The mechanics of building a valuable service business

This paper expands on the mechanics as set out in our inner workings diagram.

Building a valuable service business is much like assembling an engine. Not a mass-produced engine on a production line, but a lovingly handcrafted engine, like you would find in a Formula 1 car. Your service business converts knowhow into value. Assemble it correctly and get the gearing right and it will be a remarkably efficient value creator.

Income generation

Like any machine of interconnected components, this income-generating part of the machine will turn-over no faster than the slowest part. There are three sources of power:

- sales and marketing activity;
- service delivery; and,
- relationship management.

Income growth will be limited if your sales and marketing activity doesn't provide new clients faster than old clients move on (assuming they are of equal value). The size and structure of your team may limit your ability to service all the new clients. And if you don't manage client relationships at an appropriate level you could lose more clients than you win.

You need to turn the handles that drive all three processes – sales and marketing activity, service delivery and relationship management – at the same rate for the machine to be an efficient income builder.

Turning income into profit

When we start a business we often dream of milestones we'd like to reach. It's surprising how often those milestones are income figures. How often have you heard "I want to be turning-over £1m in five years"?

Whilst it's tempting to bask in the glory of seven figure income numbers – after all, that means a lot of people like what you do – income alone doesn't create a valuable business. It's a very good starting point, but for income to be meaningful it needs to be turned into profit. Actually, more than that – it needs to be turned into predictable profit (more on that later).

The cog in the service business machine that links income to profit is the cost base and how you use it. By far and away the largest cost in a service business are people costs, often around 60% of total costs. But of course they aren't a cost. They're an asset and often quite an expensive one. And the more productive that asset it, the higher your profit margin will be.

Unlike many businesses, in a service business if you sell more most, if not all of the income turns into profit (assuming you don't have to employ more people). A 10% increase in employee utilisation (assuming all time charged to a client is billed) will usually have a much bigger impact on profit than a 10% increase in your daily rate.

Review how your employees spend their time and consider how utilisation could be improved. For example, we often find valuable client-facing employees spend too much time on low-value admin tasks that would be unnecessary with better processes and systems. Creating more chargeable time by investing in better systems, or employing cost-effective admin support often makes financial sense.

Are you measuring utilisation? If you are, are you making use of the information to improve profitability?

The importance of predictability

People running businesses often ask us how they can build a more profitable business so they can sell it for enough money to retire on. Implicit in their question is: more profit equals a more valuable business. To a point this equation works, but it's not quite that simple.

A buyer of a business is buying the opportunity to bank future profits. That's their return on investment. So the price they will pay is based on their perception of future profits. Breaking that down to make it clearer, that is **future profits**, not the profit the business is generating whilst you own it. And, crucially, their **perception** of those future profits, which is not the same as what it has earned so far.

The thing that narrows the gap between profits earned under your ownership and a buyer's perception of future profits is predictability. The more predictable profits are, the closer the two will be and the more likely you are to be paid what you think your business is worth. Predictability is influenced by:

- **Past trends** – a consistent upward trend in profit is reassuring, whereas swings up and down make it harder to predict what will happen in the future.

- **The type of work** – high levels of recurring income from long-term contracts is more predictable than income based on short-term projects, no matter how valuable they are.

- **Spread of clients** – the more even the spread of income across your client base, the less your income is dependent on the financial success and decisions of any one.

- **Embedded processes and organisational knowledge** – the more processes are documented and followed, and the greater the spread of knowledge throughout the business, the less future profit is dependent on the knowledge in the heads of a few people who could move on. And robust processes reduce the risk of costly, unpredictable mistakes.

- **The reliance on you** – if the success of your business is intrinsically linked to what you know and do, the more likely it is a buyer will require you to stay on after they acquire the business. Over reliance on you also makes it more likely that they will want to link the amount they pay for it to its future performance, which can make it harder to reach agreement. Better to make yourself redundant before you look to sell.

- **Loyalty of people in the business**. A large part of the value of any service business is vested in the people in it. Some may be more loyal to you than the business and feel inclined to move on if you do. The uncertainty of life under a new owner may cause others to look for work elsewhere. Think about introducing long-term incentives to stay with the business after you sell to increase the predictability of profit.

So, for a valuable business, don't just build profit. Build predictability as well.

If you think your service machine could do with an overhaul, call me on 0117 971 4119.

Steve