Legal Tech Analysis

INVESTMENT AND GROWTH STRATEGIES IN LAW FIRMS
Introduction

Welcome to HSBC’s report on law firms’ investment strategies into legal technology, produced in collaboration with The Lawyer. The report builds upon a survey of leading UK headquartered law firms, with responses coming from partners and other senior business leaders including CIOs, CTOs and CFOs to build a picture of the current and expected future direction of investments in the UK legal sector.

For the first time, our survey sought to understand the growth strategies of firms by looking at their plans for geographical expansion, approach to outsourcing business services and their appetite for mergers and acquisitions. The findings indicate that investment in the UK was the priority for 68% of firms surveyed.

Continuing the trend over the last two years our report also sought to understand the investment trends in technology and to track the shifting emphasis between investments in innovative technologies, such as machine learning and artificial intelligence, against the business as usual (BAU) activities such as cyber security.

One notable outcome, and an advantage of running this survey across multiple years, is the identification of cycles of investments. In 2017 firms were increasing their levels of technology investment to ensure they were not left behind in the race to deploy new legal technology. In 2018 and 2019 the same firms have pulled back their investments on these systems to focus on business as usual activities with a 70:30 split between BAU:New technology being reported this year. According to the survey results, this 70:30 emphasis on BAU activities is expected to continue for the next three years.

Furthermore, in percentage terms at least, the results indicate that investments in technology are on the decline showing a marked reversal from 2017 where 75% of respondents had investment levels of 5% of revenue or more compared to just 25% of firms committing to this level of investment in 2019. However, with top 20 law firms returning another year of revenue growth in excess of 9%, investment has grown in real terms.

Additionally, 33% of firms reported they had already outsourced some of their business services functions to a third party. However, when comparing the top 50 against other law firms the survey highlighted a significant difference with 32% of the top 50 having already outsourced business services compared to just 14% of firms outside the top 50.

These figures are perhaps not surprising as the larger firms will have made more significant investments in business services over the years with larger teams taking up valuable, and expensive, real estate space. As a result, these firms will reap larger rewards from outsourcing services to third parties.

Having said that, with the current economic and political uncertainties, the need for efficiency gains would appear to be more important than ever, suggesting more firms need to be looking at how they can restructure at a lower cost whilst delivering the same high levels of client service.

We hope you enjoy reading this report, and if you have any questions please do not hesitate to contact me.
As in previous years, the survey sought to understand the strategic areas of focus for law firms. One factor that stood out early on was the 81% of respondents who considered technology to be the most important area of strategic development activity for their firm. On the other hand, firms had a more varied opinion on their second choice of strategically important activities with 41% selecting expansion abroad and 28% suggesting that a merger or acquisition was strategically important to them.

Other second choice priorities, listed by 31% of respondents included amongst others, a focus on future talent acquisition, improved productivity, client focus and organic growth through lateral hires. This broad spread of strategic imperatives highlight that, apart from an almost unanimous view on the importance of technology, the strategic route to success for each firm varies considerably.

Eric Belli-Bivar
Partner, DLA Piper

The rate of technical spend is continuing to accelerate as the legal industry becomes increasingly digital."
Law firms have been through a very bullish period over the last couple of years with good revenue growth, so whilst in percentage terms it might not seem like an increase, in real terms it has certainly increased.”

Nathan Hayes
IT Director, Osborne Clarke

These results suggest that law firms are feeling the pressure to meet changing client expectations in an increasingly competitive market. A market that continues to see growing levels of competition from the Big 4 and new legal companies which have often come to the market with a technology focus as their core proposition.

In an interview with the Lawyer, the head of Deloitte Legal noted that Deloitte can provide clients a different kind of experience from that provided by traditional legal practices. This encompasses meeting general counsels’ demand for a seamless global service enabled by technology – which means client-facing technology.

This view was further substantiated this time last year by the news that Axiom, who were one of the first alternative legal service providers, had grown revenues close to £50m with a significant chunk of this revenue coming from their technology driven contracts intelligence business.

If technology is deemed to be the top strategic imperative then it would appear logical that investment in technology would follow and that, for the legal sector, where investment has been relatively low (as a percentage of revenue) firms would indicate a willingness to significantly increase investment in this area.

As the table below shows, the levels of investment in technology between 2017 and 2019 have reversed. In 2017, at the beginning of the legal technology investment boom, 75% of firms reported that they were investing 5% or more of revenue. These investment figures began to decline in 2018 and have now reached their lowest point in 2019 with only 27% of firms indicating that they would invest 5% or more of revenue in their technology projects.

<table>
<thead>
<tr>
<th>% revenue on tech</th>
<th>2019</th>
<th>2018</th>
<th>2017</th>
</tr>
</thead>
<tbody>
<tr>
<td>5% or above</td>
<td>27%</td>
<td>44%</td>
<td>75%</td>
</tr>
<tr>
<td>5% or below</td>
<td>73%</td>
<td>56%</td>
<td>25%</td>
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</table>
There are two possibilities to consider for this apparent decline in investment. Firstly, some firms invested heavily in 2017 as part of a drive to embrace the new legal technology that was beginning to emerge. This was then followed by a slight decline in 2018 which was presumed to be driven by firms concentrating on implementing these new technologies and maximising their benefit to the organisation.

Secondly, financial results over the last two years show a marked increase in revenue and profitability, suggesting that in real terms, investment in technology is increasing even if, as a percentage, the level remains static.

The trend of a reduced percentage of revenue being invested in technology appears to be mirrored by the expected split of investment between business as usual and innovative technologies – projects that are anticipated to deliver a unique method of solving a business problem.

Last year, firms indicated a 60:40 (BAU: Innovative technologies) split in their technology investment but this year the dial has shifted to 70:30 with this ratio being predicted by survey respondents to continue for the next three years.

Again, there are several possible scenarios here. Firms could be continuing to leverage the investments made over the last two years, realising that the software they have invested in has many applications beyond the original scope. If this is the case, then they may see no need to make heavy investments in new software solutions.

Alternatively, what was considered as a new, innovative investment a couple of years ago is now considered to be an integral part of their legal operations and therefore, a business as usual item of expenditure. If the latter is the case, this would suggest that for some firms the recent days of heavy investment in new technologies are over, the job has been done, and it is back to normal with a sustained, but smaller level of technological investment. However, this assumption does not tally with the initial assertion that technology is the most important strategic tool for maintaining a competitive edge. Irrespective of these concerns, just over 70% of respondents believe they continue to make the right level of investment in technology to remain competitive.

The shift in focus to BAU investments may also stem from a continued need among firms to upgrade their core systems with many firms indicating they need to upgrade their client relationship management, practice management and document management solutions in the next two years.

Upgrades to any of these core systems will be considered as BAU projects requiring significant investment and, if budgets remain static or decline, then they will take resources away from the more innovative technology developments which were the focus over the last two years.

**Which of the following core systems is the firm looking to replace in the next two years?**

<table>
<thead>
<tr>
<th>Core System</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Client Relationship Management (CRM) system</td>
<td>46%</td>
</tr>
<tr>
<td>HR System</td>
<td>43%</td>
</tr>
<tr>
<td>Practice Management System</td>
<td>39%</td>
</tr>
<tr>
<td>Document Management System</td>
<td>39%</td>
</tr>
<tr>
<td>Central knowledge repository</td>
<td>36%</td>
</tr>
<tr>
<td>Time recording system</td>
<td>36%</td>
</tr>
<tr>
<td>Conflicts management system</td>
<td>25%</td>
</tr>
</tbody>
</table>
Priorities for technology investment

Two years ago, 65% of firms indicated that AI would be their focus of technology investment whereas last year 84% of the top 50 firms were focussed on cyber security.

Twelve months on and the investment priorities of the firms surveyed show a similar pattern to those of 2018. Client collaboration stands out at the top of the list with 44% of respondents selecting this as their first choice.

These tools are crucial to firms wanting to develop closer long-term client relationships by providing greater transparency of the work they are doing which is, in turn, a reaction to the reduction of the number of firms being appointed to client panels.

AI is helping with better process management. By analysing data in our practice management system, we can identify legal issues that might arise and be proactive in dealing with them. It allows us to deal with legal developments and events pre-emptively which our clients rate very highly.”

Eric Belli-Bivar
Partner, DLA Piper
Further research carried out by The Lawyer has shown there is no standard approach to budgeting for technological investments. Whilst around 50% of firms see their innovation budget as an extension of IT expenses, 43% have created an annual budget solely for R&D projects. Firms in the £1bn-plus and £501m-£1bn revenue range were split down the middle: Clifford Chance, Dentons, DLA Piper, Linklaters and White & Case all had ring fenced R&D budgets whilst Baker McKenzie, Hogan Lovells and Mayer Brown said these investments were part of their overall IT budget.

If firms are serious about delivering against a technology driven strategy, compartmentalising spend between business as usual and innovative technologies appears to be a vital step to take. If one does not put parameters in place to focus on different areas of strategy then maintaining the basic tools of business such as networks, email and document storage will always win, leaving no room for the innovative development which is required to maintain a competitive edge.

Priorities for technology investment

The emphasis on client collaboration tools indicates a shift in priorities away from strengthening their security to focusing on client interaction. However, cyber security continues to demand a considerable level of attention with respondents indicating that it remains a key area of investment. Although only 15% of firms selected this as their top priority, 48% selected it as their second or third priority.

Reading between the lines, these results indicate that cyber security has shifted from being the top investment as firms played catch-up with the threats to their systems, to an important and sustained level of BAU investment deemed necessary to ensure that they stay on top of developments in this area.

As a strategic investment however, it is vital for firms to show their clients they take cyber security seriously and that they can demonstrate the robustness of their systems and protection of client confidential information.

The significant investment in cyber security we’ve seen in recent years has started to tail off now that law firms are more up to speed with best practice.”

Nathan Hayes
IT Director, Osborne Clarke

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In which of the following areas is your firm prioritising its investment in technology?

<table>
<thead>
<tr>
<th>Area</th>
<th>1st choice</th>
<th>2nd choice</th>
<th>3rd choice</th>
</tr>
</thead>
<tbody>
<tr>
<td>Client collaboration tools</td>
<td>44%</td>
<td>13%</td>
<td>13%</td>
</tr>
<tr>
<td>Cyber security</td>
<td>15%</td>
<td>16%</td>
<td>33%</td>
</tr>
<tr>
<td>Automated document production</td>
<td>13%</td>
<td>13%</td>
<td>3%</td>
</tr>
<tr>
<td>Data visualisation</td>
<td>13%</td>
<td>4%</td>
<td>3%</td>
</tr>
<tr>
<td>Smart contracts</td>
<td>6%</td>
<td>16%</td>
<td>13%</td>
</tr>
<tr>
<td>Mobile apps</td>
<td>6%</td>
<td>9%</td>
<td>8%</td>
</tr>
<tr>
<td>Big data and predictive analytics</td>
<td>2%</td>
<td>16%</td>
<td>10%</td>
</tr>
<tr>
<td>Blockchain</td>
<td>2%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>AI</td>
<td>11%</td>
<td>8%</td>
<td></td>
</tr>
<tr>
<td>Robotic process automation</td>
<td>2%</td>
<td>10%</td>
<td></td>
</tr>
</tbody>
</table>

Conversely, AI has fallen down the list of priorities with only 19% of respondents selecting this as their second or third priority, strengthening the impression that either investments in this area are now on the business as usual side of IT investments or no new systems are required to meet the needs of the business.

Do you have a separate, ring-fenced annual R&D budget for investing in legal tech innovation projects? (segmented by firm revenue)

![Bar chart showing the percentage of firms with separate R&D budgets by firm revenue]

1-50 (£m) | 30% No | 10% No, it’s part of our IT budget | 5% Yes
51-250 (£m) | 30% No | 10% No, it’s part of our IT budget | 5% Yes
251-500 (£m) | 30% No | 10% No, it’s part of our IT budget | 5% Yes
501-1,000 (£m) | 30% No | 10% No, it’s part of our IT budget | 5% Yes
1,000+ (£m) | 30% No | 10% No, it’s part of our IT budget | 5% Yes
Technology as a business enabler

Although overall levels of investment might be faltering, the expectation placed on technology to help change and drive the business forward remains as high as ever.

Law firms are looking to technology to change one of the most complicated aspects of their business, namely pricing, with 62% of respondents expecting technology to help them shift away from the billable hour and 86% of respondents then anticipating technology will deliver or at least facilitate alternative pricing arrangements.

With technological solutions beginning to streamline pricing, whilst at the same time providing a greater level of transparency to the client on the progress of matters, it is then expected that firms will see a marked improvement in their recovery rates and lock-up.

These two factors are of vital importance in the fight to remain competitive. The firm that can firstly improve the percentage of revenue coming in from every matter (recovery) and secondly reduce the time it takes to have these fees paid (lock-up) will have increased levels of cash throughout the year and therefore a greater flexibility in their operations.

We focus on transparency and immediacy so the accounts should never come as a surprise to the client... the feedback loop we have on our completely transparent billing system is so tight that we can make adjustments almost on an intra-day basis.”

Eric Belli-Bivar
Partner, DLA Piper

Lock-up has been a perennial problem for law firms with PwC reporting last year that average lock-up was running at 123 days for the top 10 UK firms.

To put this into context, a reduction of just 15 days could generate £163m of cash that could be used for additional investments in technology projects or other strategic initiatives. Firms that solve this problem may gain significant competitive advantage.

To what extent do you agree with the following statements regarding investments in technology that improve efficiency and billable hours?

<table>
<thead>
<tr>
<th>Statement</th>
<th>Strongly agree</th>
<th>Slightly agree</th>
<th>Neither agree nor disagree</th>
<th>Slightly disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shift the proportion of matters away from the billable hour towards flexible pricing arrangements</td>
<td>21%</td>
<td>41%</td>
<td>24%</td>
<td>14%</td>
</tr>
<tr>
<td>Help facilitate the creation of more innovative pricing structures</td>
<td>41%</td>
<td>45%</td>
<td>3%</td>
<td>10%</td>
</tr>
<tr>
<td>Improve recovery (percentage of bill recovered)</td>
<td>40%</td>
<td>48%</td>
<td>20%</td>
<td>4%</td>
</tr>
<tr>
<td>Reduce lock-up</td>
<td>35%</td>
<td>31%</td>
<td>38%</td>
<td>8%</td>
</tr>
</tbody>
</table>

Strongly agree
Slightly agree
Neither agree nor disagree
Slightly disagree
It is critical that any investment decision is assessed in terms of understanding the quick wins versus longer term return on investment, both in time and monetary terms.”

Laura Bygrave
Innovation Lead, Deloitte Legal
Digging a little deeper, the results showed that the top 50 UK law firms had been more aggressive in this area with 32% compared to just 14% of other firms (those outside the top 50) having already outsourced business services activities to a 3rd party.

From a business strategy perspective, seeking out avenues for cost reduction and improved efficiency are crucial to running a modern law firm. Clients are consistently squeezing legal fees whilst increasingly looking to the alternative legal services firms for more efficient ways of delivering the legal services to meet their requirements.

The traditional law firm model designed around bringing all non-legal services in-house is no longer viable from a cost or competition perspective. Many of the alternative legal services firms created over the last few years are lean businesses, focusing on the delivery of core legal services without any of the ancillary provisions that a traditional law firm brings. As a result, they have the potential to be more agile and flexible in the services they deliver whilst at the same time carrying a lower cost base and, therefore, more competitive pricing.

Due to their size and geographic reach, the top 30 UK law firms can achieve larger gains from outsourcing business service functions. However, increased competition from alternate legal services should compel the mid-tier to review any efficiencies they can achieve, not least from outsourcing.

Are you considering, or do you already operate an outsourced model for any parts of your business services?

When I’ve looked at this, in the past, the case often hasn’t made economic sense. But this needs to be looked at in 3 ways. Cost advantage - in which outsourcing rarely delivers unless you have real scale. Service advantage - which can be an advantage with the right provider, Finally, people advantage - where this can provide real career opportunities and benefits.”

Sarah Walker-Smith
Chief Executive, Shakespeare Martineau

The survey also sought to understand attitudes towards outsourcing business services functions. Whilst 33% of respondents reported that they had outsourced some of their business services activities to a 3rd party, 26% had no plans to do so and a further 26% were considering some form of outsourcing under the firm’s ownership.
Conclusion

The 2019 survey has highlighted a shift in the technology investment strategies of many firms with a reduction in percentage terms of the level of investment compared to the last two years. Over this three-year period, which coincides with the emergence of new legal technologies primarily driven by advances in machine learning and artificial intelligence, firms have reduced their investment in tools that leverage these technologies.

Continuing the trend identified last year, law firms are pulling back from new and innovative technologies to focus on their business as usual systems that lie at the heart of operating an efficient modern law firm. It seems that what was considered a short-term dip in these investments, whilst firms implemented their innovative technology solutions, has evolved into a longer-term investment strategy.

The focus on cyber security that dominated technology investments over the last couple of years has now been reduced to a 'maintenance level' aimed at ensuring a continued level of cover that will satisfy both client and partner concerns. Last year we suggested that cyber security would continue to remain the first investment concern over the next three years however, whilst important, priorities have shifted to other areas.

Client collaboration tools continue to rank highly, possibly as an antidote to the reduction in the number of law firms on corporate legal panels, the demand for increased efficiencies and greater value from the work that law firms deliver. These tools can play an important part in building a strong and ongoing dialogue with clients through, for example, the use of transparency around pricing and billing which in the long run are designed to build client loyalty amid an increasingly competitive landscape.

Although levels of investment may appear to be declining, the survey highlights the continued strategic importance of technology to modern law firms. The results indicate that the next focus for innovative technologies may well be targeted at tackling the perennial issue of lock-up, with firms indicating that pricing tools could lead to innovative pricing structures, which in turn could result in shorter recovery periods.

Looking at other aspects of business strategy, our survey respondents suggested their focus would remain in the UK with only a small number of respondents looking to prioritise other regions in the next three to five years. There are several factors that can impact these longer-term strategies with the US – China trade wars, a weak pound focussing investment inside the UK and tougher competition for UK firms looking to expand into the US all being good reasons to pause for thought.

Of course for most UK firms, the continued uncertainty around the UK’s future relationship with Europe will also weigh heavily on their strategic decision making. The results in this survey suggest that law firms are holding tight on both significant levels of investment in technologies and on their growth plans outside of the UK until we finally learn what the Brexit outcome will be and what it will mean for longer term business strategies.

Chloe Clift
Head of Professional Services
Commercial Banking
HSBC UK Bank PLC