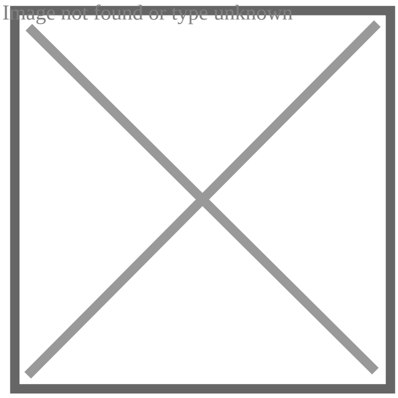

Are You Burning Money Chasing Growth (Part 1)

Description

A good friend of mine recently asked how we could apply the concept of acquisition to industrial manufacturing. He strongly suspected that his Sales investments weren't pulling their weight, and he asked me to help him think through the problem. Here is what we came up with.

THE CONCEPT

I suggested that investments in Sales and Marketing, like any other investment, could be evaluated in terms of payback or ROI. Specifically, I thought we should use a version of Customer Acquisition Cost Payback (CAC Payback), introduced by Bessemer Venture Partners in this article. Although Bessemer was focused on SaaS and Cloud businesses, the framework can be easily modified for industrial manufacturing.

Our analysis answered the following questions:

1. What is he investing in new business sales?
2. Given those investments, how much revenue and margin does he need to meet his corporate hurdle rate?
3. Given that revenue and margin goal, how much pipeline does he need at any given time?

GATHERING THE INPUTS

We started by gathering information with the following questions.

What are you investing in new business sales? *I have 15 salespeople and 7 Solution Engineers. They spend 50% of their time focused on bringing in new business and 50% of their time servicing existing recurring business.*

What are the fully burdened costs of that team – salary, incentive compensation and travel? *Fully burdened the sales team is $200k each and the Solution Engineers are $150 each*

What are you investing in Marketing? *We don't have any Marketing for this group*

What is your average deal margin? *We average 20% margins*

Is there any future value to these deals? Future business or recurring business? *For these deals, there is no residual value, so the lifetime value of the deal is equal to the initial deal*

What is your close WON rate on qualified opportunities in the pipeline? *You should assume 25%*

What is your average sales cycle? *Around 9 months, give or take*

What is your required payback on corporate investments? *We like to see a cash on cash return of greater than 1.5x. Anything that pays back 1x in two years is a good investment though, so long as by the end of the third year it surpasses 1.5x.*

THE MATH

Now we have everything we need to run the analysis to see how much margin, revenue, and pipeline his team needs to deliver to be a "good" investment.

- Sales and Marketing investment for new business – (15 heads *$200k per head *50% allocation + 7 heads *$150k per head *50% allocation) = $2.025m
- Margin needed to pay back the investment (surpass the hurdle rate) – $2.025*1.5 = $3.037m
- Revenue needed to generate the margin (divide the margin $ by the margin % to get revenue) – 3.037/20% = $15.187m
- Active pipeline needed to generate the revenue (divide the revenue needed by win rate to get pipeline needed) – ($15.187m/25%) * 9/12 months, because he will only have visibility an average of 9 months out = $45.562m
- Pipeline by quarter needed given an average 9 month sales cycle and a 25% win rate – see chart below.

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There are two important notes on this graphic:

1) The "pipeline coverage ratio" is the relationship of pipeline to the Sales target for any given quarter. In the case of the Current Quarter, the pipeline goal is $15.2m, which is 4x the revenue goal of $3.8m.

2) This is **rolling pipeline.** Which means that every quarter, the sales team will need to add $15.2m of new opportunities to make up for the expiring ones from last quarter.

ANALYSIS OF HIS BUSINESS

We then compared the analysis to his current performance. Needless to say, he wasn't pleased with the team's current performance, but at least it validated his instincts! Here's a brief summary of his performance versus his new targets

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We discussed some possible areas of further inquiry, which are beyond the scope of this article. They were:

1. Market – is it big enough to sustain his investments?
2. Team design – should he continue with hybrid reps or should he have distinct “farming” and “hunting” teams?
3. Training – is his team enabled to be successful closing new business?
4. Focus – would his team be better served focusing “sweet spot” deals?
5. Management – is the team *really* spending 50% of their time on new business?
6. Management – is the more/less pipeline than what the CRM shows? How indicative is the pipeline of the reality in the field?

CHEAT SHEET TO MAKE IT EASY TO APPLY TO YOUR BUSINESS

I created a simple table for a “quick and dirty” analysis. It will be applicable to your business under the following condition – that sales are not recurring, or said another way, the initial sale = LTV.

This table answers the following question: given my average deal margins and my corporate payback mandate, **how much revenue should my team be delivering for every $100k of investment to not miss my corporate hurdle rate?**

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CONCLUSION

When evaluating Sales and Marketing investments, the analysis above should be considered a *minimum* threshold. After all, most software companies expect more than a 4-5x return on Sales investments (i.e. $1m of annual recurring revenue for every $200k in Sales compensation).

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1. Growth Economics

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