A perspective on the legal market

The 2010/11 year in review, the first half of 2011/12, and what lies ahead

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If you have any comments on the contents of this paper or would like to have a discussion on any aspect of the legal profession more generally, please contact James on +44 (0)20 7672 1845 or +44 (0)7780 956119 or by email at james.tsolakis@rbs.co.uk as he would be pleased to hear from you.
The legal profession represents a valuable and important segment of the UK economy, generating £23.1 billion per year or 1.8% of GDP and £3.2 billion in exports, according to information provided by the Ministry of Justice and UK Trade & Investment.

In a global marketplace for goods and services in which competition is significant and intensifying, both from traditional competitors in mature markets and through the rapid emergence of strong competition from new economies, we can all take great pride in the standing of the UK legal profession. Recognised for market leadership around the world, and occupying a privileged position as the law of choice for some of the most significant transactions in global markets, the UK is widely acclaimed for its high quality delivery and reputation for legal services.

The sector-coverage model we have adopted at RBS provides us with an excellent opportunity to deliver great value and unique insights to our legal clients globally. This is just one dimension of our unwavering mission to deliver our clients a quality experience in their dealings with the bank. As an illustration of that, I am delighted to present you with a comprehensive and challenging report on the current state of the legal profession. The report provides an extensive and thought-provoking discussion on many of the topical issues currently facing businesses generally and law-firm leaders in particular.

The legal profession is an extremely important sector within the RBS UK Corporate and Institutional Banking Division, with a long and proud history as a banker to the sector. We have banking relationships with in excess of one third of law firms operating in the UK. With banking relationships extending over two hundred years with some law firms, we have a long history and a vast amount of experience and data on the financial performance of the profession.

As head of the Legal Services sector, it gives me great pleasure to share with you some of our analysis and findings in this report. I look forward to continue working with you and providing you with the benefits of our sector-coverage model. We are committed to bringing you further sector-specific commentary and research, and I hope you enjoy this report.

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“In these matters the only certainty is that nothing is certain”

Pliny the Elder
(AD 23–79)
Executive summary

Law firms have responded well to new challenges in the operating environment but, as James Tsolakis, Head of Legal Services within the Corporate and Institutional Banking Division at RBS, explains it is vital that firms are ready to adapt to the new forces that are shaping the future of the legal profession.

During the lengthy period in which I have been an observer of the legal profession, I have never been more fascinated by its financial performance than during the previous two years. Once again, despite extreme adversity and the sometimes hostile business environment in which law firms have been required to conduct business, the legal profession has once again demonstrated its resilience and stability. It has shown the enduring qualities of a business that plays an active and critical role in the orderly conduct of the open and free global markets in which we do business and in the UK more generally.

Today we are confronted by many challenges. Some of these are familiar and some have not yet confronted the legal profession and wider business communities, both here in the UK and abroad. It is these challenges that will test the profession in the years ahead. The ability of firms to respond positively to these challenges will determine which of the market participants will survive, grow and prosper. Many firms will become victims of an ever harsher and more competitive operating environment. Those firms that respond positively will prosper and dominate their sector to emerge as the market leaders in their chosen areas of expertise.

We are now experiencing an historic period in the evolution of the legal profession. In the past, across various attributes, the profession was characterised by a stability, predictability, security and certainty. Since 2007, we have experienced a succession of factors and events that have challenged the traditional law-firm model and led to change within the profession at an unprecedented rate. My expectation is that the rate and extent of change will continue. While I remain extremely optimistic about the future of the legal profession, my expectation is that the organisation, structure, shape and modus operandi of the profession in the future will look quite different to what we have experienced in the past.

The forces that are driving change in the legal profession are wide and varied. What is certain, however, is that they are present, and firms that ignore them run the risk of falling behind their competitors. I maintain that the forces of change touching the profession are so significant and so far-reaching, that the consequences will be profound.

The legal profession is currently facing extreme pressures from, among others, the following forces:

- Following a contraction in the demand for legal services, a market showing little signs of any meaningful recovery
- Consolidation in the sector, both domestically and globally, with heightened levels of transatlantic and other international merger activity
- Low levels of transactional activity, suppressed by weak and volatile economic conditions around the world
“I expect to see the emergence of new and exciting legal models with significant benefits to clients”

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Head of Legal Services, Corporate and Institutional Banking, The Royal Bank of Scotland

• The threat and arrival of new entrants
• Opportunities to practise under new business models, the arrival of multidisciplinary practices and alternative business structures
• A fragile global economy and the risk of economic shocks both in the UK and in major global economies
• Continuing pressure on billing rates
• Visible overcapacity in the sector, addressed somewhat through restructuring
• The heightened quest for talent, and increasing levels of lateral partner hiring
• Inflationary pressures emerging in the cost base, including staff compensation
• Office overcapacity
• A changing, more complex and demanding regulatory environment
• Pressure on margins and profitability
• Increased appetite for sector consolidation
• How to deploy the abundance of debt and equity capital available for investment in the sector
• Identification of the optimal operating structure in regard to rapidly evolving business models
• A trend to corporatisation and new legal structures
• The emergence of new sources of equity and ownership models

These factors will inevitably unfold differently for many firms in the sector. The quality of response for individual firms will shape their destiny, including their future success, marginalisation or demise.

I believe that these issues will redefine the landscape of the legal profession. The result will be innovation in the way legal services are undertaken by practitioners, delivered to the market and purchased by clients. I expect to see the emergence of new and exciting legal models with significant benefits to clients, including lower costs, improved service, greater efficiencies, and a more client-centric approach.
The economic and financial environment

With political and economic instability set to continue, firms that plan ahead and adopt a flexible approach to business during changing economic conditions are more likely to succeed. Below are some of the factors contributing to the challenging conditions law firms are currently facing.

If you know what to expect next in the world economy, you are in the minority. Recent events and factors driving the global and local economies in which law firms are doing business include the following:

- Germany, France and 13 other European countries put on negative watch by Standard & Poor’s for possible downgrade (6 December 2011)
- Nine European countries downgraded by Standard & Poor’s on 15 January 2012 with Austria and France losing their AAA rating
- Coordinated intervention by major global central banks to provide liquidity in the financial system (December 2011)
- The United States of America – credit rating downgraded from AAA to AA+ by Standard & Poor’s (6 August 2011)
- Growth in the United States has been revised down to 0.5% per quarter, approximately half the historical rate
- No meaningful growth in the UK economy in 2011 as measured by GDP (-0.2% Q4, 0.6% Q3, 0.0% Q2, 0.4% Q1)
- A new programme of quantitative easing in the UK, with £75 billion proposed for injection into the UK economy in addition to the £200 billion already purchased
- Stubbornly high inflation, with the consumer price index (CPI) exceeding 5.2% p.a. for the quarter ended September 2011
- No growth in Germany in the last quarter (0.1% quarter on quarter)
- Interest rates in the USA to be held at historic lows for the next two years
- Unemployment in the UK increases to 8.4% (ILO measure), the highest level since 1996
- Jobless totals for 16 to 24-year-olds hits a record of 1,020,000 in the UK, a jobless rate of 21.9% for the September 2011 quarter (Office for National Statistics)
- European national regulators ban short selling of bank shares
- Sovereign debt in eurozone countries under extreme pressure
- Bond yields rise and credit spreads widen. French and German 10-year bond spreads widen to a 19-year high
- Republic of Greece bonds need to be restructured and default is a possibility
- Greece called to deliver extreme austerity measures to curtail the country’s budget deficit
- Ireland and Portugal have received bailouts
- Spain and Italy risk losing support of global capital markets
- Austerity packages rushed through the Greek and Italian parliaments
- Germany emerges as the lender of last resort in the eurozone, but has capped its commitment to €211 billion
- Massive and unsustainable imbalances revealed in several government national accounts
- UK interest rates remain at historic lows with the base rate at 0.5% p.a. and no increase imminent. The next increase is not expected before the first quarter 2013
- Gold price exceeds US$1,650 per troy ounce, reaching a high of $1,921 in June 2011 – a flight to quality or a bubble in another asset class?
- Energy prices continue to rise – oil price consistently holding above $110 per barrel
- Equity markets around the world exhibit extreme volatility, with little support in a falling market

The confluence of global geopolitical and economic instability delivers the leaders of law firms an extremely uncertain business environment. Looking ahead to 2012/13, this will create a difficult environment for planning, forecasting and budgeting than we have seen for many years. We expect most firms to develop several plans in response to a variety of business conditions, combined with action steps which then require implementation. Firms that are flexible, nimble, agile and respond proactively to the changing conditions are most likely to succeed.
The business environment

The 2010/11 financial year was characterised by many forces that, in the main, prolonged the difficult trading conditions experienced by law firms. However, for a minority of firms their impact was to create opportunities.

Some of the forces that characterised the 2010/11 financial year:

- No material growth in the size of the legal services market in the UK
- A patchy recovery in the demand for legal services
- A weak performance in major developed economies around the world
- Slower and restrained growth in developing economies
- Inconsistent and erratic transactional activity in both the UK and major global markets
- Weakness in the banking sector, often involving governments and central banks anxious to stabilise the domestic banking system and financial markets
- Uncertainties in the broader financial services market due to regulatory risks emerging in the eurozone and other markets
- Continued restructuring of law firms in response to suppressed activity levels, although much of this was occurring outside the view of the legal market and the trade press
- Continuing government and central bank intervention in financial markets, with the threat of heightened levels of activity, such as quantitative easing and intervention in foreign exchange markets
- Increasing levels of regulation of the banking and financial services sector
- Corporate failure at levels above the historical average
- Slow recovery in asset values, particularly in the commercial real-estate sector
- Increasing levels of unemployment
- Continuing foreign exchange volatility
- Relative weakness of sterling against the currencies of other major economies and trading partners
- Stabilisation of borrowing margins combined with tight credit conditions
- Increasing softness and volatility in illiquid asset classes
- A flight to quality among investors
- Continuing favourable trends in commodity prices, particularly in precious metals and energy products
- Continuing deleveraging of corporate balance sheets
- A deferral of investment decisions and a reluctance to embark upon major new capital expenditure and investment decisions

All of these factors had an impact on the operations and financial performance of law firms and their clients during the 2010/11 year. We have observed that the impact is continuing in 2011/12, thereby restraining the desired recovery in the broader UK economy and in financial performance broadly across the sector.

“There are increasing levels of regulation of the banking and financial services sector”
Demand for legal services and revenues

The legal profession continues to recover, with areas that respond to the current economic climate continuing to perform well. Geographical diversification has also produced good results but it can involve financial risk, and firms need to remain focused on clients.

The 2010/11 year was something of a recovery year for the legal profession. However, one has to view this in the context of the nadir for the legal profession, which was the experience of 2008/09.

The financial crisis of 2008/09 produced a material decline in the demand for legal services. The global recession that followed provided the catalyst for a collapse in transactional activity which had serious and adverse implications for the volume and value of instructions available to the legal profession. The economic conditions that ensued resulted in a global recession, and the major and mature markets of the world were slow to recover.

While there has been much discussion and debate about the prospects of a double-dip recession, the discussion around the technical conditions for that to occur are a distraction from the key issue. More central and of greater importance to the legal profession is whether, or under what circumstances, transactional activity will show an improvement that can be sustained over the long term. As described above, the economic conditions that currently confront us confirm that the major developed economies of the world are struggling to expand. In the absence of the major markets in which law firms operate delivering growth, law firms cannot easily rely on organic growth to support their future revenue growth.

In an RBS survey on the outlook for revenues in the legal sector, the majority of firms expected revenues to remain broadly unchanged during the year, while slightly over one-third of firms expect revenue growth of over 5%. The current year has seen some recovery and improvement in the financial performance of the legal profession. However, the challenges of the sovereign debt crisis in some eurozone jurisdictions have yet to be fully confronted. Moreover, the implications for bank solvency, capitalisation and liquidity have yet to be dealt with, and the markets are demonstrating some of the qualities that were evident in 2008/09. Some disruption to the credit markets may become more evident. The funding of banks’ balance sheets may be less stable due to increasing disruption in wholesale interbank markets. This in turn may create challenges for banks lending to the commercial sector. The financial performance of law firms having practice areas with a heavy dependency on transactions, including M&A, private equity, commercial real estate and banking, are most likely to be adversely affected if events unfold as described.

Based on research conducted by RBS Legal Services, combined with forecasts prepared by RBS Group Economists, we believe that the legal profession will outperform the general economy in the UK. However, despite having recovered markedly from the decline in the demand for legal services since 2008/09, we expect the currently depressed levels of transactional activity and revenue growth to be a feature of the market for the medium term. This position is unlikely to alter until the UK and major global economies recover by demonstrating long-term sustainable growth. However, our research and evidence also suggest that the market for legal services is no longer in decline but has stabilised, albeit at levels up to 10% lower than the same period last year.

Revenue performance across practice areas is best summarised as patchy. Unfortunately, there is a lack of continuity of transactional flow, transaction repetition and replication. Combined with this, many transactions are not running their full course. As a result of the heightened level of transactions being aborted prior to completion, the full revenue potential of these transactions is not being realised. In particular, M&A, private equity and banking practice areas are somewhat slower as a result. Real estate practices are generally much smaller and slow, although this is not uniformly the experience of all firms.

In contrast, litigation practices are enjoying comparatively greater success. Firms with relative strengths and good reputations in this area are benefiting from higher levels of activity. This is somewhat reflective of the countercyclicality of this practice area in comparison with the larger transactional practice areas referred to above. Beyond this, restructuring, insolvency and debt recovery practices are steady, as are

Revenue growth expectations
In the next 12 months expect fees to:

- Stay the same (+5% to -5%)
- Increase (+5%)
- Decrease (<-5%)

Source: RBS Legal Sector Outlook Survey (September 2011)
The critical strategic decision for the firm is to define its target client group. Following the identification of the target client, the preferred legal services to be delivered to these clients will drive decisions around necessary practice areas and the fee-earner resources needed to deliver the required legal advice. An international network that lacks a client-driven and strategic rationale is not a satisfactory end in itself, and will only contribute value to the firm if offices in the international network are themselves operating profitably. While the strategy clearly has merits in smoothing out volatility in financial performance arising from weakness in the UK domestic market, it is not without risks and costs. Some firms with more mature international businesses have been less well rewarded from their international expansion, particularly in those jurisdictions in which the local market cannot bear the firm’s standard rates. Also problematic is where the nature of the instructions available do not provide the firm with the

“The critical strategic decision for the firm is to define its target client group”
complexity or sophistication of advice to permit it to leverage its extensive cross-border legal advisory skills across multiple practice groups. After careful analysis of the contribution of offices in some global networks, international growth as an end is not always a favourable economic experience. It is clear, particularly following the closure and material downsizing of certain international offices during the year, that the success of an international strategy must be built around the client and that cannot be measured on the number of different jurisdictions in which a firm is represented.

This is increasingly a market in which a trusted adviser will be rewarded, and clients are looking for their legal advisers to fulfill this much sought-after role. Whereas the prize was formerly premium fees on transactions redefining the business landscape, it is today more likely to be rewarded with more, and higher value, work gravitating to that fee earner and their firm. A positive point of differentiation will remain the ability to anticipate legal problems on the horizon and provide advice on their implications ahead of the problems emerging.

Revenue performance in the first half of 2011/12 is showing mixed results. Stronger firm performances are delivering results showing revenue growth in the range of 6-12%. However, revenue growth is patchy and more typically growth of up to 6% is the norm. Based on the RBS Legal Sector Outlook Survey, we estimate revenues for the legal sector represented by the top 100 UK law firms to increase by no more than 5% in the 2011/12 year. Notwithstanding the revenue growth and strength demonstrated by some firms in the first half, the immediate effects of the economic uncertainty hovering over most mature western economies, particularly the UK, Europe and the US, will have a seriously adverse impact on business volumes. This is already evident in some practice areas, particularly banking and corporate.

The delivery of revenue growth at this level will be in line with the legal sector’s performance in the previous year. It is consistent with our view of the long-term cycle into which the performance of the legal sector will be range bound, demonstrating a trend towards modest growth over the medium term. We temper this view of the sector as a whole, however, by expecting there to be some significant differences in the performance of individual participants in the sector resulting from the strategies they adopt in response to the current environment. Some of the strategic options and their implications are discussed below.

Of interest is the generally lacklustre performance of chargeable hours. These have failed to recover consistently, and patchiness is again the expression most commonly used to describe performance. Peaks and troughs are reflective of the inconsistent transactional activity evident in the market. Of concern is that the significant fee-earner capacity, which has been eliminated from the market, does not manifest itself in a more stable level of chargeable hours across all levels of fee earner and across all practice areas.

This is one of several indicators that would suggest that the UK market remains over-lawyered. In the absence of large new sources of instructions, which we do not expect, new business models and organisational structures, resourced differently than the traditional law firm, will be required to improve chargeable hours to levels that can be expected to deliver materially improved profitability over time. Alternatively, additional restructuring will be required to further eliminate fee-earner capacity. That chargeable hours continue at sluggish levels is of particular concern, given the significant fee-earner capacity that has been removed from the market over the last two years (see ‘Restructuring’ on page 12). Firms’ views on billable hours capture this point, with the majority not expecting any material improvement over last year.

| Revenue growth expectations |
| Chargeable hours per fee earner in the next 12 months will: |

- Stay the same (+5% to -5%)
- Increase (+5%)
- Decrease (<-5%)

Source: RBS Legal Sector Outlook Survey (September 2011)
In contrast with recent years, the impact of foreign exchange has been modest on revenues from a currency revaluation standpoint. The favourable impact in 2008/09 was up to 20% due to the depreciation of sterling, although in our experience, depending on the scale of a firm’s operations outside the UK, we have seen the impact to be in the range of 7% to 15%. Having said that, the question of foreign-exchange exposure is becoming an increasingly important risk of which to be aware and to manage. Firms are increasingly expanding abroad in pursuit of their growth aspirations. This embeds a foreign-exchange risk in their businesses, and firms need to understand the impact and the risk-management requirements to protect the value of foreign currency revenues, and the broader financial risks.

The RBS Legal Services team has been working closely with our foreign exchange advisory team in advising firms on the reduction of the foreign-exchange risk inherent in firms with offshore operations and the potential to mitigate the uncertainty in firms’ financial performance due to foreign-exchange volatility. While top-line revenue growth benefited in sterling terms from sterling depreciation against foreign currency revenues, it should be noted that from a net profit standpoint, foreign currency expenses also grew due to sterling weakness.

We have observed that the traditional models for law-firm organisation and structure are being challenged. Rather than build the firm according to historical and traditional paradigms and frameworks, we believe that the firms that build themselves around their clients’ priorities and strategic objectives will be more successful in the next generation.

“Firms are increasingly expanding abroad in pursuit of their growth aspirations. This embeds a foreign-exchange risk in their businesses”
Restructuring

As the legal profession continues to evolve in response to a challenging business environment, firms must be prepared for restructuring and have a plan of action in place to enable them to respond effectively to adverse business conditions.

Despite some significant restructuring completed in the legal sector in 2009/10, we have seen firms continue to embark upon restructuring initiatives during 2010/11. While in many ways much less extreme, they are nevertheless far-reaching, particularly in redefining the manner in which law firms are organised and structured, and also in the approach and techniques that law-firm management now utilises in responding to difficult business conditions.

The pursuit of these restructuring initiatives reflects:

- the continuing weakness in the demand for legal services and an inability to grow firm revenues
- the sluggishness of the recovery in billable hours, which has been very patchy among many firms
- an inability to energise, invigorate and build growth in underperforming practices
- the inability to redeploy fee earners in weakly performing practices in areas of improved activity
- performance issues among fee earners at every level of the firm
- overcapacity and performance issues among support staff
- the result of outsourcing projects and the overcapacity that has resulted

Following the recession in 2008/09, many firms completed significant restructuring. Based on our observations and media commentary, we estimate that this removed approximately 15% of fee-earner and support-staff capacity across the market. While some, particularly the larger firms, moved very early and aggressively in response to the sudden and severe decline in activity levels, others adopted a less aggressive approach. Many others had a wait-and-see attitude. For those firms that had initially been slow to respond to the economic crisis or those that had waited to determine how severe and prolonged the downturn would be, there has been a need to catch up with the early movers in order to maintain their relative position and profitability levels.

It is noteworthy that during 2010/11, restructuring continued through the market, albeit in many cases much less visibly than has been the case previously. The nature and character of the restructuring has changed. When it became a significant but innovative feature of the market in 2008/09, it was normally very deep and often highly visible. Now, restructuring has adopted two distinct qualities. First, restructurings are very often less visible and in some cases even invisible to the market. Firms have established a framework for dealing with restructurings whereby, in the interests of the individuals involved, their future prospects and the reputation of the firm, the restructuring initiatives are kept both very private and discreet, thereby avoiding any significant market attention and public commentary. In many cases, this is not visible until the individual concerned has been engaged by a new firm.

The second quality to emerge during 2010/11 is that these initiatives are embedded within the firm as a process and take on the characteristic of a continuum. In many firms it is
therefore possible, and indeed likely, that small restructurings will take place throughout the course of the year in response to changes in the business environment, some strategic initiative, weakness in profitability or some performance-related consideration. In support of this, during its dialogues with law-firm leaders, RBS now normally comments that the action plan formulated to respond to adverse business conditions is not something to be devised and considered some time after the event has materialised, but rather exists in the firm’s strategic plans, is reviewed at least monthly at board or management committee level, and is ready to be activated when business conditions suggest they may be required.

Despite all that has been done to correctly resource law firms to properly align them with correct activity levels, we expect further restructurings to have been completed in the latter months of 2011/12. This will enable firms to commence the new financial year in a more stable position, and with a more robust, sustainable and stable business model.

Based on analysis carried out by RBS Legal Services of first-half performance, and in reviewing activity levels through the second half currently in progress, it was found that insufficient fee-earner capacity has been removed from the market to return the legal profession to materially improved levels of profitability. Based on current levels of activity, we believe that at least a further 5% of fee-earner capacity needs to be removed from the market to achieve the profitability levels the profession formerly enjoyed. However, the profitability dynamics of the profession are changing, and it may be that existing levels of fee earners are sustainable, resulting in the dilution of the overall profitability of the profession when analysed over the number of fee earners in the sector. It is our view that this will not be an acceptable outcome over time, and the legal sector will commence some stratification or segmentation on profitability grounds, so as to differentiate between high, medium and low-profit firms.

Another catalyst for further restructuring is the impact of outsourcing on the legal sector. Across both fee-earner and support-staff populations, the full impact of outsourcing initiatives has yet to be fully realised. Combined with this, the business models for delivery of legal services are also changing such that the nature and location of work required for completion of instructions is breaching traditional boundaries. Notably, different resources are being identified for the completion of tasks, and the location in which these are being completed is no longer predictable, recognising that many tasks are being migrated away from modern city head office locations. All this supports a continuing evolution of the profession, and indeed an acceleration of the rate of change and the resulting need for restructuring a law firm to keep pace with the organisational and economic implications of the business environment.

Finally, the role of the client cannot be ignored in the restructuring process. It is clear that clients have a greater influence on the manner in which major legal service providers deliver legal advice. As General Counsels continue to seek greater transparency and efficiency from law firms, this will result in additional changes to the legal model to meet these expectations. Firms will need to look further at their business models and refine and restructure them to meet ongoing changes in client expectations.

“Insufficient fee-earner capacity has been removed from the market to return the legal profession to materially improved levels of profitability”
In an environment in which the competition among law firms for the short supply of legal instructions is intensifying, the value and significance of client management has never been more important.

For this reason, firms need to be consistent in both their approach and execution of client-management strategies. Historically, with strong demand for legal services driving law firm success, there was less need for the profession to focus as sharply on understanding the complexity of the client’s legal needs, driven by its business, organisation and structure. Despite this, law firms did well in the cultivation and development of client relationships.

The important difference today, however, is that there are many fewer transactions for which to compete, and relatively more lawyers who are pitching to the clients for the shrinking amount of work now available.

There is no doubt that the competition for legal instructions will become more intense. The reasons for this include:

- weaker global economic performance reducing transactional activity throughout economies
- the trend towards smaller legal panels, which is already in evidence but which looks set to accelerate
- clearer lines of division among providers of legal services, defining their areas of expertise and the work in which they excel
- the redefinition of business models driving the economics of the legal profession and qualifying the type of work for which a firm can profitably compete
- the role of LPO firms in executing part of legal instructions that would previously have been completed by the law firm
- some legal work being taken in-house

The power in the relationship between the client and legal adviser still sits with the buyer of legal services. The balance of power in that relationship shows no signs of shifting in the medium term. We therefore expect to see a continuation of the pressure firms have experienced around rates, as General Counsel continue to pursue objectives focused on the reduction in legal costs. Combined with this, General Counsel will increasingly seek additional assistance around other services that firms can provide in support of the relationship. These include the provision of secondees in support of the in-house legal team, training, and research. There is no doubt that General Counsel will strive to secure more value from the firms with which the company has relationships. It is critically important that law firms become ever more important to the companies with whom they work so as to secure their positions on panels and maintain a healthy access to instructions.

Finally, the pursuit of new instructions and new business for a law firm often takes the form of new client acquisition. This is often at the expense of work available from existing clients which a more proactive and hands-on approach to client management would uncover. Firms who do this well have a greater share of their client’s legal services spend. Likewise, through a more detailed knowledge of their client, they will possess insight into the legal issues impacting the shape of the client’s business and the industry in which it operates. In an environment in which competition is intense, the focus on protecting and defending existing clients and the revenues that they contribute must be a priority for firms. Moreover, firms that fail to deepen client relationships, service the client’s legal needs broadly across multiple practice areas, and position themselves as a trusted adviser, will miss the opportunity to expand the relationship and capture market share.

A trend towards fewer, higher value clients has been a model that has delivered greater profitability, and this looks set to continue. The firms that are able to decline new business on the grounds that it is not a good strategic fit or that it lacks the profitability and margin contribution consistent with the firms’ goals will continue to outperform those firms that do not follow this disciplined approach to transaction and client selection.
Rates

Current market conditions are not conducive to rate increases and firms are under continuing pressure to reduce rates. Law firms must also accept that clients now expect to be offered alternative fee arrangements as part of the legal service.

Law firms’ use of rate increases as a driver of revenue growth was an historical norm prior to the downturn in 2008/09. Subsequently, rates have been under extreme pressure and while that trend appears to have stabilised, we are regularly in dialogue with managing partners who describe the continuing pressure to reduce rates. This results from requests by General Counsel, and is also a response to the price pressure applied by competitor firms in the aggressive competition for new instructions.

There continues to be very little appetite in the market for rate increases. General Counsel remain under continuing pressure to reduce legal costs and extract greater value in many different forms from their preferred legal relationships. Despite this, and on an exceptional basis, we have seen some firms increasing rates during the first half of 2011/12. We believe the market has minimal ability to absorb any rate increases, and expect the quality of a firm’s WIP to deteriorate, combined with a deterioration in realisation rates as the WIP is billed.

Combined with this, we have seen a realignment of the competitive landscape during the year. In particular, regarding declining volumes of instructions in the market, there has been a shift among some firms to compete for transactions that are below the parameters the firm normally sets in defining its target market. This shift has normally been accompanied by rate discounting, sometimes quite heavily. This strategy appears to be designed to keep fee earners engaged during periods when there is little work available. It is noteworthy, however, that in order to win the instruction, this work is almost certainly priced at a level to be loss-making and erosive to the quality of the firm’s financial performance.

This process has also resulted in some crowding out of traditional law firms in certain transactions, as larger firms move down the market to keep fee earners occupied and to develop new sources of revenue. The ability of the firm to recover these costs without adversely impacting gross margin and profitability has been limited.

Another noteworthy trend is the increasing use of alternative fee arrangements (AFA). The move away from the billable hours being the traditional basis on which fees are issued to clients is starkly apparent. AFA have now been embedded into the billing expectations of the market and will increasingly become more recognisable as the norm.

The forms the emerging AFA might take are as variable as the creative minds of law-firm clients and law-firm partners might want them to be. Examples of these include:

- fixed fees
- capped fees with triggers for review
- hourly rate plus success fees
- fixed fees plus success fees
- bulk or volume discounted fees
- retainer plus success fees

We have seen AFA not uniformly embraced within firms, even to the point of creating tension, dislocation between partners, dysfunctional behaviour across the partnership, misunderstanding and scepticism among those fee earners and practice groups not using AFA, and some uncertainty in the finance department about the value and contribution of these arrangements.

It is imperative that firms accept that this is the way forward and that clients expect firms to be able to deliver AFA as a standard component of the legal service delivery package offered to them. This would seem to be well understood by the market, with the results of our research showing a strong majority of firms expecting more fixed-fee arrangements in the year ahead.

**Billing practices**

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Source: RBS Legal Sector Outlook Survey (September 2011)
Moreover, and as an extension of this, our research also confirms that the market expects fee caps to be part of the core fee arrangements for specific elements or components of particular instructions. Again, a majority of firms expect these arrangements to increase during the year ahead.

Billing practices
Expect to see: Capped fees

Source: RBS Legal Sector Outlook Survey (September 2011)

A trend to have emerged and which we expect to build momentum is an increasingly visible and financially quantifiable alignment of interests between those of the client and the law-firm adviser. Clients are increasingly demanding that the professional advisers they engage, including law firms, take some of the commercial risk, either directly or indirectly, in the transaction. As an example, there are some very significant contingent fee arrangements in place for major high risk/return litigation matters. To further illustrate the acceptance of these arrangements, our analysis revealed significant acceptance of the growth of these arrangements in the year ahead.

Billing practices
Expect to see: Risk-sharing arrangements

Source: RBS Legal Sector Outlook Survey (September 2011)

While AFA represents an obvious challenge and threat to the legal sector, it also signifies an opportunity for a law firm to redefine the basis on which the billing and collection component of the client relationship is managed. The firms that can embrace this opportunity and drive it to their advantage will have captured a unique opportunity not previously available or as easily deliverable under the hourly rate billing and collection regime.

In particular, a firm might consider making the AFA model work in its favour by:

• defining precisely the scope of the work, timing, subject, resources to be utilised

• documenting with absolute clarity the points in an agreement with the client

• agreeing fixed fees for any transaction extensions or scope variations

• capping hours on contentious parts of a transaction, creating room for renegotiation, if required

• agreeing a regular review period – monthly, quarterly, annually

• agreeing billing and payment arrangements. The opportunity to bill and collect within tighter timescales and on shorter cycles is significant

• introducing a formal process and timetable to meet and discuss the relationship

Another method for pricing transactions, which has gained wide market visibility, is via an online e-auction process. Under this system, law firms bid online at the fee level of their choice for a particular assignment or instruction. Bids may be submitted and updated over a short and clearly defined period of time advised at the commencement of the process. The law firms bidding for the work do not know the identity of other bidders, but are aware of the lowest bid for the work under consideration. Not surprisingly, all things being equal, the work is awarded to the lowest bidder.

We expect that billing according to hourly rates will continue as the most important billing technique applicable in the UK. However, we see this model under threat, and expect the dominance of this billing method to continue to be eroded over time, as clients seek more transparent, clearer and financially certain fee arrangements combined with a billing method in which the economic and business risks are increasingly shared with the law firm.
The leverage model

The leverage model within the legal profession has changed over the last few years. In particular, firms have deleveraged and many of the higher leverage models have been unwound. There are two drivers behind this constantly evolving trend. First, the economics of the high leverage model in a declining market were much less powerful. In fact, the idle capacity of lawyers not engaged in transactions and therefore not producing billable hours at the firm’s budget rate was damaging to margins and erosive to firm profitability. Beyond this, there has been some support for deleveraging coming from clients. The momentum behind this has been the General Counsel’s request for more transparency about how work is being completed and by which level of fee earner. In our discussions with law-firm senior management, they have commented that clients have expressed a desire for more direct partner contact and involvement in the execution of instructions, greater visibility and accountability by partners, and less willingness to support training of associates on their instructions.

We expect that this is yet another trend that has emerged for the legal profession and one that is set to remain for the long term. The likelihood is that as further restructuring in the legal profession occurs, the leverage will adjust to reflect those resource allocation decisions that are required. However, we expect that these will represent minor adjustments to leverage. Only when a robust and sustained recovery is in evidence do we expect that the high leverage models will return to prominence.

Meanwhile, the debate continues concerning the optimal model for a law firm, including what type of fee-earning resources are required to complete a transaction, the level of skill and experience, their location and whether they need to be part of the firm or can be sourced and contracted from an independent supplier. Legal process outsourcers are a feature of the market, expanding and developing new delivery capabilities. The most important point to recognise is that firms are experimenting with new models, all of which may have advantages, and which may enhance the client experience in terms of the way an instruction is managed. In addition, these new models may result in a more cost-effective allocation of resources aligned against the client and the instructions being executed, thereby improving the economics of the instruction and permitting the firm to deliver the legal advice and service more cost-effectively than the competition.

While there is no evidence of a preferred or best-in-class model in existence at this point, some of the models being developed include:

• on-shoring – taking work to a domestic low-cost delivery centre
• off-shoring – taking the work to a low-cost jurisdiction abroad
• outsourcing – contracting the work to a third party, domestically or abroad
• some on-shoring and/or off-shoring outsourcing hybrid model

The most appropriate model will vary according to the type of work being done by a firm, its geographic reach, and client requirements and expectations. Therefore, we expect to see a wide variety of models operating successfully in the market as the different requirements are tested by firms, and their delivery capabilities more closely aligned with particular client and law firm needs.
Human capital

As firms restructure to achieve a more sustainable business in a difficult market, managing partners are thinking creatively about how to source talented teams and individuals to create new practice areas or enhance existing talent pools.

The management of the human capital of a law firm continues to be a significant challenge in most firms, and at the same time one of the biggest factors driving law-firm performance. The human capital allocation decision in a law firm relates to:

- the practice areas in which fee earners are engaged
- the complexity of the instructions
- the type of work that they are assigned
- the level of supervision that is required
- the extent of management attention provided
- the location in which the work is completed

Firms are becoming increasingly aware of the implications of these decisions. The skills that firms demonstrate around their human capital resource allocation decisions will drive the success of the firm based on:

- financial criteria, such as margins and profitability
- ability to deliver client instructions on time
- minimising write-downs
- improving utilisation of fee earners and increasing billable hours
- the quality of the client experience
- the quality of the fee-earner experience

Restructuring

Notwithstanding that there has been a significant amount of restructuring in the legal sector, we expect that the latter quarter of 2001/12 will have seen more restructuring. The aim will be to ensure that the year closes with a more sustainable fee-earner structure in regard to the level of activity that is evident in the market. Some firms have been able to redeploy fee earners into other practice areas. However, in many cases all these possibilities have been exhausted and skills cannot be retooled to make them fit in those practice areas in which they might be required.

Recognising that labour costs are the major expense of any law firm, this would seem to be the direction in which the market will go in order to manage margins and restore firms to satisfactory levels of profitability.

Lateral hire activity

Despite the subdued conditions in the market, we rarely encounter a managing partner who does not comment that they are looking for an individual or a team in order to:

- create a new practice area and expand the offering of the firm
- build scale in an existing practice area
- develop a new market for the firm in a new geographic region, either domestically or abroad
- develop a succession plan
- improve the quality of the existing talent pool

While none of these issues are new, the intensity with which these strategic lateral-hiring decisions are being pursued, the consistency around the market for pursuing lateral hiring initiatives, the absence of suitable talent to be ‘acquired’, and the difficulty in dislodging the most attractive individuals and teams is notable.

The consequence of this is an increasing demand for a limited, indeed scarce, resource. It naturally follows that we are seeing compensation inflation in the market. Having regard for the subdued market conditions, this is troublesome and will lead to further margin erosion combined with increasing demands and pressure on firm cashflow.

Talent management

As discussed above, talent management continues to be one of the priorities for more progressive law firms. At the same time, it continues to be an area that is less well understood and managed by law-firm leaders. The issue revolves around the alignment of interests between those of the firm and those of the fee earner, and the extent to which these can be matched so as to harmonise in pursuit of shared goals.
The needs of high-performing fee earners are predictable and vary little. They include:

- access to better clients
- a desire to work on more interesting transactions
- opportunities to work with high quality, talented lawyer teams
- a clear path for career development
- for associates, more partner contact
- proactive career development
- rigorous mentoring and other support programmes
- credible frameworks for career progression
- frank, regular and open appraisals
- fair compensation

Interestingly, and potentially a danger for some firms, is an apparent disillusionment among some associates for pursuit of equity partner status. This seems to be attributable to lifestyle choices, combined with other career and professional aspirations that cannot be satisfied by the profession. It is also noteworthy that equity is being held more tightly in the legal sector, and therefore admission to the equity is much less easily attainable than during the more buoyant years of the late nineties and immediately prior to the credit crisis after 2008.

Sources of talent
Firms are thinking increasingly creatively about sources of talent. Driven by ever more demanding client needs, firms will organise their businesses differently and will identify more diverse sources of talent pools with which to resource them.

The Law Society of England and Wales is providing some good momentum for building talent outside the UK. The Law Society actively promotes English law in international jurisdictions, and provides opportunities for lawyers outside the UK to acquire the knowledge, skills and experience to qualify as solicitors under English law.

These initiatives will create increasing opportunities for law firms to acquire legal talent from outsourcers both domestically and abroad, and for law firms to similarly identify talent pools in lower-cost jurisdictions to which they can offshore certain work.

Partner mobility
The rate of lateral partner hiring is increasing and the market seems unable to satisfy the demand for skilled partner talent. The pressure in the system and the increasing demand for partner lateral hires is illustrated in the RBS research (below), which shows that more than a quarter of firms expect lateral partner hires to increase by more than 3% compared with last year.

<table>
<thead>
<tr>
<th>Expected lateral partner hires (compared with last year) to:</th>
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<tbody>
<tr>
<td>Stay the same (+3% to -3%)</td>
</tr>
<tr>
<td>Increase (&gt;+3%)</td>
</tr>
<tr>
<td>Decrease (&lt;-3%)</td>
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</tbody>
</table>

Source: RBS Legal Sector Outlook Survey (September 2011)

Despite the seemingly large partner population from which to draw lateral hires, the challenge remains in finding partners of suitable quality in regard to their legal skills, the quality of their practice and client base, the mobility of those clients and a suitable volume and value of instructions to go with them. Beyond this, on both sides of the transaction, one must then be comfortable with the soft skills and attributes a new partner brings to the firm, and the due diligence around the cultural fit is as equally important as other more tangible and quantifiable measures.

“Talent management continues to be one of the priorities for more progressive law firms”
Technology

Technology is becoming increasingly important for law firms, from the systems that support client and practice management to the smart legal technologies and applications being developed for the automation of legal tasks and advice.

Most firms consider the use of technology to be a source of competitive advantage for a law firm. This was evident in research carried out by RBS which delivered overwhelming and compelling results in support of this proposition. There are two dimensions on which to analyse these results.

The first is the use of technology for the internal requirements of the firm. The use of systems in this way supports client management, practice management, time recording, billings, collections credit control, new client onboarding and KYC requirements to name just a few.

The second dimension concerns the use of computer technology more directly in the execution of legal instructions. A simple example is around the possibilities for e-discovery in litigation matters, but the technology developers and some law firms are moving very quickly to develop a variety of smart legal technologies and applications for the automation of certain legal tasks and advice. This is most likely to start at the retail end of the market, but our expectation is that it will develop and migrate to more sophisticated areas of the law.

“Most firms consider the use of technology to be a source of competitive advantage for a law firm”
Expense management

There are gains to be made from efficient expense management but inflationary pressures combined with the pressure on billing rates and lower levels of transactional activity could present obstacles to profitability.

Firms require a continuing rigour towards expense management, recognising that they continue to operate in a weak economy and a market characterised by little growth, patchy recovery and volatile practice area performance, continuing price pressure and inconsistent transactional volumes.

However, there are expense-management risks for law firms on several fronts. First, the generally strong inflationary pressures in the economic system have the potential to migrate broadly into the expense base of a law firm in different ways. Many of these costs may not be directly controllable by the firm, nor may they be costs of a discretionary nature.

Beyond this, there would appear to be some inflationary pressure in the compensation of the fee-earner population. This is most visible as a result of the strength of the lateral hiring activity, which is now well embedded as a feature of the UK market. This was described by firms and is illustrated below.

**Expense management**

In the next 12 months expect expenses to:

- Stay the same (+5% to -5%)
- Decrease (<-5%)
- Increase (+5%)

Source: RBS Legal Sector Outlook Survey (September 2011)

The implications of this and, in turn, the danger for law firms, particularly when combined with the pressure on billing rates and lower levels of transactional activity and legal instructions, is that there will be margin pressure which will have the potential to erode profitability.
Another issue for law firms in the current environment, which has potential for either a prolonged economic slowdown or a downturn, is deterioration in the quality of firms’ WIP and debtors, resulting in an increase in bad debts. This seems to be the most likely outcome in the current environment, and we would expect this to be evident initially in a lengthening of lock-up days, followed by an increase in write-off levels of WIP and debtors. The deterioration in the bad-debt experience of firms was confirmed in the feedback provided by firms shown below:

Expense management
Expected bad debts:

- Flat
- Increase
- Decrease

Source: RBS Legal Sector Outlook Survey (September 2011)

As firms embark upon new restructuring initiatives, this will initially add additional cost burdens on them. The favourable cost impact of restructuring will, based on experience and previous examples, take around nine months to start to come through the financial statements in the form of lower running costs. The cost of premises continues to provide an expense-management challenge for some law firms. Expiring rent-free periods and landlord subsidies coming to a conclusion are adding a greater burden on the rental expenses of the firm. Many firms that moved premises and built capacity for future growth, over-expanded relative to the needs based on changing market conditions, and some of these firms still carry the financial burden of unused office space that they are unable to sublease.

A major problem for law firms is that as a percentage of a firm’s total cost base, the non-salary and wage component is relatively small. Therefore the relative gains become ever smaller as the decreasing opportunities for further cost cutting take place. We had observed a trend among international and especially global firms to reduce office space per fee earner in the offshore offices, and support staff across the network. This trend however has been in reverse in the last six months and there is generally a trend, indeed a strong appetite, for most firms to expand their office and networks abroad. The pressure on margins would therefore seem unlikely to abate. A continuing rigour towards expense management is required as firms continue to operate in a weak economy and a market characterised by no growth, extreme price pressure and low transactional volumes.

“Many firms that moved premises and built capacity for future growth, over-expanded”
Partner performance, measurement and compensation

The traditional lockstep model of equity partner compensation is being challenged and replaced with a modified lockstep and alternative models that align compensation with performance. Key to their success are effective partner appraisal systems.

While the traditional lockstep model for equity partner compensation survives, it continues to be challenged and replaced by alternative compensation models. Such is the threat to the lockstep model, it would now appear to lack the qualities required to make it sustainable. That it is losing its relevance and the qualities that make it fit for purpose in some firms is not surprising in light of the pressures that the legal sector is now facing. The reasons for the development of new compensation models in place of traditional lockstep include:

- directly aligning compensation with performance
- recognising the contribution of rainmakers and high achievers at all levels of the firm
- responding to the increasingly active and sometimes aggressive market for lateral hires
- recognition of and response to sustained underperformance
- the need to create space in the equity ranks for new and developing talent
- rewarding performance and contributions to the firm’s success which cannot otherwise be directly monetised
- financially defending talent that may not be appropriately recognised and compensated under the lockstep system
- The influence of new entrants from abroad in the UK market, particularly from the US, who typically operate some form of merit-based compensation models

In response to this, the compensation models that are now in place and continue to evolve are the modified lockstep and merit-based compensation systems. A critical issue in the successful performance of both of these compensation systems is the clarity with which these models deliver their performance measurement outcomes. This is contingent upon the firm operating an effective partner performance appraisal system. The qualities of such a system include the following:

- Transparency of key performance indicators (KPIs)
- Measurability of KPIs
- Regularity of the review process (no surprises)
- Precise and clear definition of qualitative and non-quantifiable KPIs
- Minimisation of subjective factors included in the process
- Consistency in application of the process for individual fee earners and across all partners in the firm
- Clarity in the contribution and weighting of KPIs in the compensation decision
- Greater transparency in the role and impact of soft issues on compensation decisions

The great challenge for managing partners or compensation committees will be to drive these principles forward and minimise compensation decisions based on feelings and instincts, thereby eliminating all the inefficiencies and conflicts that such subjectivity delivers. For greater success to be achieved in this area of management, IT and management information have to develop so as to measure the financial and non-financial performance of equity partners. In particular, we expect some methodology to develop for the measurement of individual equity partner and practice area contribution, margin, financial returns and profitability. These will be combined with some experience of performance success measured against the non-financial goals of the partner, the practice area and the firm, with a solid analytical framework available to support conclusions around these performance goals.

Complementing these compensation arrangements, some firms have introduced bonus pools. One of the greatest challenges facing management is defining the methodology behind allocation of the pool, providing clarity around the subjective elements of the bonus allocation and transparency around bonus allocation decisions, and managing a satisfactory appeals process.

The move towards modified lockstep and performance-based compensation models aligns the UK and US markets more closely. The issue of compensation process being more proactively managed, combined with a convergence of compensation models, will significantly reduce or remove one of the obstacles to transatlantic merger transactions.
Cashflow management

With few signs of improvement in the cashflow management position for law firms, a disciplined approach to the challenges ahead is key.

The cashflow cycle has generally stabilised for the legal profession during the year. The need for maintenance of strong core cashflows was highlighted through the recession, and improvements that were made through the ensuing period have now been embedded in law-firm treasury management and financial control practices. However, the cashflow management position for law firms can best be described as stable, and there is no noticeable evidence of any significant improvement coming through the system.

Maintenance of good cash management disciplines must remain a key priority for law firms. The cashflow philosophy of the legal profession typically favours both an early and very heavy distribution model. That is to say, after payment of operating expenses during a financial year, profit distribution to owners of the business tends to occur on an accelerated cycle compared with other corporate entities in the general economy. What this means for law firms is that a slowdown in the cash-conversion cycle will stress cashflows or require utilisation of credit facilities. Such cashflow management models will not be sustainable in the long term.

The ongoing cashflow management challenges for law firms will be:

- the absence of significant growth of tax reserves, which historically provided a predictable and reliable source of working capital as profitability increased over a long period prior to the recession. In recent research, as highlighted below, over 70% of firms indicated that they held tax reserves and used these to provide a source of working capital financing.
- the stickiness in lock-up, which had lengthened after the recession due to slower transaction completion and resulted in WIP extending and debtors remaining outstanding for longer periods. Firms did a good job over the last year in addressing this deterioration in lock-up. However, significant further progress seems elusive and firms are not demonstrating an ability to meaningfully further shorten the days outstanding in WIP and debtors.
- signs of a new slowdown, which have clearly started to appear, and the serious potential for another credit crunch. Early indicators of this have emerged, and demonstrate themselves in a renewed lengthening of WIP and debtors lock-up, confirming that we appear to have entered a cycle in which the rate at which cash circulates through the economy has slowed.
- a slowdown in the rate of transaction completion, with an increase in the number of transactions being aborted prior to completion.
- clients who are slower to pay as a result of their own credit or cashflow problems, or simply responding to their own cash-preservation strategies.
- patchiness in transactional activity and a serious inconsistency in the rate at which instructions that are being completed can be replaced.
- the threat of the economy moving into recession, which would be accompanied by a renewed decline in transactional activity with fewer billable hours available to be recorded and lesser amounts accumulating in WIP and available to be billed.
- despite the intentions of government and the banks to support the economy with favourable credit conditions, the potential for tighter credit conditions will prevent some borrowers gaining access to credit that is used to pay off their underlying debts.
- firms that are expanding domestically and abroad, either with new offices or the lateral hiring of partners and teams, need to absorb both the establishment costs associated with those moves and the costs of the teams acquired until the positive cashflow effect of the teams starts to emerge, probably after some six months.
- future restructuring, reorganisation and redundancy costs which will need to be absorbed by potentially declining.

### Tax reserves

Firms holding partners/members tax reserves:

<table>
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<th>Yes</th>
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Source: RBS Legal Sector Outlook Survey (September 2011)
cashflows originating from the core law-firm business, noting that in many cases these will not be planned or budgeted cash outgoings.

Firms have preserved cash by innovative financing of IT equipment, office moves and new office fit-outs, professional indemnity insurance premiums, redundancy programmes, tax obligations, and acquisitions of firms or lateral partner teams both domestically and abroad.

Unfortunately for almost all firms across the legal sector, the easy gains around cost control and cash preservation have been realised. The question constantly being asked now is how much further or deeper can a firm cut before it starts to damage the very infrastructure of the firm, and challenge some of its fundamental qualities, what it represents and how it services its clients? Of course the answer to this question is difficult, has many subjective elements and will vary across the market. While firms have generally done well in reducing discretionary expenditures and maintaining a heightened discipline around expense controls and management, it appears there are still some gains to be made, particularly through a more centralised and coordinated approach to procurement.

During the downturn, many firms responded to the slowdown in the cash-conversion cycle by establishing new committed credit lines, by extending the maturity profile of debt and by increasing the amount of debt available. This was done for various purposes including:

• general working capital, ie funding WIP and debtors

• funding restructuring costs and providing funding capacity in the event of a prolonged recession beyond budget estimates

• to create a committed capital standby line so as to provide certainty of liquidity to the firm in the event of a further material downturn in economic activity

We have seen firms’ appetite for credit facilities stabilise during the year and remain at relatively constant levels. The only exceptions to this have been event-driven requirements around new premises, large lateral team hires or expansion abroad. We expect this stability to continue during the year ahead, although note that there is a healthy appetite among some firms expanding with lateral hires, particularly abroad, to have above average standby credit facilities available to fund that expansion.

Some evidence for this is in the RBS Legal Sector Outlook Survey which indicates that over 18% of firms plan to increase credit lines, with the vast majority of firms leaving them largely unchanged. Interestingly, according to the results, utilisation of lines is broadly expected to follow the same distribution as that indicated above for new committed credit lines.

Cashflow management
Planned committed credit lines in the next 12 months:

- Maintain at broadly existing levels
- Increase
- Reduce

Source: RBS Legal Sector Outlook Survey (September 2011)

Finally, some firms are introducing greater flexibility into the partner distribution payment cycles. Whereas the vast majority have left the model unchanged, there has been some evidence of a lengthening in the partner distribution payment profile while a small minority of firms are accelerating partner distributions.

Partner profit
Distribution profile in the next 12 months:

- No change
- Lengthen retention time
- Payout faster

Source: RBS Legal Sector Outlook Survey (September 2011)
Firms in the legal sector have generally continued to build capital during the year. This has continued a trend that has been in evidence for some time, but which accelerated materially during 2008.

The commitment in support of this shows no signs of abating. During recent conversations we have had with law-firm leaders, the capital-management strategies and policies that support the continuing growth of capital were evident, supporting the continuation of the trend we have observed over recent years. This determination to build capital is further illustrated by RBS research regarding firms’ views on their capital position. As described in the chart below, this indicates that more than 25% of firms will build capital during the year.

Issues that have been, and continue to be, the major considerations in encouraging firms to grow their capital base include the following:

- Building a cushion to withstand future financial shocks resulting from more volatile economic conditions and the increasing risk of an economic downturn
- Presenting a stronger balance sheet to the market, recognising the heightened level of visibility of law-firm financial statements and the transparency of the financial position they present
- Providing leverage in merger discussions regarding the advantage delivered to the financially stronger merger candidate
- Attracting lateral hires by removing any concerns about the long-term financial stability of the firm
- Delivering a solid financial foundation for future investment in long-term infrastructure assets such as those associated with an office move
- Providing a financial platform for the expansion of the firm, both domestically and abroad, by financing the investment in the lateral hiring of partners and their teams, the build up of WIP and debtors and related office costs
- Maintenance of prudent levels of debt
- Management of financial leverage to ensure that financial risks are maintained within levels which do not compromise the financial standing of the firm and adversely impact the firm’s credit quality
- Reducing reliance on the bank debt market
- Developing an even greater sense of ownership by partners in their firms

Over recent years, we have seen equity held more tightly in law firms, and we expect this trend to continue. This is something of a necessary market adjustment following the accelerated growth of equity during the late 2000s prior to the downturn. Most firms have realigned the composition of their equity to account for the more challenging market conditions. However, the future growth of the equity partner population will continue to be restrained among those firms that show limited growth in profitability and stressed financial performance. Dilution in profit per equity partner has been evident in some firms but is surely not a long-term option. In those cases in which it has been evident but not destabilising to the firm’s market position, it has clearly resulted from some strategic decisions around the need for investment in the medium and long-term future of the firm. The challenge for management is to convince partners of the viability of the strategies being implemented, and to support the necessary investment required to deliver long-term returns.

An interesting development in the market among some firms is the call for capital to be contributed by non-equity partners. While this is not a market standard at this juncture, we expect that this will become a trend as the practice becomes more
accepted, and the favourable financial consequences for both firm and the participating fee earners become apparent. As this form of capital raising and investment in the firm becomes more commonplace, it will likely force other firms to respond with similar programmes as the resulting competitive pressures and tensions become more evident.

We anticipate the equity in law firms will increasingly be held longer than has historically been the case. This is despite some recovery in equity partner earnings. We expect that higher personal tax rates, less attractive pension arrangements combined with the collapse in asset values across important asset classes representing major retirement assets of equity partners approaching retirement, will encourage partners to prolong their careers in the profession. This will exacerbate the problem of managing aspiring entrants to the equity, while reinforcing the trend of equity being held ever more tightly by a smaller group of equity participants.

Many law firms have now recognised the attraction of building capital through profit retention. Those firms that have adopted this financial strategy have built a deeper capital base than many firms that have adopted a full profit distribution strategy. This profit retention strategy has benefited firms by providing an attractive financial cushion to support the firm through the slowdown, and this may yet be required again if the current difficult economic conditions deteriorate further, resulting in a double-dip recession. At the same time, it has given those firms, that responded to the market conditions by opportunistically capturing growth opportunities, the financial flexibility to respond to those opportunities as they arose, without damaging the financial stability of the firm.

We regard the need for law firms to build a strong and deep capital base that is not reliant on any underlying bank debt as highly important. The reasons for this include that it will:

- increase the amounts of funding available to the firm to provide for economic and business-cycle uncertainties
- lengthen and eliminate concentrations in the maturity profile of debt
- migrate uncommitted credit facilities to committed facilities so as to ensure availability of funding in the event of any credit market disruption

Many of these initiatives have been completed and firms are generally maintaining the relative contribution and role of bank debt in their capital structure at existing levels. Exceptions are specific financing needs around expansion associated with new premises, or growth in the firm through domestic and international expansion and lateral hiring of partners and teams.

We expect these drivers of bank debt management in law firms’ capital structure to continue to be a feature of their financial goals and for these objectives to continue into the year ahead.

We are aware of alternative sources of capital being available for law firms in private equity houses and public equity markets. Following our research, including discussions with private equity houses, we estimate that in excess of £1 billion is available to be invested in the legal sector. The challenge for private equity firms is identifying suitable investment opportunities. As the shape and structure of the legal sector begin to change, it is likely to create more opportunities for external capital from private equity firms to be deployed into the market, although not necessarily into conventional law firms as we understand them today. We expect that initially there will be some take-up, although this will be at the lower end of the market and more visible in redefining the shape of the market for delivery of retail legal services. With the benefit of some market experience, we expect momentum to build and we are aware of discussions taking place among some larger firms.

In addition to external capital as a driver of change in law firm capital structure, we expect alternative capital structures will emerge to assist in building greater transparency and flexibility into the balance-sheet structure and business model of law firms. The drivers for this will be law-firm ownership and control, staff hiring and talent retention, major infrastructure and capital investment, and consolidation within the sector.

The experience of the Australian law firm Slater & Gordon provides a useful example of how public equity markets might be accessed by law firms in the UK. We expect that at least one UK law firm will proceed to a public listing during 2012. While we believe that the role of public equity will be limited in the legal sector, we expect the appetite among investors for the asset class to be strong, and for early issues into the market to be well received.
Legal sector consolidation

While an acceleration in the rate of consolidation in the legal sector is likely in the international and domestic market, the strength, quality and reputation of smaller local and independent firms will enable them to continue to flourish.

With more than 10,500 law firms in existence in England and Wales (as registered with the Law Society of England and Wales), there is no doubt that the legal sector remains highly fragmented. It demonstrates many of the qualities of an industry that could deliver higher profitability to market participants and greater value to clients if the industry was rationalised via a process of consolidation.

We are strongly of the opinion that we will see an acceleration in the rate of consolidation in the legal sector. This follows many years during which it was often discussed by market participants and commentators as a logical and likely development in response to the fragmented structure of the sector. That consolidation did not occur was a surprise to many, although on reflection it seems logical considering the strong financial performance of the sector. The legal profession enjoyed a prolonged period of financial growth and success, delivering strong income returns and long-term financial rewards for law-firm partners. During this period, there was no compelling reason for most firms to consider changing their business model. In many cases, the financial results exceeded the expectations of the owners of the law firms and the financial returns they ever expected to derive as partners, members and owners of their legal businesses by a significant margin.

Through our dialogues with law-firm leaders, we expect drivers of consolidation will be:

- slow organic growth in domestic UK markets
- gaining access to larger and more complex instructions
- the continuing trend for globalisation
- the opportunity to capture economies of scale
- attracting higher quality, more complex and more valuable instructions through credibility, which size can deliver

Law firms will also want to remain competitive with peers who have built capabilities through scale including:

- wider geographic reach
- larger pool of resources and greater depth in particular practice areas
- higher quality teams and a commensurate reputation for superior work
- more specialised and relevant capabilities

The risks of a merger cannot be underestimated. The transactions have a multitude of challenges and complexities, relating to finance, reputation, morale, technology, integration and other qualitative risks. Nevertheless, we believe that the recent history of mergers, combined with the momentum for mergers that is currently evident in the market, will drive larger transactions and an increased volume of transactions than we have experienced in the previous 12 months.

We see three main areas of activity in the next phase of the consolidation cycle. The first of these will be in the international space. The critical and rather more problematic jurisdiction for UK firms to secure a presence is the United States. Several firms have already completed effective mergers giving them this critical US-UK cross-border capability. The importance of this competency cannot be underestimated, and a critical mass of fee earners in both jurisdictions is required to be credible as a global player. While several UK firms have established in the US, they have yet to build a profile to match their standing and reputation in the UK and other jurisdictions around the world. It would seem that, unlike other jurisdictions, the size and breadth of the US market does not lend itself to the creation of a market-leading business by building-out of a greenfield site through lateral hiring, and that mergers are the most successful...
growth strategy for successfully penetrating this market.

As the number of US-UK cross-border mergers increases, the interesting question to consider is when or whether this international legal market space will become overcrowded and saturated. The risk, which is likely to emerge as the market evolves over the long term, is that this space will become heavily populated by firms with similar legal and regional competencies. As a result, the internationalisation of firms within the legal profession will cease to be a point of differentiation, and because of the extensive availability of international coverage, clients will no longer identify this quality as being a reason to favour one firm over another.

We expect to see some merger activity in the domestic market. Through a merger, the opportunity exists for the creation of a dominant national firm and we expect this to result from the combination of one of the existing national firms with a combination of one other national firm or several local or regional firms from around the country. Given the legal market fragmentation, this has the potential to create a market leader in the UK. The scale of the firm would be of sufficient magnitude to easily leverage its substantial resources so as to extract the synergistic benefits of the merger, leverage existing systems, on-shoring, off-shoring and outsourcing arrangements and structural advantages so as to create the platform for dominance in the UK market. Such a position, and the advantages that result, might manifest itself in unique and proprietary pricing models combined with a cost of delivery that is superior to peer-group competitors.

Smaller local and independent firms may seem to have a rather difficult, unhappy and indeed limited future in the new world for the legal profession. Fortunately for those firms, because of their excellent reputation, quality and loyal client base, combined with the robust, dynamic and fiercely competitive legal market existing in the UK, we do not believe that this is the case. Indeed, recent information supplied by the Law Society of England and Wales shows them to be in agreement. A feature of the legal profession is that barriers to entry are relatively low. This certainly explains why the profession is highly fragmented with a large number of participants operating successfully. With top talent continuing to emerge from universities and enter the profession, this trend will surely continue. The emergence of small firms as new entrants, boutique firms and specialist firms around particular practice areas or serving particular market segments will be a feature of the market as it evolves. The opportunity for like-minded small and independent firms with similar ambitions to scale their businesses looks to be a logical outcome if the potential sacrifice of independence is more than compensated for by the benefits of scale. There are many areas of opportunity for this trend to grow, including professional indemnity, insurance, private client, litigation, sector focuses around new technologies and emerging industries such as renewable energy and telecommunications, and all their related requirements such as planning, property, asset financing, intellectual property and taxation.

We are of the view that the legal profession will ultimately consolidate further at the top end, to leave a handful of mega global firms. These firms will dominate global transactional activities, although smaller and niche firms will continue to succeed in their specific areas of expertise. Requirements for local bespoke legal advice will more logically and easily flow to smaller domestic firms which are more responsive, nimble and flexible in delivering the required service, while commoditised domestic services will flow to the smaller generalist and the emerging firms providing high volume commoditised legal services via low-cost delivery models.

“Through a merger, the opportunity exists for the creation of a dominant national firm”
Alternative business structures

The introduction of alternative business structures (ABS) will bring important benefits to consumers of legal services and will have far-reaching consequences for the legal profession and the way services are delivered.

Alternative business structures whereby non-lawyers can invest in law firms is finally with us. Many law firms and investors are well advanced in analysing the options and the business alternatives available, in order to appropriately structure their businesses and position themselves for the new environment. There is no doubt that the consumer of legal services will be better off for these changes, and we should see those benefits accrue to consumers in the form of:

- a greater choice of legal providers
- more innovation
- lower fees for clients
- new entrants to the legal market
- more capital invested in the profession

We can only wait to see the impact of the new ABS regime when it arises. However, sufficient firms have advised the market of their intentions on using the new rules that the impact will be much more than theoretical. Albeit initially most visible at the retail end of the market, the implications of the full impact are most likely to be far-reaching. It is inevitable that as the merits and benefits of different structures begin to emerge in a quantifiable and measurable way, these benefits will be captured by a larger group of firms outside the initial area of success. The changes are then most likely to be widespread and have a profound change on the legal profession and the way services are delivered to clients.

Implications of ABS might include the following:

- The adoption of more commercial norms in the management of the related businesses, for example, capital structure and profit retention
- The introduction of more external professional management with the new and fresh perspectives that this offers
- An improvement in governance and business transparency
- Establishment of broadly offered compensation models closely aligned with the firm’s objectives
- Building of scale with the efficiencies that might deliver across the businesses

- Deeper financial resources, providing capital for new investment, particularly in technology
- External and non-legal or professional owners
- Delivery of lower cost, broader and potentially higher-quality services to clients
- Increased competition between existing market participants and new entrants
- Conflicting objectives between owners and managers/practitioners
- Competing time horizons of interest between long and short-term objectives of management and owners
- Clashes and competition between cultures as organisations come together under ABS
- The threat of conflicts of interest between rights of clients and rights of non-lawyer participants and external owners in the ABS
- The ethical challenge of the lawyer who is a regulated person and the reconciliation of his obligations to court and client, above external owners

The emergence of ABS in 2012 will have transformational implications for the legal profession. We are aware of situations that will touch the top end of the market in short order, and have long-term consequences to the organisation and structure of the legal profession in the UK if they transpire as proposed. Ultimately, we expect ABS to be the medium through which both the government and the Legal Services Board’s vision for greater access to justice is realised.
The changing regulatory environment

The new outcomes-focused regulation (OFR) sets out appropriate service standards for clients. It presents new challenges for the profession, and is also likely to impose additional costs, but it will play an important part in the delivery of fair and transparent outcomes.

There is no doubt that changes in the business environment provide the legal profession with many challenges. Combined with this, however, and to add greater complexity to the challenges of law-firm management, on 6 October 2011, we saw the Solicitors Regulation Authority (SRA) introduce a new approach to regulation of the legal profession. The new outcomes-focused regulation (OFR) approach is in contrast to the previous rules-based approach, and is explained in detail in the new SRA handbook.

Outcomes-focused regulation concerns itself with the high-level principles and outcomes that should drive the legal practitioners in the methods by which they engage their clients. It replaces the former detailed and prescriptive rule book. The rule book approach is now replaced by a focused risk-based approach, the aim of which is to deliver appropriate service standards to clients. It delivers the profession considerably more independence, and also flexibility in how those firms interpret the guidance around how they achieve outcomes (appropriate standards of service) for clients.

Therein lies some challenges for the legal profession. The new approach to regulation is far less prescriptive than the former approach, requiring firms to exercise considerably more judgement and interpretation around the delivery of required outcomes than was previously necessary.

The OFR environment is founded on 10 guiding principles. These should be of no surprise to any practitioners:

1. Uphold the rule of law and the proper administration of justice
2. Act with integrity
3. Do not allow your independence to be compromised
4. Act in the best interests of each client
5. Provide a proper standard of service to your clients
6. Behave in a way that maintains the trust that the public places in you and in the provision of legal services
7. Comply with your legal and regulatory obligations and deal with your regulators and ombudsmen in an open, timely and cooperative manner
8. Run your business or carry out your role in the business effectively and in accordance with proper governance and sound financial and risk-management principles
9. Run your business or carry out your role in the business in a way that encourages equality of opportunity and respect for diversity
10. Protect client money and assets

The profession has now been delivered a new code of conduct. The new code looks very different from the 2007 code. Again, rather than containing prescriptive rules, supported by guidance, it comprises mandatory outcomes and non-mandatory indicative behaviours.

The SRA rules require that all authorised firms will need to appoint compliance officers for legal practice (COLP) and compliance officers for finance and administration (COFA). These new roles are central to the corporate governance and risk-management principles that are fundamental to the operation of the rules.

A firm that is a recognised body but not planning to convert to an ABS, will need to nominate a COLP and COFA for approval by 31 March 2012 and they will be authorised from 31 October 2012. Firms will need to proactively manage this process, and will also need to consider delegation of their responsibilities and obligations during those periods when they may not be personally on-hand or available to deal with the issues captured by those roles.

The new regulatory environment is likely to impose additional costs on law firms. Some of these costs will be direct financial burdens, while others will be linked to the management involved in ensuring that a firm meets its regulatory responsibilities. The extent of any additional costs to be absorbed by firms will vary. However, based on initial feedback from firms, we expect that additional resources and infrastructure will be required. The cost burden of this, combined with training requirements and reporting, accounting, compliance and auditing obligations, may create additional cost burdens on firms until the requirements are more firmly embedded in the operating protocols of a firm.

The delivery of fair and transparent outcomes is critical to the good reputation and long-term success of the legal profession. Professional conduct, based on the OFR principles, will ensure that the client’s and wider public’s interests are protected.
The future

What lies ahead for the legal profession in the domestic and global markets?

We believe that law firms will increasingly seek to follow their clients, whether domestically or abroad, and that this strategy has merit. Some firms will open new offices and even look to staff these offices with local talent. The economics of such a proposition need careful review and consideration. In addition, the absence of growth in domestic markets will encourage firms to look abroad for new sources of instructions, again, both domestically and abroad.

The growth economies of Brazil, Russia, India and China (BRIC) will continue to attract attention. However, we will see growth available from other foreign sources, which will be the source of new legal fees and the catalyst for further geographic expansion. This falls into two separate and distinct categories. The first is the economies that are expanding as a result of the activities in the BRIC countries. Two good examples of this are Australia and Canada, both of which are major suppliers of raw materials to China. Their resource sectors, combined with all the industries on which that sector has a dependency, have been growing rapidly as a result. It is notable that both Australia and Canada have seen UK firms recently establish a presence in these markets, both directly and via mergers with local law firms. The second area of geographic expansion will be those countries that are identified as emerging economies in the next generation – countries in which firms will establish and invest today in anticipation of significant economic growth in the future. Some good and recent examples of this are North Africa, where we have seen a number of firms establish a presence in Morocco in recent months, and Turkey.

We therefore expect to see more firms expanding abroad and more mergers among international firms, particularly those in the UK and the US.

Industries delivering growth and above average profitability will also provide law firms with significant opportunities in the next phase of their development. These may include renewable energy, biotechnology, information technology, alternative fuels, energy-saving and environmental protection, to suggest just a few.

Sluggish growth in the UK economy will drive more domestic consolidation as firms seek scale and the benefits described. There are material benefits that can accrue to firms that harness the value from synergies across a larger operating platform and the power of a more deeply and richly resourced firm.
“We expect to see more firms expanding abroad and more mergers among international firms, particularly those in the UK and the US”

More boutiques and niche firms will emerge. A number of factors may drive this, including larger firms restructuring and departing partners establishing their own firms, a negative reaction to large firm mergers and a rejection of the implications, certain practice areas becoming non-core as firms change strategy around client selection, practice area focus, preferred size and type of instructions, and the profitability dynamics of the firm.

And what about national firms? Some consolidation in this segment of the market is less likely, although it has the potential to deliver the resulting firm great advantages, including dominance and control of a significant segment of the market. These firms, however, look to be more focused on seeking their future success abroad than through building even greater scale nationally in the UK.

Many successful regional firms with dominance in their local markets look intent on expanding nationally, albeit on a modest scale and more in the nature of a niche strategy driven by a practice area focus consistent with other competencies of the firm.

ABS will become a common feature of the market and the capital provided by external investors will drive further changes, including consolidation in the legal sector. I would expect a law firm to be listed on public equity markets in the future, with the first AIM listing likely within 18 months. Private equity will drive consolidation and new delivery models in the retail end of the market and developments in this segment are already visible. These trends will migrate to the commercial and corporate segments of the legal market as the same principles are re-engineered to deliver value in those markets.

As firms better understand the profitability dynamics of their businesses, they should become more selective about the clients with whom they work and the types of instructions they accept. This may require some difficult decisions and discussions among partners and with the clients involved. However, it should create longer-term value for the firm, resulting in a somewhat smaller but rather more profitable business. At the same time, it will create profitable opportunities for firms that are organised to provide legal services to those affected clients via a different and lower cost delivery model.
The challenges currently facing law firms are immense, and greater than any the profession has endured in its long history. At the same time, the legal profession is being offered opportunities to conduct the business of law in a wide variety of ways that give firms massive flexibility and many options. It is remarkable that such a transformation has been possible in such a brief period of time, and law-firm leaders of the recent past will surely look with envy at the possibilities now available.

In that context, I am confident that the law-firm leaders of today will respect the challenges and difficulties presented by the markets and business environment now confronting us. At the same time, I am convinced that they will appreciate and embrace the opportunities that the evolving marketplace has the potential to offer them.

I see evidence of firms adopting new visions of their future, goals that respond to the changing environment and initiatives that are crafted to deliver immediate tactical success. Those firms are resolute and clearly articulate, pursue and execute their plans and differentiate themselves against other market participants. There is no doubt an early mover advantage in positioning the firm for success. Those firms that challenge convention and think creatively about their business model, are nimble and agile in the execution of their plans, and who quickly organise themselves to deliver superior service, value and results to their clients will enjoy success.

I am immensely optimistic about the future of the legal profession in the UK. Market participants are clearly demonstrating a willingness to respond to the challenges currently presented, and also embrace the new and exciting opportunities now available for practising law. The market leading reputation that the profession enjoys provides a solid foundation for the future and the enthusiasm, energy and determination to build upon this will ensure the legal profession continues to thrive and succeed.

Conclusion

James Tsolakis offers his thoughts on the challenges and opportunities facing the legal profession in the months ahead

Research and methodology

We have followed the same methodology as last year to ensure we are fairly representing the UK corporate legal market. We have surveyed 60 Senior Executives across 40 UK law firms between 1 January 2011 and 30 October 2011. Further details are available on request.
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The author, James Tsolakis, is Head of the Legal Services team within the UK Corporate and Institutional Banking Division, focusing broadly on the top 100 market. James has been a banker to the legal sector for over 10 years, working in the UK, Europe and the United States.

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