

Leverage in Consulting Firms: Key to Profitability and Growth

Leverage is a crucial concept for consulting firms to understand and manage effectively, but oddly one doesn't hear much about it these days.

Put simply, leverage refers to the ratio of junior to senior staff on client projects. A highly leveraged firm has a large number of junior consultants and analysts doing the bulk of the client work, with a smaller number of senior partners overseeing them and managing client relationships. A low leverage firm has the inverse - more senior partners and managers doing hands-on client work, supported by fewer junior resources.

Why Leverage Matters

As I explained in my 2021 book *Growth*, leverage is central to the economics and profitability of consulting firms. Senior partners can bill at high rates for their expertise, but much of a firm's profits actually come from the margin between what junior resources are paid in salary and what they are billed out to clients at. By staffing projects with a larger proportion of (lower cost) junior resources, a consulting firm can deliver projects at a lower cost while still charging premium rates, thus increasing profitability.

David Maister, the leading thinker on professional services firm economics, phrased it well - much partner profit comes not from what partners themselves bill, but from the surplus generated from non-partner staff. High leverage allows partners to earn outside profits compared to what they could bill on their own.

However, high leverage is not always optimal or even feasible, depending on the type of work a firm does. Highly complex, innovative "brain surgery" type projects require extensive partner time and expertise, necessitating low leverage. More standardized, repeatable "procedure" projects lend themselves to higher leverage.

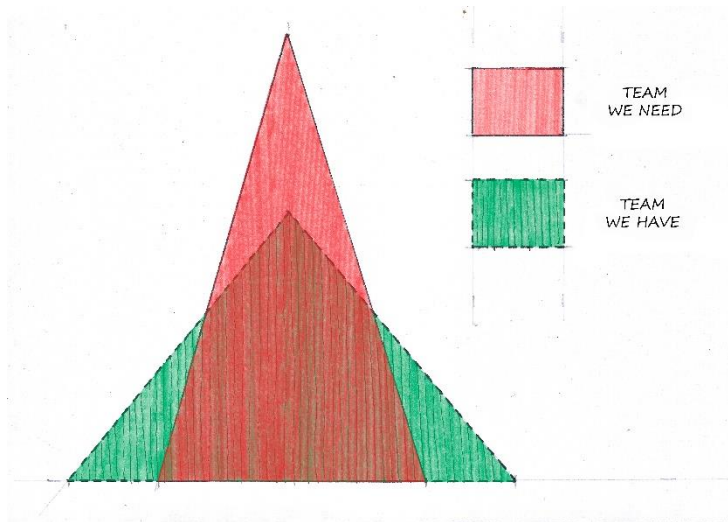
The key is to strive for the highest leverage the work will support - but no higher, or quality and client satisfaction will suffer.

Table 1: Low vs. High Leverage Firms

	<i>Low leverage</i>	<i>High leverage</i>
Service	High-quality, bespoke services usually for strategy or innovation projects. Outcomes tend to be open and hard to measure. Task complexity tends to be higher.	Standardised, repeatable services usually aimed at implementation or operational projects. Outcomes tend to be more specific and often measurable. Task complexity tends to be lower.
Finances	High day rate, high-margin work, but for shorter projects. Costs are higher due to high salaries.	Lower day rate, lower margin work, but for longer projects. Costs are lower due to lower salaries, but can be nudged upwards through investments in IT.
Knowledge management	Knowledge is generally passed through person-to-person relationships. Interpersonal networks are important.	Knowledge is embedded in IP which forms a great part of the standard operating procedure of these companies. IT systems are important for this to be effective.
Employees	The 'brand' of the company and the people within it are important. Top influencers, MBAs, client names and awards signal quality in the market. Focus on expertise, innovation and brilliance. Utilisation rates tend to be lower. Employees tend to demand and be given higher levels of autonomy.	Employees must be able to follow standardised processes. Graduates are not uncommon here, though unlikely from top-flight MBA courses. Utilisation rates tend to be higher. Employees tend to have less autonomy, even up to the middle management level.
Training	Partners are central to mentoring and developing employees on a one-to-one basis. High investment in talent development.	People are trained on the process, usually through IT systems or in groups. Lower investment in talent development.

Leverage and Pyramid Structure

A firm's leverage is reflected in the shape of its organizational pyramid or hierarchy. A low leverage firm doing mostly high-end strategy work will have a relatively "tall"



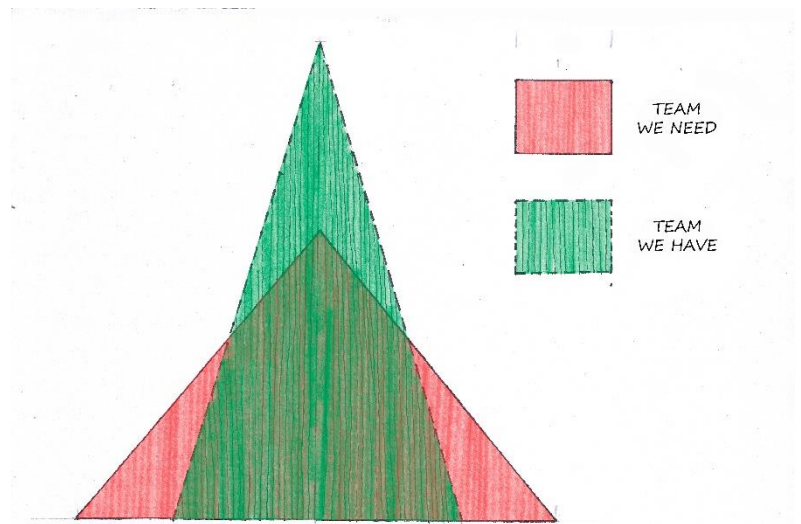
pyramid - more partners and managers compared to junior staff. A high leverage firm doing more standardized work will have a "flat" pyramid with a large base of junior resources.

As firms grow, their pyramids tend to get flatter, all else equal, because their IP improves. With more client

work coming in, they need large numbers of junior resources to execute projects.

This can create an up-or-out dynamic - there are more junior staff than there are manager and partner slots for them to be promoted into. For example, a firm might have a 80% promotion rate from junior to manager, but only 50% from manager to partner.

Some prestigious firms, like McKinsey and Goldman Sachs, purposefully maintain very high junior turnover (and flat pyramids) as a screening and talent development mechanism - only the "best of the best" get promoted and bed blockers are shifted. This only works for firms with very strong reputations that can easily recruit new "top tier" junior talent.



Considerations in Leverage Strategy

There are a number of factors consulting firm leaders need to consider and balance in setting leverage strategy:

- **Intellectual Property:** Good IP, that is regularly improved, and regularly used is the cornerstone of enabling leverage. You should undertake annual audits of IP and how effective it is at enabling juniors to do better work without impacting quality of delivery.
- **Client Needs & Expectations:** First and foremost, leverage must align with what is required to deliver outstanding results to clients. Pushing too much work down to juniors to maximize short-term profits is a recipe for sub-par quality and damaged client relationships. Clients of "brain surgery" type work expect extensive senior access and expertise.
- **Employee Value Proposition:** Leverage has a big impact on the experience of working at a firm and the "product" you are selling to prospective employees. A high leverage model provides a different career path and learning experience compared to a low leverage apprenticeship model. Be clear on your employee value prop and align leverage accordingly.
- **Repeatability of Work:** The more similar and repeatable your projects, the more you can capture knowledge in methods and templates that enable juniors to do the work. One-off, highly custom projects will always require partner heavy teams. As you win more projects in a space, strive to increase leverage.
- **Culture & Collaboration:** In a low leverage environment, juniors get a lot of direct exposure to partners which can foster a tight-knit, apprenticeship culture. In a high leverage model, communication and culture building requires more purposeful effort as there is less direct partner interaction with the base of the pyramid.
- **Partner Economics:** Obviously, higher leverage is better for partner profits, all else equal. But the other factors above put upper bounds on leverage. Still, there are often opportunities to profitably increase leverage without sacrificing quality through methods, tools, and training. This should be a continual focus.

Ultimately, each firm needs to find the leverage model that works for its strategy, culture and clients. But for most growing firms, some degree of increasing leverage over time is essential to maintaining profitability and competitive economics. By investing in repeatable methods, knowledge capture and training, firms can enable their junior talent to take on more challenging work - creating a win-win of employee development and enhanced profitability.

The key is to be purposeful about leverage strategy and proactively manage the multiple tensions involved, not let it evolve on its own. Founders especially need to fight the urge to stay involved in all the client work themselves as the firm grows. Building a sustainable, profitable firm requires a team-based approach with appropriate leverage - and that starts at the top.