THE BUSINESS OWNER'S JOURNEY

Part 2: Rapid Growth

BlueSky
BUSINESS RESOURCES

By reaching the inflection point from startup to rapid growth, you and your business have set yourself apart from the approximately 90% of all startups that have failed. This is no small feat, and it warrants taking a moment to reflect on everything you have achieved by becoming one of the elite 10%. Now it's time to roll up your sleeves and get back to work. Rapid growth is a period of new and exciting challenges. Your organization will undergo a complete transformation, and while internally it will need to entirely transform, you must never lose sight of what made the brand what it is, or you will lose your client base in the process. The rapid growth phase is a time of tension between who the company was and who it needs to become, and you will need to be the protector of quality and brand fidelity every step of the way. Buckle up, it's going to be the ride of your life.

One of the first issues you will likely face is the changing nature of your financial management systems. High growth requires tremendous investments, and you will find that for a significant portion of the early growth cycle, costs will consistently outpace revenue. It seems counter intuitive to think that when you really start to grow you should plan to lose a bunch of money, but that is exactly what you should be prepared for. Let’s take a minute to dig into that concept. For starters, rapid growth, by definition, means that new orders will be substantially greater than what you just shipped. This means that you will need to be consistently increasing your inventory, your workforce, and your mechanical capacity.

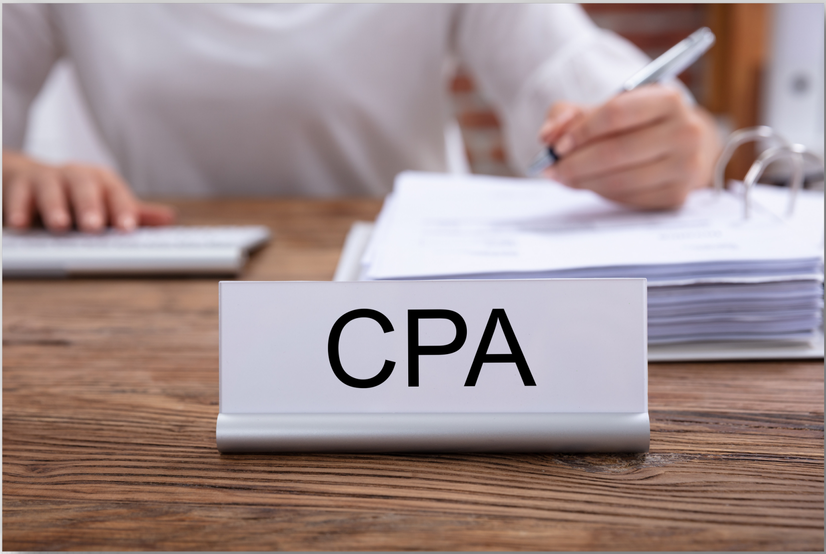
Here's an example (using arbitrarily round but not unreasonable figures) of what typical rapid growth looks like for a manufacturing company. Let's say that the company in question produces widgets for $10 each with an average 38% gross margin. The 62% cost of goods (COG) can be broken down as 28% materials, 21% direct labor, and 13% direct overhead. For simplicity's sake, we are going to assume that selling, general, and administrative (SG&A) expenses do not change meaningfully during the period in question, so we will focus our attention on Gross Profit rather than Net Profit.

Let's look at a growth cycle where they are increasing 10x per PO round. The current equipment capacity 1,000 units/cycle and new equipment installation creates an increase from 13% to 18% in direct overhead due to tuning inefficiencies and down time over two cycles. Meanwhile, workforce capacity will need to be increased every third cycle, and onboarding, turnover, and training cause an increase from 21% to 29% in direct labor margin for the subsequent cycle.

The following is a table of what a typical accrual-based P&L statement's profit would look like for just five growth cycles:

	1	2	3	4	5
Orders	10	100	1,000	10,000	100,000
Revenue	$100	$1,000	$10,000	$100,000	$1,000,000
Materials	$28	$280	$2,800	$28,000	$280,000
Direct Labor	$21	$210	$2,100	$29,000	$210,000
Direct Overhead	$13	$130	$1,800	$18,000	$130,000
COGS	**$62**	**$620**	**$6,700**	**$75,000**	**$620,000**
Gross Profit	**$38**	**$380**	**$3,300**	**$25,000**	**$380,000**
	38%	38%	33%	25%	38%

This is great, right!? I mean, sure, in period four you may have dropped to a gross margin of 25%, but that was still $25,000 in gross profit, and within just five cycles the gross profit increased four orders of magnitude. The business is doing amazing things! While, we would agree that if your business was achieving 10x per cycle growth, it truly is doing something amazing, this is a case where accrual based accounting can be misleading.



You see that the convention of accrual basis was created by accountants to tie expenses and revenue together to tell a more accurate picture of how an organization is operating over the long term. This is great over long periods, and for relatively stable operations. However, this can be a catastrophic misrepresentation in periods of rapid growth.

Consider for a minute that in reality, expenses occur one cycle before revenue can be recognized in the form of cash in hand. When you make this adjustment, the five-cycle projection is as follows:

	1	2	3	4	5
Orders	10	100	1,000	10,000	100,000
Revenue	$100	$1,000	$10,000	$100,000	$1,000,000
Materials	$280	$2,800	$28,000	$280,000	$2,800,000
Direct Labor	$210	$2,100	$29,000	$210,000	$2,100,000
Direct Overhead	$130	$1,800	$18,000	$130,000	$1,800,000
COGS	**$620**	**$6,700**	**$75,000**	**$620,000**	**$6,700,000**
Gross Profit	**-$520**	**-$5,700**	**-$65,000**	**-$520,000**	**-$5,700,000**
	-520%	-570%	-650%	-520%	-570%

We think you would agree that the differences are striking, and more than a little disconcerting. Without a strong financial management plan, growth could just be the thing that kills your company. We have seen this happen and are here to tell you that there is nothing in the professional world more devastating than seeing success kill a company. As you write your financial models and prepare to grow, please keep this information front and center in every discussion and review. Our recommendations are to first talk with your owners to determine how much cash you are willing to make available to support growth, and then to talk with your bank to see how you can structure a PO based line of credit (LOC) arrangement such that they can help to facilitate your growth. Most banks will have some form of revolver product that will achieve this end. Beyond these measures, what we wish for you to recognize before it becomes operationally obvious is that you have several new levers at your disposal. By making small adjustments like asking for some upfront cash on larger orders and making slight increases to your lead time, you can mitigate some of this upfront burden.

Now that you have some plans for managing cash flow and capitalization, let's talk a little bit about how you are going to stay ahead of your growth. It all begins by being ahead of your needs. In the first half of a rapid growth cycle, your principle focus should be reinvesting every single penny to sustain growth. Hire staff early so that they are fully trained before you need them to satisfy capacity needs. Expand your mechanical capacity ahead of reaching your production limitations. All the while, keep a close eye on your market penetration and growth potential. During this period, your attention will need to be equally divided internally and externally. This is a period where a well-rounded team and clearly defined key performance indicators (KPIs) will be a deciding factor in your long-term success. Your focus should be on identifying the smallest number of KPIs that provide you with the greatest insight, and then implementing a process to track and make use of these indicators in real time.

The ”experts” have differing views regarding whether an organization should develop strategies, OKRs,

budgets, or simply foster an agile culture. Our personal opinion is that there is no debate if you understand what each means, and how each is employed. As a business leader, your plan should be to employ some measure of all of the above and a little bit more if you want to survive and thrive. Let me dig into that statement a little bit. For starters, we have read a lot of books by intelligent, motivated, and successful entrepreneurs that say that all of this strategic planning mumbo jumbo inappropriately confines an organization's thinking and constrains agility. That's an interesting perspective, but one we can objectively address so why not do so?

To start, let’s consider the analogy of a family vacation. Whether it’s a road trip down Route 66 or an all-inclusive resort in the Caymans, we’ve all taken a vacation of some fashion. Be honest, do you remember the moments where you were first in line for a tour group excursion or the moments where your itinerary fell apart, and you happened upon the most interesting portrait artist who painted your family in front of an iconic backdrop for $5 and recommended the things you had to see while you were in town and was right about every single one? Planning is like that. When you know where you are heading, there is a significantly improved chance that you will get there, but it is the path in-between that defines who you are when you arrive. Strategic planning, budgeting, and establishing near-term objectives and key results, when handled with perspective, do exactly two things: these practices give you an idea of where you, as an organization, are going, and they provide some guideposts to help shape who you need to be when you arrive in order to make the most of the destination.

So, clearly, we are advising that you create a plan from that big picture down to the most minute detail, and then advise that you anticipate that most of your plan will not be actualized. Either we are among those individuals talking nonstop on the subway platforms to no one in particular, or there is more to what we are actually saying. We hope that you stick around to discover that we are in the latter camp. What we are actually advising is that you curate your grand vision for the long term in a way that invigorates your entire team, and then provide them with meaningful milestones that guide them to the realization of that vision. A great organizational plan delivers the big picture, provides guideposts, but really drives the point home around what we need to do today to get there. Any rigid and controlling strategic plan that has only all or nothing deliverables is doomed to fail at some point. Similarly, incentive packages that are skewed toward near-term metrics are likely to be abused by climbers within your organization. Our recommendation is that strategic planning predicated on "Why" centered objectives and defined by behaviors in tandem with outcomes will be simultaneously focused and flexible. This is the paradigm within which an organization can successfully employ all of the "best practice" strategic methodologies while remaining agile and opportunistic within their marketplace. With balance and focus comes the opportunity to achieve excellence.

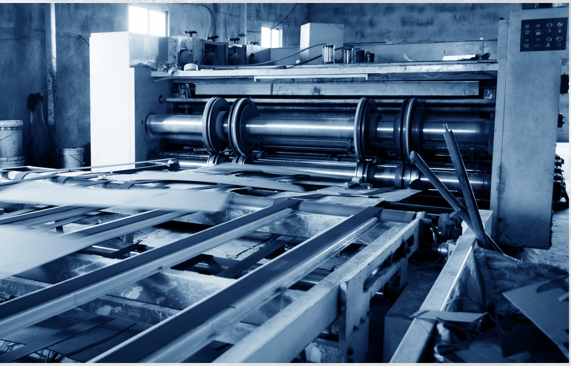
When you and your team know where you are going, and have some guideposts to identify progress, the next step is to generate key performance indicators (KPIs) to ensure that the organization does not drift off track, and to make prompt course corrections when necessary. Let’s take one more moment to reinforce that KPI management can be a blessing or a curse depending on how you implement and enforce the practice. We have seen far too many situations where middle management was incentivized too aggressively by near-term KPIs and earned significant bonuses by bankrupting a department only to have been promoted out before the reckoning arrived. Please think these risks through as you develop your performance-based compensation packages. On the other hand, it is imperative that you both generously compensate your team for the growth that they are helping you to achieve and that you are prepared to pro-actively address capital expenditures that rapid growth will necessitate. A strong KPI management strategy will offer transparency and tracking to the grand long-term vision that you have engaged your entire team to achieve. With all of this said, there is one more point of caution that we wish to offer to you. That is that while KPIs can be a tremendous boon to efficiency, transparency, and overall success, don't overdo it. As a leader, you may find yourself intoxicated with the power of KPIs and begin mandating the tracking of paper usage, pen consumption, toner depletion, and any number of SG&A expenses that you have long suspected were being abused.

In our experience, and in the experiential discourse of countless business leaders, once you get beyond seven KPIs for any team, the flavor gets lost in the sauce. The operational power of KPI management, as well as in an entire strategic management profile is in developing the smallest number of measurements and guideposts that deliver the most significant information and distinctive evidence of progress.

As a business leader, you cannot afford to be buried in the minutiae when a new circumstance arises. What you need is a clear way to view the big picture, to understand the implications of every wrinkle, and to be able to reallocate resources, when necessary, to make course corrections. It is our contention that without access to a strategic plan, a budget and active pro-forma, and frontline OKRs, it will be nearly impossible to recognize disruptions early, and even more challenging to change course within the organization. On the other hand, when the entire team is moving in lock step to achieve a goal that they all understand and believe in, the moment an obstacle arises, every individual is actively engaged in finding a solution. That is the environment we want to see you cultivate as you embark in rapid growth.

Now that you have achieved a cogent and empowering long-term vision, and every member of your team in aligned with the work of identifying and toppling every roadblock you may face, the next most important issue for you to address is cultural integrity in the face of expansion. In the days of the industrial revolution, company culture was not even part of the organizational paradigm, but in the age of globalization, working conditions and organizational culture are a key component of attracting and retaining top talent. In this exceptionally competitive and global labor market, a company cannot afford to neglect its values, the way it communicates, and the environment and relationships it fosters. Organizational culture is indicative of the heart and integrity of its leadership. This is why it is imperative that early-stage companies not only define their culture, but employ that cultural definition in its strategic planning, communication and training practices, its policies and procedures, and in its hiring and firing practices. Clarity and consistency are the key here.

Now that you are gaining a handle on your financial position, your strategic plan and metric-driven management, and are strengthening the organization's skillset and culture with every major decision or interaction, it is time to begin to define the major milestones within your growth plan. By this, we mean that your team will need to go deeper than your strategic plan to map out your capacity thresholds and



expansion costs. When looking at your capacity constraints, consider all of the major process elements including but not limited to production equipment, workforce, supply and inventory, distribution and outbound logistics and real estate. Balance growth thresholds against market and demand constraints such as size of market, geographic reach, and changing competitive environment. Once you have the major milestones identified, map out capital requirements, ramp-up time, and any other cost or time elements that are relevant to each constraint. By considering acquisition and ramp-up time compared to actual growth rates, you can map out the timing of investments in such a way that you will not run out of production capacity. Comparing this time map against net profits will allow you and your team to establish a cash allocation strategy that allows you to strategically manage your overall leverage position.

So far, we have focused almost entirely on the things going on within your operation. It is true that during the rapid growth period, your organization will completely transform itself many times over, but that does not mean that you can simply ignore the outside world and have things continue to go smoothly. No matter what stage your business is in, you, as its leader, will need to keep a close eye on the external environment, because it is out there that you will encounter your greatest threats and the new opportunities that will ensure that your success is durable. Looking one layer outside of your organization are factors described as Porter's five forces. These are the external drivers directly linked with your team's internal strategies. These forces include the competitive environment, the bargaining power of your client base, the bargaining power of your suppliers and service providers, the threat of substitutions, and the threat of new entrants. The next layer out includes elements such as technological advancements, regulatory policies, changes in consumer preference, new vectors to your client base, and changing trade environments. These are factors that are always changing and will provide early mover opportunities as well as threats of disruption. The broadest category of external threats are factors such as economic volatility, natural disasters, and wars. These are factors that will cause dramatic shifts in very short periods. This category of threat will most often require your team to exercise extraordinary discipline and adaptability, but can lead to exceptional opportunities for the agile.

The rapid growth phase of a business lifecycle is equal parts struggle, adventure, and triumph. While many companies experience multiple periods of rapid growth, none ever describe the time as mundane. As a leader through this period, you will ride an emotional rollercoaster, and make some of the best and most suspect decisions of your life. You will learn a great deal about yourself, forge deep and meaningful bonds with your colleagues, and truly define the character of your organization. We are so very excited for you and what you will become through this process.

Rapid Growth Self Assessment

Do you have a scalability strategy?

What is your customer retention model?

Does your sales process support a 10x growth?

What are your production capacity thresholds?

What is the resource requirement to expand production capacity?

What are your physical limitations (facility, geography, supply chain, distribution)?

Where are the bottle necks in your process?

What is your technological obsolescence forecast?

Are your operational processes documented, consistently executed, and continually assessed for improvement?

Do you have VOC and VOE baked into your strategic planning process?

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