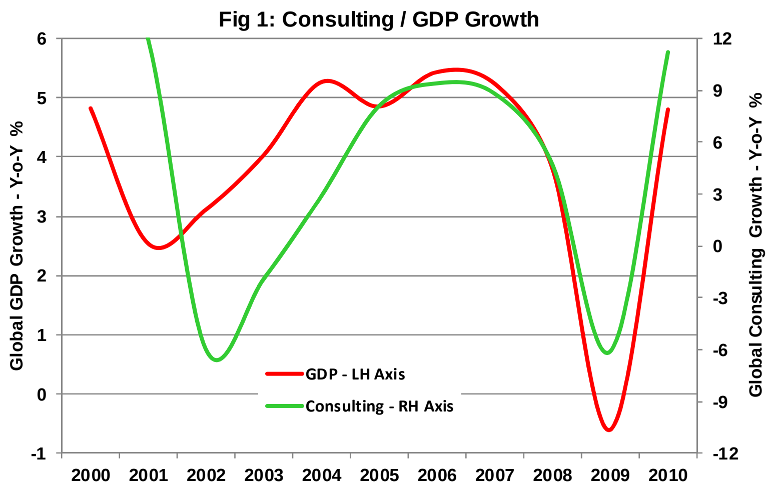
Lessons from History

With more than a decade of remuneration benchmarking data behind us, what trends have we seen in consultant earnings, and are there any lessons we might draw to guide our thinking going forward?

> *If men could learn from history, what lessons it might teach us … (Samuel Taylor Coleridge)*

The Economic Backdrop: GDP and CPI

In the past we have frequently alluded to the apparent causal relationship between GDP growth and the general health of the consulting industry. In fact, looking back over the last decade, encompassing two major recessions, that relationship has, if anything, become even more marked; witness the parallels between global GDP growth and global management consulting growth shown in figure 1.



The same trend is also seen if we track back through the 1990s, although the growth rates in consulting then were much greater: the recession of 2001 marked a step-change in management consulting from an emergent industry, posting nearly 20% compound growth, to the more mature and stable position it now occupies, with a more modest but sustainable growth which more closely matches GDP movement. This GDP : consulting relationship is not coincidental – in times of growth clients are looking for ways to optimise their position, to grow, expand, diversify and improve their operations, but when the markets turn down margins come under pressure, costs must be controlled and survival becomes the watchword. So both intuitively and logically we know that GDP movement is a primary driver of consulting activity.

The last decade also corresponds to the existence of Vencon Research as an independent entity, which means we now have substantial data, across multiple geographies, which may enable us to examine the extent to which these economic factors influence or even determine salary and bonus in the industry.

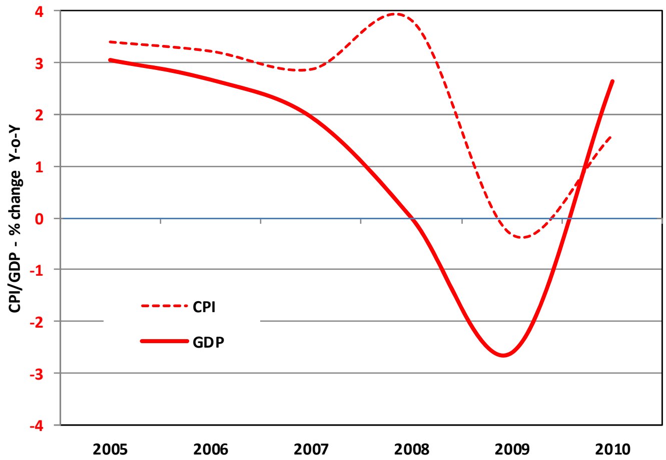
Our first attempt at investigating any such relationship starts, naturally enough, with the biggest player in both arenas: the USA equates to nearly 25% of global GDP, and almost 50% of global consulting revenues. Hence, if we are going to learn any lessons, this is the best place to start.

In future releases of 'Perspectives' we shall extend this analysis to Western Europe, to the high-growth BRIC economies, and to other major consulting markets, to see which factors appear consistent, and which may be subject to local variation. In each case, we shall examine data from two major consulting sectors, where Vencon's historical data are most extensive – the pure strategy firms, and the strategy practices of the full-service/operations-consulting firms: 'SC' and 'OPS' in the parlance of Vencon's remuneration reports.

In addition to the impact of GDP on the consulting industry overall, we have also noted in the past the relationship between inflation – particularly Consumer Price Inflation (CPI) - and long-term salary trends; again both intuitively and logically, increased consumer costs drive wage demands in general industry, and there is no reason to suppose consultants are immune to such pressures.

Figure 2 shows both GDP growth and CPI for the United States over the period 2005 – 2010. Note that inflation actually peaked in the US right at the start of the 2008-2009 recession. Both food and oil prices had seen their sharpest increase for some 18 years during the first half of 2008, but the seminal events of the economic downturn, with the progressive demise of Fannie Mae, Freddie Mac, Merrill Lynch, Lehman Brothers and AIG didn't occur until early September of that year. Thereafter the collapse in consumer demand resulted in a fall in inflation, which actually went negative in 2009. By 2010 the US economy was recovering strongly, and CPI had again turned positive.

Fig 2: United States Growth & Inflation

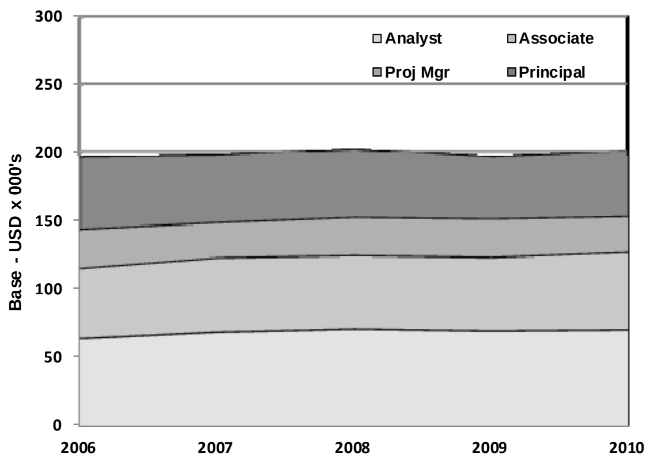


Source: The World Bank

Base Salary – the 5 Year Trend

To begin, we look at Base Salary data over the period 2006-2010. For the Strategy firms, Figure 3 gives the immediate (and correct) impression is that base salaries have barely moved over this period. On closer inspection, we detect modest increases at both the Analyst and Associate levels – the key career entry points – but minimal changes at the Project Manager levels and virtually flat for the Principal levels.

Fig 3: Base Salary Trend - USA, Strategy Consulting

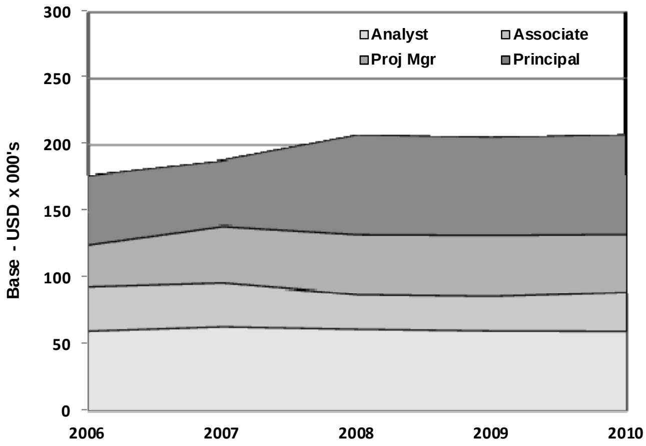


Cumulatively, over the same period, price inflation in the US amounted to just over 8%. Analyst and Associate salaries, having risen by around 10%, were therefore just ahead of inflation, whereas at the senior levels salaries have actually dropped in real terms by up to 6%.

The same analysis for the Operations firms, in Figure 4, shows a very different picture; clearly the Principal levels here saw a marked increase in Base Salaries up until 2008, whereas it appears the more junior levels have seen salary stagnation, or effectively a decrease in real terms. In fact, the overall increase at Principal level from 2006 to 2010 equates to 17.5%, or a compound growth of over 4% per annum, such that the average salary for Principals in the operations firms now exceeds that in the pure strategy firms.

The average salary for Analysts, on the other hand, has been absolutely static over this period, whilst for Associates a decrease averaging 1% per annum has been recorded, which means a drop in real terms over the full period of some 12%.

Fig 4: Base Salary Trend - USA, Operations Firms, Strategy Division



Of course, this doesn't mean any individual has actually seen their salary decrease – one of the benefits of the rapid career track in consulting is that salary movement comes primarily through progression through the ranks, rather than via cost-of-living increases. Hence such changes can be implemented through realigning the salary grid, and reducing the step between grade levels, rather than via pay-cuts. The overall effect on the pay-bill, however, is the same.

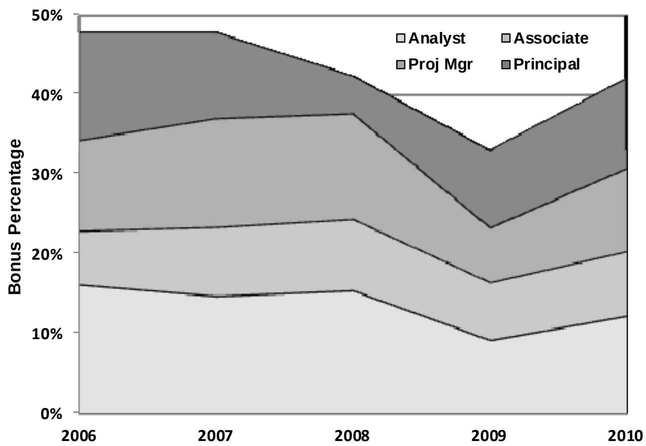
In summarising these changes in tabular form, it becomes clear that Strategy and Operations have adopted diametrically opposing philosophies in their remuneration plans, one boosting the junior salaries in real terms whilst seemingly penalising their senior staff, the other clearly increasing the differentials between entry and senior staff.

Table 1: Base Salary changes 2006-2010		Analyst	Associate	Project Manager	Principal
Strategy	Overall Change	10.2%	10%	6.4%	2%
	Annualised	2.5%	2.4%	1.6%	0.5%
Operations	Overall Change	-0.2%	-4.0%	6.7%	17.5%
	Annualised	0%	-1%	1.6%	4.1%

Bonus Payments – the 5 Year Trend

From Figures 5 and 6 the year-on-year changes in bonus payments, and their relationship to the overall economy are easy to see, whilst the differentiation between Strategy and Operations is even more marked than was the case for Base Salary.

Fig 5: Bonus %age Trend - USA, Strategy Consulting



We noted above that base salary at the Principal level in the Operations firms could now exceed those in Strategy – clearly, the payback comes in the bonuses paid in Strategy, where the percentage bonus is typically twice that seen in Operations firms across all career levels. With Principal bonus levels averaging nearly 50% of Base Salary within Strategy, there is much greater opportunity to flex overall remuneration to reflect financial performance; this is clearly seen in the dramatic fall in bonus payments which started in 2008, continued their precipitous decline through 2009 and staged a remarkable recovery once the economy had returned to growth in 2010. With so much opportunity to vary total compensation by adjusting the bonus percentages, there is obviously less need to tinker with the base salary element.

Conversely in the operations firms we see that bonus levels, even at the economic peak before the 2008 crash, were in the range 6-9% of Base for the junior levels, and even for the Manager grades fail to reach 15%. In these circumstances, in the event of an economic downturn, even slashing bonus payments in half would yield less than a 5% reduction in the overall pay-bill; in practice, we saw bonuses in Operations were reduced by perhaps a third from their 2007 peak.

Fig 6: Bonus %age Trend - USA, Operations Firms, Strategy Division

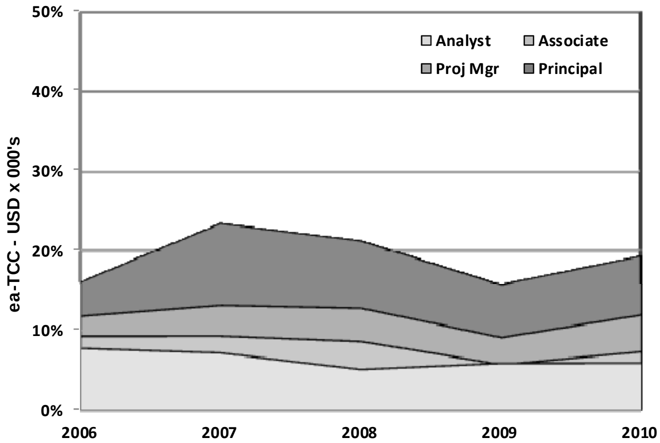


Table 2 sets out the average bonus payments, weighted by staff numbers per grade, for both Strategy and Operations firms over the 5 year period. We can see that the Strategy firms also reduced their average bonus payments by about a third, but in this case, although the reduction equates to nearly 10% of base salary, the Strategy firms were still paying bonuses in excess of the maximum ever paid by the Operations firms. For the Operations firms, with much less 'headroom' in their bonus structure, the one third bonus reduction saved only 3% on their pay-bill.

Table 2: Weighted Average Bonus Percentage	2006	2007	2008	2009	2010
Strategy	24.8%	25.1%	25.5%	16.6%	21.4%
Operations	9.8%	10.4%	9.2%	7.2%	8.7%

Consider that in the first half of 2009, when consulting firms were reporting their results for the worst part of the recession, year-on-year revenues were typically down by 20-25%. Even complete abolition of bonus payments within the Operations firms would save only 10% of employee costs, so it comes as no surprise that Base Salaries were subject to downward pressure.

Total Cash Compensation – the 5 Year Trend

Having seen both Base Salary and actual Bonus trends over the 5-year period, we can now combine them to determine the overall effect on total cash earnings – ea-TCC in Vencon terminology. To set this in context, Consumer Price Inflation in the US had risen by an overall 8.2% over the same period, or an average 1.7% per annum.

Within Strategy consulting, the combination of modest increases in Base Salary with a general reduction in bonus meant that total cash income for the Analyst and Associate levels has just about kept pace with inflation over the full period; the Manager and Principal levels, however, experienced a decrease in real-terms.

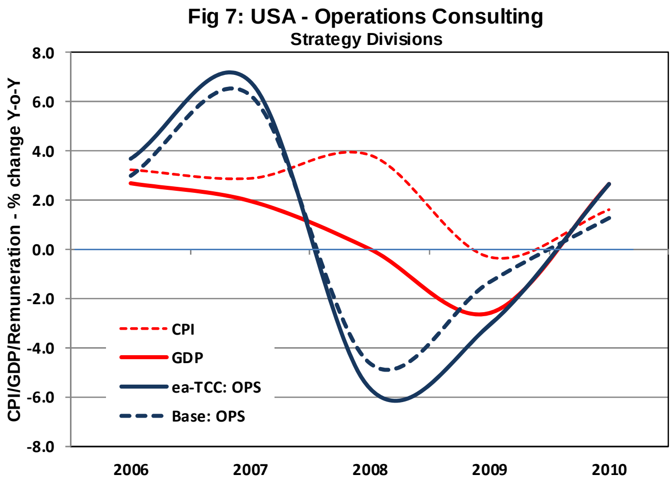
Table 3: Total Cash changes 2006-2010		Analyst	Associate	Project Manager	Principal
Strategy	Overall Change	6.5%	7.7%	3.7%	-2.1%
	Annualised	1.6%	1.9%	0.9%	-0.5%
Operations	Overall Change	-1.8%	-5.6%	6.8%	20.8%
	Annualised	-0.5%	-1.4%	1.7%	4.8%

The Operations firms exhibited the reverse trend: the junior levels have seen a decrease not only in inflation-adjusted income, but in absolute terms as well. The overall winners seem to have been the Principal levels within Operations, where a healthy 4.8% average annual increment has been well ahead of inflation, although all of this increase came in the period 2005-2008, before the economic downturn.

Economic Trends and Earnings Growth

We are now in a position to examine these salary movements against the economic indicators, to determine what if any relationship exists. Taking the GDP and CPI figures presented earlier, we can set both Base and Total earnings trends against them.

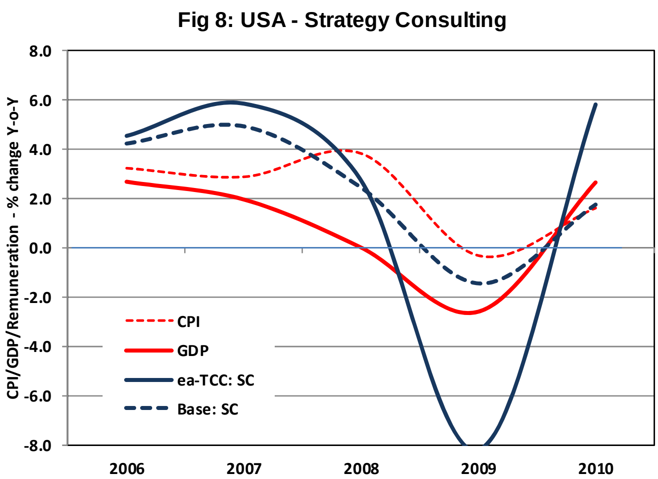
The earnings data here are, as for Table 2, weighted by the number of consultants per career level to give an overall average figure.



Within Operations firms, we can immediately see the minimal impact that the bonus element has upon overall income – with only a few percentage points to play with, most of the variation has come from varying Base Salary. The problem that arises is that changes to Base, once implemented, cannot easily be re-adjusted to reflect subsequent economic movement; salary adjustment is therefore continually playing 'catch-up' to the economic reality. In 2005 CPI was 3.5%, so salaries were being increased throughout 2006-7 just as the economy started to slow down. This led to an over-correction for the 2008 financial year when, as we have seen, CPI actually went up whilst both base and total earnings decreased significantly – and having adjusted both down at the beginning of 2008, there was little scope for further adjustment when the recession really hit in the second half of 2008 and the beginning of 2009.

Earnings in Operations therefore appear out of phase with the economic cycle, and unable to respond quickly to either economic downturn or to the subsequent upturn.

Conversely the high bonus structure of the Strategy firms is much more responsive to the economic climate. We can clearly see how modest movements in Base Salary track the GDP changes. Bear in mind any reductions exhibited here were primarily at the more senior career levels, and hence if necessary could be compensated within the significant bonus values.



Meanwhile total cash remuneration is seen to vary from +6% to -8% p.a. - the same overall range as we saw with the

Operations firms, but now completely in-phase with the economic cycle. As confirmation of bonus levels comes at the end of the financial year, not only can costs be better controlled, but there is likely to be greater understanding of the rationale for such changes by staff at all levels.

This is not to say that Strategy consulting *per se* is better at managing employment costs, but rather that a low-base/high bonus model appears better suited to a volatile economy.

Future Imperfect

> *... but the light which experience gives is a lantern on the stern, which shines only on the waves behind us.*
> *(Ibid.)*

So far we have determined that GDP growth is a primary determinant of management consulting activity, and by implication, of the total income of those working within it. Price inflation is often the driver of salary adjustment, but tends to be a lagging indicator of economic activity. And the balance between Base and Bonus is critical in being able to respond effectively to the kind of radical shifts in the global economy which, whilst not the norm, have nonetheless occurred three times in the last twenty years.

Looking forward, the US is projecting GDP growth in the current year of 3.3%, with a ‘poll of polls’ forecast of 3.2% in 2012. CPI is also expected to rise this year to an above-trend 2.1% before falling back to a more normal 1.8% next year.

At Vencon, we remain reluctant to forecast future trends: when all the world’s finance ministries and economist forecasters can be wrong, we claim no special insights. But, like our readers, we can extrapolate an existing graph and see where that takes us. In Operations, we see from Figure 7 that Base Salaries are now lagging both GDP and CPI, whilst Total Cash is exactly tracking the GDP growth. On historic trends we would therefore expect to see above-inflation increases in Base Salary, while Bonus percentages climb modestly toward their historic levels. But what a great window of opportunity exists for Operations firms re-engineer their remuneration policies by freezing Base Salaries and increasing potential Bonus levels.

The Strategy firms have already responded to the economic upturn, with Total remuneration rebounding ahead of the GDP recovery, as seen in Figure 8. Base Salary movement, however, has remained modest, in line with their historic policy, with any increase biased toward the junior, entry positions. With both GDP and CPI running at above recent trend levels, we might therefore expect further increase at the entry positions to at least ‘real-income’ levels, but most of the increase coming from restoration of the bonus to nearer 2008 levels.

For our next ‘Perspectives’, we will extend this analysis to other major consulting economies, where the impact of exchange rates further complicates the relationship between the economy and the consulting P&L.

If you would like to discuss any aspect of this work please contact
David Warren (+44 20 7731 2890) or **Erwin Harbauer** (+49 30 4435 160)