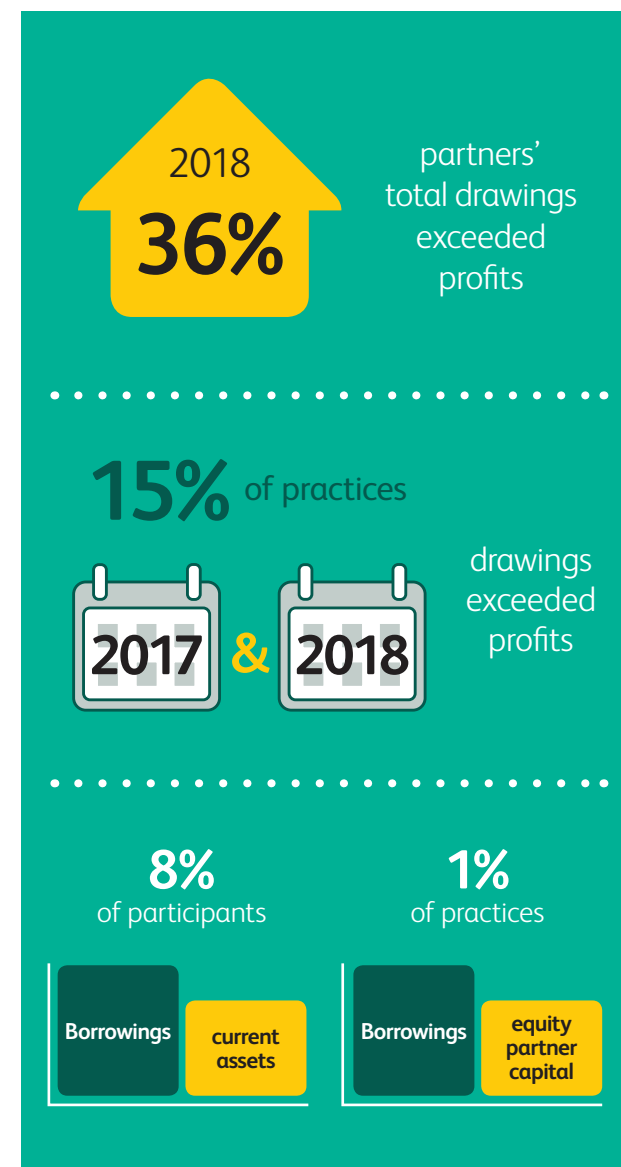
Based on these indicators, practices were assessed as red, amber or green, resulting in differing levels of supervision from the SRA. For example, red rated firms received intensive supervision from the SRA, were required to provide the SRA with regular management information and contingency plans, and were told to obtain professional insolvency advice.

From discussions with the SRA, we know that they have moved their attention to other matters, and the majority of the practices that were initially assessed as red and amber are no longer required to provide the SRA with any financial information, and have little contact with them.

There is little doubt that the indicators used by the SRA were sensible, and the focus on financial stability encouraged many practices to take action.

Every year since 2015 we have analysed the information provided by participants to see how they fared. This year's findings are as follows:

- In 2015, partners' total drawings (including income tax) exceeded profits for a quarter of participants, with a similar proportion in 2016. In 2017, this increased to 30% and the upward trend has continued in 2018, with partners in 36% of practices taking drawings in excess of profits. As we have noted in previous years, sometimes this is no more than a timing difference, i.e. when practices decide to withdraw profits, so is not necessarily a cause for concern.
- Of more concern is that last year, we reported that partners in 15% of practices had taken drawings in excess of profits for two consecutive years. We have seen a similar percentage this year.
- Borrowings exceeded current assets (WIP and debtors combined) for 8% of participants, compared to 4% last year. Borrowings exceeded equity partner capital for only 1% of practices this year, in line with last year.
- Finally, just over half of all practices reported a reduction in partner capital between 2017 and 2018, resulting in the median reduction shown on page 44.

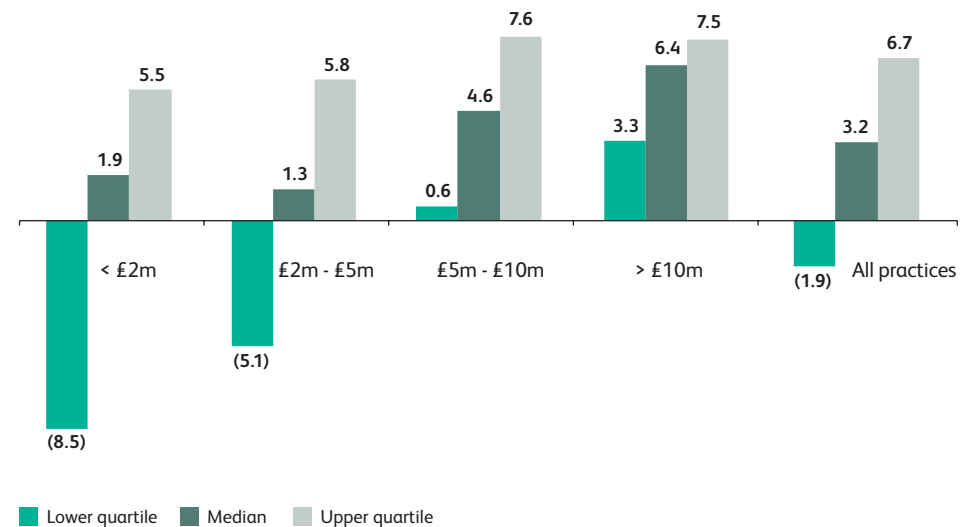


10. The short term future – fee predictions

Every year, we ask participants for their fee predictions for the next 12 months. Last year, practices predicted a median growth in fee income for 2017/18 of 4.4%, which was impressively accurate, given the actual median growth of 4.2%. Perhaps influenced by the uncertainties around Brexit, confidence has fallen a little this year, with a median growth prediction for 2018/19 of 3.2%, with larger practices in the survey feeling more optimistic than smaller practices.

The upper quartile are predicting growth up to approximately 6.7%, whilst the lower quartile are predicting a fee reduction of 1.9%.

Figure 10.1: Predicted change in fees for 2018/19 as a percentage of previous year's fees (%)



Using benchmarking information to improve your performance

Fee earner breakeven point

By combining some of our findings throughout this report we are able to calculate the expected breakeven point for a fee earner. This is the fees a practice must generate per fee earner before any profit contribution is earned. As illustrated below, this is substantially more than simply the median cost of a fee earner.

	2018 £	2017 £
Median fee earner cost, including notional salaries for equity partners (Figure 5.4)	56,315	56,106
Median support staff cost per fee earner (Figure 5.9)	20,481	20,085
	76,796	76,191
Median non-salary overheads per fee earner (Figure 6.9)	36,415	36,521
Breakeven point per fee earner	£113,211	£112,712

Working on an average of say 1,100 chargeable hours per annum per fee earner, or 220 chargeable days per annum, this equates to the following:

	2018 £	2017 £
Cost per hour	£102.92	£ 102.47
Cost per day	£514.60	£512.33

In Figure 4.6 we saw that the median fee income per fee earner was £124,253. This means that over 91% of fees earned by a fee earner are used to cover their costs. Looking at it another way, if a practice has a 31 December year end, on average it takes until 29 November for a fee earner to earn sufficient fees to cover his or her total costs for the year, and for the practice to reach 'super-profits'.

Areas to focus on

Sections 5 (Employment costs) and 6 (Profitability) include some pointers on key overheads, such as fee earner costs, support staff costs and accommodation costs, and these may help to identify areas for potential savings.

However, we expect the breakeven point to continue to increase. Salary costs are generally only going one way, and overheads in many practices have already been cut back as far as possible.

Section 4 (Fee income) is therefore the key section for practices looking to increase profitability.

Fee earner performance

Fee income is driven by a combination of chargeable hours recorded (productivity) multiplied by a recovery rate. The greater the productivity and recovery, the higher the income. For example, let's assume a practice with 20 fee earners, all with an hourly chargeout rate of £175. Fee earners record an average of 1,100 chargeable hours each per year, and recover (i.e. bill) 80% of the recorded WIP value, resulting in total fee income of:

$$20 \times £175 \times 1,100 \times 80\% = £3.08\text{million}$$

If fee earners improve productivity by 1%, then the increase in turnover and profitability is £30,800. A 1% improvement in productivity represents just one additional 6 minute unit per fee earner per day.

A 1% improvement in both productivity and recovery increases income and profits by almost £70,000.

In our experience, fee earners in many practices do not fully time record. This is often the case where the work is fixed fee, for example in residential conveyancing. Even where fee earners do time record, it is rare to see fee earners recording more than four chargeable hours per day.

11. Using benchmarking information to improve your performance

If you do not know how long it takes a job to do, how will you be able to tell if it is profitable and therefore worth doing at all? If fee earners are making the decision to not record all of the time they have taken on a matter, you also risk a further reduction being made at the point of billing, or “double discounting”. The fact that it is felt not all time can be recorded suggests that work might not be being performed at the right level, further training is required, or there are undue pressures from management.

Capturing all time spent on a client matter, for all work types, is essential, not only to allow you to charge your clients a commercial fee, but also to ensure that work is being carried out efficiently and at the right level. Fee earners should be provided with targets for both productivity and recovery, which can then be monitored, and the process of recording time and billing should be made as simple as possible.

Coming up with a suitable productivity target for each grade of fee earner can be difficult. Generally speaking, we would expect more senior people, with non-fee earning responsibilities, to have a reduced productivity target, whereas more junior people with no other responsibilities at all could be looking at a target of upwards of 1,200 or 1,300 hours. This may sound like a lot, but after allowing for holidays, sickness and other absences, it amounts to less than six chargeable hours per day.

Once you arrive at a target level of productivity and recovery, this should allow you to calculate target fees per fee earner, and for the practice as a whole, and compare them to our findings in section 4. Ideally, you should be aiming to be in the upper quartile for your turnover band, which will hopefully move you into the upper quartile in section 6 (Profitability).

Fee earner gearing

As we explained in sections 4 and 7, fee earner gearing also impacts on fee income and profitability. Generally speaking, the higher the ratio of fee earners to equity partners, the greater the fee income, and the higher the net profit. However, high gearing ratios are not suitable for all work types, particularly those requiring greater levels of supervision and experience.

As in previous years, we thought it might be helpful to include a brief list of these, to help practices make allowances in their 2019/20 budgeting process.

Interest income. In the past 18 months we have seen increases in bank Base Rates, and practices are gradually beginning to earn decent amounts of interest on client monies for the first time in years. Increasing numbers of practices now hold the top slice of client money in one or more SRA-compliant term deposit accounts in a bid to earn more interest. If you have not already done so, we would recommend that you review your banking arrangements, and have a look at your interest policy too, as lots of practices have moved away from the old £20 de minimis limit. A £50 de minimis limit is fairly common nowadays.

New SRA Accounts Rules on the way. As we mentioned in section 8, one or two changes to the Accounts Rules, expected to be introduced in November 2019, could impact on practice finances. The ability for some practices to hold monies received in advance for fees and disbursements in their office account in future could prove very beneficial to cash-flow.

Incorporation continues to be popular. As we mentioned in this report, 46% of practices operate as limited companies, compared to 30% five years ago. Part of the reason for the increase has been a drive by sole practitioners and small partnerships to take advantage of limited liability status, but larger practices in particular are now considering incorporation, as a means of both managing tax exposure and creating additional working capital more tax efficiently. Lots of practices are also considering employee ownership, which usually requires limited company status. With corporation tax rates set to reduce to 17% from April 2020, the trend is likely to continue.

Cybercrime is still a huge problem. Thankfully, we have seen fewer practices falling foul of the Friday afternoon type of fraud, but email interception, ransomware and malware are still prevalent. Strong internal controls, up to date software and staff awareness remain the best defence mechanisms here.

