Small But Mighty Agency Podcast

Episode 65: From seven to eight figures - the power of financial forecasting

Speakers: Audrey Joy Kwan, Jon Morris

Audrey Joy Kwan
How can agency owners leverage financial forecasting and modeling to better inform strategic planning and drive growth? Lean in as we talk to an agency owner, whose secret to scaling from seven to eight figures is mastering financial forecasting. You might be at the stage of business where you're doing this with minimal support. Or you might have a fractional or even full-time CFO. In other words, a chief financial officer. Either way this episode will get your gears training on how to improve decision making and allocate resources more effectively tune in.

Audrey Joy Kwan
Welcome to the Small But Mighty Agency podcast. If you are a marketer, or a consultant, or a creative who's on the journey of growth from solopreneur to agency owner, follow along because I pull back the curtains on the realities of growing and running a scalable service-based business and building a lean team. I'm your host Audrey Joy Kwan, I know what it takes to build an agency, whether it's from solo to 3, 5 or 20. I've done it, including supporting an agency owner to sell and exit. I've coached and consulted over 120 marketers, trainers and consultants and I've been behind the scenes of seven figure businesses. I also have a master's degree in communications specializing in organizational development. All this to say I know what it takes to grow, lead and operate a multiple six and seven figure small but mighty agency in here on this podcast is where we'll dive right in.

Audrey Joy Kwan
Hey friends, welcome back to the Small But Mighty Agency podcast. My guest today has built an eight-figure agency, sold it and now is on to his new adventure, where he and his team have created budgeting and forecasting software customized just for agencies. Before we dive into a story about growing an eight-figure agency and dig into the power of financial forecasting, meet Jon. Jon, tell us about you and your business.

Jon Morris
Absolutely. So, I've actually been in the agency space since the mid 1990s. In 2004, I founded an agency called Rise Interactive, I grew up from just me to one of the world's largest independent digital agencies. And when I was growing Rise, our secret sauce was really our budgeting and forecasting process. And we had a coach and our coach used to say he's like, you know, I think this is a business within itself. He's like, I've never seen numbers like this, and the way you guys make decisions. And so, when I exited Rise in 2020, I thought about what I want to do next, I thought it'd be amazing to help

other agencies scale and grow their businesses. And so, we created budgeting and forecasting software, that is just for agencies.

Audrey Joy Kwan
You mentioned that budgeting and forecasting is the primary ingredient in your recipe for scaling from seven to eight figures. What percentages worked for you, as you scale from seven to eight figures in your agency? Tell us more about the key financial metrics agency owners need to look for as they scale.

Jon Morris
Sure, so the most important number to track is your gross margin, which is just, you know, you have all this revenue, how profitably are you able to service that revenue? And ideally, your total cost in terms of payroll, technology to service your customers, should be 50% or less. And I can tell you that if it costs you 60% or more, you're gonna have a really hard time making a profit. And so you want to understand your cost to service the customers or what is called your gross margin, which is how much money you have left over after you service your customers.

Audrey Joy Kwan
Jon share a real world example of how tracking your gross margin helped you grow your agency?

Jon Morris
Absolutely. So, another metric that is absolutely crucial. This is one of the key successes of how Rise was able to grow, was we would look at what percent of our revenue do we spend on sales and marketing. And it's real simple. The more you can spend on sales and marketing, the more you should be able to grow assuming you spend your sales and marketing intelligently. Well, the only way you can do that is if you profitably service your customers. So just imagine that you had, you know, $5 million in revenue, but you spent $4.5 million in people to service that customers, you only have half a million dollars leftover. Versus if you had 5 million in revenue, and it cost you only $2 million to service those customers, you'd have $3 million leftover. And so, by focusing on your gross margin, you can actually have more money for sales and marketing, which allows you to fuel the growth of your business. That was actually one of our big secrets was we spent more of a percent of revenue on sales and marketing than probably anyone else in the industry.

Audrey Joy Kwan
What you're saying is that your success has been connected to being able to put money into specific areas of your business through better financial planning and budgeting. Now with agency owners, where do you see them spend the cash versus where you believe they should spend it?

Jon Morris
So, a lot of what I'm seeing is first of all, people don't really have a good feeling for what they're spending their money on. So, they don't know how much they're spending on servicing their customers, they don't know how much they're spending on sales and marketing. They don't know how much they spend on their operations and finance. So, the first thing is just having a clear understanding of what you're spending your money on is really important. The second thing is, most people don't understand

this. But every single agency owner has a strategic plan, whether they know it or not, and it's what they spend their money on. And so, if growing, your agency is important to you, then you should spend money on sales and marketing. If innovation is important to you, well, then you should spend money on R&D. I can't tell you how many times people come to me and they're like, you know, I really want to grow faster. I was like, cool, like, what percent of your revenue are you spending on sales and marketing? Is like, oh, no, it's all word of mouth. We're not spending any money on sales and marketing. Well, then you don't really want to grow. So, I don't know if there's like one bucketed answer and turns like they're spending money on this thing. What I would say is, most companies are overspending on delivering for their customers. So, they're not able to generate enough profit. And because of that, they're not either, they're either generating a profit, but not investing in the business, or they're investing the business and not making a profit.

Audrey Joy Kwan
What does overspending on client delivery look like in a $5 million or more agency business?

Jon Morris
Okay, so I'm going to give you just a couple of numbers here real quickly. So, the first one is, your cost of service should be 50% or less. And if it's 60% or more, you're not gonna be able to make money. The second one is if your SG&A, or your operating expenses are all your expenses that do not relate to client work, such as sales and marketing, operations, and finance, your executive team and research and development, that is typically 30% of your revenue. So, if you have a gross margin, that is too low, then you don't have that 30% to spend on your sales and marketing. But I have people that, you know, I have a client, that's spending 100% of their revenue, on their SG&A on their, you know, just general expenses to run their business. And they generally don't know this. And so, they're overspending, sometimes it's on the executive team, sometimes it's, their operations are inefficient. And so, you really need to understand the benchmark numbers of how much you should spend in each one of these categories. So that you can operate in a stabilized profitable manner.

Audrey Joy Kwan
You mentioned that a lot of agency owners don't know their numbers, what are tools or strategies to help agency owners get more clarity around their numbers?

Jon Morris
Oftentimes, what people do is they'll just have one line item in their accounting software that just says payroll. But the reality is, you've hired someone for sales, you've hired someone to do client work, you've hired someone to do recruiting, you've hired somebody to maybe help with your IT support. And so, what you want to do is you want to take your payroll and move them to the proper bucket, so if they're doing client work, you know exactly what your cost is to do client work. If they're doing sales and marketing, you know what your exact cost is for sales and marketing. So, it's bucketing everything properly into doing client work, and then expenses that are not doing client work. And then what I found is I don't care how small or how large you are, as an agency, there are only four categories in terms of how you spend your money in terms of operating your business. So, sales and marketing is one of them. Operations and finance is the second one. And that will be HR, legal, corporate, IT and general admin, as well as finance. And then there's research and development. And then there's the executive

team. And so, every single transaction, in terms of you know, creating the infrastructure to grow your business goes into one of those four areas. So, you really want to know how much you're spending in each one of those areas. And I can just give you a few benchmark numbers. Typical agency spends 8% of their revenue on sales and marketing. They spend 15% on operations and finance. They spend 7% on their executive team. And almost all agencies do not spend anything on research and development. 77% of the agencies we've benchmarked spend 0% of their revenue on research and development, which I think is a huge opportunity to grab market share and differentiate yourself.

Audrey Joy Kwan
You're highlighting a knowledge gap that you see for agency owners. The gap is financial forecasting and modeling. When proper forecasting and modeling are done, there is a strategy to allocate to those buckets you've just mentioned in a way that meets the owners' goals. With that said, what are the challenges or pitfalls to be aware of for agency owners to get more strategic about forecasting and modeling?

Jon Morris
Couple things. One the first thing is I couldn't agree with you more, you know, the idea that what financial forecasting modeling does is allows you to have deliberate planning. So, you have goals, and now you can make sure that you've budgeted for those goals. Where people run into challenges because financial modeling is hard, is it all starts with revenue. Most people are overly ambitious in their revenue projections, they don't get granular enough in terms of like, really understanding, this is what my revenue is going to be from all of my existing clients. So, this is what I'm expecting in terms of like, new business. And this is what I'm expecting from clients that I've never heard of before that, you know, is, you know, totally out there. And what I found is that whatever revenue number you put on paper, no matter how unrealistic it is, you spend your money to that revenue. And so, all those ratio numbers I just gave, they'll spend the numbers of those ratios. But if the revenue is not realistic, and the revenue ends up being a lot less, it's very rarely the other way around, then you can end up putting yourself into bad financial positioning, like you could end up losing money because you've overspent.

Audrey Joy Kwan
Are there any specific frameworks you can recommend for forecasting more realistically?

Jon Morris
Absolutely. So, let's start with... in an ideal scenario, everyone will have an aspirational goal. And by the way, I'm going to give you two examples. When I started Rise, my goal as a one-person company was to create the world's largest independent digital agency. That's what I wanted to do from the very beginning. I just was talking to a client whose revenues at $5.1 million, and they're all-time goal is to get to 6 million in revenue, never be bigger, and have 25% profit. Two very, very different aspirational goals. And neither goal is wrong. It's what you want to do with your time, that's exciting and interesting, you know, to create the agency that you want to create. So, the first thing is you have to understand what your aspirational goal is. Then we have to do is say, okay, in three years, what do I want to achieve, that's going to put me on the path to that goal? So, my, my goal is going to be very different than that other company's goal, because, you know, I'm trying to create this huge organization, and they want to be just slightly bigger than they are now and never be bigger than that. And so, once you

come up with your three goals, and I'm going to break up your three goals into four areas that you should always think about, usually have a revenue goal, a profit goal, a cash goal, and an infrastructure goal. Now, first thing, I just want to talk about that cash goal for a second, cash is highly neglected when people think about their goals, if you start building up your cash, one, you have a rainy-day fund. But two, you got to do really cool strategic things. You can buy companies, you make investments. And so, I'm a big believer in having a cash goal that you're always trying to build up to. And the last one is this infrastructure goal. And the idea is that you should be making investments, so that your business, a year later, is better than it is today. So, I want you to be thinking about in three years what that infrastructure looks like. And then you're going to come down to this specific year. So, let's just talk about 2023. If, it's, we're in April, but imagine we were in January, the idea is that in a 12-month cycle, I want the same goals, a revenue goal, a profit goal, a cash goal on an infrastructure goal. And that infrastructure goal might be I want to invest in recruiting, I can't tell you how many times people have come to me and said, I just promised the client delivery team that I'm going to stop selling because we're at capacity. Well, that just means that you didn't plan properly. Because if you invested in recruiting, you wouldn't have had to stop doing that. You know, it might be that you're going to invest in your sales and marketing. And so those are the types of things you want from an infrastructure standpoint.

Audrey Joy Kwan
So many things to dig into. Let's talk about investing in hiring. You mentioned that people don't put enough resources into recruiting, which is building infrastructure. And that's a mistake in planning. What signs from your experience help you identify that gap? You mentioned having an excellent financial forecasting and budgeting model. How did you do it?

Jon Morris
When you forecast your revenue, there are two different buckets. There's an existing clients and there's new business. And what you need to do is keep both those numbers up to date on a constant basis. And so you should be looking at your named pipeline, which is people that you know that you have in your pipeline, you haven't won them yet, but you know who they are, and determine if you're going to win them how much you're going to win them, what services are they going to buy, when are they going to start. But then what you also have to look at is from a hiring standpoint, what is your velocity to fill a role? One of the things that we did at Rise is we really invested in our team training and our management structure so that the vast majority of our hires were entry level employees. Now, the reason why that is beneficial is that it took 19 days from the time we got a job offer, to the time someone accepted that job offer on average. So, if I needed to staff up quickly, I could hire these people really quickly. Now we promoted from within, it is substantially harder to hire mid-level managers. And so, there's just a shortage of well trained digital marketers. So, if you have a really good training program, and you can make these people really dangerous within a year or two, you give them an opportunity to grow, and then you bring in new people. And so having that recruiting infrastructure allowed us to continually win new business on a regular basis. You also should look at your cadence, like how often do you win new business? Are you winning a new customer a month? Are you winning a new customer quarter? Or are you winning a new customer a day. So that's going to help you determine you know, the speed at which you need to hire, I'll add one more point there, I apologize. A typical agency is going to have 20 to 25% employee turnover on a yearly basis. The agency space is a

high turnover space, what we did is we would hire 26 people a year four in January, and then two a month, every single month after that. And we call them rolling hires because we knew that at least 26 people would leave. And so, this way, it's not perfect, you're losing a ton with experience and replace them with entry level. But I had people there right away to help with capacity and resource, as we, you know, had natural voluntary turnover.

Audrey Joy Kwan
Thank you, you're drilling down to knowing your numbers for infrastructure planning, you need to know how many clients you land on average a month, you need to have clarity in who needs to be on the team to service new clients. And you have to consider how much time it takes to train somebody to support clients. You're also accounting for team churn, it's evident that the more marketing and sales you do, the faster you grow. And the quicker you grow, the more critical it is to have these numbers figured out, so you don't implode. As agencies increase revenue and people, keying in on those numbers becomes more difficult. So, for someone who has never done the work of financial modeling, what is the first step to do this work for themselves?

Jon Morris
So, there's two different elements. So, you are completely correct. So, the more granular you can get, the better off you're going to be. So, I'm going to talk about two different things. So, the first thing is, you need to project your revenue by client by line of business by month. So many people talk to me about you know, my goal is to do $5 million in revenue for the year. And I was like, okay, well, what's your goal for January, he's like I don't know, I don't have it broken out by month. So, by taking every single client, an Excel spreadsheet, and column A, and then column B's by line of business, and then you know, January, February, March all the way to December, putting in your projected revenue, you'll get a much better accurate idea of what you think your revenue is going to be. That's going to guide all of your expenses, it's going to guide all your decision making. The second thing is, I mentioned to you that a lot of people are overspending. And generally, when they overspend in delivering for customers, it tends to be that they have too many senior people and not enough junior people. The reality is that the agency business is a young business. And what I mean by that is, you need to have a really healthy pyramid, where there's a very few number of people at the top and a lot of people at the bottom of the pyramid that are doing the vast majority of the work. So I typically recommend a four to one direct report to manager ratio. And so the more direct reports a manager has, the more scalable and the better your gross margin is going to be. And you should have a target. So, if you think about like a hierarchy in terms of titles, you should have entry level manager, director, VP and C suites. And you should have a very specific target for your revenue per entry level employee. And then if you know that you have a four to one management structure, well, then you have a revenue target for your manager, and then you have a revenue target for your director. And so that helps you build out that hiring model, so you know what your forecast is because you forecast your revenue really well. And now you know how many employees you need because you have targets in terms of how much revenue each person should be able to target or handle.

Audrey Joy Kwan
Let's talk about the four reports to one manager. Different management theories identify how many people one person can manage before overwhelmed. Typically, what I see is seven to one, so it's

typically one manager to seven direct reports and it's pushing it to have 10 reports, what are your thoughts on that?

Jon Morris
So, what I would tell you in my experience is that a manager should manage between four to seven people. Seven is on the high side, four is on the low side, your gross margin will absolutely be better if you manage seven people versus four. And if you kept that ratio. You just want to make sure that that manager really has enough time to mentor and manage those people. And so, in an ideal scenario, if you have the tools, the technology, the infrastructure to do a seven to one management ratio, that will be awesome. My experience with most agencies is that that manager is going to be spread really thin and not be able to grow their talent.

Audrey Joy Kwan
You hit on a key point, growing people within the organization requires mentorship and time investment. As much as business is about revenue. The best companies are not about squeezing people, neither of us are about that life.

Jon Morris
What I'm basically asking them to do is to figure out how do you still deliver for your customers? Without lowering the quality of work? How do you ensure that you're not burning out your employees by making them just work more and more hours? And how do you provide the financials so that you're doing this in a profitable manner? And so that's hard, because you're basically saying, okay, you got to do the same amount of work, but you got to do it in a more profitable manner. And, and that's a challenging thing for people to figure out.

Audrey Joy Kwan
This relates to why you created your budgeting and forecasting software customized for agencies at $5 million in revenue or can't do it independently. With that said, what are the key things that signal an agency owner needs more support in financial modeling?

Jon Morris
I generally recommend, probably, until you get to about a million, you can handle a ton on your own. When you get to a million to 5 million, you know, you might start getting like a finance coordinator. And then when you get to 5 million to 10 million, you'll probably start getting controller and then after that you'll really look at, you know, bringing in a fractional CFO or someone who can, you know, give you the right insights on an ongoing basis. I probably would say 5 million to start bringing a fractional CFO.

Audrey Joy Kwan
As we wrap up here is there anything you want to add about financial metrics, financial modeling, or financial processes?

Jon Morris
Yeah, so I'm going to tie it back to the financial aspects. But at the end of the day, our business or the agency business is really simple, hard to execute, but really simple. You need to win new business, you

need to keep that business, you need to grow that business. And then you need to make investments so that next year, you can repeat that cycle and do it either the same or more successfully. And so, when you think about the metrics that you're looking at, there's not that many metrics that you really need to understand you need to understand your profitability metrics, you need to understand how good are you at winning new business? And you need to understand how good are you in keeping that business? My VP of accounting used to say to me, you know, I'm gonna hand you a baby on day one of the year, and that baby is your client. And by the end of the year, that baby has to have all 10 fingers and all 10 toes and in ideal scenarios is a little bit bigger. And so really having a solid budgeting and forecasting process is going to help you understand what investments you need to do to keep your customers, what investments you need to do to go win new customers.

Audrey Joy Kwan
Last but not least, Jon, where can people find you online?

Jon Morris
So, they can find me on LinkedIn. If you connect with me, you can email me at J O N at Ramsay innovations.com. And you can also go to our website Ramsayinnovations.com.

Audrey Joy Kwan
Thank you so much.

Jon Morris
Thank you.

Audrey Joy Kwan
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