

# **What Professional Service Firms Must Do to Thrive**

by Ashish Nanda and Das Narayandas

From the Magazine (March–April 2021)



Kirsten Ulve

**Summary.** During economic slowdowns, consulting, law, and accounting firms often start offering services and taking on clients they really shouldn't, just to keep the lights on. This path is perilous. If a firm's practices have a diffuse mix of clients and unclear strategic... [more](#)

**When the going gets tough,** companies often get desperate. So it should be no surprise that during the coronavirus pandemic and the concomitant economic crisis, professional service firms (PSFs) have been chasing after all kinds of business just to keep the lights on. We

see this over and over: consultancies, law firms, accounting firms, and the like offering services and signing up clients they should never have considered. This approach to shoring up billings is perilous.

If a PSF's constituent practices are diffuse in their strategic positioning or mix of clients, the firm ends up with a weak market profile, internal conflicts, and dissension among the leadership about the firm's future direction. Conversely, if the practices are disciplined about their positioning and their client portfolio, the firm becomes stronger than the sum of its parts. In this article we'll provide a framework that shows how PSF leaders can proactively position their practices and manage their client mix.

### **The Link Between Clients, Capabilities, and Strategy**

At industrial or commercial companies, senior leaders can outline a strategy for a division and marshal support to execute it. But that top-down approach doesn't work in a PSF, because of the fluid and constantly evolving nature of the PSF's two strategic assets: its professionals and its clients.

A practice's ability to deliver value to clients rests on the skills of its professionals, and the skill set of those professionals affects the choice of clients. In turn, the clients being served affect the development of the professionals' skills. The strategy of a practice therefore is tightly linked to its clients and the professionals serving them. Whom a practice hires affects the clients it can serve, the clients it serves affect how the skills of its professionals evolve, how the skill set evolves affects the clients the practice can acquire in the future, and the cycle keeps repeating.

Practice leaders can use two tools—the *practice spectrum* and the *client portfolio matrix*—to assess, track, and make adjustments to the development and deployment of professionals and the management of the client portfolio and thus achieve lasting superior performance. These tools are based on our research over the past two decades, more than two dozen cases on PSFs that we have written, and our discussions with several thousand PSF leaders.

# The Practice Spectrum

According to our colleague Jack Gabarro (who built on the ideas of former HBS professor David Maister), PSF practices fall on a spectrum of sophistication that ranges from “commodity” to “procedure” to “gray hair” to “rocket science.” Successful practices are clear about their position on this spectrum.

## The Professional Service Spectrum

	COMMODITY	PROCEDURE	GRAY HAIR	ROCKET SCIENCE
Client need	Solving routine, often simple problems	Implementing a complex project with several interrelated parts	Deciding on a major, ill-defined issue with which the client has little experience	Addressing a unique and difficult problem with major consequences for the client
Selling proposition	Low cost	Systematic and comprehensive approach	Track record of dealing with similar problems	Ability to solve complex challenges
Organizational capabilities	Efficient delivery processes	Methodologies	← Rigorous empirical analysis →	State-of-the-art theory
			Learning from experience	
	← Knowledge management →			
Professionals' skills	Focused execution against specific requirements	Following procedures rigorously and comprehensively	Converting specific knowledge to judgment that's applicable in other settings	Applying theoretical and empirical tools to devise innovative solutions
Profit drivers				

- A *commodity practice* helps clients with relatively simple, routine problems by providing economical, expedient, and error-free service. The Big Three Indian outsourcing giants, Wipro, TCS, and Infosys, have gained scale and recognition while operating at this end of the spectrum.
- A *procedure practice* offers a systematic approach to large, complicated problems that may not be cutting-edge but require attention to a plethora of considerations. Accenture's Technology Consulting practice has long been an archetypal example of this.
- A *gray-hair practice* provides seasoned counsel based on experience. Consulting firms like McKinsey, for instance, often market their strategy development advice to clients by noting that they have guided similar corporations through strategy exercises.
- A *rocket science practice* addresses idiosyncratic, bet-the-company problems that require deep expertise and creative problem-solving. An example is the mergers and acquisitions practice of the boutique law firm Wachtell Lipton, famed for its cutting-edge work for businesses fighting hostile takeover bids.

Although a practice's profile can extend across more than one type, we've found that the best-performing practices have a sharp focus. Clients know what services such practices offer, practice leaders which performance levers to pull, and recruits what type of work they'll do. A diffuse profile dilutes a practice's identity and renders it a jack of all trades and a master of none.

Plotting a practice's profile on the spectrum enables its leaders to understand how to manage the practice, diagnose any misalignment, and shift its positioning if needed. It's important to note, however, that practice profiles change as demands of the business and the environment change. During the 1970s the newly formed strategy consultancy Boston Consulting Group, not wanting to compete head-on with incumbents like McKinsey, chose to position itself more as a

rocket science than a gray-hair practice. Unlike McKinsey, which offered experience-based, judgment-driven advice, BCG offered advice that drew on innovative empirical models such as its growth-share matrix and experience curve. By the 1980s, BCG had become more of a gray-hair practice. The transition was driven in part by its leaders' recognition that rocket science practices, however successful, tend to remain small; BCG aspired to a growth rate and size that would provide ample career opportunities to its professionals.

The relevant organizational capabilities, professional skills, and impact of profitability levers vary across categories. Practice leaders must ensure that all those elements are aligned with the practice's position on the spectrum.

**Recruitment and development.** A rocket science practice's strategic assets are brilliant, creative professionals who deliver innovative solutions. Do their leaders care whether their recruits' intellect is complemented by social grace? Not necessarily. The head of one rocket science legal practice described its approach to hiring this way: "We are not looking for 'polished pebbles' who come across as well-rounded and sophisticated. We seek to hire 'splendid spikes,' individuals who have extraordinary abilities on the dimensions that matter to us."

Gray-hair practices seek wise counselors whose sound judgment and tailored advice reflect wisdom gleaned from experience. Where are such professionals recruited? Usually not laterally from other firms, because they may bring with them approaches and attitudes inimical to a practice's culture. Instead these practices usually recruit individuals with an aptitude for "growing gray hair quickly," as the director of one strategy consulting firm told us. McKinsey, for instance, typically hires top graduates of premier professional schools. Academic success demonstrates an ability to absorb and analyze information, consider it from different perspectives, and articulate one's views cogently. It predicts that someone can learn quickly from experiences with senior partners and clients and develop judgment that he or she can apply in consulting engagements.

Recruits are not only trained in the nuts and bolts of consulting work but also inculcated with the firm's mores, particularly those related to client service. The goal is for consultants to come across as sage advisers in both the content of their advice and its delivery.

A procedure practice seeks individuals with "fire in the belly"—a desire to achieve through hard work and enterprise. This is evident in the reason one business process consulting firm turned down a recent candidate for an associate position. When he asked how to improve his prospects with similar firms, the interviewer told him, "Your résumé and your interview conveyed a sense of privilege. It was reflected in your schooling, your choice of a major in college, and your hobbies. We worry about recruiting professionals who, if asked to work an hour longer on an assignment, convert the conversation into a philosophical debate. We're looking for individuals who have demonstrated in their background, activities, and interests a willingness to work hard and battle against adversity and the capacity to put in whatever hours the work might demand."

Whereas procedure practices value drive and tenacity, commodity practices prefer dependability. They recruit steady individuals who will produce regular output at a reliable pace and quality. A human resources executive at a commodity practice explained, "We're looking to hire people who have a minimum level of skill, are willing to undergo training to achieve proficiency, and are dependable. They do not absent themselves without notice and are not churning through organizations rapidly. Basically, we're looking for qualified individuals who are glad to have the job and sincere about doing it well."

**A diffuse profile dilutes a practice's identity and renders it a jack of all trades and a master of none.**

The skills professionals need to cultivate also vary along the continuum. In commodity practices, they must learn to deliver efficiently against established standards; in procedure practices, to understand and apply methodologies rigorously; in gray-hair practices, to apply experiential learning to future projects; and in rocket science practices, to remain at the forefront of their field of expertise.

Incentives for junior staff differ as well. In rocket science practices, young professionals are motivated by intrinsic challenge, the culture of innovation, and the opportunity to develop cutting-edge skills. In gray-hair practices, they're motivated by mentorship, experience that develops judgment, and the chance to make partner. In procedure practices, they value pay for performance, bonuses for achievements, and training and experience that develop generalized skills that can be used across organizations. In commodity practices, young professionals value job security, rewards for applying themselves steadily to the tasks at hand, and overtime in the case of long hours.

**Strategic capabilities.** Efficient delivery, while nice for any practice, is a crucial requirement for commodity practices. Application of state-of-the-art expertise is critical for rocket science practices. Central to both procedure and gray-hair practices is knowledge management, though its nature differs at each.

Procedure practices' systems capture and codify the experiences of project teams to make them available to other teams. Professionals undertaking an external audit of a large client, for example, will follow and refine an established methodology. Knowledge management in this context involves developing and improving an effective process. Knowledge management systems in gray-hair practices, in contrast, are more akin to the Yellow Pages than to an information storehouse. They connect experienced professionals with one another and promote a culture of developing and sharing road-tested tools, approaches, and insights. A strategy consulting partner working with a client in the automotive sector, for instance, might

reach out to another partner in the firm who has worked in that sector to understand industry dynamics without breaching client confidentiality.

**Drivers of profitability.** In a professional service partnership, profitability, which is profit per partner, is driven by four factors, according to the following formula:

$$\text{Profit/Partner} = \text{Profit/Revenue} \times \text{Revenue/Time billed} \times \text{Time billed/No. of professionals} \times \text{No. of professionals/No. of partners}$$

This simplifies to: Profitability = Margin x Rate x Utilization x Leverage

Profitability of publicly owned professional service companies is driven by these four plus two additional drivers: debt to equity ratio, also known as financial leverage, and capital intensity, which is capital employed per senior professional.

It's important not to use *billed rate* in the profitability calculations but to account for discounts given and use only *realized rate*. Also, some practices “value bill” their clients, charging either a fixed fee or a fee contingent on results achieved. Although they don't explicitly bill by the hour, they can calculate implied rates using estimates of time required to provide services for fixed-fee contracts and, for contingency-fee contracts, the probability of achieving desired results.

The four drivers of profitability—*margin*, *rate*, *utilization*, and *leverage*—vary along the practice spectrum. *Margins* tend to be 50% or more at rocket science practices, 35% to 50% at gray-hair practices, 20% to 35% at procedure practices, and often in single digits at commodity practices.

*Rate* also is highest for rocket science practices; because their services are so valuable to clients, they command big fees. At the other extreme are commodity practices that secure engagements by

underbidding competitors, often in response to exacting requests for proposals.

*Utilization*, in contrast, is lowest at rocket science practices and rises as you move toward the other end of the spectrum. Professionals in rocket science practices must stay on the frontiers of their specialties by attending conferences and workshops, conducting research, and so on. As a result, they spend less time directly on client matters. In a commodity practice, fixed costs are high and margins are thin, so high utilization is essential to economic success.

*Leverage* is low for rocket science and gray-hair practices because their clients expect senior professionals to contribute significantly to service delivery. Clients of procedure and commodity practices, on the other hand, expect junior professionals to do most of the work under the oversight of senior ones.

How profitability changes along the spectrum cannot be predicted, given that two of its drivers (margin and rate) increase and the other two (utilization and leverage) decrease as you move left to right on the spectrum, from commodity to premium service. The good news is that a practice can be highly profitable anywhere on the spectrum, provided it appropriately employs its profitability levers.

## **Misalignment of Practices**

In our workshops, most PSF leaders place their practices toward the premium end of the spectrum, regardless of where their margins suggest they belong. The mismatch becomes apparent when a practice leader says something like “I know we’re a terrific practice offering excellent service to our clients. Our clients, though, don’t appreciate the value we contribute and are exerting price pressure on us.”

A practice’s position on the spectrum is determined not by the practice leader’s presumptions but by the clients’ appraisal. When a leader doesn’t recognize that a practice is on the less-premium end of the spectrum, problems emerge. The leader may operate the practice

with low leverage and promise recruits exciting, challenging work that produces innovative solutions. But clients will be more concerned with efficient delivery of relatively routine solutions. They'll exert price pressure, forcing the practice to focus on metrics more appropriate to commodity services, such as utilization. The professionals will then be frustrated by the nature of the work and the way they're being managed. As a result, the practice will flounder.



Kirsten Ulve

There are two reasons for such misalignment. One is pride that sometimes borders on arrogance. Professionals often overestimate the distinctiveness of their offerings. The other is that over time a

practice drifts to the left on the spectrum. It may have started out as specialized but gets commoditized as competitors copy its offerings, clients internalize some elements of the service, technology helps diffuse knowledge, and people move, taking their expertise to other firms. What was rocket science yesterday becomes gray hair today, procedure tomorrow, and commodity the day after.

Practices can counter this drift in various ways. They can try to safeguard distinctive features of their service by limiting knowledge leaks—impeding competitors’ access to information, minimizing professionals’ turnover, and setting up technological barriers. Rocket science advisers in financial services, for example, maintain secrecy about precisely how they arrive at their recommendations, and gray-hair consulting practices nurture a mystique that protects their intellectual property even as it adds to their brand image.

Fighting drift solely by striving to maintain the status quo, however, can be a losing battle. A practice must innovate, launching unique new offerings, and give up offerings that have become commoditized. Neither is easy to do. Innovation is by nature Schumpeterian: As it creates new solutions, it destroys the existing order. Professionals will resist innovation mightily if it threatens to make their skills obsolete.

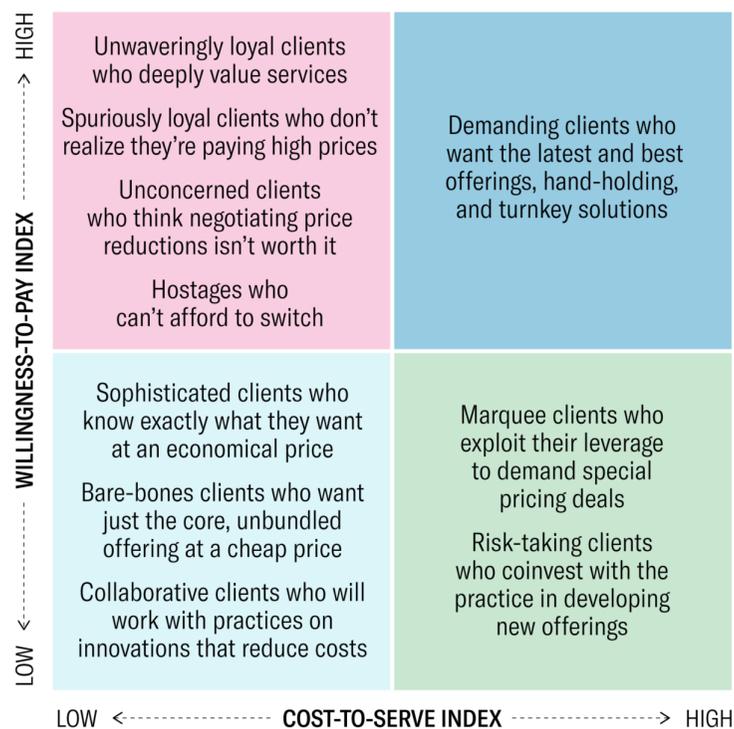
Giving up existing business is also challenging. The justifications for continuing with commoditized offerings often are that any revenue above marginal cost will boost the bottom line and that continuation of service will stave off competitors. Such a line of reasoning is most vigorously advanced by practices that measure performance by revenue or are operating below capacity. But it disregards the fact that once a practice has become commoditized in the market’s view, it’s extremely difficult for it to move back toward the premium end of the spectrum, and the long-term damage to the practice can be devastating.

## **Client Portfolio Management**

To achieve superior performance, a practice has to manage both its capabilities and its client portfolio systematically.

A useful way to examine portfolios is to determine where clients fall in the four quadrants formed by comparing the cost to serve clients (CTS) with clients' willingness to pay (WTP). This matrix is similar to the one used in the 1987 HBR article "Manage Customers for Profits (Not Just Sales)," by Benson P. Shapiro, V. Kasturi Rangan, Rowland T. Moriarty, and Elliot B. Ross. CTS doesn't include direct service costs (such as billable hours and expenses). Rather, it comprises all the indirect costs incurred, including client acquisition and client relationship management and retention efforts.

## Different Types of Clients



HBR

We have found that PSFs pay a lot of attention to direct costs, because in addition to being easily measured and managed, they're captured as revenue and are the lifeline of practices. Firms are generally not as diligent about monitoring indirect costs, which are treated as overhead. In fact, indirect costs account for a substantial part of the

overall cost structure of a practice and can vary significantly across clients. While hard to measure, these costs can have a sizable impact on the true profitability of a client relationship.

One might assume that the ideal is to have all clients be in the low CTS/high WTP quadrant. A few practices have successfully employed this strategy, but they've tended to be boutique businesses. For instance, Wachtell Lipton focuses primarily on high-stakes M&A transactions, but because it does not have other large practices, it is the smallest of the top 100 U.S.-based law firms.

A practice may also attempt to cluster clients in the high CTS/high WTP or low CTS/low WTP quadrants. (Note that clients in those two quadrants may be equally profitable.) Practices that focus on building relationships in the first are typically market leaders, while those focused on the second are intent on being the lowest-cost providers. Either approach demands extreme discipline. When firms are forced to play in both quadrants at once (which is often the case for market share leaders), things are even more difficult because the nature of client relationship management differs dramatically in each quadrant.

Most practices discover that their clients are spread across all four quadrants. That indicates that they have no clear strategy and are trying to be everything to everyone. This happens mainly because they can't say no to clients. Irrational confidence about being able to turn any situation around makes it hard to pass up opportunities. And a lot of practices will undertake any task a client puts forward rather than allow a competitor to develop a relationship with it. The tendency to obsess over revenues rather than profits, moreover, fosters an "any business is good business" mentality.

Few practices gather all the data needed to get a complete picture of their client relationships. And though each partner tries to optimize his or her own client portfolio's profitability, that doesn't necessarily lead to maximized profits for the practice, which might require jettisoning some clients of individual partners.

## **Relationship Strategies for Each Quadrant**

Now let's look at how to approach relationship management with the four kinds of clients.

**1. High CTS/high WTP.** Clients in this quadrant typically view the practice as a value-adding partner and look for long-term commitment. They consciously choose not to develop expertise in-house or make investments that could reduce their need for the practice's services. One reason strategy consulting firms exist, for instance, is that clients have chosen not to build internal strategy capabilities. Hiring and maintaining top-notch business development skills is far more expensive for them than periodically paying an outside firm to develop strategic plans. These clients commonly demand turnkey solutions and expect a lot of hand-holding. In our analysis of PSF practices, we find that 15% to 20% of a practice's clients are usually in this quadrant.

**2. Low CTS/high WTP.** Broadly, there are two client segments in this quadrant. The first are *unwaveringly loyal* clients. They deeply value the services provided and will pay a premium to keep getting them. This may seem irrational at the transaction level, but it makes sense when viewed through the lens of a long-term relationship. The clients are happy to reward a practice for past assistance and a guarantee of continued service. The costs of serving them can drop as a practice becomes better at acquiring and retaining professionals to support them.

The other segment we call *spuriously loyal* clients. These include *uninformed clients*, who don't know they're paying high prices and can be easily lured away; *unconcerned clients*, who have concluded that the cost of negotiating price reductions far exceeds the benefits; and *hostages*, who can't end a relationship with a practice because of high switching costs.

A practice that wants to be more strategic about its clients would probably start by targeting those in this quadrant, particularly the unwaveringly loyal ones. Unfortunately, in our experience fewer than 10% of a practice's clients are likely to be in this quadrant. When

clients are at risk of falling out of it owing to intense price competition or the forces of commoditization, a practice can proactively migrate them to the high CTS/high WTP quadrant through timely innovation or let the relationships slip into the low CTS/low WTP quadrant.

**3. Low CTS/low WTP.** This quadrant also comprises two client types. One rejects all valued-added services and wants the core, unbundled offering at a reduced price. Nearly half a mature practice's clients tend to be of this type, and they can often be lured away by the smallest price differential. They can be profitable only if practices formulate lean relationship strategies (for example, replacing on-site tech-support teams with online self-help). Firms that add expensive support services and other bells and whistles and expect to be paid for doing so are likely to see such clients walk. At best, these clients will agree to use additional services for free, increasing the practice's CTS. One tactic we've seen more and more practices use in the past decade is to offshore account management activities or digitize extra support services to lower clients' CTS.

The second type of client—usually accounting for 10% to 15% of a firm's portfolio—works with the practice to reduce costs through joint investments and learning. A client might try integrating its systems and processes with the PSF's, assume some functions traditionally provided by the practice, or explore with the practice ways to provide the service more efficiently. Such clients effectively force practices to innovate in service delivery. Investments in relationships with them tend to be idiosyncratic and hence have little value elsewhere, so switching costs are elevated for both sides, encouraging long-term relationships. In fact, relationships with this type of client can be the longest-lived in a portfolio. They are common with long-term outsourcing arrangements, in which the practice's team is usually housed in the client organization and processes are so intermingled that in time it becomes hard to separate the functions provided by the internal teams from those provided by the practice. We have seen this happen sometimes with accounting firms' audit teams that serve

global clients. In some parts of the world, regulation now mandates a change in providers after a specific period to prevent the unwanted side effects of close relationships, such as reduced auditor independence and objectivity.

**4. High CTS/low WTP.** Clients in this quadrant are at best marginally profitable. They end up here for a variety of reasons. Often they're a practice's largest clients, volume-wise. The power asymmetry in the relationship and a practice's desire to keep the client at any cost can be a disastrous combination, especially when the practice's services come to be perceived as commodities. We have often heard account teams joke that such accounts have been internally labeled "strategic" in order to make it difficult to fire them or take action to improve their profitability.

Client relationships in this quadrant aren't always bad. Sometimes rocket science or gray-hair practices with high fixed costs are forced to take on marginally profitable business to utilize capacity, especially during downturns. It's also common for *showcase accounts*—marquee clients that enhance practices' reputations—to be in this quadrant. Practices that provide multiple services to a client have often used one as a loss leader to acquire the account. Some services are literally given away to protect margins of other, more profitable lines. "Learning" relationships also can land in this quadrant: A client willing to share the risk of developing a new offering will often expect a discount for having "skin in the game."

Practices typically use a foot-in-the-door approach, acquiring clients through offers of low prices and high levels of hand-holding. The plan is to increase prices or cross-sell other services to them over time—common tactics in software and technology services. While that approach has merit, it's ineffective when the focus is just on raising prices. Though in rare instances clients may be unable to exit a relationship, most are smart enough to detect and unwilling to accommodate a price escalation. The only effective solution is to expand the scope of the relationship.

A relationship in this quadrant can become dangerous, however, if the amount of hand-holding creeps up over time. Gradual but constant increases in costs to serve can go unnoticed for a long period, and practice leaders are often shocked to find that clients they believed were in other quadrants are, in fact, in this one.

We have observed clients in this quadrant consume as much as two-thirds of a practice's resources while accounting for about a third of its revenues. The easiest way for a practice to improve financial performance is to shed them or migrate them to more-profitable quadrants. Moving these clients to the high CTS/high WTP quadrant is extremely difficult, because it involves getting them to pay higher prices, but one strategy is to introduce innovations that change the game in the relationship. A more straightforward approach is to educate clients about the true costs to serve. We've occasionally seen clients accommodate changes in the delivery of services if the accommodation reduces the CTS without affecting the value provided. But at the end of the day, a practice should be clear about the reasons for having a client in this quadrant and plan to move away from any relationship that cannot be economically or strategically justified.

The professional services game is no longer just about maximizing market share; the quality of market share also matters. Client portfolio analysis can help practices improve it. They'll need to perform it often to track changes in individual relationships over time and assess whether they're beneficial. If not, practices can make timely adjustments and take corrective action well before any relationship spins out of control and becomes an unprofitable resource drain.

...

Our framework allows practice leaders to develop an understanding of the interplay between their business's supply side and its demand side. On the supply side, leaders analyze the practice's location on the

practice spectrum and what that implies about the skills and capabilities to be developed. On the demand side, the leaders develop a profile of the client portfolio and figure out which accounts to cherry-pick and how to differentially serve various clients.

By using this framework, a practice can develop a clear profile, among both clients and professionals, and formulate a coherent strategy for itself. After all, good strategy is about knowing who you are and making the right choices.

A version of this article appeared in the March–April 2021 issue of *Harvard Business Review*.

## AN

**Ashish Nanda** is a senior lecturer of business administration and the C. Roland Christensen Distinguished Management Educator at Harvard Business School and former director of the Indian Institute of Management at Ahmedabad.

## DN

**Das Narayandas** is the Edsel Bryant Ford Professor of Business Administration, senior associate dean for Harvard Business Publishing, and senior associate dean for external relations at Harvard Business School.

