

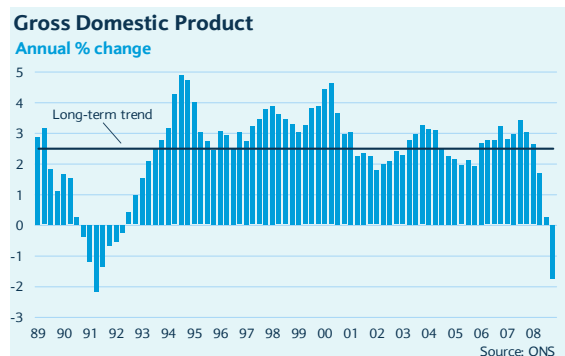
# Professional Services Review

February 2009

## Summary

- The continuing credit and financial market dislocation has resulted in a synchronised recession across the key global economies, with the UK economy expected to experience its first full-year contraction since the early 1990s during 2009.
- Although reports suggest that a slowdown is now under way, following several years of strong growth, overall demand for legal and audit services should hold up reasonably well.
- However, there is likely to be a shift away from real estate, M&A and corporate finance, which had previously flourished amid strong global growth, towards activities such as corporate restructuring and insolvency.
- In contrast, property-related services will continue to be impacted by a further deterioration in both the residential and commercial property markets.
- The contraction in construction activity will also affect smaller construction professional practices in particular.
- However, poor prospects for residential and commercial activity are expected to be offset (to a degree) for larger firms by increasing infrastructure and other public sector workloads.

## Macroeconomic Overview



Dislocation in the credit and financial markets over the past 18 months has had a significant impact on both the UK and wider global economy, which had previously recorded robust rates of growth. The latest official data reveal that UK GDP contracted by 1.5% on a quarterly basis in the final quarter of 2008, having previously contracted (by 0.6%) in the third quarter. As a result, the UK has now joined both the US and the

eurozone in recession<sup>1</sup>, bringing to an end a 15 year period of continuous UK growth.

The recession is expected to continue during 2009, amid further retrenchment by both consumers and businesses, with international trade and investment volumes also likely to decline as a result.

Allied to declining inflationary pressures (largely the result of falling oil and commodity prices), declining activity has resulted in a marked reduction in official interest rates. UK and eurozone policy rates have fallen to historic lows of 1.5% and 2% respectively and are expected to fall further during the first half of 2009, while the US Federal Reserve has moved to a target range of 0%-0.25% and begun implementing a number of 'quantitative easing' measures to stimulate credit flows and economic activity.

Recession has also resulted in significant government interventions across the globe, which have been designed to mitigate the impact of recession, as well as to engineer a recovery in

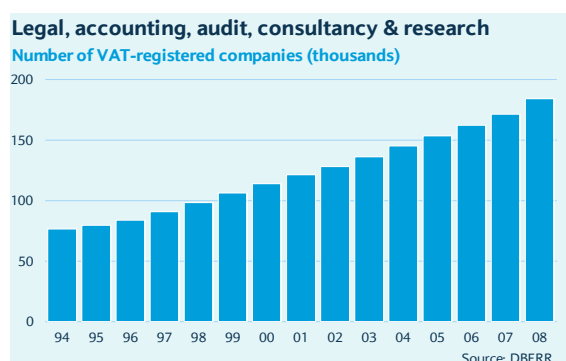
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<sup>1</sup> According to the most widely accepted definition, a 'technical' recession occurs when GDP contracts for two consecutive quarters.

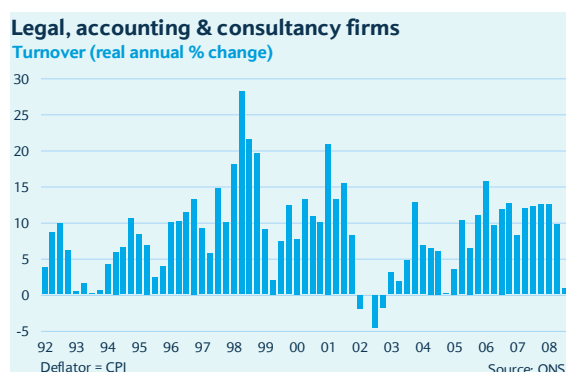
the credit and financial markets and, as a result, the wider economy. However, this is unlikely to prevent further contraction in the coming quarters at least.

### Corporate Professional Services Overview

According to the Department for Business, Enterprise & Regulatory Reform (DBERR), the number of firms providing corporate professional services continued to grow rapidly in 2007-08, when the sector recorded its fastest rate of net new firm formation (7.5%) in almost a decade. The number of firms in the sector has increased by one-third in the past five years and by almost 90% in the past decade to 184,240.



Supported by previously strong domestic and global GDP growth, robust financial markets, record global merger and acquisition (M&A) activity, healthy growth in global foreign direct investment (FDI) flows and initial public offerings (IPOs), major regulatory change (notably the implementation of Sarbanes-Oxley and Basel II), the boom in derivatives and other complex financial instruments and strong growth in financial services activity generally, the sector enjoyed double-digit real growth in turnover in 2006-07.



However, the financial market dislocation of the past 18 months has resulted in a reversal of these positive trends as the UK and many of the other key global economies has shifted from relatively robust economic growth to recession, which has in turn resulted in a significant slowdown in M&A, FDI and IPO activity, as well as financial services activity, and demand for related professional services.

This has begun to feed through to sector income, with turnover increasing at an annual rate of just 1% in real terms in the third quarter of 2008, according to official data. This compares to growth of 12.3% a year earlier. However, efforts to restrain cost growth and maintain flexibility (primarily via restrictions on growth in partner numbers) should ensure that many firms are better placed to cope than during previous downturns.

Concerns over liability in recent years have prompted a number of larger firms to adopt new structures (such as limited liability partnerships) to mitigate associated risks, with surveys suggesting that this trend is continuing (albeit slowly). More fundamental changes may be forthcoming as a result of the 2007 Legal Services Act which will, in time, allow legal services firms to operate as multi-disciplinary practices (which could result in partnerships with non-legal professionals service providers) and lift ownership restrictions on legal services firms, potentially allowing banks or even supermarket chains to provide legal services.

### Legal Services

#### Private practice solicitors' firms and offices\*

Year	Firms	Offices
1998	10,120	13,903
1999	9,983	13,818
2000	9,770	13,561
2001	9,251	12,966
2002	9,231	12,834
2003	9,198	12,708
2004	9,211	12,579
2005	9,081	11,746
2006	8,926	11,445
2007	8,663	11,006

\* England & Wales

Source: Law Society

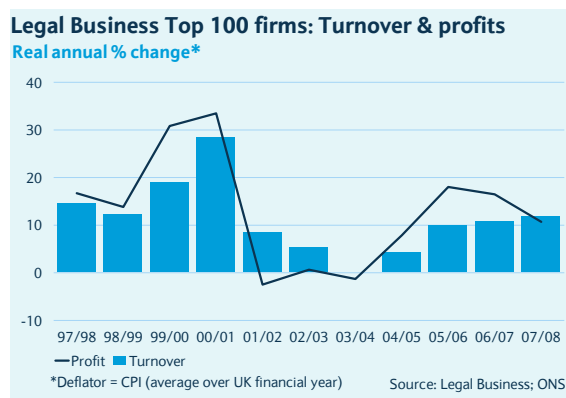
The latest Law Society estimates reveal that the number of private practice law firms operating in England and Wales has continued to decline. The fall in the number of private practice firms has

been primarily driven by a reduction in the number of smaller firms operating in the sector, although sole and 2-4 partner firms still account for 86% of all law firms.

Nevertheless, larger firms continue to employ the majority of solicitors and generate the lion's share of the sector's revenue. Even among the largest firms, income remains highly concentrated. The top four firms alone accounted for 35% of the £14 billion of turnover generated by all of the top 100 firms during 2007-08. However, a number of smaller top 100 firms are on a par with the top four in terms of profitability (as measured by profits per equity partner and revenue per lawyer).

The latest Legal Business survey reveals that the Top 100 legal firms saw turnover increase by an inflation-adjusted 11.8% in 2007-08, following a 10.9% increase the previous year. However, this in part reflects the favourable impact of sterling weakness (particularly against the euro) on overseas earnings, which have become an increasingly important source of income for a number of the UK's leading law firms.

Although still robust, real profits growth slowed, for a second successive year, to 10.7% (raising aggregate profits to £4.2 billion). This meant that profits growth lagged behind that of turnover for the first time since 2003-04. This largely reflects rising costs, with the number of lawyers employed by the Top 100 increasing by a further 3% (following an 8% increase the previous year). As a result, growth in profits per lawyer slowed for a second successive year.



The number of equity partners at Top 100 firms also increased slightly. Firms have sought to constrain growth in the number of equity

partners in recent years to maintain cost flexibility. However, this has seen a further sharp rise in the number of non-equity partners, which in turn has resulted in a further above-inflation increase in salaries.

The latest PwC Law Firms' Survey notes that while 2008 was another strong year for the sector's largest firms, 'a positive first half performance masked a significant weakening in the second half of the year.' Allied to the deteriorating outlook, this has seen confidence in the sector diminish and prompted a number of firms (including the largest 'Magic Circle' firms) to reduce headcount, particularly in previously high growth areas of practice that have been negatively impacted by the global slowdown, such as real estate, M&A and corporate finance.

Activity in these areas is expected to remain relatively muted as recession continues across much of the industrialised world. However, across the industry as a whole, this may be at least partially offset by increased activity in areas of practice such as insolvency and litigation.

Outside the Top 100, the sharp downturn in the housing market during 2008 (see Property Professionals section below) will have seen a number of smaller firms, for whom conveyancing fees typically represent a greater proportion of total revenue, come under significant pressure. Some larger firms will also have come under pressure from the slump in the commercial property market. At the same time, continuing pressure on legal aid expenditure, and structural changes to the legal aid system, are likely to see a further decline in the number of firms operating in this area of practice.

### Accountancy Services

Like the legal services sector, the accountancy sector consists of a large number of small firms, but is dominated by a small group of large firms. Indeed, even among the largest firms, income and activity is highly concentrated among a group of four large, multinational firms which generate income and profits several times greater than those of their nearest rivals. According to Accountancy magazine, these four firms together generated over 70% of the combined fee income of the Top 60 companies in 2007-08.

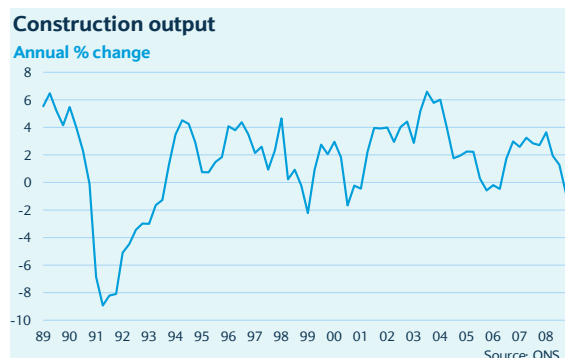
Although still relatively robust, the Top 60 accountancy firms saw growth in fee income slow to 4.2% (adjusted for inflation) in 2007-08 from 11.3% in 2006-07. While partner numbers increased only slightly, growth in average fee income per partner nevertheless slowed to less than 1% (a decline in real terms).

Fee income from audit and assurance work, although experiencing slower growth, was the main income driver in 2007-08, although consultancy fee income also enjoyed strong growth. A number of firms also reported growing demand in 'non-traditional' areas of practice, such as wealth management.

Despite experiencing relatively robust growth in recent years, the leading firms have sought to control costs, particularly with regard to partner numbers (although overall staff numbers have risen, with an overall increase of 6.5% in 2007-08). Nevertheless, like their legal counterparts, accountancy firms are likely to adjust both their operations and their headcount, with recession likely to see activity switch from areas of practice such as M&A and corporate finance to corporate restructuring, recovery and insolvency.

### Construction Professionals

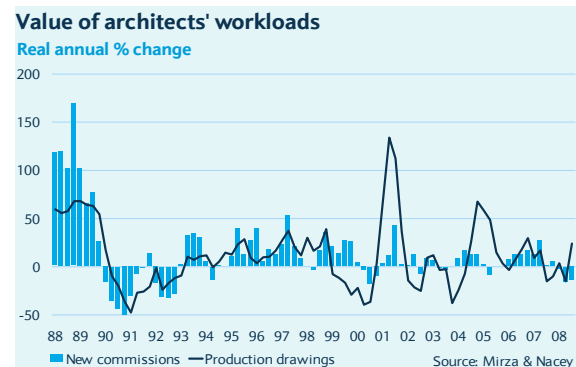
According to DBERR data, there were 67,330 VAT-registered firms in the sector at the beginning of 2008. At 15%, the rate of net new firm formation in 2007-08 was the fastest recorded in the sector since comparable records began in 1994 (although this may be revised down).



However, continued capacity growth has come at a time when demand for construction professionals' services has been negatively affected by the downturn in the wider

construction industry, which contracted by 0.8% in the year to the fourth quarter of 2008. The decline in construction activity has been driven by a fall in residential property construction, which is the key source of demand for smaller architects and many other providers of professional construction services. The downturn in the commercial property market has also had a negative impact on architects' workloads although, for some larger firms, the decline in residential and commercial property related workloads has been partially offset by continued demand from public sector and infrastructure projects.

Mirza & Nacey's latest Construction Futures survey shows that, although the value of later-stage production drawing workloads picked up briefly in the third quarter of 2008, the value of new commissions continues to decline as the pipeline of new projects has dried up.

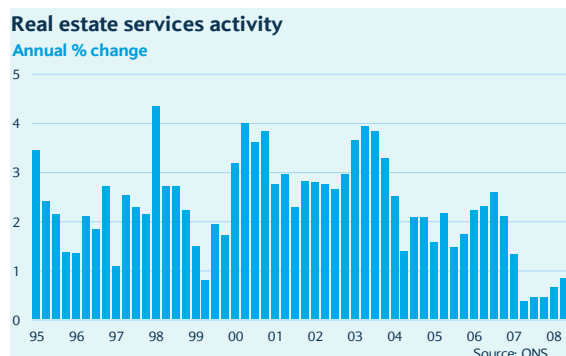


Confidence in the sector is also reported to be at an all-time low, with workloads widely expected to continue to fall amid a continued decline in commercial, as well as residential, commissions. With prospects likely to remain very poor through most of 2009 at least, there are now signs that firms are reducing headcount accordingly.

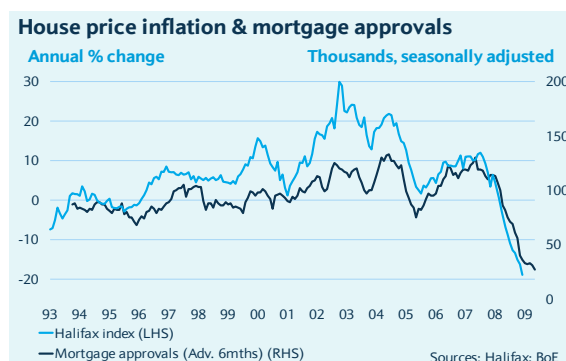
### Property Professionals

Providers of real estate services have seen growth in activity slow markedly over the past 18 months, according to official data. More restricted availability of credit and the deteriorating economic outlook have resulted in a sharp reversal of previously buoyant conditions in the UK housing market over the past 12-18 months. Changes in the official data make the precise impact on transaction volumes difficult to determine, but the available data indicate a clear

downward trend. This is corroborated by industry surveys and other data. Indeed, recent Royal Institute of Chartered Surveyors (RICS) surveys suggest that property professionals are facing the most challenging conditions since the survey began in 1978, with property sales per surveyor falling to a record low.



The slowdown in transactions has resulted in a rapid fall in house prices, which accelerated to 16.2% on an annual basis in the three months to December, according to the latest Halifax data. This has further dampened lenders' appetite to advance mortgages against collateral that is declining in value. At the same time, potential buyers also remain wary of buying in a falling market, despite the fact that affordability, previously a key barrier to home ownership for first time buyers in particular, has improved significantly as house prices have fallen.



As a result, Bank of England data show that mortgage approvals for house purchase fell to (27,000) in November 2008. This was the lowest monthly total since comparable records began in 1993 and marked a fall of almost two-thirds compared to November 2007. As mortgage approvals are a strong lead indicator of house price trends, this suggests that prices are likely to continue to fall in the near term at least,

especially as growth in unemployment has begun to accelerate.

Survey evidence suggests that the supply of properties coming onto the market is also slowing. With potential vendors unwilling to realise large equity losses, a growing number have chosen to rent out their properties instead. This has boosted demand for lettings agents, especially as many potential buyers deterred by the prospect of a further fall in house prices are choosing to rent.

However, reports suggest that growth in the supply of rental accommodation has outpaced that of demand (especially in those regional cities in the north of England and the midlands, where there was already an over-supply of city centre flats in particular) and that this is having a dampening effect on rental growth.

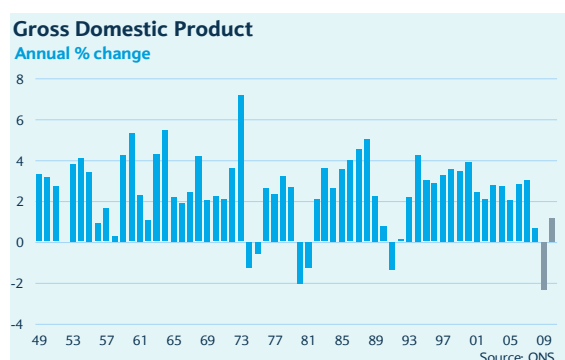
For larger estate agents and surveyors, the downturn in the residential property market has been exacerbated by the continued deterioration of conditions in the commercial property market. Commercial property values have fallen by over 30% since their peak in June 2007 (surpassing the decline experienced in the early 1990s), with substantial falls recorded in all of the main sub-sectors.

Although this has helped push rental yields back above financing costs, concern is growing over future rental growth as declining consumer spending takes its toll on the retail property sector, manufacturing continues to struggle and declining activity across the wider services industry dampens demand for office space. Declining demand for office space will have a particular impact on the London market, which had seen an increase in speculative development, but which will bear the brunt of mounting job losses in financial services and related sectors.

The largest firms, a number of which had expanded overseas, are unlikely to be afforded much protection from this strategy, as many of the major economies are experiencing similar property downturns. Indeed, rather than mitigating the impact of the UK downturn, diversification into overseas markets may be exacerbating it for some firms.

The downturn across the UK property market is likely to result in a period of consolidation in the professional property services sector, especially in those areas that have seen rapid capacity growth during the preceding property boom, such as estate agents. The number of VAT-registered estate agents continued to increase, by 7.9% in 2007-08 according to DBERR data, which is the average rate of net new firm formation in this sector during each of the past five years. On this basis, the number of estate agents has doubled in a little over a decade and increased by almost 50% since 2003. However, reports suggest that estate agents are now closing branches and laying-off staff on a large scale, with further consolidation likely to reduce the excess capacity that has built up.

## Outlook



The onset of recession in the second half of the year meant that UK economic growth slowed to just 0.7% during 2008 from an above-trend rate of 3.1% in 2007. The economy is expected to continue to contract amid further retrenchment by both consumers and the corporate sector during 2009. Indeed, consensus forecasts now suggest that GDP will decline by 2.4% this year, which would represent the UK economy's worst performance since at least 1949.

Although growth is expected to resume in 2010, it is expected to remain significantly below the 2.5% long-run trend rate at around 1.2%.

Both the US and the eurozone are also expected to remain in recession during 2009, with the latest European Commission forecasts suggesting that GDP could shrink by 1.9% in the 16-country zone, with growth only slowly recovering in 2010. The IMF has also cut its 2009 global growth forecast from 2.2% to just 0.5% (the lowest since

the Second World War), with the advanced economies expected to contract by 2%, following aggregate growth of just 1% in 2008. Although the Fund expects global growth to pick up in 2010, at 3% it is expected to remain subdued (relative to the 4.9% annual average growth recorded during 2004-07). At just 1.1%, growth in the advanced economies is expected to remain muted, from a longer term perspective.

However, the risks to these forecasts remain on the downside given the continuing dislocation in credit and financial markets and the acceleration in the pace of the downturn in recent months. The turmoil in financial markets and subsequent contraction in economic activity have had a significant impact on the business services & finance and property & construction industries which are the key sources of demand for professional services providers. Although activity in the corporate professionals services sector is likely to slow further, overall demand for legal and audit services should hold up relatively well. Nevertheless, there is likely to be a shift away from real estate, M&A and corporate finance towards activities such as litigation, corporate restructuring and insolvency.

With both the commercial and residential property markets expected to deteriorate further as the UK economy continues to contract, both property and construction professionals face significant challenges, with consolidation likely in some segments. Continued recession is also likely to see a further deterioration in property markets across many of the other major global economies, which will continue to weigh down on firms with overseas operations.

However, larger firms in particular should benefit to a degree from government plans to bring forward capital spending (announced in the recent Budget). This should help to boost the pipeline of infrastructure projects, with accelerated social housing investment providing some limited support for property and construction professionals.

Prepared by Dr Brian Clark, Senior Economist, Portfolio Management, Barclays Bank PLC.

All data and factual information referred to in this report were correct as of 27th January 2009

Source of ONS data: National Statistics website:  
[www.statistics.gov.uk](http://www.statistics.gov.uk)

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