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Why agency owners DESERVE to make a 20% profit

Having analysed the financials of more than a hundred agencies of all shapes and sizes, from traditional PR firms to cutting-edge digital shops, I must admit I am downright flummoxed about one common and disturbing trend: far too many owners are way too content with downright measly or non-existent profit margins.

I have heard all the excuses.

"We can't charge more for our services." "We know we over service accounts—but our philosophy is to do whatever it takes to make our clients happy." "I make a decent living—that's all that counts." "Our focus is on building up our top line and look for a buyer in five years." Or, "We did 10% last year—that's pretty good, right?," said one owner, who was taking a salary of $75,000 (which meant her actual profit margin, after adjusting for a fair market salary, was way south of that).

I often ask, why do you think you are the only business in the country that doesn't deserve to make a decent profit?

Profit, in a nutshell, is the reward that you deserve for the RISK you are taking as an entrepreneur. Consider, for a moment, your business as an investment. What kind of return should you expect to receive for the decades of sweat equity, the never-ending challenge of staying at the top of your game to satisfy the requirements of demanding clients, the constant need to compete for new business, make payroll, offer competitive salaries and benefits, etc.?

I believe that return can be quantified, based upon a common methodology business analysts use in assessing the relative degree of risk of various financial investments, which is sometimes referred to as the Ibbotson additive approach or capitalization of historic earnings approach to risk assessment. I'll spare you the details—but here's basically how it works (the numbers and ranges are approximate and variable—but I think it will give you the gist of the approach, since it is largely based upon common sense.)

Say you had a million dollars to invest. What is the safest investment you can make with that money? It's probably some type of long-term US treasury bond that might return 2% to 4%. If your risk tolerance was higher, you might consider a blue-chip stock, which could yield on the order of 7% to 9% in a good year. That means the stock equity would have an extra (or additive) risk premium of 3% to 5% compared to the treasury bond.

But say you have a good friend who has a successful shoe store, or restaurant, or construction company. Why not invest your money in his business? Well you could, but based upon risk calculation studies compiled over the years by the financial industry (which are documented in directories that all certified valuation analysts utilize on a daily basis), you have to add a whopping 8% or more *additional* risk premium, which equates to a total risk factor of 17% or higher—for the simple fact that all such businesses are classified as small closely-held businesses that pose significant additional risks—about twice the risk as a blue-chip stock.

But some businesses are riskier than others, you say. Correct—so tag on an additional 2% to 3% if you happen to own an advertising or marketing services firm (that does not have hard assets), since ad agencies and the like are considered riskier than the average small business.   Interestingly, *some* public relations agencies may have a smaller or even a negative risk factor, since they might be classified as management consulting businesses by a valuation expert.

But you're still not done, because you have to also take into consideration the specific financial dynamics and "value drivers" of your own business. The strength of your management team, the services you offer, the markets you serve, longevity of accounts, and many other factors are taken into consideration when assigning an additional risk factor for your business. That could tack on still another 2% or more, adding up to a total risk factor of 20% or more (this is sometimes refer to as the capitalization or cap rate).

So you want to sell your firm? That's pretty much what an investor, be it one of the big holding companies, or a private equity group, would expect in return for investing their money in your business versus a bond or the stock market. (The lower the cap rate, the more valuable your business is.)

It is certainly possible that your cap rate might be lower. Or an investor may still be willing to buy your business even if your pre-tax net income was subpar if, say, you offer leading-edge services or specialize in a vertical sector that is able to command a higher "multiple" in an M&A transaction. (By the way, the average pre-tax profit margin in the industry for small to mid-size independent agencies is about 15% of Adjusted Gross Income, or AGI, which is total fees and retainers minus costs of sales). But even then, the buyer would do so only if your agency offered significant growth potential that would eventually translate into a 20%+ return in the not too distant future.

Whether you hope to sell some day or not, you deserve to reap the rewards of an entrepreneur each and every year you are able to keep the doors open (okay, at least after your rocky start-up years). If you aren't doing at least 20% today, you should begin to refocus your management strategy and energy to enhancing the bottom line. After all, it is your career and family's welfare you have on the line. You and they deserve nothing less.

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