Professional services profit drivers

White Paper

New Light Strategies

Professional services profit drivers

The professional services profit drivers are the four elements that drive the revenue and overall profitability of a professional services business. Revenue and profit is a performance outcome and not the drivers.

The four elements that make up the professional services profit drivers are:

- Efficiency
- Value (billing rates or fee value)
- Structure
- Cost

Efficiency

Efficiency is comprised of:

- **utilisation**, which is a measure of the extent to which people are working on billable engagements; and
- **realisation**, which is the measure of how much of the billable time is actually realised as invoiced fees to the client.

Efficiency is the first area that needs to be managed. It is important to measure and manage whether the professional services team are fully engaged on fee-earning work and deviations from expected utilisation levels need to be investigated and addressed.

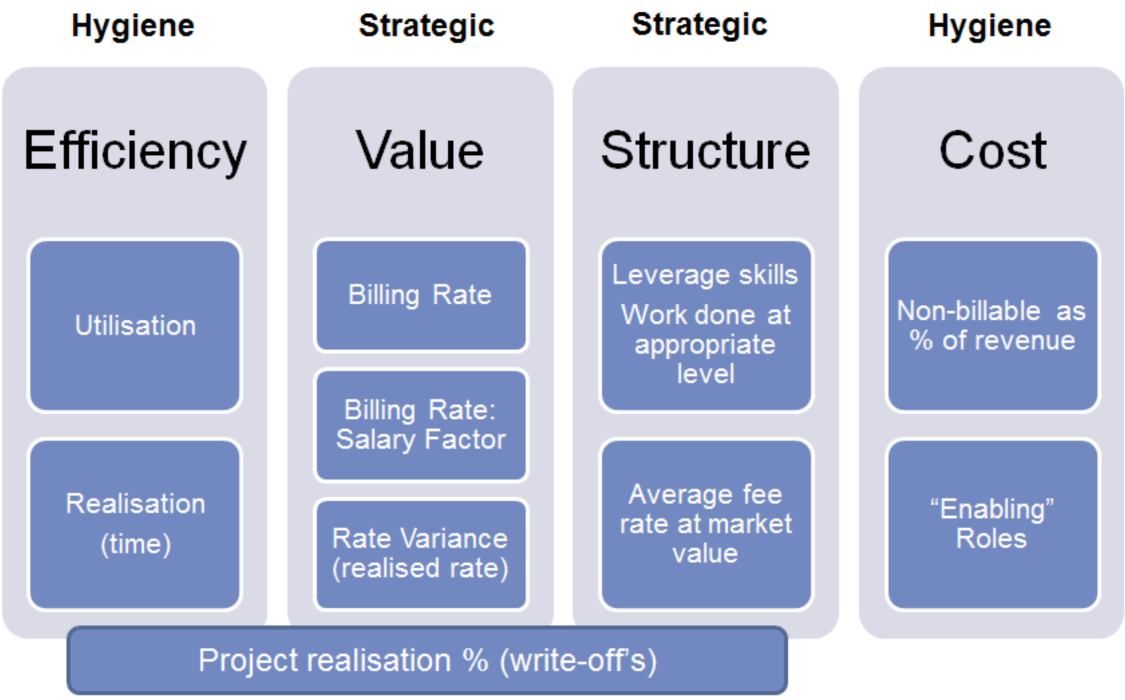
It is furthermore essential to monitor and ensure that productive fee-earning time is invoiced to clients, i.e. that the time is realised in fees. This is discussed in more detail in the section headed "Project realisation".

Efficiency is known as an "operational" profit driver. It is an essential management discipline, but it is not one of the strategic drivers due to the fact that the profit derived from "working harder" very quickly plateaus.

Value

This is the value of the services provided to clients. It is most often reflected as a billing rate (or charge-out fee rate) per hour for each professional services team member. Value is one of the two strategic profit drivers. A higher billing rate (or revenue output) per person, reflects the value that the market places on your services.

Value and structure are inter-related profit drivers. A low billing rate (or low value) doesn't necessarily deliver a low profitability, provided that the structure and leverage model used to deliver the



services takes account of the lower billing rates. What we mean by this is that if you have a service that the market places a lower value on, you can still achieve a required profitability provided that you are structured to deliver this service offering with more junior staff at a lower cost.

Billing rate (or revenue output per person) per se or in isolation of other measures therefore doesn't indicate relative profitability. The key is whether the billing rate and fee value relative to salary costs will produce an acceptable profit margin. An essential profitability measurement therefore is the "Fee/Rate:Salary" factor. If this factor is below 2.0 (which delivers a 50% gross profit), your business has a fundamental strategic issue that has to be addressed. The traditional and historic professional services billing rates (or fees): salary factor is 3.0. Whilst it's accepted that this factor may not be achievable in all professional services firms, it is nonetheless a valid benchmark and a deviation from that benchmark needs to be considered, challenged and justified.

A low Fees/Rate:Salary factor invariably indicates that experienced highly paid professional services people are delivering a service not adequately valued by the marketplace. There are many potential reasons for this happening, but whatever these reasons are, it is essential for your business to understand and address the underlying cause if it is to succeed and achieve an acceptable and required economic return.

Once billing rates have been set based on the Fees/Rate:Salary factor and assessed against market rates, it is important to determine whether these rates are being realised. In other words, are you achieving these rates/fees in your proposals and bids and are they being realised as invoiced fees to clients. Discounting at proposal or bid stage or fee related write-off's on projects provide an indication as to whether your billing/fee rates are achievable in the market and whether your service delivery teams are correctly structured to deliver projects at market-related average rates.

Structure

Structure, which is more often referred to as "leverage", is the structure that you have for delivering your services. Again, when looked at in isolation, there is no right or wrong structure. A highly leveraged team can produce the same profitability as an un-leveraged team, provided the nature of the services delivered and the value placed on it by the market is aligned with the structure.

The correct structure in your service delivery teams has two important strategic factors. Firstly it is important to ensure that your experienced and specialised practitioners' are "leveraging" their skills by imparting their knowledge to more junior people. This facilitates a learning and developing organisation. It also enables the experienced specialised professional to delegate work to more junior people, freeing up his or her time to develop further knowledge and more specialised and higher value service offerings.

Secondly, a leverage structure when properly applied, leads to greater competitive pricing within the market as you are able to deliver your services with less senior specialists and more junior lower-cost people. The overall average fee rate, which ultimately is the price paid by your clients, can thereby be lowered whilst still producing the same gross profit margin. This is an asset in any professional services business, but is only achievable if the business is able to develop service delivery methodologies, appropriate training and delegation and project management approaches.

Structures where there isn't high leverage is found in instances where there is a need for expert specialisation. In these circumstances the client wants the expert's direct involvement and where it's therefore not appropriate for the services to be delivered by more junior people. This is a valid structure for expert specialised services. In these instances the experts must and can charge a higher fee rate commensurate with the higher valued services. If a higher fee rate is not sustainable in the marketplace, then one has to question whether it in fact is a valid specialised expert service offering.

Structure/leverage and billing/fee rates are the two key strategic drivers and there is a direct inter-relationship between them.

Project realisation

Project realisation is the measure of billable revenue on projects (being time recorded on the project x the billing rates) being realised as invoiced fees. For instance, a 90% project realisation rate will indicate that 10% of possible billable revenue has not been invoiced to clients. Project realisation rates are often referred to as "write-off's".

Project realisation is normally reflective of issues within one or all of the efficiency, value and/or structure profit drivers. It's therefore not a profit driver as such, but is a strong indicator of issues (or strengths) within these other profit drivers.

It is critical to understand the underlying causes for low project realisation (or high write-off's) and then to address these underlying causes. The causes could be poor scoping, valid scope variations not invoiced to and recovered from clients, perceived lower value of the services by the market, inadequate project management, lack of service delivery methodologies or service delivery performance issues.

Cost

Cost must be controlled and should not be at a level where profitability is negatively impacted by excessive overhead costs.

Costs that typically need to be budgeted, assessed and monitored are:

- Selling, marketing and pre-sales costs (with pre-sales costs normally being included as non-billable costs above-the-line within Cost of Sales/Cost of Services)
- Management overheads, both within the professional services delivery teams as well as within overheads
- Admin and support
- Other overheads

Although cost control and discipline is not a strategic profit driver, it still remains important.

As a general rule we look to costs not exceeding 33% of revenue.

Mathematical equation

There is a mathematical equation that demonstrates how the professional services profit drivers produce the overall financial result.

Professional services profitability is traditionally measured as the Profit per Principal. The reason for this measure is that Principals lead the professional services process, from developing the service offerings, through the sales process, people leadership, service delivery and ultimately to the financial performance outcomes. Whilst this most clearly demonstrated in partnerships, the principle holds true in all professional services organisations.

The profitability equation is as follows:

$$\boxed{\text{Profit per Principal (Profit / Principals)}} = \frac{\text{Profit}}{\text{Fees}} \times \frac{\text{Fees}}{\text{Hours}} \times \frac{\text{Hours}}{\text{People}} \times \frac{\text{People}}{\text{Principals}}$$

Professional services profit drivers	Costs	Value (charge out rates)	Efficiency (utilisation and realisation hours)	Leverage structure

By focusing on the individual profit drivers, the financial outcome of profit per principal (or profit %) is capable of being managed at a granular level and becomes the performance outcome as opposed to the driver (which it isn't).

Summary

All four of the professional services profit drivers are important and essential.

Costs have to be controlled and utilisation has to be managed and achieved in order to deliver the required profitability. These two profit drivers are however operational and don't drive your firm's strategic direction.

The two strategic profit drivers are Value and Structure. They are inter-related and in combination they define your organisations strategy within your market.

Once costs and efficiency are addressed through operational disciplines, the ongoing strategic profitability is always determined by the decisions that you make and the success of implementing appropriate strategies in respect of Value and Structure (leverage).

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