



## Visual Flight Rules vs. Instrument Flight Rules:

### How Are You Piloting Your Business?

By

John A. Lanier, DSL

#### Introduction

My childhood was punctuated by crop dusters, some of whom were veterans. They buzzed us and tipped their wings to and from their routes when they spotted us farmers tending our fields. As customers, they recognized that the entertainment was also advertising. Perhaps there was something about crop dusters that reminded me of the monochrome World War II movies I watched as a youngster, such as *Flying Tigers* and *Twelve O'clock High*. Combat pilots are fascinating. The recent *Top Gun: Maverick* installment pleases me greatly. Some pilots opine that landing is a controlled crash. A common quip is that any landing from which the pilot walks away is a good one. True, if injury avoidance is the sole criterion, then a rough landing is successful. However, reusable equipment is part of the sustainability equation. This is particularly interesting for Naval aviators who exact 24/7 landings on both rough and calm seas.

My bachelor's degree cohorts were commonly trained by Vietnam-era veterans, irrespective of profession. A particular trainer of mine left an indelible impression. He flew a Loach helicopter. (Think T.C. on the *Magnum PI* TV show.) He described his job as flying at treetop level to draw fire. He was flanked by Cobra and Huey gunships which would address an elicited threat. I deduced he was bait. He grinned in agreement.

*Conditioned responses to common scenarios are an objective of effective training.*

The Loach pilot endeavored to acculturate me on the value of Pavlovian responses to common ecosystem scenarios. He emphasized his point by asserting that his chain of command had a high degree of confidence in how a 19-year-old Warrant Officer stewarding a very expensive machine would perform in stressful conditions.

Indeed, my veteran trainer exceeded expectations. He was shot down three times; moreover, he was shot up so badly on several missions that the chopper was not airworthy after landing. He described two such examples. First, his tail rotor was destroyed to which he stated only impaired hovering—and his motivation was coincidentally a straight line evading the danger. Another example regarded extricating casualties to MUST (medical unit self-contained transportable) units—the successors to Korean War era MASH (mobile army surgical hospital) units. My trainer often over-torqued the gearbox to save precious minutes in life-or-death situations.

My trainer was fearless. In much less threatening scenarios, he expected me to be predictably productive. Pilots commandeer their aircraft by two basic flight rules: visual flight rules (“VFR”) and instrument flight rules (“IFR”). VFR is how citizen pilots start, but weather watching is imperative. IFR is more technical. IFR rated pilots remain cautious about adverse conditions. They wield additional skills on avionics upon which to rely in conditions with less margin for error, including visibility, altitude, and controlled air space. Ignoring instruments is inadvisable. Inclement darkness without points of reference may induce disorientation.

This quarter’s installment draws from the VFR vs. IFR metaphor for navigating in post-COVID economic turbulence. In this case, let’s focus on prudent metrics as the instruments if IFR leadership.

### **What’s the Weather?**

Growing up on a farm, I made my spending money from a herd of over 100 low maintenance goats. Goats rivaled meteorologist accuracy. If they inexplicably headed

*Identify reliable sources of practical leadership signals which others may unwisely ignore.*

toward the barn midday, it was time to take shelter. My goats were an agrarian version of IFR. Their instincts were attuned to invisible leading indicators such as change in barometric pressure. I retain the same leading indicator from

my senior year of high school. A motorcycle accident resulted in a mangled shoulder. I still know when rain is coming by the aching in my joints. Many arthritic readers of this article can relate.

Michael Porter imparted that the essence of strategy is choosing what not to do. Winston Churchill observed that “those who fail to learn from history are doomed to repeat it.” The economy is attempting to recover from a pandemic induced aberration. However, we could be on the precipice of stagflation—something only aging baby boomers can clearly

recall from a time when their ages mirrored present Gen Z workforce entrants. My Vietnam veteran trainers observed that stagflation and combat casualties have something in common: (i) they are painful, (ii) recovery is protracted, and (iii) the cost is excessive.

Presently, M3 is fielding inbound inquiries about “mid-hold period” strategic planning. This is intriguing by its prima facie contrast to the norm. Many lower middle market investors which M3 encounters do not annually engage in “white board” strategic planning. Indeed, a more common scenario leaves the investment thesis unaltered and focuses on an incremental budget. The alleged root cause for the incoming strategic planning inquiries was a problem statement: the budget was missed for inexplicable reasons. The signal was an outcome metric, i.e., a lagging indicator. However, root causes are associated with input and process variables. This contrasting phenomenon catalyzed a Pavolian *Five Whys* technique juxtaposed against a fishbone diagram.

### The Right Questions

One of the joys of my practice is guest lecturing to MBA students. Some of my client friends are adjuncts or alums of some prestigious schools who occasionally treat their students to this “Dawg” who might “bark” some life lessons which bridge academic theory with practical application. Pandemic recovery phenomena compelled me to reframe a recent lecture on a single slide of symbiotic critical thinking questions. I was gratified by the blind feedback from the class. Here are the questions (plus come color):

*Good critical thinking questions correlate with superior decisioning.*

- *What is our unique value proposition?*

A unique value proposition explains why customers *voluntarily* trade their cash for vendor goods and services. Customers only do this if they perceive at least as much utility as the cash exchanged. Customers perceive a bargain when the price of dominion is less than the utility of usage.

A common vendor error is confusing features with benefits. Benefits satiate a customer need. Features explain how benefits are derived. Unless and until a customer perceives a benefit, features are irrelevant. Are we over-engineering the features which produce the benefits of our unique value-proposition? We won't know unless we ask our customers the right questions. The most reliable methodologies commonly entail independent third parties using “blind” techniques to facilitate candor. There may be a

dearth of such discipline in the lower middle market. This is a weather alert for VFR CEOs. This is an occasion for IFR flight rules.

- *What is our total addressable market?*

The US Census Bureau estimates our population at 332 million. Not all of them are customers. The Small Business Administration reports that their 31.7 million constituents comprise 99.9% of all US businesses. Not all businesses are customers either. When determining total addressable market, the variables include demographics of would-be customers, geography, and barriers to entry. A rule of thumb in an established industry is aggregate competitor revenue discounted by variables covered in the next bullet. VFR CEOs, is this another weather alert for IFR expertise?

- *How will we differentiate from competitors?*

Customer decision drivers are rooted in four basic variables: value, quality, timeliness, and service. Value was addressed above. Quality is how reliably well the purchase performs over time. Timeliness regards access when the customer wants it. Service is predominantly graded by the vendor reaction when any combination of the other three variables fails to meet expectations. I am often impressed by how quickly some vendors can ship things to my house. I would be even more impressed if they shipped me what I ordered. I'd be amazed if returning the item were simple.

Hamilton Helmer's book, *7 Powers: The Foundations of Business Strategy*, is a must-read on competitive differentiation. Capital allocation should be predicated on wielding at

*Steve Jobs' "think different" and differentiation are first cousins.*

least one of the levers Helmer profiles: (i) scale economics, (ii) network economics, (iii) counter-positioning, (iv) switching costs, (v) branding, (vi) cornered resource, and (vii) process power. The examples are a little dated but recognizable. The seven powers are timeless.

Enticing labor to return from the two-year COVID foxhole experience is at least more expensive. However, those on the clock may be modeling behaviors counter to customer-centricity. Perhaps our quarantine has eroded our emotional intelligence. Apparently, M3 has company in this observation. In Callum Borchers' September 8 *Wall Street Journal* article, "What the #@%! Happened to Our Manners at Work?", he deemed the malady "pandemic rust." Manifestations include aggressive driving, interpersonal rudeness, and eschewed etiquette. Food for thought: Over four decades, I have not perceived an easier time to differentiate by adherence to basic customer service best practices, i.e., own it and fix it—fast! Good manners brand service.

- *What are our marketing channels?*

Marketing channels regard how we reach the customers deemed predisposed to consider our value-proposition. Acquisition cost for new customers may be pricey. Getting marketing channels wrong exacerbates the expense. Ironically, giving good customer service may provide us the cheapest and best advertising possible: word of mouth. Efficient marketing channels are tantamount to IFR flight plans: predetermined routes for maximum safety.

- *What are our critical value chain processes?*

The #1 thing vendors have control over is cost. The focus is elimination of waste. We must first design goods and services to deliver exactly what the customer values—and no more. This point was posited earlier. Next, we must reengineer processes to improve quality and timeliness at the lowest cost. This quest concurrently critiques insourcing vs. outsourcing vis-à-vis workflow.

- *How does our supply chain enable/cripple us?*

One of the more interesting M3 observations of aggressively acquisitive investment theses is bulk purchasing and vendor consolidation leverage. Fulltime purchasing managers may have a good internal rate of return (“IRR”). However, the COVID-19 pandemic sobered us to the reality of supply chain disruption. So has the Russian invasion of Ukraine. There are numerous examples to ponder. What are our alternatives and contingencies?

- *How do we improve productivity?*

Labor is an essential input element for value chains. Especially in the face of expensive labor, automation is the answer for taking the “best” process to the next level of superior productivity. This does not necessarily portend a labor reduction in force (“RIF”).

*Productivity is the holy grail of value chains.*

Rather, the liberated bandwidth of acculturated and trained teams may easily handle more growth.

- *What is our sales model?*

Boots on the ground salesforces are not cheap. Selling is also a process which should be scrutinized the same as the value chain. The shorter the sales cycle, the more likely it can be displaced by virtual tools—but beware. Many of us shop on the web. More vendors seem better at peddling over the web than managing exceptions in virtual mode. Even stalwart Google may be fudging. Take note of the results when the specificity of

complex searches is ignored, e.g., key words and/or exactness within quotation marks connected by plus signs.

- *What is our revenue mix?*

Many vendors have oodles of stock keeping units (“SKUs”). Safety stocks for quick delivery is a common strategy. Moreover, cushion quantities of slower moving SKUs are rationalized against production change-over costs. Even so, the convenience of equally prompt shipment of slower moving SKUs should be reflected in pricing because of the carrying cost. Another point to consider regards “innovative” companies whose SKU novelty wanes with time. How much of the revenue stream is comprised of new products? For that matter, what is the definition of a new product? There is a catch regarding disruptive innovation: customers may not have noticed their unmet need. This requires effective marketing.

- *On whom do we make money and how?*

Many small businesses concede that they lose money on some combination of products and customers. However, they cannot answer the question with precision. This may be worsened by customer concentrations in deficiently profitable relationships. Product lifecycle management is also a consideration. Some vendors cannot “retire” antiquated product/service lines (whose support costs may be increasing) because their BIG customers “will not let them.” Big customers can also exercise their leverage for “freebee favors” which erode margins. IFR Hint: Reliable cost accounting is essential to the integrity of customer profitability analysis. Indeed, it may be possible to make more money with less revenue if losing propositions may be isolated and extinguished.

*Good operating systems  
and good cost accounting  
go hand in hand.*

- *How will we find/win/keep talent?*

The post-COVID talent war is intense. Rising expense is axiomatic. Better talent per unit cost is imperative. Before we may onboard, train, develop, reward, and retain, we must find talent. Marketing principles are the best place to start. What types of talent (i.e., skills) are required? How do we reach these candidates—especially by unique means compared to recruiting rivals? Could stagflation bring insult to injury on labor costs? Consider the possibilities inferred by the 0.7 correlation between work stoppages and average inflation from 1970 through 2021.

## The Right Metrics

Purely rational decisioning, and by extension rational economic theory, has long since been debunked by research substantiating that we are more fearful of failure than enticed by gain. (Thanks again, Amos Tversky and Daniel Kahneman.) Indeed, as we cross the mental DMZ from homeostasis to our fight or flight mechanism, the rational thinking part of our brains literally turns off. All humans suffer anchoring bias and cognitive dissonance. We even retrofit to make history fit our paradigms as evidenced by such pronouncements as “I knew that was going to happen.” Even so, few have parlayed such omniscience to the Las Vegas gaming tables for “certain” fortunes.

Facts are agnostically irrefutable; they are rooted in empiricism. By contrast, truth is personally manufactured from a subset of facts. Since “perfect” decisioning is elusive, we require the discipline of scientific method to improve the odds of success. Operators phrase their challenges as “problem statements” which serve the same purpose as the null hypothesis of scientific method. Our default null hypothesis is that no decision we make will improve results. Since inaction is normatively untenable, shrewd leaders focus on material variables within their control—variables whose measured manipulation may result in favorable outcomes. Multiple regression sifts historical data for clues. Design of experiments and multivariate testing yields formulaic application to sustainably resolve the problem statement.

Pilot cockpit avionics and metrics are essential to IFR conditions. Engineers designed them in conjunction with flight simulators. Test pilots perfected them. Instruction and training yields IFR certifications. While the balanced scorecard has virtues analogous to cockpit avionics, there is a more essential subset that correlates with the going concern viability of the business model: inputs, process, and outputs.

*The longer the business cycle, the more critical are input and process metrics.*

Consider the algebraic equation  $x * y = z$ . The dependent variable is  $z$ , i.e., an output metric. The two ultimate output metrics are ROI (return on investment) and IRR. The former addresses quantity of profitability while the latter describes how effectively, efficiently, and productively the sum was achieved. Private equity investors tend to communicate ROI as a multiple—not a percentage. For example, tripling an investment may be referred to as a 3X return. But how long did this take? In private equity parlance, the conjunction of the multiple and time (e.g., years) may be communicated as “3x in 5”—a thrice multiple in five years. The IRR scores the cash flows relative to time.

The longer the business model cycle, the more critical become input and process leading indicators. There is an undercurrent of caveat emptor for any single metric. Thus, it is wise to lean on accompanying metrics to avoid three null hypothesis errors: type one (i.e., erroneously concluding a difference), type two (i.e., erroneously assuming no difference), or type three errors (i.e., solving the wrong problem).

- Input Metrics

Long cycle B2B business models have a good leading indicator: customer order backlog. What about B2C business models with no backlog? Consider the impact of COVID-19 economic relief programs which artificially stimulated discretionary demand that has since dried up. Presently, many consumers are triaging among subsistence consumption amid an inflationary environment not seen in decades. What is the appropriate indicator for that?

Are we tracking the raw materials lead time from our vendors? If it is stretching out, what does that mean? How well do we know our vendors? Vendors have supply chains, too. Can we get the materials from another source at any price?

We may sometimes overlook the possibility of process metrics doubling as a leading indicator. Consider employee turnover. If rolling 90-day turnover for an opening line position is 50 percent, then it takes two hires to keep one—in the short run. High turnover necessitates better recruitment and onboarding. However, there is another cost to consider: the learning curve from competence to proficiency in an ideal trajectory toward excellence. For large direct labor content, should we be surprised by the correlation of high employee turnover and lower relative productivity?

Macro metrics may be useful for interpreting the micro metrics within our domain. These include consumer confidence polls, workforce participation, Treasury yield curve, durable goods orders reports, stock markets indices, employment numbers, building permits, and U.S. Conference Board's Leading Index (of economic indicators).

*It's not what labor costs, but rather the value labor produces.*

No metric should be accepted at face value. We should always ask "Why?" Why is it so favorable? (To wit, low labor participation belies low unemployment figures.) Why is it so negative? Why didn't it change? Input metrics should be pondered against these ground rules:

- Over what do we have dominion which should be a leading indicator?
- Over what do we not have dominion which we should consider?



- What complementary metrics help us both protect from a “sample of one” and confirm the most appropriate interpretation?
- Process Metrics

The ultimate process metric is productivity, e.g., units of output divided by units of input. There is some debate over what belongs in the numerator and denominator, respectively. M3 favors first pass yield per time. The numerator is the *outcome* of committing labor, materials, and appropriate allocations to a “widget” to which customers ascribe value. The denominator is the labor hours (or cost). First pass means complete adherence to quality standards, i.e., a “get it right the first time” expression. This should not be limited to the high-level depiction of operations. Indeed, many companies only measure quality at the finished goods level, but this hides defect reworks to pass final inspection. A better approach is for each major stage in the value chain being similarly measured. One compelling reason is that the cheapest defect is the one detected earliest in the process.

The *Wall Street Journal* published a September 18 article to which productivity patrons should pay attention, “China’s Factories Accelerate Robotics Push as Workforce Shrinks.” Perhaps U.S. industry should take note that our largest economic rival, China, is making major investments in automation. China’s catalysts are an aging and plateauing workforce concurrent with increasing labor costs. Whereas Chinese productivity is presently a fifth of U.S. numbers, their labor disintermediation may bridge the gap—and thus, improve Chinese competitiveness.

Conversion rates and cycle times for value-creation stages are also beneficial. Several stages may have bottlenecks which cause overall value-chain traffic jams. One of the virtues of Lean Manufacturing techniques is adjusting capacity and productivity to mitigate the impact of bottlenecks. This is more of a journey than a destination in that the resolution of the primary bottleneck invariably reveals the next one. Lean helps concurrently eliminate waste, improve capacity, accelerate velocity, maximize labor productivity, and identify candidates for automation to displace labor.

*Ask “Why?” until you are convinced the root causes are irrefutably revealed.*

## Conclusion

The National Transportation Safety Board attributes three quarters of aviation crashes to “pilot error.” Analogously, what might business leaders adopt in complement of IFR flight plans for dynamic, expedient midcourse correction? Perhaps these questions vector us in the right direction:

- What should we be measuring?

We should remain intrepid if the data elements are not handy for computing insightful metrics. If the need is critical, manual capture is better than “flying” blindly. Collectively, the need for good metrics is an “input” for the types of information systems a business needs to transform from VFR to IFR leadership. The ability to passively produce these data is no longer a luxury, but rather a necessity. All good metrics architecture enables drill-down capabilities. If the high-level metric violates control limits, then the drill-down to empirically isolate primary root causes portends sustainable resolution. Even if the metrics are not available, what will suffice as a surrogate?

- Who should be using the data?

Leadership should not hoard information. That is tantamount to increasing crashes by denying pilots IFR capabilities. Managers and their teams should have the data for facilitating dynamic decisioning. Both should be taught how to use the metrics within their spans of control.

- How should the data be used?

Robust organizations are architected with empowerment. Not only is productivity at stake, but safety may be an imminent concern. Meetings should be anchored in metrics. Performance management goals should be tied to those metrics. Finally, data should be used for strategic planning. The data should be aimed at the critical thinking questions which gauge viability and prosperity. What IFR leading indicators suggest macro navigational changes? Moreover, what new types of metrics help us rationalize midflight corrections?

\*\*\*\*\*

*Middle Market Methods™*

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.