

JONATHAN STARK

THE PATH TO VALUE PRICING

Website: <https://expenseproblem.com>

BACKSTORY

In 2005, I was making a little over \$90,000 USD annually as the VP of a boutique software development firm. It was a good company and I loved my fellow employees, but I was miserable. I spent my days arguing about invoices with clients, hounding developers to log their hours, and responding to RFPs with estimates that almost always turned out to be low.

Then one day I saw with total clarity that billing clients by the hour was hurting me, my company, and our clients. It was the source of just about every problem that we had.

Best of all, I saw an alternative: value pricing. I left the hourly firm, set up my own consultancy, and in the first year I doubled my income using value pricing. All while working with better clients, on more interesting problems, with lower labor intensity, and almost zero administrative overhead.

AGENDA

- How hourly is hurting your business
- How value pricing works
- 3 ways to transition to value pricing

HOURLY BILLING

HURTS YOUR BUSINESS

Why question the logic of hourly billing at all? It's what your clients expect, right? And it's how your competitors do business, right? Not to mention other professional service providers like lawyers, accountants, and psychiatrists. If it works for them, why won't it work for you?

I'll tell you why: hourly billing is corrosive to client relationships across all professional services. This includes "digital" disciplines like graphic design, user experience design, copy writing, software development, and so on. You can not truly partner with your clients if you're billing by the hour, which means that you can't do your best work, which means that your clients aren't loving you as much as they could :-)

THREE REASONS

- Misaligns incentives
- Encourages aimlessness
- Discourages efficiency

There are lots of reasons why this is the case. Here are three:

1. Misaligns incentives - Misaligns the direct financial incentives between you and your client (i.e., the longer the project takes, the better it is for you and the worse it is for the client). This creates trust fractures which erode the relationship over time if your estimates are not accurate. This erosion is manifest as questioning hours, micromanagement, and lack of testimonials/referrals.
2. Encourages aimlessness - Allows you to get started before knowing your client's goal. If you don't have a goal, you can't succeed. If you can't succeed, your client isn't going to be happy.
3. Discourages efficiency - There is no financial incentive to become more efficient (e.g., tools, systems, automation, processes, education, training, professional development, etc). On one of my first value based projects, I found myself shopping around for plugins. I found one that did just what I needed. It was \$700 which might sound like a lot but it was going to save me weeks of time.

HOURLY BILLING LIMITS YOUR INCOME

But the biggie is this: hourly billing places an artificial limit on your income.

40 HOURS
x 50 WEEKS
x \$100 PER HOUR
x 70% BILLABLE
= \$140,000 CEILING

You can only charge so much per hour and there are only so many hours in the year:

40 hours x 50 weeks per year x \$100 per hour x 70% billable hours = \$140,000 max

HOW COULD YOU DOUBLE YOUR
INCOME WITH HOURLY BILLING?

- Work More
- Raise Rates
- Hire Juniors

Let's say you wanted to double your income while billing hourly. There are really only three ways:

1. Work twice as much
2. Double your hourly rate
3. Hire about six junior employees

1. WORKING MORE

Working more is probably not attractive to anyone. You probably feel like you're working too much already. In any case, it's unsustainable and doesn't scale your business in a meaningful way. Working more will decrease your productivity (and therefore produce diminishing returns) and eventually lead to burnout.

2. RAISING RATES

Increasing your rate significantly will make it tough to close deals because the new rate will appear unfair or offensive in comparison to old rate or market rate for similar services. Significantly increasing your rate will be unattractive to your existing clients because you have conditioned them to believe that you are worth \$X per hour. If you suddenly announce that you now cost \$2X per hour, they'll likely consider this an unfair increase and start shopping around. Assuming that your rate is more or less in line with other folks in your industry, doubling your rate will make you the premium option. If you don't have anything significant that differentiates you from your competitors, you are not going to close many deals.

3. HIRING JUNIORS

Hiring junior employees is probably the most seductive of the three options so I want to take a second to dispel any fantasies that might be floating around out there. If you hire junior employees, you will no longer spend your days doing the thing that you love; you will be a manager.

HIRING JUNIORS

- Posting jobs
- Reviewing resumes
- Writing training docs
- Managing benefits
- Sending tax documents
- Doing one-on-ones
- Boosting morale
- Chasing time sheets
- Generating reports
- etc...

You will be posting jobs, reviewing resumes, writing training docs, managing benefits, sending tax documents, doing one-on-ones, boosting morale, demanding time sheets, generating productivity reports, and more.

HIRING JUNIORS

- Writing proposals
- Closing deals
- Managing resources
- Tracking timelines
- Sending invoices
- Chasing late payments
- Haggling over hours
- etc...

Note that I haven't even mentioned client-facing administrative duties like writing proposals, closing deals, managing resources, tracking timelines, sending invoices, chasing late payments, haggling over hours entries, etc.

HIRING JUNIORS

- Marketing
- Sales
- Payroll
- Pay Mortgage
- Pay Mortgage
- Pay Mortgage

And OBTW... let's not forget marketing and sales. If you have even a half-dozen employees, you're going to need a steady stream of leads to cover payroll every month. Every. Single. Month.

"If you're not ready to fire employees,
you're not ready to hire employees."

-JONATHAN STARK

My rule of thumb about hiring is this: If you're not ready to fire employees, you're not ready to hire employees.

YAY, VALUE PRICING!

The good news is, these aren't the only options you have available for doubling your income. Value Pricing to the rescue.

WHAT IS
VALUE PRICING?

Value Pricing is like fixed bids on steroids. Unlike a typical fixed bid quotes - which are based on a cost-plus or time and materials - the prices in a value priced quote are based on - you guessed it! - the client's perceived value of the project outcome.

"Value is the maximum amount that a
consumer would be willing to pay for an item."

-RON BAKER

But what exactly do I mean by value? I like this definition which I found from Ron Baker:

> Value is the maximum amount that a consumer would be willing to pay for an item

I find this to be an extremely elegant definition because it concisely illustrates the inherent subjectivity of value. Value is not an intrinsic property of an item - it's a vague sense of "what something is worth" to a particular person in a particular context.

HOW PRICE BASED ON VALUE

So... how do you figure out what something is worth to your clients? You can't exactly (even they don't know exactly) but you can get close enough to drastically increase your fees. This is another gray area that folks are usually pretty uncomfortable with, but it's the key to closing deals.

1. DEFINE GOALS

1. Start with a conversation about goals

- * Push past self-diagnosis with "Why?"
- * Try to talk them out of hiring you ("Why pay me a million bucks to build you a website when you could just use WordPress/SquareSpace/Fiverr?")
- * Capture exact quotes
- * Drill down until you hit money

2. ESTIMATE COST

2. Estimate your cost floor

- * Time
- * Money
- * Stress

3. ESTIMATE VALUE

3. Estimate the client's perceived value and divide by 10 or so

$\text{MAX}(\text{COST}, \text{VALUE} / 10)$

I give you the Value Pricing Formula™!

4. Present higher of two numbers

- * If cost is greater, you won't get the deal
- * If numbers are close, you'll have to negotiate
- * If value is greater, they'll pay immediately

HOW TO TRANSITION TO
VALUE PRICING

Now that you have a feeling for the desired state, how do you get from where your are to where you want to be?

THREE WAYS

1. Add a fixed option to hourly proposal
2. Price a small chunk of an hourly project
3. Create a productized service

Strictly speaking, these options are not value priced. However, they do disconnect your time from your income and they do give you the feeling of "working without a net" by removing the security blanket provided by hourly billing.

1. Add a fixed option to an hourly proposal

1. Add a fixed price option to an hourly proposal. Call out the risk associated with each to justify the premium price.

2. Price a small chunk of a larger hourly project

2. VP a small chunk of a larger hourly project. e.g., doing a design phase prior to a quoting a website build.

3. Create a productized service

3. Create a productized service. This is like value pricing in reverse - you set a price for a defined outcome and buyers self-select based on the ROI to them. After you sell a few at a give price, increase it by 65% or so. Wash, rinse, repeat.

QUESTIONS?

The Book

Hey there! I recently published a book about how and why to ditch hourly billing. It's not free but you can [click here](#) to find out more.



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