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Chapter One: Size the Prize

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CHAPTER 1

Size the Prize

> *"For which of you, intending to build a tower, sitteth not down first, and counteth the cost, whether he have sufficient to finish it?"*
>
> — *Luke 14:28,* The Holy Bible, *King James Version* (*1611*)

You don't decide anything in your first week running a company, bought or inherited. Not the reforecast, not the overtime request, and not the two heads somebody in sales is certain the pipeline needs. Every one of those asks arrives wrapped in a board pack, and a board pack was built to report a result rather than to explain one. Which customers make the company money? Ask four leaders and you'll get four confident answers and no number between them. Everyone has an opinion. Earning the right to one takes the first two weeks of the job, and nothing else gets decided until that's done.

That's the rule for this chapter, and I don't bend it: nothing gets decided until the three files are clean and you've read the ratio. Not a discount policy, not a headcount cut, not a new territory, not even the plant that wants Saturday overtime approved by Friday. I've seen leaders skip this step to save two weeks. They didn't save anything. They just started guessing, and they guessed with a lot of confidence.

The Three Files

What does the diagnostic run on? It runs on three files, and only those. The board pack and the budget aren't part of it, and neither is the customer relationship management (CRM) system. In most mid-market companies, that's a spreadsheet somebody color-codes and nobody left in the building can explain.

The first file is twelve trailing months of transactions at the line level. That's every invoice line shipped, with the customer, the product, the revenue, the material cost, the freight, the order number and the line number. Not a summary. The lines. You don't need perfection. Ninety percent clean is clean enough to run on, and a company that waits for the last ten percent will still be waiting on Day 100. Chapter 2 carries the cleaning rules: what counts as a customer, what counts as a product and which twelve months. It also covers what a credit or an intercompany line does to all three.

The second is your profit and loss statement (P&L), in the program's shape, which is a different shape than your accountant keeps it in. Revenue comes first, then material margin: revenue minus purchased material and net freight. That's the dollars a product leaves you after you've paid for what's in it and what it cost to move it. Then total employee cost (TEC): every dollar of people, in the plant and in the office, wages through benefits through the contractors doing an employee's work. Then other costs: energy, maintenance, rent, insurance, information technology, travel, everything that's neither people nor material. Material margin less total employee cost less other costs is EBITDA, what's left before interest and taxes come out, and before depreciation and amortization do too. It's the profit line a private-equity term sheet actually prices. Where does direct labor sit on your books today? Most likely it's inside cost of goods sold, with the rest of the people hiding inside selling, general and administrative expense (SG&A). Pull every one of them out. Otherwise you'll only see what your chart of accounts calls them, and you'll never see what people actually cost you.

The third is the people file: every position, its loaded cost, the manager it reports to, and a first pass at where its time goes. Use positions, and leave the names off. On the first cut, managers answer the time question badly and in an afternoon, and that's fine. A proper time study comes later, once you know which Fort you're staffing for. What you need now is a total that reconciles to the P&L. The second and third files have to agree with each other before you let either of them support a decision. Build them by hand or with the tools you have (Chapter 3 shows what an AI tool can pull together in an afternoon), and tie each one to the P&L before you read a number off it.

That's three files (transactions, P&L and people), and one rule I've learned not to bend: don't act on any one of them without the other two. A transaction file alone tells you which customers are big. It can't tell

you which ones are worth having, because there isn't a single salary in it.

Size the Prize

Now you have three clean files and still no decision. That's where most diagnostics stop, because a spreadsheet won't tell you what to do with it. I call the next fourteen days Size the Prize, and the report they produce carries the same name. Think of a surveyor's report on a property you already own: what it's worth today, what it could be worth, where the foundation has cracked. Nobody confuses that report with the renovation.

Why does the report lead with its answer instead of its evidence? Because the answer is the page a Board reads, and everything behind it is your receipts. The 80/20 impact estimate (three levers, a total, a comparison to the Board's number) sits on page one. Behind it come the reminders, in order. First, the three pyramids out of the Illinois Tool Works tradition: your revenue, your customers and your overhead, each stacking the same way, with roughly a fifth of the base carrying most of the weight. Then the quartiles: customers and products each cut into four equal-count buckets by revenue, to show how long your tail runs and whether margin rises or falls along it. It should rise. In most companies it falls, because the tail costs more to serve than the head does, and nobody has ever priced it that way. And then the Quad: the four boxes that A and B customers make against A and B products, the map Chapter 2 opens in full. Size the Prize doesn't teach the Quad. It uses the Quad, the way a surveyor uses a plat map somebody else already drew.

Then, last and load-bearing, comes the Right to Grow ratio.

The Right to Grow Ratio

A profit and loss statement will tell you the company made 9.2 percent, and 9.2 percent is a fact with no diagnosis inside it. Is that a price problem? A people problem? A volume problem hiding behind an otherwise decent quarter? The P&L won't tell you, because it was built to report the result rather than the cause. You need one number that tells you which play to run, and I call that number the Right to Grow ratio.

It's material margin divided by total employee cost. Nothing else goes into it. Rent, depreciation and the debt a sponsor put on the company all

stay out, because none of those tells you how well your people turn what you buy into profit. Think of the airspeed indicator in a small aircraft: one needle over a dial marked in colored arcs, and each arc tells the pilot what the airplane may safely be asked to do at that speed. The ratio is that dial for a company. It's built from the only three things you control this quarter — the top line, the margin rate and the people cost — and it leaves out everything else on purpose.

You read the dial in five zones.

1. Below 1.0, people cost more than the margin they produce. Simplify and cut to survive, and if margins are compressing on top of it, take price now. Inflation has already gotten ahead of you, and you haven't passed it on to your customers yet.
2. About 1.5 is break-even for most companies, and it's usually the worst kind of break-even, where revenue fell and people cost didn't follow it down. Trim the people cost and recenter on the customers and products that pay.
3. From 1.5 to 2.0, complexity is weighing the company down: too many products, too many customers, growth stalled under the pile. Most companies I meet are sitting here, and more likely than not, so are you. The play is to simplify aggressively. Take roughly eighty percent of the fourth Quad's complexity out. Trim about 12.5 percent of total employee cost, and redeploy about the same again onto the customers and products that pay for it.
4. Above 2.0 and rising, you've earned the right to grow. Simplification turns from aggressive to routine maintenance. Resources go to the Fort, the minimum goes to the two Quads in between, and nothing goes to the fourth.
5. Above 3.0, stay disciplined. Up here the ratio swings hard, because a small move in margin moves a large numerator. Watch EBITDA instead of the ratio, don't overreact to one quarter, and keep clearing whatever tail remains.

You have to read it two ways at once. Read it at a point and as a trend: a 2.1 that fell from 2.4 is a sicker company than a 1.9 climbing from 1.6, and the P&L alone leaves you guessing which one is in front of you. And read it more than once: for the whole company, for each unlike business inside it, and for each Quad. An average of four diagnoses doesn't tell you what's wrong with any of them. Which zone are you in? Most CEOs I meet guess one zone higher than the number says, because a guess is flattering and a ratio isn't.

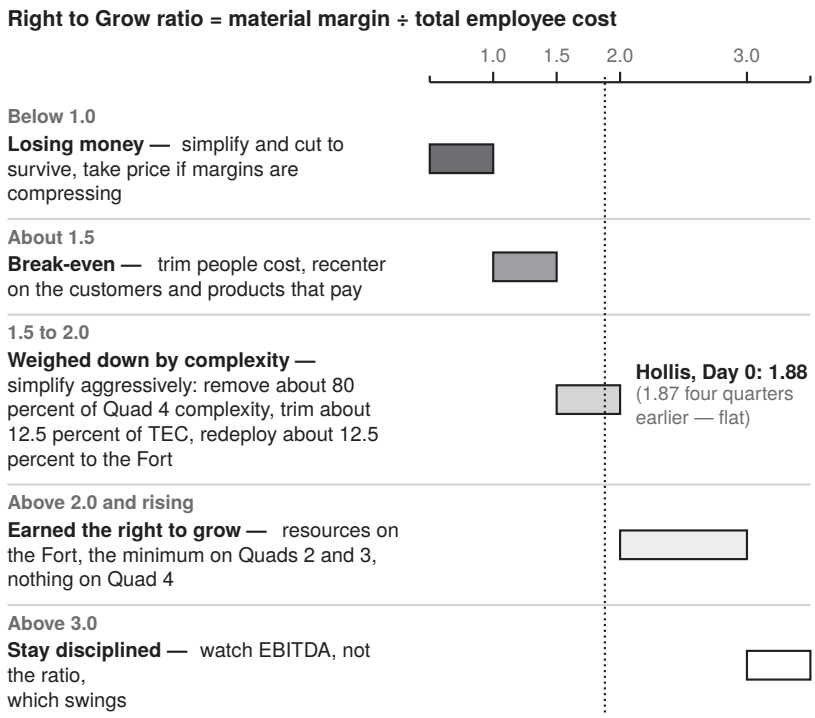


Fig. 01-01: The Right to Grow ratio, material margin divided by total employee cost, and the five zones it names, each with its play. Hollis at Day 0: 1.88, flat.

A trend needs a bridge, because "the ratio moved" tells you nothing about why it moved. Three drivers do the work: volume, margin rate and people cost. Volume changes the numerator at the old margin rate. The margin rate itself — price and mix — changes it again, for better or worse. And people cost changes the denominator, usually in the wrong direction, since people cost rises on its own schedule whether revenue rises with it or not. Add the three and you'll know why last year isn't this year, which is something a single percentage can't tell you.

The Prize and the Gap

There are three levers (margin, resourcing and growth), and you size each one from the pages behind it, conservatively and on purpose. An estimate that gets beaten earns a Board's trust for the next one you bring

them. An estimate that gets missed spends trust you'll want later, when the number is harder to hit.

Margin expansion is getting paid for the complexity sitting in the second, third and fourth Quads. It also means correcting a tail whose margins run backward, thinner at the bottom where they should be thicker, because the bottom costs more to serve. The program sets a margin spread for the second and third Quads above the Fort's own margin (Chapter 5 carries the spreads). Apply the low end of that spread to what those two Quads already sell, and add a point or two of list price across the Fort itself. Count the fourth Quad for almost nothing, since most of that revenue should leave once it's priced for what it actually costs to serve.

Resourcing is the third zone's own arithmetic, applied without rounding it up. Trim about 12.5 percent of total employee cost, and redeploy about the same again from the tail onto the Fort. The trimmed half is the estimate. The redeployed half belongs to growth, and that's the whole reason to redeploy it instead of cutting it.

What does growth mean in this arithmetic? It means the Fort at twice the market for three years, funded by the people resourcing just freed, with no new overhead added anywhere in the company. It's the largest lever in the estimate, and it's the last one you get to pull, because it's the only one that needs the other two to have happened first. If you pull it first, you haven't really grown. You've just built a bigger version of the company that complexity was already costing you.

Add the three levers and set the total beside the Board's number. That number has to be the one financial goal, set with the Board, in dollars, and announced to the whole company, the way *Take Control* teaches setting it. Most of the time the levers fall short of it. Don't read that shortfall as a failure of the diagnostic. The diagnostic is telling you what the company you already own can do on its own, and reminding you that a Board is allowed to want more than that.

Hollis

Theo Marsh, Hollis's financial planning and analysis (FP&A) manager, had the transaction file pulled from the enterprise resource planning (ERP) system by Day 6 and matched it to the P&L within a rounding error by Day 7. It came in dirty on the first pass. The second and third files disagreed by $1.1 million. Plant budgets were carrying contractors

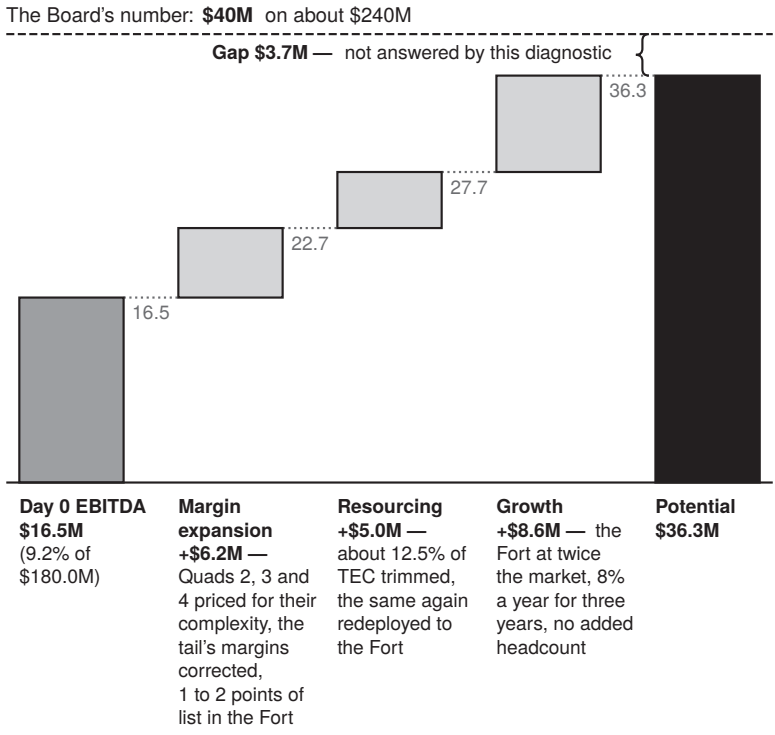


Fig. 01-02: Hollis at Day 0 and the prize: the Day 14 impact estimate bridged from $16.5 million to $36.3 million, the Board's $40 million marked above it, the $3.7 million gap named.

who were really direct labor, and the supplies line was carrying temps who were really people cost. We moved both, and the files agreed.

Sorted by revenue, the customer list ran 1,420 lines. At the top was Great Plains Fluid Distributors of Kansas City, at $9.4 million. At the bottom, a customer had bought just fifty-five dollars of seals in a year. That was one order, one line, picked, packed, invoiced and collected by the same people who served Great Plains. Nobody at Hollis had been wrong to sell that fifty-five dollars. Nobody had decided to, either. Who decided? That's the question three clean files let you ask. A P&L can't help you ask it, because a P&L was built to add the fifty-five dollars to the $9.4 million and report only the total.

Dana Whitlock, the chief financial officer, built the bridge on Day 12. Four quarters earlier the ratio had stood at 1.87. Revenue had grown

about two percent since, roughly $3.5 million, worth four hundredths of a point on the ratio at the existing margin rate. The margin rate itself had drifted down a tenth of a point on mix, worth about one hundredth back. People cost had risen $0.4 million, worth two hundredths more. Plus four, less one, less two: plus one. Hollis had grown just two percent, spent all of that growth on people, and stood still at 1.88.

That number named the play that same afternoon: simplify aggressively. Trim roughly $5 million of the $43.0 million of total employee cost, and redeploy about the same again onto the Fort. By Day 14 the impact estimate was built and added up — $6.2 million of margin, $5.0 million of resourcing and $8.6 million of growth, $19.8 million in total, against Day 0's $16.5 million of EBITDA. That put potential EBITDA at about $36.3 million.

On Day 30 I read that estimate to the Board and set it beside their own number. Victor Haldane was Redfield Capital Partners' managing director and the Board's chair. He had underwritten the deal on $40 million of EBITDA against a business of about $240 million by Day 1,000. He had that figure before I ever set foot in Rockford. Beside his $40 million, my $36.3 million left a gap of $3.7 million, and Victor asked, fairly, where the rest would come from. I told him the truth. It wouldn't come from this diagnostic. Three files can tell you everything the company you already own is capable of earning. They can't tell you about a company you might buy or a market you haven't entered yet, so on Day 30 the gap had no name. It got one later, on its own schedule. I didn't mind the wait, because a Board that hears the truth about $3.7 million on Day 30 will believe the $36.3 million on Day 365.

From the Record

This chapter's rule (count everything before you decide anything) is nine centuries older than a profit and loss statement.

At Christmas 1085, William the Conqueror held his court at Gloucester and, the *Anglo-Saxon Chronicle* records, took very deep speech with his council about the land he had ruled for nineteen years. A Danish fleet was rumored to be crossing, and he had shipped a mercenary army over and billeted it on his own barons. By his own account, he didn't know what the kingdom could bear or what was owed him from it. So he sent commissioners into every shire, and in every hundred they put the same questions to a sworn local jury. Who held this manor in King Edward's day, who holds it now, how many ploughs, how many villeins,

how many slaves, how much wood and meadow. All of it led to one more question: what was it worth then, what is it worth now, and could more be had from it. A second set of commissioners, strangers to each shire, rode behind the first to check the count against itself.

The monks who kept the *Chronicle* didn't care for being counted so closely. So narrowly did he have it searched out, one of them wrote, that not an ox, a cow or a pig was left off the record. And the king thought it no shame to have it done. The returns were in within the year, in time for the oath William took from every landholder in England at Salisbury on August 1, 1086. Within a century clerks were calling the two volumes Domesday, because, a treasury official explained around 1179, its word could no more be appealed than the Last Judgment's. The Exchequer went on ruling from it for two hundred years afterward. William had held the country for nineteen years and was already taxing it when he ordered every pig counted.

Neither should you. Read the ratio before you run the play.

Do This

1. Pull the three files (twelve months of transactions at the line level, the P&L in the program's shape, the people file) by Day 7.
2. Compute the ratio for each of the last four quarters and write the zone and the play in one line.
3. Read the quartiles and the Quad, but don't act on either of them yet.
4. Write the impact estimate by lever (margin, resourcing and growth) on one page, by Day 14.
5. Set it beside the Board's number and write the gap down as a dollar figure, without explaining it away.
6. Don't act on anything else for fourteen days.