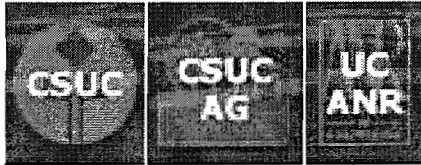


WORKSHOP HANDOUTS



ECONOMICS

RANCHING FOR PROFIT

THE THREE SECRETS FOR INCREASING PROFIT

There are only three choices in any business: 1. We can make it profitable; 2. We can subsidize the business; or, 3. We can go out of business (bankruptcy). Whether we realize it or not, most of us choose the second option, we subsidize our businesses. I'm not speaking about government subsidies, but rather the ways in which we subsidize ourselves. Living off inherited wealth and appreciating land values, relying on off-farm income to make ends meet and working for less than it would cost to replace yourself are all ways in which we subsidize our ranches.

I'll assume that most ranchers would rather not have to subsidize their ranches and would prefer to make profit. There are only three ways to increase profit. At Ranch Management Consultants we call them the three secrets. They are:

1. Reduce Overhead Costs
2. Improve Gross Margin Per Unit
3. Increase Turnover

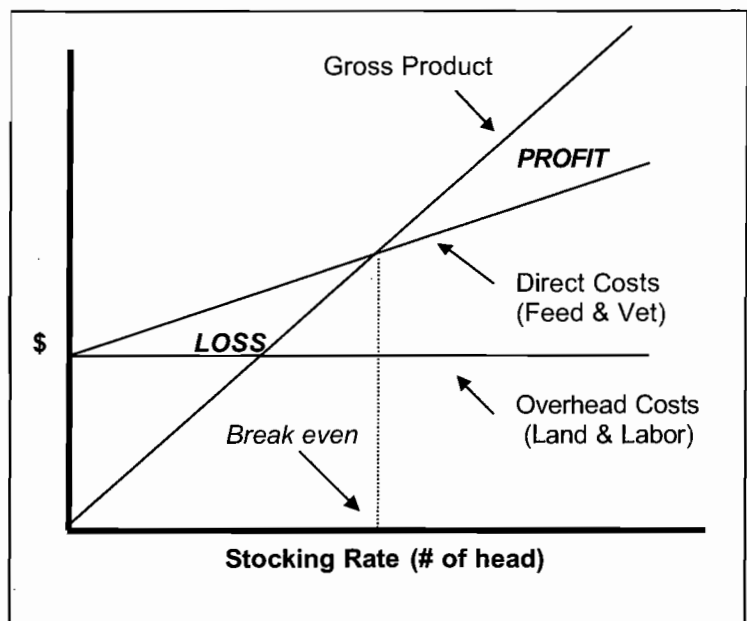
Reducing Overhead Costs

Overhead costs are those costs that don't change much as livestock numbers change. There are two types of overheads: land and labor costs. Any costs related to land (e.g.

fencing or water trough repairs, property taxes, leases, etc.) are overheads. Likewise, any costs related to labor (e.g. salaries and benefits, vehicles and equipment costs, etc.) are labor overheads. Economists sometimes call these fixed costs. But they are not fixed, they can be changed, and that is one of the three secrets for increasing profit.

Improve Gross Margin Per Unit

Gross margin is a measure of the economic efficiency of your livestock. It is calculated by subtracting the *direct costs* of production from *gross product*. Direct costs are those costs that increase or decrease as cow numbers increase or decrease. Direct costs include feed, health, freight, marketing commissions, and interest on livestock loans. Gross product refers to the gross value of production. This includes livestock sales minus purchases. It also includes changes in the value of your herd. Total gross margin is divided by the number of animals in the herd to calculate gross margin per unit. Increasing gross margin per unit (the efficiency of production) is another way to increase profit.



Increase Turnover

In ranching, "turnover" is the number of animal units carried. If gross margin is positive, increasing turnover will increase profit if it doesn't increase land or labor costs or damage the resource base. However, there is no point in increasing the number of units if each unit makes a negative contribution toward overhead costs.

Historically, as an industry we have tried to increase profit by increasing production (increasing gross product). We have done an amazing job increasing conception rates and weaning rates. In fact, I'm told that the average beef cow in Alberta produces 20% more pounds of beef per year than she did just 20 years ago. So why aren't we 20% more profitable? Part of the answer is obvious: the increased production resulted from, among other things, increasing direct costs (e.g. feed, health products, etc.). But there is more to the story. Those direct costs had to be administered by someone (increasing labor overheads) somewhere (increasing land overheads). On most ranches today, overheads account for 60-80% of total costs. It is the cost of building and maintaining the infrastructure we created to increase our efficiency that has depressed profit.

Imagine a chain with three economic links: overheads, gross margin per unit and turnover. If the gross margin link is weak, strengthening the overhead and turnover links won't make the chain stronger, in fact, they may make the chain weaker by putting more stress on the weak link. In the next article in this series I'll describe how to find the weak link for your business. That's critical if you want to be Ranching For Profit.

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RANCHING FOR PROFIT

DIAGNOSING PROBLEMS & OPPORTUNITIES

In my previous article I showed that there are only three things a rancher can do to increase profit: 1. Decrease the overhead costs; 2. Improve the gross margin per unit; and 3. Increase the turnover (the number of units). But only one of these three things is the most important. If high overheads are the problem, increases in production efficiency are likely to increase your work load but may not significantly increase profit. If gross margin is the problem, then decreasing overheads won't have much effect and increasing turnover may actually help you go broke faster. It isn't enough to know the numbers. We must now find out what the numbers mean.

The diagram below shows the thought process we teach people at the Ranching for Profit School to diagnose the problems and opportunities in their businesses. Let's take a closer look.

We calculate profit by adding the gross margin for each enterprise and subtracting overheads. If the difference is positive the business made profit. If it is negative the business lost money.

$$\begin{array}{r} \text{Gross Margin (enterprise a)} \\ + \text{Gross Margin (enterprise b)} \\ + \text{Gross Margin (enterprise z)} \\ - \text{Overhead Costs} \\ \hline \end{array}$$

Profit (Loss)

Profit is calculated by subtracting overhead costs from gross margin. So if profit is low it is either because gross margin is too low or overheads are too high.

Gross margin is calculated by subtracting direct costs from gross product, so if gross margin is too low, it is either because direct costs are too high or gross product is too low.

Gross product is a measure of how much we produced and how much we got paid for it, so if gross product is too low it is either because we didn't produce enough (production), or we didn't get paid enough for what we produced (price).

If we didn't get paid enough it is either because the market is too low or our marketing is not adequate.

If the gross product is low but the price is reasonable then production is too low. If production is low it is either because we didn't produce enough things (reproduction) or because the things we produced weren't big enough (gain).

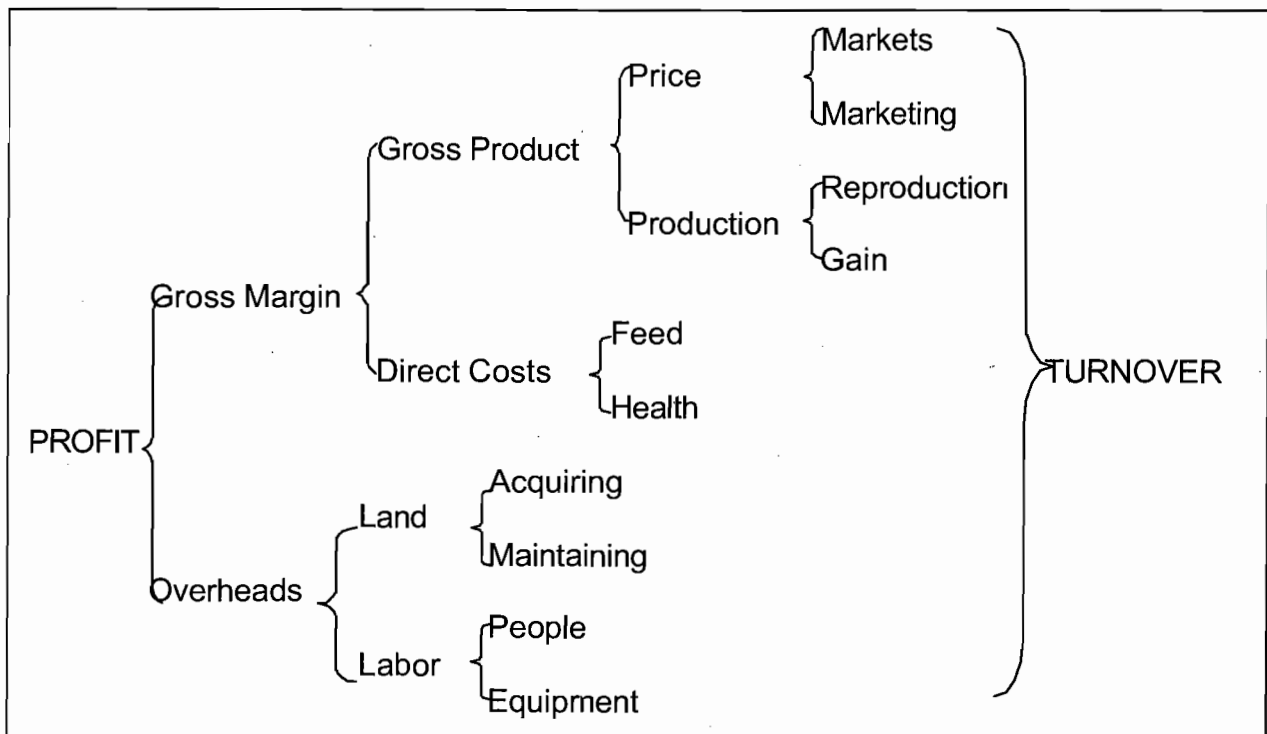
If gross margin is low, but gross product is not the problem, then the focus turns to direct costs. There are only two major direct costs: feed costs and health related costs.

If gross margin is healthy but the business still isn't profitable, the problem may lie in the overhead cost category. There are only two kinds of overheads: land costs and labor costs.

There are only two kinds of land costs: the cost of getting land (e.g. lease payments) and the cost of maintaining the land and the improvements on it.

If land costs aren't the problem, the focus turns to labor. There are two major labor costs: costs associated with people (e.g. salaries, retirement plans, health benefits, etc.) and costs related to vehicles and other equipment.

But we also know that cutting overheads and improving gross margins aren't the only ways to increase profit. Increasing turnover is the third way to increase profit. If gross margins are healthy and there's no room left to cut overheads, then turnover is probably the most promising way to increase profit.



At the Ranching for Profit School, participants review a case study of an actual ranch business in dire economic condition. When asked for solutions on the first day students come up with a shot gun array of possibilities. After using this thought process to guide them they discover the source of the problem and find that some of their original solutions would have actually made matters worse.

RANCHING FOR PROFIT

MANAGING CASH FLOW

There are three basic questions we need to think about when it comes to money in our businesses:

1. Is it profitable? (economics)
2. How will I pay for it? (finance)
3. What are the tax consequences?

This is the order in which we should ask the questions. If a venture isn't profitable, the financing should be irrelevant. It doesn't make any sense to finance a losing proposition. If the business is profitable, and we've created adequate cash flow, then we should take steps to minimize taxes. Too often we ask these questions in reverse order and in our efforts to minimize taxes make questionable economic or financial decisions.

Sometimes financial constraints limit economic opportunities. For example, if an investment pays big dividends in several years from now, but doesn't provide short-term cash flow we may find it hard to put food on the table now. But frequently the constraints are self-imposed and result from not recognizing the time value of money or being unwilling to manage cash flow.

Here's an example. A rancher recently told me that he needed to maintain a spring calving herd and a fall calving herd so that he had income twice a year instead of once a year. He acknowledged that it would probably be more profitable to shift to one herd, but said he needed income twice a year to make their loan payment. This isn't a problem of two paychecks versus one. The problem is ignoring the time value of money and failing to manage cash flow.

Time & Money

Which would you rather have: \$120,000 today, or \$10,000 a month for the next 12 months? Using simple interest at a rate of 10%, the \$120,000 paid today would be worth \$132,000 a year from now. The \$120,000 paid over the next 12 months in equal installments would be worth about \$125,500 at the end of the year. I'll take the money up front please.

Managing Cash Flow

Managing cash flow begins with creating a cash flow budget that projects income and expenses for the year. At the Ranching for Profit School we teach participants how to construct a cash flow including one income column

Cash Flow				
	Income	Overhead Costs	Direct Costs	Capital Expenses
JANUARY Budget				
Actual				
Difference				
Cumulative Difference				
FEBRUARY Budget				

per enterprise, several columns for overhead costs, several for direct costs, and at least one for capital expenses. We use four rows for each month. The first row is to record the budget for each income and expense item. A good time to prepare the budget is after weaning and preg-checking in the fall. The next row shows the expense for each item that was actually incurred that month. This should be completed as soon as figures are in for that month. The next row simply shows the difference between the budget and the actual expenses for that month and for the year to date.

The cash flow clearly shows periods of cash surpluses and shortages before they occur and can help you determine how to manage through these periods. It will help determine if, when and how to use short-term financing. But the cash flow is more than just a page of income and expense figures. At the *Ranching for Profit School* we refer to the cash flow as "*the minutes of the production meeting, written in dollars and cents.*" The plan communicates precisely what is planned to partners and workers. It shows when you expect sales to occur, and when you anticipate making major purchases. It will also help you determine the tax consequences of your plans well before the taxes are due.

The cash flow plan is more than just a budget. In fact, the greatest value of the cash flow is not the plan itself, but the process of completing it. The thought that goes into assessing various management alternatives is much more important than the sheet of paper (or the computer screen) that holds your projections.

The cash flow is also a monitoring tool. By updating it each month to show the actual movement of cash into and out of the business it will send up a red flag warning as soon as there is a significant deviation between the budget and actual income and expenses. Used this way, the cash flow becomes an essential tool if you are Ranching for Profit.

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RANCHING FOR PROFIT

BUILDING A BUSINESS THAT WORKS FOR YOU

How many ranch businesses do you know that could pay cash rent for the land, borrow all the money invested in livestock and machinery, pay a decent wage for labor and still make a profit? The fact is that most North American ranchers are not profitable and only stay in business because they are subsidized. They are subsidized by inherited wealth, appreciating land values, off-farm income, working for less than it would cost to hire someone else to do the job or by some other activity on the property not related to livestock (e.g. recreation, timber, etc.).

Most ranch businesses earn a very low rate of return on the assets invested. We accept that as normal. But can you imagine a grocery, a bank, a hotel or a garage staying in business if it could not pay rent on the building it uses, cannot pay a competitive wage to the people it employs, and expects to get less than bank rate on the money invested in its inventory? That is precisely what we consider normal in ranching. We don't expect ranching to be as profitable as other businesses, after all we are told time and again, ranching is a "life-style" business.

Some life style. Of course there's the home on the range, wide open spaces, working for ourselves, and all the rest. But what about the economic and financial stress, the stress of uncertain prices and drought and the personal pressures from parents, children, siblings, our spouse and ourself? Statistics show that depression, divorce and suicide rates are highest in rural areas, and higher for farm and ranch families than other segments of the population. Wide open spaces and independence don't go very far when you take medication for your ulcers, your banker is knocking at your door and no one in your family talks to one another anymore. Lifestyle business? Some life style.

The title of Stan Parson's new book *If You Want To Be A Cowboy Get A Job*, sums it up pretty well. Stan's right when he writes, "*If you want to ranch and be a cowboy - disaster beckons. The two just don't go together.*"

When you are a cowboy, your business is just a place to go to work. You invest years of hard work supporting the business. But you are not supposed to be supporting your business, your business is supposed to support you!

Some of us have a hard time grasping this concept. Maybe it is because of all the personal sacrifices, stress, injuries, blood, sweat, tears and years of our lives we've spent keeping things together. But that's not the way it is supposed to be. Your business should be supporting you! If it's not, you need to spend less time working *in* your business and more time working *on* your business.

Steven Covey defines insanity as doing the same thing over and over and expecting different results. Not only do we do the same things, we do more and more of them.

Our answer to poor profit, eroding range health and personal stress has been to work harder and harder. But when you discover you're in a hole the last thing you ought to do is dig faster. What makes us think that continuing to work harder *in* our businesses to increase production efficiency will increase profit and strengthen our businesses? It hasn't worked in the past. It won't work in the future.

WORKING ON YOUR BUSINESS

In his book *The E Myth*, management consultant Michael Gerber reports that a staggering proportion of start up companies fail in their first few years. According to the statistics, 40% don't survive to see their first anniversary. An additional 40% fail before their fifth year. Eighty percent of the remaining businesses fail by the 10th year.

You might suspect that ranching is exempt from the statistics, but it's not. Similar trends in agriculture have been masked by the internal subsidies described earlier. Due to these subsidies, farm and ranch businesses take about 25 years to use up the accumulated net worth before they perish.

We blame factors beyond our control like the weather, low prices and high costs, for these failures. But if the prices or the weather really determine profit, why do some businesses survive, even thrive, in these conditions while others fail? Depressed markets are a crisis for some but a profitable opportunity for others. It is not the situation, but the way in which we position our business and the decisions we make that determine success or failure.

Whereas the vast majority of start-up businesses fail, Gerber reports that franchise businesses have a 10 year survival rate of 97%. Why the difference? Simply put, franchise businesses have a clear-cut blueprint on how to run a business. The franchiser has worked on the business to build a business that actually works. We are so busy working *in* our businesses (doing \$5 to \$10/hour jobs) we often don't ever get around to working on our businesses (the \$100+/hour work). This is the work that determines the winners and the losers in any business...including yours.

It is critical to understand the difference between *working in the business* (WITB) and working on the business (WOTB). The technician works in the business, the businessman works on the business. Most ranchers do a lot of WITB and very little WOTB. We are very good technicians. When it comes to roping a steer, vaccinating a cow, pulling a calf or seeding a pasture, we do a great job. The problem is that we may not do the *right* job.

Most of us in ranching actually have several jobs. Sometimes we work as a hired hand. Sometimes we are the CEO. The hired hand breaks the ice in the winter, feeds the cattle and fixes the fences (WITB). The CEO develops and implements the business plan (WOTB). Most of us are more comfortable doing the **cowboy's** work rather than the **businessman's** work. The primary reason for the failure of most small businesses, including most farm and ranch businesses, is inadequate WOTB.

Most producers I talk to recognize that their business would be better off if they spent more time on WOTB, but there are several reasons they don't. See if any of these are familiar:

- *"I don't have time. I'm so busy working in my business that I don't have time to work on it."* If we do get around to it, it is usually late at night and we are so tired from a day of WITB (\$5.00/hour work) we may not be awake enough to do WOTB (\$100/hour work) effectively.
- *"I don't like the WOTB as much as the WITB."* We tend to feel more of a sense of accomplishment after pounding fence posts in the ground all day long than we do after a day of researching market trends and developing a marketing plan. But, if you just want to be a cowboy, you'd better get a job for someone who gets the WOTB work done.
- *"I don't know how to do it."* That shouldn't be surprising. Your father probably taught you how to drive a tractor or dehorn a cow, but did he ever teach you how to create goals for the business or build a plan to achieve those goals? Every Ag College has courses on animal husbandry, range management and business, but none teach you how to make and implement the strategic decisions that will determine the future of your business.

At the *Ranching for Profit School*, we teach ranchers how to work *on* their business. One of the keys is to hold regular WOTB meetings.

WOTB Meetings

Most of us have held staff meetings or family meetings where we lay out the work that needs to get done in the coming days or weeks (mostly WITB work). Sometimes we even tackle some of the WOTB issues at these meetings, but the outcome rarely results in definitive action.

In sharp contrast, WOTB meetings concentrate on strategy and the result is always a specific plan of action.

If you haven't held WOTB meetings before, your first meetings should focus on what you, and the others involved in the business want personally and what the business will need to look like to meet those needs. Once you have a well defined vision for the business, WOTB meetings should be used to develop the strategic plan to achieve the vision. Once the plan is in place, you'll use your WOTB meetings to monitor your progress and tackle new issues.

Regular meetings are essential. In most family run ranch businesses WOTB meetings should be held once a month. In addressing some issues, (e.g. developing a strategic plan for the business) WOTB sessions may need to be held more frequently for a defined period. Once you have decided how frequently to hold your regular WOTB

meetings, the key is regularity. **Do not** allow operational crises or excuses to get in the way of planned WOTB meetings.

Everyone who is in a decision-making position should attend your WOTB meetings. In a small business it may be the whole staff. The owner/president should prepare an agenda, which should be distributed prior to the meeting. He should also chair the meetings, making sure that they start and end on time. This usually means allocating time to each agenda item to ensure everything gets covered.

Structure and some formal procedures are important. The first item on the agenda is always the same: read the vision statement and goals. Read aloud and take turns around the table. It is amazing what a powerful effect this has in keeping everyone focused.

The bulk of the meeting is spent discussing strategic issues. Don't put more than three issues on the agenda. Conclude the discussion of each issue by creating a *written* plan of action. The action plan should list the specific actions that will be taken, who is responsible to take each action and when each task will be completed. For major projects, (e.g. the estate plan) break the project down into smaller tasks and assign a deadline for each one.

Close the meeting with two final agenda items: "Worry Areas" and "Commitments." Worry areas are things that are bothering you. They may be big strategic issues or small WITB concerns. Ask each person at the meeting to list their worry areas. Input from everyone at the meeting often brings quick solutions to the problems.

End the meeting by reviewing the commitments agreed to in the action plan. Each person should state what they have committed to do, and the deadlines they are committed to meeting. The person's name, commitment and the time frame are all recorded in the minutes of the WOTB meeting. At the beginning of the next WOTB meeting, after reading the vision statement, take a few minutes for everyone to give a quick update on their progress.

Effective WOTB takes discipline and practice. But it is the single most important step toward increasing profit in any business, including yours. When a ranch is structured and run as a "for profit" business, ranching can be a great lifestyle. You may even be able to afford to be a cowboy now and then.

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ELECTRONIC NEWSLETTER

We are happy to continue sending newsletters by snail mail, but if you'd like to receive your copy electronically let us know. Sending newsletters electronically saves us resources, time and money. Please e-mail us at rmc@ranchmanagement.com if you would like to receive the newsletter on line.

WHEN PROFIT ISN'T PROFIT

At an *Executive Link* meeting last year, a board was reviewing financial statements in a member's business report. The numbers looked good. The gross margin appeared healthy and the business appeared to be profitable. There was only one problem. The business was making a loss!

The numbers hadn't been doctored, but two important numbers had been left out: the opportunity cost of cattle and the opportunity rental of the land. The conventional definition of an opportunity cost is the return that you could achieve if the money invested in land or livestock was invested in the next best investment. Some people roll their eyes when we bring up "opportunity costs" thinking that these aren't real costs and don't make a difference to them. Opportunity costs don't involve cash, but they are real. They provide critical information about real opportunities facing your business.

Take for example a ranch with a herd of 1,000 cows valued at \$750/head grazing 20,000 acres of rangeland. The total value of the herd is about \$750,000 (1,000 cows x \$750/head). If gross income generated from the herd is \$400,000 and direct costs (not including the opportunity costs) are \$150,000, the Gross Margin would be \$250,000. That's a gross margin return of 33% of the value of the inventory. According to the benchmarks we use at the Ranching for Profit School, that's not bad. All of the land is owned. Total overheads equal 160,000 leaving \$90,000 profit.

Gross Income	\$400,000
- Direct Cash Costs	-\$150,000
Gross Margin	\$250,000
- Overhead Cash Costs	-\$160,000
Profit	\$90,000

Now let's throw in the opportunity costs. In the *Executive Link* program we charge opportunity interest of 10% on the conservative value of the cattle. That adds \$75,000 to our direct costs, making our gross margin only \$175,000. That's a 25% return on the beginning inventory value. According to our benchmarks we ought to do better. Now, let's see what happens if we add opportunity rent. Let's say we could have rented our pasture to someone else for \$150/head/year. That's a total opportunity rental of \$150,000. Add in the labor and our total overheads equal \$310,000. Instead of a \$90,000 profit, our business

really made a \$135,000 loss! We would have been dollars ahead to sell the cows, invest the money and rent out our land. Our decision to ranch cost us \$135,000! That's why Stan Parsons calls his book: *If You Want To Be A Cowboy Get A Job*.

Gross Income	\$400,000
- Direct Cash Costs	- \$150,000
- Opportunity Interest	- \$75,000
Gross Margin	\$175,000
- Overhead Cash Costs	- \$160,000
- Opportunity Rent	- \$150,000
(Loss)	(135,000)

An Opportunity To Buy Cattle

Some ranchers are still not persuaded that opportunity costs are real, so let me propose another valuable definition. *An opportunity cost is the cost of pursuing increased profit.* We all know from the Ranching for Profit School that there are three ways to increase profit: 1. Lower Overhead Costs; 2. Improve Gross Margin/Unit; and 3. Increase Turnover. We'll have interest costs on our loan to finance our livestock purchase if we increase turnover. By including the costs of pursuing this opportunity in our Gross Margin calculation it becomes clear if expansion makes sense.

You can argue that 10% on a loan to buy cattle is too high. You're right. But remember, we valued the cow herd at its liquidation value, not its replacement value. Using that conservative value makes the 10% interest rate come out just about right.

Opportunity Rent

Ranchers must also charge rent for the land they own to their cattle business. Failing to account for land rental makes it impossible to determine which part of the business makes the money: the land or the cattle. As with the opportunity cost of cattle, opportunity rent can be looked at two ways. The conventional view would be the income you could receive if you leased the land out for someone else to graze. I prefer to ask, what would I have to pay to lease a similar property if I wanted to expand my enterprise.

Base the opportunity rent on the rental value of the grass, not the purchase price of the property. As we've discussed at the school and in previous newsletters, grazing is only one of many values contributing to the total value of land in most areas.

Most ranchers ignore opportunity costs, but then most ranchers are failing economically and only survive financially because of internal subsidies like off-farm income, borrowing against appreciating land values, living on inherited wealth and relying on low-cost family labor. The profit targets established by including opportunity costs may seem daunting, but returns in each of the Executive Link benchmark businesses exceed these targets. You'll never hit the target if you don't aim for it.

FARMING FOR PROFIT

In March I attended the "Bio Business Farming School" (BBF) in Australia. BBF is a farming version of the Ranching for Profit School. It is run by our Australian counterpart, Resource Consulting Services, Ltd. Ranch Management Consultants will hold our first farming school in Springfield, Illinois, February 9-14, 2004. As a Ranching for Profit School alumnus you are entitled to attend the farming school for \$1,000 (US\$) (half the regular school tuition).

LIVING IN THE BUSINESS

Too much WITB and too little WOTB is a huge problem for many farmers and ranchers. WITB isn't the only problem. We also suffer from LITB (Living In The Business). When we live inside our business it makes it very difficult to separate who we are from what we do...to separate our life from our business.

A great question they asked participants in the BBF School in Australia was: "Are you a human-being, or a human-doing?" When most of them responded that they were humans-doing, they realized that their identity was so wrapped up in their work and their business that they didn't have an identity beyond that. What they do has become who they are. "What's so bad about that?" you might ask. First, it makes us more susceptible to stress and depression. When prices fall or drought hits, it isn't just an attack on the business, it is an attack on us. As a result, we are less able to manage effectively through these recurring phenomena. Second, we've all heard about people who retired from whatever it was they did, and died. When they stopped doing, they stopped living.

Your Business or Your Life

Your business is not your life...or at least it shouldn't be. This first struck me years ago, just after my son Jack was born. I'd been setting up a research trial with a rancher on a spring evening. We'd stopped for a moment to enjoy the evening. We were talking about the thrill of having a baby when he started sobbing. He said he'd worked so hard to put food on the table and to build up his ranch for his kids, that he had become a stranger to them. Now his adult children wanted no part of him or the property. He was questioning, what it had all been for. A good question, but one he should have asked when they were still in diapers.

A lot of ranchers assume one of the primary purposes of their business is to pass it on to future generations. That paradigm leads to debilitated management and a floundering business until teen-age and adult children decide what they want, which ironically, probably won't be a floundering business run by debilitated management. The next generation would be more excited about getting involved if we built a business that excited ourselves.

What is it all for?

What is the purpose of business? Not long ago I heard someone say "*Profit is to business as breathing is to life.*" In "Built to Last," a book about "visionary" companies, the authors support that sentiment in writing, "*Profit is like oxygen, food, water and blood for the body; they are not the point of life, but without them, there is no life.*"

"I think many people assume, wrongly, that a company exists simply to make money. While this is an important result of a company's existence, we have to go deeper to find the real reasons for our being."

David Packard, 1960

People don't work for you to make you rich. In fact research shows that money is an inefficient motivator. After all, you can buy someone's hands, but you can't buy their mind or their heart and that's where their creativity and their loyalty lives. Research backs this up, showing that "achievement" is 6 times more powerful a motivator than "salary." It is no accident that companies that have a purpose beyond profit were about 6 times more profitable than similar companies whose primary objective was profit. Engineers and technicians didn't work on the Apollo space program because it paid more than other projects. They did it because they were going to the moon!