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The 80/20 Company

Field Guide preview

Chapter One: Size the Prize

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Chapter 1

Size the Prize

Chapter 1 of the book. Size the prize before you touch anything, with three clean files, the Right to Grow ratio and an estimate of the program's worth, set beside the Board's own number. Instruments: worksheets 1, 2 and 3.

Every CEO I have ever met arrived with a plan. Most were good. Almost none were built on the three files, because almost nobody had pulled them, and a plan built on a P&L is a plan built on an average. The P&L says the company earns 9.2 percent. It cannot say that 284 customers earn all of it and 1,136 spend the rest, because a P&L was built to average exactly that away.

So the first thing the program asks of you is the hardest thing a new CEO does on the first morning. Don't act. Pull the files, compute one ratio, read what it says about the play you are running, and write down what the whole thing could be worth. Fourteen days. I have never seen a company that could not afford them, and several that could not afford to skip them.

The pages that follow are those fourteen days. Worksheet 1 is the data and the cleaning rules. Worksheet 2 is the ratio, the zones and the bridge. Worksheet 3 is the prize by lever, the Board's number beside it, the gap written down. Fill them in that order. The ratio without the files is a guess, and the prize without the ratio is a wish.

WHAT IT LOOKS LIKE WHEN IT IS MISSING

- The leadership team can recite the company's EBITDA percentage and cannot say which twenty customers produce it.
- Somebody has a spreadsheet of customer profitability, built three years ago, that nobody has opened since.
- Material margin and total employee cost are not lines anyone reports, so nobody has ever divided one by the other.
- The Board's number lives in a deck, the plan to reach it lives in the CEO's head, and the two have never shared a page.
- The last diagnostic was a consultant's, and it found what the consultant sells.
- Every function believes it is understaffed, and no one can say what the people are spent on.

The tell is a CEO who has been in the seat for ninety days and has already reorganized something.

IN THE BOOK

Chapter 1 argues that you earn the right to decide anything by counting everything first, in three clean files and fourteen days. It names Size the Prize, the report that turns a year of transactions, a P&L rebuilt in the program's shape and a people file into the quartiles, the Quad and one governing number. It names the Right to Grow ratio, material margin divided by total employee cost, read at a point and as a trend, in five zones, each with its own play. And it names the impact estimate, the prize sized lever by lever, margin, resourcing, growth, set beside the Board's own number so the gap is a fact, not a feeling. At Hollis the ratio came in at 1.88, flat against 1.87 a year earlier, the prize totaled $19.8 million against $16.5 million of Day 0 EBITDA, and the gap to the Board's $40 million was $3.7 million the diagnostic could not see. Its Do This list, as a checklist:

☐ Pull the three files — transactions at the line level, the P&L in the program's shape, the people file — by Day 7.
☐ Compute the ratio for each of the last four quarters and write the zone and the play in one line.
☐ Read the quartiles and the Quad. Act on neither yet.
☐ Write the impact estimate by lever, margin, resourcing and growth, on one page, by Day 14.
☐ Set it beside the Board's number and write the gap as a dollar figure, not an excuse.
☐ Do nothing else for fourteen days.

WORKED EXAMPLE

Hollis's three files came in over the first week. Theo Marsh, the FP&A manager serving as Analyst, pulled the transaction file by Day 6 and matched it to the P&L by Day 7, within a rounding error. It came in dirty: the second and third files disagreed by $1.1 million, plant budgets carrying contractors who were really direct labor, the supplies line carrying temps who were really people cost. Both moved into total employee cost, and the files agreed. Sorted by revenue, the customer list ran 1,420 lines, from Great Plains Fluid Distributors at $9.4 million a year down to a customer who had bought fifty-five dollars of seals in one order. Nobody had decided to sell that fifty-five dollars, and nobody had decided not to — the question three clean files ask, and a P&L cannot.

The P&L, rebuilt in the program's shape: revenue $180.0 million, purchased material and net freight $99.0 million, material margin $81.0 million, 45.0 percent. Total employee cost $43.0 million, other costs $21.5 million. Take 81.0, less 43.0, less 21.5, and you have 16.5, the EBITDA the P&L had always shown, now with a reason attached. The ratio, 81.0 over 43.0, was 1.88, against 1.87 four quarters earlier. Dana Whitlock, the CFO, built the bridge on Day 12: growth added four hundredths of a point, mix cost a hundredth back, people cost took two hundredths more, net plus one hundredth, the whole distance between 1.87 and 1.88. Hollis had grown, spent the growth on people, and stood still, flat, in the zone between 1.5 and 2.0. The play: simplify aggressively, trim about one eighth of total employee cost, redeploy the same again from the tail to the Fort.

The estimate, on Day 14, by lever: margin expansion $6.2 million, most of it in Quads 2, 3 and 4, where the tail was priced below the Fort. Resourcing $5.0 million, the twelve and a half percent of people cost the zone said to trim, and the same again redeployed. Growth $8.6 million, the Fort at twice the market's four percent for three years at Fort margins, no added headcount. The three lines summed to $19.8 million, the organic program worth about $36.3 million of EBITDA against Day 0's $16.5 million.

The Board's number was $40 million of EBITDA on about $240 million of revenue by Day 1,000, the figure Victor Haldane, Redfield Capital Partners' managing director and the Board's chair, had underwritten the deal on before I arrived. On Day 30 I read the estimate to the Board beside his number. The gap, $3.7 million, went on the last line, with the sentence that mattered: not from this diagnostic. Three files can tell you what the company you already own can earn, not what a company you might buy, or a market you haven't entered, could. The gap had no name on Day 30. It earned one later, on its own schedule.

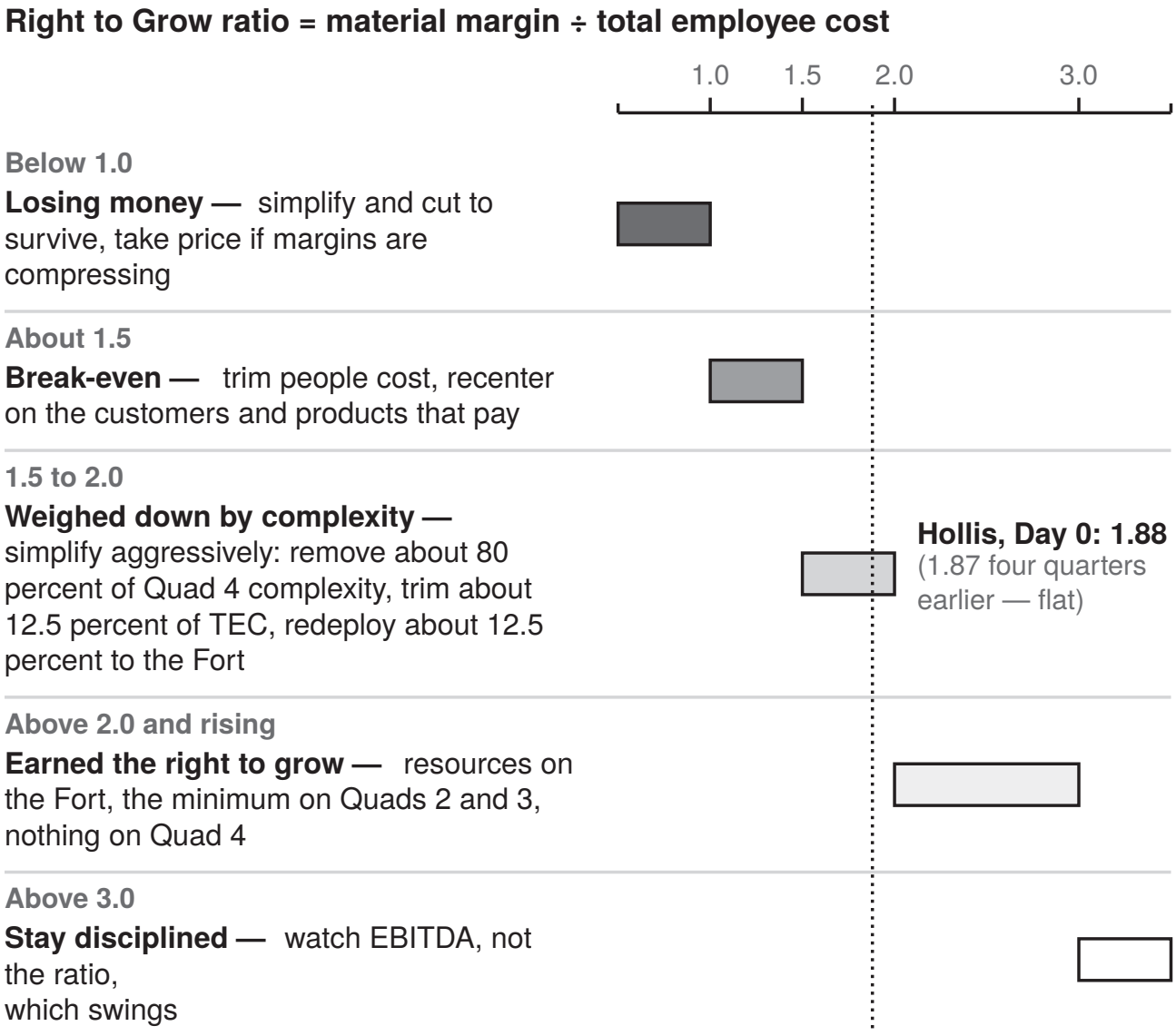


Fig. 01-01: The Right to Grow ratio, material margin divided by total employee cost, and the five zones it names, each with its play. Hollis at Day 0: 1.88, flat.

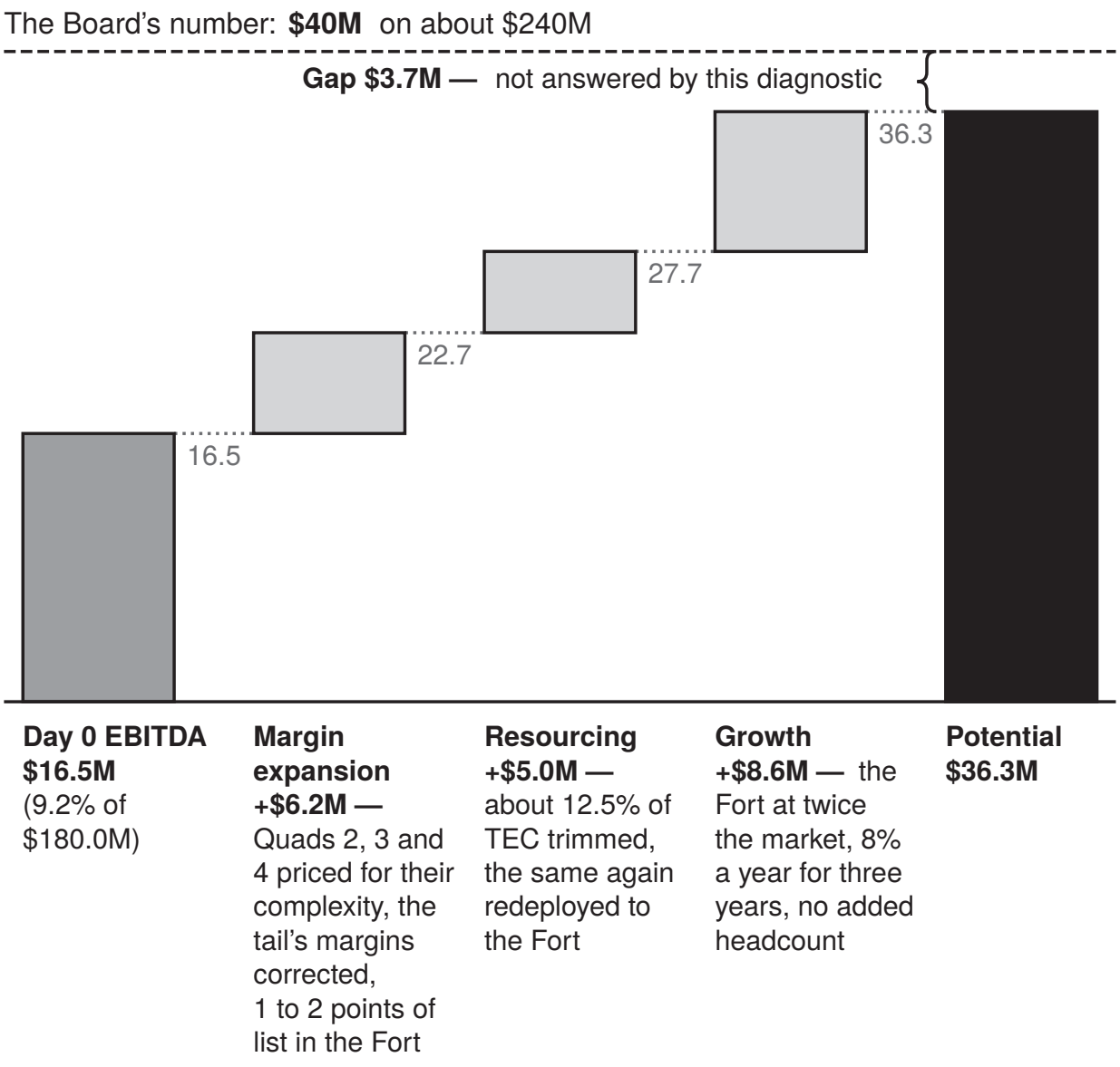


Fig. 01-02: Hollis at Day 0 and the prize: the Day 14 impact estimate bridged from $16.5 million to $36.3 million, the Board's $40 million marked above it, the $3.7 million gap named.

Three worksheets carry the fourteen days. Fill the checklist first — a ratio computed on a P&L that still has freight inside cost of goods sold is a ratio you will compute again.

WORKSHEET 1

The three files checklist

What the diagnostic runs on, and the cleaning rules. The Analyst fills it in, the CFO signs it. Pull the files by hand or with the tools you have, and tie the totals to the books.

Company or segment

Trailing twelve months, from

to

Analyst

CFO sign-off, date

The transaction file. One line per invoice line for the trailing twelve months.

☐ Customer number is the bill-to, and every ship-to rolls up to one
☐ Product number is a saleable part, not a family or a category
☐ Revenue is net of returns and credits, and credits carry the original customer and product
☐ Material cost is on the line, at standard or actual, and the basis is written down
☐ Freight is netted to the ship-to, not booked to one account
☐ Intercompany, samples and scrap are tagged and excluded
☐ Nothing that shipped is left out, however small

Line count

Customers

Products

The P&L in the program's shape. Four lines, twelve months.

Line	Amount	Source and basis

Revenue. Purchased material and net freight. Total employee cost (every dollar of people: wages, benefits, payroll taxes, contractors doing employees' work, plants and office). Other costs (everything that is neither people nor material). EBITDA is the first line less the other three.

The people file. Every position, loaded cost, and where the time goes.

Position	Loaded annual cost	Segment	Quad (best guess today)	Manager

The cleaning rules you wrote. One per line, with who decided it.

Rules

> **Hollis's version**
> 412,000 lines, 1,420 customers, 9,600 products. Pulled from the ERP by Day 6, matched to the P&L by Day 7. The people file and the P&L disagreed by $1.1 million at first, plant budgets carrying contractors who were really direct labor, the supplies line carrying temps who were really people cost, both moved into total employee cost. The P&L: 180.0 / 99.0 / 43.0 / 21.5 / 16.5.

WORKSHEET 2

The Right to Grow ratio — calculator and zone reader

One number, read at a point and as a trend, for the company, each segment and each Quad. The Analyst computes it, the CEO reads it aloud.

Quarter	Revenue	Material margin	Total employee cost	Ratio

Ratio = material margin ÷ total employee cost. Compute it on the trailing four quarters, one line each, and write the trend in one word: rising, flat or falling.

Ratio today

Ratio four quarters ago

Trend

The zone, and the play. Circle one.

☐ Below 1.0 — losing money: simplify and cut to survive, take price now if margins are compressing too
☐ About 1.5 — break-even: trim people cost, recenter on the profitable core
☐ 1.5 to 2.0 — weighed down by complexity: simplify aggressively, trim about 12.5 percent of people cost, redeploy the same again
☐ Above 2.0 and rising — you have earned the right to grow: focus resources on the Fort, keep simplifying
☐ Above 3.0 — stay disciplined: the ratio swings, watch EBITDA instead

The bridge. Why the ratio moved from four quarters ago to today.

Driver	Dollars	Effect on the ratio

Volume (revenue up or down, at the old margin rate). Margin (price and mix). People cost. Anything else, named.

By segment and by Quad. The same arithmetic, once the Quads exist (worksheet 6).

Segment or Quad	Material margin	People cost	Ratio	Zone

Hollis's version
81.0 over 43.0 is 1.88, from 1.87, flat. Zone: 1.5 to 2.0. Bridge: revenue up about $3.5 million, two percent, worth four hundredths of a point. Margin rate down a tenth of a point on mix, worth a hundredth back. People cost up $0.4 million, worth two hundredths more. Net: plus one hundredth. By Quad at Day 0: the Fort 2.71, the Necessary Evil 1.32, the Transactional Quad 1.49, Price Up or Exit 0.56. By segment: Pumps & Seals 2.16 and rising, Engineered Valve Assemblies 1.46 and falling.

WORKSHEET 3

The impact estimate by lever

What the program is worth, by lever, set beside the Board's number. The CFO builds it, the CEO signs it, the Board sees it.

EBITDA today (trailing twelve months)

The Board's number, in EBITDA

By when (Day)

Lever	Estimate	Where it comes from	How sure

Margin expansion: getting paid for complexity in Quads 2, 3 and 4, plus a point or two of list in the Fort. Resourcing: the people cost the zone says to trim, and its redeployment. Growth: the Fort at twice the market, at Fort margins, no added headcount.

Total of the three levers

EBITDA potential (today plus the total)

Gap to the Board's number

Where the gap comes from, if not from the levers above

> **Hollis's version**
> Margin expansion $6.2 million. Resourcing $5.0 million. Growth $8.6 million. Total $19.8 million. Potential $36.3 million against $40.0 million. Gap $3.7 million, not answered by this diagnostic.

RUNNING IT WITH THE TEAM

The three files are not a meeting. They are two weeks of the Analyst's time with the CFO looking over one shoulder and, once, the CEO looking over the other. Book the room for Day 14, not Day 1.

Before that, three conversations. On Day 1 the CEO tells the CFO and the Analyst what the three files are, hands them worksheet 1, and says the sentence that keeps it honest: nothing that shipped is left out, however small. On Day 4 the Analyst brings the cleaning rules as written, and the CFO signs each one, because a rule nobody signed is a rule somebody will unwind. On Day 10 the CFO brings the P&L in the program's shape and the ratio for four quarters, and the CEO reads it and stays quiet for four days.

Day 14 is the room: the leadership team, ninety minutes, at the wall, worksheet 2 and worksheet 3 printed one copy each. The CEO opens with the ratio, reads the zone aloud, with the play. The CFO walks the bridge, then the estimate by lever, the Board's number beside it, the gap. The CEO closes with two sentences: this is what the company is worth if we run the program, and nobody decides anything for two more weeks. The Driver takes the room's questions on one sheet and answers none that day — every one is answered by a worksheet in Chapter 2.

What goes wrong the first time. The CFO argues the definition of total employee cost, usually to move the benefit load or the contractors out of it, because the ratio looks better without them. Leave every dollar of people in. Somebody says the ratio does not apply to their business. It applies. Somebody wants to start simplifying that afternoon, because the Quad-4-only count is right there on the page. Not yet. Somebody will believe the estimate is a forecast. It is the size of the prize, not a forecast, and the program is how you go get it.

THREE QUESTIONS FOR MONDAY

1. What is your ratio, today and four quarters ago, and which zone does that put you in? Did the P&L already exist in the program's shape, or did you have to build it?

2. Which of the three files does your company not have in usable form, and who will have it by Day 10?

3. Write the Board's number and your own honest estimate of the prize side by side. What is the gap, and what do you suspect it will take to close it?

BEFORE YOU MOVE ON

You should now have, on paper:

☐ Worksheet 1 — the three files, cleaned, with the rules signed by the CFO
☐ Worksheet 2 — the ratio for four quarters, the zone, the play and the bridge
☐ Worksheet 3 — the estimate by lever, the Board's number and the gap in dollars
☐ A room booked for Day 14, and nothing decided before it