The Anatomy of a Consulting Firm

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The structure and management of consulting firms is driven primarily by two key factors: the degree of customization in the firm's work activities and the extent of face-to-face interaction with the client. Both of these characteristics (customization and client contact) imply that the value of the firm is often embedded less in the properties of the firm and more in the specific talents of highly skilled individuals. The consulting firm must therefore compete actively in two markets simultaneously: the "output" market for its services, and the "input" market for its productive resources, the professional workforce. It is the need to balance the often conflicting demands and constraints imposed by these two markets that creates the special challenge of structuring and managing the consulting firm.

Leverage Structure

The consulting firm may be viewed as the modern embodiment of the medieval craftsman's shop, with its apprentices, journeymen and master craftsmen. The early years of an individual's association with a consulting firm are, indeed, usually viewed as an apprenticeship, and the relation between juniors and seniors is the same: the senior craftsmen repay the hard work and assistance of the juniors by teaching them their craft.

Every consulting project (and hence every consulting firm) has its own appropriate mix of three kinds of people. By tradition, these are called "finders, minders and grinders." This refers to the three main activities that make up consulting work. Finders (usually the most senior level) are responsible for bringing in the business, scoping and designing the projects, and engaging in the high-level client relations necessary during the work. The main responsibility of minders is to manage the projects and the team of people working on it. Grinders (the lowest level) perform the analytical tasks. Naturally, this is an idealized structure and, depending on the firm, all may participate in analysis and/or junior people may be delegated tasks associated in the ideal model with higher levels.

The required shape of the organization (the relative mix of juniors, middle-level staff and seniors) is usually described as its leverage structure, and is primarily determined by the (aggregate) skill requirements of its work: the mix of senior-level, middle-level and junior-level tasks involved in the projects that the firm undertakes.

Getting the leverage structure right is key to the consulting firm's success. If a firm brings in a mix of client work that requires more juniors, and fewer seniors, than the firm has in place, higher-priced people will end up performing lower-value tasks (probably at lower fees), and there will be an underutilization of senior personnel. The firm will make less money than it should be making. The opposite problem is no less real. If a firm brings in work that has skill requirements of a higher percentage of seniors and a lesser percentage of juniors, the consequences will be (at least) equally adverse: a shortfall of qualified staff to perform the tasks and a consequent quality risk. Matching the skills required by the work to the skills available in the firm (i.e., managing the leverage structure) is central to keeping the firm in balance.

Leverage and the People Marketplace

The connection between a firm's leverage structure and the people marketplace can be captured in a single sentence: people do not join consulting for *jobs* but for *careers*. They have strong expectations of progressing through the organization, from grinder to minder to finder, at some pace agreed to (explicitly or implicitly) in advance.

While the pace of progress may not be a rigid one ("up or out in x years"), both the individual and the organization usually share strong expectations about what constitutes a reasonable period of time for each stage of the career path. Individuals who are not promoted within this period will seek greener pastures elsewhere, either by their own choice or career ambitions or at the strong suggestion of the firm.

Few firms offer career positions at the middle-level or junior ranks. Partnership or ownership is usually restricted to those who attain the highest levels. In recent years, however, which have seen a people shortage or "war for talent," some firms have experimented with offering profit sharing, stock options or other financial incentives to allow those who are not at the highest levels to share in the firm's overall success. This has not removed the expectation that most staff will continue to strive for promotion to the highest levels.

This promotion system serves an essential screening function for the firm. Not all young professionals hired will develop the project management and client relations skills required at the higher levels. While good initial recruiting procedures may serve to reduce the degree of screening required, they can rarely eliminate the need for the promotion process to serve this important function. The existence of a "risk of not making it" also serves the firm in that it puts a degree of pressure on junior personnel to work hard and succeed.

The promotion incentive is directly influenced by two key dimensions: the normal amount of time spent at each level before being considered for promotion and the "odds of making it" (the proportion of juniors promoted.) For any given rate of growth, a highly leveraged firm (one with a high ratio of juniors to seniors) will offer a lower probability of making it to the top, since there are many juniors seeking to rise and relatively few senior slots opening up. A less leveraged firm at the same rate of growth will need to bring along a higher percentage of its juniors, thus providing a greater promotion incentive.

Leverage and Profitability

A consulting firm's leverage is also central to its economics. The rewards of partnership or ownership (the high levels of compensation attained by vice presidents or senior partners) come only in part from the high hourly (or daily) rates that the top professionals can charge for their own time. A significant portion of profits derives from the surplus generated from hiring staff at a given salary and billing them out at multiples of that salary. By leveraging its high-cost seniors with low-cost juniors, the professional firm can lower its effective hourly rate and thus reduce its cost to clients while simultaneously generating additional profit for the partners.

The market for the firm's services will determine the fees it can command for a given project; its costs will be determined by the firm's ability to deliver the service with a cost-effective mix of junior, manager and senior time. If the firm can find a way to deliver its services at the same quality with a higher proportion of juniors to seniors, it will be able to achieve lower service-delivery costs. (Note that this is true whether the firm bills by the hour or on a fixed-fee basis.) The project team structure of the firm is therefore an important component of firm profitability.

The Client Marketplace

Degrees of client contact and customization vary from to firm, or even practice area to practice area. Some differences between types of practice are shown in Figure 1. This defines four kinds of professional practice, which for the purposes of example we'll call Pharmacist, Nurse, Brain Surgeon and Psychotherapist.

The Pharmacist

A Pharmacy practice is one where the client is trying to buy a relatively familiar service and does not require very much counseling, consultation or contact. The client wants the service performed to strict technical standards at a minimal cost. Notice that this type of practice is defined as a standardized *process* conducted with little, if any, client contact. This does not mean that the *result* cannot be highly customized, merely that the process to be followed in producing the result is well specified. While this type of work is common in systems installation and other IT firms, it can also be found in high-end strategy firms, where component analyses of cost structures, market shares, competitive positioning and many other studies, as valuable as they can be, have been highly proceduralized and can be conducted with thoroughness and accuracy by junior staff. The method of conducting these analyses does not vary from job to job.

Quality standards, in the sense of "conformance to specifications," must be high for this work, since the client will be "swallowing the pills." However, the client does not require that the pill be specifically designed for him or her. The client wants to buy well-established methodologies and procedures, not innovation and creativity.

The client is in effect saying, "I have a headache, and I know that you, along with many others, are licensed to dispense aspirin. Don't waste your time and mine trying to convince me that it's brain surgery that I need. I've done this before, and I can tell for myself the difference between the need for aspirin and for brain surgery. I want aspirin! What's your best price?"

The Nurse

The Nursing practice also delivers relatively familiar (or "mature") services that do not require high levels of innovation. However, it differs from the Pharmacist practice in that the emphasis is not only on the ability to dispense the pill (which still may be required), but also on the ability to counsel and guide the client through the process. This time, the client wants to be nurtured and nursed: "Help me understand what's going on; explain to me what you're doing and why; involve me in the decision making; help me understand my options. Be with me and interact with me throughout the process until this is all over. I need a front-room advisor, not a back-room technician." (The nursing practice can be distinguished from the pharmacy practice by the proportion of total project time that is spent in contact with the client.) Practices that work in this area are those where the consultant's approach to is to help the client (and the client's organization) arrive at its own decisions and conclusions, rather than performing independent studies and presenting the consultant's recommendations. This requires interpersonal and consultation skills in addition to analytical skills.

The Brain Surgeon

The Brain Surgeon combines high levels of customization, creativity and innovation with a low degree of client interaction. The client is searching for a practitioner who is at the leading edge of his or her discipline, and who can bring innovative thinking to bear on a unique assignment. Here, the client says, "I have a bet-your-company problem. Save me! I don't want to know the details, just find the right answer! If I wake up in the morning, I'll pay your outrageous bill! I'm not shopping on price, I'm trying to find the most creative or technically superior provider I can." Consulting firms positioned here tend to be regarded as leading thinkers, and tackle unique, one-of-a-kind problems in the areas of strategy, technology or organization.

The Psychotherapist (or Family Doctor)

Finally, the Psychotherapist (or Family Doctor) practice is one where the client says, "Again I have a bet-your-company problem. This time, I don't want you to give me the anesthetic and leave me out of the process. I want to be intimately involved in the problem-solving process. What I'm really trying to buy is someone who can sit down with me, help me understand why my company is falling apart, how I should differentiate between a symptom and a cause, what I *must* deal with and what I can afford to postpone. Sit down with me and my executive team and help us understand our problem and our options."

As with the Brain Surgeon, the emphasis for the Psychotherapist is as much about creative diagnosis as it is about execution. When buying the services of a Nurse or Pharmacist, clients know what they want done: they are hiring someone to execute it. But with Brain Surgeons and Psychotherapists, the clients are seeking help determining what needs to be done as well as how to do it.

Psychotherapy practitioners can be found in most high-end consulting firms, since many client projects contain an initial diagnostic component. Except for solo practitioners and other small firms, few consulting firms spend all their billable hours in this activity.

Differences Between Practices

There is a market for all four of these kinds of providers, and they all represent "honorable" ways of being of value to clients. However, the four services described represent four profoundly different businesses. Virtually everything, from marketing to hiring, managerial styles to economics, key skills to career paths and performance appraisal criteria, varies significantly depending upon which service the firm is trying to provide.

Consider, for example, how each of these providers makes money. The Pharmacist is in a fee-sensitive business where the key to economic success lies in finding ways to dispense the "aspirin" at a very low cost (without compromising quality). This means getting the work done with a minimum of high-priced senior professional time and extensive use of either low-cost (junior) time or time-saving tools such as methodologies, systems, templates and procedures. The Pharmacist is in a low-fee, high-leverage business.

The Nurse also needs to have well-established procedures, methodologies and tools, but if the Nurse has superior counseling skills, then he or she can command higher fees than the Pharmacist. Since the client is buying a relationship with a "primary care provider," he or she will be less inclined to shop on price and more likely to pay a premium for an advisor they can work well with and trust.

However, since much of the work is likely to involve client contact, there is probably a little less chance to leverage (by using low-priced junior professionals) for the "front-room" portion of the work. The Nurse thus makes money by charging higher fees than the Pharmacist, but probably employs lower leverage.

The Brain Surgeon is paid for innovation, creativity and frontier technical skills. Accordingly, the Brain Surgeon has even less ability to get projects done by leveraging junior resources or established methodologies. Instead, the Brain Surgeon firm makes money if (and only if) it is truly recognized by the market as being a leading-edge practitioner that justifies premium fees. Brain Surgeons make money through high fees and low to modest leverage.

The Psychotherapist (or Family Doctor) has the most unleveraged business of all. Since most of the work is face-to-face counseling at the highest level of the client organization, little use can be made of junior staff (except for background analytical work in support of the Psychotherapist's efforts).

The Psychotherapist makes money in one of two ways: Either high fees are charged or a diagnosis results in work that can be referred to other parts of the "hospital." In other words, the Psychotherapist may not be very profitable on a stand-alone basis, but makes money by being a "relationship manager" and generating work for others.

The Need to Focus

The categorization scheme used here does not define whole disciplines, but rather different market segments. For example, some clients for a service like market research may (historically) seek out a Pharmacist (the work, in their view, being mostly programmatic and performed with little need for ongoing client contact). However, other market research clients may want pioneering work and require (and request) extensive diagnosis, and also want a great deal of ongoing client interaction. They may seek a provider with demonstrated Nursing or Psychotherapy skills and methodologies. Which box a firm is in is determined less by the profession it practices than by the market segments it is trying to serve.

And therein lies the problem! Suppose that you are a highly skilled tax practitioner who handles complex, frontier tax problems through creative, innovative thinking (i.e., you are a Brain Surgeon). A client comes along who wants to get their basic tax forms completed to ensure compliance with all tax laws. Since this is your client, it's a tax problem and you're a tax provider, it is tempting to conclude that you're the perfect person to help the client.

Wrong! As a Brain Surgeon, you are probably high-priced, and your key talent is creativity and complex problem solving. Completing tax forms and ensuring compliance is a Pharmacy job; it is not work for a Brain Surgeon. A Brain Surgeon may have the tendency to treat all problems as if they required Brain Surgery: The client says, "I'd like to buy some aspirin," and the Brain Surgeon replies, "Sure! But first, get on the operating table so we can investigate and find out whether it's aspirin you really need!"

(Of course, the opposite problem is equally unacceptable. If a client says "I have a unique bet-your-company problem," it is not very sensible to respond by saying, "Let us show you our established methodology based on years of solving identical problems!")

Even if you as a Brain Surgeon recognize the need to treat a problem as an "aspirin" job, it would still be a misallocation of resources for you to do it, since low-cost, methodology-driven activities are not the Brain Surgeon's key talents. In fact, everyone will lose if you, a Brain Surgeon, do it yourself: The client will not get low cost, you will be underutilizing your talents (and will probably find the work dull) and your junior staff will be denied the opportunity to perform work that, while old hat for you, might be interesting and skill building for them.

What this analysis points out is that while it may be acceptable for a *firm* to be a "full-service hospital" with capabilities to meet a broad range of client needs, it is not acceptable for individual professionals to try to do so. It is highly unlikely that any one individual will excel simultaneously at *all* the virtues of efficiency, creativity, counseling and diagnosis.

While Brain Surgery is the traditional self-image of many professions, the harsh reality is that Brain Surgeon needs probably represent a very small percentage of the total fees paid in any profession. It is also true in "real" health care, where surgeons may be the most glamorous providers but represent only a tiny fraction of the health care needs of society.

Ownership and Governance

Among the many things that are affected by the market positioning (i.e., mix of services) of the firm are ownership and governance. The traditional model in consulting has been a privately held partnership, with all significant decisions being made after extensive consultation with the senior group. This model matches well with a Brain Surgery or Psychotherapy practice, which requires significant power and autonomy to be left in the hands of the senior practitioners. A related, but different, part of the partnership tradition is that senior people are rewarded by the income they derive during their time at the firm, and not from the increase in the value of the firm itself. (Many firms transfer their ownership between generations through an "in and out at book-value" system.) Ownership is restricted to those currently practicing within the firm.

However, recent years have seen the emergence of publicly held consulting firms. Theoretically, there is nothing in the corporate form or in public ownership that would prevent the preservation of a "partnership ethos," with decision making through extensive consultation and the retention of significant autonomy for senior practitioners. However, when a firm has gone public, the value of the shares (and hence the company) takes on a greater significance, and this inevitably affects the process of decision making. A greater emphasis is given to building the systems of the firm to embed value *in the firm*, not just in the individuals who belong to it, and this often leads to greater codification. It is easier to "own" a chain of pharmacies than a rambunctious group of brain surgeons and psychotherapists.

Structural Trends

Two trends suggest where the bulk of the market lies. First, clients are buying fewer services as if their problem is totally unique. They more frequently want to tap into a firm's accumulated experience and methodologies in order to benefit from the efficiencies that come from dealing with providers who have done it before. They are buying less brain surgery and more aspirin. (The widespread use of technology also has the effect of allowing complex analyses formerly performed by Brain Surgeons to be conducted by junior staff, thus reinforcing this trend.)

Second, clients are increasingly reluctant to say to their professionals, "You take care of things and report back when it is done." More and more, clients want to be involved in the process, or at a minimum be kept informed of their options, kept up-to-date on progress and assisted in understanding what is going on and why.

From these two trends, we can hypothesize that the bulk of the market is moving towards Nursing (established, proven procedures with high client contact) and away from Brain Surgery. As reflected by the amount of price competition in most professions, the Pharmacy also represents a high percentage of fees. While critical, the role of Psychotherapist is not a high-volume area. It is filled with those few individuals who have sufficiently earned their clients' trust and confidence so that, whenever the client has a problem, the Psychotherapist is called in to diagnose what is needed.

Most professional firms put new entry-level people to work in the Pharmacy first, so they can learn the key technical skills of their profession. As time progresses, people have historically moved in one of two directions, either following the technical career path to Brain Surgeon or the client contact career path to Nurse.

Psychotherapists have tended to evolve from the more creative Nurses, although not all Nurses can make the transition to being accepted as the client's prime diagnostician. While it is possible for Brain Surgeons to become Psychotherapists, it is rarer. Unless a professional learns the basic client contact skills early in his or her career, they are difficult to develop later.

This traditional approach to career development (often called "paying your dues") is increasingly under attack. Consider the Pharmacy service. Under the traditional career model, the aspirin is being dispensed by professionals temporarily working in the Pharmacy, serving their time until they are promoted to a higher-level service. This method of having the aspirin dispensed by "Brain Surgeons in training" is not entirely aligned with the clients' interests.

Unlike the Brain Surgeon firm, which can only afford to hire the best and brightest from the top schools, a focused Pharmacy practice would, appropriately, view these as the wrong people to bring in. Not only do they command higher salaries, but their superior intellect may be inappropriate for the service the Pharmacy is trying to provide. If a firm's business is making hamburgers, it will not want to hire people who are dreaming of the day they can leave and become Cordon Blue chefs. It will want and need people who are excited about hamburgers.

A focused Pharmacy practice should be able to hire people without a formal education in its *specific* area, since smart people can learn to apply well-defined methodologies and tools. Training and development should be structured and formal to ensure that new people can quickly learn to apply the firm's established methodologies. (This is exactly what is happening in some management consulting firms, which now hire people with degrees in such diverse fields such as anthropology and liberal arts.)

Employees in the Pharmacy are not promised a fast-track promotion and career path. In fact, there should be no traditional "up-or-out" policy. (This is one reason why the big accounting firms, increasingly realizing that much of their business is Pharmacy, have recently moved away from such policies).

The Nursing practice requires capable people who are not only able to apply methodologies but who are able to work well with clients. One common approach is to hire individuals who have prior industry experience working in client environments in order to maximize the chance that these individuals can empathize with the client situation.

Guru Associates: A Numerical Example

Let's consider a numerical example (Figure 2) to see how the forces at work in a consulting firm interrelate. Guru Associates, which engages in a variety of projects, nevertheless has a "typical" project that requires 50 percent of a senior's time, 100 percent of a middle-level person's time, and the full-time efforts of three juniors. In order for the firm to meet its economic goals, it requires that seniors and managers be engaged in billable work for 75 percent of their time, and juniors 90 percent.

Guru Associates currently has four seniors. If it is to meet its target of 75 percent billed senior time, its available senior time will be four multiplied by 75 percent, or the equivalent of three seniors working full-time. This implies six projects if the typical project requires 50 percent of a senior's time.

With six projects, the firm needs the equivalent of six full-time middle-level staff according to the project team structure. (Each project requires 100 percent of a middle-level person's time.) At 75 percent target utilization (billed hours divided by available hours), this means that the firm must have eight middle-level staff (6 × 0.75). Similarly, at three juniors per project, the firm needs 18 full-time juniors (at 90 percent billability, that means 20 juniors).

Simple calculations such as these show that, with eight seniors, the firm would need 16 managers and 40 juniors. The proportions remain constant: one senior to every two managers and every five juniors. Unless there is a change in either the project team structure (e.g., the types of projects the firm undertakes) or the target utilization (matters that will be discussed below), the firm must keep these ratios constant as it grows.

This seemingly simple-minded calculation relating the staffing mix requirements of the work to the staffing levels existing in the firm is in fact of extreme importance.

If we know the salaries of the staff members and their billing rates, we can construct the pro forma income statement of this firm at full utilization. (Figure 3)

The role of leverage is amply illustrated by Guru Associates. The four seniors (partners) personally bill a total of $1,200,000, or $300,000 each. At per-professional overhead costs of $40,000 (including the costs of all secretaries, administrative staff, space, supplies, etc.), this would result in a per-partner profit of $260,000 if these seniors were totally unleveraged.

With a healthy seven staff members per senior, partner profits now total $420,000 each. About 60 percent of each partner's profit comes not from what he or she bills but from the profit generated by the nonpartner group. Thus the benefits of leverage!

It should be immediately stressed that high leverage is not *always* good. As we have already observed, having high leverage is completely inappropriate if the firm has a high level of Brain Surgery or Psychotherapy work. What we can say is that leverage should be as high as the requirements of the work allow.

We now turn to Guru Associates' position in the market for staff. Guru Associates has the following promotion policies: It considers that it requires four years for a junior to acquire the expertise and experience to perform the middle-level function, and it expects to promote 80 percent of its candidates to this position. A lower percentage would be insufficient to attract new juniors, and a higher percentage would imply that insufficient screening was taking place (i.e., that there was no room for hiring mistakes). From middle level to senior is also expected to take four years, but because fewer candidates develop the critical client relations skills that Guru Associates requires, on average only 50 percent of the candidates make it.

We shall now trace the evolution of Guru Associates over time. Among the eight middle-level staff, we may assume that, since it takes four years to make senior, in any given year there are one-quarter (i.e., two) of these managers in their final year as middle-level staff. If

Guru Associates is to abide by its promotion policies, then it can expect to promote 50 percent, (i.e., one candidate) in that year. Whether by firm policy or by the personal decision of the individual, the nonpromoted candidate will leave the firm. (Note that this result tends to happen in most consulting firms regardless of whether the firm has an up-or-out policy. Middle-level staff may, if allowed, hang on for another year or two, but most eventually leave if not promoted. As we shall see, there is a strong incentive for the firm to encourage them to leave, since they are occupying a slot eagerly being sought by the juniors coming up behind them.)

Counting both those promoted and those leaving, we have reduced the number of middle-level staff by two and increased the number of seniors by one. Since we now have five seniors, we require ten middle-level staff (unless the mix of project types changes), and have six remaining. We must seek out four new middle-level staff from among our juniors. Of the 20 in the firm, we assume one-quarter (five) will be in their final year as juniors. Since our expectation (or policy) is to promote 80 percent at this level, we will indeed promote four out of the five to fill our four available slots. (The fact that these figures match is not, of course, fortuitous. The percentage that can be promoted at a lower level is determined by the shape of the professional pyramid.) Like the "passed over" middle-level staff person, the fifth junior may reasonably be assumed to leave the firm.

We now have 15 juniors left. However, with five seniors and ten managers, the firm requires 25 juniors: it must hire ten. These changes are summarized in Figure 1-7, which follows the same logic for years one through nine.

In year five, the first batch of middle-level staff that were promoted from junior in year one will be ready to be considered for promotion to senior. It will be recalled that there are four of them. If promotion opportunities are to be maintained, then 50 percent will be promoted (i.e., two) and two will leave. This creates a total of ten seniors. With a total of ten seniors in year five, 20 middle-level staff are required. Of the 16 in the firm the previous year, four have been promoted or have left, meaning that a total of eight juniors must be promoted. Fortunately (but not fortuitously) there are 10 juniors who were hired in year 1, and are to be considered for promotion. The expected 80 percent target may be maintained!

What must be stressed at this point is that we have arrived at these staffing levels solely by considering the interaction of the firm's leverage structure with the promotion incentives (career opportunities) that the firm promises. What we have discovered by performing these calculations is that the interaction of these two forces determines a target (or required) growth rate for the firm. As Figure 1-7 shows, Guru Associates must double in size every four years solely to preserve its promotion incentives. If it grows at a lower rate than this, then either it will remove much of the incentive in the firm or will end up with an "unbalanced factory" (too many seniors and not enough juniors) with a consequent deleterious effect upon the firm's economics.

If the firm attempts to grow faster than this target rate, it will be placed in the position of either having to promote a higher proportion of juniors or to promote them in a shorter period of time. Without corresponding adjustments, this could have a significant impact on the quality of services that the firm provides.

We have seen that the leverage structure and the promotion policies together determine a target (required) growth rate. It should be acknowledged, however, that there is another way of looking at the relationship between these variables. An equivalent way of stating the relationship would be to observe that, if given a growth rate and a leverage structure, the promotion incentives that result can be specified. We may see this by examining Figure 8 once more. Suppose that we had constructed this by specifying the growth rate and the project team structure. We would then have discovered that we could afford to promote only four out of five juniors and one out of two managers. We would also have discovered that we would have a built-in, or target, turnover rate averaging over 4 percent (two resignations per year for the first four years, while the average number of nonsenior staff was 45.5).

In this example, Guru Associates can achieve what would be considered an extremely low target turnover rate if it achieves its optimal growth. However, the norm in many consulting firms is a much higher rate than this, often reaching as high as 20 to 25 percent or even 30 percent. The key point to note here is that, given a growth rate and an organizational structure, the target turnover rate of the firm can be specified. (This does not, of course, tell us what the actual turnover experience of the firm will be. We are considering here the turnover that the firm requires to keep itself in balance. While it may be able, through its promotion system, to ensure that the actual rate does not get too low, it may have to use other devices to ensure that the actual turnover rate does not get too high through too many people quitting.)

In most professions, one or more firms can be identified that have clearly chosen a high target rate of turnover. Under this scenario partners (or shareholders) can routinely earn a surplus value from the juniors without having to “repay” them in the form of promotion. This high turnover rate also allows a significant degree of screening so that only the best stay in the organization. Not surprisingly, firms following this strategy tend to be among the most prestigious in their industry.

This last comment gives us the clue as to why such firms are able to maintain this strategy over time. Individuals continue to join these organizations, knowing that the odds of “making it” are very low. In the eyes of many potential recruits, the experience, training and association with the prestigious firms in the industry make the poor promotion opportunities at such firms worthwhile.

Young professionals view a short period of time at such firms as a form of “post-post-graduate” degree, and often leave for prime positions they could not have achieved (as quickly) by another route. Indeed, most of the prestige firms following this strategy not only encourage this but provide active “outplacement” assistance. Apart from the beneficial effects that such activities provide in recruiting the next generation of juniors, such alumni/ae are often the source of future business for the firm when they recommend to their corporate employers hiring their old firm (which they know and understand) over other competitors.

The ability to place ex-staff in prestigious positions is thus one of the prerequisites of a successful churning strategy. (An exception might be provided by those professions where legal requirements such as professional certification necessitate that juniors spend time in a firm. However, even here the prestige firms provide active outplacement assistance.)

Growth and Profitability

Before we leave the topic of growth, we should take a quick peek back at Guru Associates. How did its growth contribute to its profitability? Let us perform our analysis on the basis of constant (year zero) dollars, to remove the effect of inflation. By implication, this means that the salaries and billing rates at each staff level remain the same. What does the firm's P&L now look like? Figure 1-8 repeats the analysis of Figure 1-6 using year-five staffing levels instead of year zero.

The result? Per-partner profits have not increased! In fact, they have remained precisely the same!

What this simple example shows is that there is no necessary relationship between growth and profits. As we have seen, growth in a professional firm is driven primarily by the need to attract and retain staff, and is critical for that reason, but it is not a guarantee of higher per-partner profits.

Why is this so? We shall explore the reasoning in greater detail in subsequent chapters, but the basic fact is this. If a firm grows subject to two conditions, as Guru Associates has, whereby (a) the mix of client projects (and hence fee levels) remains the same; and (b) the project staffing (or leverage) is such that the same *proportion* of senior or partner time is required to handle each project, then the number of seniors or partners that the firm requires will correspond *exactly* to the growth rate. In consequence of this, the profit pool may increase because of the higher volume, but it must be shared among a correspondingly increased number of partners.

If per-partner profits are to increase, then one of the two conditions must be broken. Either the firm must bring in a different mix of business commanding higher billing rates (i.e., find higher-value work for its people to do) or it must find ways to serve the same kinds of work with an ever-increasing proportion of junior time and a declining proportion of senior time.

It is an interesting observation to note that few prominent consulting firms act as if growth were profit-neutral. Indeed, rapid growth is often listed as a primary goal of the firm, and advances in top-line growth are used as a primary internal and external measure of success. If justified in the name of providing career opportunities for staff, this indeed makes sense. However, if desired on profitability grounds, it looks like many consulting firms are fooling themselves!

Summary: The Key Role of Leverage

Perhaps the most significant management variable to be disclosed by the previous analysis is the choice of the mix of projects undertaken and the implications this has for the (average) project team (i.e., leverage) structure. As we have seen, this latter variable is a significant force in influencing the economics of the firm, its organizational structure and its positioning in the client and people markets. The leverage structure, in the sense used in this book (the average or typical proportion of time required from professionals at different levels) has not been a variable that is routinely monitored by firm management. However, as we have shown, its role in balancing the firm is critical.

It is possible, and not uncommon, for the firm's project team structure to change over time. If it is possible to deliver the firm's services with a greater proportion of juniors, this will (in general) reduce the costs of the project. Competition in the market for the firm's services will, over time, require the firm to seek out lower costs for projects of a particular type, and there will often be opportunities for an increasing proportion of juniors to be used on projects that, in the past, required a high proportion of senior time. What in past years had the characteristics of a Brain Surgeon project may, in future years, be accomplishable as a procedural or Pharmacy project.

When considering new projects to undertake, it is usually more profitable for the firm to engage in one similar to that recently performed for a previous client. The knowledge, expertise and basic approaches to the problem that were developed (often through significant personal and financial investment) can be capitalized upon by bringing them to bear on a similar or related problem. Frequently the second project can be billed out to the client at a similar (or only slightly lower) cost, since the client perceives (and receives) something equally custom-tailored: the solution to his problem. However, the savings in costs incurred by the firm in delivering this customization are not all shared with the client (if, indeed, any are). The firm thus makes its most money by "leading the market": being able to sell as a fully customized service (at a fully customized price) what increasingly becomes a service with reproducible, standardized elements.

While it is in the best interests of the firm that similar or repetitive engagements be undertaken, this is often not in accord with the desires of the individuals involved. Most individuals that join consulting firms do so out of the desire for professional challenge and variety and the avoidance of routine and repetition. While they may be content to undertake a similar project for the second or third time, they will not be for the fourth or sixth or eighth.

The solution, of course, is to convert the past experience and expertise of the individual into the expertise of the firm by accepting the similar project but utilizing a greater proportion of juniors on second- or third-time projects. Apart from requiring a lesser commitment of time from the experienced seniors, this device serves the admirable purpose of training the juniors.

For all these reasons, we might suspect that, over time, the proportion of juniors to seniors required by the firm in a particular practice area will tend to increase. If this is allowed to proceed without corresponding adjustments in the range of practice areas, the basic project team structure of the firm will alter, with significant impacts on the economics and organization of the firm. The dangers of failing to monitor the leverage structure are thus clearly revealed.

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See Graphs on pages that follow.

Figure 1: Different Types of Practices

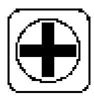
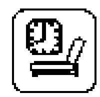
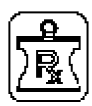
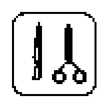
	STANDARDIZED PROCESS EMPHASIS ON EXECUTION	CUSTOMIZED PROCESS EMPHASIS ON DIAGNOSIS
HIGH DEGREE OF CLIENT CONTACT VALUE IS RENDERED IN THE FRONT ROOM, I.E., DURING INTERACTIONS WITH THE CLIENT	**NURSE** 	**PSYCHOTHERAPIST** 
LOW DEGREE OF CLIENT CONTACT VALUE IS RENDERED IN THE PROFESSIONAL'S BACK ROOM. CLIENT FOCUS IS ON RESULT ONLY	**PHARMACIST** 	**BRAIN SURGEON** 

Figure 2: Guru associates

Level	Requirements for Average Project (By Number of Partners)	Target Utilization	Required Staffing For 6 Projects @Target Utilization	Required Staffing For 12 Projects @Target Utilization
Senior	50% of 1 person	75%	4	8
Middle	1 person	75%	8	16
Junior	3 people	90%	20	40

Figure 3: The Economics of Guru Associates

Level	No.	Utiliza -tion	Available Hours to Bill*	Billing Rate	Billings	Individual Salary	Total Salaries
Senior	4	75%	6,000	$200	$1,200,000		
Middle	8	75%	12,000	$100	$1,200,000	$75,000	$ 600,000
Junior	20	90%	36,000	$ 50	$1,800,000	$32,000	$ 640,000
Total					$4,200,000		$1,240,000

Contribution to Overhead and Profits =

Billings - Salary Costs = $4,200,000

($1,240,000)

$2,960,000

Assume overhead costs of $40,000 per professional:

Overhead $1,280,000

Partner Profits $1,680,000

Per Partner $ 420,000

Figure 3: The Consequences of Guru Associates' Promotion Policies

					Year					
	0	1	2	3	4	5	6	7	8	9
Level										
Senior	4	5	6	7	8	10	12	14	16	20
Middle	8	10	12	14	16	20	24	28	32	40
Junior	20	25	30	35	40	50	60	70	80	100
TOTAL	32	40	48	56	64	80	96	112	128	160
New Hires		10	10	10	10	20	20	20	20	40
Resignations		2	2	2	2	4	4	4	4	8
Annual Percent Growth in Staff		25	20	17	14	25	20	17	14	25

Figure 4: The Economics of Guru Associates - 5 years later

Level	No.	Utili-zation	Available Hours to Bill*	Billing Rate	Billings	Individual Salary	Total Salaries
Senior	10	75%	15,000	$200	$3,000,000		
Middle	20	75%	30,000	$100	$3,000,000	$75,000	$1,500,000
Junior	50	90%	90,000	$ 50	$4,500,000	$32,000	$1,600,000
Total					$10,500,000		$3,100,000

Contribution to Overhead and Profits =

Billings - Salary Costs = **$10,500,000**

($ 3,100,000)

$7,400,000

Assume overhead costs of $40,000 per professional:

Overhead **$2,560,000**

Partner Profits **$4,200,000**

Per Partner **$ 420,000**

* Based on a 2000-hour year