

2. THE GROWTH EFFICIENCY KPI

In a hypergrowth environment, the sole focus of senior management should be on maximising the return on the cost of growth. For management to achieve this, they must understand the true costs associated with driving growth.

The CTM Tool Kit provides a growth-efficiency key performance indicator (KPI), also referred to as the GP/CoE ratio. This calculation expresses the ratio between gross profit generated and the cost required to execute or complete a sale. It can be used to determine how efficiently sales growth is taking place and to identify the most effective ways to invest in further growth.

To calculate a GP/CoE ratio and conduct a growth-efficiency analysis, it is important to have sufficient data available and to know what should be included. All relevant data for GP/CoE analysis should typically be found within the profit and loss statement (P&L) and the customer relationship management (CRM) system.

The GP/CoE ratio helped me measure the quality and efficiency of my growth investments when no clear model existed. It guided my decisions during major business growth challenges as an executive in Denmark and later across Europe, the Middle East and Africa for Hewlett Packard Networking.

In a couple of pages, read the whole story of how this KPI was originally invented.

THE GROWTH EFFICIENCY KPI (GP/COE RATIO)

The Growth Efficiency KPI, or the GP/CoE ratio, is used to measure the impact of investments in growth.

$$\text{GROSS PROFIT} / \text{COST OF EXECUTION}$$

Gross profit

The relevant measurement value driver for assessing gross profit is net revenue with only the cost of goods sold deducted, excluding any sales or marketing expenses. This should include only the bill of materials and direct production salaries. It is also important to ensure that gross profit is adjusted for any noncommercial income, such as grants or pilot income, as these cannot be considered representative of the actual gross profit or cost of earnings associated with the income.

Cost of execution (CoE)

Encompasses all expenses directly related to sales efforts, including costs associated with salespeople, pre-sales personnel and sales support staff. It also covers all sales-related marketing activities, market and customer analytics, partner programmes, lead-generation and demand-generation initiatives. In short, the cost of execution includes all entities that carry a cost tied to sales activities.

In short, the cost of execution includes all costs tied to sales activities. Put another way, it represents all expenses that would disappear if a company ceased its sales operations.

INTERPRETATION OF GP/COE VALUES

Less than 1

Watch out and analyse further!

Over 1

If your overall cost base is not aligned with the CoE, meaning that you can invest in CoE and increase the net profitability of your business, you should for sure invest, as your EBITDA ratio will increase.

Over 2

Accelerate your investments into supporting pipeline-building activities as much as you can, until you see the ratio drop to a stable level.

CHANGING THE MATH

COST OF EXECUTION

In essence, all costs associated with generating opportunities and enhancing capabilities can be defined as the cost of execution (CoE).

In other words, the CoE is a measure of how ‘expensive’ it is to acquire a single customer. Traditional business theory refers to this as customer acquisition cost (CAC), but where CoE differs is that it is focused entirely on the entities driving that cost. For example, a relevant question is not whether it costs more to win a customer than the gross profit that customer would generate – but what entity is driving higher cost of execution than relative GP. Typical entities or data points in the ratio include sales staff, marketing staff, targeted ads and promotion costs. However, it can also encompass expenses such as transportation to conferences, costs for CRM systems and similar entities. As a result, the CoE is unique to each company and requires a thorough understanding of the company’s cost base to determine accurately. More importantly, the CoE should be regarded as a group of entities with associated costs. This is an important distinction when considering which execution costs can later be replicated to fuel growth.

The simplest way to calculate CoE is to consider all expenses that would vanish if you froze all entities that operate in relation to commercial activity in your business. In terms of the Growth Formula, we can now expand on this concept:

CREATING HYPERGROWTH

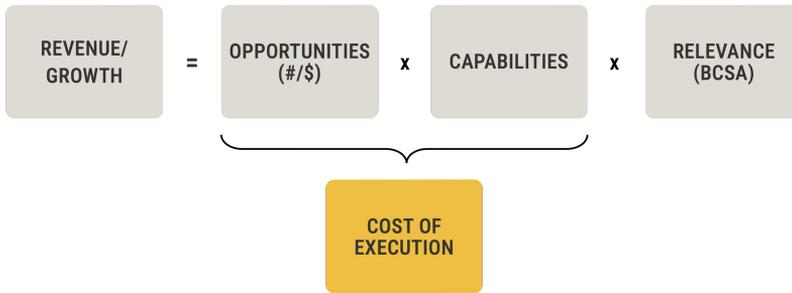


Figure 8. *Cost of execution* is all costs associated with generating opportunities and enhancing capabilities.

GROSS PROFIT

Because the aim is to measure the impact of investments in growth, the relationship between gross profit and cost of execution entities must be transformed into a KPI and, subsequently, a ratio. To do this, CoE must be weighed against something meaningful.

The net return on your CoE is the profit generated exclusively from your commercial activities, which is already defined as gross profit (GP or GP1).

Let us frame this within the context of the Growth Formula:

CHANGING THE MATH

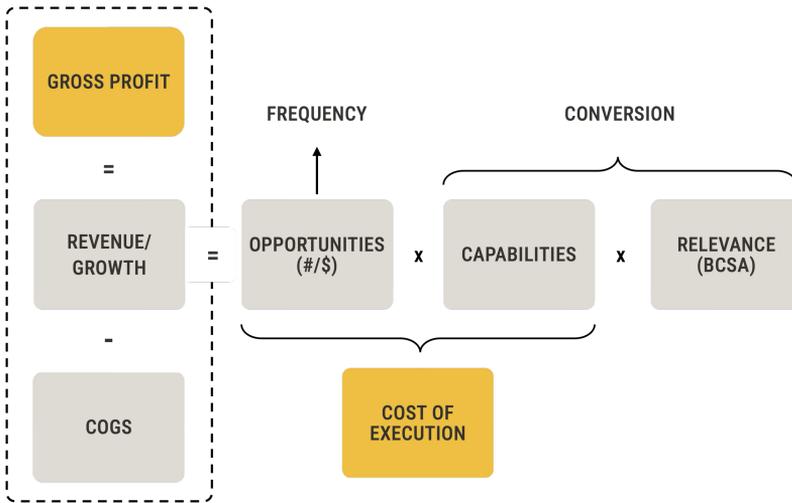


Figure 9. Gross Profit in the context of the Growth Formula.

THE GP/COE RATIO

Therefore, the logical method for assessing the efficiency of growth investments is to divide GP by CoE. This is referred to as the Growth Efficiency KPI, or the GP/CoE ratio.

This means the ratio can be used to determine how efficiently sales growth is taking place. It can also be used to identify the most effective areas for further investment in growth, as it enables direct comparison of the effectiveness of go-to-market strategies, business models and customer segments.

‘By introducing CoE, management, sales executives and investors are empowered to make highly growth-return-oriented decisions’.

CREATING HYPERGROWTH

The best sales strategy is one where this deployment of capital delivers the highest possible gross profit, that is, when the GP/CoE ratio is maximised.

By introducing CoE, management, sales executives and investors are empowered to make highly growth-return-oriented decisions, whereas the EBIT or EBITDA margin is a much more complex and diluted financial KPI when used to steer growth-investment efficiency. A sales manager's or CEO's role is essentially to ensure that CoE is deployed in a way that achieves the highest effect, i.e. the highest GP returned to the business. Therefore, actively tracking your GP/CoE ratio will allow you to understand the impact of your go-to-market activities both at the top level and in greater detail, as you can analyse specific marketing activities or new sales investments based on this factor.

RULE OF THUMB

Remember that your sales and expansion activities are not break-even before your GP/CoE ratio exceeds 1.0.

WHAT IS THE RIGHT LEVEL OF GP/COE FOR YOUR BUSINESS?

Despite having coined and created a new KPI, I still had no frame of reference or comparison for what constituted a good GP/CoE ratio. The absence of a benchmark led me to underinvest in CoE while leading the enterprise sales business at HP Networking EMEA. I became overly focused on increasing the GP/CoE ratio, without considering overall growth. In hindsight, I should have invested far more in sales efforts once I had identified where the returns could be maximised. As long as I was achieving a high digit GP/CoE ratio, I should have kept going. The business was already highly profitable, and the GP/CoE ratio was strong. However, without any benchmarks at the time, it was difficult to resist the urge to improve the ratio further, simply to demonstrate that I could generate increasing effectiveness values.

The lesson here is to be wary of over-engineering your ratios. Provided you have a robust GP/CoE for the net business, resulting in strong EBITDA performance, it may be a better investment to radically increase CoE or maintain the same ratio while accelerating, rather than chasing, a higher stand-alone ratio. The attach-rate opex for the rest of the organisation – the cost associated with servicing CoE, which is the delta between GP and EBITDA – is what you need to keep in mind. Naturally, as long as the GP/CoE ratio exceeds the overhead cost ratio associated with servicing CoE, your EBITDA margin will increase positively.

‘As long as the GP/CoE ratio exceeds the overhead cost ratio . . . your EBITDA margin will increase positively’.

AN ACTIVITY-BASED COE EXAMPLE

If you have considered working with activity-based CoE analytics, this is a simple framework to get started. Let us assume that your opportunity pipeline is generated from three lead sources:

- Outbound telemarketing
- Conferences
- Online demand generation

Suppose you spend roughly €100,000 in each category annually, but they all yield different returns on opportunities. Let us assume the three lead sources generate opportunities like this:

	Outbound telemarketing	Online demand generation	Conferences
Leads	50	500	100
Cost per lead	€2,000	€200	€1,000
Lead-to-opportunity conversion rate	50% = 25 opportunities	15% = 75 opportunities	25% = 25 opportunities
Value per lead	€100,000	€50,000	€75,000

If we assume that all opportunities are equally good and the conversion is 33% and GP is 50%, then you will get the following clean GP/CoE return of the three activities:

	Outbound telemarketing	Online demand generation	Conferences
Pipeline value	€100,000 x 25 = €2,500,000	€50,000 x 75 = €3,750,000	€75,000 x 25 = €1,875,000
Conversion value	33% x €2,500,000 = €825,000	33% x €3.75m = €1,237,000	33% x €1,875,000 = €619,000
Gross profit	50% x €825,000 = €412,000	50% x €413k = €619,000	50% x €619,000 = €309,000
Activity GP/CoE	€412,000/€100,000 = 4x	€206,000/€100,000 = 6x	€309,000/€100,000 = 3x

The initial result is quite clear, as online demand generation, at a pure activity level, delivers a GP/CoE of 6x, compared to the conference, which only achieves a 3x return. Therefore, if your management team were considering investing another €100,000 in growth, the conclusion is straightforward: The focus should be on further engaging with your outbound marketing agency and prioritising online demand generation but only as long as the return remains around 6x.

As simplified in the table above, this is how you would calculate GP/CoE based solely on marketing activities, which does not reflect the full CoE perspective. Although pipeline value in this instance refers to the cost associated with the driver, there are several underlying costs related to everyday business operations that would also factor into the equation.