27 October 2022

Sector: Support Services

A requiem for the Magic Circle?

Thought Leadership Series

- **Arden Research demonstrates that US firms not Magic Circle firms now dominate advice to the global elite corporates in London.**
- **Key US firms' annual UK revenue growth was three times that of UK firms in 2021, and this is not a one-off. From this base, US firms are likely to overtake UK firms in the next year.**
- **US firms' unparalleled position in the dominant US home market gives them the balance sheet strength to consolidate their position further in a forthcoming recession coinciding with inflation.**
- **UK firms will struggle to sustain their competitive advantage over the global elite if they continue to be priced out of the market for top junior talent.**
- **Magic Circle firms may need to re-invent themselves and reposition towards a mid-market position, which is all the more important given the increased success of the silver circle firms in their target markets.**

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For the first time ever, a US firm sits at the top of The Lawyer's UK Corporate 50 rankings, with Latham & Watkins dislodging Linklaters this year, following a +168% increase in corporate revenues since 2020. The growth of US firms has been the dominant trait of the London legal market for the last five years. The extent to which the market has shifted is evident not only by the rise of the likes of Latham and Kirkland & Ellis (which also more than doubled corporate revenues, pushing Linklaters to third place in the rankings), but by the fact that US firms now outnumber their UK counterparts in the Corporate 50. There has been a root and branch re-ordering of London's corporate landscape and the American threat to the historic dominance of domestic City players – the Magic Circle – is very real.

American power

There are parallels here with how the City changed following financial deregulation in the 1980s. Big Bang not only changed the organisation of business in the City, it also transformed the nature of City institutions. Within a few years, virtually all the exchange's jobbing and broking firms, together with most of London's UK merchant banks, had been acquired, by predominately US banks. Established names disappeared for ever, and it transformed the way in which business was conducted – liquid lunches disappeared, and we all had to work harder.

In the mid-1980's the UK investment banks still dominated the UK FTSE corporate finance market. By the end of the 1990's, however, few of these banks still held significant positions in that market.

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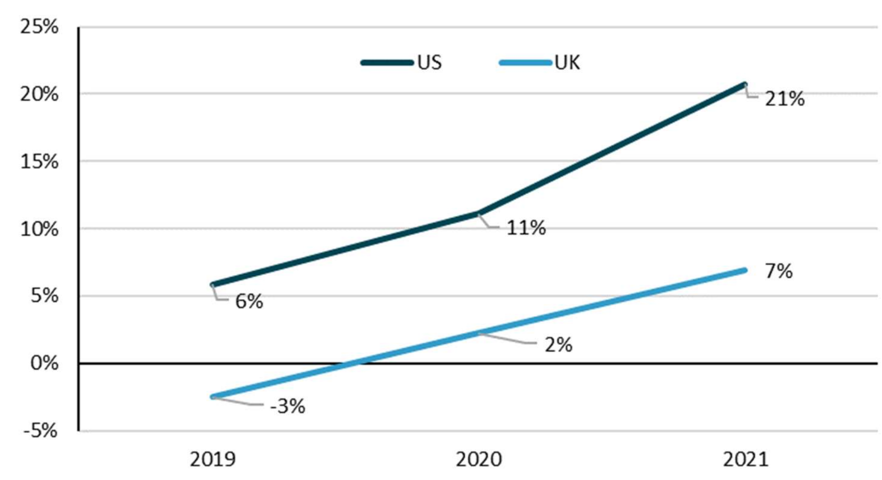
Since the '80s, European banks have in turn tried to penetrate the American market. However, not only have they failed (and sometimes catastrophically), but it has also been a tale of relative decline. Indeed, European banks' last stronghold fell to the Americans during Covid, with their share of investment banking fees on their home patch falling below 50% for the first time. There are a few reasons for European banks' failure to compete. The macroeconomic backdrop has not helped, with a more tepid recovery in Europe post the global financial crisis (GFC), combined with negative interest rates weighing on profitability. However, fundamentally, the US banks' commanding position in their home market – the biggest and most profitable in the world – has given them the financial firepower to hire the best dealmakers and the resources to invest in Europe. As European corporates became more global, they increasingly came to rely on US investment banks to support them globally.

Does a similar fate now await the Magic Circle? London has been at the forefront of the global expansion strategies of US law firms since 2000, despite the increasing attractiveness of other global markets across Asia and Continental Europe. London remains one of the most important financial markets in the world, and the strategy for US firms, particularly those with financials dominated client bases, has been to have pre-eminent offices in both New York and London, as clients have become bigger and more international, demanding ever-more complex advice. However, it has taken time for the US outfits to become a real threat to the likes of Linklaters and Clifford Chance. Whereas the venerable City banking institutions got swallowed up overnight, it has taken US law firms the better part of two decades to reach critical mass. From here, the competitive challenge is likely to snowball.

The rise of US law firms in London

Before the financial crisis, the biggest obstacle to building a practice in London was the lack of mobility – it was hard to make lateral hires and it was also hard for US firms looking to grow if they had no profile in the UK. However, that changed after the GFC, a combination of the weakening of the traditional lockstep partnership combined with ranks of deep-pocketed US law firms on a hiring spree. The market became much more open and far less characterised by the preconceptions and hierarchy that had persisted for decades. The last decade has seen a consequent boom in legal recruitment.

Figure 1: 3-yr UK revenue growth at UK and US firms



Source: The Lawyer; Total UK revenue, annual growth.

Expansion was client-led and has been particularly driven by private equity (PE). Post GFC, PE houses sought opportunities in Europe with the intention of using London as a launch pad for that capital. More US law firms entered the London market, and by 2016, the 50 largest US firm's London offices were generating $4.6bn[1] between them, with the City offices of Kirkland and Latham posting $534mn and $520mn, respectively. The flow of US PE money into London ramped up further in the second half of the decade and continued to flow despite Brexit. Relentless deal activity followed.

The total UK revenue amassed by the 50 largest US firms grew to $6.1bn in 2019 and then jumped to $7.9bn in 2021[2], driven by their corporate businesses which almost doubled their revenues during the period.

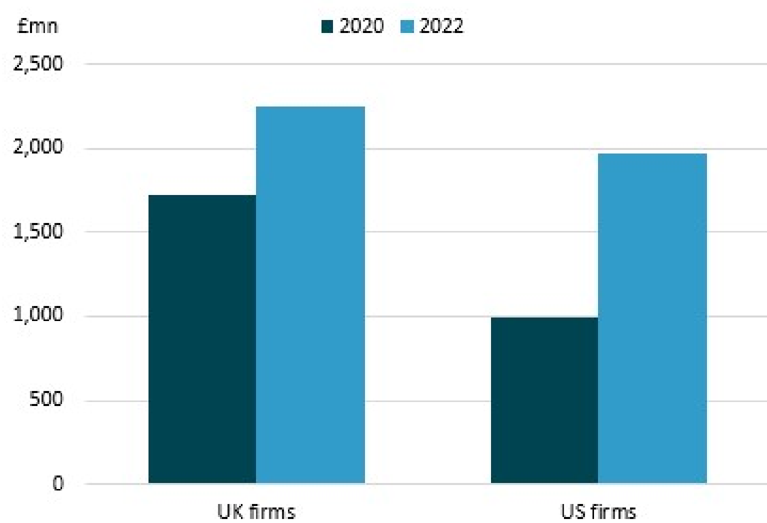
Brexit hasn't weighed, as London has remained a significant business and financial centre and English law still dominates in a wide range of financial and corporate transactions, while English courts and dispute resolution is still attractive to international clients. Expansion in London has enabled US firms to seamlessly advise clients across matters globally, whether the governing law is English or US, giving them a competitive advantage when dealing with global clients.

Size matters – the Magic Circle besieged

US firms' corporate ambitions in the City have tended to fall into three camps – those, like Kirkland and Simpson Thatcher, which have successfully targeted the financials sponsor market, those like Sullivan & Cromwell, Cleary Gottlieb and Davis Polk, that have built high quality practices advising mainly US corporates/financial adviser clients, and finally, those like Latham & Watkins that have been trying to build something closer in form to a UK firm.

However, the common thread is that new entrants to the London market have all pursued growth aggressively in the past decade, with the 10 fastest-growing firms over that period all being US headquartered. That growth accelerated in the last couple of years, with US firms in The Lawyer's UK Corporate 50 almost doubling revenue since 2020 (and accounting for two-thirds of the market growth), against a +30% increase for UK law firms. From this base, US firms are likely to overtake UK firms next year.

Figure 2: UK Corporate Revenue (Top 50)



Source: The Lawyer; 2022 UK Corporate 50 is based on published financial results for the most recent full financial year.

Latham & Watkin's rise to the top of the UK Corporate 50 rankings is the clearest indication of the extent to which US firms have successfully challenged the Magic Circle in their own backyard. Latham has been so successful because the firm's largest clients are increasingly engaged across the firm's global network of offices. The result is that they are coming with larger commitments on a more regular basis, with Latham growing

[1] Estimates by The Lawyer.

[2] Source: US 50 2022, The Lawyer.

its global revenue by c. +40% in the last two years – becoming the first law firm to break the $5bn revenue threshold.

"It's hard to convince a room full of millionaires that they've got their business model wrong"[3]

But given Clifford Chance's average profit per equity partner (PEP) broke through the £2mn barrier for the first time this year[4], rising by +10%, as did Freshfields, increasing by +8%, aren't the Magic Circle in rude health? The strength of the market *has* lifted profits across the board. However, these PEP figures are actually a little underwhelming when compared with the top two layers of US firms. Latham's PEP, for example, increased by +26% to $5.7mn last year, which was on the back of a +20% increase in the prior year. We don't know what their City partners were paid but given the London work is all high end (read high margin), it is very likely higher than the firmwide average.

The fundamental issue for the Magic Circle is that there is only a limited number of firms that can reliably colonise a space in advisory work for transatlantic mega-corporations. Up until a couple of years ago, the leading five UK firms held their positions relatively well in the global top 20 M&A deals by value, the same number as a decade earlier. However, that fell to three in 2021 and just two in 1H22. Since the financial crisis it's been increasingly difficult to sustain a top-tier practice in London without having a credible US presence. However, while US firms have been achieving significant gains in the UK, the reverse simply isn't true to any extent in the US. The trans-Atlantic importance of M&A – being able to compellingly deal with both sides of the Atlantic – is increasingly the gating item.

It is hard to overstate the advantage that the US economy and client base gives US firms. Like banking, the US legal market is simply by far the largest, accounting for around half the world's total (versus 7% for the UK). Like Wall Street's bulge bracket, this has given US law firms the wallet to pay up for talent, which they have done, with for example, around two-thirds of lateral hires made in Kirkland's City office since 2015 poached from the Magic Circle. The issue here is that momentum begets momentum, with higher revenue growth by US law firms in turn driving higher profitability, making it harder and harder for the Magic Circle to compete. Latham & Watkins' +40% increase in global revenues in the last two years (which in turn drove the commensurate rise in profit per equity partner), was against the c. +10% increases at the likes of Clifford Chance and Linklaters.

Paying up for junior talent

Booming revenues has driven booming hiring, and booming pay, with the most significant disrupting factor of the last couple years being the astonishing increase in associate salaries. The Magic Circle has tried to compete but are being increasingly priced out of the market, with associate rates now exceeding $200k for a first-year lawyer and approaching $500k (and this, pre-bonus) for a senior associate. A gap is now opening up both between the highest payers (the US law firms) and the Magic Circle, as well as within the Magic Circle itself. Freshfields increased its basic pay for newly qualified lawyers to £125k in April, with Clifford Chance following in May. However, neither Linklaters nor Allen & Overy followed, with the rate for NQs standing at £107,500. This is now leading to difficulty in attracting and retaining the best young talent, in our view.

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[3] Richard Susskind, author and independent adviser to international professional firms.
[4] For the financial year 21/22.

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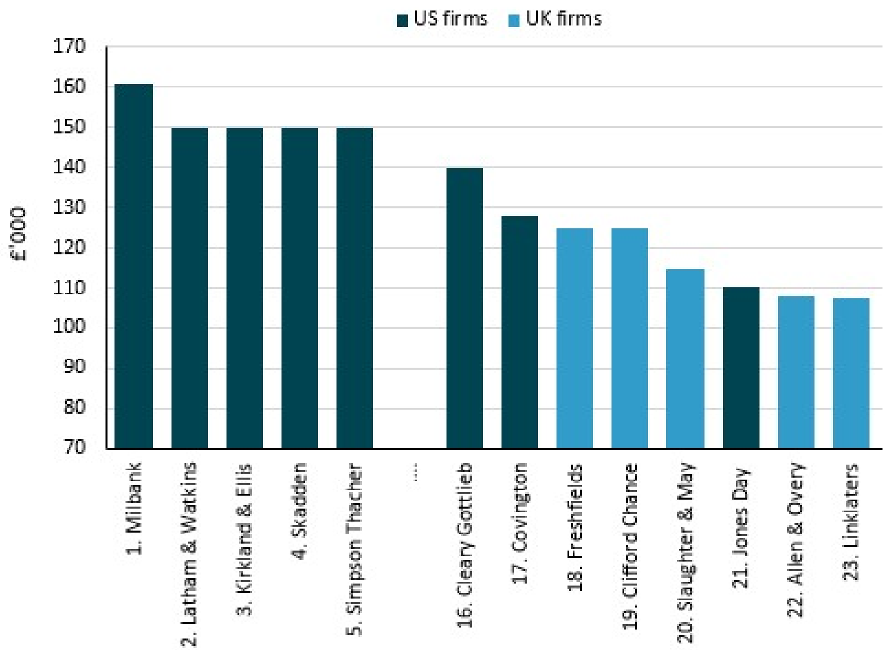
Figure 3: NQ Salary (UK)



Source: The Lawyer.

The Magic Circle can't compete as wage inflation would go through the whole firm. The reality is that they have only maintained their high margins by cutting product areas and cutting some of their senior partners (which has in turn weighed on revenue growth), but once you have done that trick once, you can't repeat it. The Magic Circle are facing relentless wage inflation and they simply can't compete. That's not sustainable, since if you can't get elite people into an elite model, then it simply doesn't work – ultimately you can always tell (and sell) top quality – with the risk being that the City's elite law firms are going the way of the British investment banks in the 1980s.

You have to think that a Herbert Smiths is a case in point here. Herberts had the 6th largest UK corporate franchise in 2020[5], but dropped to 10th in 2022, having grown revenues by just 5% over the last two years, and will likely drop out of the Top 10 next year. Herberts is currently ranked 25th by pay for NQ's at £105k. Size matters and the Magic Circle are not only being out competed at the top end of the corporate and finance deals market where the margins are highest, they are being outcompeted for talent – and it's a snowball effect. Look at private equity law – that used to be dominated by Clifford Chance, Freshfields and Ashurst, but now it is US firms. The UK elite are now facing the greatest challenge on their own turf.

Conclusion

The legal market's tectonic plates, which normally move in a glacial manner, are now shifting at an accelerated pace. The difficulty for the Magic Circle is that they are being attacked from all angles. It is not just the US law firms, but over the last decade the Big Four accounting firms have captured a significant share of the UK's market for legal services and have increasingly begun to compete with traditional firms. Big Four accounting firms are well placed to accelerate their share of procedural legal work for large corporates i.e., due diligence and employment. Deloitte, EY, KPMG, and PwC have used their brand recognition, global reach, technological capabilities, and huge existing client bases to rival mid-market and even top tier firms, and are now looking to seize an even larger share of the legal market. This is also highlighted by the rising importance of alternative legal services providers (ALSPs) as competitors to traditional firms,

[5] Estimates by The Lawyer.

underlining the sense that real change is finally here. With the Big Four and ALSP's attacking the soft underbelly, the Magic Circle are being forced to focus more on the high end but are being increasingly outcompeted by the Americans.

The consensual models and staid world of the Magic Circle is being challenged and the question is whether they have the right answers – particularly now given the economic backdrop. Recessions and inflation are not good things for law firms, since they struggle with their revenues, and this at a time when they are facing broad-based inflationary wage pressure. The conclusion might be that they probably don't have the right answer because they are a room full of millionaires that refuse to believe that their business model is in trouble.

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