

# Profitable Pricing in Professional Services



**Professional services are a different type of product for pricers. These products are not tangible but are rather based on demonstrating a distinct value to each client based on their needs and results provided. Because of these characteristics, professional services have been historically difficult to price, especially in a down economy. With increasing pressure on professional services rates, it may be time for a fresh look at the subject, as the authors explain. Timothy Matanovich is President at Value & Pricing Partners, LLC and can be reached at [tim@valueandpricing.com](mailto:tim@valueandpricing.com). George Cressman is President at World Class Pricing and can be reached at [george.cressman@worldclasspricing.net](mailto:george.cressman@worldclasspricing.net).**

**P**rofessional services are different. Different than hard goods, and even different than other kinds of services. Delivering professional services requires great skill in diagnosing customer needs and understanding the relationship between very diverse components of a customer's business. It requires skill in tailoring a solution to precisely meet a customer's needs, and communicating that effectively. And finally, it requires coordinating the efforts of a highly expert team of people to deliver the services on time and on budget.

Professional services organizations are also a diverse group. On one extreme there are temporary agencies like Accountemps or Robert Half that provide their clients with skilled specialists on an hourly or daily basis. On the other extreme are firms like Deloitte or Accenture that are business problem solvers, *extraordinaire*. Then there are hybrids, professional services arms of technology companies like HP, Informatica or GE Aircraft Engines whose primary task is to make complex technologies work in their customers' businesses.

Historically, professional service firms have relied on cost driven pricing, both because it is a relatively easy approach and because it can be managed to achieve profitable performance. Costs, however, may have little relationship to the value customers receive, and more than one consultancy has found itself upside down in this regard. More recently, with benchmarking data becoming available, some professional services firms have moved to more market based (aka competitor based) pricing in search of improved performance. But market based pricing tends to increase price competition, again undermining profitability.

Value driven pricing has proven itself in many sectors, but experience has shown that it is more the exception than the rule in professional services<sup>1</sup>. Professional services managers are skeptical of its applicability in a time and materials world. Further, these managers often lack an appreciation for the upside profit potential value based pricing creates, and see it as added work in an already complex management environment. In many cases professional services managers treat pricing as an event, rather than a process

essential to profitable performance.

In this article we will demonstrate that value driven pricing is a viable, in fact preferred, pricing model for driving profitability in professional services. We'll look at the costs of ineffective pricing using two real life examples. Then we will look at the six key elements of profitable pricing strategy in a professional service environment. Finally, we'll introduce a framework of a more successful – that is, more profitable – pricing process for professional services firms.

## **Costs of Ineffective Pricing**

Professional services leaders at Acme Systems believed that the prices they were charging for installing and integrating software packages were too low.<sup>2</sup> This is an important issue at software companies because professional services revenues on any given engagement can be 2-5X the price of the software alone. Historically Acme employed cost based pricing for its professional services, but found this approach was not permitting the firm to achieve desired margins. An industry benchmarking study revealed that professional service prices at the firm were below the norm relative to peer organizations. In response, Acme leaders raised their prices and used the industry data to justify the move with sales.

Despite the efforts at justification, this sales force had been accustomed to lobbying historically low prices even lower. So this price increase genuinely felt like an impediment to closing deals. In ensuing months, business leaders observed the gap between list and realized prices growing, and discovered more frequent efforts to bypass formal approval processes.

How much was the dysfunctional pricing-sales relationship costing the firm? Using conservative assumptions, investigation revealed that lost revenues exceeded 4%, costing the firm 18% of its professional services operating margin.

The InfoMatrix Services Company faced a different problem. With a dedicated professional services sales force, paid substan-

tially on margin, sales objectives and business objectives are aligned. In this case, however, sales people do not have a process for triaging buyers, so that price buyers and value buyers can be provided different offerings at different price points. In a professional services environment, where value varies widely from engagement to engagement and customer to customer, this shortcoming represents a sizable lost pricing opportunity. Moreover, there is lost productivity as sales directors invest valuable time servicing small, price sensitive accounts. In this case, the cost of ineffective pricing was even greater than that at Acme. Using conservative assumptions, estimates revealed that sales costs could be reduced by 12% and revenues could be increased by 9%, resulting in an overall margin improvement of 28%.

In sum, the costs of ineffective pricing are high for professional services firms; perhaps higher than leaders in professional services imagine. While both of these examples focused on the costs of poor execution, the strategic opportunity of value based pricing remains unaddressed.

For insight into the strategic pricing opportunity, let's look at the results of the TSIA Professional Services Market Rates Study, a global study of professional services pricing and practices in high technology industries.<sup>3</sup> Survey results reveal that some firms com-

mand rates twice as high as other firms for the same job description. In other words, where one firm captures \$300 per hour for a technical architect another captures only \$150. What are the consequences of this difference for the firms involved? How much opportunity is the lack of value based pricing costing?

### Factors Driving Pricing Effectiveness

Given the demonstrated payback from improved pricing effectiveness, how can a professional services firm better manage their pricing? In a professional services environment, highly profitable pricing strategy is based on six interacting elements, illustrated in Figure 1.

**Resource Allocation** – In the professional service firm, effectively managing human resources is the heart of the business. Selection, training and retention of world class service providers are critical. Then managing this team, whose members have an assortment of skills and experiences, across a national if not global client base, where each engagement is unique, is a daunting task. The successful professional services firm allocates people resources to those clients and activities that allow them to deliver superior, differentiated value at competitive advantage.

In this environment it is no surprise that managers try to simplify

Figure 1: Profitable PS Pricing – Six Elements



their lives with cost based pricing. Business leaders in professional service might like the benefits of value based pricing, but unless it can be executed efficiently, the price of progress may not be worth the pain of change.

However, if the complexity of value based pricing can be managed, then it is tailor made for professional services where the goal is to dedicate resources to the highest value opportunities.

**Service Delivery** – If putting the right people in the right places is the top priority, then delivering results that exceed expectations is the second. Successful professional services firms recognize from the get-go that they must build strong service histories to manage client perceptions, gain references and develop favorable word of mouth communication.

Again, this is a natural fit for a value driven approach to pricing. Strong service histories enable the professional services firm to effectively demonstrate and document value delivered in monetary terms. This is the key to understanding the Economic Value Drivers of the sale. In sum, the greater the economic impact the more the customer can be convinced to pay for a service.

The challenge, though, is the customer may not recognize all the value being delivered with the service. An understanding of both the symptoms and systemic causes of business problems is necessary. When the customer does not recognize underlying systemic issues as causal factors for the problems they are facing, it is more likely the customer will not recognize the economic impact of the professional services firm's work. Intensive communication efforts are necessary to ensure the customer both understands the real issues it is facing and the value of the professional service firm's solutions.

**Intellectual Property (IP) Management** – The competitive advantage of a professional services firm is built on the strength of their people; but where there are people, there is turnover, so a firm is at constant risk of losing its competitive advantage. The solution is protection and management of the firm's intellectual property. Effective IP management permits the firm to grow capabilities over time, to get paid for meaningful differentiation and to drive down costs of delivery.

When IP is converted to a recurring revenue stream through service engineering, it can become the professional services firm's most profitable revenues. An important element of a pricing strategy for professional services, then, is how IP is packaged, valued and factored into the pricing equation.

**Emotive Drivers** – Because of the intangible nature of professional services, purchase decisions often are made on the basis of a complex stream of decision variables. While some of these decision variables lend themselves to rigorous analysis, as in the Economic Value Drivers described above, other decision criteria are highly subjective. These are called the Emotive Drivers of the purchase, and they can be as important as the economic drivers to a professional services pricer.

Emotive drivers may very well determine whether you get an inbound call, or whether a prospective client will take your call to begin a relationship. The customer's experience, beginning

with the first call through your final negotiation, will determine how your relationship evolves and how well it flourishes. In some cases emotive factors can win or lose an order even when the professional services firm has a strong economic argument. Emotive drivers include factors like perception of quality, interactions between consulting and client staffs and references.

**Value Exchange** – Ultimately, the most effective professional services pricing managers are masters at managing the value exchange. The value exchange is the continuing process whereby the customer is forced to acknowledge and pay for value delivery. And these words are used purposefully – the customer is forced to acknowledge and pay for value delivery.

Managing the value exchange begins before the first contact is made and extends through the final stages of negotiation. It is strategic and it is tactical. The most profitable pricing strategies result when the professional services firm:

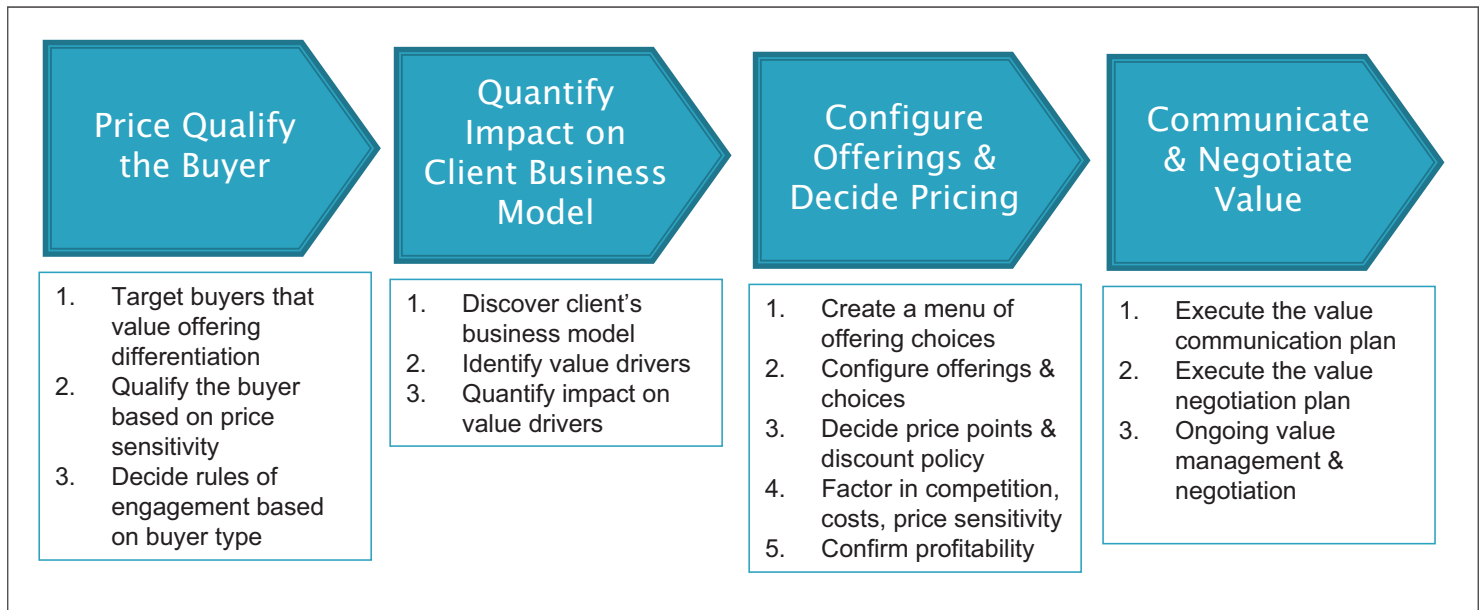
- Chooses target clients where they can deliver superior, differentiated value at competitive advantage
- Understands client business models and client value drivers  
Constructs service offerings and service options that deliver quantifiable economic impact to target client businesses.
- Negotiates value trade-offs rather than price concessions with target clients
- Sets prices based on delivered value, while actively managing emotive drivers.
- Provides sales with the motivation and capability to execute the pricing strategy

**Competitive Dynamics** – Of course, any discussion of pricing would be incomplete without reference to competition. However, experience from across many clients over many years has shown that most of the damage attributed to competitors is actually self inflicted. Through unmanaged discounting, lack of effective sales incentives, weak value communication and negotiation strategies, and an unwillingness to charge for value delivered, many professional services firms have created the price sensitivity they see in their customers. Looking at it from the outside, it is patently obvious. From the inside, it looks like competition.

As a start, effective professional services pricers act to minimize the actions that prompt price sensitivity. Then, rather than reacting to competitive actions, effective professional services pricers manage their competitive arena through:

- Actively communicating their intentions and capabilities in their market space.
- Acting consistently with their announced intentions, avoiding opportunistic actions.
- Evolving their service offering platform and sources of competitive advantage well in advance of competition.

Figure 2: Effective PS Pricing – Process



To this point we have demonstrated the financial impact and the elements of an effective approach to pricing. The professional services pricing process that follows is the day to day “how” of pricing strategy execution. It is a process that firms can integrate into their existing sales and marketing process to implement a value based approach and drive higher profitability. Figure 2 illustrates the process.

**The professional services pricing process has four stages:**

**1. Price Qualify the Buyer** – Successfully capturing a value price depends on targeting buyers who benefit from and are willing to pay for value. These are customers for whom the firm has the ability to deliver differential value at competitive advantage. In the real world, however, some buyers are value buyers and others are not. So the pricing process starts with price qualifying the buyer based on price sensitivity. This price qualification drives the entire pricing process. A price buyer, for example, is treated much differently than a value buyer in sales approach, offering configuration and negotiation strategy.

**2. Quantify Impact on the Client Business Model** – For the professional services firm’s management team, targeting a class of value buyers means developing a deep understanding of their business model and the drivers of value. Value drivers are key focal points for the customer’s management team, related to:

- How the customer drives revenue flow and profit, and/or,
- How the customer manages costs, and/or,
- How the customer deals with the psychological/emotive issues related to managing their firm and their approach to market.

The team then quantifies how their service offerings could impact the customer’s value drivers, setting the stage for value based pricing.

Though the focus above is on value buyers, the management team should not neglect understanding value for other types of buyers. For example, it is not that the price buyer does not want value. Rather they may want narrowly scoped, undifferentiated value, e.g. “I want a business analyst to work on our marketing database for eight weeks.”

**3. Configure Offerings and Decide Pricing** – Given an understanding of the client’s price sensitivity and how they will derive value from a solution, it is time to configure offerings. In the case of professional services, this is some combination of differentiated resources, commodity resources and intellectual property. The objective of the professional services management team is to construct a menu of offering choices for the customer. The menu provides real options with real value tradeoffs for. A menu of options is critical in limiting price negotiations and discounting, forcing customers to negotiate on value delivery rather than on price.

Value delivery is then quantified for the alternative options, and price points are set to provide a sufficient economic incentive for the customers to buy. Multiple offerings give the customers options that limit attempts to price deal and result in higher margins for the professional services firm. Should the firm decide to offer any discounts, discount policy is determined at this point.

Only when the economic value to the customer and price points are established does the team look at costs to assess profitability. The team determines the resources required to deliver the specified value, and costs are estimated. In most cases the price points determined by this value driven pricing approach will exceed those of the cost based approach.

Should profitability be below desired levels, the professional services firm’s management team has several options:

- Target different customers where value delivery may be greater and/or price sensitivity lower, allowing higher price points.

- Increase price points, recognizing this reduces the client's incentive to purchase and possibly increasing customer price sensitivity (price sensitivity increases as the firm tries to capture more of its delivered value).
- Add additional services (i.e., modify the service offering menu) with services that increase value faster than costs increase, allowing higher price points and more profitable offerings.

Note that nowhere here has it been stipulated that value pricing must be fixed bid. The value based pricing approach is not a specific pricing model. Rather it is a system for setting and capturing a fair price, based on value to the customer relative to competitive alternatives, with the objective of maximizing long term profitability. So a value price may be high or low, and may be fixed bid, time and materials, or some combination.

**4. Communicate and Negotiate Value** - A value driven customer communication plan is then developed, as well as a negotiating plan. The negotiating plan is based on the previously developed service offering menu, and forces customers to trade off options with real value differences in order to get a lower price. A key principle for value driven pricing success is making tradeoffs necessary and consequential.

Finally there is continuing value management and negotiation throughout the engagement. As Yogi Berra observed, "It ain't over 'till it's over." Evidence suggests that requirements change in a third of many professional services engagements after the proposal has been agreed to.<sup>4</sup>

### **Closing Thoughts**

There is a growing price resistance among buyers of services; this resistance is especially acute in the professional services sector. Professional services firms have a tough assignment: convince customers to pay for their hard won expertise.

Professional services firms employing cost based pricing often fall short in convincing customers they should pay for high value service delivery. By their own actions they are inclined to increase price sensitivity among both sales people and customers, have high levels of revenue leakage, have higher than necessary sales costs and end up selling the skills of highly talented people at price-buyer rates to customers willing to pay for value. The resulting costs can be sizable.

Value based pricing processes are a proven means to manage customer price resistance and to deliver more profitable results. The process we have introduced here can be integrated with existing professional services sales processes. Profitable, value based pricing in professional services firms requires active management, but the process we have introduced here can be integrated with existing sales processes without undue effort. Active management includes the careful selection of customer segments, design of offerings for each segment and pricing practices based on value delivery to target customers.

Managers in professional services firms can often dramatically improve their business's profitability by adopting value based pricing. It certainly takes effort, but the results make the trip most worthwhile.

### **Endnotes:**

<sup>1</sup> In the 2009 TSIA PS Market Rates Study, no respondents described themselves as "value driven."

<sup>2</sup> Cases reported here and the financial impact estimates are real. Details have been changed so as not to compromise the identities of the firms.

<sup>3</sup> Technology Services Industry Association.

<sup>4</sup> Thomas E. Lah, Steve O'Connor, Mitchel Peterson, *Building Professional Services*, Prentice Hall PTR, Page 93.