

## How Good Are Your Leading Indicators?

### Do they help your management team to keep well ahead of business and market changes?

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*In our last article in this series we talked about how you can lead your company so that it emerges from the current economic downturn much stronger than its competitors. A number of companies such as Siebel Software and Cisco Systems have been celebrated in the press for seeing the start of the downturn before their competitors. (See the boxes on pages 2 and 4.) But, anticipating the impact of the economic downturn and reacting early to control discretionary spending are not enough to enable a company to capitalize on the downturn. To gain market share and improve your company's competitive position, your organization also needs to know early on when to adopt a more aggressive posture, so that it can be winning new business as customers begin to reopen their wallets. Such a strategy will enable your company to increase its share of the most profitable segments of the market, while the competition is still wondering if the worst is past.*

Congratulations! Your organization has weathered the economic downturn without too much damage. Profits may be down, but they are not out. The balance sheet is in OK shape. And the takeovers, draconian consolidations, and, in some cases, Chapter 11 filings of your weaker competitors have not affected your company. But what do you do next? How long should you stay hunkered down? When is the right time to shift back into growth mode? How much of a shift should you order? How do you know?

The key to success in today's topsy-turvy economy is anticipating both the size and timing of downturns and their reversals in your company's markets and then taking well-targeted actions, first to rein in discretionary spending, and then to turn up the heat as the market comes back to life. Critical to this strategy is having a good set of leading indicators to let you know how the business and its customers are doing, so that you can act before results show up in the after-the-fact score-keeping systems such as financial statements, market share figures or analysts ratings.

For most CEOs, this kind of anticipatory action is impossible because they are almost wholly dependent on financial reports for understanding the pulse of their businesses. Unfortunately, financial reports tell what has been the effect of actions taken several months previously, and give a much-delayed picture of what is happening currently. For example, if you were such a CEO and customers canceled a few large orders for goods to be delivered by your company over the next year, the revenue hits show up in your P&L only a little bit at a time. The net result is that you find out too late when the market is contracting and have to resort to draconian and often futile responsive measures to preserve margins. On the reverse side of the recession, you would learn that the market is firming up too late to allow you to accelerate the roll out of new products, marketing campaigns, and so on. As a result, your company would wind up ceding share to its more forward thinking competitors. Let me illustrate the problem with the example of one of our clients, whom we will call Company X.

Company X is in the business of selling specialized information products and services to the financial services industry. When the recessionary drop in the demand for capital and Wall Street's bear market began to bite into the profits of the major financial institutions who are X's main customers, they slowed down their purchases from Company X. Because X's CEO was largely dependent on backward-looking financial reporting to gauge the health of his business, it was not immediately visible to him that this was happening.

In this case, an external event, the attacks of 9/11, made it obvious that customers, many of whom lost staff and customers of their own in the collapse of the World Trade Center, would be cutting back in their spending with Company X. In response to 9/11, the CEO did all the right things of freezing discretionary

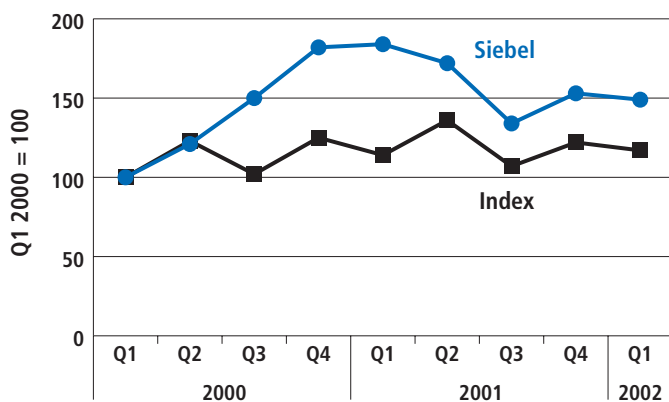
hiring and spending to maintain his company's enviable track record of quarter-to-quarter profit growth.

The CEO's problem now, however, is in knowing when to reverse course. He has heard anecdotal data that his company's largest customers want a new set of service bundles that cut across X's many divisions. He knows that his organization is poorly equipped to sell and deliver these bundles. His gut says he should launch a crash program to develop the new service offers and train a specialized sales force to sell them. But he is reluctant to follow his gut instincts because he lacks hard data to tell him how soon and how fast the market will turn up. Also, he is worried about making the very visible increase in spending for the needed product development and sales training; he fears that such an increase in spending will send a

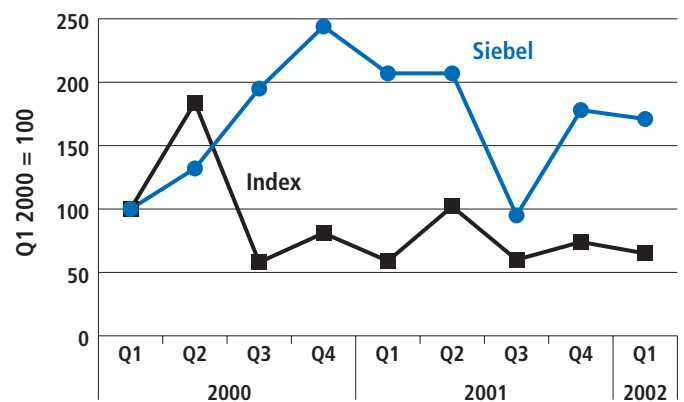
Tom Seibel, the CEO of Siebel Software, has gotten a great deal of press for using his own company's product to see the onset of the current recession early enough to take effective action. Reputedly, what Siebel saw were reports on the sales funnel that indicated an increase in the number of customers who were slowing down their decision making processes or putting them off entirely. Based on

this information, Siebel slowed down hiring and other cost drivers before their growth outran the company's reduced rate of revenue growth. The net effect was that Siebel Software came through the recession with gains in revenues and profits while the sector index of half a dozen other large enterprise software vendors lost. See the graphs below.

Siebel Revenue vs. Sector Index



Siebel Profit vs. Sector Index



message to operating managers to be less diligent about costs at a time when the financial reports do not yet warrant a loosening of spending controls.

Because this CEO is almost totally dependent on retrospective monthly financial reporting for guidance on how to manage the business, and that reporting reflects the results of revenue and cost management decisions made several months ago, he does not have a clear fix on where the business is, let alone where it is going. Consequently, for lack of a good set of leading indicators, X's CEO risks either increasing spending too early by addressing this new market need, or ceding several months' lead time to his principal competitors by not addressing it now. How should he choose what to do?

The issue of leading indicators is one that applies at many levels in a business. Clearly the CEO needs early warnings of changes that may necessitate fundamental shifts in P&L management and capital investment priorities. In order to deliver on the smooth EPS growth that Wall Street so values, the CEO needs to be able to see shifts in the underlying performance drivers of his principal operating units early enough to redirect efforts all around the company. In this way, he can shift resources from businesses that the leading indicators say are likely to under-perform to other units which the leading indicators suggest can take up the slack. Perhaps even more importantly, divisional management needs to be able to see changes and take corrective action well in advance of the lead-time offered by financial reporting metrics alone. Otherwise the division may deliver a dreaded 'surprise' of bad financial results to the boss.

Leading indicators are also very important for functional management, and these managers are often the least well-served by companies' reporting systems. While the SVP for manufacturing will see immediately that orders have picked up or slowed down, he often needs to know much earlier than that in order to secure additional raw materials at a good price, add a shift to production, install added equipment, and so on. But how many directors of manufacturing have timely and accurate information on the sales lead stream, the financial health of their company's

main customers, or other companies' changes in demand for critical raw materials that might cause a cyclical price rise or fall? Similarly, R&D needs to know when to speed up or slow down development programs so that they can reach the market early enough to capture the competitive high ground without being so early that customers are not yet ready for the new offers.

## Designing a good set of leading indicators

The only hard and fast rule for designing a simple but powerful set of leading indicators is that there no hard and fast rules on what constitutes the right set of things to look at. The choice of indicators depends on the nature of the business, its market, and the availability of good, operating-level internal and external data. The good news is that there are a few broad rules for designing an indicator set for a given business:

1. The indicators must enable you to forecast the principal revenue and cost drivers of your business, division, or functional area.
2. The indicators must be simple to understand, coherent, and actionable at multiple levels in the company.
3. The leading indicators must comprise a small but balanced set.

In the next few pages we will explain these ideas in a bit of detail and show how you can apply them to your business.

### **1. The indicators must enable you to forecast the principal revenue and cost drivers of your business, division, or functional area.**

In the vast majority of companies or business functions there is a small set of operational numbers that drive the majority of changes in the P&L. Most of the other lines in the P&L are reasonably stable and change in easily predictable ways.

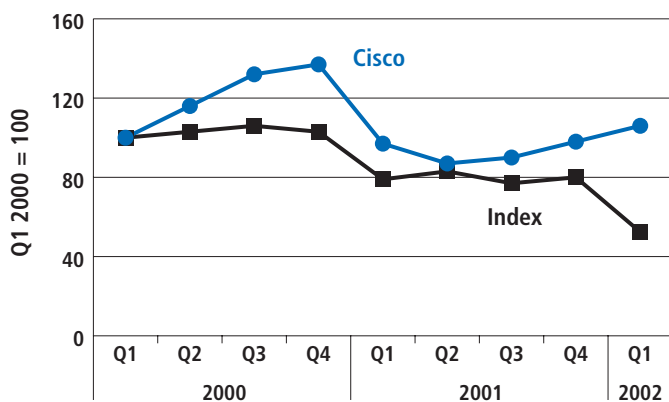
We generally find this set of drivers by building a simplified mathematical model of the business, so that we can identify how sensitive the main elements of the P&L are to changes in the underlying operating measures of the business, and how they vary with changes in scale, both up and down. This modeling exercise supplies the hard quantitative data on the size and timing of market shifts that, for example, the CEO of Company X needed to complement his gut feel for his business.

To build the model, we look at drivers of both revenue and cost. We analyze the revenue side by examining data that is (or should be) in the Customer Resource Management (CRM) system to see how customer behavior changes over time and understand what causes this behavior to change. For example, with a business services company we found two drivers of revenue changes:

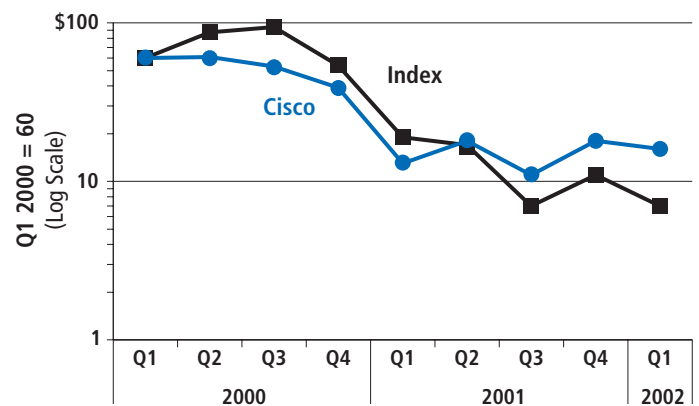
Tom Siebel was not the only one to be able to sense early that change was happening in his company's market. In the winter of 2000–01, John Chambers, CEO of Cisco Systems, detected a sharp increase in financial difficulties among the telecommunications carriers who comprised his company's largest customers. Chambers maintains very strong personal relationships with the CEOs of his company's best customers. During visits to customers, he detected a growing unease among them with their highly leveraged balance sheets and faltering profitability, with the latter driven by an industry glut in telecommunications capacity. These two issues had the potential to drive these customers' capital expenditures sharply downward. When Chambers's gut-level concern was borne out by the rapid-fire Chapter 11 filings of several upstart carriers each of whose annual purchases from Cisco topped \$100M/year, he took quick action. He froze hiring, which was adding a net 10% to staff every quarter and

reminded managers of the need to remove the bottom-performing 5–10% or the staff at each review cycle. He terminated the contracts of the many contractors who supplemented Cisco's internal staff. He forced a quick triage of development projects, ending those that seemed to be faltering, while protecting those that represented the key next generation of products for his company. As a result of these quick actions, Cisco suffered significantly less damage during the recession than its principal competitors (see the graphs below), and is emerging in a significantly enhanced competitive position. Indeed, Chambers has begun to step up new product introductions and marketing while his major competitors are still cutting heads, and selling or closing divisions. Interestingly, Wall Street initially punished Cisco's share price for taking these early actions. However, its subsequent performance has beaten an index of other communications equipment companies by more than a 2:1 margin.

Cisco Revenue vs. Sector Index



Cisco Share Price vs. Sector Index



- Economic cycles, in which marginal customers enter during the up-cycle and go out of business during the down-cycle
- Service quality, in which periods of weaker quality cause an increase in customer churn, after a 3–5 month delay

On the cost side of the ledger, we review historical impacts of changes in the most important inputs, such as scaling up or down of productive capacity to meet market demand, changes in the productivity of capital assets and labor, changes in the cost of materials, etc. With one client we found a particularly effective system that used outsourcing to scale service capacity to market demand.

After determining what this small set of numbers is, and how it drives P&L, we then design a process to track closely these numbers, their growth or shrinkage, and the resulting P&L shifts. We generally find that increases or decreases in growth rates of these indicators give the best early warnings of future major changes in their values. By monitoring these few drivers as well as variations in their rate of growth or shrinkage, you can get early insight into what the financials will look like in the following several quarters or years.

More specifically, on the revenue side of the ledger, our experience has shown time and again that a surprisingly small set of customers account for almost all the variations in revenue almost all of the time. For example, if a business unit sells cars that appeal to blue collar workers in the Midwest, changes in manufacturing employment and hours worked may affect directly their propensity to buy from it. These same indicators are much less likely to be useful in other parts of the country.

It is important to note that the subset of customers who drive changes in revenue may not be the same subset of customers who produce most of the company's profit – indeed they may be the marginal customers. For example, with banks, poor credits figure disproportionately in the changes to the revenue line relative to customers who can be counted upon to

meet their interest and principal payments reliably. These weak credits produce high fee and interest income in good times, and but require large bad debt reserves in bad times. In the case of Cisco (see box above), the Chapter 11 filings of a series of a second-tier telecom companies like ICG and NorthPoint Communications indicated the coming downturn in demand, even as the mainstream carriers like AT&T, Verizon and Sprint continued to order.

If the small group of customers that drive changes in the revenue line are businesses, a detailed tracking of their business health and the size, quality and time-to-close of sales leads from them will yield early insight into where your business is likely to go. If these customers are consumers, monitoring the economic forces that drive the behaviors of the psycho-geo-demographic groups that make up this subset of your customer base will perform the same early warning function for your business.

Similarly, on the cost side of the ledger, you need to understand in detail what drives variations in costs at the margin. In businesses such as manufacturing, the prices of a few key raw materials may be the key drivers. In many businesses small changes in the utilization of staff or capital equipment are what need to be watched. For example, in a system integration business the utilization rate for staff, adjusted to reflect discounts and project over-runs, is the key cost driver. Utilization rates can be predicted by examining the backlog of signed contracts and the sales pipeline. In customer service functions, often the best leading indicators have to do with the timing of new product rollouts and sales campaigns or with changes in quality upstream that cause sudden changes in the volume and content of customer calls.

Finally, we cannot emphasize enough the importance of tracking not only the actual value and current trends for these revenue and cost drivers, but also tracking deviations from trend. Only rarely do managers watch these deviations, yet they are often the most accurate timing predictors of all. We once worked with an insurance industry CEO who was

uneasy about operating efficiency even though profits were rising steadily. A careful analysis of the company's financial performance showed that, while profits were rising steadily, from \$150 M in the first year to \$174 M in the second and \$195 M in the third, the percent rate of profit growth was slowing down, from 20% growth in one year, to 16% in the next, to 12% in the third. A detailed analysis then showed that administrative costs were rising faster than revenues on a percentage basis and would cause profit growth to go flat within three years unless firm actions were taken to control these costs.

## **2. The indicators must be simple to understand, coherent, and actionable at multiple levels in the company.**

Any good set of leading indicators needs to be simple to understand. If managers do not see clearly how the measures relate to meeting their organization's objectives, they are unlikely to take action based upon them. When I took over leadership of a major business unit at an international consulting firm, I received a monthly package of indicators that was at once overly complex, and also incomplete. I quickly developed my own set of metrics around measures of staff utilization, order backlog, and sales pipeline so that I could track weekly to predict the future P&L. Using these metrics I could then make the critical decisions of when to hire and when to turn up the heat on business development or discount work, to deliver both high growth and high margins.

The measures need to be coherent across a given business. If separate departments that participate in a given business process are working against inconsistent measures, the business rapidly becomes unmanageable. The measures need to translate comfortably down the management chain, with sub-departments' measures bearing an obvious and consistent linkage to the larger whole. I recall working with an organization in which each department measured cycle time

differently, and the sum of the separate times across departments did not add up to the cycle time that the customer experienced. The net effect is that each department thought it was pushing its work out quickly, but the customers were upset because they were not getting what they ordered when they ordered it.

And the measures need to point naturally towards actions. If the leading indicators are to have any value, managers must understand immediately what to do when a key measure veers off its intended trajectory. If it takes months of analysis and committee meetings to decide what to do, the competitive advantage of having a good set of leading indicators is totally dissipated.

One of our clients wrestled with the problem that each of its service centers reported that it was working very efficiently with high quality, but a rising tide of customer complaints, including withheld payments totaling hundreds of millions of dollars, suggested otherwise. Corporate would publish a monthly operations analysis of its service centers that contained hundreds of measures of service efficiency and effectiveness. At any given time, some of these measures were likely to be giving good readings, whence each department's high performance claims.

However, these measures were totally disconnected from both the next department's metrics and the customer's experience, so that no one saw the order quality problem except the Collections Department, which received a monthly beating from the CFO for letting receivables get out of control. And, because Collections was constantly in the CFO's doghouse, no one paid any attention to their complaints about order quality problems upstream from them.

Further, because there were so many measures, it was never clear which ones really mattered and managers never knew what actions to take. Indeed, given five managers with similar roles, there would be five different choices of which few measures to focus on. The

result was that parallel units were driving their businesses towards different objectives. One would focus on order throughput and therefore large complex orders would take a backseat. Another would focus on revenue increase, so orders to stop deliveries would fall to last in priority, irritating customers and needlessly tying up inventory. Finally, it took months of work on our part and untold amounts of internal committee work on the client side to determine what actions to take to bring order processing back under control.

### **3. The leading indicators must constitute a small but balanced set.**

In any business there are multiple factors that determine its ultimate success. We have all seen the disasters that befall organizations that focus on only one measure, say revenue growth, market share, or unit cost, to drive their business. Similarly, if management focuses on only one leading indicator, perhaps the sales funnel, order backlog, or interest rates, it is likely to be blind-sided by other factors. In short, after understanding what the major drivers of success are in a given business, one then has to choose a set of leading indicators that give early visibility into future positive or negative changes in those drivers.

Secondly, the set of leading indicators for a given organization needs to be limited to a small set whose meaning is commonly understood across the organization. Organizational psychologists claim that a manager or individual contributor can only focus on 3–7 things at a time. Moreover, if different managers draw different conclusions from the same data, direction changes in response to shifts in the leading indicators are likely to cause total confusion rather than successful transition to new conditions in the market. Quickly driving this common understanding of what a change in the leading indicators means for the business is one of the qualities that distinguishes great leaders like John Chambers, Tom Siebel, Sandy Weill, or Jack Welch.

### **In conclusion**

The companies that win the competitive battles in the long run are the ones that can anticipate sooner than their competitors when to rein in the growth engine, and by how much, because revenue growth is likely to slow down. Likewise, they know sooner than the competition when to turn the engine on again, and by how much. They have hard quantitative facts to judge when and how much to adjust their operations to what the business will need in the coming months.

In this way corporate winners use cyclical downturns in their markets as a means to gain stronger market positions than their competitors. Generally speaking, these competitive gains reflect themselves in steadier revenue and profit growth, better returns on capital, and stronger than average share prices. And managers can act with the confidence that comes from having coherent and useful data about their market and operations supported by realistic models of how changes in that data will drive changes in their P&L.

If you would like to explore how we can apply the ideas in this paper to your company, division or business function, please contact the author at [gss@sacerdote-co.com](mailto:gss@sacerdote-co.com).

### About the author

George Sacerdote, the President of Sacerdote & Co., Inc., has counseled telecommunications and information technology companies on issues of corporate strategy and operating efficiency for more than 20 years. Recent consulting projects he has led have included:

- Developing and implementing market-based corporate strategies
- Improving efficiency and effectiveness of customer-facing functions such as sales, marketing, and customer care
- Successfully acquiring and integrating new businesses
- Using Internet and allied technologies to achieve operating efficiencies and improve margins

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