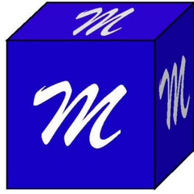

Middle Market Methods™ 2021: 3rd Quarter

The New Labor Normal

By

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Introduction

Middle Market Methods (M3) has long advised equity sponsors and their portfolio companies about the multiplier effect of an effective (or conversely, the ineffective) C-level position. Liz Wiseman provides a solid argument on the subject in *Multipliers, Revised and Updated: How the Best Leaders Make Everyone Smarter*. The precept is analogous to the Keynesian "multiplier effect" taught in basic economics courses. Investopedia defines the term as a change in output proportionately higher than the change input. For C-levels, this issue is the amplified impact for a singular leader's bandwidth focused (or not) on management and leadership. However, top-down is not the topic this quarter. Rather, the focus is the opposite direction: entry level positions. Moreover, the focus is on an employee cohort instead of an individual position.

Many M3 clients pine for the return to normalcy. However, the global seismic shift induced by the COVID pandemic may be catalyzing a new normal which has not fully evolved. Among the manifestations may be work-life balance recalibration and protracted virtual employment. Those who remained relatively confined to quarters may have ventured less often to spend. Others tapped into the convenience of home delivery. Virtual existence often amplified productivity—if for no other reason than trimming long commutes off the workday. Even so, a plethora of goods and services commerce require employees to be on site. The managers of the onsite labor pool are experiencing many frustrations, including but not limited to:

- Reluctance to return to site work—even after government programs cease,

- Upward wage pressure,
- New hires accepting offers but not showing up to work, and
- Exacerbated turnover.

Even if not directly involved in this phenomenon, downline consumers may be feeling the consequences. For example, when was the last time you called a customer service line? If you did, first ask yourself “Why?” Was the reason product performance that did not meet expectations? And what were those expectations? Then, ask yourself how difficult it was to get someone on the line—and/or whether the person on the other end of the line impressed you as motivated to protect their employer’s brand equity through the manner which they comported themselves?

Turnover should be examined in both opportunity cost and GAAP terms.

Every M3 client with high proportions of Fair Labor Standards Act (“FLSA”) non-exempt labor (i.e., hourly wages) is wrestling with instability. Calculating the cost of turnover relates to a sage quip offered by Peter L. Bernstein:

> The information you have is not the information you want. The information you want is not the information you need. The information you need is not the information you can obtain. The information you can obtain cost more than you want to pay.

While M3 does not claim to have a silver bullet resolution, enough time and thought were invested modeling the costs attributable to turnover lends credence to this assertion: throwing compensation peanuts at this elephant is not going to solve the problem. No doubt, this is not a welcome statement. The real cost of turnover does not cleanly lend itself to generally accepted accounting principles. Indeed, “opportunity costs” must be considered, i.e., the productivity forfeited by chronically high turnover. The consequent costs have a multiplier effect on profitability and enterprise value. Key variables will be highlighted in this article.

Heads up! This may be one of those articles for which you might benefit by reading the *Summary* first to absorb the topical points more contextually.

Productivity

Productivity is the holy grail of all business models—and highly correlated with internal rate of return. Productivity is defined by the units of output derived from units of input. Labor is a key input. One metric that encapsulates the point is gross margin dollars per direct labor dollar. Indeed, it is not what you pay for labor, it is what that labor produces relative to that cost. This is a subject that needs better comprehension in the lower middle market. In substantiation of that point, a common M3 engagement pursues reasons for margin erosion. One of the likely suspects identified for forensic analysis is production labor productivity. There are two means by which to critique this point. The first is line labor and the second is supervision.

Think value of outputs relative to cost of inputs.

Companies with the combination of high direct labor and high turnover should consider the following:

- Do not calculate turnover in the traditional way of annual attrition of the entire employee base. Loyalty legacy labor tends to bloat the denominator and dilute the calculation. Rather, focus on the specific functions most challenged by high turnover.
- Calculate turnover on those challenged functions for rolling 90-day periods by a different technique: How many of the new hires for the period left within that period? Do not be surprised to find numbers exceeding 100 per cent. Why focus on such a short rolling timeframe? The answer is that most turnover occurs proximal to the hire date, not long term. The solution quest should be process oriented, i.e., how the recruitment, onboarding, training, and supervision processes could be refined to mitigate turnover.

- The productivity rates for new hires typically differ dramatically from seasoned veterans. M3 challenges its clients to fathom three stages of employee productivity:
    - How long does it take a new hire to become **competent**? “Competent” is not a pejorative term. The initial objective is understanding how to operate safely in the work environment while learning the job.
    - How long does it take the new hire to become **proficient**? Proficiency is the requirement to keep the job long term.
    - How long does it take the new hire to become **excellent**? Excellence is the essence of differentiation. These employees are the ones who managers should engage for cross-training others to assimilate preferred techniques.
- Productivity variation abounds across the **competent** to **excellence** spectrum.
    - Relative supervision might be higher for greener employees.
    - Productivity may be lower for new hires.
    - Quality might be lower for entry level teammates.
    - The timelines for individual employees may materially vary through the three productivity stages.
    - Some employees may never make it to proficiency.
    - Some employees may never reach excellence, but this does not portend termination. A predominantly proficient and stable workforce is a desirable goal.

Some M3 clients have service-oriented business models whose expenses are predominantly labor. Historical entry level labor is inexpensive. The base wage rationale is the length of time to train the employee toward proficiency. Meanwhile, turnover is high. So, too, are client complaints on service delivery. Suppose the clients are large. Further suppose that the courtship for such relationships is protracted, i.e., the acquisition cost for landing such clients is steep. What if the average client length is 10 years but the relationship is lost after two. This means that eight years of amortized

acquisition cost in the pricing model is part of the hole that had to be filled before thinking about net revenue gains. Ouch!

Supervision

The litmus test of value from the customer's perspective is getting at least as much utility by possessing a good or service as the amount paid for domination of the good or service. This explains why no one cared how much Peyton Manning made or Tom Brady makes. Winners win. The Colts bet against Manning and lost. The Broncos send their thanks. Ditto for the Patriots on Brady; the Buccaneers are ecstatic. We do not yet know how many more Super Bowl teams Brady will steward before he retires at age 65.

Supervisors must be engaged to create value for customers.

The lesson applies to supervisors. We should focus less on what they are paid and more on the value creation attributable to their span of control. The ability to capture and analyze data are getting cheaper over time. Leaders who eschew analytics is a symptom of eventual extinction.

Other issues should be considered in developing valuable supervisors. Here are a few:

- Companies may promote their best individual contributors into supervisory roles. Some company cultures may project an aura of unwarranted superiority in a title. A great employee may be happier as an individual contributor than a manager. Did we ask?
- Management tends to be a sink or swim proposition, i.e., no training. Managerial skills are not inherited. They must be developed. Among the most important skills to develop are interviewing, data-driven decisions, and performance management. How are they going to learn it?
- Especially in high turnover situations, the amount of time consumed by interviewing may seem incomprehensible. This is time not spent supervising.

Moreover, the new hires need to be trained and more highly monitored in relative terms.

The Cost of Quality

Total Quality Management ("TQM") institutionalized empowerment of line employees to jettison defects at the earliest stages of production—even if it means stopping a production line. Why? TQM protagonists understand that a defect gets increasingly expensive the longer it traverses the value chain.

Think about new hires in a high turnover environment. Until a green recruit achieves the proficiency performance echelon, should we be surprised by higher relative quality issues? Are employers calculating the correlation between new hires, reworks, and/or scrap? What if the scrapped raw material were among the pricey rare earth elements utilized in high-tech production?

Customer Facing Positions

It's nice to be important, but more important to be nice
~ Walter Winchell

M3 admittedly has position pet peeves. At the top of the heap is customer service. One of the easiest ways for an entrepreneurial David to competitively slay a Fortune 1000 Goliath in this environment is simply to give a darn about their customers. Especially in these times, it is important to own and expeditiously fix the problem. This begins with who answers the phone—amplified by how they answer the phone.

Irrespective of the type of business model, the "receptionist" at a small company tends to be among the least compensated in the ranks. Moreover, the position tends to be the dumpster for all other undesirable necessities of the "front office." The problem is exacerbated by a lack of training. Consider the calming impact of a "smile you can hear" from the person who answers the screaming phone call of a disgruntled customer.

Two things a customer most assuredly does not want to hear are:

- “It has never done that before.” First, how would one know that answer absent tracking data. Second, the caller may be the first but would not care if they were the millionth because the problem happened to them.
- “It is not supposed to do that.” But it did! Moreover, such an asinine response infers user error which may be false.

Does company leadership realize the magnitude of phone etiquette? Who is training these skills?

Antidotes to Labor Ills

Alfie Kohn offers a thoughtful critique on tradition managerial gimmicks in *Punished by Rewards: The Trouble with Gold Stars, Incentive Plans, A's, Praise, and Other Bribes*. Several best practices are available to consider in ameliorating direct labor cost pains. Think of these in terms of antidotes to the #1 reason employees leave: the boss. This perennially prominent exit interview reason is too simplistic and masks the more descriptive reasons for the erstwhile employee’s rationale:

- Enjoying what they do.
- Having autonomy over how they do it. Even if the job does not lend itself to poetic license, the next best thing is continual solicitation of—and participation in—process improvement feedback.
- Liking their teammates. Remember Peter Drucker’ admonition: “culture eats strategy for breakfast.” What are leaders doing to nurture a healthy work climate? Who is teaching them?

With these thoughts in mind, the following suggestions have favorable odds:

- Approach recruitment the same way that professional marketers attack total addressable market.
    - First profile the employee strike zone in terms of technical and behavioral propensities. Don't assume an answer here. Ask your best employees in the role.
    - Second, decide where these candidates are found in competing and transferable industry sectors. This is equivalent to marketing channels for new hires.
    - Third, aggressively and proactively flood these channels with messaging.
- Recruit and interview even if there are no openings. There are two reasons.
    - First, great talent is hard to find. Attracting great talent facilitates top grading.
    - Second, favorably disposed prospective employees reduce the pressure of settling for undesirable options under duress.
- Train interviewers. Indeed, the overwhelming majority of hiring managers are not trained and tend to repeat chronically inadvisable mistakes.
- Institutionalize fidelity to tools and processes for consistency and productivity.
- Acculture GREAT onboarding programs. This includes, but is not limited to, making a new hire feel welcome by teammates—and modeling sincere interest in their success in the new role.
- Regularly communicate how the company is doing and how each teammate connects to that outcome.
- Celebrate the success of good work.

Just as important to "antidotes to labor ills" is recognizing snake oil "solutions." One of the more common gimmicks M3 encounters is retention bonuses. These are problematic for three primary reasons:

- Entry level labor tends to be on the lower end of the compensation spectrum. Accordingly, there may be little discretionary income. Incentives should be frequent to be effective, i.e., per pay period.
- Retention bonuses for a fixed period may be a catalyst for quitting when the period ends.
- Favoritism for new hires tends to be disruptive to legacy employees. If veteran employees feel shortchanged and/or disrespected, the unintended consequence may be their diminished productivity and/or turnover.

The macro compensation strategy may need overhaul. New hire compensation is a subset thereof. Accordingly, new hires may accomplish wage improvement via “certification” through the eventual stages of competency, proficiency, and excellence. A thematic prerequisite is an appropriate training and verification process.

A Keynesian Approach to Turnover Cost

This article opened with an allusion to the *multiplier effect* which has its roots in Keynesian economics. The short explanation is that the marginal propensity to consume (“MPC”) stimulates the economy. The complement of consumption is saving. The formula is thus:

$$1 / (1 - MPC) = \text{Multiplier Effect}$$

If consumers spend 90 percent of each dollar earned, then the multiplier is 10:

$$1 / (1 – 0.90) = 10$$

This phenomenon is commonly a part of the tax cut argument to stimulate consumer spending in recession recovery strategies. The model may be analogously applied in pursuit of turnover “opportunity cost.” Ponder the percentage of wasted motion attributable to the variables from the gist of this article. (*Note: The multiplier effect is*

intended as a macro argument and should not be confused with the individual variable modeling M3 alluded to in the Introduction.)

FTEs	1st 90 days	2nd 90 days	3rd 90 days	4th 90 days	5th 90 days	6th 90 days	7th 90 days	8th 90 days	9th 90 days	Weighted Attrituion Avg	Lost Labor $ for 90 days	Multiplier Impact
Initial Hiring Cohort A	32											
Cohort A Attrition	16									8	$ 76,800	$153,600
Rehire Cohort B		16										
Cohort B Attrition		8								4	$ 38,400	$ 76,800
Cohort A Attrition		5								2	$ 23,040	$ 27,106
Rehire Cohort C			13									
Cohort C Attrition			6							3	$ 30,720	$ 61,440
Cohort B Attrition			2							1	$ 11,520	$ 13,553
Rehire Cohort D				9								
Cohort D Attrition				4						2	$ 21,120	$ 42,240
Cohort C Attrition				2						1	$ 9,216	$ 10,842
Rehire Cohort E					6							
Cohort E Attrition					3					2	$ 15,168	$ 30,336
Cohort D Attrition					1					1	$ 6,336	$ 7,454
Rehire Cohort F						4						
Cohort F Attrition						2				1	$ 10,752	$ 21,504
Cohort E Attrition						1				0	$ 4,550	$ 5,353
Rehire Cohort G							3					
Cohort G Attrition							2			1	$ 7,651	$ 15,302
Cohort F Attrition							1			0	$ 3,226	$ 3,795
Rehire Cohort H								2				
Cohort H Attrition								1		1	$ 5,438	$ 10,877
Cohort G Attrition								0		0	$ 2,295	$ 2,700
Rehire Cohort I									2			
Cohort I Attrition									1	0	$ 3,867	$ 7,734
Cohort H Attrition									0	0	$ 1,632	$ 1,919

Lost Wage Analogy		Multiplier	Lost Wages	Multiplier
Primary Cohort Attrition	50%	2.0	$ 209,916	$419,833
Rehire Cohort Attrition	15%	1.2	$ 61,815	$ 72,723
		Totals	$ 271,731	$492,556

Table 1: Multiplier Effect

Assume the following:

- Fully loaded line position cost of $20 per hour, or $41.6 thousand per year.
- A 50 percent turnover calculated on a rolling day 90-day period. Just to be clear, this means that half of each new hire cohort leaves within 90 days after hire.
    - Substituting the turnover for the MPC, the multiplier equals two.

- Further assume additional cohort attrition of 15 percent in the second 90 days, but stability thereafter.
  - The multiplier for the second 90 days is 1.2.
- Assume 32 positions were initially posted.
  - According to Table 1 above, it may take nine quarters to achieve stability for all 32 positions.
  - “Lost wages” in this total $272 thousand over that period.
  - The multiplier effect of that turnover is $493 thousand.

Is this impact hyperbolic? Probably not upon considering the impact of the variables discussed in this article which are not even considered in the multiplier formula.

Let’s revisit the argument from one more angle. What if adding four dollars per hour eliminated turnover for the initial cohort of 32. The incremental compensation approximates the wages lost to attrition and is about half the multiplier cost. Tempting? Maybe, but be careful. The effect on legacy employees must be considered.

Summary

Business leaders must solve their labor problem now. The ugly truth may be that this means wage inflation beyond anything experienced in many years. Brand equity and market share are at stake. This argument is tantamount to an insurance policy. The salve is not nickels and dimes—it is dollars. Take heart, however. The corresponding productivity and quality upside may cover the “cost.”

When your house is on fire, think bigger than a garden hose!

Longer term, business leaders must be maniacal about two consecutive points. The first is taking waste out of the system. This begins with delivering exactly what the customer requested without frills. This eliminates benefits and features which the customer does

not value. In complement to the eradication of product waste is the elimination of process and materials waste which produces those goods and services.

Second, the ultimate answer is the disintermediation of labor by automation. Before ruling this one out, answer this question: When was the last time you stood in line at your bank's teller window?

"Can't" never could and "won't" never will. Perhaps it is time to visit our version of Steve Jobs' "reality distortion field." Borrowing from Ryan Holiday's best seller title, *The Obstacle Is the Way*. A sustainable solution must be engineered from the chronic turnover chaos. Entrepreneurs ideally suited for this challenge.

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Our firm offers a value-creation toolbox of growth, productivity, and cultural solutions to portfolio companies of private equity firms. The premise is that best practice adoption correlates with a smoother investment hold period, resulting in higher exit multiples. Additionally, deal team time is liberated from operational surprises to invest in new transactions.

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