Profitability Management webinar with Marcus Petipas and Drew McLellan

16:59
Drew McLellan
All right, I'm going to start the recording now that the music is done, so welcome, everybody. Thanks for joining us today. I'm gonna share the screen, and then Marcel, if you want to kick it off, and then we'll go from there. We will. I'll be. We'll be watching the chat. We'll try and answer questions as we go. We have baked in Q and A time at the end, so feel free to hold your questions to the end, but we will try and get to all of your questions, so hang tight here. All right. Seeing my full screen?

17:47
Marcel Petitpas
Yes, I can see it. And for. For those of you on zoom that maybe can't see that screen, check the top of your zoom window. There'll be a little tab that says Drew McClellan screen, and that'll get you up to speed. So. All right, everyone. Hi, my name is Marcel Petipa, and I'm excited to be here today, joined by the one and only drew McClellan to talk about money. Everyone's favorite topic and the thing that hopefully we're all making in our firm. And if we're not making as much of it as we want, that's the thing that we're trying to solve for today. So Drew and I are going to be talking about mastering profit management. So before we dive in, a little bit about me. I run a company called Parakeeto, and we help agencies measure and improve their profitability.

18:29
Marcel Petitpas
We're building the world's first profit management firm. And essentially what that means is we bring together data from finance, delivery and operations and new business and bring it together. In such a way that it helps you answer the questions you're asking every day about your firm. Like, do we make money on the stuff that we sell and work on for clients? You know, do we need to hire people or fire people? Are we charging enough? Do we spend too much or not enough time on client engagements? And empower you with the data and the process to get clear on all those things. I also host a podcast and I get to help software businesses with the service side of their industry as well through SaaS Academy. So that's a little bit about me.

19:05
Marcel Petitpas
And I'll turn it back over to Drew to introduce himself, although I'm sure most of you know who he is at this point.

19:11
Drew McLellan
Now you never know. I'm Drew McClellan. I am the CEO and co owner of Agency Management Institute and the host of the Build a Better Agency podcast. We've been doing that for, gosh, over a decade now. Do a lot of strategic coaching, helping with succession planning and things like that, and just try and as best we can, be an educator. So.

19:37
Marcel Petitpas
Yeah, this is what we do at Parakeeto. I kind of covered it already, but just the spark notes. We help agencies measure and improve their profitability. And the thing that I'll just append to this is we're not like just a tech company that decided they wanted to niche down to agencies or like an accounting firm that said, oh, let's focus on agencies. The whole business was sort of built from the ground up with the idea that answering these questions is hard and there has to be a better way to do it. And so that's what we spent the last seven years doing. Back to you, Drew.

20:06
Drew McLellan
All right, well, at ami, our whole focus is elevating small to mid sized agencies by teaching them how to make the work of running their business. So we don't teach you how to do anything that's client facing, but we focus on the back of the house stuff. How do you run a more profitable agency and how do you make that easier and more systemized? And so we focus on what the agency owner should be doing. We focus on the team, new business systems and processes and what we're talking about today, finances. And the whole goal is to help you

build a business that's more stable and sustainable and if you want to someday that down the road that you can sell it. So that's what we focus on. All right, let's talk a little bit about core financial metrics.

20:54
Drew McLellan
So just so we have some vocabulary that's the same so gross. Billings, everything we bill a client. This is a very difficult concept for agency owners to grasp because when the holding companies or the Ad Week or Ad Age or any publications like that talk about agencies, and they always talk about them in terms of their gross revenue. But the reality is gross billings or gross revenue is simply a vanity number. And it doesn't matter because it's not your money. It's money that passes through your agency and it has no bearing at all on your profitability. The reality is it's all about adjusted gross income, or AGI. So if that's a term that you are not familiar with, if that's the money that you actually get to run your agency.

21:37
Drew McLellan
And so you're going to spend the adjusted gross income on three things, but the way you get to that number is your gross revenue or gross billings, minus all of your costs of goods. And what's left over is your adjusted gross income. That's the money you as a business owner get to keep and spend as you choose to spend it. And so we're going to talk a little bit about best practice of how and where you should spend it. So, cost of goods. This is such a confusing area. People are very confused about what it is. Some of them are simple printing media, software you use for clients. So if you're a media buying and planning agency, you wouldn't be paying for Strata or any of that software if you didn't do that work for clients.

22:18
Drew McLellan
So that's a cost of goods as opposed to an overhead expense. The big one is contractors 1099s here in the States, anybody who's not on your payroll is actually a cost of goods. And if you have a generalist accountant, they will argue with you about this till the cows come home. But the reality is they're a variable cost. You only pay them they when you have client work for them. And we'll talk about the variance in that in a minute. But they are a cost of goods. But other things like influencer fees, web hosting, all of those sort of things, those are just the cost of doing business with your clients, not the cost of running a business, but the cost of doing business with your clients.

22:57
Drew McLellan
So that is a hard cost that gets subtracted so that you can get to the adjusted gross income. So overhead, as you know, this is just the cost of doing business in general. So for those of you that still have an office space or you're in a wework, it's ren. It's what you pay your attorneys. It's professional Development fees, if you take a class or go to a conference, all of these kinds of things. So it's just basically business expenses, not tied to a specific project or a specific client. So when we have our adjusted gross income, this is the money that we get to spend. This is the ideal metric. So 55% of it is going to be spent on your people. So that's loaded salaries, 25% on overhead and 20% is left for profit.

23:47
Drew McLellan
Some agency owners will steal from one to the other. Unfortunately, where they mostly steal from is the profit bucket, not the overhead bucket. So many of you will struggle to get your salaries, your people cost to 55%. If you're going to do that, you got to steal from the overhead bucket, not the profit bucket. But we see oftentimes that's not the first place that we steal from, unfortunately. So again, this is where your general accountant will get this wrong. So all of your people, so if you're in the US, it's your W2. If you're in Canada, it's your T4 or your T4A. Those of you that are in Europe, it's your version. But basically anybody who's on, who gets a paycheck from you, those people get categorized in your AGI or people contractors in country or contractors international.

24:41
Drew McLellan
If they're doing work for clients, right, so they're doing web dev for you, they're doing SEO, things like that. Though they are a cost of goods. Now if you'd outsource administrative support, many agencies will outsource accounting, for example, that becomes part of your overhead expense. And if you have full time employees, which is, this is a new trend we're seeing quite a bit of over the last couple of years where these are people who

are not really contractors to you. If they lived in the United States, they'd be an employee. They just happen to live in another country. So you pay them differently. But the reality is they are your full time employee, they come to internal meetings, they're involved in all of the other parts of your business. They're a fixed cost, not a variable cost like we talked about before.

25:29
Drew McLellan
So those folks are part of your people expense or your AGI. So as you're sort of mapping this out, that's sort of where you would put all the different people to get to an appropriate AGI number. And I'm assuming somebody's w, are you watching the chat? So if I need to answer something. Yeah, somebody's like, okay, Great, we make 20% profit now. I have to pay tax on that? No, you're going to spend it in different ways, but we want you to get to an EBITDA of 20% and then we want you to invest it in places other than giving it all to the government. So typically you're going to spend about 25%. And again, this is going to be country by country different on taxes. Ideally you would take 25% of that profit and give it to your team.

26:17
Drew McLellan
And bonuses that are tied by the way to KPIs, not just because it's the end of the year and you're feeling generous, but you're going to want to tie that to performance. You should take 25% in bonus or dividends, depending on your legal structure, and then you're going to spend that other 25%. You're going to reinvest in the agency. You might have pass throughs expenses that you can use pre tax dollars for rather than post tax dollars. You might invest in other retirement plans like a defined benefits program. But the key is you want to be able to show the 20% EBITDA and then demonstrate this is how you spent that money because it's going to affect the valuation, the value of your business.

26:58
Drew McLellan
And so you want to be able to demonstrate when we, so when we do a lot of valuations for agencies and we always do what we call normalize the books. So we pull out all the things that the agency owner has run through the business, their car, their cell phone, travel. And that all gets added back as profit because it is profit that they just happen to take out in a different way. But you still need to shoot for the 55, 25, 20 so that your agency values properly when you go to sell it. It's one of the biggest sort of mistakes and regrets we bump into when we do valuations is that you have run the business so leanly that there's no profit left. And then it's really hard to prove to a buyer that they're buying anything of value.

27:46
Marcel Petitpas
Drew, we've got two questions in the chat that I think are worth addressing before we shift gears here. One is from Tessa. She asks about, you know, folks that have a business model where they intentionally have very few full time employees. They mostly lean on contractors, but those contractors are essentially making up the majority of the capacity in the firm. Does that color this in a slightly different way? How do you think about that within your framework?

28:11
Drew McLellan
Yeah, so if you, we have a couple agencies that all they, that they have no employees other than the agency owner and everybody else is a contractor, which means that they're doing a mix of client work, but they're also probably doing a fair amount of administrative work. They're helping doing the marketing for the agency and all of that. So in that model, you would have to look at that as your people cost. You would have to recognize that's going to be your 55%. Right. So if somebody is pure, if someone is that you only call on them to do client work, that's going to be different. But if they're doing a blend of client and agency service work, then in your case, you would use that number as your 55, because you don't have any payroll other than you. And.

28:58
Drew McLellan
And in some cases, you might not even be payroll. You might just pay yourself by dividends or distributions, and you may not run payroll at all. You have to be really careful about that. At least in the states, you have to be super careful about that, because as we all know, the irs, and by the way, your state frowns on the fact that you're calling somebody a contractor when really they're an employee. So you want to look at the. The list of reasons, the checkbox of, oh, they have other clients. Oh, I'm writing a check to a business rather than a person.

Other things like that make sure that you're protecting yourself from the question of should they really be an employee?

29:39
Drew McLellan
And by the way, am I not paying payroll taxes to my state or the federal government that they're going to come back and penalize me for? So just be careful about that.

29:48
Marcel Petitpas
Awesome. Yeah, we're pretty aligned on that. And I'll talk a little bit more about this, Tessa, when we talk in the next segment. Now, there's one more question here from Megan. I think this is related to when you were talking about either people costs. Yeah, I think you were talking about people costs, which is what about consultants? I think you've addressed this here in terms of outsourced admin support, sales support. That would probably go to overhead. But yeah, the question is, what about consultants, Drew?

30:13
Drew McLellan
Yeah. So if you are. If you have a consultant that doesn't work on any client work, then they're helping you with the business itself. Right. Then it would be an overhead expense, Megan.

30:23
Marcel Petitpas
Yeah.

30:24
Drew McLellan
No different than a lawyer or an accountant.

30:27
Marcel Petitpas
Perfect.

30:28
Drew McLellan
So for some of you, it might be a business coach or things like that. Like, you know, if you're paying Ami or. Or parakeeto for that kind of help, that we would be an overhead expense.

30:37
Marcel Petitpas
Yep.

30:38
Drew McLellan
Yeah.

30:39
Marcel Petitpas
Awesome. All Right. Well, with that, I'm going to shift gears here a little bit and talk about the sort of intersection of Parakeeto Ami. So just to kind of take a step back, you know, like, when I first got into this industry, Drew was the person that I was learning a lot of these fundamentals from. And what you've just witnessed is sort of like, to me, the starting point for every firm in terms of, like, how do I get a sense of if things are going well in the business or not, and that we're, you know, balanced in terms of how we're spending money across the firm. And that 55, 2520 rule, I think, is so elegant.

31:19
Marcel Petitpas
And it's funny because there was a point in time when I was like, I don't like this 55, 2520 rule because it's too simple and I wanted to make things too complicated. And over time, what I've realized is that's actually the

thing that's so elegant about it, because most of us, when we look at our P and L, there isn't actually that much sophistication going on in terms of delineating, you know, delivery versus non delivery costs, etc.

31:43
Marcel Petitpas
This sort of meets a lot of firms where they're at in terms of, you could go pull up your P and L today and you could probably get a sense of how you stack up against those benchmarks where without having to change your bookkeeping process, without having to do a whole bunch of nuanced calculations, dig into account levels, your books are probably already structured very closely to that, if not already to that framework. And if you did need to make modifications, your accountant's not going to want to kill you. Whereas a lot of what we do at Parakeeto is more advanced and is also a lot more heartburn and a lot more work.

32:16
Marcel Petitpas
And so what I'm going to talk about here next is sort of like, if you want to go a step further and into understanding why you might not be achieving these ratios, how you can dig a little bit deeper, do a little bit more work, but also get a little bit more insight and hopefully start to get clear on what you need to do to get to a better place in the firm. So in order to do that, I'm going to go ahead and share my iPad screen here, and hopefully I'm spotlighted and everybody can see me.

32:45
Marcel Petitpas
But essentially what I'm speaking to here is where we go from, I think, what we just talked about, which is essentially some of the value that you can get from Finance in understanding how the business is doing and now shifting into what we would call profit management, which is sort of where you start incorporating insight from operations and delivery and to some degree, insights from what's happening in new business. Because the blessing and the curse of the finance department is that they're going to be looking at retroactive data, and that data is going to be very precise. And there's a reason for that. You. You might go to jail if you mess this up. Right. It's. There's. There's some stakes here that are pretty high. There's some requirements.

33:26
Marcel Petitpas
And so finance is going to give you a very accurate picture of what's going on in the business, and it's going to be very precise. But the challenge is it's often only getting to you a few weeks after the month is over. You're sort of looking in the rearview mirror, and you might be able to see that there's a problem, but you might not necessarily have all the insight into why you have a problem. For example, our labor costs are 65% of AGI. Okay, well, we know that's a challenge, but why is that? And there's a bunch of reasons that could be. So what I want to talk about today here is, you know, one of the three ingredients for profit management today.

33:59
Marcel Petitpas
And I want to focus on framework, which is really talking about what are the metrics that we need to pay attention to, the. The formulas for how to measure those and the relationships that those metrics have with your business. What we won't be talking about as much today is the tools and the data and the process to actually get this going inside of your business. But we will share some resources towards the end, if you want to dig deeper into that stuff and learn more about what it looks like to do this in practice. So with all of that said, I'm going to talk about the slightly different way that we talk about this at Parakeeto.

34:32
Marcel Petitpas
And those of you that have been following both of us, you'll know that we have a slightly different way of approaching this, but why they're not actually different. Right. So we also focus on agency gross income. I think that's critically important for all the reasons that Drew discussed. And one of the things that we try to do in this sort of next level of complexity is differentiate between what we call delivery costs and overhead costs. So we know from Drew's explanation here that AGI is a function of gross billings. Right. So all the money that comes into the firm, minus cogs or what we sometimes call pass through. So that gets us to agency gross income.

35:11
Marcel Petitpas
And then the next question that we're now trying to answer in this, again, somewhat more complex version of

this is how much of the agency gross income actually went into doing delivery work within the firm. And our goal is generally to keep this under 50% of agents or gross income. Now, here's the problem with measuring this. It's the reason that it's hard and not a lot of people are doing it, is in order to do this, we have to go through every person on the team and figure out, well, how do they spend their time? What is their job? Some people are going to be 100% delivery. Some people are going to be only partially allocated to delivery.

35:52
Marcel Petitpas
So if we have all of our payroll going into one account on the P and L, we got to start to do some work to separate those things out. That can be a lot of additional cost in the accounting side. And the same thing is true about things like software or other expense accounts in the business that might be shared between delivery and overhead. We need to start to spend the time to delineate those things. So it is quite a bit of extra work, but it gives us a good amount of insight into how much are we actually spending to run the delivery portion of the business versus what we're spending on overhead. In our model, this would be inclusive of payroll that goes towards overhead. And the goal here is generally to keep this under 30% of AGI.

36:32
Marcel Petitpas
Now, here's the thing that's kind of funny. It's basically impossible to accomplish this and also not accomplish everything that Drew just talked about. So that's the nice thing here is like, if you're hitting the 55, 2520 rule, you're. You're probably also accomplishing this. This becomes useful if you're not accomplishing the 55, 2520 rule. And you want to get a little bit more insight into, well, what exactly is going on here? Now, I'll save you some time. The vast majority of firms, their biggest issue is that their delivery cost is greater than 50% of their agency gross income. So in other words, it's costing more money to earn their revenue than it should. And that could be a function of underpricing. It could be a function of over servicing or anything in between. Really, it can only be a function of, you know, three things.

37:22
Marcel Petitpas
So all of this should equal 20 to 30% profit, right? Or more. If you can accomplish it, all the power to you. And so I want to talk today about Essentially, what are the three main things that you can do to increase the delivery margin of the business and therefore give yourself more optionality to achieve greater profitability? And there's really only three ways to do that. And it comes back to, you know, our delivery margin formula. So if we think about this, we have agency gross income minus delivery cost over agency gross income. Right? So if we think about this in the simplest possible terms, we can either earn more money with the team that we already have and not spend more on that team, or we can spend less money on the team without decreasing the amount of revenue that we earn. Right.

38:15
Marcel Petitpas
Great. Thanks, doc. That sounds awesome. But how do we actually accomplish that and how do we get leading indicators into that? And really, there's three ways that we can do it. The first is we can start to control for average cost per hour. And this is really a proxy for our delivery cost. So the big idea here is we could start to run reports that look at different projects, different clients, different types of work within the business and get a sense of, on average, what is the cost of an hour of labor on this type of work. And to the degree that we can start to lower that cost of labor, we can start to, over time, decrease our delivery costs, or as we scale our revenue, our delivery cost scales at a slower rate.

38:59
Marcel Petitpas
And so functionally, what that looks like is we have a $150,000 a year person that is very experienced that's doing a whole bunch of different things. When we do brand design for clients, is there anything that person is doing that we can build? Better training, better documentation, better templates, better technology supports, better process so that somebody less experienced and therefore less expensive can complete a larger share of that work. So the next time we need to start hiring people, maybe Instead of hiring two people that cost 150 grand, we can hire one of those and a more junior designer or brand strategist that costs less money. And in doing that, we can again compress or slow the rate at which our delivery costs increase relative to our agency gross income.

39:48

Marcel Petitpas
And for those of you that do have a lot of contractors in the business, the latency can be a lot shorter here because as you shift towards lower cost contractors, you're going to see that hit the bottom line quicker. So that's how we control for the cost side. Now, the other way that we can think about this, and this is the one that's most interesting to me, a lot of the times this gets me the most excited, is how do we get more productive and Earn more value with the team that we already have. And there's two ways that we can accomplish that, or two leading metrics that we can think about. The first is average billable rate. An average billable rate is essentially a function of how much money do we earn for every hour of effort that we put into client engagements.

40:29
Marcel Petitpas
So just to look at the formula of this very closely, to measure average billable rate, we take agency gross income and we divide it by what I call delivery hours, which is not necessarily the same thing as a billable hour. Because I don't care if you build the client for it. I care that the time got spent working for the client. Right? So if you mess something up and you spend 150 hours, but you only build the client for 100, well, your average billable rate on that engagement is whatever you got paid divided by however much time it took you to get the thing done. Now, this is the same formula. No matter how you bill clients, Whether it's hourly flight, flat rate, value based pricing, time and materials, weekly sprints, percent of ad spend, it doesn't matter.

41:17
Marcel Petitpas
All we care about is what did we get paid after subtracting the cost of goods sold that Drew talked about, and what did it take to get it done. And in calculating it this way, we can really normalize this formula and compare everything apples to apples. And this gets really insightful, where we can start to run reports like this one, for example, where we're looking at different projects, getting an understanding of how efficiently did we actually earn money. Right? Most clients without this information over here, they would look at this and say, well, obviously the website was our most profitable project. We got paid the most money for it.

41:51
Marcel Petitpas
But when we factor in the efficiency with which we earned revenue, we start to realize, like, actually we got paid twice as much money for this, you know, little funnel build project for every hour of effort versus the website build. And so in theory, if we could do all of our work at this rate, we would earn twice as much revenue as a firm without changing any of our cost structures. That sounds too simple to be true, but it's not my opinion. It's just math. That's how this business model works. So this can be a really insightful metric because it can help point you towards things that could be more efficient. So that might be the conversation we have around the website build. Did we miss something here? Did we underprice it? Is there something about our processes getting in our way?

42:34
Marcel Petitpas
Is there something about this client that we should have been more on Top of when were onboarding them. And similarly, with the funnel build, we might say, hey, what's going on with funnel builds that we can learn from and apply to the other work that we're doing? Why are we so efficient at getting this done? You know, the client's happy, the work is good, and we can find opportunities to get more efficient here. And a little hack for you. If you can measure your average billable rate and your average cost per hour, you can do what I like to call Kirkland brand delivery margin, and you can start to get a sense of what the margins are on your work on different areas of the business.

43:05
Marcel Petitpas
With these two simple numbers that are created by operations data, you don't have to wait for your accountant to do some big, complicated cost accounting or project accounting process to figure out if a project is profitable or not. You can use time tracking data and a little bit of information about your team and about how much you're getting paid and get a directionally accurate sense of how things are going without relying on the accounting team. So that's a little hack for you. So the last thing I want touch on here, and this is one that Drew's going to talk about a little bit more as well, is the last and probably the most important but also the most misunderstood metric in the agency space, which is utilization. Some of you worked at a big consulting firm in the past or a big agency.

43:49
Marcel Petitpas
You got hives when I said this word. This is the last and probably one of the most important vectors for how much revenue you can generate with your team is how utilized are they. And the simple way to talk about utilization is what percentage of the time that you buy from your team actually gets used to do client work. And so the simple way that we think about measuring this is we take delivery hours. So this is the time that was spent doing work for clients. And we divide it by gross capacity. And this formula is the same whether you're measuring one person or you're measuring a group of people, whether it's a department, the entire team, one individual person. And this can really help us get an understanding of, is our team busy enough?

44:35
Marcel Petitpas
Is there a part of the business that's super busy, but another part that's not? And essentially, are we letting the inventory that we buy, which is people's time, go bad in real time, and we're just paying for that and it's waste? And we could be doing a lot more work, but we're not? Or we theoretically could be doing a lot more work but there's an operational issue that's holding us back from being able to accomplish that. Or maybe there's some assumptions about people's capacity that are totally off and totally unrealistic. For example, they should be billable 40 hours a week. I would argue that's probably not a realistic expectation in 2025. So these are the kinds of insights we can get. I won't, I won't labor you with the detailed calculations with this, but I can provide that later.

45:15
Marcel Petitpas
So I want to just finish with a really quick example of how these things work together to bring this to life. So let's imagine we have an agency here. They have a capacity of 100,000 hours per year. So this is, you know, roughly a team of 50 people. They spend $3 million a year on delivery costs. That's the payroll and, you know, the other expenses that go into delivery. And they spend a million and a half dollars on overhead. So that's the payroll and expenses that go into overhead. So in the first example, this firm is utilized at a rate of 50%. So 50% of their 100,000 hours get used for client work. That's 50,000 hours. And on average, across all the things that they do, they earn about $100 for each hour of effort that goes into client work.

45:56
Marcel Petitpas
So bonus points to anyone inside the chat that can do this math. How much money can this company earn in a given year? The answer is 50,000 hours multiplied by $100 per hour, or $5 million in AGI. Now they spend 3 million to get that work done. So they have a 2 million dollar delivery profit, which is a 40% delivery margin. And then they spend another one and a half million to run the business. So they end up with a 500k profit or 10%. So it's not bad, but it's not great. Now, in example number two, they managed to get their utilization up to 60%. This firm can now do $6 million with the same team, assuming nothing changes about their cost structure. They now earn 3 million in delivery profit and $1.5 million in bottom line. That's a 25% net profit.

46:52
Marcel Petitpas
And in the final example, they maintain that utilization and they're able to get their average billable rate up to 125. And maybe they do this without raising at all. They just get more efficient. They spend fewer hours to get things done and therefore they can take on a few more clients because they're better at what they do in terms of process. Now they can earn $7.5 million. With their same team, same cost structure, they earn four and a half million dollars of delivery profit, which is a 60% delivery margin. And now they're at a three million dollar EBITDA which is 40%. And we haven't talked about cutting average cost per hour. We haven't talked about cutting overhead. We haven't talked about really any cost reductions. We've just focused on two numbers, utilization and average billable rate.

47:35
Marcel Petitpas
And we've been able to take their profit from 500k to 3 million. So that's why these simple numbers are so powerful. And if you have a good grip on these, you will have confidence in your P L before you ever get it and be able to focus on the right lever operationally to lead you to the outcomes that you're looking for and get those ratios looking more healthy on the P and L. So that's my shtick when it comes to the sort of operations side of profit management and how that ties back to financials. And with that I want to turn it back over to Drew and

we're going to talk about a couple of tactics now on how to actually improve profitability and move some of these numbers.

48:17
Drew McLellan
All right, so are you guys seeing my screen now?

48:24
Marcel Petitpas
Okay, great.

48:25
Drew McLellan
So we're gonna talk a little bit about pricing. First of all, we just cannot get this right. I, I don't care how you do it, you're going to be wrong. You can just assume you're going to be wrong. And we can't get it right when it's wrong from the get go. So when we build our estimates by default, we have to start with the right number. And even if, when we start with the right number, we have to accept that we're still wrong. So here's the reality. So the way, and it doesn't matter, as Marcel said, it doesn't matter if you bill by the hour, time and materials, if you value price doesn't matter. We still figure it out the same way. We still ask ourselves, how many hours is this going to take? How many hours is that going to take?

49:00
Drew McLellan
We have a billable rate that we're going to multiply it right by Right. So 175 to $200 an hour. But by human error, we're always going to get it wrong. And so we have to start knowing that we have to fix the fact that the methodology, and if somebody has a methodology, we go back and we look at past ones, we do whatever, but we're always going to be A little bit wrong. And. And that's okay because we can fix for that for a second. So, first of all, the first mistake we make is that many of you are still billing at an hourly rate. Even if you don't bill the client by the hour, you use some sort of hourly rate to decide how much to charge a client. Many of you are south of 175.

49:43
Drew McLellan
And in today's world, with the cost of employees and everything else, it's very difficult for an agency to be profitable if they're not at $175 or higher an hour. So, number one, the first place we get it wrong is that we are devaluing an hour of our time. And so if you're still at $150 an hour, which was kind of the norm for, like, the last decade, if you have not post Covid adjusted that to 175 or 200, by the way, if you're a PR firm, you probably get away with 225, even 250 an hour. But if you can't justify that, then maybe the question you need to ask yourself is this thing we're delivering really of great value to the client? We're seeing more and more agencies like making this stuff getting marginalized.

50:29
Drew McLellan
And it really is about the strategy and things like that and the outcomes that we deliver. If we cannot prove an outcome, then it's hard to charge anybody $200 an hour for something. So, number one, got to be at 175 or $200 an hour. And number two, this relates to. No, I would say hourly rates are not significantly different in the US And Canada. They may be different in other parts of the world, but we haven't seen a big variance. But in North America, honestly, the other thing you need to think about is, as you're thinking about, can I afford to hire another person? If I'm looking to add to my staff, I need about $175,000 of AGI to add a person.

51:15
Drew McLellan
Which means that if I'm at that 55%, remember, 55% of loaded salaries, or my AGI is loaded salaries means my average salary is around $96,000. So those two factors keep that in mind. But then we have to remember that our estimates are wrong. Here's what happens when we do estimates. We go around and we say, drew, you're going to write this. How long is it going to take? And I go, oh, a landing page. I can write that in two hours. They say, oh, Marcel, you're going to Lay that out. How long is it going to take? He's like, oh, I can do that my sleep. I've done a million of them and do that in an hour. But we. And that is true.

51:50

Drew McLellan
If I was uninterrupted, if I had gotten eight hours of sleep, if my slack wasn't pinging, if I wasn't worried about the fact that my K kid's about to get kicked out of kindergarten, all the things that influence our brain, I probably could write it in two hours and he probably could lay it out in an hour. But that's not true. That's not actually how we work. So our estimates are always shy, almost always shy. So if you go around the horn and you figure out how much everybody's going to do their part and you multiply it by 1.3. I know this sounds ridiculously simple, but AMI is all about keeping the math simple. If you multiply by 1.3 to protect your profit, that's almost always where you're going to land. And that's really what it's actually going to cost.

52:34
Drew McLellan
So you're not padding it right. You are just actually allowing for the error in setting your estimate. So take into account that we're going to do our estimates better. But the other part that Marcel started to talk about was this idea of utilization. So we think of it as opportunity lost. And you'll see in the deck, we calculate this a little differently, but you kind of get to the same place. So we look at an Employee's year is 1920 hours. How did we get to that? It's 48 weeks times 40 hours. So assuming between vacation and holidays they have about four weeks off, you might have to adjust this if you're super generous with time off or holidays or whatever.

53:19
Drew McLellan
But we say, okay, we're going to take the number of employees we have times 1920, and that gives us our capacity for the year. So that gives us how many hours we have. So If I have 10 employees times 1920, that means I have 19,200 hours. That's my total number of hours. So back to the capacity issue that Marcel was talking about. The goal. And Sarah, I'm answering your question now that you asked in the chat. The goal is I'm looking at all the hours. Billable people, non billable people. Why? Because the billable people have to pay for the non billable people. Right. So we still have to have enough money that we are able to maintain that ratio of the 55, 25, 20. So 75% of all available hours.

54:05
Drew McLellan
So 10 people times 1920 is 19275% of those hours should be spent on billable tasks, knowing that we're not going to be able to bill every client for every billable hour we want to get to 60% of. Again, that 19,200 hours translates to an invoice. So again, it doesn't matter how we bill. I'm just going to take that, whatever that 60% is, I'm going to multiply it by my billable rate of 175 or $200 an hour, and I'm going to see how far off I am.

54:41
Marcel Petitpas
Right.

54:42
Drew McLellan
I'm going to see. So I'm going to see how much I left on the table when we come in and we do an audit. And Marcel, I'm curious where you would come in this, but when we come in and we look at how much of an agency's time actually translates to an invoice for a client, it's usually 40% or less. So that's what they're leaving on the table. You're paying for those people and you're not getting the ROI off of that because you're not being thoughtful about how they're spending their time. And is that time translating to an invoice? Okay, by the way, you can typically afford one non billable person for every five fts with this ratio. So you can do the math, right?

55:28
Drew McLellan
So you just figure out how many hours you spent on billable tasks over divided by the number of total hours, and you'll see where you're at. So in my example, so again, when we come in and we do an audit, let's say this agency's at 45, almost 45 and a half percent of the time that they have at their disposal. Their time inventory is actually billed to a client. So their bill, their AGI at the end of the year is about 1.5. If they were at the 60% that is the gold standard, they would be billing without a new client, without a new project, without anything. Their AGI would be at $2 million. So they're leaving a half a million dollars on the table. Okay. All right, back to you, my friend.

56:18
Marcel Petitpas

Yeah, man, I'm so glad you touched on that, because it is. There's basically two main reasons that firms aren't profitable, and half the time it's utilization. It's exactly what you just described. It's like we could theoretically be doing 2 million in revenue, but we're only doing 1.5. So there's the entire bottom line in some cases and then some, and then the other side of that. And this might resonate for the folks where your accountant keeps telling you that you're overstaffed, but every time you talk to your team, they're like, you need to hire three people yesterday. Usually for those firms, they're significantly underachieving on average billable rate. So you think that you're charging 1,75 an hour, but then by the time you spend double the amount that you expected to on every single project, you're actually only effectively earning half of that.

56:58
Marcel Petitpas
And therefore, even though your team is maxed out and busy, you're still only earning, you know, X amount of revenue because you're spending so much time to earn it. So one of those two things is often the crux of why a firm is underperforming. So with all of that said, I want to talk really quickly about how we typically encourage clients to think about pricing, especially when you have multiple pricing models inside of your firm. And if some of you on this call today saw the hourly rate target that Drew put out and you thought, well, that doesn't really apply to me either.

57:32
Marcel Petitpas
A, because like we charge way more than that, or B, because like we could never charge that much in our market or based on the work that we do, or we don't need to charge that much cause our staff is lower. I want to talk really quickly about a delivery margin based formula for this. And so I'm just going to switch to my iPad again and I will spotlight myself and hopefully everybody will be able to see that. And so here's the big idea is for no matter what billing model you're doing, or if you are setting your rate and you're trying to figure out like what does our rate need to look like because you have much higher, much lower staff costs than the average firm. This is how I would typically encourage you to think about it.

58:11
Marcel Petitpas
The first thing you want to understand is what is your direct delivery cost, Right? So essentially, like, what does it cost you to get this project done? If you're thinking about this in terms of hourly rates, you would just think about the average cost of an hour of labor for your firm or for that role or however you're structuring your rate card, then you want to divide that by one minus your margin target. And then in the case of a project, if you do have cogs or pass through expenses, you would add those after the fact. And so what this ends up looking like in practice. We'll go through an example together. Let's imagine we're scoping out a project. We figure out, okay, it's going to cost us about $2,000 worth of time to get this done.

58:57
Marcel Petitpas
Let's call it a hundred hours at twenty dollars per hour for the staff that's going to work on this and we're going to have $10,000 of pass through costs. And our margin target on this project is 75%. And I know that might seem really high, but 70ish percent is the floor for most firms if they want to be able to afford to make a few mistakes, have a couple of projects go sideways, maybe have a couple of utilization issues throughout the year and still end up with that 55, 2520 ratio, or you know, the ratios that we would typically measure, which is 50%, delivery margin, overhead under 30 and profit. Right. You need to leave some room in your per project estimate to pay for sort of the inefficiency that occurs when you look at the whole business.

59:37
Marcel Petitpas
So in this example, the math would fall out as follows. We would take our $2,000, we would divide it by 1 minus 75%, which.

59:51
Drew McLellan
Is, I'm just looking at the chat. The $2,000. Marcel, that's your hard cost of those human beings.

59:57
Marcel Petitpas
That's correct. Yeah.

59:58
Drew McLellan
Yeah, right.

59:59
Marcel Petitpas
So in this example, I would say, okay, it's going to take us 100 hours of this person that costs $20 per hour. There's an entire other webinar on average cost per hour. What's included in that, what's not included in that? I can provide some resources in the chat and at the end to dig deeper into that. That's a whole other monologue, but I digress. So in this case, if we take 2000 and we divide it by 0.25 right off the hop, what we see is that we need to be earning at least $8,000 in AGI on this project. Right. And then what we also need to be able to do is cover all the hard costs or the cogs that are going to come out of this. So that's an extra $10,000.

01:00:41
Marcel Petitpas
So you add those two things together for this engagement, I would need to charge at least $18,000. That's my floor if I want to achieve this margin target of 75%. And, and hopefully what I've also done is, as Drew pointed out earlier, I've added a little bit of contingency to this cost estimate. Alright, so I'm confident that this is actually going to make sense and that this is going to get me to where I need to be. So this is a helpful formula, this sort of minimum price formula. If you have maybe a more complicated or not a rate card based way of pricing, or you have a lot of different pricing models going on, or maybe you just. The industry benchmarks that apply to most firms don't necessarily apply to your situation.

01:01:21
Marcel Petitpas
And then the last thing that I will talk about here is revenue replacement. So one of the my favorite tactics for improving profitability in a firm, which is really applicable to those of you that have recurring revenue in the business, is very counterintuitive, but I think needs to be paid attention to, which is the idea of revenue replacement. Especially when you have a lot of recurring engagements and especially when you have the blessing and the curse of incredibly good client retention. What often happens is over time, your most loyal clients become your least profitable. And I've seen this get so bad that in some firms, we found that they were actually paying money to work with their clients each month in the sense that the labor cost that went into that client was greater than what they were making in agency gross income.

01:02:10
Drew McLellan
Every one of you has a client on your roster where you are paying for the privilege of doing work for them. Guarantee it, every one of you, if you have not done some cleansing. And this will make you cry when you do the math and you figure it out, but I promise you're paying for the privilege.

01:02:26
Marcel Petitpas
So with that being said, this is part of the reason that in some cases you get bigger, you have more revenue, you have more people, but yet cash flow just kind of seems to be getting worse all the time and the profit's not there. And you wonder like, what's going on? It's all this indigestion that often stacks up in recurring revenue businesses, especially with rev with legacy clients. Now, one of the best times to do something about that is when your utilization is high. In particular when you're getting to the point where you're like, we might need to start thinking about hiring people if we close any more new business.

01:02:58
Marcel Petitpas
And when you get to that moment and you get that next client, rather than do the thing that most people have been doing the whole time, which is throw the client on top of the pile and then go out and hire more people, take a moment, run an average billable rate analysis on all of your clients, right? Just look at what are we getting paid, how many hours is going in, who has the lowest average billable rate? Go to that client and we use the three R's. Right. Can you a recapture the scope that they're not paying for and say, hey, here's all this extra work that we're doing. This is what it would cost. Or can we build them extra hours or however that engagement is structured? If they say no, then you go to re scope. Okay, great.

01:03:36
Marcel Petitpas
Well, can we adjust the scope of your engagement to fit within the budget? If they say no, you go to number three, replace. No problem. My concern is that, you know, we're not going to be able to meet your expectations in the scope of this work. So I want to introduce you to another firm that I think is a better fit for you going forward, and you replace that client with the new client that probably has the latest rates and a fresh scope and a good relationship and way more profit. And in doing that, you've just increased your agency gross income, you've increased your profitability, you've increased your revenue, but you haven't actually gone out and increased your cost basis and hired more staff.

01:04:11
Marcel Petitpas
And you'd be amazed that you know by the time you go through five or six clients, most of them are going to agree to better terms. And when you finally replace a client, you're going to have significantly improved the profitability of the firm. And when you do go back to growing, you'll have more oxygen to do it. And I mean, we've worked with clients that could grow 60% year over year and increase their profit by 3 or 400% without adding a single client to their business just by pausing the growth and focusing on revenue replacement for a few quarters. So think about that the next time you're really busy. Take a moment to appreciate that and consider, can we use this leverage to tidy up some of the client relationships that we know are sort of creating drag on the business?

01:04:57
Marcel Petitpas
So with all of that, Drew and I have some free resources and I want to make sure we take a couple of questions before we wrap up. So I'm going to add you to the spotlight here, Drew, and then we will open it up for Q A. So if you have a question, go ahead and let us know in the chat and we will try to get it addressed here and we'll drop some resources as well.

01:05:22
Drew McLellan
I'm going to show some.

01:05:30
Marcel Petitpas
So I'm going to put a link in the chat.

01:05:31
Drew McLellan
Click on my screen, you'll see I'm going to show you the URLs. If you have to scoot out at the top of the hour, I don't want you to miss this. So if you go to parakeeto.com backslash toolkit.

01:05:43
Marcel Petitpas
That's right. So that's essentially a free course that goes much deeper into the things that I talked about today and provides you with a bunch of tools and resources and cheat sheets to implement that and go a lot deeper. So encourage everyone to check that out. It's no cost to you. And you can unsubscribe from my emails if they annoy you.

01:06:03
Drew McLellan
And then we've got some tools as well, including a discount on a workshop that we're teaching where we talk about this stuff for two days. And it's also where you will find the replay of this video. The deck is already there, but the replay will be there in a day or two, so you can get that as well. So, all right, what questions do you have for us? And by the way, most of your clients that you're losing money on are they know that they're taking advantage of you and they're waiting for you to say something, but they are not going to go, hey, by the way, you should bill me more. But when you say, you know what, we're losing our shirt and we've been doing this for a long time, we need to make some adjustments.

01:06:39

Drew McLellan
They're oftentimes in their head and sometimes right out of their mouth they'll go, yeah, I've been waiting for this conversation. So. So you're much more hesitant than you need to be.

01:06:49
Marcel Petitpas
That is true.

01:06:50
Drew McLellan
Does what link work?

01:06:53
Marcel Petitpas
We've got some questions in the chat. I'm going to start with Sarah. She asked, you know, what are some tools and platforms that efficiently help agencies capture and measure utilization? It's a good question. There's a lot of course, there's a ton of time tracking tools out there. The challenge that most people have with time tracking tools and measuring utilization is most of them don't have a concept of capacity. So what they do to measure utilization is they say what percentage of the hours that were tracked in your time tracking tool were marked as billable, which is not really utilization rate because it assumes that people tracked 100% of their time, which has never happened in the history of anything ever.

01:07:28
Marcel Petitpas
And what it also assumes is that the way that you are using the object of billable in the time tracking tool is correct, which is also often not true. People are marking internal times as billable. They're marking client stuff as not billable. Like the convention around. That is not necessarily correct. So for most people, a spreadsheet is going to be the answer or some kind of, you know, transform process where you extract the data and actually get that to be accurate. And that should be connected to some kind of model of your capacity.

01:07:59
Marcel Petitpas
But there have been some tools that I've seen out there that do a bit of a better job of this float is one that I think does a decent job and also does some resource planning which can be an alternative to timesheets in if your team isn't spread across too many different projects at once, you could actually just use the resource plan as the source of truth for times going as opposed to timesheets. So hopefully that's helpful. Sarah, I don't know if you have.

01:08:22
Drew McLellan
Anything Melissa's asking, do you have insights for working with a tax or accounting firm for your business who wants your books to work best for tax purposes but isn't helpful in pulling ratios? Well, first I will tell you, I just want to remind you that they actually work for you and you pay them money. So you need to it's sort of like a doctor, you sometimes you have to tell them how you want to be taken care of. Number two, I would say generalist accountants are much harder to work with than accountants that specialize in agencies. An accountant that understands the agency business model is much more likely to be more pliable to the way you want to do the books.

01:08:58
Drew McLellan
But honestly, we'll set it up that way to begin with because they understand what you're trying to do and why you're trying to do it. But often times if you set up your I'll add we have a sample P and L. I'll add that to the free pages. The free page. If you have your P and L set up that way, then honestly, you can pull most of that data very easily on your own if you have to, or your software, even QuickBooks, will pull most of those reports for you.

01:09:26
Marcel Petitpas
I'll just add to this that, you know, I heard an accountant say this once and I think it was really astute, right? Like, why would you optimize your books for 12 months out of the year for something that only is relevant for

one month out of the year and the other 11 months out of the year, you don't have insight into how your business is performing because you're doing what you do to minimize tax, which is obfuscate how well you're performing. You know, ideally to minimize the amount of money it looks like you're making to pay less tax. So my argument is I would focus on doing accounting in A way that is accretive to making management decisions.

01:10:01
Marcel Petitpas
That's likely accrual accounting, maybe gaap, working with a firm that specializes in that and then loop in the tax people at the end of the year and make whatever adjustments you need to make and do them in a way that's like very easy to back out when you run your management accounting reports the rest of the year. And this is why, you know, generally speaking, I'm not a huge fan of like bookkeeping being done by the tax firm because again, like, they're just going to be biased towards like what's efficient for us to do our thing at the end of the year. But that sort of gives you a handicap for the other 11 months, which I don't think is very great.

01:10:36
Drew McLellan
And it also is the difference between a tax strategist and a tax preparer. Somebody who just wants to make their job, their own job easy is probably not the right tax advisor for you.

01:10:47
Marcel Petitpas
I want to talk to Ruben's question here. I think it's a good one. Right. Which is how do you talk to clients in such a way that they'll realistically consider value based pricing? You know, it seems to be a struggle to kind of justify moving away from time materials with some clients. I have an initial thought on this and I think Drew will have some too.

01:11:08
Drew McLellan
Yep.

01:11:08
Marcel Petitpas
The way I think about shifting to a different pricing model, whether it's value based pricing or even just abstracted time materials, which I like for high risk, high value work or flat rate fees, and is to me the first sale that should happen is the methodology that is most likely to get the client to the outcome that they want. So in the case of value based pricing, you know, the first thing that I would be focused on is like, what is the way of working together that is most likely to get the client to the outcome? And once they agree on that, then this contract model should enable that way of working together. Right.

01:11:46
Marcel Petitpas
So for example, if you're like, hey, you know, this is a big challenging problem and we want to partner with you and be able to just like keep making changes and keep adapting and keep working and not have to stop every time something in the scope changes, to be like, this is how much it's going to cost. Do you approve this? Do you not approve this? Like that's just going to get in the way. Right. So I suggest that we work this way and therefore I suggest we set up the contract so I don't have to stop and bug you every time something changes. We can Just react and take the lead and own this and drive towards the outcome, then I think it's much easier to justify the pricing model.

01:12:19
Marcel Petitpas
I think where we get into trouble is when we just arbitrarily try to like shift to a pricing model, but it's not actually helping the client relationship get better. When you align those two things, I think it does get easier. That's my take.

01:12:32
Drew McLellan
Honestly. I think when a client understands flat fee, whether you call it value pricing or project pricing, whatever, but it's not time and materials. When they actually understand that once you agree on a very defined scope and a price point for that scope, it's now on the agency to manage their time and expertise to hit that

number. And if they don't, then that burden falls on the agency. So as long as the client doesn't go outside of scope, then it's really the agency's responsibility to bring in whether they bring in that project at a profitable level or not.

01:13:07
Drew McLellan
And so one of the ways to help clients understand that is that they really minimize their risk with a flat fee price or a value based price because they've agreed to a set of deliverables for a, a certain dollar amount and now all of the burden is on the agency to deliver for that. And again, the other burden on the agency is to manage the scope so a client doesn't go rogue and ask for a bunch of things that you just do for free. But that's, it's, it actually is much friendlier to their budget. It's also a way for them to budget better because they don't have to, you know, time and materials, they're not quite sure what it's ever going to be on any given month or quarter.

01:13:47
Drew McLellan
Whereas again, with a fixed fee price, again, whatever language you use around that, they can budget for that better. And so it's actually to their advantage.

01:14:00
Marcel Petitpas
I love it. Tessa has a great question here. Can you elaborate on the conundrum of my finance team is saying we don't have room in the salary cap for more people, but my people are saying we need three people yesterday. So this is generally one of the symptoms of trying to measure the business exclusively on financial data. Because the problem is you don't have an understanding of time. So what it's going to look like on the utilization. Right, right. And this is sort of the old school way of doing it. If you go back like 20 years and you look at everything through finance, it's like utilization was a function of time billed to the client.

01:14:34
Marcel Petitpas
So the problem there is, if your team spent 500 hours on a project but only billed the client for 250, the finance manager is going to say, oh, well, were only utilized for 250 hours. And in their mind, the team only worked those 250 hours, and they're going to say we have a utilization problem, when in reality, the team worked twice as much as that. And so the real problem is your effective rate is half of what you think it is. So to just like, show this in a, like a mathematical example, I'll pull.

01:15:02
Drew McLellan
Up this little calculator while he's pulling that up. So that could be your estimates wrong, and you had to write off a bunch of time. It could mean your scope document's really vague and your client asked for a bunch of stuff that really you didn't think was part of the scope, but you didn't have a leg to stand on to defend the scope. So part of the problem is now you have enough data to dig into what the real problem is. So it may very well be that you have too many internal meetings and your people aren't that billable. And if you took them out of all the internal meetings because you're building a new website or whatever's going on, then you don't need more bodies.

01:15:38
Drew McLellan
Or it might be that your estimates are so bad, your people are really working 35 hours a week on billable work, but they're only able to build 20 hours of it. So it all, it. It gives you enough clues to start figuring out what the problem is. But it's not as simple as just a math problem.

01:15:56
Marcel Petitpas
Yeah, and this is just sort of a symptom of, you know, if you go back long enough in the agency industry, and this is, it's still like this in other professional services industries, where it's like everybody just build on time materials. So the assumption was essentially like whatever our effective rate is, or whatever the rate is on the rate card, let's assume that's what we earn. And so if we take our revenue and we divide it by that rate, that tells us how many hours we think we worked. And if that's a lot less than our capacity, then the finance team is going to go, okay, well, we're underutilized and you can't hire more people, even though the team might be absolutely slammed. So what that looks like in practice is, you know, here, let's take this firm.

01:16:31
Marcel Petitpas
Let's assume that, like, the rate on the rate card is 150 and their max utilization is 60%. If I'm here only earning, let's call it $100 per hour, watch what happens to our revenue and to our profit. Right. We lost $1 million and went from being highly profitable to losing 266 grand. Right. But what this is going to look like in the finance team's eyes, because for them, the rate never changes. They're going to say, oh, well, we only earned $2 million because were, you know, let's just keep lowering this until we get to 2 million. Right. Because we're only 40% utilized, they're assuming that the rate never changes. So that's effectively the issue is without considering operations data, which most finance teams won't do, mostly because it's complicated and it's not within their scope and it's, you know, not really their department.

01:17:20
Marcel Petitpas
And that data may not exist and it may not be clean or, you know, there's multitude of reasons for that. All you can know is that you're earning less income than you could be. But the important question is why? Because how we solve for this is very different than how we solve for.

01:17:37
Drew McLellan
Sure.

01:17:38
Marcel Petitpas
This. Right.

01:17:40
Drew McLellan
And by the way, in most firms, it's a little bit of both. Right. It's also not so black and white that it's like, oh, if we just raised our average billable rate, we'd be good. Or, oh, everybody is utilized at the appropriate amount. It is typically a combination of three or four factors, but that you have to solve for, and then you just figure out which one is the worst part of the problem. Solve that one first, and then just keep working through the list.

01:18:06
Marcel Petitpas
These are excellent questions. I don't have a hard stop, so if there's any more I can stick around and take. Take more. Do you recommend annual client rate review? Good question. I'll defer to you for this one first, Drew.

01:18:22
Drew McLellan
Well, I think you need to look at a profit. You should be looking at profitability by client and profitability by deliverable. And so that's going to tell you whether or not you have a rate problem. In most cases. Most of you don't have a ton of variance between your rates. Most of you have some sort of flat rate, again, somewhere between 150 and two and a quarter an hour. And it really is typically not the rate. It is. It is. Again, because as Marcel was saying, let's say it's 175. You're not actually getting $175 an hour. For every hour you have an employee, you're getting something less than that. So the question is how much less and why? So it's not typically the top number. I mean, unless you're really under billing, it really is. What's happening to marginalize that number?

01:19:15
Drew McLellan
That's where you have to pay attention. Yeah.

01:19:20
Marcel Petitpas
From my perspective, Kobe, like you, regardless of your pricing model, you should have a mechanism to, on some regular basis, make sure that the scope and the price of whatever you're working on with the client is accretive to both parties and is profitable. And so that could be. Yeah. Quarterly business reviews with clients. In your case, if. If they are sort of buying time materials from you, then I would set that expectation upfront. I would write that into the contract. And yes, I would have regular cadences where we meet with them and they

expect our rates to increase a certain amount every year, every quarter, or that the scope of our engagements is changing based on how their needs are changing over time.

01:20:03
Marcel Petitpas
And I would say that for most, especially larger clients that are used to buying services on time materials, they will have come to expect that kind of thing. Because the alternative. Right. Is especially if they're with you for a long time, if they go to market to hire a different firm, chances are they're going to pay a lot more on an hourly basis. Right. If they're still on your legacy rate. So you do have leverage in that sense.

01:20:24
Drew McLellan
Absolutely. Megan, simple rule of thumb for determining loaded salary expense. Kind of depends on what kind of benefits you give and all of that. But just a simple one is if you took their salary and multiplied it by 1.25. That's ballpark. Right. At least in the states. I would say 1.25, maybe 1.3, but not higher than that. We're. We're very generous, but we're not that generous.

01:20:46
Marcel Petitpas
Yeah, it kind of comes down. I found healthcare is the big determining factor on if it's a 1.15 or a 1.25 or 3. Yeah. Yeah. All right. Does delivery costs include both cogs? So, yeah, we're talking about our framework here, Amy, and I do encourage you to go into the toolkit. There's a video that breaks this down. You can watch it at half speed and watch it multiple times if you need to. But delivery costs would be everything after what Drew defined as cogs here. So the employees and the software and so on that are just for the delivery function of the business. So we're really just trying to isolate, like after we take out the stuff, the money. That's really not ours. And that goes to third parties. What are we spending to earn our revenue? Hopefully that helps.

01:21:33
Drew McLellan
So Sarah's asking you to define the difference between the 75% margin target on a project versus the 55% delivery margin target.

01:21:41
Marcel Petitpas
Yes. This is one of the more nuanced parts of our framework. And again, this is part of the reason I encourage people to start with Drews, because it's way simpler. Okay, but here's how we think about that. When you're measuring. How do I not turn this into a massive monologue? All right. When you're measuring the profitability of an individual piece of work, we call that direct delivery margin. And this is meant to measure the unit of work that could be an hour, it could be a project, it could be a client relationship, what have you. And this is where you want to generally target 70% or more. Now, the thing that we want to be doing here isolating externalities. Right?

01:22:22
Marcel Petitpas
So what I don't want is for my sense of how profitable projects are to be changing because our overhead is higher or low this month than it was last month, or because our utilization is higher or lower this month than it was last month. That is something that affects the profitability of our business, but that should not affect the profitability of our projects. Right. That's a false positive or a false negative. So here what I want to pay attention to is just the direct delivery costs that go into a given piece of work. And then when I look at delivery margin for the whole entity, this is where I'm looking at the cost of the salaries and etc. That go into delivery. And what is going to affect that are three things. We call these indirect delivery expenses, unutilized time, shared delivery expenses.

01:23:07
Marcel Petitpas
So that's like your Figma subscription, your Adobe Creative Cloud. It's like your. That subscription isn't going up or down if you win a client or lose a client. And you can't really attribute it directly to that project, but it is a thing that your team needs to do their job. And these shared delivery expenses, for most firms, we see these take up anywhere from 2 to 6% of AGI. And then you're going to have your delivery overhead, which is almost the same as on utilized time. But this is like you have account managers and project managers, and you have your

creative director who they spend like half their time not doing client work, but still managing the delivery team. So it's a delivery cost.

01:23:45
Marcel Petitpas
It's a cost of running the delivery function of the business, but it's not showing up on, you know, client invoices necessarily. So we have to take into account these costs, and these are generally going to take up anywhere from 15 to 25% of our agency gross income, these indirect delivery expenses. So that's why we want to set a higher direct delivery margin target, because we know that there's going to be some amount of indirect cost to just running the delivery team to unutilized time, and that gives us enough margin to still land at our 50% plus target on the P and L. So that hopefully that answers your question, Sarah. And again, the reason we do this is because we want this number to be horizontally consistent.

01:24:28
Marcel Petitpas
So if I'm trying to figure out, like, this project from six months ago, that was a website, in this website from today is one more profitable than the other, I'm stripping out the things that would make it seem different that actually shouldn't affect that number at all.

01:24:43
Drew McLellan
So for those of you that saw Sarah got it. And you're like, I don't get it. Just so you feel better, Sarah's an accountant by training. So just other questions for us.

01:24:55
Marcel Petitpas
Finance.

01:24:56
Drew McLellan
Finance. Yep. Okay, Sorry. Sarah's a finance professional, not an accountant.

01:25:05
Marcel Petitpas
Awesome.

01:25:06
Drew McLellan
Sarah does math for a living is what I'm saying.

01:25:09
Marcel Petitpas
Yes. Money math. The best kind of math.

01:25:11
Drew McLellan
Yep.

01:25:12
Marcel Petitpas
Amazing. I gotta say, I had a lot of fun here, and I appreciate the great questions in the chat. I do encourage everyone to check out the free resources and reach out to Drew and I. I'm very available on LinkedIn. Love to chat with any of you and if you enjoyed this collaboration. I think it's been a while since we collabed on some content.

01:25:31
Drew McLellan
Drew, I know it was fun. Yeah. I'm always for it.

01:25:34

Marcel Petitpas
If the people liked it, let us know and we'll know to keep doing it. But I want to thank everyone for being here. This was a. This was a blast. And thank you, Drew, for putting this together.

01:25:43
Drew McLellan
Oh, you met. My pleasure. It's always fun to partner with you guys. All right, guys, thank you very much. The replay. We will send out a link by email again, just like you got the zoom link to make sure you get the replay. We're going to try and get it done by middle of this week, so watch for that. But the deck and stuff is already there, so you've got that. All right, thanks for. Thanks for joining us. Talk to you soon.

01:26:05
Marcel Petitpas
Cheers, everyone.

01:26:06
Drew McLellan
All right, bye.