THE BEST TEAM MONEY CAN BUY

9/14/2011

Hiring Top Performers to Grow Profitability

Crabtree Rowe & Berger
Seeing Beyond Numbers

Find out how to implement an NFL-style salary cap in your business so you can hire the best team possible to drive your profits down the field and reach your ultimate profitability goal.

The Best Team Money Can Buy

HIRING TOP PERFORMERS TO GROW PROFITABILITY

Did you ever wonder why some NFL teams win game after game and others flail on the field, even though each team has the same salary cap? They focus on labor efficiency. It's no different in business. You only have so much to spend on salaries. You can either spend that money on a mediocre staff with a few all-stars, or you can spend it on a team of top-notch players to drive your profits to the end zone and finish ahead of your competition.

Labor efficiency is the first thing I focus on with each new business client. Increasing your labor efficiency is the number one factor in improving profitability and unleashing growth. It can be split to measure direct labor, sales labor, and management labor to help you hone in on areas of profitability and see where improvements need to be made. Focusing on labor efficiency has these additional major benefits:

- Measures whether your costs outweigh your profits or if your costs are levers to generate profits
- Helps managers identify unproductive labor and take appropriate corrective actions
- Helps senior management hold midmanagers accountable for delivering results
- Lowers capital requirements, lowers the cost of capital, and attracts top-level investors

To help drive the point home, let's set up the data:

	Monthly Amounts	% / Labor Ratios	Notes
Revenue	450,000.00		
Direct costs (excluding labor)	130,000.00		
Gross profit (GP)	320,000.00	71.11%	GP as % of revenue
Direct labor	90,000.00	$3.56	GP per direct labor dollar
Contribution margin (CM)	230,000.00	51.11%	CM as % of revenue
Management/admin labor	75,000.00	$3.07	CM per management labor dollar
Sales labor	35,000.00	$6.57	CM per sales labor dollar
Other operating costs	100,000.00		
Pretax profit	20,000.00	4.44%	Pretax profit as % of revenue

This is an example of a company that is underperforming. I consider a company with less than 5 percent pretax profit to be on life support, 10 percent pretax profit is a good business, and 15 percent pretax profit or better is a great business (with rare exceptions). This management team is faced with several choices to improve profit:

- Cut nonlabor costs: This approach yields minimal gain because you cannot cut kitchen or office supplies enough to get profitable. Cutting marketing costs is counterproductive because it ultimately leads to nobody knowing about you.
- Cut labor costs: Your labor costs can be divided into direct labor, management labor, and sales labor:
    - Direct labor: This is your production engine, so you would only cut here if someone is truly not performing or is not needed.
    - Management labor: As with direct labor, you would cut here only if someone is underperforming or is no longer needed.
    - Sales labor: Again, you would not reduce this labor unless necessary, but make sure your sales people have proper sales targets for their compensation. Sales incentives based on gross profit are much more effective if the sales team has the authority to negotiate prices.
- Grow your way into higher profits: If there is market share to be gained, this is the preferred method after you have addressed unproductive labor. The key to this strategy is knowing where you have excess capacity in your labor segments (direct, management, and sales). This is reflected in what I call your labor ratios. In the previous table, you can see the following labor ratios[1]:
    - Direct labor: $3.56 gross profit per labor dollar
    - Management labor: $3.07 contribution margin per labor dollar
    - Sales labor: $6.57 contribution margin per labor dollar

The keys to successfully growing your way into higher pretax profit are to grow as much as possible without adding labor; identify which labor segment will get the first addition of labor; and add labor to one segment at a time, drive your profits back up, then add labor to the next segment and drive your profits back up again.

STEP 1: HOLD LABOR CONSTANT AND DRIVE TO 10 PERCENT PRETAX PROFIT

Given the data in the previous table, the company should refocus its strategy and get profitable without making any changes. It needs to increase its pretax profit to 10 percent before it can add labor. Most people think they have to buy something or hire people to make them profitable, but the majority of my

[1] Contribution margin is the numerator for the management labor and sales labor efficiency ratios because management decisions drive the effective utilization of direct labor. You can create a large amount of gross profit, but if overpriced labor does the work, it lowers the efficiency ratio of direct labor.

clients get profitable by committing to a target without adding labor. You can change which personnel you have, but you cannot spend any more than what you have been spending.

For our first step, the new target is as follows:

	Monthly Amounts	% / Labor Ratios	Notes
Revenue	492,195.19		
Direct costs (excluding labor)	142,195.19		
Gross profit (GP)	350,000.00	71.11%	GP as % of revenue
Direct labor	90,000.00	$3.89	GP per direct labor dollar
Contribution margin (CM)	260,000.00	52.82%	CM as % of revenue
Management/admin labor	75,000.00	$3.47	CM per management labor dollar
Sales labor	35,000.00	$7.43	CM per sales labor dollar
Other operating costs	100,000.00		
Pretax profit	50,000.00	10.16%	Pretax profit as % of revenue

The company needs to add only $42,195 of monthly sales, with the same cost structure, to get to 10 percent pretax profit. Typically, the only costs that are truly variable are the direct costs that exclude labor. Gross profit is the number I try to get everyone to focus on. Revenue is more of a vanity number, especially if your gross profit can vary by customer or product. Your gross profit establishes the amount of money you need to cover the costs you control.

Take a close look at the change in labor ratios as you approach 10 percent pretax profit. Your gross profit and contribution margin per labor dollar increase in each labor segment, so now you know your labor ratio targets for maintaining 10 percent pretax profit. If any one of the three labor ratios go down, you have to balance it out with one of the others. Your other operating costs (such as office supplies, business licenses, professional fees, etc.) typically do not go up under this scenario because you are just adding productivity to existing costs.

STEP 2: KEEP GOING UNTIL YOU HIT 15 PERCENT PRETAX PROFIT

Because your goal is 10 percent pretax profit, don't stop here. Adding labor is expensive. Drive toward 15 percent pretax profit before you incur this cost so you don't fall behind your goal.

Continuing our example, here is how that looks:

	Monthly Amounts	% / Labor Ratios	Notes
Revenue	534,383.35		
Direct costs (excluding labor)	154,383.35		
Gross profit (GP)	380,000.00	71.11%	GP as % of revenue
Direct labor	90,000.00	$4.22	GP per direct labor dollar
Contribution margin (CM)	290,000.00	54.27%	CM as % of revenue
Management/admin labor	75,000.00	$3.87	CM per management labor dollar
Sales labor	35,000.00	$8.29	CM per sales labor dollar
Other operating costs	100,000.00		
Pretax profit	80,000.00	14.97%	Pretax profit as % of revenue

Once again, we held all costs constant and continued to push to see what our capacity could produce. To get to this stage, the most common steps management takes are as follows:

- Low-producing team members are replaced, but the total wages are held constant.
- Senior management (i.e., CEO and VPs) reengage in the sales process to reposition the company.
- Marketing spending is maintained, but the message is retooled.
- Customers that generate 20 percent of the revenue but constitute 80 percent of the client base are moved up or out, leaving more time to deal with target customers.

When companies get to this stage, they usually experience some cracks in the system. Management should identify where the major stress points are and decide which labor segment to spend money on first.

STEP 3: THE SALARY CAP

This is where the NFL salary cap concept comes into play. The goal is to use some revenue to add labor but not drop below 10 percent pretax profit. When you make it to 15 percent pretax profit, calculate the amount of labor you can add and not allow the company to drop below 10 percent pretax profit.

Take 5 percent of your revenue, which in this step is $534,383, and that gives you $26,719 monthly ($320,000 annually) to spend on additional labor. That is a lot of wages, and it is unlikely that you can spend that much more all at once. Even if you could, it would be hard to integrate that much new labor in a short period of time. Every new hire needs an existing employee to show them the ropes, and they rarely hit the ground running. Try to stagger hiring as much as possible so you have time to evaluate the impact of each new hire.

You will have already decided which labor segment to spend money on first, based on where the greatest need is, but for our example let's presume you add $100,000 of annual wages to direct labor, $100,000 to management labor, and $100,000 to sales labor. At this point, you should see some rise in your other operating expenses, so you'll have to leave some room for that extra cost. However, they should rise at a lower rate as a percent of revenue. Most other operating costs are fixed in nature, so the category as a whole will increase in steps at a much slower rate than other costs. For example, the base amount of office supplies you need to initially open an office is larger per person than the ongoing cost for each additional person.

Let's take a look at the numbers:

	Monthly Amounts	% / Labor Ratios	Notes
Revenue	534,383.35		
Direct costs (excluding labor)	154,383.35		
Gross profit (GP)	380,000.00	71.11%	GP as % of revenue
Direct labor	98,333.33	$3.86	GP per direct labor dollar
Contribution margin (CM)	281,666.67	52.71%	CM as % of revenue
Management/admin labor	83,333.33	$3.38	CM per management labor dollar
Sales labor	43,333.33	$6.50	CM per sales labor dollar
Other operating costs (OOC)	101,666.67	19.03%	OOC as % of revenue
Pretax profit	53,333.33	9.98%	Pretax profit as % of revenue

You can see that adding labor cost causes your labor ratios to drop, even though your revenue is constant. It takes time for new people to reach maximum productivity, and as their productivity grows, your team gradually matures and learns to work together more efficiently.

STEP 4: GROW BACK TO 15 PERCENT PRETAX PROFIT

Now that you have added your new labor, hold the wages constant until you reach 15 percent pretax profit again. You know what your labor ratios can be from your previous experience at this profit level, and you should see each labor component move back toward your best performance levels. As your company gets larger, you will see some drop in your direct labor ratio because you have to lower your prices to be more competitive, but efficiencies in your management labor and sales labor segments should make up for it.

Here is what the company performance would look like as it gets back to 15 percent pretax profit with the addition of new labor:

	Monthly Amounts	% / Labor Ratios	Notes
Revenue	587,821.68		
Direct costs (excluding labor)	169,821.68		
Gross profit (GP)	418,000.00	71.11%	GP as % of revenue
Direct labor	98,333.33	$4.25	GP per direct labor dollar
Contribution margin (CM)	319,666.67	54.38%	CM as % of revenue
Management/admin labor	83,333.33	$3.84	CM per management labor dollar
Sales labor	43,333.33	$7.38	CM per sales labor dollar
Other operating costs (OOC)	105,000.00	17.86%	OOC as % of revenue
Pretax profit	88,000.00	14.97%	Pretax profit as % of revenue

Now that you have proven you can add new labor under the salary cap concept, you continue to repeat the process until you either reach the optimal allowable market penetration or you decide to slow the company's growth. After you hit the ideal company size, you can transition to a prune-and-grow strategy so that complacency does not set in. This will allow you to maintain the character of a growing company yet hold the overall company size relatively constant.

RECAP OF STEPS AND OBSERVATIONS

Let's take a look at the progression of steps and analyze the data:

	Original	Step 1 10%	Step 2 15%	Step 3 Back to 10%	Step 4 Back to 15%
Revenue	450,000.00	492,195.19	534,383.35	534,383.35	587,821.68
Direct costs (excluding labor)	130,000.00	142,195.19	154,383.35	154,383.35	169,821.68
Gross profit	320,000.00	350,000.00	380,000.00	380,000.00	418,000.00
Direct labor	90,000.00	90,000.00	90,000.00	98,333.33	98,333.33
Contribution margin (CM)	230,000.00	260,000.00	290,000.00	281,666.67	319,666.67
Management/admin labor	75,000.00	75,000.00	75,000.00	83,333.33	83,333.33
Sales labor	35,000.00	35,000.00	35,000.00	43,333.33	43,333.33
Other operating costs (OOC)	100,000.00	100,000.00	100,000.00	101,666.67	105,000.00
Pretax profit	20,000.00	50,000.00	80,000.00	53,333.33	88,000.00
Pretax profit as % of revenue	4.44%	10.16%	14.97%	9.98%	14.97%
CM as % of revenue	51.11%	52.82%	54.27%	52.71%	54.38%
OOC as % of revenue	22.22%	20.32%	18.71%	19.03%	17.86%
Labor Ratios					
Direct labor	$3.56	$3.89	$4.22	$3.86	$4.25
Sales labor	$6.57	$7.43	$8.29	$6.50	$7.38
Management labor	$3.07	$3.47	$3.87	$3.38	$3.84

From looking at the flow of this data, the first thing that jumps out at me is that there is still capacity in the sales labor segment. You should be able to get the sales labor ratio back to $8.29 before you add more salaries in this segment. By getting sales labor back to its best performance level, you will have more gross profit to add to the direct labor engine.

Direct labor needs attention because the labor ratio of that segment has exceeded the efficiency from step 2, when the company was previously at 15 percent pretax profit. I would either give raises for increased productivity, because the maximum productivity from step 2 is being exceeded, or look for stress cracks in this segment that will have to be filled with additional labor.

SUMMARY

It may sound simplistic, but there is power in having a clear and simple target. After you commit to your profit target and the data comes in each month, you will have some tough decisions to make about unproductive labor, but this concept has worked for many of my clients and my own firm.

It doesn't matter how many heads you have or if they are full-time, part-time, or your brother-in-law. What matters is gross profit or contribution margin per labor dollar. If you employ unproductive employees and protect them from accountability, your team won't make it to the Super Bowl. Like a successful NFL franchise, buy the best team you can within your salary cap, then drive your profits down the field to reach your ultimate profitability goal.