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Determining Your Firm's Profitability in 5 Steps

developers · Tuesday, November 17th, 2020

In the unpredictable world we live in, it isn't uncommon for you to wonder if your firm is charging too much or too little. Are your billable rates in line with your competitors? Is it best to bill by the hour? By flat fee, subscription? It's no question that there are a lot of options. So with all this in mind, how do you determine your firm's profitability? How can you make decisions that will be in the best interest of both your firm and your clients? Let's take a look.

Determining Your Profitability

There are five critical steps you should be taking when you're considering how to price or re-evaluate your legal services.

1. Think about the products you're offering
2. Identify your revenue model
3. Consider your customer acquisition costs (CAC)
4. Determine your case value and customer lifetime value (LTV)
5. Understand your fixed costs

Product Offering

Yes, you are delivering legal services, but that is not your quote-on-quote product. Take the time to evaluate your niche and your unique value proposition.

Whether you're a software company or a law firm, you are ultimately selling a product. There are millions of products in the world, so being able to narrow down and pin-point your offering is crucial to making you stand out. Are you a real-estate attorney with subject matter expertise in environmental liability issues? Are you a family law attorney who has expertise in same-sex couple adoption? As you begin to look at your profitability metrics, it is important to narrow down what your firm specializes in and use those case numbers to more accurately reflect how lucrative your firm is. Drilling down on what makes your firm unique will only bolster your client experience, but your profitability as well.

Revenue Model

When you look at your revenue model and you're considering how you want to bill your clients, the first place you need to be looking at and research are the market demands. Analyze what your potential clients want, what they are looking for, and what they're demanding. Are you serving small business owners who may want to pay for services as work pops up? Or perhaps you're serving primarily start-ups with small budgets who prefer to see all costs upfront? No two clients are the same, so it is important to understand what they're looking for and how you can best meet those expectations. Additionally, you must also take into consideration the operational requirements needed to manage those clients. For example, if you're billing hourly, then the operational requirements to successfully do this would require a software that allows you to capture and track your time.

Customer Acquisition Costs (CAC)

The truth of any business is that it costs money to acquire new clients. Customer acquisition costs represent the time, money, and effort required to get leads and then convert those leads into paying customers.

Look at the data you have available. It is best to go over things in increments of 6, 9, and then 12 months to ensure you're getting the most accurate information. When you're considering your sales and marketing costs for your firm, the first thing you should think about is your time. This could be the time spent on business development, networking events, anything that takes time out of your day to pursue in the effort to expand your book of business. Next, tabulate any additional money spent on digital advertisement, or direct mailings. These hard costs will be the foundation for determining your customer acquisition cost. Your costs to close a lead are incurred through the bottom of the funnel activities that take up your time like consultations or meetings.

Let's go through a fictitious example utilizing 12 months of made up data:

Calculating your CAC

$20,00 Cost of your time
$15,00 Digital ad spend
$6,00 Targeted mailings

$41,00 Total sales & marketing
75 New clients

$547 Subtotal
$80 Cost to close a lead

$627 Total CAC

In this example, we took the estimated cost of your time plus the amount you spent on marketing and targeted campaigns to determine a total sales and marketing figure. We then took that figure and divided it by the total number of clients you work with throughout a given year. With that number, you subtract the final estimated costs associated to close that specific lead, and what is left is your total cost to acquire that particular client.

So going forward when you consider growing your business, this type of easy calculation will be able to help you understand that if you invest X amount of dollars, you will be able to attain X amount of new clients. By adding some predictability into your equation, you will be less surprised at the end of the road if things don't go your way.

Customer Lifetime Value (LTV)

Customer LTV represents the amount of business value or gross margin that is received over the course of a client's lifetime. When that client first steps through your door, you must begin to evaluate how much revenue you are gaining from your client on a case-by-case basis.

Let's go through a fictitious example of an attorney who bills by the hour utilizing 12 months of made-up data:

In this example, we took the number of hours this fictitious attorney was spending on Client X's matter and multiplied it by their billable rate. Next, we took a look at how much money the attorney was spending to do that work. In this case, 25 hours of work resulted in 17 billable hours, which converts to a little over 70% profit margin. And lastly, we multiplied that total profit margin number by the total number of matters Client X typically brings to this attorney in a 12 month period. This resulted in an LTV around $14,400. A customer's lifetime value is important to calculate because it will highlight to you which clients bring you repeat business without you having to spend those marketing and sales dollars to get them through the door.

Understanding how to calculate LTV in this easier scenario will allow you to replicate this information when you start looking at multiple fee arrangements. Like discussed earlier, if the market is demanding subscription billing, or consolidated billing (to just name two), you and your firm need to be able to meet these needs in order to remain competitive. Your customer experience will make or break your business, and how your clients want to be billed needs to be met with "yes we can make that happen," not "sorry, we cannot accommodate that billing arrangement."

Fixed Costs

At this point, you have figured out what expertise and skill set you have that sets you apart, you have determined what specific product you're offering, how your want to set up your billing structure, how much money it costs for you to get clients in the door, and how much margin you can generate from that client in a given period of time. The last step now is to understand your fixed costs. Fixed costs represent the amount of money you are spending to support your law firm as a whole. On an annual basis, how much money are you spending to pay the firms office rent, support staff, legal technology, annual license fees, etc? These are your fixed costs.

What Does All This Mean?

The things that are really important when you look at customer acquisition costs and lifetime value are the scalability of your law firm and whether or not you can be sustainable in the long term.

The first thing you can do when you have these numbers is to look at how long it takes you to recoup your customer acquisition cost. To do this, you take your total $627 CAC cost and divide it by how much profit you generate, which in our fictitious example was $4,800. So, what this means is that you recoup your CAC by the time you are 13% of the way through your first case with that client. A general rule of thumb is that you recoup your customer acquisition costs within that first year of starting the particular matter. This low percentage indicates that you have a little more room to spend on acquiring new clients if you so choose.

The second thing you must do is ensure you're making money over a customer's lifetime. If you take the $14,400 LTV we calculated in the fictitious example (profit per case multiplied by the number of cases that client brings to you in a year) and divide that amount by the $627 CAC cost, that's roughly a 22.3x return on investment per client. This is a huge number! This indicates that you could lower your billable rate to get clients through the door and still make a decent size profit. Do your research and determine where the market stands and then evaluate if you have room to adjust.

Scalable Business Model

Your CAC and LTV are what we describe as unit economics. In the long term, if what we calculated are your unit economics, can your firm ultimately make money? The answer would be yes. From a business perspective, there are always things you can do in the short-term that will get you by, but those bandaids will eventually come off to reveal a less than favorable result. Let's do some quick calculations. If you're generating $6,800 in revenue per case (determined from our LTV example), and you're taking on about 50 cases per year, that's about S340,000 in annual revenue. Now let's say your direct costs total around $95,000 a year to serve that revenue, you're left with a gross margin of around $245,000. Now, after your fixed costs, and sales and marketing expenses (for this hypothetical example, let's say those total up to $50,000), your total income before tax comes to $195,000. If you can make these calculations each year, you will be able to determine if you can serve your clients profitably, while also saving enough cash for future growth.

All of this leads to what you should walk away with… without favorable unit economics, you will not have a sustainable law firm in the long run. Understanding how much it takes to bring new clients in and how much money those clients bring to your firm over the course of their lifetime will ultimately tell you how successful your firm will be in the future. There are levers you can pull after you understand this data. These levers are either revenue or pricing driven like billable hour vs. flat fee, or whether you're above market or below market. You can adjust these metrics accordingly. The other thing you can do is adjust your service levels. If you're spending too much time serving one client then you need to either keep your service level the same and bump up your rate, or if your rate is already in line with your competition, then keep your rate the same and spend less time performing that work.

The goal is to understand your data at the customer level to determine whether or not you'll be successful in the long term with your entire book of business.

This entry was posted on Tuesday, November 17th, 2020 at 12:00 am and is filed under Billing & Accounting, Finance You can follow any responses to this entry through the Comments (RSS) feed. Both comments and pings are currently closed.