How To Estimate And Price Contingency-Based Consulting Engagements
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Blog entry

Do you know that, on average, a movie makes about 5 times more from its DVD sales than ticket sales? It seems movie producers understand delayed gratification, and I reckon this is why movie production companies are wealthier than most consulting firms.

For instance, the most expensive movie, Titanic cost $200 million to make, but it was also the most successful movie, making $1.835 billion so far. It seems, movie people invest boldly in their creations and then cash out boldly.

For the sequel of “The Chronicles of Riddick”, Vin Diesel worked for minimum wage in order to make the movie “R” rated. He may have worked for chicken feed on the front end, but on the back end, he raked in some serious money. He understood delayed gratification.

Sylvester Stallone wanted to play the same card in Rocky Balboa, so he opted for profit sharing. The problem was that he signed to receive a percentage of net profits. The movie made some $200 million, but the net profit was big, fat, juicy zero.

This is how Sly summed it up to GQ magazine:

“They have this thing called ‘back end’. Or ‘Watch my back end move into the horizon as you lie there, shackled in naivety.’ You can make a movie for $12 million that makes $250 million, but it still ends up in the red. The studios say they added $50 million in publicity in the Ukraine or somewhere, and you're like, ‘What?’”

In “The Godfather” movies, Marlon Brando was offered 10% of profits, which he gave up a flat $120,000. That may seem like a pragmatic move, but the three Godfather movies have made $597 million.

And since many consulting firms do the kind of work in which their clients expect them to work partially on contingency, I think it’s a good idea to write about it a little bit.

Clients may request contingency work from you, but in my experience, the more enthusiastically clients request it, the more enthusiastically you should stay away from it.

Many of those companies market and try to sell unsellable rubbish in rather idiotic ways. Basically, they stand in the way of their own success.

But at one point they got tired of selling, and now want to delegate it to someone else.

But have you noticed that they insist on the methodology.

“I’ve got tired of the method I’m using, so, although it doesn’t work, I hire someone and make him responsible for making it work. And I pay him for the results that he can generate by using my non-working approach.”

It reminds me of MLM companies. You must use those companies Neanderthal methods, including harassing your friends and family. The attrition rate is high, the success rate is low, but the companies make truckloads of money by selling motivational books, CDs and DVDs.

So, let’s start with...
Your Own Character

This is vital because you have to work with people and you may not want to be a chameleon, changing your character, like a car salesman, in order to please everyone. You want to be the real you, and work with people who are similar to you.

In some aspects there can be differences, but it’s a good idea if some your values are similar. I don’t work with smokers in person because their environments smell like a vacuum cleaner’s armpits, and I hate the smell of cigarettes. I like working with people who exercise and rate their health as top priority. It shows they respect themselves.

But there are acceptable differences. I can work well with both Arab and Jewish people, but I don’t eat Halal or Kosher meat, because I regard both Halal and Kosher slaughtering practices as stressful and cruel to animals. I respect their religions, but stay away from Halal and Kosher meat.

Anyway...

Just pay attention to what similarities and differences you can handle.

Now we can move to...

The Characters Of Ideal Contingency Clients

These characters change from company to company, so what I’ve written here are just guidelines. You have to compile your own list.

Those companies...

- **Company’s vintage:** I prefer to work with companies that have been in business for 5 years or more. Based on statistics that start-ups go tits-up in their first five years in business, the five-year life span is pretty reasonable.

- **Owner’s character:** Is this person a straight shooter or a bullshitter? Is he a walker or a talker? Does he walk his talk? I like having 1-to-1 lunches with key people and evaluate them individually.

- **Criminal record:** Make sure the company’s top executives are not crooks. This is not 100% sure, because people have become even their countries’ presidents in spite of that. Tricky Dicky even declared that he wasn’t a crook, but he turned out to be one. It’s not easy, but with some help from the right sources, you can figure it out.

- **Credit history:** Get the company’s credit history to make sure it has money to pay you.

- **History of projection and reality:** This will show you how realistically the company can project its sales figures. Look at the variances how much the company has exceeded or come short of its sales projections.

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1 “People have got to know whether or not their president’s a crook. Well, I’m not a crook.” – President Nixon’s speech to 400 Associated Press managing editors in Orlando, Florida, on 17 November 1973.
• **Information technology**: How effectively does the company use technology to systemise and automate repetitive processes? Let’s remember that systemisation and sensible automation represent predictability and consistency, which are good indicators of healthy companies. If even the smallest tasks depend on armies of employees, then run. The company’s overhead is probably high, and that can have an impact on your contingency earnings.

• **Performance indicators**: How does the company track performance? Are the indicators cause- or effect-based. Employee absenteeism, energy and enthusiasm are cause-based indicators. Profit and revenue are effect-based indicators, caused, among others, by employee absenteeism, energy and enthusiasm. Also, pay more attention to judgeable indicators than to measurable indicators. Judgeable indicators are usually cause-based. Measurable indicators are usually effect-based. Of course, look at the financial indicators too, like gross margin, gross revenue, revenue per employee, etc.

• **Market positioning**: Is this company a reasonably recognised player in its market? What percentage of the market knows about this company? Stay away from unknown entities.

• **Leadership style**: Get a feel for the company’s management style. Are the employees proud of working there or do they feel terrorised by Monday mornings when the weeks start? Do managers let people do their work or do they act as interfering busybodies?

• **Attitude to business development**: This will show you what the company’s leaders’ and key executives’ overall view is on business development and how seriously they take it. If it is treated as a “we’ll do it someday” topic, then run very fast and very far or you’ll never see your money.

• **Compensations**: Yes, this is a touchy topic, but you want to know what the company pays its employees. From this information, you can gauge whether the company employs top professionals or bottom feeders whose other option, besides working at this company, is the welfare office. You’d better stay away companies where the production depends on underpaid, and most probably grossly disgruntled, employees. Yes, money is not a major motivator, but the lack of money kills motivation very very fast.

• **Too visible wealth gap**. Look around in the car park? Do the top dogs drive Porshes and Ferraris, while the workers drive smoking rust buckets and ride beaten up bicycles? It may show that the owner(s) are skimming the company and take every penny out of it for personal gain. They may take your money out too, so be careful.

• **Payroll, accounts payables and receivables**. This is hard and maybe impossible to check. But they are useful too, because they can give you an idea about incoming and outgoing monies. Also, do employees get paid regularly and correctly?

• **Operating philosophy**. Is the company’s operation based on abundance or scarcity? Or carrot or stick?

• **General terms of doing business**: The company may bill its clients 180 days net, which
means that it takes a hell of a long time for you to get paid. Nevertheless, negotiate your own payment terms regardless of the company’s payment terms with its clients.

- **Company’s marketing and sales approaches**: Does revenue depend on armies of peddlers roaming the land pounding pavements and dialling for dollars? If so, you may have a very hard time to make your own money.

- **Location**: Some businesses just don’t lend themselves to virtual work. You have to know how far you’re willing to travel to see clients.

- **Tax issues**: Does the company owe back taxes to the tax authorities. That can be a big red flag.

- **Language issues**: Do the people you work with speak good English. Unlike in the UK, in North America you can get an MBA or even a Ph.D. even if your English is seriously sketchy. So, don’t get blinded by impressive-looking diplomas. Nowadays you can get a Harvard MBA for $80-120, including shipping... all the way from China.

I like doing contingency gigs with good companies that want to become great companies, but I wouldn’t touch an awful company to help it to become barely mediocre.

Remember, the state of the company is a reflection of the owner’s mindset.

**Compensation**

Some clients may try to push you into working for 100% contingency payment, but don’t take it. Clients must have a skin in the game, otherwise it’s not their games, but yours alone.

It’s just a healthy balance of risk and reward. If you take all the risk, then you should have at least most of the rewards.

Also consider that there are many aspects of success that are in your client’s control, but not in yours. For instance, you generate good leads, but your client’s salespeople blow them.

There is one important point here. Some clients may want to peg your fees against your individual performance.

Reject it.

As a result of your help and support, your client’s whole company gets better off, so you can rightfully require a certain percentage of the company’s gross sales.

Also, some clients may want to pay you a percentage of net profits.

Again, reject it.

For instance, due to your expertise, your client makes an extra $1 million a month. Even at 25% contingency, you could earn a neat sum of **$250,000**.

But what happens if your percentage is calculated on net profits? Let’s see...

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And at this point the owner announces that he buys a new company car for himself, a brand new Ferrari for $550,000. Now the money - $700,000 minus $550,000 - is down to $150,000, so your share is 25% of $150,000 = $37,500.

There is a huge difference between the $250,000 and $37,500.

And now you’re subsidising the owner’s ostentatious choice of company car and the ineffective operation of his business. And since these costs come out of your pocket, he neither cares to improve operational effectiveness nor will he be satisfied with a less expensive car.

Besides, you have your own costs of business acquisition.

So, just insist on payment on gross revenue. Also, as clients negotiate down on the flat fee, push up both your percentage and your level of control. Make sure that the percentage you earn is actually largely under your control.

For instance, if you are hired to generate sales leads online, rather than fiddling with the client’s existing flawed system, build a new channel.

Create a new website on your server, get a new email list manager programme (Aweber, Infusionsoft, etc.) and keep all passwords to yourself.

You report to your clients about the number of new leads generated, but your client has no access to the lead generation system.

A client of mine had a problem with a non-paying client in 2009. He quickly disabled the website and put a temporary message on the home page...

“Due to refusal of payment, XYZ Company’s website is suspended and seized operation.”

It turned out that everything was on track with the client, but some self-important busybody mid-manager at Accounts Payable decided to wield a little control that he didn’t really have and withheld payment. The COO showed him the brand-destroying web message and unceremoniously fired his self-important arse.

But if the client had decided not to pay, my clients would have shut down the system, and walked away with an optimised website and a database of potential clients.

So, request a reasonable flat payment that makes it possible for you to put up a good fight in your client’s corner. You must be paid for your participation, and then we can talk about winning.

After all, you are expected to improve a business’ performance whose already handsomely compensated owner(s) and top executives haven’t been able to improve. They get paid for their “inability and incompetence” to create the kind of results you’ve got hired to create.
Essentially, you’re working on achieving something that the company’s well-paid top dogs have failed to achieve. And remember those people are judging your performance. It’s pretty ironic. More often than not, “no skin” also means no commitment. What that means is that you’re all alone to pull the expected achievement off and can’t expect help and support from someone who hasn’t made an investment in the initiative.

**Baseline Method**

This is important with contingency fees. In order to know how much extra money your contribution has created, jointly with your clients, you must establish their baseline revenues, that is the revenue the cline has created without you.

You can base this on the last 3-5 years of average monthly revenues. Try to ignore the first few years of revenues when businesses are still in the survival limbo. Remember, some 80% of start-ups fail in the first five years. Well, 80% of the remaining 20% fail in the second five-year period, but we have to start somewhere.

Let’s say, your client has made...

- $1,200,000 in year #3
- $1,600,000 in year #4
- $2,300,000 in year #5

That’s a total of $5.1 million. Now divide it by 36, and you get the average monthly revenue of $141,666.

What that means is that your percentage must be calculated on the amount above and beyond $141,666.

But there is one stipulation to this equation.

Your clients may discontinue certain initiatives that have been creating this baseline revenue, and continue with your initiatives only since they are more lucrative. In that case, ignore the baseline, and calculate your percentage on the full revenue.

After all, now the company’s full revenue is due to your help and support, and no revenue is coming from the company’s own effort. At this point, it’s you who keeps this company alive. You’re the proverbial life support machine of the company.

**Varying Time Frames For Fee Plus Performance Payments**

Let’s say you offer a 1-year deal for $10,000 per month plus 10% of the increased revenue. Don’t offer less than a full year, because your recommendations take time to kick in.

If the 1-year deal at $10,000 per month plus 10% of the increased revenue is accepted that’s good. If the client says he wants to try if for short time, and if you think you can bring in money, then go for it.

Of course, when some good results happen, the client is keen to renew the gig for a longer period.
of time.
Yes, he can, but now your rate is $15,000 per month plus 15% of the increased revenue.
If the client accepts it, that’s great.
If he rejects it, you pack up the whole system and walk over to the competition to the other side of the road. He may well really want what you have and is willing to pay for it.

**Logistics**

Since being paid for performance is a pretty gray area, it’s important that you explain it to your clients properly.

In many companies there is this mantra that no one can earn more than the top dogs in the boardroom.

At this point remember you’re hired because the current executive team has failed to achieve certain results. And now the executives dump full responsibility on you to reach a goal they have been unable to reach. And that requires better than “merely” executive grade compensation for you.

Be 100% committed to reinforce it regardless of how uncomfortable it may feel. Keep an eye on...

- **Declining percentages:** Some clients may insist that in your first year of your help you get 20%, next year 15% and after 10% of the revenue. But the result of your help is the smallest in year #1 and then keeps increasing. And since you’ve created those results, no one has the right to steal your percentage. Protect it like a junkyard dog.

- **Measuring results:** The method of measuring results must be pre-agreed. Every month you receive your payment with the accountant’s copy of the sales report for the previous month. This must be the same sales report that is used to report revenue to the tax authorities.

- **Performance capability:** Since you’ve been hired to create results, keep every bit of result-creating capability (Databases, sales letters, email messages web pages, etc.) under your FULL control, and give no access to anyone.

- **Receiving payments:** Demand payment on previous month’s revenue by 5th of the next month. Don’t let payments drag on. And stipulate the fine for late payments. When payments stop, make sure result-creation instantly ceases. Just think about what happens when you fail to renew your web domain or hosting. The website gets suspended with some nasty commercial displayed under your domain. So, suspend everything.

- **Ownership of wealth creation:** Since this is not a normal consulting gig that includes skill sharing with clients to pass on the performance capability, you have the right to keep the performance capability to yourself. If the client cuts you off, the performance instantly stops.
- **Solving disputes**: Forget about the legal stuff. I’ve been sued twice. Once I won and once I lost. The client admitted that it was his fault that the project failed but still took me to court to recover his investment. All right. My fault. I accepted an arsehole as a client. If you can’t solve a problem, instead of the law, use something much more powerful: The media. Write press releases about the bad treatment you’ve received.

Especially when you have engagements with larger clients, some bureaucrats can get between you and your real buyers. Some overzealous accountants may envy you for the money you make and decide to sabotage your compensation. Again, instead of going the legal road, use the fact that many of these bureaucrats belong to professional associations. Feel free to report them for malpractice.

One more thought here. I would never accept 100% performance-based work. The client must have a skin in the deal.

And just because clients have fancy titles after their names and have fancy association memberships, they may not be 100% honest and ethical in their practices. My general observation is that the more clients resist putting skin in the game, the more likely they screw you on payments.

**Knowledge Sharing Not Included**

In traditional fee-based consulting it’s our responsibility to help clients to catch a fish and teach them how to catch some more without our ongoing help. Our job is to improve clients’ performance capability, so the next time they can fix the same problem without our help.

All this changes in contingency gigs...

Contingency gigs are about catching fish FOR your clients, and you’re not obligated to teach clients about the art and science of fishing. As long as clients want the extra revenue you bring in, they must keep you and pay you.

This is vital because when the fruits of your work start rolling in, some clients may decide to cut you off. But since you kept the performance capability (system, sales copy, etc.) to yourself, once you’re out of the picture, your clients’ performance drops back to the level it was before you came along, and now you’re free to offer your expertise and the same system, including the database you’ve built so far, to your former clients’ competitors.

**Special Stipulations In Agreements**

**Intellectual Property**

The performance capability (systems, processes, infrastructure, sales copy, etc.) leading to the new level of performance remains the consultant’s property, and after disengagement the client is forbidden to use them in any way. Further, the illegal use of the consultant’s materials is
considered as infringement of copyright, and the consultant will take the appropriate legal steps to rectify it.

Every sales lead, newsletter subscriber, white paper downloader and client the consultant has generated during his engagement remains in the consultant’s database, and the client can buy it from the consultant. If the client doesn’t buy the list, the consultant is free to sell it in the open market.

If the client wants to continue using your database and intellectual property, the client can lease it from the consultant at a pre-agreed fee.

**Payment**

The consultant’s compensation consists of a $10,000 setup fee to develop and set up the necessary processes and systems plus 25% of the gross revenue the consultant generates above and beyond the established baseline. In order to maintain uninterrupted service, payment must be made by the 5th of each month.

Every month the consultant is to receive the accountant’s copy of the client’s monthly sales report for the previous month. This must be the same sales report that is used to report revenue to the tax authorities.

The consultant is also permitted a certain number of spot checks on the client’s books.

**Transferability**

This agreement, once entered into, is not transferable by either party without the full and express agreement of the other.

**Summary**

Working on contingency, while it can be lucrative, is a pretty grey area. There are many moving parts, so you have to customise each deal.

However, the good point is that it offers you long-term passive income.

Make sure you vet clients properly as well as you can. The best bet is to do contingency only after having done a normal fee-based engagement. The first engagement allows you to observe the client, her people and her operation, and decide whether or not she’s worthy of contingency work.

Hopefully, you’ve found this issue valuable, and see how you can use it in your work. After all, a little passive income never hurts.

**About The Author**
Since 1996, using battle-tested military principles and strategies, Organisational Provocateur, Tom "Bald Dog" Varjan has been working with consulting firms, both locally and globally, to improve personal and firm-wide performance, by helping them to sell their expertise at the highest margin.

For a fiendish selection of consulting resources, including his monthly newsletter Commando Consulting and practice management black paper, “The Dark Side Of Firm Management: Ten Deadly Management (Mal)Practices That Often Bring Consulting Firms to Incalculable Suffering or Even Agonising Death”, you can visit Tom’s website at http://www.di-squad.com.