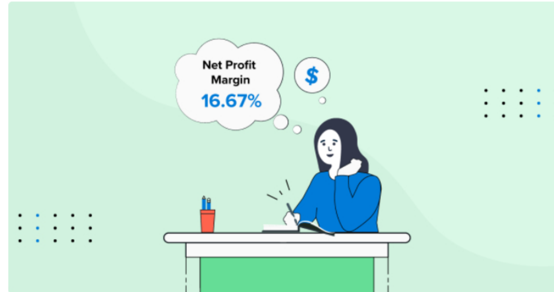
‹ Back to Blog

A Complete Guide to Calculating Agency Margins



Christian Sculthorp
Marketing at AgencyAnalytics

January 13, 2021
Agency Advice

Running an agency often means wearing far too many hats, juggling clients across verticals, and dealing with a perennial talent shortage.

The last thing you want in the mix is dealing with low margins due to pricing issues.

The question now is: how exactly do you calculate your margins? And if your margins are too low, what can you do to increase them?

In this article, I'm going to help you answer these questions and more.

How to calculate your profit margins

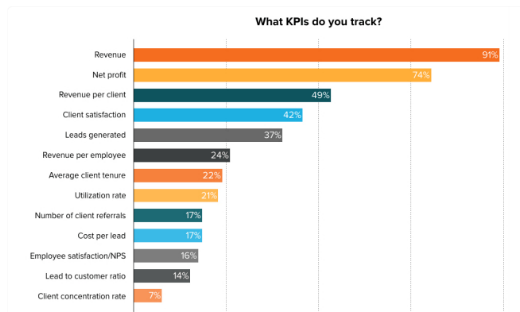
Calculating margins for a digital agency can be notoriously difficult.

While eCommerce and SaaS companies typically know *exactly* how much it makes for each product sold, digital agencies often have to deal with unforeseen expenses and client budget changes.

The account that made you a $500 profit at a 25% margin? A couple of revision requests from the client and your profit drops to $200.

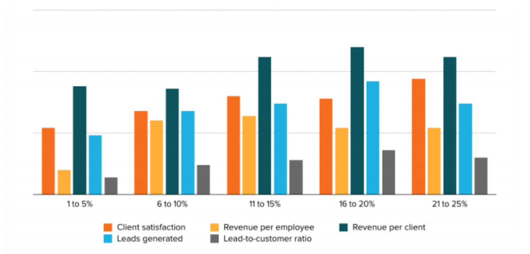
In this uncertainty, the first thing you need to do is to calculate your own margins.

Surprisingly, in a survey of 750+ agencies, only 49% said that they tracked revenue per client. Even fewer (24%) tracked revenue per employee.



The same survey found a correlation between profit margin and revenue tracking. Agencies that tracked revenue per client had higher profit margins than those that didn't.

Average Profit Margin by the KPIs Tracked



The first thing you need to do, therefore, is to track your profit margins for each client.

Let's look at a step-by-step process for doing this:

Step #1: Calculate hourly cost per staff member

Your first step should be to calculate the hourly cost for each staff member.

For your full-time staff, this should include:

- Gross wage
- Pension (if applicable)
- Insurance & other benefits
- And other expenses

Next, calculate how many hours per year they're available to work. To do this, simply calculate the total available hours in the year (40 hours per week x 52 weeks) minus the number of paid holiday, sick leave days, and national holidays.

If you assume a 40 hour work week, and two weeks each of vacation and sick leave, you get 1,920 total hours of available work.

To calculate your hourly staff member cost, simply divide their total annual cost by the total available work hours.

For instance, an employee with a $50,000 salary and $12,000 in benefits costs $32.29/hour ($62,000 / 1,920 hours).

Do the same for any freelancers you hire. This should be straightforward since most freelancers work on hourly rates.

Step #2: Calculate overhead

To calculate net margins, you need to estimate your overall expenses for the year.

Your overhead should include every single foreseeable expense, such as:

- All non-billable hours
- Admin staff
- Rent
- Insurance
- Transport
- Entertainment expenses
- Office equipment
- Software, hosting, and tools

Add all these up to calculate your overhead. These are your expenses in addition to the employee costs you calculated above.

Step #3: Calculate cost per hour for overheads

In the next step, calculate your total billable hours for the year.

For example, if you have 5 employees, you get 9,600 billable hours for the year (@ 5 x 1,920 hours).

This effectively means that you have 9,600 billable hours to pay for your overheads.

You can calculate your cost per hour for overheads by dividing total overhead

with total billable hours.

$$\text{Overheads cost per hour} = \frac{\text{Total overheads}}{\text{Total billable hours}}$$

For example, if your overheads are $1,92,000, your cost per hour would be $20 (@ $1,92,000/9,600).

Step #4: Calculate gross and net margin for each client

The gross margin is easy enough to calculate – just subtract your gross sales by total hours worked per employee and cost per hour of the employee.

Gross margin = (Gross sales) - (Total hours worked * Employee cost per hour)

For example, if an employee costing $30/hour works 100 hours on a client project, your total cost is $3,000. Assuming a contract value of $6,000, your gross margin is $3,000 (@ $6,000 – $3,000).

To calculate net margin for a client, you need to add your overhead costs/hour to employee cost/hour.

That is:

Net margin = (Gross sales) - [Total hours worked * (Employee cost per hour + Overheads cost per hour)]

In the above example, your net margin would be:

- Gross sales = $6,000
- Total hours worked = 100
- Employee cost per hour = $30
- Overhead cost per hour = $20
- Net margin = $6,000 – (100 * ($20 + $30)) = $1,000

Expressed as a percentage, your net margin is $16.67%.

I know this is an oversimplified explanation, but it should give you an idea of the process.

In reality, you'll have employees working at different rates and a variety of recurring and one-off clients.

This makes the calculation more complicated, but the overall process remains the same.

Using a profit margin calculator

Thankfully, you don't have to go through the entire process yourself; there are plenty of profit margin calculators to help you out.

Start with the ultimate profit margin calculator from LemonadeStand. Read the instructions here to get started, then click this URL and make a copy of the Google spreadsheet to plug in your numbers.

fx 2500

	A	B	C	D	E	F
1	Lemonade Stand's Ultimate Profit Margin Calculator for Internet Marketing Agencies					Lemonade Stand
2	Thanks for using this cool tool with the super long name. :) With this calculator, you'll be able to quickly calculate P&L for your SEO, PPC, & one-time clients while also keeping a running, interactive calculation of your entire book of business. You're free to use it for any private or agency use. I hope it will help make your life just a little bit easier or make things a little more organized for you and your team. Please feel free to contact me with your feedback and please share this tool with your friends and followers. SCROLL DOWN TO GET STARTED.					
3						
4	**Creator**	**Twitter**	**Instructions, Tips, Updates, & More Tools**			**Scroll Down to Enter Important Data**
5	John Rowa	@JohnRowa	LemonadeStand.org/Ultimate-Profit-Calculator			
6	**Agency**	**Agency Twitter**	**Latest Revision**			
7	Lemonade Stand	@LemonadeStnd	*12/09/15 - Adjusted layout of The Bottom Line. Adjusted columns in One-Time Projects to be more easy-to-understand.*			
8						
9	**Key**					
10	Blue	<- Edit these fields. Data will be used to calculate P/L.				
11	Gray	<- Edit these fields to save any notes.				

Get Started | Recurring Clients | PPC Clients | One-Time Projects | The Bottom Line | Data

While this calculator works wonderfully well, it is best suited for larger agencies with a wide variety of clients and employees. Instead of the tiered "levels" used in the spreadsheet, you might just have 3-4 employees at the same rate.

Modify the spreadsheet accordingly.

If this is too complicated, try the calculators from TrinityP3.

ANNUAL SALARY CALCULATOR		
1. HEAD HOUR RATE	$120	per hour
2. BILLABLE HOURS *	1650	per annum *
3. OVERHEAD MARK-UP	100%	on direct salary costs
4. PROFIT MARK-UP	25%	on direct salary costs
5. ANNUAL SALARY	$79,200	per annum

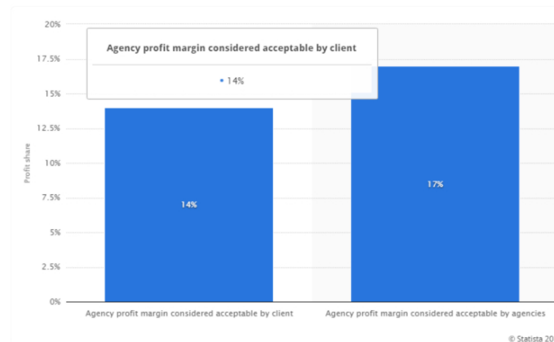
trinity P3

These calculators will help you figure out your profit multiple, annual salary, and head hour rates.

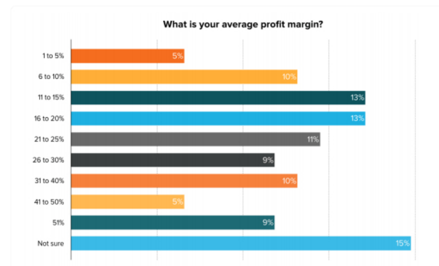
What is the average profit margin for digital agencies?

When it comes to agency margins, what's acceptable to clients, and what's acceptable to agencies themselves is seldom the same.

Case in point: according to one study, clients believe a 14% profit margin acceptable. Agencies, on the other hand, see a 17% margin as more acceptable.



[In HubSpot's survey of digital agencies], a majority of companies were either not sure of their profit margins, or reported margins between 11 and 20%.



As a rule of thumb, margins in the single digits are probably too low to run a viable business.

Anything above 20% means you're doing great. Beyond that and you're doing spectacularly well.

What to do if your profit margins are too low?

While we'd all love to make 20%+ margins, unforeseen costs, unpredictable clients and an uncertain business environment can eat into your profits.

In such a situation, there are a few things you can do to boost profit margins:

1. Switch to value-based pricing

Most agencies use a cost-based pricing model. They calculate their cost for each resource, add their profit margins, and quote a price.

The problem with this model is that it creates an adversarial relationship with your clients.

If you're an agency veteran, you already know this – clients will question you on everything from your efficiency and quality to your expertise and personnel selection.

One way to solve this problem is to shift from a cost-based to a value-based pricing model.

This essentially means that instead of charging clients on your costs, you charge them based on the value you bring to their business.

There is a simple formula for calculating your pricing based on value:

Value-based pricing = Number of new customers * 10% of Customer LTV

For example, if you bring in 10 new customers each month with an average customer LTV of $10,000, you've just helped the client make an extra $100,000.

If you were to charge even 10% of that, your pricing would be $10,000.

It doesn't matter whether you spent $1,000 or $5,000 on acquiring these customers, what matters is the value you provide your clients.

Of course, this is a big shift in the way you structure your pricing. It's also radically different from the pricing structure your clients are used to.

However, if you can convince your clients to adopt this model, you'll never have to struggle with low margins.

As MIT Sloan Management Review notes, value-based pricing is the "most preferable way to set new product prices or to adjust prices for existing product", and that "customer value-based pricing is especially relevant in highly competitive industries".

2. Create a long-term capacity plan

On paper, this is a problem every agency would love to have – growing *so fast* that you can't keep up with the demand.

In reality, if you don't have a capacity plan to deal with rapid growth, you'll end up outsourcing work or even losing older clients.

Not to mention the effect on your team's morale of pulling far too many all-nighters to meet deadlines.

The result? Lower profit margins and poor hiring practices.

One way to solve this problem is to create a capacity plan.

Here's how you can do this:

A. Estimate capacity

Start by auditing your existing staff and estimate your total billable hours for each service type. This should include their total billable hours each week minus their non-billable hours (i.e. time spent in administrative tasks).

You might have a table like this:

Role	Total employees	Billable?	Available hours/week	Billable hours/week	Non-billable hours/week
Copywriting	5	Yes	200	175	25
Design	3	Yes	120	90	30
Sales	2	No	80	0	80

This gives you a fair idea of your existing capacity and what kind of talent you need to hire for future growth.

B. Calculate capacity utilization

Dig through your data to see how much of your existing capacity you're currently utilizing for each role.

$$\textbf{Capacity utilization (\%)} = \frac{\text{Available hours} - \text{Billed hours}}{\text{Total available hours}}$$

Doing this for each month will tell you which roles are being fully-utilized and which areas need more attention.

For example, suppose your data shows that you bill for 60 hours of design work each week. However, your existing capacity is 90 billable hours/week, which means that 30 hours, or 33% of your capacity is being unutilized.

In contrast, if your data shows that you consistently bill for 100% of available hours of your copywriting work, it's probably a good sign to hire more

copywriters to meet future demand.

Do this for all your roles and you'll have a good idea of projected demand and your existing capacity.

3. Focus on predictable revenue channels

It's estimated that 70%+ of US agencies rely on per-project or hourly billing pricing.

The problem with this approach is that it creates a "feast or famine" cycle. One month you're drowning in work, and the next there's a sudden glut.

This not only affects your cash flow and profit margins, but also your team morale and the long-term financial health of your agency.

To solve this problem, shift focus to more predictable revenue channels such as marketing services with recurring billing or selling products (both digital and physical).

Omelet, an LA-based digital agency, experimented with a physical product – a brand of peanut butter named "Betsy's Best".

Similarly, there has been a shift towards subscription billing among digital agencies to create more predictable revenue streams.

For example, WebPageFX, a leading Pennsylvania based digital agency, offers monthly plans for nearly all its services.

SEO Pricing Packages

Features Need more information? Call Us: 717-609-1553	AGGRESSIVE PLAN $600/mo after inital campaign investment	MARKET LEADER $1,000/mo after inital campaign investment	MARKET LEADER W/ EARNED MEDIA $2,000/mo after inital campaign investment	ENTERPRISE Custom Pricing
Number of keyphrases optimized (Keyphrases with less than 1M results) What's This?	Up to 80	Up to 150	Up to 300	Custom
Web server analysis & reporting What's This?	✓	✓	✓	Custom
Keyphrase research What's This?	✓	✓	✓	Custom
Predictive keyword analysis What's This?	✓	✓	✓	Custom
Meta tags (Title & description) What's This?	✓	✓	✓	Custom
Optimization of robots.txt & GoogleBot crawls What's This?	✓	✓	✓	Custom

This shift towards subscription billing has been facilitated by the rapid adoption of SaaS tools among enterprise customers.

Since companies are already used to paying a flat monthly rate for software, subscription billing for services doesn't seem like a radical idea.

It also helps that the subscription billing model is both agency and client-friendly. Clients don't have to worry about agencies billing them for non-productive hours, and agency employees don't have an excuse to slack off and inflate work hours.

This also ties into the value-based pricing model I discussed earlier. With recurring billing, you have more room to deliver the best possible solution and not necessarily the solution that will take the most man-hours—a win-win for both clients and agencies.

Closing Words

Calculating your agency margins is the first step in raising your prices and profits. By tracking profit and revenue per client and per employee, you'll not only have a better picture of your company's financial health, but will also be able to spot areas of improvement.

If you do find that your marketing agency margins are too low (< 10%), try the

three strategies outlined above to shift to better capacity utilization and more profitable pricing models.

Here's what you should take away from this post:

- Average agency margins are in the 11-20% range. Single-digit margins are a sign of trouble.
- Use a profit margin calculator to figure out your margins.
- If your margins are too low, adopt value-based pricing, switch to recurring billing and create a capacity plan.

Try AgencyAnalytics Free for 14 Days

Enter your email...

CREATE ACCOUNT

© 2021 AgencyAnalytics Inc, All Rights Reserved. Privacy Policy • Terms and Conditions