chapter 1

Eliminate Billable Hours

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Inefficiency is the enemy of success.

DISRUPT OR BE DISRUPTED

Disruptive innovation can hurt, if you are not the one doing the disrupting. This term, coined by Harvard professor and bestselling author Clayton Christensen (@claychristensen), and commonly talked about in technology circles, is a very real issue for marketing agencies.

According to Christensen, disruptive innovation, "describes a process by which a product or service takes root initially in simple applications at the bottom of a market and then relentlessly moves 'up market,' eventually displacing established competitors."[1]

Disruptive innovation is already happening in the marketing-services industry, and it is going to change everything, including pricing and service models, measurement methods, tools and platforms, higher education, industry accreditation, marketing budgets, organization charts, and career paths.

Think about the firms coming up that have superior knowledge and capabilities in the high-demand areas of search, mobile, content, and social. Do you think the status quo is sustainable for traditional marketing firms? The upstarts and innovators may not immediately attack the core larger enterprise markets sought after by the big agencies, but before you know it, the collective ecosystem of emerging agencies will have built a diverse and collaborative empire that will shift the power in the industry. Then, it is only a matter of time.

Whether you are an emerging agency seeking to disrupt or a traditional firm on the wrong end of the impending evolution, here are several things to remember about disruptive innovation:

- Disruptive business characteristics include: lower gross margins, smaller target markets, and simpler products and services.
- It often comes from the outside, and once you realize what is happening, it is probably too late.
- Success requires an uncommon tolerance for risk and a desire to embrace the unknown.
- Victory favors those who are bold and decisive in their actions.
- Traditional agencies that are slow to adapt will fail, and many existing industry experts will become irrelevant. This will be good for the industry.
- Unparalleled opportunities will arise for marketing agencies and professionals, and new career paths will be defined.
- The underdogs and innovators will become the leaders.

Pricing strategy is a key component to disruption. Agencies motivated to change will shift away from the inefficient legacy system of billable hours, and move to more results-driven, value-based models accessible to the mass market. This presents the opportunity for agencies and independent consultants to disrupt the industry with lower prices, and potentially higher profit margins.

A BROKEN SYSTEM

I started my career in the marketing industry at a traditional PR firm. In those days (1999–2005) we charged a flat rate of $125 per hour, and billed in quarter-hour increments. The flat rate meant that clients paid the same hourly rate for my work as they did for time logged by our most senior personnel. This was easier to track and report internally (when people actually completed their timesheets) than a tiered hourly rate, but from a client's perspective, I always struggled to understand how paying a junior associate and a senior executive the same $125 per hour made any sense. Where is the value in that?

Then again, I also never bought into the tiered-rate model. Even today I cannot comprehend how firms justify charging upward of $964 per hour for a senior executive's time, which, according to the 2009 American Association of Advertising Agencies (4A), was an

average rate for large U.S.-agency chief creative officers.[2] Even more shocking to me is that there are corporations willing to pay those excessive fees.

This is the core issue of what I call the *salary-rate fallacy*.

The Salary-Rate Fallacy

A standard formula used by agencies to determine billing rates is to apply a salary multiple, commonly a factor of two or three. According to communications industry consultants StevensGouldPincus, the most profitable PR firms should target 35 percent of revenue for base salaries, and 50 percent of revenue for total labor costs, including salaries, bonuses, and freelance/outsourced labor.[3] So, in theory, if employees generate three times their base salaries in revenue, then firms will fall within target profitability ranges.

Firms may use variations when determining hourly rates, and take additional factors into account, but a simple salary multiple enables them to account for overhead expenses and employee compensation, while leaving room for net profit margins. Target net profit margins vary greatly based on agency size, growth rate, and life stage, but, most likely, they will fall in the range of 10 to 25 percent, depending on which benchmark report you reference.

In order to understand the deficiencies of this approach, let's take a look at an example of how an agency professional's hourly rate would be calculated using a 3× multiple.

In this scenario, we will assume the professional's *production rate*, or the time he is billable, is approximately 57 percent (or 100 hours per month). The remaining 43 percent of nonrevenue-generating time may be accounted for through administrative tasks, account management, business development, professional development, and networking. Here is how it breaks down:

Forty-seven weeks (number of work weeks in a year after accounting for five weeks of vacation, personal days, and holidays)

Forty-five hours per week (assumes five, 9-hour days)

Annual available hours = 2,115 (47 weeks × 45 hours per week)

Annual billable hours = 1,200 (assumes conservative estimate of 100 hours per month)

Salary = $150,000

Required Billings (3×) = $450,000

Billing Rate = $375 per hour ($450,000/1,200 hours)

Assuming there are 1,200 hours of billable work to be done in the year, this formula seems easy enough, and makes financial sense, at least for the agency. The problem is that the formula is completely agency driven. It is tied exclusively to outputs, not outcomes, and assumes that all agency activities—account management, client communications, writing, planning, consulting, creative—are of equal value.

Thus, the fallacy: A marketing agency executive making *X* ($150,000) per year is worth *Y* ($375) per hour. The fact is that the amount a professional is paid does not have a direct correlation to the quality or value of the services they provide, especially when you consider the impact of change velocity, selective consumption, and success factors, which were discussed in the introduction. And yet, we have an entire industry built on this pricing concept.

Maybe the executive's time is worth $375 per hour to build advertising creative or to consult on crisis communications situations, if that is what he built his career and salary on, but now client needs are rapidly evolving (change velocity). They are demanding different services (selective consumption) and measuring return on investment (ROI) in new ways (success factors).

Clients are willing to pay a premium for experience and knowledge they do not have, but the unfortunate reality is that young professionals, who have grown up in a digital world, may be more qualified to provide consulting and services in high-demand areas such as social media, SEO, and mobile. It is almost a reverse of how the industry has traditionally worked. Clients would pay for inefficiencies of junior account executives while they learned the craft and gained experiences, but the labor and hourly rates were cheap. Now clients pay for the inefficiencies of senior executives to learn the digital game, but their hourly rates are not coming down.

In addition, as costs increase to run and grow the agency, including rising employee salaries, there are only two obvious options to maintain or increase profits: (1) raise hourly rates or (2) demand professionals work more hours, neither of which creates greater value for clients.

The salary-rate fallacy is the core reason that billable hours are a broken system. Unfortunately for many traditional firms, it is the basis for their financial structure and incredibly difficult to change. Even for firms working off retainers, rather than project-based hourly rates, in order for the agreements to make financial sense, retainers still must be based on an estimated number of service hours using the hourly rate formula.

For example, if an agency has a $5,000 per month retainer, the number of hours that will be dedicated to the account each month could look like this:

Senior account executive ($300/hour × 5 hours)	= $1,500
Account executive ($150/hour × 10 hours)	= $1,500
Assistant account executive ($100/hour × 20 hours)	= $2,000
TOTAL : 35 hours	= $5,000

If the agency exceeds its monthly allotment, they either absorb the losses or request more budget. The other, less desirable options are to push more hours to cheaper junior staff with less experience, record the time against other projects with available budgets, or make it up by shorting time spent on the account during the next month. In other words, traditional retainers do not really solve what is wrong with billable hours.

The Cost of Inefficiency

To further explore the challenges of the billable-hour model, consider the case of a press release. What do you think a press release is worth?

The correct answer, like any product or service in a free market, is whatever a client is willing to pay. However, in the traditional model, the cost comes down to two primary factors: hourly rate and the producer's efficiency. So let's examine the practical application of billable hours in an agency.

Scenario 1 Professional A is an assistant account executive and an exceptional copywriter who requires minimal oversight. She is assigned a press release that will be distributed on a national wire service. She completes a strong original draft that is reviewed internally with no edits, and it is then quickly approved by the client. As a result, the cost is relatively straightforward.

Hourly rate	= $150
Hours to complete	= 3
Cost	= $450

Scenario 2 Now let's look at what happens to the price had Professional B, who also has an hourly rate of $150, been assigned the same press release. Although she wrote a few releases in college, this is her first real-world project. In addition to her raw writing skills,

Professional B is easily distracted. She is addicted to her Twitter stream and has e-mail alerts that pop up every two minutes, so she rarely focuses on her tasks for extended periods. As a result, she takes a bit longer than Professional A, and the quality is subpar, requiring multiple revision rounds before it even goes to the client for approval. The cost for the first draft:

Hourly rate	=	$150
Hours to complete	=	5
Cost	=	$750

However, we are not done yet. We also need to account for the one hour of a senior associate's time to edit and revise the original draft, 15 minutes to review the edits with Professional B, 30 minutes for Professional B to make the edits, and another 30 minutes for the senior associate to edit and approve the final version. Oh, and the senior associate's hourly rate is $250 an hour. So, the final cost looks like this:

Original draft ($150/hour)	= 5 hours or $750
Senior associate edit and review ($250/hour)	= 1.25 hours or $312.50
Professional B edits ($150/hour)	= 0.50 hours or $75
Senior associate final edit—Round 2 ($250/hour)	= 0.50 hours or $125
Total	= 7.25 hours or $1,262.50

There is zero added value for the release from Professional B, yet, the client pays nearly three times more for the exact same deliverable. The client is actually penalized, and forced to pay for the agency's inefficiency and professional development.

The model is broken.

Inefficiency Factors

There are countless factors that can affect a professional's efficiency, but distractions, time tracking, and motivation are three of the biggest culprits.

Distractions Marketing agency professionals are multitaskers. At any given moment, they are connected through an array of channels competing for their attention—Twitter, Facebook, Internet, TV, chat, e-mail, phone, text, Skype, Intranet—not to mention face-to-face time and meetings. In essence, they are always distracted or anticipating distraction, and, therefore, they are never performing at their peak and never achieving flow.

Yet clients are expected to pay full hourly rates when, in reality, professionals rarely are focused solely on the project at hand. I know if I were paying someone for their creative work, I would rather they spent 60 uninterrupted minutes straight on my project than 60 minutes over three hours with calls, e-mails, tweets, and instant messages in between. I will take efficiency with higher levels of creativity and attention every time.

Distractions lead to higher costs and lower quality.

Time Tracking Time tracking is not exact by any means. Although agencies and professionals may have the best of intentions for accuracy, it is easy to accidentally leave the meter running or even to forget to start the meter as you battle distractions and jump from one project to the next. As a result, it is common to estimate or round your time in logical increments. This means clients commonly pay for time that never happened. A five-minute phone call tracked as 15 minutes may not be a big deal once, but multiply that out over a 12-month campaign, and you are looking at hours of wasted time and money.

Plus, professionals responsible for billable-hour quotas certainly do not want to miss any client time, so they try to account for every activity, no matter how mundane. This time adds up and can eventually start to take valuable hours away from more meaningful and measurable work.

My experience was that, over time, clients would often avoid calling, or even stop keeping us in the loop on key strategic discussions because they did not want to incur the charges for us to have a chat or read and compose an e-mail. So agencies make a few dollars to fulfill billable-hour goals, but lose out on long-term opportunities. This is the type of shortsighted thinking that will doom agencies.

Motivation There is little motivation for agencies or their professionals to complete work more efficiently. The value of employees to an agency, and, therefore, their ability to advance and build wealth, is directly tied to how many hours they log and how many of those hours actually get billed to clients. As a result, professionals often are more worried about meeting hour quotas or staying within monthly retainer limits than they are with delivering the level of service and quality needed to produce measurable results for clients.

Going back to the press-release example, which professional looks better on paper based on the standard model? Professional A, who finished the release in three hours for $450, or Professional B, who took more than seven hours with the help of her supervisor for a cost of $1,262.50?

Well, if the client had the budget available to allow for the inefficiency, Professional B comes out ahead and the client never knows the difference.

Low-quality work should not cost the client more, but that is exactly what happens. Either that or the agency eats time as professional development, but that is not something most agencies are eager to do.

Just think what an agency could accomplish, and how much value it could bring to its clients, if it rewarded professionals for retention and growth of accounts, rather than how many hours they bill in a year.

THE POWER OF TRANSPARENCY

There is a certain mystery to billable hours and agency services. Clients are not always sure exactly what they are getting or what it costs. This works for agencies because billable hours are an imperfect mix of art and science, and as long as the agency produces results, clients are happy.

However, there are those times when things do not go so smoothly. Maybe the client anticipated a return on investment sooner, does not feel like the account is getting enough attention, or is just too demanding and unrealistic. There is also the possibility that the agency may have slightly overpromised to win the business and just cannot deliver to the expectation levels that were set.

All of a sudden, invoices are being scrutinized a little more closely. The client's chief financial officer (CFO) takes a keen interest in the growing monthly expense, and now the chief marketing officer (CMO) has to explain the value of the agency to his executive team. The problem is that he has no idea. After four months at $10,000 per month, he has invoices full of activities but nothing tangible to share with his bosses to justify the relationship. The mysterious nature of billable hours is not that much fun for either party at this point.

Now the agency team has to invest nonbillable (in theory) hours reviewing and explaining invoices, and scrambling to demonstrate some meaningful and measurable impact they have had. Even though both sides entered the engagement with the best of intentions, the relationship becomes tenuous, and time and energy that should be focused on producing outcomes is diverted to saving the account.

This scenario, which played out continuously over my first five years in the industry, was a primary motivating factor in my desire

to create a different agency model. I became obsessed with the idea of making services tangible with clearly defined costs, features, and benefits, almost like buying a product off a retail shelf or signing up for a software service. My theory was that, if clients understood exactly what they were getting and agreed ahead of time what it was worth, then we could remove the mystery from the equation and focus on delivering value and results.

Transparency would build trust, remove the friction from the client-agency relationship, and make it simpler to sell services to the mass market. The problem was that the billable-hours model was the only one I had ever known. How would I build an entirely new financial model and productize a service business?

THE MOVE TO STANDARDIZED SERVICES AND SET PRICING

My solution was to standardize services, and apply set prices based on a number of variables. In essence, I believed it was possible to achieve economies of scale in the production and delivery of services, much like a manufacturing company does with products. If we could lower the cost of services over time by improving efficiency, then, in theory, we could increase profits, possibly even above industry benchmarks.

Set prices would enable us to bundle services into packages designed to fit specific market segments, such as franchise owners, and it would dramatically reduce time spent building new business and account development proposals. Plus, we would be able to make marketing agency services more affordable and effective to the underserviced market of small businesses in the United States and around the world. Everyone wins.

It seemed so obvious, but I had no idea how to actually build a financially viable business model. So I set out on a 21-month journey from February 2004 to November 2005 to make it happen.

VALUE-BASED PRICING

I took the approach that if you can define the scope, which is possible with nearly every marketing agency service, then you can standardize the service and assign a set price. Although some services, such as website projects and marketing plans, are more complex than others, the vast majority of agency services can be standardized by clearly defining the scope of what is to be done.

Sample Standardized Service

Standardized services, such as the following case-study example, commonly include description, features, benefits, and set price:

Provide prospects and customers with powerful examples of how your products or services deliver value and results. Case studies are ideal website content for your visitors, make great marketing and sales tools, and can be used as editorial submissions.

What Makes a Good Case Study?

- Satisfied, recent customer.
- Unique or high-profile application (company, product, event, etc.).
- Clearly defined challenge and solution.
- Impressive, quantifiable results.
- Innovative or customized solution.
- Hi-res photos available.
- Customer resources willing and able to be interviewed.
- Limited legal concerns with trade secrets/proprietary information disclosure.
- Story highlights key product/service benefits (speed, efficiency, productivity, profitability).

What's Included?

- Following a standard outline of challenge, solution, and results, PR 20/20's professional marketing copywriters will craft a case study for publishing on your corporate website, blog, or media room.
- Approximately 700 words.
- Optimized with priority keywords and written with buyer personas' key needs in mind.
- Additional fees apply for graphic design and strategic planning if you plan to use case studies in print or PDF form as sales support.
- Average turnaround: 15–20 business days.
- Price = $1,000.

The guiding principle was that set prices had to be value based, meaning they were to be determined based on perceived and actual value rather than the number of billable hours something takes to complete. So if a trifold brochure was priced at $2,500, then it did not matter if it took 15 or 35 hours to produce, the client would pay $2,500. The burden was on the agency to build systems and processes, and put the right talent in place, to profitably deliver at the set price.

In the traditional billable-hour model, the basic formula to determine cost is *hourly rate* × *billable hours*. It is simple, but as we have seen it is also inefficient and favors the agency's needs over the client's. On the other hand, the value-based pricing model takes seven primary variables into account:

1. Estimated hours.
2. Hourly revenue target (HRT).
3. Costs.
4. Perceived value.
5. Builder vs. driver.
6. Loss leader.
7. Service level.

In most cases, you will be able to determine prices by simply calculating *estimated hours* × *HRT*, but you want to take the other variables into account before finalizing the price.

Estimated Hours

At peak efficiency, how many hours will it take the agency to complete a project? Keep in mind *peak efficiency* is the key here, and one of the main differences from the traditional model. For services to be value-based, clients should not pay for agency inefficiencies. They should be charged for the estimated time in which the agency is capable of completing the service. The actual time invested will vary project to project, but if your estimates are accurate, and your team works efficiently, it should average out over time.

The best way to determine estimated hours is by referencing historical timesheets. Let's say you want to standardize blog post copywriting. Pull reports from the last 10 blog posts your agency has completed, and look at the average hours needed. If you do not have timesheets to reference, analyze the scope of the service, and forecast time to complete based on your experience and educated best guess.

I can tell you from more than six years experimenting with this model, value-based pricing is about testing and revising. You will get some pricing very wrong, and you will get burned a time or two, but as long as you have the right tracking and reporting systems in place, you can quickly adjust and move on.

It is important to note that the value-based model does not eliminate the need for timesheets. Accurate time tracking actually becomes more essential in order to monitor efficiency and productivity, evaluate employee performance, produce activity reports, and evolve pricing. We will talk more about time-tracking systems and software in Chapter 4.

Hourly Revenue Target (HRT)

How much revenue does the agency need to generate per hour of client work to achieve profit goals? For solo practitioners, the HRT will probably be similar to your hourly rate, but, for agencies with multiple employees, you will need to consider additional variables such as expenses, growth goals, payroll, and target profit margins.

In essence, the HRT is similar to a flat rate in the traditional billable-hour model, but now it is only one of seven factors taken into consideration when determining service prices. My best advice is to talk with your accountant or financial advisors to determine your agency's HRT, but following is a very simplified way to look at calculating it using the industry standard benchmark of revenue per employee.

We will assume an agency has five full-time professionals with varying client-service hour capacities. For example, the CEO may be forecasted for 50 hours per month, whereas the assistant account executive is targeted for 140 hours per month. The agency's annual revenue per employee goal is $120,000, which translates into $600,000.

CEO	=	600 client-service hours/year (50/month)
Vice president	=	960 client-service hours/year (80/month)
Senior account executive	=	1,200 client-service hours/year (100/month)
Account executive	=	1,440 client-service hours/year (120/month)
Assistant account executive	=	1,680 client-service hours/year (140/month)
Total client-service hours	=	5,880

So, if the agency delivers 5,880 client-service hours, it would need to earn $102 per hour in order to achieve its annual revenue goal of $600,000 ($600,000/5,880 = $102 per hour).

Again, this is not the only option to calculate HRT, but it provides a basic structure to determine a starting point.

Costs

Are there any costs associated with the production and delivery that will be built into the price? This may include fees from partner agencies for services such as graphic design, video production and editing, or licensing fees. I suggest considering these costs when determining your HRT.

For example, you may decide that, on average, it takes your agency eight hours to write a 1,000-word sales sheet, and your HRT is $105. Your price would be $840, but that does not take graphic design fees into account. So you contact your preferred designer and negotiate a fixed cost of $500 on design. Now you have a price of $1,340, which you can leave as is, or round up to $1,400 to account for markup or to give yourself a little flexibility on your time estimate.

Is a 1,000-word, professionally designed sales sheet worth $1,400? That question leads us to our next factor, perceived value.

Perceived Value

What is the fair market value? What are clients willing to pay for the service? In many cases, this is the most important factor to consider. By drawing on your own experience and researching what other agencies are charging, you can often settle on pricing that fits market demands.

Revisiting the example sales sheet, you may determine that $1,400 is too low. You have been charging clients $1,800 to $2,200 for the same job for the last two years and have had nothing but rave reviews. So put the price at $2,000 and move on to the next one. You have now created a value-based price that meets client needs, and gives you the chance to earn more than your HRT of $105. Use your time-tracking system to ensure that future jobs are actually getting completed on time and on budget, and adjust the set price as needed.

In some cases, clients will put tremendous value on project work that has no measurable impact on the bottom line. This may be because they simply do not have the resources or knowledge internally to deliver the services your agency is capable of providing, or because of basic supply and demand rules. If your agency has capabilities that are scarce and in high demand, then you are in a strong pricing position, and I suggest you take advantage of the fundamental economics working in your favor.

Builder vs. Driver

Is the service designed to set the foundation for future success (*builders*) or to produce short-term results (*drivers*)? This directly affects the perceived value and what clients are willing to pay.

For example, if a client comes to your agency for support to create and grow the company's social media presence, it is going to take time before your services have any real impact. You have a lot of building to do, and, therefore, the client may not consider the services as valuable. On the other hand, say a client comes to you with a sales database of 25,000 prospects, and your agency plans and conducts a webinar that generates 1,000 qualified leads. That is driving real business results that organizations highly value.

We will talk more about builders and drivers in Chapter 8.

Loss Leader

Is the service designed to entice first-time clients with attractive pricing? Is it proven to create cross-sell and up-sell opportunities?

In retail, loss leaders are products sold at lower prices in order to drive sales of more profitable items. For example, we originally used PR and marketing plans as loss leaders, assuming they would convert into ongoing campaigns. We would charge a few thousand dollars and invest 100 hours or more of our top talent's time building incredibly comprehensive and valuable plans. Project-based clients would thank us, use the plan to justify hiring more staff, and then take everything in-house.

We have learned that plans as loss leaders are a bad idea, so I do not suggest replicating that approach. I highly recommend requiring clients to commit to contracts of six months or more before providing detailed strategic plans.

This goes for the business development process as well. Do not give away the whys and how-tos just to win accounts. If prospects or clients want plans for free, they will never truly value your agency's services and knowledge. This is a primary reason that requests for proposals (RFPs) are often so detrimental to agencies, and such a flawed system. Agencies invest significant time and energy developing creative and strategic concepts for prospects, and the organization only compensates the firm that wins the bid. RFPs are an archaic process that devalues agency experience and expertise.

Service Level

Will basic-, intermediate-, or advanced-level talent produce and deliver the service? Even if you are no longer charging hourly

rates, there is an hourly cost associated with every employee, so do the math.

A senior account executive making $75,000 per year in total compensation—salary, benefits, and bonuses—costs the agency approximately $32 per hour, while an assistant account executive earning $30,000 costs approximately $13 per hour. These hourly rates are based on 260 business days per year at nine hours per day, or a total of 2,340 hours.

$75,000/2,340 = $32.05/hour
$30,000/2,340 = $12.82/hour

Work that primarily requires basic-level service should cost less in the value-based model, and high-level services should cost more.

Consider the service-level factor in the example of an e-mail newsletter and a crisis-communications plan. Assuming both are completed in 10 hours, which is more valuable? I would argue that the crisis communications strategy, which requires advanced capabilities to devise, should be priced at two-to-three times the e-mail newsletter, which can be completed efficiently by an assistant account executive.

Remember, we are pricing on perceived value, and a strategic plan to mitigate risk and protect your client's brand is gold. When demand exists for advanced expertise, you have the opportunity to create and capture tremendous value. Always make your profits where they are justified.

Revenue-Efficiency Rate

Although estimated hours to complete a service are heavily weighted in the value-based pricing formula, prices are no longer based on how many hours it takes the agency to deliver services. Efficiency becomes the primary driver of success. So rather than relying on straight billable-hour reports to determine agency performance, we came to focus on revenue-efficiency rates (RER).

Simply stated, the RER measures how efficiently your agency turns one hour of service into *X* dollars in revenue, with *X* being the HRT.

The RER formula is relatively straightforward, once you know your target HRT. Let's say that your agency strives to generate $100 in revenue for every client service hour. The goal is to deliver the service as close to 100 percent efficiency as possible in order to achieve your desired profits. As we discussed in the previous section, you want to take costs into account as well. Here is how to calculate the RER of a completed project: RER = [(Price – Costs)/Hours]/HRT.

Sample 1: Website Project

Price = $20,000
Costs = $8,000 (graphic design and programming are outsourced)
Gross Profit = $12,000
Hours = 120
Hourly Revenue Target = $100
[($20,000 – $8,000)/120]/$100 = 100 percent

This is excellent. The agency's gross profit (or revenue after subtracting vendor fees) on the project was $12,000, and it invested 120 hours to complete the project. That means that it generated $100 for every hour of service for a 100 percent efficiency rating. Assuming that the services were provided by an account executive earning $45,000 per year, or approximately $19 per hour ($45,000/2,340 hours), the agency has plenty of room in there to cover operating costs, employee compensation, and a nice profit margin.

Now let's look at an example of how this can go wrong.

Sample 2: Marketing Plan

Price = $5,000
Costs = $0 (completed by internal staff)
Gross Profit = $5,000
Hours = 120
Hourly Revenue Target = $100
[($5,000 – $0)/120]/$100 = 42 percent

Marketing plans can be time intensive, and they often drain significant agency resources to execute. In this scenario, the HRT is $100, and, like the website project, it takes the team 120 hours to complete the project. At set price of $5,000, the revenue-efficiency rate is only 42 percent. In other words, the agency only generates $42 per service hour. To make matters worse, the marketing plan requires heavy senior-staff involvement, which costs the agency more to deliver the service.

The agency can absorb the inefficiencies as long as it is being delivered as part of a larger contract and campaign, otherwise it can be a major problem. But what is the alternative? Charge the client for all 120 hours at whatever the hourly rate is?

If we assume a billing rate of $150 per hour, then it would be $18,000 for a marketing plan that will be outdated by the time it is presented. Are there clients willing to pay that much for a plan? Even if there are, will you be comfortable with the value they will get from it, knowing how quickly plans change?

I would argue that with a 12-month contract in place, this is potentially a loss leader worth taking. Your goal is to build long-term client relationships, and this gives your team the chance to immerse itself in the industry and put a solid foundation for success in place. However, do not make a habit of taking on low-efficiency projects like this.

When Do Billable Hours Make Sense?

Even knowing all the challenges with billable hours, when variable scope is involved, they may be the only viable solution. This applies to services such as consulting time and media relations, which can be very difficult to forecast, given their dependence on variables such as ever-changing client needs and demand from third-party audiences.

For example, a PR firm may forecast 20 hours to make targeted pitches to 10 high-priority journalists, and coordinate any follow-up communications and interviews. If it takes 15 hours to research, craft, and distribute the 10 pitches, 5 hours are left for any additional work. However, when all 10 journalists respond and request supporting materials and onsite interviews, the agency realizes it dramatically underestimated hours.

My solution would be to define the known scope—research, craft, and distribute 10 highly targeted pitches—and commit to a value-based set fee for that first phase, regardless of how long it actually takes to complete. Then, have a contingency allotment of service hours available based on media demand. Although still integrating billable hours, this approach is preferred for a few reasons:

- Clients know exactly what it will cost to develop and send the pitches, and they agree to the value of that work, knowing it does not come with any guarantee of results. In other words, they see the value in the outputs provided by your firm, which they would prefer not to handle in-house.
- The up-front set fee forces your professionals to be focused and work as efficiently as possible, knowing that if it takes longer than forecasted, the agency, not the client, is losing time and money.
- The hourly-rate contingency will only be activated if the client will gain additional value from your services, because it only comes into play when the media responds and expresses interest.

FOCUS ON RECURRING REVENUE

There is an enormous, albeit unstable, market for project-based services. The success of solutions such as Logoworks, crowdSPRING, and the HubSpot Services Marketplace has demonstrated a rising wave of interest in affordable marketing support. As a result, agencies and professionals that figure out models to profitably meet growing demand for project work stand to prosper.

However, project-based work is less predictable, making it incredibly difficult to forecast workflow, expenses, staffing, and income. In other words, if you are planning to stay a solo practitioner or if you are building a distributed network of contractors, project-based opportunities may be exactly what you need. However, for those of you focused on building an agency, success depends on your ability to create recurring revenue from a diverse and stable client portfolio.

The goal should be to sign up the majority of your client base to long-term contracts, preferably 12 months or more, and to have 80 percent or more of your annual revenue coming from those contracts. This ensures a predictable and steady cash flow, assuming clients pay their bills on time, and it gives you the confidence to invest in growth and take the calculated risks needed to innovate and excel.

While building your contract base, your largest client should not account for more than 20 percent of your annual revenue. This rule is flexible if it is a long-time loyal client that has grown organically over time, but never for newer, high-risk accounts. You take on too much exposure, to borrow an insurance industry term, when you rely so heavily on one account.

No matter how good you are, there are too many variables out of your control that can lead to an account loss. We have had solid contract accounts disappear overnight due to bankruptcy, mergers and acquisitions, internal shakeups, and poor management decisions. On the other hand, we have also had to drop clients for a variety of reasons. You have to protect yourself and your employees. When accounts leave, you are stuck with the overhead, and you either need to quickly replace the business or make difficult decisions to cut back expenses, which may include staff reductions. You can mitigate your risk and give yourself the freedom to walk away from deadbeat accounts by having a well-balanced portfolio.

Chapter Highlights

- The traditional billable-hour system is tied exclusively to outputs, not outcomes, and assumes that all agency activities—account management, client communications, writing, planning, consulting, creative—are of equal value.
- The amount professionals are paid does not have a direct correlation to the quality or value of the services they provide, especially when you consider the impact of change velocity, selective consumption, and success factors.
- Distractions lead to higher costs and lower quality.
- Transparency in pricing builds trust, removes friction from the client-agency relationship, and makes it simpler to sell services to the mass market.
- If you can define the scope, you can standardize the service and assign a set price.
- The burden is on the agency to build systems and processes, and put the right talent in place, to profitably deliver services at set prices.
- The value-based pricing model takes seven primary variables into account: estimated hours, hourly revenue target (HRT), costs, perceived value, builder vs. driver, loss leader, and service level.
- Accurate time tracking in a value-based pricing model becomes more essential in order to monitor efficiency and productivity, evaluate employee performance, produce activity reports, and evolve pricing.
- If prospects or clients want plans for free, they will never value your agency's services and knowledge.
- Your goal should be to sign up the majority of your client base to long-term contracts, preferably 12 months or more.
- The largest contract client should not account for more than 20 percent of your annual revenue.
- Efficiency is the primary driver of success.