

Salience

*A Better Way to Measure
& Manage Business Risk*

Chip Castle

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A Better Way to Measure and Manage Business Risk

Chip Castille

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Salience: A Better Way to Measure and Manage Business Risk

First edition.

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Published by Chip Castille.

Printed in the United States of America.

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Colophon. This book was typeset using L^AT_EX with the `kaobook` class, which implements a Tufte-inspired page layout with wide margins for sidenotes, figures, and annotations. Charts were produced with TikZ and pgfplots. Cover illustration is Standing Waves at a Japanese Beach by Cithlally Castille.

sa·li·ence *noun*

| *say-lee-uhns* |

The property by which some thing stands out.

For Bruce. I can link.

“It’s not mathematics, it’s not economics, it’s not even business administration.”

— Milton Friedman, attributed,
on Harry Markowitz’s 1952 doctoral dissertation,
Portfolio Selection

Preface

This is a book about managing risk in privately held companies. I came to this subject in conversation with a friend. His company had a 12 percent annual revenue growth target. Eight months into the forecast, they were running at minus 2 percent. My response was, “Well, nobody will be happy with that. But really, how bad is it?” The question made me realize I had no idea what statistical properties a sales forecast contained. In this particular instance, was minus 2 percent kind of bad, really bad, or never-seen-before-in-the-universe bad? Also, what consequences would emerge if one understood the statistical properties of a sales forecast? To answer this, we need a measure of uncertainty, or risk.

Since the 1970s, the formal measurement and management of risk using tools known as risk models has reshaped most of the financial services industry. As we will see in Chapter 2, very few areas of finance have been left untouched by risk models. Even after the Global Financial Crisis, when the limits of those models were clearly exposed, no serious proposal emerged to abandon them. They were corrected and kept.

Risk models became pervasive because modern investing evolved to rest almost universally on the idea of risk-adjusted return. We like return, and we do not like risk. Risk-adjusted return is a measure of efficiency that indicates the rate at which we can trade the pain of bearing risk for the reward of return. To get a measure of *prospective* risk-adjusted return, we ask investors to forecast return and we run risk models to forecast risk. Put together, we get a forecast of risk-adjusted return.

One area where risk models have not been widely used is in private equity. The reasons for this are mainly due to the lack of historical price data that public equity risk models rely upon. The implications of a practical risk model for private companies are vast. Consider that in the United States there are roughly 4,000 publicly traded companies with an estimated total value of about \$70 trillion at the time of this writing, and this wealth is largely managed using risk models. At the same time there are also more than 33 million private businesses with tens of trillions of dollars of value, plausibly equal to the publicly traded total, and very little formal risk management in place. The pieces of a suitable framework have existed for decades in adjacent disciplines; what has been missing is their assembly into a tool a private business can use.

In the pages that follow, I introduce a new way of thinking about business risk. Most risk models need a history of prices or returns to estimate uncertainty. Saliency uses common measures from a CRM system, a billing system, and a chart of accounts to estimate the sources and sizes of uncertainty in the operating activities of any business with a sales process. The opportunity for growth is significant. As we will see, proper risk management almost always increases the value of a business. At the level of an individual company, the value created by reducing earnings variance is often 10 to 20 percent of enterprise value, sometimes more. At the level of the U.S. private business sector as a whole, the aggregate potential is measured in trillions of dollars.

So what is a risk model? Simply put, it is a tool that tells you where sources of uncertainty reside. Here is a familiar example. The dashboard indicator in your car that shows the pressure of each tire is a risk model. When one of your tires is not at the right pressure, something unexpected is likely to happen, like a blowout. The tire pressure indicator is a simple risk model that quietly does its job whenever you are driving.

Like the tire pressure indicator, Saliency indicates where risk resides in the operations of a company: in the revenue activities, the variations in expenses, the valuation model, and the ability to service

debt. Salience goes further than a simple risk model because it also illustrates how risk originates, then propagates, and changes through a complex structure to eventually reside in some place. Risk that originates in revenue activities propagates through earnings, to operating cash flow and finally comes to reside in the ability to service debt. Salience shows how this happens at each stage, and because it measures risk at the sources, it can also be used to manage risk by changing the underlying business practices that create risk.

These same phenomena also occur in a portfolio of private businesses. Salience indicates how risk originates, concentrates, and propagates through a portfolio, allowing a portfolio manager to make more informed decisions.

Having said that, inertia is an underrated force in business, and the framework I describe here is built to acknowledge it. The book does not ask the reader to abandon what works. It simply asks the reader to add a small piece of new information to a decision they were already going to make, and to see what happens. If the new information is useful, the reader will add it again on the next decision, and the framework will become part of how they think without anyone having to declare a project to introduce it. If it is not useful, no time has been lost. The cost of trying is roughly an afternoon.

A word on the design of the book. The layout follows the wide-margin tradition associated with Edward Tufte, whose work on the visual display of information demonstrated that margins can be a second channel of communication. Throughout this book, the margins carry two kinds of annotation. The first is a key insight, set in a lightly shaded box, which distills the paragraph it accompanies into the sentence the reader would underline. The second is a case note, which offers a concrete example or illustration without interrupting the main argument. Neither type is essential to follow the text, and neither introduces material that is not developed in the body.

This paragraph may seem quaint in a few months, given the current pace of events, but I want to disclose that this book was written in collaboration with an AI: Anthropic's Claude. I mention this for two reasons. The first is transparency. Here's how the book came to be. The earlier referenced conversation with my friend unexpectedly provided the answer to a question I had been asking for close to two decades: "Why don't we run a business like we manage a portfolio?" We have powerful portfolio risk management tools, but don't apply these techniques to manage business risk. I was never satisfied with the answers I previously developed. The reward for my frustrations was a stack of writings and python scripts; each of which were attempts to apply ideas from portfolio management to the practice of managing business risk. The conversation with my friend around the revenue miss was the lightbulb moment when I realized estimating revenue variance was perhaps the right place to renew my efforts. I spent a few months thinking about the idea of revenue variance; how to formulate the problem and what consequences emerged from that formulation. I then provided these thoughts, my earlier materials, and a detailed outline to Claude with the goal of writing this book. We iterated. I spent time shaping Claude's writing voice to match what I wanted. I am sure there are a few glaring AI tropes still in here, but for the most part I am pleased with how the voice holds. The second reason for explaining AI's role in this process is that it was unusually productive and rewarding. Working with a well-coached AI is like having access to an extremely capable mind that is also a tireless typist. I am hopeful about what these types of collaboration hold for the future creation and dissemination of knowledge.

As of this writing, most of the analyses described in the book are available at castillelabs.net.

Lafayette, Louisiana
July 2026

Acknowledgments

I have worked in investment management for over thirty years. If you believe in mostly efficient markets as I do, that means I can only hope to have a few more allies than rivals. To those allies with the largest entries on my ledger, the size of my gratitude is a debt I can never hope to repay. For those who think that makes me a type of credit risk, please read on for suggestions on how to handle this: Bruce Goddard, Matt Scanlan, Matt O'Hara, Stephen Bozeman, Kevin Kneafsey, Blake Grossman, Partha Mamidipudi, Richard Grinold, Larry Davanzo, Steve Nesbitt, Rob Fairbairn, Rob Kapito, Rob Goldstein, and Charlie Hallac.

Reading this Book

Salience is a new approach to risk, and the book develops the ideas in full. Some readers will want that development; they won't trust a model they can't see derived. Most readers, though, are managers, owners, and investors in private companies who want a tool that solves a problem, not a derivation.

The book is built to serve both. In most chapters the technical work lives in an appendix, and the body stands on its own. Where a chapter needs its derivation in the main text, it opens with the result, so you can decide whether the steps that produce it are worth your time. Skim the heavy passages whenever they feel that way; the motivation, the intuition, and the use of each technique hold without them.

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THE PROBLEM AND ITS HISTORY

Two Companies, One Number

1.

In which two companies with identical earnings and identical growth rates command different prices and would service the same debt with different reliability, and the question of why turns out to have a precise, operational answer — one an investor will use again to finance the business, improve it, and decide what to hold it beside.

A private equity investor is looking at a company. Before she is finished with it, she will have to answer five questions. What it is worth. How much debt it can carry without putting the equity at risk. Which operational change buys the most value per dollar of effort. What acquisition, if any, to bolt onto it first. And whether it belongs in her fund beside the companies she already holds. In most firms these are five separate analyses, run by different people at different times with different tools. The five questions share a common origin, and in that sense they are the same question: how uncertain are this company's earnings, and where does that uncertainty originate?

Salience is a tool designed to answer those five questions. To do so requires tracing how the natural variability in a company's revenue-generating activities propagates through its financial structure, affecting earnings, enterprise value, and the ability to service debt. The framework depends on operational data rather than stock prices, which means it applies to any company with a sales process and a chart of accounts, whether public or private, large or small, early-stage or mature.

The story that follows in this chapter begins to answer the first question: what is a company worth. The chapter isolates that uncertainty in its simplest form. Two companies look identical on paper, with the same earnings and the same growth, yet command very different prices. The entire difference traces to a single measurable quality that decomposes into specific operational sources. Once that quality can be put on a number for one company and one question, we are in position to address the remaining questions, and the rest of the book follows it there.

1.1. The Same Earnings, a Different Price

An investor is evaluating two companies.¹ Both generate \$25 million in annual EBITDA. Both are growing at 12% per year. Both operate in the same industry, serve similar customers, and employ competent management teams. The financial statements, read side by side, look like photocopies.

1: The companies in this chapter are composites, constructed to isolate a single variable. Real companies differ in many dimensions simultaneously. The point here is that even when every other dimension is held constant, predictability alone produces a large valuation difference.

Four hundred contracts is a large enough base that the loss of any single customer is a rounding error. This is the structural source of Company A's predictability, and experienced investors recognize it immediately, even if they do not express it in statistical terms.

The investor offers 10x EBITDA for Company A and 7x for Company B. The difference is \$75 million in enterprise value, which arises from a single quality that does not appear on either income statement.

Company A is a commercial services business with 400 active contracts, each averaging about \$75,000 in annual revenue. The contracts renew annually, with a churn rate below 5%. Revenue arrives in a steady, distributed pattern across the year. The CFO can project next quarter's results within a few percentage points, and the board receives earnings guidance that rarely needs revision. The business has the quality that investors describe, somewhat vaguely, as "high-quality earnings."

Company B operates in the same industry but earns its revenue differently. Its contracts are fewer and larger, negotiated individually, with timing that clusters unpredictably around quarter-ends. A single large deal can shift quarterly revenue by 10% in either direction. The CFO's projections are competent estimates of an inherently uncertain process. The board receives guidance with wide ranges and occasional revisions, and has learned to treat the midpoint as a hope rather than a plan.

The investor knows all of this. The 10x and 7x multiples reflect a judgment that has been standard in private markets for decades: a more predictable earnings stream is worth more per dollar of earnings than a less predictable one. Every experienced deal professional understands this intuitively, and predictable businesses command premium valuations as a matter of course.

The judgment is sound, but one reason for this book is whether it can be made precise: whether the difference in predictability can be put on a number, traced back to the operational characteristics that produce it, and connected to the specific changes that would close the gap.

1.2. The Investor's Intuition

The experienced investor who assigns different multiples to these two companies is drawing on a form of pattern recognition that develops over years of evaluating deals. The pattern has several components, each of which the investor understands qualitatively.

The first component is customer concentration. Company A has 400 customers. The loss of its largest customer reduces revenue by less than 1%. Company B has 40 customers, and the loss of its largest reduces revenue by nearly 8%. The investor knows that higher concentration means more uncertainty in the revenue stream, even if the expected revenue is the same.

The second component is deal size. Company A's average contract is \$75,000, which means any given deal is a small fraction of the total.

Company B's average deal is ten times larger, which means each deal carries proportionally more weight in the annual outcome. The investor knows that larger, lumpier deals make revenue harder to predict.

The third component is timing. Company A's revenue arrives in a relatively even pattern across the year, driven by a renewal cycle that is distributed over twelve months. Company B's revenue clusters in ways that are difficult to forecast: a deal expected in Q2 slips to Q3, or a Q4 pipeline that looked strong softens in November. The investor knows that unpredictable timing makes quarterly and annual results harder to call.

Each of these components, customer concentration, deal size, and timing, contributes to the difference in predictability that the investor prices through the multiple. The investor's intuition about these factors is usually correct. What the investor lacks is a way to express that intuition as a single, comparable number, to decompose it into its constituent parts, and to trace a path from specific operational improvements to a quantified impact on valuation.

1.3. Giving the Intuition a Number

Salience provides a framework for converting the investor's qualitative assessment into a precise, decomposable measure. The measure is called the coefficient of variation, or CV, and it captures the degree of uncertainty in a business outcome as a single, scale-free number.²

The concept is straightforward. Every forecast has an expected value, the number the management team is targeting, and a range of plausible outcomes around that expectation. The CV is the width of that range expressed as a percentage of the target. A CV of 18% means the standard deviation is 18% of the expected value. In practical terms, this means roughly two-thirds of outcomes will fall within 18% of the target, and roughly 95% will fall within 36%.

Company A, the predictable services business, has an earnings CV of 18%. Company B, the lumpy transaction business, has an earnings CV of 35%. The investor's intuition that Company A has "higher-quality earnings" now has a number attached to it, and the difference between 18% and 35% is what the market prices at \$75 million.

The term "quality of earnings" is familiar to everyone who has participated in a due diligence process. High-quality earnings are predictable and durable. Low-quality earnings are lumpy and sensitive to timing. The CV is the number that this concept has always pointed to. It makes the qualitative judgment quantitative,

2: Scale-free means the CV does not depend on the units or magnitude of the quantity being measured. A \$10M company with a CV of 25% and a \$500M company with a CV of 25% face the same relative uncertainty. This is what makes comparison across a portfolio of different-sized companies possible.

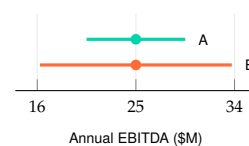


Exhibit 1.1.: Same \$25M expected EBITDA, different predictability. Company A (CV 18%) ranges \$20.5M–\$29.5M; Company B (CV 35%) ranges \$16.25M–\$33.75M, each covering two-thirds of outcomes.

Table 1.1.: Two companies with identical expected earnings and different predictability. In this controlled comparison, the entire valuation difference is attributable to the CV.

	Company A	Company B
Annual EBITDA	\$25M	\$25M
Expected growth	12%	12%
Earnings CV	18%	35%
EV/EBITDA multiple	10x	7x
Enterprise value	\$250M	\$175M
Quality premium	\$75M	

and in doing so it makes two further questions answerable: where the uncertainty comes from, and what can be done about it.

1.4. Where Predictability Comes From

Company B's 35% earnings CV is the accumulated result of several distinct sources of uncertainty, each associated with a specific aspect of the business and a specific set of operational decisions. Salience decomposes the total into its components and ranks them by contribution.

The largest single source, accounting for roughly a quarter of Company B's total valuation uncertainty, is churn: the uncertainty in how many existing customers will renew. The second largest is the uncertainty in how many new deals will close, which accounts for another fifth. Together, these two sources represent nearly half of the predictability gap, and both are addressable through specific operational programs: customer success and renewal management for churn, pipeline generation and sales process discipline for new logos.

The remaining uncertainty comes from deal size variability, expansion rate fluctuations, expense ratio changes, hiring timing, and the inherent uncertainty in valuation multiples. Each source has a corresponding operational lever. Salience identifies which levers move the most uncertainty per dollar of effort; the choice of which to pull belongs to the operator.

If Company B's management reduces its earnings CV from 35% to 18%, through better churn management, more predictable deal sizes, and tighter expense controls, the company's multiple might increase from 7x to 10x. On \$25 million of EBITDA, that is \$75 million in enterprise value created through improved predictability, with no change in expected earnings or growth rate. This gives the operating improvement program a concrete, measurable objective that complements the traditional mandate of growing EBITDA.

Each component of the decomposition corresponds to an observable feature of the revenue or expense process: the number of deals, the size of each deal, the timing of renewals, the variability of cost ratios. These are quantities that sales leaders, CFOs, and operating partners already track and already have intuitions about.

The quality premium. If Company B reduces its CV from 35% to 18%, its multiple might increase from 7x to 10x: \$75M in enterprise value created with no change in expected earnings. In this example, each percentage point of CV reduction is worth approximately \$4.4M.

1.5. Two Questions, One Source

The valuation premium for predictability is one consequence of operating uncertainty. There is a second consequence, equally important for businesses that carry debt, that runs through a parallel path: a more predictable business services its debt more reliably.

Suppose both Company A and Company B have taken on debt requiring \$15 million of annual debt service against their \$25 million of expected EBITDA. On paper the two companies look identical here as well. The expected ratio of cash flow to debt service is the same, and a covenant set at 1.25x coverage looks comfortable for either.

In any given year, however, the cash flow each company actually generates is a draw from a distribution whose width is set by its operating CV. Company A's narrower distribution puts about a 3% chance of falling below the \$15 million debt service threshold. Company B's wider distribution indicates a 22% chance of failing to meet the threshold.³ One company expects to fall short on debt service roughly once a generation; the other expects it about once every five years.

	Company A	Company B
Expected EBITDA	\$25M	\$25M
Annual debt service	\$15M	\$15M
Earnings CV	18%	35%
Probability of cash shortfall	3%	22%

The reliability gap has a consequence beyond the safety of the existing debt. If the shortfall risk that Company B carries at \$15 million of debt service is the most either owner is willing to tolerate, then Company A, with its narrower distribution, can support a materially larger debt load before reaching that same threshold. That additional borrowing capacity, deployed against a fixed enterprise value, reduces the equity required to own the business and raises the return on the equity that remains. This is a separate consideration from the valuation premium: predictability raises what the business is worth and also raises how much of that worth can be financed with debt, and the added leverage, at the same level of risk, delivers a higher return to equity.

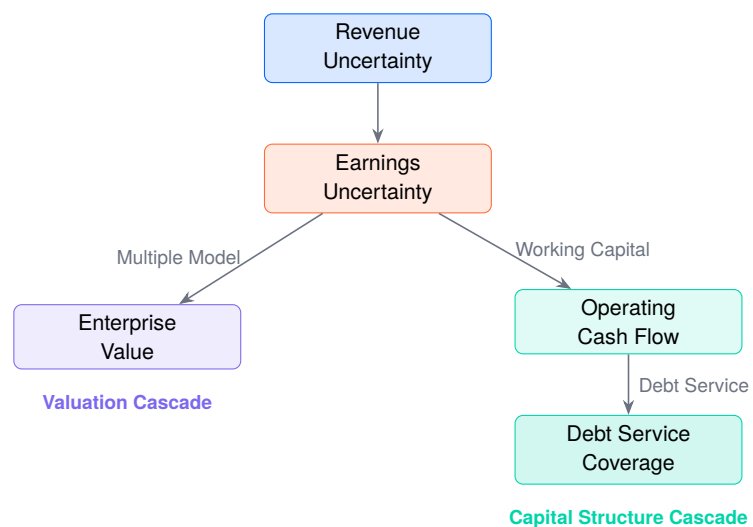
The same operational sources, churn, deal count, deal size, expense ratios, that produced the valuation gap are what produce the reliability gap. A reduction in Company B's churn rate narrows its earnings distribution, which simultaneously expands its multiple and reduces its shortfall probability. The decomposition that ranks operational levers by their valuation impact ranks them, in a closely related order, by their credit impact.

3: The shortfall probabilities reflect cash flow uncertainty after the working-capital cycle, which widens the earnings distributions shown here; computed on the earnings CVs alone, the probabilities would be roughly 1% and 13%. The connection to valuation is direct: both consequences flow from the same operational source.

Table 1.2.: Two companies with identical expected EBITDA and identical debt service, carrying that debt with very different reliability. The reliability gap is produced by the same CV that produces the valuation gap.

This pattern, uncertainty originating in revenue and propagating downward through the layers of a business along parallel paths, is what Saliency calls a *cascade*. Revenue uncertainty cascades into earnings uncertainty through the expense structure. Earnings uncertainty cascades along one path into valuation uncertainty through the multiple, and along a second path into operating cash flow uncertainty through the working capital cycle, and from there into the ability to service debt. Exhibit 1.2 shows the structure. The two paths share a common root in revenue and earnings, which is why one set of operational improvements moves both consequences at once. This Saliency cascade, flowing from a single operational source through two parallel paths, is the central organizing structure of the framework and the subject of the remainder of the book.

Exhibit 1.2.: The Saliency Cascade. Uncertainty originates in revenue and propagates through two parallel paths: one to enterprise value (the valuation cascade) and one to debt serviceability (the capital structure cascade).



1.6. What Follows

The remainder of this book develops the Saliency framework in detail, and it is built for two readers. The first is the owner or manager running a single company, who wants to see where that company's uncertainty originates and what reduces it. The second is the investor holding a portfolio of companies, who wants that same per-company view — the owner's view, held one step removed for each company in the portfolio, and who also wants something the owner never needs: a reading of how the companies move together. The per-company framework serves both readers; the portfolio layer is built on top of it and serves the second.

Part II introduces the Saliency Cascade as a structural concept and traces a single company through both paths. Part III develops the valuation cascade tier by tier: revenue variance, earnings variance, and valuation variance. Part IV develops the capital structure cascade: operating cash flow, debt covenants, and the probability of breach. These three parts are the per-company core.

The book is designed so that each part builds on what came before, with technical detail deferred to appendices at the end of each chapter. A reader who skips the appendices will miss the derivations but none of the concepts.

Part V carries the framework from the single company to the portfolio. It begins with the capital-efficiency synthesis of Chapter 12, which is still a per-company chapter: it draws the valuation and capital-structure cascades into a single risk-adjusted number for one company. The portfolio view proper begins one chapter later, at Chapter 13, where the question shifts from a single company to the covariance across many, and it continues through the portfolio analyses, acquisition analysis, and the ongoing management cycle of tracking, attribution, and reporting. Part VI takes up the roles the framework is built to serve, and it closes the book.

Salience asks managers to express their judgment in a form that can be measured, propagated through the mechanics of a business, and improved through specific operational actions. The investor pricing different multiples on the same earnings and the lender pricing different covenant headroom on the same debt service are exercising the same underlying judgment about operating predictability — and so is the same investor when she later decides how much to borrow against the business, which improvement to fund first, what to bolt onto it, and whether it belongs beside the companies she already holds. The five questions that opened this chapter are forms of a single one, which the remainder of the book develops into a measurement and traces to each of the decisions it informs.

A Brief History of Risk-Adjusted Thinking

2.

In which several industries discover, one after another, that measuring uncertainty changes everything, and none of them go back.

The framework described in this book belongs to a sequence of developments, stretching back roughly seventy years, in which one domain after another discovered that formal tools for measuring uncertainty produced durable competitive advantages for those who adopted them. The pattern is consistent enough to be worth examining before we develop our framework, because the pattern tells us something about what is likely to happen when similar tools are introduced in a new domain.

2.1. Public Equities: From Stock Picking to Risk Budgeting

In the early 1950s, a doctoral student at the University of Chicago named Harry Markowitz proposed an idea that most professional investors at the time would have found self-evident in principle and useless in practice.¹ The idea was that investors should care about the variance of their portfolio's return, not just its mean, or expected value. Two portfolios with the same expected return are not equivalent if one has a wider range of plausible outcomes than the other. The investor who ignores this distinction is making an implicit bet that volatility does not matter, which is a bet that a single bad quarter tends to expose.

The insight was formally correct and practically impossible to implement. Calculating portfolio variance requires knowing the correlation structure of stock returns. How do stock prices tend to move together? To optimize the variance for a portfolio of even a few hundred stocks, you needed to estimate thousands of pairwise return correlations, a computational task that exceeded the capacity of the machines available at the time and the patience of the people who would have had to collect the data. For nearly two decades, mean-variance optimization remained an academic idea with a small and devoted following and no commercial application.

The transition from theory to practice began in the 1970s, when Barr Rosenberg and a small group of researchers at the University of California, Berkeley, recognized that the correlation structure of equity returns could be described compactly using a small number of common factors. A stock's return could be decomposed into a component explained by its exposure to these factors and a residual component specific to the company. The covariance matrix of a thousand stocks, which in its raw form contained half a million

1: Markowitz's 1952 paper, "Portfolio Selection," appeared in *The Journal of Finance*.

The factors Rosenberg identified, market exposure, size, value, momentum, and industry membership, are now so deeply embedded in investment practice that it is difficult to remember they were once novel. The company he founded, BARRA, was acquired by MSCI in 2004 for \$816 million.

distinct entries, could be approximated by a much smaller matrix of factor covariances and a diagonal matrix of specific variances. This made mean-variance analysis tractable.

The commercial implications were substantial. MSCI, through its Barra subsidiary, reported total revenue of \$2.9 billion in 2024, of which its Analytics segment contributed approximately \$675 million. Bloomberg's PORT risk analytics are embedded in terminals used by virtually every institutional investor. BlackRock's Aladdin platform, the most prominent example of the category, monitors approximately \$21 trillion in assets and generated \$1.6 billion in technology services revenue in 2024.²

2: The \$21 trillion figure encompasses BlackRock's own \$10 trillion under management plus the assets of hundreds of institutional clients who license Aladdin as their risk and portfolio management infrastructure.

The tools added a layer of discipline that made portfolios more intentional in their risk exposures, leaving fundamental analysis intact. Managers who resisted adoption were operating without information their competitors had.

The adoption curve followed a recognizable shape. The first commercial factor models appeared around 1975. By 1985, quantitative managers and large institutional investors had adopted them. By 1995, risk budgeting, tracking error management, and factor-aware portfolio construction were standard practice at the largest firms. By 2005, they were effectively universal among institutional asset managers. The entire transition took roughly one generation.

The mechanism of adoption was competitive pressure. Managers who used risk tools could offer clients portfolios with better risk-adjusted returns, not because they were better stock pickers, but because they avoided unintended risk concentrations, managed exposure to systematic factors, and allocated their active risk budget more efficiently. Over time, clients and consultants began requiring risk analytics as a condition of mandate awards, and the tools became a standard requirement of institutional practice.

The tools told managers how much risk they were taking and where it was concentrated, and left the stock-picking where it had always been. A portfolio manager who believed strongly in a particular sector bet could still make that bet, but now with full knowledge of the risk it contributed and the conditions under which it would underperform. The tools made the bet visible and measurable.

2.2. Credit and Lending: From Relationship Banking to Structured Analysis

For most of the twentieth century, commercial lending was a relationship business. A banker evaluated a borrower based on personal knowledge of the company, the character of the management team, and the bank's accumulated experience with similar credits. Loan pricing reflected the banker's judgment, institutional guidelines, and the competitive dynamics of the local lending market. The process worked tolerably well in stable environments where the banker's experience was a reliable guide to future outcomes.

The limitations became apparent as lending markets, in response to deregulation, grew in complexity and scale. A banker who knew a particular industry and a particular geography could make sound individual credit decisions. Aggregating those decisions into a portfolio-level view of risk, understanding how defaults might be correlated across industries or geographies or economic cycles, was beyond the reach of individual judgment. The portfolio of loans was, in effect, constructed without any systematic understanding of its aggregate risk properties, which is roughly analogous to constructing an equity portfolio without knowing the correlations between its holdings.

Beginning in the 1990s, credit risk models introduced quantitative frameworks for estimating default probability, loss given default, and expected loss across loan portfolios. These models drew on the same statistical foundations as equity risk models and applied them to the specific dynamics of credit: the asymmetric payoff structure (limited upside through coupon payments, significant downside through default losses), the role of collateral and recovery, and the correlation of defaults across borrowers exposed to common economic factors.³

The adoption trajectory was accelerated by regulatory intervention. The Basel Committee on Banking Supervision, recognizing the value of systematic risk measurement, incorporated model-based approaches into capital adequacy requirements. Basel II, finalized in 2004, allowed banks to use internal ratings-based approaches to compute their regulatory capital, which meant that banks with better risk models could hold less capital against the same loan portfolio. The incentive to adopt went from competitive stakes to structural: better models reduced the cost of doing business.

Within fifteen years, credit risk models moved from optional analytical tools to regulatory requirements. The transformation involved real failures along the way; the 2008 financial crisis exposed severe limitations in the way credit models handled correlated defaults and tail risks. The industry responded by improving the models, and its relationship with quantitative credit risk assessment, once tentative, became permanent.

The relevant insight for our purposes lies in the underlying mechanism rather than the regulatory dimension. A banker who believed that a particular borrower was lower risk than the model suggested could still make that loan. The model provided a baseline for the conversation, a structured starting point against which the banker's private information could be measured. This is the same relationship that the Saliency framework seeks to establish with operating managers and investors: a measurable baseline against which judgment can be expressed.

3: The asymmetry of credit payoffs is one reason credit risk required its own modeling tradition rather than simply inheriting the equity framework. An equity investor's upside is theoretically unlimited. A lender's upside is the coupon. The shapes of the relevant distributions are fundamentally different.

Credit risk models gave the banker's judgment a structured form: a way to express it, propagate it through a portfolio, and compare it across credits. The models supplied a common language for the judgment that experience had always carried.

2.3. Insurance: Frequency and Severity

The insurance industry offers perhaps the most direct conceptual parallel to the framework described in this book, because it arrived at the same decomposition centuries earlier in a completely different context.

Modern actuarial science rests on the observation that the total loss from a book of insurance policies depends on claim frequency and claim severity: how many claims occur, and how large each one is. The distinction between them is the foundation of every pricing model, every reserve calculation, and every reinsurance treaty in the global insurance market.

This frequency-severity decomposition is the intellectual ancestor of the framework described in this book. An insurer evaluating a book of property policies asks two questions: how many claims will occur this year, and how large will each claim be? A company evaluating its revenue forecast asks equivalent questions: how many deals will close this year, and how large will each deal be? The analytical structure is the same. The insurer has two centuries of actuarial science to draw on; the company has generally had spreadsheets and judgment, which is the gap Salience addresses.

An insurer asks: how many claims, and how large? A sales organization asks: how many deals, and how large? The analytical structure is the same. The insurance industry formalized it centuries ago. Salience applies the same formalization to revenue processes.

The insurance industry's adoption of formal frequency-severity models transformed a business that had been priced largely through experience rating and accumulated judgment into one governed by quantitative risk analysis. The transformation did not eliminate the role of underwriting judgment. Experienced underwriters still evaluate individual risks based on factors that models cannot fully capture: the quality of a building's fire suppression system, the reputation of a ship's captain, the maintenance history of a fleet of trucks. The models provide the framework within which that judgment operates, and they enable something that judgment alone cannot: the aggregation of thousands of individual risk assessments into a portfolio-level view of total exposure. This aggregation is what makes it possible to price reinsurance, to allocate capital across lines of business, and to set reserves that reflect the actual distribution of potential losses rather than a conservative guess.

The parallel to business revenue is precise. A sales leader evaluating a pipeline of opportunities is performing an exercise structurally identical to an underwriter evaluating a book of risks. Both are estimating the total outcome from a collection of individual events with uncertain timing and uncertain magnitude.

2.4. Options and Derivatives: Pricing What Could Not Be Priced

The derivatives market provides a fourth example, and in some respects the most instructive, because the introduction of a formal risk framework created an entirely new market where one had barely existed.

Before the early 1970s, options on common stocks were traded in thin, informal markets.⁴ The fundamental problem was pricing. No one had a reliable, widely accepted method for determining what an option was worth. Sellers charged what the market would bear, discounted by their willingness to assume directional risk. Buyers relied on intuition about likely price movements and their assessment of the seller's sophistication. The market was small because the absence of a pricing framework meant that neither side could confidently assess whether a given price was fair, which is a condition that tends to suppress trading volume.

In 1973, Fischer Black and Myron Scholes published the formula that came to bear their names and changed this. The Black-Scholes formula established a closed-form relationship between five observable or estimable inputs — the current stock price, the strike price, the time to expiration, the risk-free interest rate, and the volatility of the underlying asset — and the fair value of the option. Of these five inputs, four were either known or easily determined. The fifth, volatility, was the one that required judgment, and it became the language of the entire market. For the first time, participants had a common, computable way to express their views about uncertainty and translate those views into prices.

The impact was extraordinary in both speed and scale. Within a decade, the options market grew from a niche activity to a central feature of global financial markets. The notional value of listed options and over-the-counter derivatives expanded from negligible amounts to trillions of dollars. An entirely new industry of market-making, risk management, and structured products emerged, all of it resting on the shared analytical foundation that the pricing framework provided.

The framework did not eliminate disagreement about fair value. Market participants continued to differ in their estimates of volatility, and these differences became the basis for active trading. A trader who believed that realized volatility over the next month would be 25% and observed an implied volatility of 20% in the options market had a structured, quantitative basis for a trade. Before the framework, the same trader would have had an intuition about the same opportunity, with no reliable way to express it as a price or size it in proportion to the confidence of the view.

The relationship that Black and Scholes formalized, between the volatility of an asset and the value of claims on that asset, has a direct

4: The Put and Call Brokers and Dealers Association facilitated over-the-counter options trading in New York, with contracts negotiated individually between counterparties. Volume was modest, spreads were wide, and participation was limited to a small community of specialists.

The CBOE opened for trading on April 26, 1973, the same year the Black-Scholes paper appeared. Scholes and Robert Merton received the Nobel Prize for this work in 1997.

The options framework established a formal relationship between volatility and value. Salience establishes an analogous relationship: higher operating uncertainty, lower business value, through a mechanism that can be measured and managed.

analogue in the relationship between the operating uncertainty of a business and the value that investors assign to it. An option on a volatile stock is worth more than an option on a stable one, all else equal, because the range of outcomes is wider. A business with volatile earnings is worth less than one with stable earnings, all else equal, because the range of outcomes creates risk that investors discount. In both cases, volatility is the variable that determines how uncertainty translates into value. The options market gave that variable a precise definition and a pricing mechanism, and Salience extends the same relationship to operating businesses.

2.5. The Common Pattern

These four histories, spanning public equities, credit, insurance, and derivatives, share a structure that is worth making explicit, because the same structure applies to the domain this book addresses.

In each case, the transition followed a consistent sequence. A quantitative framework emerged that could express uncertainty in terms of a small number of estimable parameters. In public equities, this was factor-based covariance estimation. In credit, it was probability-of-default modeling. In insurance, it was frequency-severity decomposition. In derivatives, it was the relationship between five inputs and option fair value. In each case, the number of parameters was small enough to be practical, the parameters themselves were estimable from available data, and the framework was expressive enough to capture the distinctions that practitioners already made intuitively.

Early adopters gained a structural advantage. They did not necessarily have better judgment than their peers; they could express that judgment more precisely and propagate it through complex structures, identifying concentrations that were invisible to unaided intuition. A portfolio manager with a factor model could see that her portfolio had an unintended bet on small-cap value stocks; a credit officer with a default model could see that his loan book was concentrated in borrowers whose defaults were correlated through a common exposure to commercial real estate. The tools made risks visible that had been present all along.

The tools became standard practice through a combination of competitive pressure, client demand, and in some cases regulatory mandate. The specific mechanism varied by domain. Public equity consultants and clients drove adoption by requiring risk analytics as a condition of mandate awards; credit regulators codified the tools into capital requirements; reinsurance markets demanded actuarially priced treaties; and in derivatives, the existence of a pricing framework created a market that had not previously existed. The mechanisms differed across domains, and the outcome was the same in each.

The anxiety that quantitative tools will replace human expertise is a recurring feature of every adoption cycle, and the historical pattern has been otherwise. The best portfolio managers, credit officers, underwriters, and derivatives traders continued to rely on experience, pattern recognition, and qualitative assessment. The tools gave them a way to make that experience auditable and improvable. A judgment that was previously private and untestable became a measurable deviation from a model, which could be evaluated on its merits and tracked over time.

2.6. The Ratchet Effect

Perhaps the most important feature of risk-adjusted approaches, across every domain in which they have been adopted, is that adoption is irreversible. No major asset management firm has voluntarily returned to purely judgment-based portfolio construction after implementing factor-based risk management, and no major bank has abandoned credit risk models in favor of purely relationship-based lending. The same holds for insurers and the actuarial models that replaced experience-based pricing, and for derivatives markets, which have not reverted to the pre-framework era of bilateral negotiation.

The tools are imperfect⁵ in ways that have been extensively documented, debated, and in many cases exploited; adoption is irreversible for a simpler reason: once practitioners can see the risk architecture of their decisions, choosing not to see it is a competitive disadvantage they cannot justify to their clients, their boards, their regulators, or themselves. The information, once available, cannot be deliberately ignored without accepting that competitors who use it will, on average and over time, make better-informed decisions.

5: The 2008 financial crisis demonstrated the consequences of over-reliance on models that underestimated tail risks and correlations. The response was to improve the models, not to abandon them. The models were wrong in specific and identifiable ways. The alternative, having no models at all, was not seriously proposed as a remedy.

This is the ratchet effect. Each domain that has adopted risk-adjusted tools has found that the adoption creates a new floor below which practice does not return. The floor rises as the tools improve, as the data becomes richer, and as the practitioners who grew up with the tools advance into positions of authority. The generation that regarded factor models as exotic academic tools has largely retired, and the one that regards them as ordinary infrastructure now runs most institutional investment organizations.

2.7. Where Salience Fits

The framework described in this book applies the same analytical structure to a domain where it has not previously been available: the operational activities of businesses, both public and private.

The risk analytics industry generates revenues well in excess of \$5 billion annually, aggregating MSCI's Analytics segment, BlackRock's technology services, Bloomberg's risk tools, and smaller vendors including Axion, Northfield, and FactSet.

The existing risk model industry, represented by firms such as MSCI, Bloomberg, and BlackRock, has built a substantial business estimating the covariance structure of publicly traded asset returns. The analytical foundation is sound, and the commercial success is well-established. The tools serve approximately 4,000 publicly listed companies in the United States, out of more than 33 million registered businesses.

The gap reflects a structural limit on the existing tools rather than a failure of them: risk models that depend on traded market prices cannot serve entities that do not have traded market prices. The resolution requires a different starting point: estimating uncertainty from the operational activities that produce revenue, earnings, and cash flow.

This is the starting point for the Salience framework, and it is why the historical parallels in this chapter are relevant. The framework extends the concept of formal uncertainty measurement into a domain where it has been absent: the operating activities of any company that generates revenue through discrete economic events. The tools for this extension already exist in the mathematical traditions described in this chapter. The frequency-severity decomposition of insurance, the factor-based covariance structures of equity risk models, the portfolio mean-variance analysis of Markowitz, and the volatility-centric pricing of derivatives all contribute concepts, methods, or both to the framework that follows.

Three other traditions sit close to the framework, and each supplies a piece the framework builds on.

[1]: RiskMetrics Group (1999), *CorporateMetrics Technical Document*

[2]: Stein et al. (2001), *A Comparables Approach to Measuring Cashflow-at-Risk for Non-Financial Firms*

The first is corporate risk management. J.P. Morgan's CorporateMetrics technical document[1] defined earnings-at-risk and cash-flow-at-risk for nonfinancial companies in 1999, and Stein and his coauthors built a comparables-based cash-flow-at-risk measure shortly after[2]. Both estimate the dispersion of an operating outcome, and both work from the outside in: market factors or the histories of comparable companies supply the variance, which is then imposed on the company being analyzed. The cascade works from the inside out, deriving the variance from the company's own deal counts, deal sizes, and churn.

[3]: Hertz (1964), *Risk Analysis in Capital Investment*

[4]: Savage (2009), *The Flaw of Averages: Why We Underestimate Risk in the Face of Uncertainty*

[5]: Hubbard (2014), *How to Measure Anything: Finding the Value of Intangibles in Business*

The second is decision analysis. David Hertz put Monte Carlo simulation on capital-investment decisions in the Harvard Business Review in 1964[3], and the practice matured through spreadsheet simulation add-ins into modern planning tools that carry probability distributions natively. Sam Savage's flaw-of-averages critique[4] and Douglas Hubbard's measurement writing[5] brought the same argument to general management audiences. These tools propagate whatever distributions the analyst supplies, and the analyst still has to invent the inputs. Salience closes that gap by deriving the input distributions from the structure of the revenue process itself.

The third, is the stochastic customer-base tradition in marketing science. Andrew Ehrenberg fit a negative binomial distribution to consumer purchase counts in 1959[6]; Schmittlein, Morrison, and Colombo, and later Fader and Hardie, built the modern count-and-spend models of customer behavior on that foundation[7, 8]; and McCarthy and Fader assembled those models into customer-based corporate valuation, which produces firm valuations, with intervals, from the dynamics of customer acquisition and retention[9]. This is bottom-up stochastic revenue modeling in earnest, and any claim of novelty has to be made carefully around it. The difference is scope at both ends of the pipeline: the customer-base models describe contractual and repeat-purchase relationships, where the count-size structure of Chapter 5 covers any revenue process built from discrete economic events, and their output is a valuation, where the cascade carries variance onward through earnings, operating cash flow, covenant headroom, and portfolio covariance.

[6]: Ehrenberg (1959), *The Pattern of Consumer Purchases*

[7]: Schmittlein et al. (1987), *Counting Your Customers: Who Are They and What Will They Do Next?*

[8]: Fader et al. (2005), "Counting Your Customers" the Easy Way: An Alternative to the Pareto/NBD Model

[9]: McCarthy et al. (2018), *Customer-Based Corporate Valuation for Publicly Traded Noncontractual Firms*

What Is New Here

The mathematics in this book—compound Poisson processes, variance propagation, mean-variance optimization—are established, some for decades. The compound Poisson model has been standard in insurance since the 1960s. Portfolio mean-variance analysis dates to Markowitz in 1952. Variance decomposition is a staple of statistical analysis.

What is new is their integration into a single framework that traces uncertainty from its operational origin through earnings, valuation, and capital structure. Insurance models the frequency and severity of claims and stops short of enterprise value; portfolio theory optimizes across assets without explaining where each asset's variance comes from; credit models estimate default probability without connecting it to the operating decisions that drive cash flow volatility.

The contribution is the through-line: a continuous analytical path from the parameters a sales manager controls (deal count, deal size, churn rate) to the outcomes an investor prices (earnings quality, valuation multiple, covenant headroom, portfolio risk). No existing discipline spans this full path. The nearest neighbors — customer-based corporate valuation, cash-flow-at-risk, and simulation-based planning — each cover a segment of it, as the preceding paragraphs locate. The framework builds the full path by connecting disciplines that have, until now, operated in isolation.

The historical record suggests that once these tools become available and a critical mass of practitioners adopt them, the adoption will follow the pattern observed in every prior domain: early movers gain a structural advantage, competitive pressure broadens adoption, and practice settles at a new floor below which it does not return. The chapters that follow describe the framework itself,

beginning with the concepts and measures that make it work, and proceeding through the specific mechanics of how uncertainty originates in revenue, propagates through earnings and valuation, and flows through capital structure into the questions that investors, lenders, and operating managers confront every day.

What Is Risk, and Why Does It Matter?

3.

In which we define the terms that the rest of the book depends on, starting from the simplest and proceeding to the most useful.

The previous two chapters established a problem and a historical context. The problem is that operating uncertainty affects both the value and the creditworthiness of a business, and the tools for measuring it have not been available to the people who manage it both within a company and within a portfolio of companies. The historical context is that every domain that has gained such tools has adopted them permanently. This chapter provides the conceptual vocabulary that makes the framework possible.

3.1. Return

The concept of return is familiar enough that it might seem unnecessary to define. A business earns revenue, pays expenses, and produces a profit. An investment is purchased at one price and sold at another. Return is the change in value over a period, expressed as a fraction of the starting value.

The reason to state this explicitly is that Saliency applies the concept of return at several levels of a business simultaneously. Revenue has a return: the growth in sales over the forecast period. Earnings have a return: the growth in profit after accounting for expense structure. Enterprise value has a return: the change in what the business is worth to an investor. Capital structure has a return: the equity return after accounting for the amplifying effect of debt.

Each of these returns is a meaningful quantity for a different audience: revenue return is what the sales leader manages, earnings return is what the CFO reports, and equity return is what the investor pursues. Saliency connects them through a single propagation framework, showing how uncertainty at the revenue level flows through to each subsequent level.

Each of these returns is a different slice of the same underlying economic activity. Revenue return is the broadest. Earnings return filters it through the cost structure. Equity return amplifies it through the capital structure. Saliency traces the connections between them.

3.2. Risk

Risk, for the purposes of this book, is the uncertainty in a return: the range of plausible outcomes around an expectation, the width of the distribution of possible results.

A company targeting 15% revenue growth faces risk because the actual outcome could plausibly be 8% or 22% or anywhere in between, whatever the merits of the target itself.¹ A company

1: This is the sense in which Markowitz used the term in 1952. Risk is variance, not loss. The connection to loss is the subject of Part IV.

with \$25 million in expected EBITDA faces risk because the actual number might be \$20 million or \$30 million, and the consequences of those two outcomes are very different for a business that must service \$18 million in annual debt.

Risk, then, is the spread. A narrow spread means the outcome is likely to be close to the expectation, and a wide spread means it could land far from it. The most commonly found measure of spread is the standard deviation; the average amount of spread around the expected outcome. Yet there are other measures that are more useful in particular situations. One of these, the coefficient of variation (CV), is what we use in Salience for reasons defined shortly. Regardless, the spread is what makes allocation difficult: an investor comparing two opportunities with the same expected return cannot treat them as equivalent, because the one with the wider spread carries a higher chance of landing far below its expectation, including the chance of a loss.² The question that follows immediately is how to measure the spread in a way that is useful and comparable across companies.

2: This is the insight Markowitz formalized and the risk model industry operationalized, covered in Chapter 2. Expected return orders opportunities only when their risks are equal, which they rarely are.

3.3. From One Company to a Portfolio

The spread of a single company is one part of the picture. Anyone who holds more than one business faces a combined spread that is not the sum of the individual ones. A private equity fund holds a dozen companies; a lender holds a book of loans; and in each case the risk that matters for the decision is the risk of the collection taken as a whole.

The combined risk depends on how the individual outcomes move together. Two companies that each carry equal earnings risk combine into a portfolio whose risk is less than that of each company when their outcomes are imperfectly correlated, because a shortfall in one is often offset by an ordinary or strong result in the other. The benefit shrinks as the correlation rises, and it disappears entirely when the two move in lockstep. The quantity that governs the combination is covariance, the degree to which two outcomes vary together, and it is as central to portfolio risk as the standard deviation, is to a single position.

The risk model industry estimates covariance from co-moving prices, which requires a market history and exists only for companies whose shares trade. Yet, two private companies that sell into the same customer base, or that depend on the same input costs, have revenue that moves together at the source, well before any price exists to record the co-movement. Salience reads correlation the same way it reads single-company risk, from the operational drivers the businesses share, which means the operational view that gives a single company's risk its decomposition extends without modification to the portfolio.

The consequence is that the decomposition which ranks operational sources within one company also identifies which sources are shared across companies, and therefore where portfolio risk concentrates and which operational changes reduce it. A fund that recognizes its companies share exposure to a single demand cycle can see the diversification it does not have, and can weigh the cost of acquiring it. Part V develops the measurement and management of portfolio risk in full, built on the same operational data that serves the single company.

3.4. Measuring Risk: A Layperson's Guide

The most natural way to describe the range of outcomes is to say how spread out they are. A sales team targeting \$20 million in new business might realistically achieve anywhere from \$14 million to \$26 million. Another team, also targeting \$20 million, might realistically achieve between \$18 million and \$22 million. Both have the same target. The first team faces more uncertainty than the second. Measuring risk means putting a number on the difference.

The standard measure is the standard deviation, which is a single number that captures how far outcomes tend to fall from the expected value. The first sales team, with a range of \$14 million to \$26 million, has a standard deviation of roughly \$3 million. The second team, with a range of \$18 million to \$22 million, has a standard deviation of roughly \$1 million. The standard deviation tells you the typical distance between the actual outcome and the target.

For a single company or a single forecast, the standard deviation is a perfectly adequate measure of risk. The difficulty arises when you need to compare risks across different companies, different tiers of the financial structure, or different time periods. A standard deviation of \$3 million means something very different for a \$20 million target than for a \$200 million target. The first represents a 15% dispersion. The second represents a 1.5% dispersion. The dollar figure is the same, but the relative uncertainty is an order of magnitude apart.

This is why Salience uses the coefficient of variation, or CV, as its primary measure of risk. The CV is the standard deviation expressed as a fraction of the expected value:

The coefficient of variation is the standard deviation divided by the expected value. A company with \$20 million in expected revenue and \$3 million in standard deviation has a CV of 15%. A company with \$200 million in expected revenue and \$30 million in standard deviation also has a CV of 15%. Despite

Standard deviation has a useful intuitive interpretation for distributions that are roughly bell-shaped: approximately two-thirds of outcomes fall within one standard deviation of the expected value, and approximately 95% fall within two standard deviations. This rule of thumb is accurate enough for most business applications, and precise enough for many, but not all, confidence intervals used throughout this book. Chapter 8 provides the details.

The CV in one sentence. A CV of 25% means the standard deviation is 25% of the target, which translates to roughly a one-in-three chance that the actual outcome differs from the target by more than 25%.

the tenfold difference in absolute dollars, both face the same relative uncertainty. This scale-free property is what makes the CV useful as a common measure across companies of different sizes, across tiers of the cascade, and across portfolios of diverse businesses.

The CV has three properties that make it the right measure for the Salience framework.

The first is scale independence. Because the CV normalizes by the expected value, it can be compared directly across companies of different sizes. A \$10 million company with a 20% CV and a \$500 million company with a 20% CV face the same relative uncertainty, which means they can be placed in the same portfolio analysis, compared on the same chart, and evaluated by the same criteria.

The second is clean propagation. When financial quantities interact through multiplication, as they frequently do (revenue times margin yields earnings, earnings times multiple yields valuation), the squared CVs of the components add to produce the squared CV of the result.³ This means that uncertainty accumulates in an intuitive, tractable way as it moves through the cascade. The squared CV of a valuation is approximately the sum of the squared CVs of its components: revenue uncertainty, margin uncertainty, and multiple uncertainty. This decomposition makes it possible to determine which component contributes the most to total uncertainty.

The third is interpretability. A CV of 25% means the standard deviation is 25% of the expected value. For a roughly bell-shaped distribution, this translates to a practical rule: approximately two-thirds of outcomes will fall within 25% of the target, and approximately 95% will fall within 50%. A sales leader can understand this immediately. A board member can interpret it without statistical training. The CV converts the abstract concept of uncertainty into a concrete statement about the range of outcomes, expressed in terms that the audience already thinks in: percentage of the target.

Throughout the rest of this book, we sometimes use the term “goal risk” to refer to the CV of a forecast. Revenue goal risk is the CV of revenue. Earnings goal risk is the CV of earnings. Valuation goal risk is the CV of enterprise value. The term is useful because it connects the statistical concept to the operational reality that every business goal carries a risk of not being achieved, and with Salience, that risk has a measurable size.

3: This additive property of squared CVs is the mathematical basis for the cascade. It means that uncertainty accumulates in a tractable, decomposable manner as it propagates through the tiers. The full derivation is in the technical appendices of Chapters 5 and 6.

A natural objection: the CV treats a 20% upside surprise and a 20% downside miss as equally “risky.” Why not use a downside measure—semi-variance, Value at Risk, or conditional VaR? The answer is architectural. Downside measures do not decompose: you cannot attribute downside risk to individual components the way squared CVs add. They do not propagate through the contribution margin filter in any tractable way. The cascade requires a measure that decomposes and propagates, and CV is the only standard measure that does both. The asymmetry objection is real, but the framework addresses it structurally. The capital structure cascade (Part IV) adds breach probability as a separate term, capturing the catastrophic downside that CV misses. RACE (Chapter 12) combines both: symmetric risk through the variance penalty, asymmetric risk through the distress cost. The Salience Cascade *is* the answer to the downside risk objection.

3.5. Managing Risk: From Measurement to Action

Measuring risk is only the first step. The practical value of a risk measure lies in what it enables: decomposition into sources and prioritization of the actions that address them.

A measured CV decomposes into sources. The CV of a company's earnings is the accumulated result of several components: the uncertainty in how many deals will close, the uncertainty in how large each deal will be, the uncertainty in customer retention, the variability of expense ratios, and so on. Each source contributes a measurable share to the total, and the decomposition tells the manager where the uncertainty lives.

This decomposition supports prioritization. Some sources of uncertainty are cheap to address; tightening deal desk governance to reduce deal size variability might cost very little, while reducing customer churn might require a major investment in customer success. Decomposition, combined with a rough ordering of costs, produces a ranked list of variance reduction opportunities sorted by impact per dollar of effort.

This ranked list becomes the sequenced improvement plan. Each intervention has a quantifiable expected effect on the CV, which in turn has a quantifiable effect on valuation through the multiple and on credit risk through the coverage ratio. The plan names specific interventions with measurable returns attached to each step.

This pipeline, from measurement through decomposition through prioritization to action, is the operational core of the Salience framework. Every chapter that follows applies this pipeline at a different tier of the cascade: revenue, earnings, valuation, cash flow, and capital structure.

The decomposition is the step that converts a risk measure from a reporting tool into a management tool. A total CV of 30% is informative; attributing 12 of those points to churn count risk and 8 to deal size variability is what makes the number actionable.

3.6. Salience: Risk at Its Source

The risk models described in Chapter 2, the factor models of public equities, the default models of credit, the actuarial models of insurance, share a common characteristic. They estimate uncertainty by observing outcomes: stock prices, loan defaults, insurance claims. The outcomes are downstream consequences of operational activities that occurred months or years earlier. A stock price today reflects the market's assessment of future cash flows, which depend on revenue, which depends on sales activities that are already in progress. The price is what the risk model observes; the sales activities behind it are not part of its inputs.

Salience takes a different starting point. It estimates uncertainty by observing the operational activities themselves: the number

4: This is why the framework works for private companies, which do not have stock prices to observe. The operational data that Salience requires, deal counts, deal sizes, churn rates, expense ratios, exists in every company with a CRM, a billing system, and a chart of accounts. The data is already being collected. Salience assembles it into an integrated estimate of variance.

of deals in the pipeline, the size of each deal, the churn rate of the installed base, the variability of expense ratios, the timing of revenue recognition. These are upstream quantities, closer to the source of uncertainty than the financial outcomes they eventually produce.⁴

The advantage of this approach is that it produces not just a measure of total risk but a decomposition into sources that correspond to specific operational decisions. A factor model reports that a stock has a beta of 1.2 and an annualized volatility of 35%; Salience reports that 40% of the underlying company's revenue variance comes from churn and 25% from deal size variability, because it measures risk in the business operations that produce the financial outcomes.

This is the framework that the remaining chapters develop, tier by tier, through the cascade. Part II introduces the cascade structure with a complete worked example. Part III traces the valuation cascade from revenue through earnings to enterprise value. Part IV traces the capital structure cascade from earnings through cash flow to debt serviceability. Part V brings the two together in the context of investment, portfolio construction, and ongoing management. The concepts established in this chapter, return, risk, the CV, decomposition, and the measurement-to-management pipeline, appear in every one of them.

THE SALIENCE CASCADE

Growth and Survival

4.

In which we trace the uncertainty of a single company through both cascades, from revenue through enterprise value and from revenue through debt serviceability, and see why improving one improves the other.

The previous chapters established the vocabulary and the historical context. This chapter puts the machinery in motion. We take a single company with a defined set of operating parameters and trace its uncertainty through the two paths that Salience calls the Salience cascade: the valuation cascade, which answers the question of what the business is worth given its operating uncertainty, and the capital structure cascade, which answers the question of whether the business can reliably service its debt. The two paths share a common root and produce different, complementary insights. Seeing them work together on a single example, before the detailed treatment in Parts III and IV, gives the reader the complete picture that the subsequent chapters will develop in depth.

4.1. The Company

Athena Industrial Services is a commercial facilities maintenance company operating in the southeastern United States.¹ The company has been in business for twelve years, operates from a single headquarters, and serves commercial and industrial facilities within a three-hour driving radius. It generates revenue through annual service contracts, each negotiated individually, covering HVAC maintenance, electrical systems, plumbing, and general building upkeep.

1: Athena is a composite, constructed from the operating characteristics of several mid-market services businesses. The numbers are representative of the category. The name is invented.

Metric	Value
Annual revenue	\$48M
Revenue model	Transactional (service contracts)
Active contracts	320
Average contract value	\$150,000
Contract value std dev	\$65,000
Annual churn rate	8%
Growth target (new contracts)	\$12M
EBITDA margin	22%
Variable cost ratio	45%
Total debt	\$28M (senior term loan)
Annual debt service	\$5.6M

Table 4.1.: Athena Industrial Services at a glance. A mid-market commercial services company with a straightforward revenue model and a leveraged capital structure.

Athena was acquired three years ago by a private equity sponsor that financed the transaction with a mix of equity and a senior term loan. The operating plan calls for steady organic growth through new contract acquisition, supplemented by improved customer

retention. The sponsor's thesis is that the fragmented commercial services market offers opportunities for operational improvement and, eventually, bolt-on acquisitions. The investment committee approved the deal at 8x EBITDA with 2.7x leverage.

The CFO, the operating partner at the sponsor, and the lender all understand that the business faces uncertainty. Contracts are won and lost, deal sizes vary, and churn and expenses fluctuate with project mix and labor availability. Everyone involved has a qualitative sense of how much uncertainty the business carries. Salience adds the quantitative measure of that uncertainty and a way to trace its consequences through the financial structure of the deal.

4.2. The Valuation Cascade: What Is Athena Worth?

The valuation cascade traces uncertainty from revenue through earnings to enterprise value. Each tier inherits the uncertainty from the tier above and adds its own.

4.2.1. Revenue Uncertainty

Athena's revenue comes from two sources: renewal of existing contracts and acquisition of new ones. Each source carries its own uncertainty.

On the renewal side, Athena has 320 active contracts. At an 8% annual churn rate, approximately 26 contracts will not renew. The uncertainty is in the number: churn could be 20 contracts (a good year) or 35 (a bad one). Each lost contract removes roughly \$150,000 in revenue, with some variation around that average.

On the new business side, Athena is targeting \$12 million in new contracts. At an average contract value of \$150,000, this requires approximately 80 new wins. The uncertainty is in both the count (how many deals close) and the size (the value of each). The standard deviation of contract value is \$65,000, which means individual contracts range widely, from small maintenance agreements under \$75,000 to larger integrated service contracts above \$250,000.

Taken together, these sources produce a revenue CV of 14%. Athena's expected revenue next year is \$48 million plus \$12 million in growth minus approximately \$3.9 million in churn, for a net expected revenue of roughly \$56 million. In practical terms, there is roughly a one-in-three chance that actual revenue will differ from the target by more than 14%, which translates to a range of roughly \$48 million to \$64 million covering two-thirds of outcomes.

This decomposition into renewal revenue and new business revenue is the simplest form of the count-and-size framework introduced in Chapter 3. Renewals have a count (how many existing customers renew) and a size (how large each renewal is). New business has a count (how many new deals close) and a size (how large each new contract is).



Exhibit 4.1.: Athena's expected revenue: \$56M mean, \$48M–\$64M for two-thirds of outcomes (revenue CV 14%).

4.2.2. Earnings Uncertainty

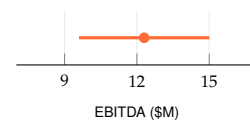
Revenue uncertainty is filtered through Athena's expense structure, which absorbs part of the variability before it reaches the bottom line.

Athena has a variable cost ratio of 71%, meaning that 71 cents of every revenue dollar goes to costs that scale with activity: labor for service calls, materials, vehicle expenses, subcontractor fees. The remaining 29% is the contribution margin. When revenue falls short, these variable costs fall proportionally, cushioning the impact on earnings. When revenue exceeds expectations, variable costs rise correspondingly, limiting the windfall.²

The expense structure also adds its own uncertainty. Project costs vary with the complexity of each job. Labor rates fluctuate with the local market. Subcontractor pricing is not perfectly predictable. These sources layer additional variance on top of the propagated revenue variance.

The net result is an earnings CV of 22%. Expected EBITDA is approximately \$12.3 million. The 29% contribution margin on \$56 million of growth-adjusted revenue produces \$16.2 million of pre-fixed-cost earnings. Roughly \$3.9 million in fixed costs (headquarters, insurance, and other overhead) reduces this to \$12.3 million, or an EBITDA margin of 22%. The earnings CV (22%) is higher than the revenue CV (14%), not because earnings are more uncertain in absolute dollar terms (the standard deviation actually decreased from \$7.8 million to \$2.7 million), but because EBITDA is a much smaller number than revenue, so the same relative uncertainty is concentrated into a narrower base.

2: Variable costs absorb a portion of revenue variance because they move with revenue: when revenue falls short, variable costs fall with it, and when revenue exceeds expectations, they rise to meet it. Semi-variable cost components and correlations between revenue and cost ratios add further absorption beyond the baseline contribution-margin effect. The full derivation, including the variance decomposition for count and size risk separately, is in the technical appendices of Chapters 5 and 6.



4.2.3. Valuation Uncertainty

The final tier of the valuation cascade translates earnings uncertainty into enterprise value uncertainty. Athena is valued on an EBITDA multiple basis. The base multiple is 8x, reflecting the company's market position and growth trajectory. The multiple itself carries uncertainty. Comparable transactions in the commercial services sector run from 6x to 10x, a spread that measures how much those companies differ from one another in size, growth rate, and market position. Athena's own exit multiple is uncertain for a narrower reason: its size and growth rate estimates are known, and what remains unsettled is the market environment on the date it sells. That component carries a CV of 15 percent, a value that is arrived at usings methods discussed in Chapter 7.

The valuation CV combines the earnings CV and the multiple CV. With an earnings CV of 22% and a multiple CV of 15%, the valuation CV is approximately 27%, because the squared CVs add ($0.22^2 + 0.15^2 \approx 0.071$, and $\sqrt{0.071} \approx 0.27$). This additive property

Exhibit 4.2.: Athena's expected EBITDA: \$12.3M mean, \$9.6M–\$15.0M for two-thirds of outcomes (earnings CV 22%).

is what makes the cascade tractable: each tier's contribution can be isolated independently. Expected enterprise value is approximately \$98 million (\$12.3M EBITDA times 8x). The range of plausible valuations, covering two-thirds of outcomes, runs from roughly \$72 million to \$124 million, which is wide enough to matter for exit planning and investor returns.

4.3. The Capital Structure Cascade: Can Athena Service Its Debt?

The capital structure cascade traces the same revenue and earnings uncertainty through a different path, one that terminates in the ability to meet financial obligations rather than in enterprise value.

4.3.1. Operating Cash Flow

Accrual earnings and cash are not the same thing. Athena records revenue when contracts are signed and services are delivered, but cash arrives when customers pay their invoices. The gap between the two is working capital: the cash tied up in receivables, payables, and any inventory of materials.

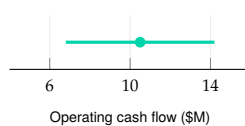


Exhibit 4.3.: Athena's expected operating cash flow: \$10.5M mean, \$6.8M–\$14.2M for two-thirds of outcomes (OCF CV 35%).

Athena's customers pay on 45-day terms on average, with some variation. The company pays its suppliers on 30-day terms. This cash conversion cycle means that Athena's operating cash flow is somewhat lower and materially more variable than its EBITDA. After accounting for working capital dynamics, Athena's expected operating cash flow is approximately \$10.5 million, with a CV of 35%, meaningfully higher than the 22% earnings CV. The gap reflects the additional variability that working capital introduces: a handful of large customers whose payment timing swings by weeks, seasonal compression in fourth-quarter collections, and the friction between when costs are incurred and when the cash they generated arrives.³

3: The working capital adjustment adds its own variance layer on top of the earnings variance. A company that is growing rapidly consumes more working capital (new customers create new receivables), which means fast growth can temporarily reduce cash flow even as it increases earnings.

4.3.2. Debt Service Coverage

Athena carries a \$28 million senior term loan with annual debt service of \$5.6 million (interest plus scheduled principal repayment). The debt service coverage ratio, DSCR, is operating cash flow divided by debt service:

A DSCR reading below 1.25x constitutes a technical default under the loan agreement. The lender's contractual remedies are immediate. They can accelerate the loan, demanding repayment of the full \$28 million principal that was supposed to amortize over the next seven years. They can block dividends and management fees to the

Metric	Value
Expected operating cash flow	\$10.5M
OCF standard deviation	\$3.7M
Annual debt service	\$5.6M
Expected DSCR	1.88x
DSCR standard deviation	0.66x
Covenant threshold	1.25x
DSCR headroom	0.63x
Annual breach probability	17%
Cumulative breach probability (5-year hold)	61%

Table 4.2.: Athena's credit profile. The expected DSCR looks comfortable. The distribution around it tells a different story.

sponsor, suspending the distributions that anchor the return model. Cross-default clauses in trade facilities, equipment leases, and any subordinated debt can trigger cascading defaults across the capital stack, turning a single covenant miss into a company-wide credit event.

In practice, lenders rarely accelerate; they negotiate, and the negotiation is costly. A typical forbearance agreement on a facility of this size requires a waiver fee in the low six figures, tighter going-forward covenants, a mandatory equity cure in which the sponsor injects fresh cash at roughly twice the shortfall, and often a 100 to 200 basis point increase in the credit spread. The event appears in the next LP letter as a paragraph that is difficult to write favorably, and the next deal from the same sponsor tends to face harder terms from the same lender.

The expected DSCR of 1.88x looks comfortable on the cover page of the credit memo, and the covenant threshold of 1.25x provides 0.63x of headroom. However, with operating cash flow varying at a 35% CV, that comfort coexists with roughly a 17% probability that cash flow falls below the level needed to maintain the 1.25x threshold in any given year, and over a five-year hold the cumulative probability that at least one breach occurs is approximately 61% — higher than the probability that it does not.

Athena's capital structure cascade. Earnings CV 22% → OCF CV 35% → DSCR 1.88x with 17% annual breach probability, 61% cumulative over a five-year hold. The same operating uncertainty that drives the valuation range drives the credit risk.

4.4. Two Cascades, One Source

Athena's operating uncertainty flows from a single source to produce different outputs for different audiences.

The valuation cascade tells the sponsor that Athena's enterprise value is approximately \$98 million with a 27% CV, producing a range of \$72 million to \$124 million for two-thirds of outcomes. This is the information that matters for exit planning, return projections, and LP reporting.

The capital structure cascade tells the lender (and the sponsor) that Athena's DSCR is 1.88x with a 17% annual breach probability, and a 61% cumulative probability over a five-year hold. This is the

information that matters for covenant compliance, debt sizing, and credit committee decisions.

Both outputs flow from the same source: Athena's revenue uncertainty (14% CV), filtered through its expense structure (71% variable cost ratio) into earnings uncertainty (22% CV). The two cascades diverge at the earnings tier, one path going through the valuation multiple and the other through working capital and debt service. The point of divergence is also the point of connection: any operational improvement that reduces the earnings CV improves both the valuation (through a tighter distribution of enterprise value) and the credit profile (through a lower breach probability).

Table 4.3.: The effect of reducing Athena's revenue CV from 14% to 9% through improved customer retention and pipeline management. Both cascades improve simultaneously.

	Current	After Improvement
Revenue CV	14%	9%
Earnings CV	22%	15%
Valuation CV	27%	21%
Risk-adjusted multiple	8.0x	8.7x
Implied enterprise value	\$98M	\$107M
OCF CV	35%	25%
DSCR (expected)	1.88x	1.88x
Annual breach probability	17%	9%
Cumulative breach (5-year hold)	61%	38%

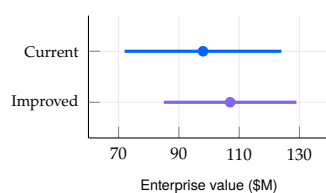


Exhibit 4.4.: Athena's enterprise value distribution: point for the mean, bar for the $\pm 1\sigma$ range. The 5-point revenue CV reduction raises the mean by \$9M and narrows the range from \$52M to \$44M.

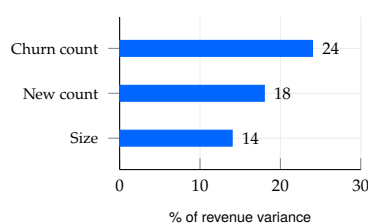


Exhibit 4.5.: Athena's revenue variance by source, named components. Together these three account for roughly 56% of total revenue variance; smaller components make up the remainder. Each named source is tied to a specific operational lever.

The table illustrates the dual benefit. A 5-percentage-point reduction in revenue CV, achieved through better customer retention and more predictable pipeline management, flows through both cascades. The valuation cascade produces a \$9 million increase in implied enterprise value (from multiple expansion driven by the lower earnings CV). The capital structure cascade produces a reduction in annual breach probability from 17% to 9%, and a reduction in cumulative five-year breach probability from 61% to 38%. The expected DSCR is unchanged, because expected cash flow is the same; the dispersion around it narrows, and the dispersion is what the covenant tests.

The 5-point reduction in the table summarizes a specific plan rather than a general aspiration. Saliency produces a variance decomposition at each tier that isolates the operational sources of uncertainty and their individual contributions. For Athena, the revenue CV decomposes into churn count risk (24% of the total), new business count risk (18%), new business size risk (14%), and a set of smaller components. Each source is tied to a specific operational lever: customer-retention programs target the churn component, pipeline management targets new business count, and deal desk standardization addresses size dispersion. Each lever has a quantified impact on the CV, computed from the same model that produced the tier-level numbers. The improvement plan is therefore a ranked list of named actions, ordered by variance-reduction yield per dollar of cost. The 5-point reduction shown here is the combined effect of the top two or three. Chapter 6 develops the full ranking as the Sharpe Improvement Staircase.

The improvement in valuation and breach results did not depend on new revenue, reduced costs, or additional debt; it came entirely from reducing the variability of existing operations, which the cascade traces through both the equity and the credit outcomes.

4.5. Why This Matters for Decisions

The Salience cascade changes three conversations that occur routinely in a leveraged business.

Operational improvement is the first conversation. The discussion ordinarily centers on expected outcomes: which initiatives will grow revenue or reduce costs the most. The cascade adds the uncertainty dimension: which initiatives reduce the CV the most, and how that reduction translates into valuation and credit outcomes. An initiative that produces modest expected revenue growth while substantially reducing revenue CV may be more valuable, in total, than one that produces strong expected growth with no change in uncertainty.

Debt capacity is the second. Leverage in the absence of the cascade is sized by convention and market appetite. The cascade lets the sponsor show the lender the specific breach probability at each leverage level, decomposed into operating sources and connected to the management team's plan for reducing them. The conversation moves from "we think this business can support 2.7x leverage" to "at 2.7x leverage, the annual breach probability is 17%, driven primarily by churn count risk, which the customer success investment is designed to address; under the planned variance reduction, that probability falls to 9%."

Risk-adjusted returns are the third. The return projection presented to LPs is ordinarily a point estimate: "we expect a 2.5x return over five years." The cascade-aware projection includes the range: "we expect a 2.5x return with a goal risk of 27%, meaning two-thirds of outcomes fall between 1.8x and 3.2x. The operating plan targets a reduction in goal risk to 21%, which would narrow the range to 2.1x to 3.3x around an expected multiple raised to 2.7x through improved predictability."

Each conversation becomes more specific and better connected to the actions available, which makes it more likely to produce good decisions. The cascade leaves the facts of the business unchanged but changes what can be said about them, and therefore what can be done with them.

The chapters that follow develop each tier of the cascade in depth. Part III covers the valuation cascade: revenue variance in Chapter 5, earnings variance in Chapter 6, and valuation variance in Chapter 7. Part IV covers the capital structure cascade: operating cash flow in Chapter 9, debt and covenants in Chapter 10, and capital structure

The phrase "the market will go to 3.5x for a business of this quality" is a standard feature of credit discussions. The cascade gives the word "quality" a measurable meaning: the CV of operating cash flow. Two businesses at the same EBITDA may justify very different leverage levels if their CVs differ.

risk in Chapter 11. Each chapter follows the measurement-to-management pipeline introduced in Chapter 3, applying it to the specific parameters and decisions of its tier.

THE VALUATION CASCADE

Revenue Variance: Where Uncertainty Begins

5.

In which we examine the first tier of the cascade and discover that revenue uncertainty, in every business model, reduces to two observable factors.

Every company that earns revenue does so through discrete economic events. A software company closes deals; a subscription business renews customers and acquires new ones. An asset manager collects fees on a fluctuating base of assets, and a usage-based platform meters consumption across its customer base. The specific mechanics differ, sometimes substantially, but the underlying structure is the same in each case: revenue over a forecast period is the accumulated result of individual events, each with uncertain timing and uncertain magnitude.

This observation is the entry point of the cascade. It means that revenue uncertainty, regardless of the business model, can be understood through two factors that are present in every revenue process and observable in standard business records.

5.1. Count Risk and Size Risk

The first factor is the number of revenue-generating events that occur in the forecast period. For a transactional sales organization, this is the number of deals that close. For a subscription business, it is the number of renewals, the number of new logos acquired, and the number of expansion events. For a usage-based business, it is the number of active customers generating consumption. This is count risk: the uncertainty in how many events will occur.

The second factor is the magnitude of each event. For a transactional business, this is the deal size. For a subscription business, it is the value of each renewal or new contract. For a usage-based business, it is the consumption level per customer per period. This is size risk: the uncertainty in how large each event will be.

Together, count risk and size risk account for the bulk of revenue variance in most businesses. The decomposition, known formally as the compound Poisson structure (a model that has been in use in actuarial science for over a century, where it describes total insurance claims as the product of claim frequency and claim severity), is a natural partition that reflects the actual mechanics of how revenue is produced. A company that closes fewer deals than expected has experienced count risk. One that closes the expected number at smaller sizes has experienced size risk. A company that misses its revenue target by \$3 million might have missed

Table 5.1.: Count risk dominates in most businesses. It reverses only when deal sizes are highly variable.

	Count	Size
Industrial	78%	22%
Enterprise SW	62%	38%
Boutique M&A	35%	65%

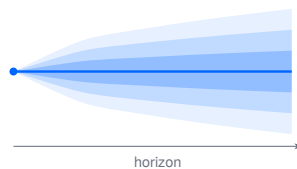


Exhibit 5.1.: A confidence fan. The expectation runs through the center and each band marks a further multiple of σ ; the bands widen as the forecast reaches further out, because variance accumulates with the horizon. Figure 5.4 puts the same construction on Athena's revenue with the bands quantified.

A company that closes 40 deals per year with perfect uniformity would close 10 per quarter with minimal variation. The same company, if 60% of its deals close in Q4, has substantial quarterly variance even if the annual count is predictable. Timing risk is the difference between these two situations.

because it closed 10 fewer deals than expected (count risk), because its average deal was \$40,000 smaller than expected (size risk), or because of some combination of both. The management response to each case is different: the first points to pipeline and demand generation, the second to pricing and deal qualification.

From variance to z-scores and bands. Variance is the natural mathematical statement of count and size risk; its square root is the standard deviation σ , the unit that indicates the spread around its predicted mean. An observation's z-score is the number of standard deviations between its value and the predicted mean, negative when the observation falls short. z-scores plotted around the expected outcome give us confidence bands; a quantity that indicates what percent of outcomes should land between the bands. The revenue CV used throughout the book is $\sigma/E[R]$; the standard deviation scaled by the expected revenue.

5.1.1. Timing and Seasonality

Count risk and size risk describe what happens over the full forecast period. There is a third factor, related to but distinct from count risk, that describes when events occur within that period: timing risk.

Revenue-generating events rarely arrive at a uniform rate across the year. Enterprise software deals cluster at quarter-ends, when budget cycles create urgency and sales teams push to close. Retail businesses concentrate revenue in the fourth calendar quarter. Construction and facilities services follow seasonal patterns tied to weather and building occupancy cycles. This clustering means that the uncertainty in quarterly or monthly revenue is greater than you would expect from the annual figures alone.

Salience captures timing risk through a parameter that measures the degree of temporal clustering in deal arrivals. When clustering is high, the count variance within any sub-period is larger than the annual count variance would suggest, which affects quarterly tracking, in-period forecasting, and the significance bands used for performance evaluation. A sales team that appears behind plan at the end of Q2 may simply be experiencing the natural back-loading of a business with strong Q4 seasonality, and the timing parameter ensures the framework does not flag this as a meaningful departure. The technical appendix develops the parameter formally. The back-of-book mathematical companion (Appendix A) develops the calendar-event indicator extension that handles concentrated spikes, and a smooth seasonal index that absorbs a deterministic calendar structure when the data is rich enough to support it.

The practical consequence for management is that seasonality becomes a measurable source of within-period variance that interacts

with count risk and, in businesses with seasonal pricing or contract structures, with size risk as well. A company that can smooth its revenue timing through contract restructuring, staggered renewals, or diversification across geographic markets with offset seasonal patterns reduces its within-period variance without changing its annual outcome, which improves quarterly predictability and reduces the false alarms in performance monitoring.

5.1.2. Pipeline Coverage and Momentum

Two further mechanisms amplify count variance in ways the seasonality parameter does not capture.

Pipeline coverage is the first. A sales target requires a pipeline of opportunities long enough, and moving fast enough, to deliver the implied number of closes during the period. When the pipeline is short, with fewer opportunities or longer cycle times than the target requires, count variance is amplified, because the same number of expected closes is being drawn from a smaller and slower base.

Self-exciting clustering is the second. Some sales processes exhibit momentum, where a closed deal raises the probability of further closes in its neighborhood through referral chains and sales-team energy effects. The clustering is structurally distinct from seasonality, because the trigger is endogenous to the process rather than imposed by the calendar. Salience models this through a Hawkes process with a branching ratio that names the average number of follow-on events triggered by each parent event. As the branching ratio rises toward one, count variance amplifies sharply, and the framework prices the amplification as a separate component of the decomposition. The back-of-book mathematical companion (Appendix A) gives the coverage derivation, drawing on Little's Law, and the Hawkes self-excitation result.

5.2. Iowa Liquor: The Bare Formula on Real Held-out Data

The chapter has so far argued the compound Poisson decomposition analytically: the structure of a sales process makes this distribution, along with its extensions, the natural model. The variance it produces should match what a real revenue process actually carries. The argument is elegant, but not entirely complete. Before elaborating further on the framework, we first test the basic bare version on data the framework's authors did not collect.

The test that follows is the empirical foundation the rest of the framework's results stand on. The revenue tier is the headwater of the cascade. Each later tier adds an increment of its own — the expense structure at earnings, the multiple at valuation, debt service

1: Commercial revenue-intelligence platforms score deal-win probabilities and produce forecast ranges from CRM data with machine-learned models. Those systems estimate the level and its likely error from history; the count-size structure derives the dispersion analytically from the pipeline's composition, which is what makes the attribution to operational sources possible.

Source: <https://data.iowa.gov>

We are using a 12-period out of sample dataset because most users will be using Saliency with an annual 12-month forecast. The sample size is admittedly small, but the tests recover that the CV is likely right.

at the capital-structure tier — but each one begins by inheriting the variance this tier supplies. An error in that inheritance does not stay where it started: it is filtered through the expense structure, carried through the multiple, and read out again in covenant headroom and portfolio covariance. Testing the revenue tier against a real revenue process is therefore a test of the input on which every downstream number depends.¹

The *Iowa Liquor Sales* database records every wholesale shipment from licensed Iowa distributors to retail establishments since 2012. The five years from 2019 through 2023 contain roughly 478,000 invoices and \$2 billion in revenue. The seasonality is moderate and stable from year to year, which makes the dataset the cleanest test of the bare formula on a multi-year B2B revenue process.

The test goal is goodness of fit on variance alone. The framework's claim is that, given a level for the period supplied by the planner, the count-size structure of the business produces a predicted variance that matches observed variance to within sampling tolerance. The level is the planner's input — a sales plan, a budget, a projection — and not what the framework supplies; the dispersion around the level is what the framework supplies. The test fits the count-size structure on a training window, applies it to a held-out window using the held-out window's level, and compares the predicted variance to the observed variance the data carries.

Four calendar years of monthly revenue, 2019 through 2022, produce forty-eight observations on which to estimate the count-size parameters, with a fifth year, 2023, held out to predict against. The in-sample fit is clean. Predicted monthly variance, derived from the count-size structure of the 2019–2022 training window, matches observed monthly variance across all five years to within sampling tolerance. The result holds at the quarterly resolution as well, where each observation aggregates four months of within-period structure. The bare formula reproduces the variance the data carries.

The out-of-sample test is sharper. Trained on 2019–2022 monthly data and applied to the held-out 2023 calendar year, the formula predicts a monthly revenue distribution centered on a trained mean of roughly \$33 million with a predicted dispersion near \$5 million. Every one of the twelve months in 2023 lands inside the predicted two-standard-deviation band; six of the twelve sit inside the one-standard-deviation band, close to the 68% coverage rate a normal distribution would produce on a twelve-month sample. A binomial test against the predicted 68% coverage produces a two-sided p-value of 0.21, well inside the sampling tolerance. Observed revenue ranges from \$32.1 million in February to \$41.3 million in June, and the largest absolute deviation from the trained mean is 1.5 times the predicted dispersion. The seasonal lift the data carries — modestly higher Q4, a summer plateau — is small enough relative

to the count-size dispersion that the bare formula clears the band on every held-out month (Exhibit 5.2).

The Iowa data does carry seasonality — a modest Q4 lift and a summer plateau — so it is fair to ask whether the cascade’s seasonality adjustments developed in Section A.1 of the back-of-book mathematical companion sharpen the forecast. It does not. The reason is structural. The seasonal swing is small relative to the dispersion the count-size structure already carries: the December peak and the February trough both sit well inside the bare formula’s predicted band, the largest held-out month falling only 1.5 standard deviations from the trained mean. The framework adjustments are designed for larger seasonality effects, such as the concentrated-calendar-event case of Section 5.6.2, where a Black-Friday week can break the bare formula.

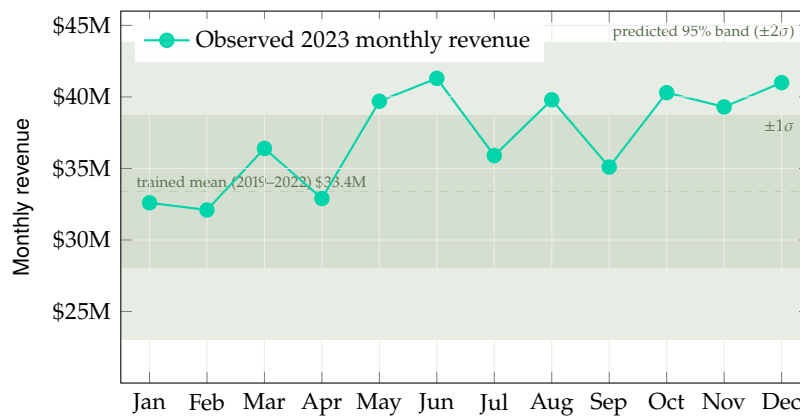


Exhibit 5.2.: Iowa Liquor 2023 lands inside the predicted band on every month. Monthly revenue (teal) for the held-out 2023 calendar year, scored against the compound-Poisson forecast trained on 2019–2022. The trained mean is \$33.4M (dashed), the predicted 95% band runs from \$23.0M to \$43.8M (light fill). Every one of the twelve held-out months lies inside the band; the largest absolute deviation from the trained mean is 1.5 times the predicted dispersion. The seasonal lift the data carries is small enough relative to the count-size dispersion that no calendar adjustment is required.

From here the chapter builds out the framework’s structure — the family of revenue models, the management uses of variance attribution, the connection from CRM pipeline to cascade parameters — with the knowledge that the central decomposition has cleared an out-of-sample test. Section 5.6 returns later in the chapter to another public dataset that demonstrates where the bare formula’s boundaries lie and how the cascade extends them.

5.3. A Business as a Portfolio of Forecasts

Most real companies do not fit a single revenue model cleanly. A software company sells enterprise contracts through a field sales team, subscription seats through a self-serve channel, and usage charges for API overage. A wealth manager earns asset-based fees on its managed portfolios and performance fees on a smaller pool of alternatives. A diversified industrial company runs a maintenance business with recurring service contracts, a project business with discrete installations, and a parts business with high-volume low-

value sales. Each slice has its own mechanics and its own variance profile.

Saliency accommodates this by treating the company as a portfolio of forecasts. Each forecast covers a distinct slice — a product line, a subsidiary, a geography, a channel, or a cross-tab such as “enterprise / North America / managed services” — and uses the revenue model best suited to its mechanics. As such, we can consider the business to be a portfolio of forecasts, distinct from a portfolio of businesses as we shall encounter in later chapters. The company-level revenue forecast is the sum of the slices, with the correlations between them accounted for at the total business revenue level.

A business is rarely a single model. Saliency decomposes the revenue plan into as many separately modeled forecasts as the business itself uses to manage its operations.

This portfolio structure mirrors how many businesses actually generate revenue, and it is what makes channel-mix decisions, bolt-on acquisitions, and geographic expansion quantitatively evaluable. The channel-mix example later in this chapter illustrates the common case of two revenue streams with different variance profiles, combined to produce a portfolio-level CV lower than the weighted average of the individuals. The same logic scales to as many forecasts as the business requires.

The portfolio structure also changes what the framework’s management uses can deliver. Because each line carries its own variance decomposition, the improvement roadmap the framework produces becomes line-specific rather than generic, and because each line forecast has a natural owner, that roadmap doubles as an assignment of accountability. The section on managing revenue risk develops both.

5.4. Revenue Models

Different businesses generate revenue through different mechanisms, and Saliency accommodates this through a family of revenue models. Each model captures the specific dynamics of a revenue type while maintaining the same underlying count-size decomposition. The models are different parameterizations of a single underlying structure, each tailored to the mechanics of the business it describes. A single company can use several at once — one per slice of the portfolio of forecasts — and Saliency combines them into a single revenue-tier CV at the company level. As we describe these models, we ask the reader to take note of the modest amount of data required for each model. In every case, the data can be derived from a CRM or can simply be supplied heuristically. Saliency does not require a data project. The data is already in circulation at the firm.

5.4.1. Transactional Revenue

The simplest model, and the one that makes the count-size decomposition most transparent, is the transactional model. It applies to any business where revenue comes from discrete deal closings: professional services, equipment sales, project-based work, commercial real estate transactions. The Athena Industrial Services case in Chapter 4 uses it. Three parameters — the revenue target, the average deal size, and the variability of deal sizes — yield the expected count, the count risk, the size risk, and the total revenue CV.

Transactional parameters. Expected Deal Count · Deal Count CV · Avg. Deal Size · StdDev. Deal Size · Seasonality (optional).

5.4.2. Subscription Revenue (ARR)

Subscription businesses generate revenue through a waterfall: a base of recurring revenue, minus churn, plus new logo revenue, plus expansion. Each component is a separate count-size process; the total revenue variance is the sum of component variances adjusted for correlations between them. Churn count risk is often the dominant component, because losing an existing customer is a high-certainty event with a large per-event impact. New logo acquisition has high count uncertainty with typically smaller per-event impact. Expansion sits between. A subscription business with 5% churn and strong new-logo acquisition has a different CV profile than one with 15% churn and aggressive expansion, even at the same expected revenue.

Subscription ARR parameters. Base ARR · Churn Rate · Avg. Churn Size · Churn Rate CV · Churn Seasonality · New ARR Target · Avg. New Deal Size · StdDev. New Deal Size · Expansion Target · Avg. Expansion Size · StdDev. Expansion Size · Expansion Rate CV.

5.4.3. Asset-Based Fee Revenue (AUM)

Asset managers and wealth advisors earn revenue as a percentage of assets under management. The assets fluctuate with market conditions, client flows, and fee rate changes. The model carries an exogenous variance source the others do not: market return, which is outside any single fund's control. The revenue CV decomposes into endogenous (flow, fee-rate discipline, client retention) and exogenous (market) components. The manager who wants to isolate commercial execution can hold the market return at its expected value to read off the endogenous CV alone. At the firm level the market exposure is to some degree a portfolio-level decision: a manager who builds a bond franchise alongside an equity book is performing market-variance management through product mix, even when no single fund's market return is controllable.

AUM parameters. Base AUM · Fee Rate · Expected Market Return · Market Vol · Gross Inflow Target · Avg. Inflow Size · StdDev. Inflow Size · Redemption Rate · Avg. Redemption Size · StdDev. Redemption Size · Redemption Rate CV · Redemption Seasonality · Flow-/Market Correlation.

5.4.4. Usage-Based Revenue

Usage-based businesses earn revenue from customer consumption: API calls, data processing volumes, compute hours, transaction counts. The uncertainty has three layers — customer count, per-customer usage, and the rate applied to each unit of consumption. The model attributes total variance to each layer, providing the product and finance teams with a decomposed view of where usage-revenue uncertainty actually lives.

Usage-based parameters. Customer Count · Avg. Usage per Customer · Usage StdDev (cross-customer) · Usage Autocorrelation · Top-10% Contribution · Unit Price · Min. Commitment · Acquisition Rate CV · Churn Rate · Churn Rate CV.

5.4.5. Capacity-Based Revenue

Capacity-based models apply where revenue is constrained by a fixed resource: sales representatives, service technicians, billable consultants. Revenue is the product of headcount, productivity, and deal size. A sales organization with 20 reps each carrying a \$2 million quota has a theoretical capacity of \$40 million; actual revenue depends on attainment rates, ramp times for new hires, and deal-size dispersion. The decomposition reveals whether variance is driven primarily by headcount, by attainment, or by deal-size variability — which directs the operational response.

Capacity-based parameters. Number of Reps · Quota per Rep · Avg. Deal Size · StdDev. Deal Size · Rep Performance Correlation.

5.4.6. Pre-Revenue: Milestone-Based Models

Pre-revenue companies do not yet have the steady flow of revenue events the other models decompose. Their near-term trajectory depends on achieving discrete milestones: completing a product, securing regulatory approval, closing a first customer, launching commercially. Salience characterizes each milestone by a feasibility probability, an expected timing, and an expected revenue upon achievement with its own CV. The model produces a probability-weighted revenue expectation and a revenue CV that feed directly into the cascade, which is what lets pre-revenue companies enter the same earnings and valuation pipeline as revenue-stage ones. The defective Gamma arrival distribution behind the milestone timing is developed in Section A.6 of the back-of-book mathematical companion.

Milestone parameters. Per milestone: Horizon · Likelihood · Timing Predictability · Revenue at Achievement · Revenue CV · Post-Milestone Growth · Growth CV.

Table 5.2.: Six revenue models. Each is a different parameterization of the count-size framework.

Model	Events	Key Drivers
Transactional	Deal closings	Deal count, deal size
Subscription	Renewals, new, expansion	Churn, new logo pipeline
Asset fees	Fee periods	Market vol, net flows
Usage-based	Consumption	Usage vol, acquisition
Capacity	Rep output	Attainment, headcount
Milestone	Achievements	Feasibility, timing

5.5. From Parameters to Uncertainty

Each revenue model has a small core of *irreducible* inputs that produce a first-order uncertainty profile — three for the transactional and usage-based models, four to six for the subscription and AUM models, five for the capacity model — and a larger catalog of *optional* parameters that let a user override the defaults for a specific feature of the business. The preceding section's margin notes list each model's full catalog; the core set is a strict subset. Every parameter, core or optional, is estimable from data that exists in standard business systems.

From these inputs, Salience derives the expected revenue, the revenue variance, the revenue CV, confidence intervals at any desired level, and the decomposition of total variance into its count-risk and size-risk components. The output is a distribution, characterized by its mean and its spread, with the spread attributed to specific operational sources.

Core vs. catalog. For the transactional model the core is the revenue target (or equivalently the expected deal count), the average deal size, and the deal-size variability. The catalog adds an over-dispersion parameter for seasonal clustering and an optional deal-count CV for pipelines that deviate from the Poisson baseline. Salience defaults the optional parameters — zero over-dispersion, independent processes, Poisson-implied count variance — so most users specify only the core inputs.

5.6. Boundaries and Recoveries

The bare formula clears its test on the Iowa Liquor data. A second public dataset, the NYC Yellow Taxi trip records, shows what the framework claims at its boundary. In this dataset, the count-size dispersion structure is approximately stable across years while a large level move runs across them. The divergence is a level-forecast failure that the framework's stable CV makes detectable. Beyond this worked case the framework names three further extensions — a calendar-event partition for concentrated seasonality such as Black Friday, the Little's Law pipeline-coverage penalty, and the Hawkes self-excitation amplifier — each a boundary the cascade anticipates and formalizes in the back-of-book mathematical companion (Appendix A).

5.6.1. NYC Yellow Taxi: Detecting Level-Forecast Bias With a Stable CV

The taxi data illustrates the division of labor the framework claims. The framework supplies the CV, a dimensionless ratio computed from the count-size structure of the business and decomposable into operational sources; the planner supplies the level, derived from channel mix, market-share assumptions, headcount plans, or rolling history. The CV provides a band in which the relative outcomes will almost always reside. By default, Salience centers the band on the user's forecast-level, producing a band of the correct relative width, centered on that level. If the planner is right on the level, the band is right. When the forecast-level is wrong the CV width becomes the noise floor that makes the level

error detectable. As results accumulate, and Saliency's tracking functionality indicates the forecast-level is wrong, the user can shift to another forecast-level which re-centers the CV band. The user can then wait for further results. This chapter is designed to test whether Saliency can produce the right CV value.

Source: <https://www.nyc.gov/site/tlc/about/tlc-trip-record-data.page>

The NYC *Yellow Taxi* trip records, published monthly by the Taxi and Limousine Commission, are a high-volume transactional record of every metered trip. The six years from 2014 through 2019 cover the post-Uber, pre-COVID institutional regime, with 743 million trips and \$12.2 billion in revenue. Within this window the count-size dispersion structure (the dimensionless CVs, not the levels) is approximately stable, while a large level move runs across the years: a 49 percent collapse in trip count, partly offset by a 26 percent rise in mean fare, leaving revenue down 36 percent from 2014 to 2019.

A planner who forecast 2019 from the 2014–2018 monthly average would have anchored on a trained mean of \$175.6M, a level forecast biased high by 30 percent of the realized level because Uber market-share erosion through the period was not extrapolated forward. The framework's CV, applied to that forecast, produces a band centered on \$175.6M with a 95% lower bound near \$152.7M. Every one of the twelve months in 2019 came in below \$152.7M. Twelve consecutive months below the forecast level is by itself a one-in-four-thousand event under an unbiased forecast; twelve consecutive months below the lower 2σ bound is essentially impossible. Despite the forecast level being wrong, the CV estimate held: Exhibit 5.3 shows all twelve out-of-sample results falling within the green CV band centered on the realized mean of \$135.1M, while the orange band, centered on the biased forecast-level, sits above them. The twelve-month run below the forecast is a bias signal in the level, made visible by the framework's stable CV.

Tracking the bias as it accumulates. The platform's tracking methodology operationalizes this directly. After each month the planner sees the realized observation against the band. One $z < -2$ observation is a 2.3% event under the planner's forecast. Two consecutive $z < -2$ observations is a 0.05% event; an indication the level forecast is biased high. Accordingly, the planner resets the level; the CV stays the same; the band recenters without changing its width. By the third or fourth month of 2019, a planner working with this discipline would have been operating against a level forecast in the realized \$135M range with a band centered on it, and the remaining months would land inside two standard deviations as the framework predicts. The cascade's CV is what gives the planner the threshold; the planner's own domain expertise — channel, headcount, market — is what supplies the recentered level. Saliency makes the level forecast's quality measurable while leaving the forecast itself to the planner.

The CV itself is what the test validates. Computing the count-size dispersion structure on the training window — the relative dispersion in monthly trip counts and in trip values, computed within each training year and averaged across the five training years — defines a dimensionless CV near 6.5%. Applied to the realized 2019 monthly mean of \$135.1M, this CV produces a band whose ratio of predicted to observed variance is 0.69, well within the sampling tolerance for a twelve-month held-out window. All twelve held-out months sit inside the resulting two-standard-deviation band; six of the twelve sit inside the one-standard-deviation band, close to the 68% rate a normal distribution would produce. The binomial coverage test produces a two-sided p -value of 0.21. In the within-year version, fit on 2019 alone, the predicted variance matches observed to within two percent. The CV is robust across the regime shift; it is a property of the count-size structure that survives the level move (Exhibit 5.3). Read as a CV with a tracking discipline, the framework performs to its specification on this data.

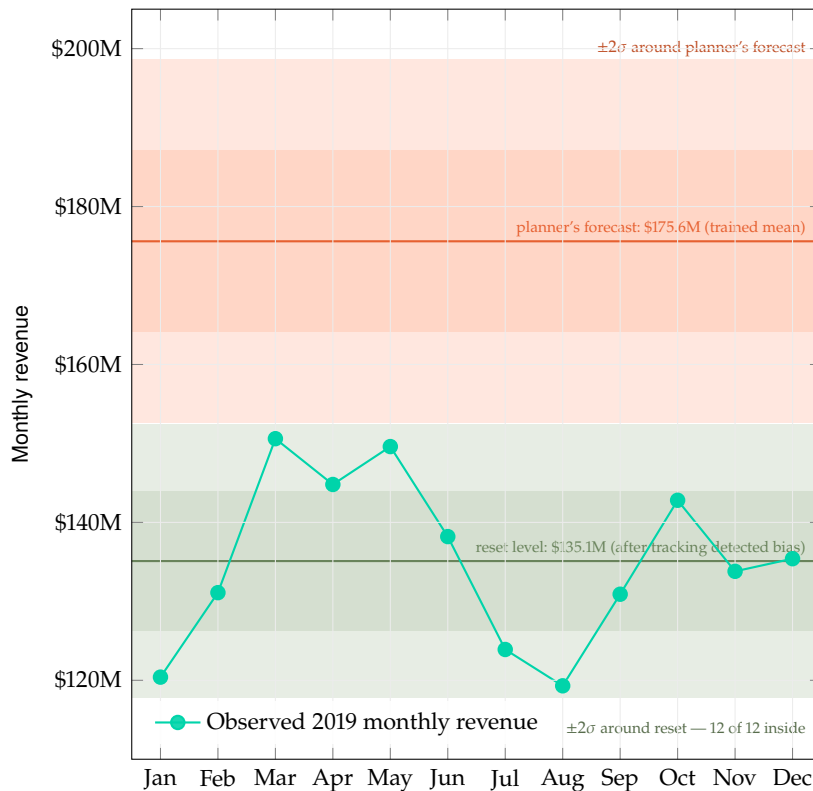


Exhibit 5.3.: A stable CV makes level-forecast bias detectable. Monthly revenue for 2019 (teal) against two bands of identical CV-derived width centered on different means. The orange band, centered on the planner's forecast of \$175.6M, has a lower 2σ bound at \$152.6M; all 12 observed months land below this bound, a 1-in-4,000 event under an unbiased forecast. With the CV the planner can distinguish bad luck from a biased level forecast. The sage band, centered on the realized 2019 mean of \$135.1M — the level the platform's tracking discipline would converge on after one or two $z < -2$ observations — covers all twelve months at 2σ and six of twelve at 1σ . The CV's width is the same in both bands; only the center moves.

5.6.2. Named Extensions

Some businesses pack a deterministic share of the year into a few days: a single Black-Friday week in retail, fiscal-year-end compression in enterprise sales, a conference-driven burst. A concentrated calendar event of this kind defeats a single stationary count-size fit, which has no way to represent the spike which leads to overstating the annual variance several-fold using the count-size

Source: <https://archive.ics.uci.edu/dataset/502/online+retail+ii>

fit for the whole period. The remedy is to name the event: partition the period into the event window and its complement, fit the count-size structure separately within each, and add the two variances, so the spike enters as deterministic structure rather than noise. The dataset that exhibits both the failure and the recovery is *UCI Online Retail II*, the complete invoice record of a UK-based online giftware retailer from December 2009 through December 2011. The two years contain roughly one million invoice lines across tens of thousands of orders, and many of the retailer's customers are wholesalers, which keeps the data closer to a B2B revenue process than the consumer storefront suggests. Revenue concentrates heavily in the weeks before Christmas — exactly the deterministic calendar spike a single stationary fit cannot represent. Section A.2 of the back-of-book mathematical companion formalizes the calendar-event indicator and validates it on this data.

The framework names two further count-variance amplifiers that this chapter's public data cannot cleanly exhibit: a pipeline-coverage penalty derived from Little's Law, which inflates count variance when the pipeline is too short to cover the period's target, and a Hawkes self-excitation amplifier $1/(1 - n)^2$, which prices the referral and reference-account flywheels through which one close raises the odds of the next (Sections A.3 and A.4 of the mathematical companion).

5.7. Managing Revenue Risk

2: The full formal treatment of significance thresholds, the language for converting an observed deviation into a probability, and the tiered-response framework for acting on each tier are developed in Chapter 16, where the same machinery extends to earnings, cash flow, and capital-structure outcomes.

The decomposition of revenue variance into sources converts risk measurement into risk management. Once the sources are identified and ranked, the management team has a basis for allocating effort and investment toward the sources that contribute the most to total uncertainty. Before the section turns to specific management uses, it is worth being precise about what the framework produces and what it leaves to the operator.² Salience computes the relative dispersion of revenue from the count-size structure of the business and propagates the resulting CV through the cascade; the level forecast remains the planner's input. The two contributions compose: the planner's level becomes the center of the period's revenue band, the CV becomes the band's relative width. When the level is right, the band reads observed deviations as the natural variation the business carries. When the level is biased, the systematic run of observations on one side of the band becomes a calibrated bias signal — a single $z < -2$ observation is a 2.3% event, two consecutive such observations a 0.05% event — and the planner's tracking discipline resets the level while leaving the CV unchanged. Section 5.6.1 works exactly this case on the NYC Yellow Taxi data.

5.7.1. Assigning Forecast Responsibility

Most organizations assign revenue targets to individuals or teams: a sales leader owns a quota, a customer success manager owns a renewal book, a product team owns a usage metric. Salience extends each assignment to the variance dimension — once the decomposition shows that 25% of revenue variance comes from churn, the person who manages churn owns 25% of revenue risk.

5.7.2. A Line-Level Roadmap and the Alignment It Produces

Modeling a business as a portfolio of forecasts — the structure of Section 5.3 — turns variance attribution into a look-through into which line-level source moves company-level uncertainty the most. Each line carries its own count-size decomposition and its own dominant driver: a diversified industrial company might find its maintenance line churn-dominated, its projects line count- and coverage-dominated, and its parts line concentrated in a handful of large accounts. The roadmap the framework produces is then a set of line-specific levers — the maintenance line's churn, the projects line's pipeline coverage, the parts line's customer concentration — each ranked not by its weight within its own line but by how much it contributes to the *company-level* CV through the correlation structure that binds the lines together. A churn program that matters enormously inside a small line can rank below a pipeline program in a large one once both are expressed in company-level terms.

The structure that produces the roadmap also assigns it. Each forecast has a natural owner — a line general manager, a sales leader, a customer-success team — and because every line's variance rolls into the same company CV, each owner's contribution is stated in the same currency. A line owner becomes accountable not only for the line's target, but also for its goal risk; and initiatives that live in different lines and pull different operational levers become directly comparable, because a percentage point of company-level CV removed in the maintenance line and a point removed in the projects line are equivalent. The decomposition that tells the company what to fix, in priority order, can also indicate who owns each fix, on a scale that lets the two be ranked against each other.

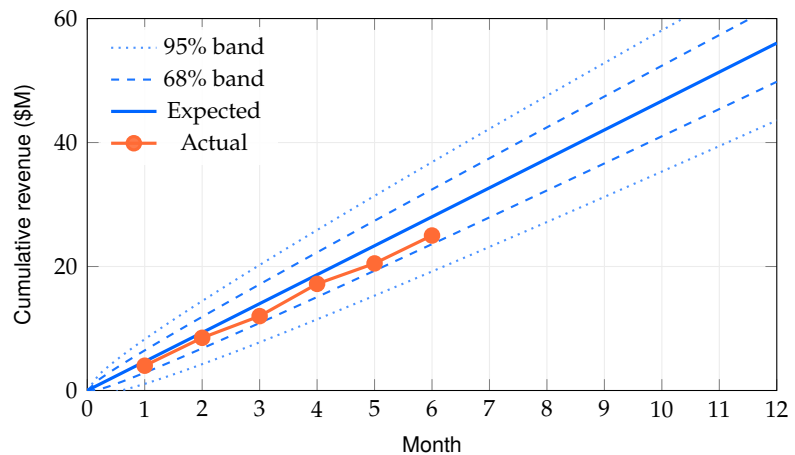
A single company forecast yields a generic improvement list. A portfolio of forecasts yields a line-specific one: which lever, in which line, moves the most company-level variance per dollar of effort.

5.7.3. Tracking Actuals Against Forecast

Once the year begins, actual results start arriving. The framework's bands prevent two common errors in performance management: premature intervention (reacting to what is actually normal variation) and delayed recognition (ignoring a genuine departure because it looks like noise). A sales team that has closed 35% of

its annual target by the end of the first quarter might be ahead, behind, or in line, depending on the expected seasonal pattern and the natural variability of the process.

Exhibit 5.4.: A confidence fan for revenue tracking. Expected cumulative revenue (solid blue) bounded by the 68% band (dashed) and 95% band (dotted). The actual path (orange) runs within the 68% band through six months, indicating normal variation rather than a systematic departure. Band widths grow with $\sqrt{t}$ because variance is additive over independent sub-periods.



The framework computes significance scores for each deviation, enabling a tiered response where the threshold for investigation is a function of the company's own CV: a 10% quarterly shortfall at a company with 25% revenue CV is unremarkable, while the same shortfall at a company with 8% CV is a meaningful signal. The formal z-score thresholds, tiered-response table, and variance-attribution schemes are developed in Chapter 16.

5.7.4. Variance Attribution

Table 5.3.: Same \$2M miss, different diagnoses.

	X	Y
Fewer deals	1.4	0.2
Smaller deals	0.6	0.6
Higher churn	—	1.2
Total (\$M)	2.0	2.0

When actual results diverge from the forecast, Saliency decomposes the gap into its operational components. The same \$2 million shortfall can read as \$1.4M from fewer deals plus \$600K from smaller deal sizes at one company and as \$800K from higher churn plus \$1.2M from slower new-logo acquisition at another. The totals match while the diagnoses differ, and the management responses differ with them.

5.7.5. Channel Mix as Risk Management

A company with multiple revenue streams has a natural risk-management tool: diversification.³ A managed services company that sells enterprise contracts (around thirty per year at a million dollars each, standalone CV near 22%) alongside self-serve subscriptions (roughly three thousand customers paying ten thousand on average, standalone CV near 8%) carries two streams that are effectively uncorrelated — enterprise responds to procurement calendars while self-serve responds to product changes and word of mouth. Exhibit 5.5 sweeps the self-serve share from zero to one hundred percent at constant total revenue, and the combined CV in the interior falls below either standalone value.

3: This is the revenue-level analogue of portfolio diversification in public equity. Imperfectly correlated revenue streams, combined, produce a portfolio-level CV lower than the weighted average of the individual CVs. The mathematical framework is identical to Markowitz's, applied to revenue streams rather than securities.

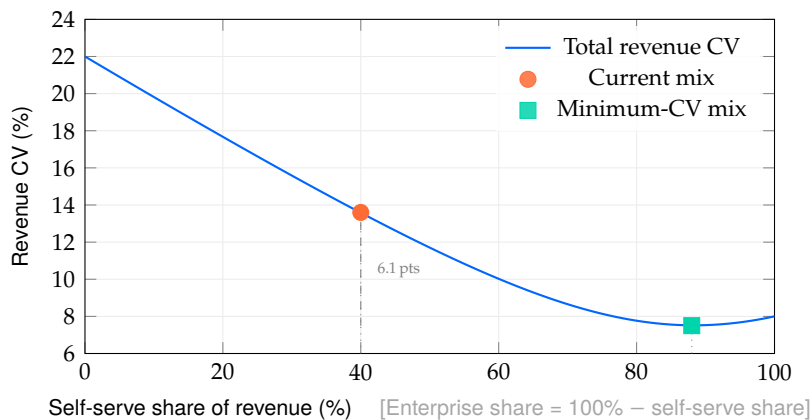


Exhibit 5.5.: Channel mix as a variance lever. Total revenue CV as a function of the self-serve share, with the enterprise share filling the remainder and total expected revenue held constant. Both endpoints carry the standalone CV of a single channel, which is higher than what diversification produces in the interior. The minimum sits at roughly 88% self-serve (teal), where the calmer channel dominates the mix and the small enterprise remainder still cancels a portion of its variance. The current mix (orange, at 40% self-serve) sits well to the left of the minimum, carrying about six percentage points of avoidable variance at no cost in expected revenue.

That diversification reduces variance has been familiar since Markowitz. What changes here is the visibility of the curve itself: the manager who can locate the current mix on it can make a quantitative decision about how far to shift, and where further shifting begins to cost more than it saves. The three percentage points of revenue CV the rebalancing recovers do not remain at the revenue tier — they propagate. At a contribution margin of around 50%, the earnings CV falls by roughly two points, which a buyer at nine times EBITDA prices as a meaningful multiple expansion. The same earnings, arriving more reliably, also tighten the cash-flow distribution lenders use to size debt. The revenue manager rebalancing the channel mix is also performing valuation engineering and credit improvement. The cascade is what makes the secondary effect computable.

5.8. From Pipeline Data to Cascade Parameters

The count-size framework works, in its forecast context, with three aggregate parameters: the expected count of deals in the period, the average deal size, and the standard deviation of deal size around that average. The natural source of all three is a system the company already runs — the CRM pipeline. Each named deal carries a stage-based close probability and a contracted or estimated value; the expected pipeline count is the sum of close probabilities across all named deals plus a *pipeline residual* for deals not yet individually identified, and the size moments are the probability-weighted average and dispersion of deal values across the named pipeline.

Two views of count converge at the pipeline. The top-down view reads the count as the target-implied quantity — the revenue target divided by the average deal size. The bottom-up view reads it as named-deal close probabilities plus the pipeline residual's

The CRM as a variance model. Close probabilities, deal values, and the residual pipeline together specify Saliency's revenue model. The data is already in the system; the cascade reads it as a count-size decomposition.

expected count. Sales teams already track the ratio under the name *pipeline coverage*: a bottom-up count short of the target-implied is a pipeline deficit calling for demand generation; one that exceeds it suggests conservatism or a misunderstanding of the opportunity at hand.

The formal derivation of how the bottom-up pipeline translates into aggregate size-count, and a worked numerical example are in Section A.5 of the back-of-book mathematical companion. The intuition is that the count-size framework and the CRM pipeline are the same model at different resolutions: the framework works top-down from aggregate parameters, the pipeline works bottom-up from named deals, and the two meet in the middle at a variance number the head of revenue can compute from the forecast call.

5.9. Case Study: Trading Targets for Predictability

Consider a VP of Sales at a mid-market software company evaluating two growth plans for the coming year. Both plans target similar total revenue, but they differ in structure.

These plans represent a genuine trade-off that many sales leaders face. Aggressive new logo acquisition carries high count risk (will the pipeline deliver?) and often high size risk (new logos tend to be less qualified than renewals). Conservative expansion-focused growth carries lower count risk (existing customers are easier to forecast) with modest size risk.

Plan A: Aggressive new logo growth. The company targets 120 new logos at an average contract value of \$100,000 for \$12 million in new business, plus a base of \$38 million in renewals. Total expected revenue: \$50 million. New logo acquisition has high count uncertainty (the pipeline conversion rate varies quarter to quarter) and moderate size uncertainty. Revenue CV under this plan: 18%.

Plan B: Expansion-focused growth. The company targets 60 new logos at \$100,000 (\$6 million in new business), invests heavily in customer success to reduce churn from 10% to 6%, and launches an expansion program targeting \$4 million in upsells from the installed base. Total expected revenue: \$48 million, roughly \$2 million lower than Plan A. Revenue CV under this plan: 11%.

The VP's traditional metric, expected revenue, favors Plan A. Salience adds a second metric: goal risk. Plan B produces \$2 million less in expected revenue but carries 7 percentage points less in CV. That difference propagates through the cascade. At the earnings tier, Plan B's lower CV produces a tighter earnings distribution, which at the valuation tier supports a higher multiple and, at the capital structure tier, a lower breach probability.

The result is counterintuitive to someone trained to maximize expected revenue. Plan B, with \$2 million less in expected revenue, produces \$4 million more in implied enterprise value and a breach probability that is one-third of Plan A's. The lower CV, propagated through the cascade, more than compensates for the lower expected outcome.⁴

4: This does not mean that lower revenue targets are always better. The trade-off depends on the specific CVs, the capital structure, the risk appetite of the board, and the magnitude of the revenue difference. What Salience provides is the framework for evaluating the trade-off quantitatively rather than relying on the default assumption that higher expected revenue is always preferable.

	Plan A	Plan B
Expected revenue	\$50M	\$48M
Revenue CV	18%	11%
Earnings CV	26%	17%
Risk-adjusted multiple	7.8x	8.5x
Implied EV	\$85M	\$89M
Breach probability	12%	4%

Table 5.4.: Two growth plans for the same company. Plan B trades \$2M in expected revenue for 7 points of CV reduction, which produces a net positive effect on both valuation and credit metrics.

This is the kind of decision that Saliency is designed to inform. Some companies have the capital structure headroom and the investor appetite for aggressive, high-CV growth. The decision benefits from full visibility into the risk-adjusted consequences alongside the expected outcomes.

5.10. Technical Appendix

This appendix derives the core count-size results the chapter's claims stand on: the compound Poisson distribution, the Cox decomposition of rate variability, the over-dispersion parameter ϕ , and the model's assumptions and boundaries. The specialist extensions — smooth seasonality, calendar-event indicators, pipeline coverage, self-excitation, and the bottom-up construction of parameters from a named-deal pipeline — are developed in the back-of-book mathematical companion (Appendix A).

5.10.1. The Compound Poisson Distribution

Revenue arrives as a sequence of discrete events each with its own dollar value. Total revenue for a period is the sum of these events: the count of events multiplied by their average size, with variability on both axes. Two distinct sources of uncertainty are in play. The first is count risk: the uncertainty in how many events occur. The second is size risk: the uncertainty in how large each event is, conditional on it happening. The compound Poisson is the probability model that composes the two.

The plain Poisson distribution describes the count. It has a single parameter λ that is *simultaneously* the mean and the variance of the count. The Poisson is the limit of n independent Bernoulli trials each with success probability p , taken as $n \rightarrow \infty$ and $p \rightarrow 0$ with $np = \lambda$ held fixed; both the mean (np) and the variance ($np(1-p)$) collapse to λ in that limit, because $1-p \rightarrow 1$. The intuition is that under independent rare arrivals there is only one source of count uncertainty — the arrivals themselves — so any accounting of dispersion lands on the same number that counts the expected arrivals.

A Poisson-distributed count with expected value 10 has a standard deviation of $\sqrt{10} \approx 3.2$; a count with expected value 100 has a

Frequency and severity. The compound Poisson is the actuarial tool for insurance claims; Saliency applies the same mathematics to revenue events under different names.

The same Bernoulli framing reappears in a different role in the back-of-book mathematical companion. Section A.5 works bottom-up from a CRM pipeline of named deals, where each individual deal is its own Bernoulli trial with a known close probability and value. The top-down Poisson-limit view here and the bottom-up Bernoulli-sum view there are dual descriptions of the same revenue process.

standard deviation of 10. Absolute uncertainty grows with $\sqrt{\lambda}$, while relative uncertainty — standard deviation divided by mean — shrinks as $1/\sqrt{\lambda}$. This is the law of large numbers at work. More events make the count more predictable in relative terms, even as the absolute variability grows.

The compound Poisson extends the plain Poisson by making the event being counted also a random variable. With the intuition in place, the formal model reads straightforwardly. Revenue over a forecast period is the sum of a Poisson-distributed number of independent, identically distributed sizes:

$$R = \sum_{i=1}^N S_i, \quad (5.1)$$

with $N \sim \text{Poisson}(\lambda T)$, where λ is the arrival rate per unit time and T is the length of the forecast window. The sizes S_i are drawn independently from a common distribution with mean $\mu = E[S]$ and variance $\sigma^2 = \text{Var}(S)$. The convention $R = 0$ when $N = 0$ closes the definition. The size distribution is not specified beyond its first two moments — a property the section returns to once the variance formula is in hand.

The product λT is the expected number of events in the window. Carrying λ and T as separate symbols is what allows this appendix and the mathematical companion to reason about time-varying arrival rates: the Cox decomposition lets λ itself become random across periods, the non-homogeneous Poisson process in Section A.1 of the companion lets λ vary deterministically as $\lambda(t)$ within the window, and named-event partitioning in Section A.2 lets λ jump between regimes.

The mean. Conditional on N , revenue is a sum of N identical-mean sizes, so $E[R | N] = N\mu$. The law of total expectation gives the unconditional mean:

$$E[R] = E[E[R | N]] = E[N\mu] = \mu \cdot E[N] = \lambda T \mu. \quad (5.2)$$

The variance. The size and count contributions combine through the law of total variance, an identity this appendix uses repeatedly:

$$\text{Var}(R) = E[\text{Var}(R | N)] + \text{Var}(E[R | N]). \quad (5.3)$$

The Cox decomposition (Section 5.10.2) and the Bernoulli-sum derivation (Section A.5) are the same identity applied with different conditioning variables.

Step 1: the conditional variance. Given N , revenue is the sum of N i.i.d. draws from the size distribution, so $\text{Var}(R | N) = N\sigma^2$. Taking the outer expectation:

$$E[\text{Var}(R | N)] = \sigma^2 \cdot E[N] = \lambda T \sigma^2. \quad (5.4)$$

This is **size risk**: the within-count variability, averaged over the count distribution.

Step 2: the variance of the conditional expectation. The conditional mean $E[R | N] = N\mu$ varies with N , contributing

$$\text{Var}(E[R | N]) = \text{Var}(N\mu) = \mu^2 \cdot \text{Var}(N) = \mu^2 \lambda T, \quad (5.5)$$

where the last step uses $\text{Var}(N) = \lambda T$ for the Poisson count. This is **count risk**: the variability the count itself contributes to the conditional mean.

Adding the two parts:

$$\text{Var}(R) = \lambda T \sigma^2 + \lambda T \mu^2 = \lambda T (\sigma^2 + \mu^2). \quad (5.6)$$

The standard variance identity $E[S^2] = \sigma^2 + \mu^2$ collapses the two terms into a single second-moment expression:

$$\text{Var}(R) = \lambda T E[S^2]. \quad (5.7)$$

The same λT scales both the size term and the count term because the Poisson count carries its mean and variance in a single parameter.

The size distribution requirements. The result depends on the size distribution only through its first two moments μ and σ^2 . The shape of S beyond those — whether deal sizes are heavy-tailed, bimodal, or skewed — does not enter. The cascade can be computed from CRM data without committing to a parametric form for the size distribution; the empirical mean and variance of historical deal sizes are sufficient inputs. The Poisson assumption on the count is what produces the clean factor of λT multiplying $E[S^2]$; weaker assumptions on N are what the Cox decomposition addresses next.

The CV of revenue is then:

$$\text{CV}(R) = \frac{\sqrt{\text{Var}(R)}}{E[R]} = \frac{\sqrt{\lambda T E[S^2]}}{\lambda T \mu} = \sqrt{\frac{E[S^2]}{\lambda T \mu^2}} = \sqrt{\frac{1 + \text{CV}(S)^2}{\lambda T}} \quad (5.8)$$

Equation (5.8) makes visible two structural features. First, the revenue CV decreases as the expected count λT increases: more deals means more predictability, which is the same law of large numbers recovered from the Poisson-only case. Doubling the rate has the same effect as doubling the window: both raise expected events and shrink relative dispersion. Second, the revenue CV increases with the CV of deal sizes: more variable deal sizes mean less predictable revenue, even at the same expected count. The dominant levers on revenue uncertainty in the simplest case are the rate λ , the window T , and the size dispersion $\text{CV}(S)$.

5.10.2. Cox Decomposition of Rate Variability

The derivation above used the Poisson identity $\text{Var}(N) = \lambda T$ to collapse count risk into a single λT factor, with λ a fixed rate. Real revenue processes typically carry more count variance than this baseline supplies, and the Cox process (the doubly stochastic Poisson, in which the arrival rate λ is itself random) supplies the decomposition that names the two sources.

Treat λ as a random variable that varies across periods. Conditional on a realized λ over a window of length T , the count is Poisson with mean λT , so $E[N | \lambda] = \lambda T$ and $\text{Var}(N | \lambda) = \lambda T$. Applying the law of total variance (5.3) a second time, now with λ as the conditioning variable:

$$\begin{aligned}\text{Var}(N) &= E[\text{Var}(N | \lambda)] + \text{Var}(E[N | \lambda]) \\ &= E[\lambda T] + T^2 \text{Var}(\lambda).\end{aligned}\tag{5.9}$$

The first term is the within-rate Poisson contribution: the variance the count would carry if λ were the constant $E[\lambda]$. The second term is the rate-uncertainty contribution: the variance added by the rate's own period-to-period variability. The decomposition gives the variance attribution two named rows where it would otherwise have one. A Poisson-dominated process has rate-uncertainty share near zero; a strongly seasonal or regime-switching process has rate-uncertainty share near one.

Propagating to revenue variance. Substituting equation (5.9) into the law-of-total-variance derivation of $\text{Var}(R)$ gives the Cox-level revenue variance before any specific rate-uncertainty tool is chosen:

$$\begin{aligned}\text{Var}(R) &= \sigma^2 \cdot E[N] + \mu^2 \cdot \text{Var}(N) \\ &= E[\lambda]T \cdot E[S^2] + \mu^2 \cdot T^2 \cdot \text{Var}(\lambda).\end{aligned}\tag{5.10}$$

The first term is the within-rate Poisson revenue variance — the variance the cascade would compute if λ were the constant $E[\lambda]$,

which recovers equation (5.7) with $\lambda T = E[\lambda]T$. The second term is the rate-uncertainty contribution to revenue variance: the rate's period-to-period variability, scaled by the squared mean deal size and the squared window. Rate uncertainty enters revenue variance through the count channel only — the size-risk side $\sigma^2 \cdot E[N]$ depends on $E[\lambda]T$ and is unchanged by $\text{Var}(\lambda)$.

How the cascade's three rate-uncertainty tools compose. The task now at hand is to choose an approach to handle $T^2 \cdot \text{Var}(\lambda)$, the rate uncertainty. We have three choices, each of which can be used separately or in combination.

- ▶ The over-dispersion parameter ϕ developed in Section 5.10.3 captures rate uncertainty in a single number, with no commitment to its source. It is the right tool when the user has limited data or no clear calendar structure.
- ▶ The non-homogeneous Poisson process $\lambda(t)$ developed in Section A.1 of the mathematical companion absorbs the deterministic, calendar-driven portion of rate uncertainty into a smooth function of time. After $\lambda(t)$ is fit, what remains in the rate-uncertainty bucket is the residual rate uncertainty — the stochastic portion the smooth fit cannot account for.
- ▶ The calendar-event indicators developed in Section A.2 of the companion absorb the concentrated discrete-event portion that smooth seasonality cannot resolve; a single Black-Friday week, a fiscal-year-end compression, a conference-driven burst.

The three tools compose hierarchically. A user with one year of data and no clear calendar structure uses ϕ alone. A user with multi-year data and a smooth annual cycle fits $\lambda(t)$ and accepts a smaller residual rate uncertainty captured by ϕ . A user with both a smooth cycle and a discrete spike fits both $\lambda(t)$ and the calendar-event indicators, again leaving a residual rate uncertainty ϕ for whatever remains. The variance attribution in each case has a row for each tool: the Poisson baseline, the seasonal-component contribution from $\lambda(t)$, the named-event contribution from the indicator, and the residual rate uncertainty ϕ for unmodelled rate variability. Operational improvements address each row through a different lever.

The terminology requires one disambiguation to avoid collision with the mathematical companion. The “residual” here, and throughout the cascade's rate-uncertainty tools, names whatever rate uncertainty remains after the deterministic structure has been absorbed. It is a leftover variance term in the count process. The bottom-up view in Section A.5 of the companion introduces a separate quantity — the *pipeline residual*, an expected-revenue bucket of unidentified deals — which is a structural component of the period's level rather than a leftover variance. The two senses share a word but live in different places: the residual rate uncer-

tainty is a top-down stochastic remainder, the pipeline residual is a bottom-up expected-revenue contributor.

5.10.3. Seasonality and Over-Dispersion

The over-dispersion parameter ϕ developed here is the simplest of the cascade's three tools for filling the rate-uncertainty bucket of the Cox decomposition (Section 5.10.2). It captures the entire rate-uncertainty piece in a single number, with no commitment to its source. The two structural extensions — the smooth seasonal index $\lambda(t)$ and the calendar-event indicators, developed in Sections A.1 and A.2 of the mathematical companion — compose with ϕ rather than replacing it: each absorbs a portion of the rate-uncertainty bucket, and whatever stochastic variation remains is what ϕ then represents.

Real revenue processes rarely conform perfectly to the Poisson assumption that the rate of deal arrivals is constant. Deals cluster at quarter-ends. Pipeline activity fluctuates with marketing campaigns and trade shows. These phenomena produce over-dispersion: variance in the count that exceeds the Poisson mean.

Over-dispersion is modeled by allowing the variance of N to exceed $E[N]$. A dispersion parameter ϕ captures the degree of temporal clustering:

$$\text{Var}(N) = E[N] \cdot (1 + \phi \cdot E[N]) \quad (5.11)$$

When $\phi = 0$, equation (5.11) reduces to the Poisson case. When $\phi > 0$, the count variance is larger, reflecting the burstiness of deal arrivals. This adds an additional term to the revenue variance that captures the contribution of seasonality and temporal clustering to total uncertainty.

Relating ϕ to the rate's CV. Equation (5.11) is exactly the Cox decomposition (5.9) with the (expanded) rate-uncertainty piece written as $\phi \cdot E[N]^2$. Setting $E[\lambda T] = E[N]$, matching variances, and rearranging both sides gives:

$$\phi = \frac{\text{Var}(\lambda)}{E[\lambda]^2}, \quad (5.12)$$

or equivalently $\phi = \text{CV}(\lambda)^2$. The interpretation: ϕ is revealed as the squared coefficient of variation of the rate. The rate's CV, $\sqrt{\phi}$, is the period-to-period diagnostic the cascade reports.

Why no distributional assumption on λ . The natural parametric route is $\lambda \sim \text{Gamma}$, which makes N negative binomial via the Poisson-Gamma mixture and recovers exactly the over-dispersion form (5.11) with $\phi = 1/r$ at Gamma shape parameter r . The framework does not commit to this assumption for the same reason it does not commit to a distribution for S : the revenue variance depends on the rate only through its first two moments. The distributional shape of λ matters only for quantiles or tail probabilities of the count itself, where the Gamma assumption supplies a closed form via the negative binomial.

Propagating to revenue variance. The ϕ parameterization is the Cox-level revenue variance (5.10) with the rate-uncertainty term written as $T^2 \cdot \text{Var}(\lambda) = \phi \cdot (\lambda T)^2$:

$$\text{Var}(R) = \lambda T \cdot E[S^2] + \phi \cdot \mu^2 \cdot (\lambda T)^2. \quad (5.13)$$

The first term is the Poisson-baseline revenue variance from equation (5.7); the second is the over-dispersion contribution. The structural form matches the general Cox decomposition — a Poisson-baseline term plus a rate-uncertainty add-on, the add-on scaling with μ^2 rather than $E[S^2]$ because the rate's variability multiplies the count's mean contribution to revenue, not the size's intrinsic dispersion.

Empirical reading. On the UCI Online Retail II monthly counts (twenty-three complete months, February 2010 through November 2011), the rate-uncertainty share of $\text{Var}(N)$ is 99.2%; the Poisson baseline contributes only 0.8% of total count variance. The implied period-to-period rate CV $\sigma(\lambda)/E[\lambda]$ is 26.8%. The diagnostic on this dataset is sharp: the count variance is rate-driven, and the rate's period-to-period variability is the quantity operational improvements should target.

Intuition: from ϕ to months of clustering. The product $\phi \cdot E[N]$ is the natural scale. It measures how many units of *extra* count variance, per unit of Poisson baseline, the temporal clustering adds. Expanding equation (5.11): $\text{Var}(N) = E[N] + \phi \cdot E[N]^2$. The first term is the Poisson variance the business would see if deals arrived uniformly. The second term is the seasonality contribution. Their ratio, $\phi \cdot E[N]$, is the amplification factor. The five regimes below translate typical values into the kind of closing calendar they imply, using a business with $E[N] = 40$ annual deals as the anchor.

Count CV in the table is $\sqrt{\text{Var}(N)} / E[N]$ at $E[N] = 40$. The Poisson baseline of 16% corresponds to $\sqrt{40}/40$; the $\phi = 0.5$ row — where the feast-or-famine amplification takes variance from 40 to 840 — produces a count CV that exceeds half the mean. A rough rule of

Table 5.5.: Five regimes of ϕ and the closing-calendar patterns they imply. “Year-end” and “quarter-end” refer to the entity’s fiscal calendar, not the calendar year — the math is calendar-agnostic and just measures count over-dispersion.

ϕ	$\phi \cdot E[N]$	Count CV	Calendar pattern	Typical business
0	0	16%	Uniform across months	E-commerce, utilities
0.01	0.4	19%	Mild quarter-end concentration	Steady-state SaaS renewals
0.03	1.2	23%	Strong quarter-end concentration	Sales-led B2B SaaS, professional services
0.05	2.0	27%	Mild year-end concentration	Enterprise software, ad platforms (Q4 budget-flush dynamics)
0.15	6.0	42%	Heavy year-end concentration	Capital equipment, PE deal services (revenue-rec push, long deal cycles)
0.50	20.0	73%	Feast-or-famine	Early-stage enterprise, project services

thumb: if the business concentrates the bulk of its closings into roughly k of the 12 months, an $E[N] = 40$ business has effective $\phi \approx (12 - k)/(k \cdot E[N])$. Four active months gives $\phi \approx 0.05$; two active months gives $\phi \approx 0.125$; a single month (true December-only closings) gives $\phi \approx 0.28$. The translation is approximate because real closing calendars have a long tail rather than a hard zero elsewhere, but the mapping is accurate enough to orient a first estimate.

5.10.4. Assumptions and Boundaries

The cascade addresses the stationarity violation through three composable tools: ϕ (Section 5.10.3) for stochastic period-to-period rate variability, and — in the mathematical companion — the NHPP $\lambda(t)$ (Section A.1) for smooth seasonality and calendar-event indicators (Section A.2) for discrete spikes. Inter-arrival dependence is addressed separately through the Hawkes amplifier (Section A.4). Independence between arrivals and sizes, and approximate symmetry of the size distribution, are maintained throughout.

The compound Poisson model assumes that deal arrivals and deal sizes are independent, that the arrival rate is stationary within each period, that arrivals are independent of one another, and that the distribution is approximately symmetric around its mean. Real revenue processes can violate any of these. Large deals may create pipeline fatigue that suppresses subsequent arrivals or trigger follow-on closes through referral chains (violating arrival independence in either direction). Market shocks may shift the arrival rate mid-period (violating stationarity beyond what ϕ , $\lambda(t)$, and partition-blend can absorb). A handful of outsized deals may skew the distribution, making the mean a poor summary of the center (violating the symmetric, bell-shaped assumption that underlies the confidence intervals).

The framework treats the compound Poisson as a structural baseline—a first-order approximation that captures the dominant sources of variance—rather than a complete statistical description. The CV, being a ratio of standard deviation to mean, is robust to moderate departures from these assumptions: it remains a meaningful measure of dispersion even when the underlying distribution is not perfectly Poisson. When the violations are severe—a

single contract dominates revenue, a regime shift has occurred, or outcomes are heavily skewed—the CV will systematically understate true risk, and the confidence intervals derived from it should be interpreted with additional caution.

The diagnostic Section 5.6 uses a two-sided exact binomial test of the observed within- 1σ coverage rate against the normal-prediction null $p_0 = 0.6827$. On the Iowa Liquor and NYC Taxi held-out windows the observed coverage is $6/12 = 0.50$, the binomial p-value is 0.21, and the framework’s predicted dispersion is not rejected at conventional levels. The expected count under H_0 is $np_0 = 8.19$ with binomial standard deviation 1.61; the observed deficit of 2.19 months is one binomial standard deviation below expected, which the $n = 12$ sample size makes indistinguishable from the prediction. The Wilson 95% confidence interval on the observed coverage rate spans $[0.25, 0.75]$ on the same data, which contains the predicted 0.68 comfortably; the interval communicates the sampling uncertainty about coverage that the binomial p-value summarizes in a single number. The UCI Online Retail II partition-and-blend test pools $n = 23$ across the two leave-one-year-out folds and obtains 17 in $\pm 1\sigma$ and 23 in $\pm 2\sigma$, with binomial p-values of 0.66 and 0.63 respectively—both consistent with the prediction at a sample size where the test has materially more power than $n = 12$ admits.

The Wilson interval is the natural way to communicate sample-size uncertainty about coverage; it widens our knowledge about whether the bands’ nominal coverage matches reality without widening the bands themselves. A genuinely band-adjusting alternative, conformal prediction, would set the band’s half-width from the empirical residual quantile rather than from the model’s predicted variance and would obtain finite-sample coverage by construction. The framework’s parametric variance prediction does not pursue conformal correction; the binomial coverage diagnostic is reported instead, on the understanding that a model whose predicted dispersion matches observed dispersion at the available sample size is the test the section is making.

Earnings Variance: Revenue Filtered Through Expense Structure

6.

In which revenue uncertainty meets the expense structure, and the choice between fixed and variable costs turns out to be, in part, a choice about risk.

Between revenue and earnings sits the expense structure, which can either dampen or amplify the effect of a revenue shortfall on the bottom line. The degree of dampening depends on the mix of fixed and variable costs, and this mix, which most companies think of purely as a margin question, is also a risk management decision. This chapter develops the earnings tier of the cascade: how revenue variance propagates through expenses, what additional variance the expense structure contributes, and why the resulting earnings CV is almost always higher, in relative terms, than the revenue CV that produced it.

6.1. The Dampening Effect of Variable Costs

The central insight of the earnings tier is that variable costs act as a natural hedge against revenue uncertainty.

When revenue falls short, variable costs, those that scale with activity, fall in proportion. Commissions decline because fewer deals closed. Cost of goods sold declines because fewer units shipped. Cloud infrastructure costs decline because less capacity was consumed. The effect is automatic and immediate: the expense structure absorbs a portion of the revenue shortfall before it reaches earnings.¹

The degree of dampening depends on the contribution margin, the fraction of revenue that remains after variable costs. A company with a 60% contribution margin (40% variable cost ratio) passes through 36% of its revenue variance to earnings. A company with a 40% contribution margin (60% variable cost ratio) passes through only 16%. The relationship is quadratic: the variance that reaches earnings is the revenue variance multiplied by the square of the contribution margin.

The table in the margin makes the arithmetic concrete. A company with 20% variable costs has an 80% contribution margin and passes 64% of its revenue variance through to earnings, absorbing only 36%. A company with 80% variable costs has a 20% contribution margin and passes through only 4%, absorbing 96%. High variable costs produce thin margins and predictable earnings; low variable costs produce wider margins with substantially more earnings volatility.

1: The same mechanism works in reverse. When revenue exceeds expectations, variable costs rise correspondingly, which means the earnings upside is smaller than the revenue upside. Variable costs dampen both the downside and the upside, which is precisely what a hedge does.

Table 6.1: Variance passed through to earnings by cost structure.

Var %	Margin	Passed
20%	80%	64%
40%	60%	36%
60%	40%	16%
80%	20%	4%

6.2. The Trade-Off Between Margins and Predictability

This result reframes a decision that CFOs and operating partners make routinely. Expense structure carries two dimensions: variable costs reduce expected margin, and they also act as insurance against revenue variance because they fall when revenue does. The traditional view treats only the margin dimension. The trade-off is most visible in outsourcing decisions, where converting a function from internal headcount (fixed) to per-unit fees (variable) typically worsens the margin and improves the earnings variance, both quantifiably.

The cascade evaluates outsourcing decisions as movements along a single curve, where conventional analysis takes them one at a time and on margin alone. Exhibit 6.1 shows the curve for a representative company with a 20% revenue CV. The horizontal axis is the variable-cost ratio, swept continuously from a fully fixed structure (10% variable) to a fully outsourced one (75% variable). The vertical axis tracks two quantities at each point: the expected earnings margin (which falls as variable costs rise) and the earnings CV (which also falls, because more variance is absorbed by the cost structure before it reaches earnings). The cost decision is a movement along a frontier with two outputs — expected margin and earnings CV.

Exhibit 6.1.: The margin-predictability frontier. As a company shifts from a fixed cost structure (left) to a variable one (right), expected earnings margin falls (blue, left axis) and earnings CV falls with it (orange, right axis). A shift toward variable costs lowers expected margin and lowers earnings CV together. Points A and B mark the two discrete structures discussed below; the frontier shows that there are infinitely many intermediate choices. A levered company near a covenant threshold should sit further right than its peers; a well-capitalized growth company can afford to sit further left. The position on the frontier is a deliberate strategic choice.

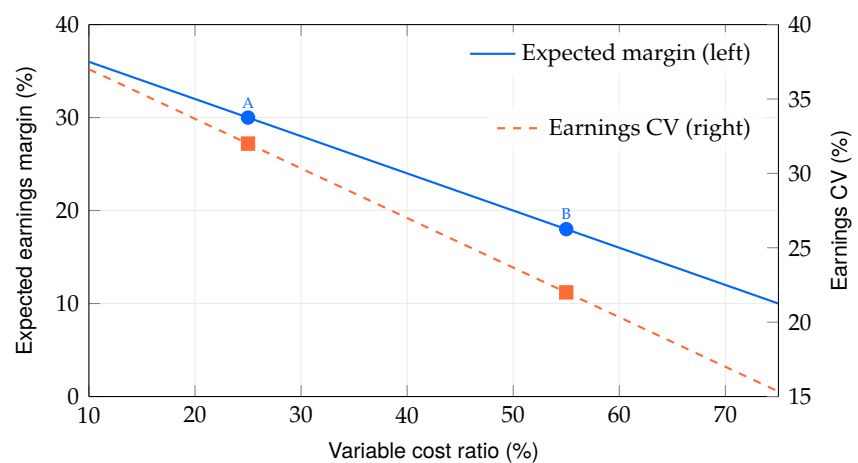


Table 6.2.: Two structures, two outcomes.

	A	B
Variable ratio	25%	55%
Exp. margin	30%	18%
Earnings CV	32%	22%
95% worst	14.2%	11.5%
99.5% worst	5.3%	7.8%

To make the trade-off concrete, consider two specific points on the frontier: Structure A at 25% variable costs and Structure B at 55%, both applied to the same revenue stream.

Structure A produces higher expected margins, 30% versus 18%, and any analysis that considers only the expected outcome would prefer it. The preference survives more scrutiny than the CV column suggests: at the 95% worst case, Structure A's margin

of 14% still exceeds Structure B's 11%, because twelve points of expected-margin advantage absorb a great deal of bad luck before the higher variance overtakes them. The ordering reverses beyond roughly two standard deviations, where the tail is thin but the stakes concentrate. Structure B's variance absorption is deep-tail insurance, purchased with twelve points of expected margin, and whether the premium is worth paying depends on how much a very bad year costs the company beyond the income statement — the question the capital structure cascade takes up in Part IV.

The choice between these structures depends on the company's revenue CV, its capital structure (a leveraged company cannot afford negative earnings), its growth stage (an early-stage company may need margin to reinvest), and the preferences of its investors, with no single answer correct across all four dimensions. What the cascade provides is the ability to evaluate the trade-off quantitatively, along the entire frontier rather than at two arbitrary points. The decision remains the manager's, now informed by the range and the decomposition the cascade supplies.

The reduction in earnings CV does not stop at the income statement. A drop from 32% to 22% expands the buyer's adjusted multiple by something on the order of half a turn, which on the same EBITDA is often worth more in enterprise value than the contribution margin that was given up. The same lower earnings CV also changes the conversation about leverage. A sponsor who was sizing debt against a 32% earnings CV had to leave room for distress in the worst quartile of years; at 22% CV, Structure B's worst quartile is closer to the median, and the same coverage cushion supports a meaningfully higher leverage level (or the same leverage level operates with a more comfortable margin against the covenant). The frontier is therefore an operating decision that the cascade also prices in valuation and capital structure terms, on the same axis and in the same units, which allows the manager to weigh the operating, valuation, and credit consequences together.

Expense structure as a risk lever.

Variable costs are a natural hedge against revenue uncertainty as well as a margin drag: they absorb variance before it reaches earnings. The choice between fixed and variable cost structures is, in part, a choice about how much revenue risk the company is willing to bear at the earnings level.

6.3. Expense Models and Their Variance Contributions

The earnings tier propagates revenue variance through the contribution margin and adds its own sources of uncertainty from the expense structure itself.

Salience supports several expense models, each capturing a different pattern of cost variability. The models differ in how they relate expenses to revenue and in the additional variance they introduce.

2: The expense tier adds only size variance from the expense process. It does not duplicate the count variance already captured in the revenue tier. If revenue falls because fewer deals closed, the variable costs associated with those deals also disappear. The expense tier captures the additional uncertainty in the cost per deal, not the uncertainty in how many deals occurred.

Proportional parameters. Fixed Expense · Fixed Rate CV · Variable Ratio · Ratio CV · Cost Trend · Trend CV.

Semi-Variable parameters. Fixed Cost Base · Fixed Base CV · Variable Ratio · Variable Ratio CV.

Correlated parameters. Base Variable Ratio · Ratio CV · Revenue-Cost Correlation · Non-Linearity Factor.

Deal-Specific parameters. Avg. Deal Margin · StdDev. Deal Margin · Scope Variance · Staffing Mix Premium.

Cloud Usage-Based. Avg. Unit Consumption · Consumption CV · Unit Cost · Unit Cost CV · Revenue-Consumption Lag · Consumption-Revenue Correlation.

Cloud Committed. Committed Spend · Overage Rate · Exp. Utilization · Utilization CV · Overage Probability.

Project-Based. Exp. Project Count · Project Count CV · Avg. Project Cost · StdDev. Project Cost · Overrun Probability · Overrun Magnitude.

SaaS Per-Seat. Base Seats · Seat Growth Plan · Per-Seat Cost · Seat Count CV · Price Escalator.

6.3.1. Proportional and Semi-Variable

The simplest expense model treats variable costs as a fixed fraction of revenue, with some variability around that fraction. The expense ratio itself is uncertain: a company that expects 40% variable costs might experience 38% or 42% in a given year, depending on supplier pricing, labor market conditions, and project mix. This variability adds a layer of expense-specific variance on top of the dampened revenue variance.²

Semi-variable models extend this by separating expenses into a fixed component (per-deal setup costs, minimum staffing) and a variable component that scales with revenue. The fixed component creates a floor below which expenses do not fall, regardless of how low revenue drops, which amplifies the earnings impact of a revenue shortfall.

6.3.2. Correlated and Deal-Specific

Some expense ratios move with revenue in non-proportional ways. A company whose cost ratio increases when revenue is high (because high-revenue periods require overtime, expedited shipping, or premium subcontractor rates) has a correlated expense structure. The correlation deepens the dampening effect: the cost ratio rises to absorb strong periods and falls to cushion weak ones, pulling earnings toward the mean at both ends.

Deal-specific models assign a separate cost ratio to each deal or project, with its own mean and variability. A professional services firm where each engagement has a different margin profile, depending on scope, staffing, and client complexity, fits this pattern. The variance contribution depends on the dispersion of deal-level margins across the portfolio of engagements.

6.3.3. Cloud, Project-Based, and Subscription Expenses

The remaining expense models capture patterns common in technology and services businesses. Cloud usage-based costs scale with consumption, sometimes with a lag relative to revenue. Cloud committed costs are fixed commitments (reserved instances, minimum spend contracts) that create a floor. Project-based costs follow the timing and staffing patterns of specific engagements. SaaS subscription expenses are per-seat costs that scale with headcount rather than revenue.

Each model adds its own variance contribution, which Salience decomposes and attributes alongside the propagated revenue variance. The total earnings variance is the sum of the dampened revenue variance plus the expense-specific variance, and the decomposition tells the CFO exactly how much of the earnings

uncertainty comes from revenue-side factors versus expense-side factors.

6.4. Earnings CV: The Amplification Effect

The earnings CV is almost always higher than the revenue CV, even though the absolute dollar variance of earnings is lower, because the contribution margin shrinks the denominator faster than the variable costs shrink the numerator.

Revenue of \$56 million with a standard deviation of \$7.8 million has a CV of 14%. That revenue, filtered through a 29% contribution margin and a fixed cost base, produces expected earnings of \$12.3 million. The earnings standard deviation is lower in absolute terms, roughly \$2.3 million from the propagated revenue variance and \$2.7 million once expense-side variance is added, because the variable costs absorbed a substantial portion of the revenue variance. The earnings CV, the standard deviation divided by the expected value, is \$2.7 million divided by \$12.3 million, or 22%.

This amplification effect explains a phenomenon that CFOs and analysts encounter routinely: earnings are harder to forecast than revenue because the margin structure concentrates whatever revenue uncertainty exists into a smaller number; the earnings process itself introduces relatively little additional uncertainty. A company with a 10% operating margin and a 15% revenue CV will have an earnings CV that could easily exceed 40%, depending on the fixed-variable mix. The cascade makes this amplification visible and quantifiable, which is the first step toward managing it.

This amplification is the reason earnings guidance is difficult even for companies with predictable revenue. A 14% revenue CV, which might feel manageable, becomes a 22% earnings CV after filtering through the cost structure. The earnings range is proportionally wider than the revenue range, even though the dollar range is narrower.

6.5. Managing Earnings Variance

The measurement-to-management pipeline applies at the earnings tier just as it does at the revenue tier. The tools are the same: decomposition, sensitivity analysis, and a cost-ordered action plan.

6.5.1. Decomposition: Revenue-Side vs. Expense-Side

The earnings variance decomposition separates total uncertainty into its sources: propagated revenue variance (filtered through the contribution margin) and expense-specific variance (from the expense model's own variability). For Athena Industrial Services, approximately 70% of earnings variance comes from the revenue side and 30% from the expense side. This tells the CFO that revenue predictability improvements will have roughly twice the impact on earnings CV as expense predictability improvements, which is useful information for allocating improvement effort.

6.5.2. Sensitivity Analysis

Sensitivity analysis at the earnings tier answers two distinct questions. Mean elasticity measures how a change in each parameter affects expected earnings: which parameters drive the plan. Variance elasticity measures how a change in each parameter affects the earnings CV: which parameters drive the risk. The two can diverge significantly.

A revenue growth target might have the highest mean elasticity (it moves expected earnings the most) while churn rate variance has the highest variance elasticity (it moves the CV the most). A CFO deciding between investing in growth and investing in retention needs both pieces of information to make the right allocation.

6.5.3. The Sharpe Improvement Staircase

The Sharpe Improvement Staircase, introduced conceptually in Chapter 3, is applied concretely at the earnings tier. It ranks creation initiatives by their cost-effectiveness.

The risk-adjusted metric the staircase tracks is the Sharpe ratio, defined here as the ratio of expected earnings to the standard deviation of earnings:

$$S_R = \frac{E[E]}{\sigma(E)} = \frac{1}{CV(E)}. \quad (6.1)$$

The Sharpe ratio here is the reciprocal of the earnings CV, not the textbook asset-pricing definition that subtracts a risk-free rate; the cascade operates on growth and variance in operational output rather than on returns, so no risk-free baseline enters. Sharpe and CV carry the same information.

The staircase takes the variance decomposition, combines it with a user-provided cost ordering (cheapest to most expensive), and computes the incremental improvement in S_R from each step. The result is a sequenced action plan where each step has a quantified impact on earnings predictability, and the cumulative effect traces a rising curve of improving risk-adjusted performance.

The operating partner reviewing Athena's staircase might find that deal desk standardization (low cost, moderate variance reduction) ranks first, customer health scoring (moderate cost, high variance reduction) ranks second, and headcount expansion to diversify the pipeline (high cost, high variance reduction) ranks third. Each step has a specific, quantified effect on the earnings CV, which flows through the cascade to a specific effect on valuation and breach probability. Table 6.3 walks through a representative staircase on Athena, starting from Athena's baseline earnings CV of 22% (Sharpe 4.55) and arriving at 17.3% CV (Sharpe 5.79) after four sequenced interventions.

Sharpe ratio and CV are reciprocals. $S = 1/CV$ whenever expected earnings are positive. A Sharpe of 2 corresponds to a 50% CV (high uncertainty); a Sharpe of 10 corresponds to a 10% CV (high predictability). Improving the Sharpe ratio and reducing the CV are the same operation viewed from opposite sides. The staircase presents the metric as Sharpe because the cumulative improvements read naturally as a rising sequence.

Step	Intervention	Cost	Var. share	Reduc.	CV after	Sharpe
0	<i>Baseline</i>	—	—	—	22.0%	4.55
1	Deal desk standardization	Low	18%	60%	20.8%	4.81
2	Customer health scoring	Med	22%	50%	19.5%	5.14
3	Accelerate Q2 hires by 1Q	Med	15%	40%	18.7%	5.35
4	Pipeline channel diversification	High	30%	35%	17.3%	5.79

Table 6.3.: Athena’s Sharpe Improvement Staircase. Variance share is the component’s contribution to baseline total earnings variance. Reduction % is the share of that component the intervention is expected to remove. CV and Sharpe are recomputed after each step, compounded through the sequence.

The table makes two features of the staircase visible. First, the marginal Sharpe gain is not monotone in variance share: step 4 addresses the largest share (30%) but yields a smaller absolute Sharpe gain per dollar than the lower-cost steps earlier in the sequence, because CV reductions compound non-linearly as the baseline falls. Second, the step with the largest Sharpe jump in the full sequence is the one with the best combination of share and reduction depth, not simply the cheapest or the biggest. The staircase captures this by computing ΔS_R at each step rather than asking the operator to intuit it from the variance decomposition alone.

6.6. The Amplification on Public Data

The chapter’s claim decomposes into two parts that public filings can test at scale. Propagated revenue variance should amplify through the cost structure — the earnings CV rising above the revenue CV as the contribution margin concentrates dispersion into a smaller base — and the expense side should contribute its own variance on top, the second term the earnings-variance equation carries. Every 10-K contains the three series the test needs: revenue, operating income, and enough history to measure the dispersion of both.

The test uses roughly one hundred non-financial U.S. companies with at least twelve fiscal years of XBRL filings.³ For each company, the pass-through of revenue changes into earnings changes — the empirical contribution margin — is estimated on the first half of its history, and the prediction $CV(E) = (CM/m) \cdot CV(R)$ is scored against the earnings CV the company realized. The design is deliberately out-of-sample within each company and cross-sectional across companies: nothing about a firm’s realized earnings dispersion enters its own prediction.

The medians land where the chapter’s arithmetic says they should. Median revenue CV across the sample is 9.0%; median earnings CV is 21% — an amplification of roughly 2.3×, produced by cost

3: Revenue and operating income from SEC companyfacts, fiscal-year values from 10-K filings, tags merged across the 2018 revenue-recognition migration. Dispersion is measured on first differences, which removes trend: $CV_X = \sigma(\Delta X)/\bar{X}$. Firms with negative mean operating income or margins below 2% are excluded, since a level CV loses meaning near zero earnings. The scripts and company-level results ship with the book’s repository.

structures whose median pass-through and margin imply amplification of the same order. Firm by firm, the predicted earnings CV correlates with the realized one at about 0.6, and the association between revenue CV and earnings CV alone runs at 0.7. The propagation is visible in data the framework's authors did not create, at a strength comparable to the valuation-tier evidence of Chapter 7.

The cross-section also exposes the equation's second term. Sorting companies by their predicted revenue-driven CV, the lowest quintiles realize earnings CVs well above their predictions — a floor near 17% that persists even where the revenue channel predicts almost nothing — while the upper quintiles converge to the prediction. Table 6.4 shows the pattern with the floor included in the prediction: one fitted expense-side parameter, common to all firms, closes the gap.

Table 6.4.: Median predicted and realized earnings CV by quintile of the prediction, across 101 non-financial companies with twelve or more fiscal years of filings. The prediction is each firm's first-half pass-through applied to its revenue CV, combined with a single fitted expense-side floor of 16.5% CV: $CV(E)^2 = (CM/m)^2 CV(R)^2 + 0.165^2$. Correlation between predicted and realized values is 0.59.

Quintile of prediction	Predicted CV(E)	Realized CV(E)
1 (smallest revenue channel)	16.9%	18.8%
2	18.2%	16.6%
3	20.1%	16.4%
4	25.6%	27.4%
5 (largest revenue channel)	36.2%	35.2%

4: Athena's 30% expense-side share, used throughout the book's worked examples, describes a labor-heavy services business whose costs track activity closely. The broad public cross-section, weighted toward larger and more complex companies, runs nearer to 60% expense-side. The split is a property of the business, which is why the cascade measures it per company rather than assuming it.

The floor is the expense-side variance of this chapter's second term, measured. For the median public company in the sample, the revenue channel carries roughly 40% of earnings variance and expense-side sources — input costs, one-time items, operating-leverage surprises — carry the rest.⁴ The two-part structure — dampened revenue variance plus expense-side variance — is what the data supports, and neither term alone reproduces the cross-section.

The test also marks a boundary worth stating. Predicting each company's amplification *ratio* from its own short history is unreliable: pass-through estimates drift, one-time items land unevenly, and a decade of annual observations is a small sample for a regression slope. The level prediction survives this noise; the ratio prediction does not. The boundary is the reason the framework elicits the cost structure from the business — the variable ratio the CFO already knows — rather than regressing it out of history, and it is the same design choice the revenue tier made in Chapter 5. Quarterly data tells the same story with more observations and more noise: the amplification medians rise (one-time items concentrate in single quarters), the quintile pattern holds, and the ratio prediction remains the weak link.

6.7. Case Study: A CFO Providing Better Earnings Guidance

The CFO of a mid-market SaaS company is preparing earnings guidance for the board ahead of the annual planning cycle. The company has \$80 million in ARR, growing at 25%, with a 65% gross margin and a 15% operating margin. The board expects a point estimate for next year's EBITDA, and the CFO has historically provided one, derived from the revenue plan and the expense budget.

This year, the CFO is working with Salience. The revenue team's subscription model produces a revenue CV of 16%, driven primarily by new logo acquisition uncertainty (45% of revenue variance) and churn count risk (30%). The expense model adds additional variance from hiring timing (the company plans to add 40 engineers in the first half, and the timing of those hires affects the expense run rate). The resulting earnings CV is 28%.

	Traditional	With Salience
Expected EBITDA	\$15M	\$15M
Earnings CV	(not provided)	28%
68% range	(not provided)	\$10.8M – \$19.2M
95% range	(not provided)	\$6.6M – \$23.4M
Largest variance source	(not provided)	New logo pipeline (32%)
Second largest	(not provided)	Churn (22%)
Third largest	(not provided)	Hiring timing (15%)

Table 6.5.: The CFO's guidance to the board, with and without the cascade. The point estimate is the same. The range and the decomposition are new.

The board conversation changes. The discussion shifts from whether \$15 million is the right number toward whether 28% is an acceptable level of earnings uncertainty, which sources contribute the most to it, and what the company plans to do about them. The CFO can explain that the new logo pipeline represents a third of the uncertainty and that the sales team's pipeline coverage ratio is the leading indicator to watch. The CFO can show that the hiring plan contributes 15% of earnings variance and that accelerating the engineering hires by one quarter would reduce it by half, at the cost of higher near-term expense.

The cascade leaves the point estimate unchanged and adds context around it: the range of outcomes, the sources of uncertainty, and the operational levers that affect both.

6.8. Technical Appendix

6.8.1. The Law of Total Variance

The law in words. The total variance of Y is the average of its conditional variances, plus the variance of its conditional means. The first term captures variability that remains when X is held fixed; the second captures variability in Y 's typical value as X changes. The two pieces are orthogonal — they never double-count — so they sum cleanly.

The law of total variance is the workhorse identity the cascade uses at every tier boundary. For any two random variables Y and X with finite variances:

$$\text{Var}(Y) = \underbrace{E[\text{Var}(Y | X)]}_{\text{expected conditional variance}} + \underbrace{\text{Var}(E[Y | X])}_{\text{variance of conditional mean}}. \quad (6.2)$$

The two terms have a clean operational reading. The first is the residual variance that persists even after X is revealed — the part of Y 's uncertainty that is *not* explained by X . The second is the part of Y 's uncertainty that *is* explained by X — the spread in Y 's typical value as X varies. Summing them recovers the marginal variance of Y .

Applied at each tier of the cascade. Every tier transition in Saliency conditions one tier's variance on the one below it and applies equation (6.2):

Revenue → Earnings. Condition earnings on revenue. The conditional mean $E[E | R]$ varies with R through the contribution margin, contributing $(1-v)^2 \cdot \text{Var}(R)$ to total earnings variance. The conditional variance $\text{Var}(E | R)$ captures expense-model variability at fixed revenue, contributing approximately $R^2 \cdot \text{Var}(v)$. The two pieces are what the main-text equations (6.4) and (6.5) compute.

Earnings → Valuation. Condition valuation on earnings. The valuation multiple is the equivalent of X 's role, and the term $(\text{multiple})^2 \cdot \text{Var}(E)$ propagates earnings variance through the multiple. The conditional variance of valuation given earnings adds the multiple's own variability — the risk-adjustment term the book revisits in Chapter 7.

OCF → DSCR. Condition debt-service coverage on operating cash flow. Part IV works through this case explicitly: the conditional mean of DSCR given OCF carries the propagated OCF variance; the conditional variance of DSCR given OCF is driven by interest-rate variability on floating-rate tranches.

The structural shape is constant across tiers: tier variance = propagated variance from below (the $\text{Var}(E[Y | X])$ term) + tier-specific variance added here (the $E[\text{Var}(Y | X)]$ term). The cascade is, at its core, repeated application of equation (6.2).

Earnings variance, derived. With the law in hand, the earnings variance follows from the definition of earnings in terms of revenue R and expense ratio v :

$$E = R \cdot (1 - v) - F \quad (6.3)$$

where F represents fixed costs. Conditioning on R gives $E[E | R] = R(1 - v) - F$ (treating v 's mean as constant) and $\text{Var}(E | R) = R^2 \cdot \text{Var}(v)$. Equation (6.2) then yields:

$$\text{Var}(E) = (1 - v)^2 \cdot \text{Var}(R) + R^2 \cdot \text{Var}(v) \quad (6.4)$$

assuming independence between R and v . The first term is the dampened revenue variance: revenue variance multiplied by the square of the contribution margin $(1 - v)$. The second term is the expense-specific variance: the square of expected revenue multiplied by the variance of the expense ratio.

When revenue and the expense ratio are correlated (as in the correlated expense model), an additional covariance term appears:

$$\text{Var}(E) = (1 - v)^2 \cdot \text{Var}(R) + R^2 \cdot \text{Var}(v) - 2R(1 - v) \cdot \text{Cov}(R, v) \quad (6.5)$$

Positive correlation between revenue and the expense ratio (costs rise faster than proportionally when revenue is high) deepens the dampening effect. Negative correlation (the cost ratio declines when revenue rises, as in scale-economy businesses) works against it, widening earnings dispersion while raising the expected margin at high volumes.

6.8.2. The Earnings CV Amplification

The earnings CV can be expressed in terms of the revenue CV, the contribution margin, and the operating margin:

$$\text{CV}(E) \approx \frac{(1 - v)}{m} \cdot \text{CV}(R) \quad (6.6)$$

where m is the operating margin (earnings as a fraction of revenue) and $(1 - v)$ is the contribution margin. Since $m < (1 - v)$ for any company with fixed costs, the ratio $(1 - v)/m$ is greater than 1, which means the earnings CV exceeds the revenue CV. The amplification factor is larger for companies with high operating leverage (large fixed costs relative to earnings), which is why high-margin companies with significant fixed cost bases often have surprisingly volatile earnings despite relatively predictable revenue.

Valuation Variance: Where Predictability Becomes Value 7.

In which earnings uncertainty becomes enterprise value, and earnings quality, long discussed in adjectives, finally submits to arithmetic.

Two tiers of the valuation cascade are now in place. Revenue uncertainty was traced to its count-size sources in Chapter 5, and earnings uncertainty was shown in Chapter 6 to be revenue variance run through the expense structure, which sometimes dampens it and sometimes amplifies it. The third tier, which produces enterprise value, is where earnings quality takes a specific numerical form: a discount with a known slope, a closed-form dependence on the earnings CV, and a dollar figure for every point of variance that a management team removes or adds.

This chapter's roadmap. The chapter first tests one of the framework's central claims: that the value of a business moves with the CV of its earnings, the effect the earlier chapters have called quality of earnings. It then separates the two primary forces driving the multiple — the discount from earnings CV and the premium from expected growth, the quality of the growth opportunity — and adapts the familiar Gordon growth model to carry both. It closes by calibrating λ_{CV} , the parameter that sizes the discount applied per unit of earnings CV.

7.1. The Claim and the Test

Private companies are valued through a familiar set of methods: comparable-transaction multiples, trading comps against public peers, discounted cash flow, revenue multiples where earnings are not yet meaningful, and asset-based approaches in distress. This chapter uses the EBITDA-multiple form, which is the language of middle-market private equity. The logic of the chapter carries unchanged to the other methods with different variables in the same roles.

Enterprise value is earnings times a multiple. A company with \$20 million in EBITDA and a 10x multiple has an enterprise value of \$200 million. The multiple is the lever this chapter examines. The chapter's central claim is that the earnings CV from Chapter 6 is one of the things that moves it. Earnings CV is one contributor among several, and a major one, with a contribution identifiable in datasets the framework's authors did not create.

1: The firm-level association is established in the accounting and corporate-finance literatures: Rountree, Weston, and Allayannis find investors price cash-flow volatility directly[10]; Minton and Schrand trace the costs of cash-flow volatility through investment and financing[11]; Dechow, Ge, and Schrand survey the earnings-quality evidence broadly[12]. The aggregate test here asks the same question at the level where the heterogeneity problem cancels.

Specification. We regressed the index earnings yield $1/\text{CAPE}$ on the squared rolling 5-year CV of real NIPA after-tax corporate profits, with VIX (forward-looking implied volatility) and the 10-year Treasury yield (discount-rate environment) as controls; eq. 7.1 below. The sample is 1995-Q1 through 2023-Q3, $n = 115$ quarters; standard errors are Newey-West HAC at lag 4 quarters.

Result. $\lambda_{\text{CV}} = +0.332$ with $p = 0.0006$. The full specification ($\text{CV}^2 + \text{VIX} + 10Y$) explains 23% of the variance in $1/\text{CAPE}$. Variance-inflation factors stay below 1.3, so realized CV^2 and forward-looking VIX identify economically distinct channels rather than the same signal twice.

Why firm-level data is the wrong place to look. The CV-to-multiple relationship the chapter develops is a claim that a one-unit change in CV moves the multiple by λ_{CV} units *with everything else held fixed*. At the firm level, “everything else” includes business quality, brand strength, secular growth profile, capital structure, capital-intensity differences, segment composition, and the firm’s exposure to the prevailing macro regime. EDGAR, yfinance, and the like give us the multiple and the CV cleanly but no usable controls for the other determinants — a heterogeneity problem the calibration method later in the chapter returns to.

The natural response is to aggregate. At the level of the whole equity market, idiosyncratic firm variation cancels out, leaving exposed the systemic risk-pricing channel the chapter’s claim describes. The prior discussion has focused on private companies because that is where Salience is uniquely useful, but the framework applies to public companies too — which means we can borrow the most familiar multiple of all, the S&P 500’s price-to-earnings ratio, and ask a simple question of 28 years of public data: is the movement in the multiple correlated with movement in the variance of earnings?¹

The intuitive read of the data is yes. The three regimes of elevated earnings volatility in the window the test covers — the early-2000s recession, the 2008 financial crisis, and the 2020 COVID dislocation — each coincide with compressed multiples. The inverse case is equally visible: through the long 2010–2017 post-crisis recovery, CV^2 fell steadily as the 2008-era earnings shocks rolled out of the rolling window, and the multiple roughly doubled over the same stretch. Panel (a) of the exhibit below shows the co-movement in both directions; panel (c) plots the relationship directly with one point per quarter and a fitted line through it. The regression model is provided below and defined in the margin.

$$\frac{1}{\text{CAPE}_t} = \beta_0 + \lambda_{\text{CV}} \cdot \text{CV}^2(\text{NIPA profits})_t + \gamma \cdot \text{VIX}_t + \rho \cdot 10Y_t + \varepsilon_t. \quad (7.1)$$

The relationship between multiple and CV of earnings survives after controls are considered. After accounting for forward-looking implied volatility and the rate environment, the chapter’s predicted positive co-movement between earnings volatility and the earnings yield (i.e., the negative co-movement with the multiple) is recovered cleanly. The economic magnitude is meaningful too: a one-percentage-point increase in earnings CV^2 corresponds to a CAPE compression of roughly two turns at sample-mean conditions.

The role of VIX as a control deserves a word. Without it in the regression, the recovered λ_{CV} is roughly half what the full-controls specification gives. VIX absorbs a confound that the simpler regression conflates with CV^2 : realized earnings volatility (a structural

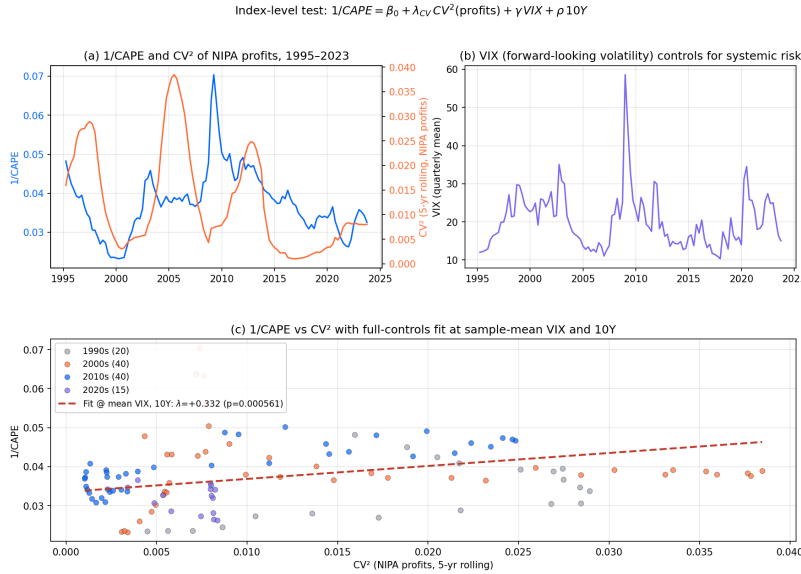


Exhibit 7.1: Aggregating to the index recovers the chapter's claim. (a) The S&P 500 earnings yield 1/CAPE (blue) and the rolling CV² of corporate profits (orange) move together: noisier earnings, lower multiples. The early-2000s recession, the 2008 crisis, and 2020 are all visible. (b) VIX over the same window, used as a forward-looking-volatility control. (c) Scatter of 1/CAPE against CV² with the regression line evaluated at sample-mean VIX and 10Y; the upward slope is the relationship the chapter predicts.

property of the cash flow stream) and forward-looking implied volatility (a sentiment signal about future risk) each price the multiple, and each holds its own when both are included.

Specification	λ_{CV}	p	R^2
Levels: CV only	+0.149	0.15	0.034
Levels: CV + VIX	+0.216	0.034	0.127
Levels: CV + 10Y	+0.248	0.022	0.115
Levels: CV + VIX + 10Y	+0.332	0.0006	0.227
First-diff: ΔCV only	+0.067	0.54	0.003
First-diff: $\Delta\text{CV} + \Delta\text{VIX}$	+0.078	0.29	0.407
First-diff: $\Delta\text{CV} + \Delta\text{VIX} + \Delta 10Y$	+0.067	0.36	0.421

How much of that R^2 is earnings variance pulling specifically, versus the volatility and rate controls? Two readings of the same regression give complementary answers. Averaged across every possible order in which the three predictors could enter the model, CV² contributes roughly the same share of explained variance as VIX and a slightly larger share than the 10Y — the three predictors are comparable on this reading. The sharper test is what each predictor *uniquely* adds, given that the other two are already in the regression. By that measure CV² is the largest contributor of the three: removing it from the full specification more than halves the explained variance, while removing either VIX or the 10Y leaves more of R^2 intact. Earnings variance carries information the standard volatility-and-rates controls do not.

The relationship operates at regime frequency, not quarter-to-quarter. Looking at changes period-over-period rather than levels — a first-differences specification — the slope effectively disappears. This is what the chapter wants. λ_{CV} is a structural parameter that prices a slow-moving property of an earnings stream; it is not a tracking signal that updates every quarter. The level of earnings volatility builds up over years and the market's reset of multiples

Table 7.1: Specifications of the regression in eq. 7.1. The full-controls levels specification delivers the chapter's predicted positive λ_{CV} at high significance.

Two decompositions. *Shapley* R^2 (also called LMG, after Lindeman–Merenda–Gold) averages each predictor's incremental contribution to R^2 over all orders in which the predictors could enter the regression; the column sums exactly to total R^2 . *Semipartial* R^2 is the unique contribution given that the other two predictors are already in the model: $R^2(\text{full}) - R^2(\text{full} \setminus \{p\})$.

First differences. $\Delta(1/\text{CAPE})$ on ΔCV^2 , ΔVIX , $\Delta 10Y$ gives $\lambda_{CV} = +0.067$, $p = 0.36$. ΔVIX absorbs nearly all the high-frequency variation ($p < 10^{-9}$). The CV-multiple channel does not run at quarter-to-quarter speed.

Table 7.2.: Variance decomposition of the full-model $R^2 = 0.227$ across the three predictors.

Predictor	Shapley R^2	Share	Semipartial R^2
CV ² (earnings variance)	0.0790	34.8%	0.1310
VIX (forward-looking vol)	0.0828	36.5%	0.1115
10Y (rate environment)	0.0651	28.7%	0.1002
Sum (= R^2 full)	0.2269	100.0%	—

follows on the same time scale, which is exactly what a regime-frequency relationship looks like in the data.

The test's central claim is therefore confirmed at the level it was designed to operate: aggregate pricing of earnings-stream risk. The relationship between CV of earnings and multiple is significant. The deal-level calibration developed in Section 7.6 remains the right operational procedure for individual-firm valuation, because firm-level identification requires controls that no public-market panel can supply by sample selection.

7.2. Two Qualities

The empirical relationship the previous section established sits inside a larger structure. The chapter is decomposing the multiple along two axes the practitioner reader needs in advance: quality of earnings and quality of growth opportunity.

Quality of earnings is the cascade's contribution. It is what $CV(E)$ measures: the dispersion of the earnings stream around its expected level. A low-CV earnings stream is reliable, plannable, and credit-friendly; a high-CV stream is volatile in ways the operator and the buyer both have to absorb. Saliency computes $CV(E)$ from operational data and decomposes it into named sources, each of which a manager can address.

Quality of growth opportunity is the forecaster's contribution. It measures g : the rate at which the earnings stream is expected to grow. A high-growth opportunity is one where the addressable market is large, the competitive position is durable, and the management team has the operational capacity to execute. A low-growth opportunity is one where the market is mature, share is contested, or scale is already approaching saturation. Saliency does not compute g ; that is the forecaster's job, drawing on sector outlook, competitive analysis, and management assessment.

The two qualities are inputs to the same multiple. In the Gordon form developed in Section 7.5, g enters the denominator with one sign and CV^2 enters with the opposite sign; both move the multiple but through different channels. Empirically the two correlate weakly negative across most samples — high-growth businesses tend to carry higher earnings CV — but with consistent exceptions in both directions. The 2×2 of cases is what makes the chapter's argument legible.

	Low CV(E)	High CV(E)
High growth	Top tier — durable compounding, premium multiples	Optionality plays — high multiples <i>despite</i> variance (early SaaS, biotech)
Low growth	Solid mature — modest multiples (well-run staples, utilities)	Bottom tier — discount multiples (mature cyclicals)

Table 7.3.: The two-qualities matrix. A company's position is the joint product of earnings quality (column, supplied by the cascade) and growth opportunity (row, supplied by the forecaster). A high-CV high-multiple SaaS company is a Top-Right cell, where high growth quality offsets high earnings variance in the Gordon form.

The cascade prices the columns differently; the forecaster's g prices the rows differently. A high-CV high-multiple SaaS company is a Top-Right cell, where the forecaster's high g overpowers the cascade's high CV^2 in the Gordon form.

The full attribution. The two qualities cover the company-side parameters in the Gordon form $M = 1/(r_0 + \lambda_{CV} \cdot CV^2 - g)$. The form has four parameters total, and each has a different source:

Parameter	Source	What it measures
g	Forecaster	Quality of growth
CV^2	Cascade	Quality of earnings
r_0	Macro / sector	Baseline cost of capital
λ_{CV}	Market or investor preference	Price of earnings variance

Table 7.4.: Every parameter in the chapter's working form has a source. The first two are about the company at this moment; the other two are about the market environment.

The first two are company qualities, named in this section. The other two do not change with the company: r_0 moves when risk-free rates move or when the sector re-rates, and λ_{CV} moves when the price of earnings variance moves. Each of the four parameters has a section in the chapter that addresses it directly. Section 7.3 develops drift in g (endogenous) and drift in r_0 (exogenous) over time. Section 7.4 develops the channel through which CV^2 moves the multiple. Section 7.5 introduces the Gordon mechanism that combines all four parameters. Section 7.6 recovers the market-side pair from observable transaction data.

λ_{CV} admits two readings under the same symbol. The first is the market-clearing price of earnings variance, recovered from comparable transactions in Section 7.6; this is the multiple the company will fetch at exit, and it tightens or relaxes with the market's appetite for paying up for predictability. The second reading is a particular investor's own risk preference — the analogue, in this setting, of a risk-aversion parameter that sits away from the tangent portfolio in mean-variance theory. A market clears at one λ_{CV} , but other investors hold portfolios consistent with higher or lower preferences. A fund with conservative LPs may apply a higher λ_{CV} than the market does and pass on a Top-Right cell the marginal buyer would acquire; a turnaround fund may apply a lower one and require the market to discount further before bidding. The same Gordon form serves both readings: $M = 1/(r_0 + \lambda_{CV} \cdot CV^2 - g)$ returns a market valuation when λ_{CV} is calibrated from comparables and a sponsor's

reservation price when it reflects the sponsor's own preference. The wedge between the two prices is the buy/pass decision: a fund acquires when its reservation price exceeds the market price, and the same wedge is where comparative-advantage arguments about risk capacity enter portfolio construction in Part V.

7.3. Multiple Expansion

Section 7.2's 2x2 was a snapshot. This section addresses how a company moves through the matrix over time — the row-direction movement, where the forecaster's g drifts. That drift is what the market calls multiple expansion. The chapter separates it into two components.

Endogenous expansion is earned: the market revises its priced-in growth rate for this specific company as execution proves durability, and the re-rating attaches to the company's own track record. *Exogenous* expansion is received: sector re-rating or macro drift lifts the multiple of every company in the exposure class, regardless of what any individual company does. A software-sector tailwind, a compression in sector risk premia, or a fall in the risk-free rate all produce exogenous expansion; a two-year track record of delivering on guidance produces endogenous expansion. Both arrive as higher multiples at the moment of sale, but they answer to different drivers and belong in different accounts.

In the Gordon formulation of the appendix, endogenous expansion is drift in the market-priced g for this company; exogenous expansion is drift in r_0 , the zero-CV cost of capital. The reduced-form g_M in (7.10) captures both.

The distinction matters for attribution and for portfolio construction. An operating partner earns the endogenous expansion that follows from execution; the exogenous expansion is the sector tide and cannot be credited to operational action. Salience's growth elasticities and the Sharpe Improvement Staircase developed in Chapter 6 turn "earn the endogenous expansion" into a ranked workplan that orders each operational lever by its growth potential and variance reduction per dollar of cost. In portfolio construction, exogenous expansion is shared across holdings in the same exposure class and enters the portfolio covariance as a common driver, while the endogenous component stays company-specific. Part V develops the portfolio mechanics in more detail.

7.4. The CV Discount

Where multiple expansion is the row-direction mechanism, the CV discount is the column-direction one — the channel through which CV^2 moves the multiple at any one moment. The CV discount reflects the market's penalty for unpredictability, applied to whatever multiple the growth environment already supports. Two companies with identical growth expectations and different earnings CVs will command different multiples, with the premium going to the

Two mechanisms push the discount in the same direction. A risk-averse buyer values the certainty equivalent of the earnings stream, which sits below its expected value. A buyer financing the deal with debt faces higher breach probability when earnings variance is higher, raising the effective cost of capital.

predictable one. This discount operates at every growth level, or rows of the 2×2 table.

The separation matters for operating strategy. For a mature company whose growth expectations are already fully priced, CV reduction is often the main lever left. For an early-stage company whose multiple is expanding rapidly on revenue growth, the CV discount may look secondary in relative terms and still be large in dollars, because the base multiple it discounts is itself large.

Systematic and idiosyncratic shares of the CV. Earnings variance further partitions into a component that loads on macro factors and a component specific to the firm. Asset-pricing theory says only the first should command a premium; the empirical literature has spent half a century identifying factors that crossed from the second bucket into the first, and private-market data is too sparse to settle the question on its own. The practical caution is for peer-comparable construction: if the target's variance composition diverges meaningfully from the pool's, the calibrated λ_{CV} will price the target's variance asymmetrically. Narrowing the pool to comparables whose composition plausibly resembles the target's is the operational defense within this chapter; a formal structural decomposition of the partition becomes feasible only once sufficient cascade analytics across the middle market accumulate.

7.5. The CV-to-Multiple Curve

At fixed EBITDA, growth, and buyer risk aversion, the multiple is largely a function of the earnings CV. Enterprise value, being the product of earnings and multiple, moves when the multiple changes. This movement occurs along a curve, the shape of which is defined by a model that relates uncertainty and price.

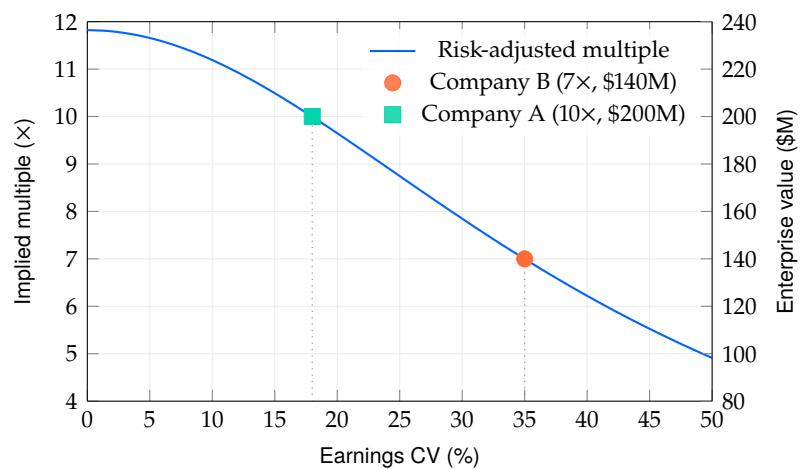
The model we'll use in this chapter is the one most readers will recognize. Gordon growth prices a perpetual stream of earnings growing at rate g as $M = 1/(r - g)$, where r is the buyer's required return on the stream. At zero earnings uncertainty the required return is r_0 , which bundles the risk-free rate and whatever systematic premium comparable public peers already carry. The base multiple the growth environment supports is $M_0 = 1/(r_0 - g)$. This is the multiple that enters analyst models and deal memos against a deterministic version of the stream.

Salience's contribution is to add an earnings-variance premium to the required return. A risk-averse buyer demands extra expected return to hold an uncertain stream, and that premium scales with the squared coefficient of variation: $r = r_0 + \lambda_{CV} \cdot CV(E)^2$. Gordon growth then delivers an adjusted multiple $M = 1/(y_0 + \lambda_{CV} \cdot CV^2)$ with $y_0 = r_0 - g$, which is the form plotted in Exhibit 7.2. Other

functional forms appear in the literature and fit the anchors adequately — a mean-variance certainty-equivalent gives a multiple linear in CV^2 , a lognormal specification gives an exponential decay. Each has its defenders. The Gordon-growth form is used here because its parameters map most directly to our discussion and because its one-line derivation is familiar. The technical appendix works through it in full.

Exhibit 7.2 plots the curve. The left axis shows the implied multiple; the right axis shows the corresponding enterprise value at \$20 million of EBITDA. Company A (18% CV, 10x, \$200M) and Company B (35% CV, 7x, \$140M) are the Chapter 1 anchors. The curve between and around them is the shape the operating partner needs to read.

Exhibit 7.2.: The CV-to-multiple curve. Implied multiple (left axis) and enterprise value at \$20M EBITDA (right axis) as functions of earnings CV. The curve is Gordon growth with an earnings-variance premium in the required return: $M = 1/(y_0 + \lambda_{CV} \cdot CV^2)$, fit to the Chapter 1 anchors at $y_0 \approx 0.085$ and $\lambda_{CV} \approx 0.48$. Company B (orange) and Company A (teal) are the Chapter 1 anchors: 35% CV at 7x, 18% CV at 10x.



The curve flattens at both ends for related reasons. At very low earnings CV the variance premium is small against the baseline cost of capital, and the multiple is already close to the ceiling the growth environment supports. At very high earnings CV the variance premium dominates the denominator and the multiple is small in absolute terms; each additional point of CV still compresses the rate, but on a base that has already fallen far. Across the middle — roughly 15% to 40% earnings CV, which is where most middle-market companies live — the curve runs through a broad range on which a point of variance reduction delivers close to its maximum dollar impact.

The dollar figures make the shape actionable. From the exhibit, a point of earnings CV earned from an 18% starting position (Company A) is worth about \$3.4 million of enterprise value to a moderately risk-averse buyer; a point earned from Company B's 35% is worth about \$3.3 million; the peak per-point value sits near 25% CV at about \$3.6 million. The value creation case for variance reduction is broadly strong across the band where the operating partner is likeliest to meet it. A more risk-averse buyer (higher λ_{CV}) sees a steeper version of the curve and pays more for each point; a less risk-averse buyer sees a flatter one.

Salience computes the curve's shape from each company's cascade parameters, which gives the operating improvement program an objective that sits alongside the traditional mandate to grow EBITDA. The operating partner's brief widens from "grow EBITDA" to "grow EBITDA and improve EBITDA quality." The cascade supplies the levers for each, and the valuation tier converts both into enterprise value.

The two mandates sometimes work against each other. A growth initiative that adds \$2 million to expected EBITDA while adding five points to the earnings CV can destroy more value through multiple compression than it creates through growth. An initiative that shifts revenue mix from a high-margin, high-variance line to a lower-margin, lower-variance one may slightly reduce expected EBITDA while expanding the multiple enough to raise enterprise value on net. Salience makes these trade-offs visible and quantifiable.

The dual mandate. Grow EBITDA (increase the base) and improve EBITDA quality (reduce the CV). Both create enterprise value. The cascade quantifies each.

7.6. Calibrating the CV Discount to the Current Market

This section is about the market-clearing reading of λ_{CV} introduced in Section 7.2 — the price of earnings variance that the marginal buyer in this sector is paying right now, recovered from recent comparable transactions. The investor-specific reading, which reflects a particular sponsor's own risk preference, is a separate quantity the analyst supplies independently.

The market-clearing λ_{CV} varies with the rate environment, the sector, the buyer pool, and the general appetite for risk at the moment the deal closes. A software company in 2024 trades at one λ_{CV} ; the same company at a later date trades differently, not because anything changed about the company but because the market may be discounting variance differently in a different rate environment. The zero-CV multiple $M_0 = 1/y_0$ moves for the same reasons. Both parameters are observable from the same source: the transactions the sector has recently completed.

A minimum of two comparable transactions calibrates the curve. If sector comparables include companies A and B with observable multiples (M_A, M_B) and estimable earnings CVs (CV_A, CV_B), applying equation (7.6) to each gives two equations in two unknowns:

$$\begin{aligned} 1/M_A &= y_0 + \lambda_{CV} \cdot CV_A^2, \\ 1/M_B &= y_0 + \lambda_{CV} \cdot CV_B^2, \end{aligned}$$

yielding

$$\lambda_{CV} = \frac{1/M_A - 1/M_B}{CV_A^2 - CV_B^2}, \quad y_0 = \frac{1}{M_A} - \lambda_{CV} \cdot CV_A^2. \quad (7.2)$$

The market reading of λ_{CV} is measured, read off recent comparable deals. A sector's market λ_{CV} tightens and relaxes as conditions change, and the value of a CV reduction plan moves with it. The investor's own λ_{CV} is a separate input that this calibration does not recover.

The Chapter 1 anchors are themselves a two-point calibration of this form. The 18% CV at 10× and 35% CV at 7× observations resolve to $y_0 \approx 0.085$ and $\lambda_{CV} \approx 0.48$, the values used throughout this chapter.

With more than two observations, the same procedure generalizes to a linear regression of $1/M$ on CV^2 across the comparable pool — typically a small, deliberately homogeneous set of roughly five to fifteen recent transactions in the same sector, size class, and buyer type, where the pool's homogeneity is what justifies the two-parameter specification. The slope is λ_{CV} , the intercept is y_0 , and the residuals measure the noise of individual deal dynamics that the two-parameter model does not try to capture: synergies in strategic buyers, distressed pricing, outliers in buyer quality. Residuals that look biased rather than noisy are a signal that the pool is mis-specified, containing companies with genuinely different growth environments or buyer types mixed into one sample. The remedy is to narrow the comparable set, not to add parameters to the model.

For the regression to recover the variance-pricing channel rather than composition differences across the pool, the comparable set has to be deliberately homogeneous. Companies that look alike on sector, scale, growth profile, transaction window, and buyer class will respond to the same market λ_{CV} ; companies that mix those dimensions will not, and the recovered slope will pick up whatever happens to vary across the sample. With a small pool, a single deal driven by strategic synergy or by distress can drag the line; the right discipline is to flag and inspect those outliers rather than mechanically remove them.

The slope λ_{CV} also carries a standard error the chapter's worked numbers have so far suppressed. The two-point anchor used earlier delivers an exact slope through the two points by construction and supplies no band around it; the regression form fits a slope and a band together, both of which carry information for a deal team.

The payoff for a company is that the value of a CV reduction plan becomes a concrete dollar figure reflecting the market the company is actually in. A two-point reduction under a calibrated $\lambda_{CV} = 0.60$ produces meaningfully more enterprise value than the same reduction under $\lambda_{CV} = 0.35$. The investment case attached to the program is specific to the market the company is being valued in, and it moves as market conditions evolve.

Recalibration happens whenever the sector completes enough recent transactions to support a new fit. In active deal environments that can be quarterly; in thin markets it may be yearly. A rolling window of the last twelve to twenty-four months is a reasonable default; longer windows average over environments that may have since changed, shorter windows lack the sample size to separate signal from deal-level noise. If recent deals are clustering below

the curve the calibration predicts, the environment has drifted and the window should be shortened.

What the calibration delivers is the market price of earnings variance for this sector right now — the multiple the company will receive at exit and the parameter the deal team negotiates against. A sponsor's own λ_{CV} , set by the fund's risk preference and capital base, is a separate input that sits alongside the market reading and may sit above or below it. When the two diverge, the gap is the buy/pass wedge introduced in Section 7.2: a fund acquires when its reservation price (built with its own λ_{CV}) exceeds the market price (built with the calibrated λ_{CV}), and the same gap is what comparative-advantage arguments about risk capacity carry into Part V's portfolio mechanics.

7.7. The View from the Valuation Tier

The valuation cascade is now complete. From the top of it the whole chain resolves into a single frame. Every dollar of enterprise value uncertainty runs back through the valuation tier, through earnings, through revenue, and lands on an operational parameter a manager can name and fund. The attribution that follows collects the three tiers in one table, in which the count-size machinery of Chapter 5, the expense-structure mechanics of Chapter 6, and the multiple mechanics of this chapter appear as shares of a single number: the *CV of valuation*.

Source	Share	Operational Lever
Churn count	24%	Customer success, QBRs
New logo count	18%	Pipeline, outbound
New logo size	11%	Deal desk, pricing
Expansion rate	9%	Upsell programs
Expense ratio	8%	Vendor management
Hiring timing	5%	Recruiting pipeline
Multiple uncertainty	14%	Market conditions
Interaction	11%	(cross-tier effects)

Table 7.5.: Variance attribution for a subscription software company, traced from valuation back through earnings and revenue to specific operational sources.

The table is a management tool of a practical sort. Customer success, addressing the 24% churn contribution, buys roughly three times the valuation-variance reduction per dollar that tightening expense controls against the 8% expense-ratio line does. Revenue-tier sources account for 62% of total valuation variance, earnings-tier sources for 13%, and valuation-tier sources for 25%; for this company, the path to higher enterprise value runs primarily through revenue predictability. Each row of the valuation-CV attribution connects to a named function and a budget line.

7.8. Case Study: An Executive Committee Building a Better Growth Strategy

The executive committee of a PE-backed subscription software company is assembling a three-year value creation plan. The company earns \$30 million in EBITDA at an 8x multiple, producing \$240 million of enterprise value, with an earnings CV of 30% that the cascade decomposes into the sources shown in the attribution table above.

The operating partner proposes three targeted initiatives, each aimed at one of the top variance contributors.

Table 7.6.: Three variance reduction initiatives and their combined impact on earnings quality. Total investment: \$3.5M over two years. Value created: \$60M.

Initiative	Cost	CV Impact	EV Impact
Customer health scoring	\$1.2M	−4 pp	+\$18M
Deal desk standardization	\$0.5M	−3 pp	+\$14M
Expansion playbook	\$1.8M	−3 pp	+\$14M
Combined	\$3.5M	−10 pp	+\$46M
+ Multiple expansion			+\$14M
Total	\$3.5M	30% → 20%	+\$60M

Together the three initiatives pull the earnings CV from 30% to 20%. The direct consequence is a tighter distribution of earnings outcomes. The valuation consequence is a multiple that expands from 8x to 10x, which on \$30 million of EBITDA adds \$60 million of enterprise value for a two-year investment of \$3.5 million.

The 17x return (\$60M created on \$3.5M invested) belongs to this company's parameters, not to the genre. The general point is that variance reduction investments carry a quantifiable valuation return that can be weighed against other uses of capital on the same footing.

The return on the variance reduction program is roughly 17x, measured in enterprise value created per dollar invested. The figure is computed from the cascade using the same parameters the company already uses for planning, and it can be tracked over time as actual results arrive and the CV is updated with observed data.

The executive committee walks away with a growth strategy that retains the traditional levers — revenue growth, margin expansion — and adds a new one, earnings quality improvement, with a quantified return of its own. The old levers remain in place alongside the new one, which in this case turns out to carry a larger contribution to enterprise value than either of the traditional two.

7.9. The Valuation Cascade Complete

The valuation side of the framework now stands complete. A single source of operating uncertainty has been traced through three tiers, each with its own measure and its own decomposition: revenue CV from the compound-Poisson structure of count and size, earnings CV from the dampening and amplification of the

expense structure, valuation CV from the product of earnings variance and multiple variance. Each tier draws its parameters from systems the company already maintains, and each produces a number that flows deterministically into the next.

The reader who has followed the argument this far holds three results at once. Earnings quality is a number, operational improvements have a valuation return that can be computed from the same parameters used to plan them, and two companies with identical expected EBITDA can be compared on a dimension that used to separate them only by intuition. The inputs are data the company already holds.

The same revenue uncertainty that drives the valuation cascade runs a parallel path through working capital, operating cash flow, and debt service. That second path is the capital structure cascade, and it is the subject of Part IV. The two paths share a root at the earnings tier and diverge from there, one running toward equity outcomes and the other toward credit outcomes; the next three chapters develop the second.

Three tiers, one source. Revenue CV $\rightarrow$ Earnings CV $\rightarrow$ Valuation CV. One operating uncertainty, three measured consequences, each with its own decomposition and its own levers.

7.10. Technical Appendix

7.10.1. The Law of Total Variance at the Valuation Tier

The three-term valuation variance formula is the Law of Total Variance (introduced in the Chapter 6 appendix) applied to the product $V = E \times M$. Conditioning on earnings:

$$\begin{aligned} E[V | E] &= E \cdot E[M], \\ \text{Var}(V | E) &= E^2 \cdot \text{Var}(M). \end{aligned}$$

Plugging into $\text{Var}(V) = E[\text{Var}(V | E)] + \text{Var}(E[V | E])$:

$$\begin{aligned} \text{Var}(V) &= E[E^2] \cdot \text{Var}(M) + (E[M])^2 \cdot \text{Var}(E) \\ &= ((E[E])^2 + \text{Var}(E)) \cdot \text{Var}(M) + (E[M])^2 \cdot \text{Var}(E) \\ &= (E[M])^2 \cdot \text{Var}(E) + (E[E])^2 \cdot \text{Var}(M) + \text{Var}(E) \cdot \text{Var}(M). \end{aligned}$$

The three terms are exactly what equation (7.3) below lists: propagated earnings variance (through the expected multiple), tier-specific multiple variance (through expected earnings), and the interaction term that emerges mechanically from the $E[E^2]$ expansion. The interaction term is what the law produces when both factors are random.

Recall. For any two random variables, $\text{Var}(V) = E[\text{Var}(V | E)] + \text{Var}(E[V | E])$. The first term is residual variance at fixed E ; the second is the variance contributed by E 's own spread.

7.10.2. The Three-Term Valuation Variance Formula

When valuation $V = E \times M$ where both E (earnings) and M (multiple) are random variables, the variance of V is:

$$\text{Var}(V) = M^2 \cdot \text{Var}(E) + E^2 \cdot \text{Var}(M) + \text{Var}(E) \cdot \text{Var}(M) \quad (7.3)$$

The three terms in (7.3) are: the earnings variance scaled by the multiple squared, the multiple variance scaled by earnings squared, and the interaction term (the product of the two variances). Dividing by $E^2 M^2$ gives the squared CV:

$$\text{CV}^2(V) = \text{CV}^2(E) + \text{CV}^2(M) + \text{CV}^2(E) \cdot \text{CV}^2(M) \quad (7.4)$$

For moderate CVs (below 30%), the interaction term is small and the approximation $\text{CV}^2(V) \approx \text{CV}^2(E) + \text{CV}^2(M)$ is adequate. For higher CVs, the interaction term becomes material and should be included.

7.10.3. Risk-Adjusted Multiples

The CV discount on the valuation multiple follows from Gordon growth with an idiosyncratic-variance premium in the required return. Let the required return on equity for the earnings stream be

$$r = r_0 + \lambda_{\text{CV}} \cdot \text{CV}(E)^2, \quad (7.5)$$

where r_0 bundles the risk-free rate and the systematic (beta) risk premium that would be charged against a deterministic version of the same stream, and λ_{CV} is the marginal price the buyer assigns to idiosyncratic earnings variance. Applying the Gordon-growth multiple $M = 1/(r - g)$ gives:

$$M_{\text{adj}} = \frac{1}{y_0 + \lambda_{\text{CV}} \cdot \text{CV}(E)^2}, \quad (7.6)$$

where $y_0 = r_0 - g$ is the cost of capital net of growth at zero earnings CV. The zero-CV multiple is $M_0 = 1/y_0$, the ceiling the growth environment and sector would support if earnings were deterministic. The anchors of Chapter 1 fit this form with $y_0 \approx 0.085$ and $\lambda_{\text{CV}} \approx 0.48$, yielding $M_0 \approx 11.8$, $M(0.18) = 10$, and $M(0.35) = 7$.

The form has three properties that matter for the chapter. It is everywhere positive and monotonically decreasing in CV, unlike the quadratic-utility certainty-equivalent $M_0(1 - \frac{\gamma}{2}\text{CV}^2)$, which turns negative at high variance. Its per-point slope,

$$\frac{dM_{\text{adj}}}{d\text{CV}} = -2 \lambda_{\text{CV}} \text{CV} M_{\text{adj}}^2, \quad (7.7)$$

vanishes at $CV = 0$ (the first point of variance added to a deterministic stream costs nothing at the margin) and again as $M_{adj} \rightarrow 0$. And the slope reaches its peak at

$$CV^* = \sqrt{\frac{y_0}{3 \lambda_{CV}}} \approx 24\% \quad (7.8)$$

for the middle-market parameters above, which lies inside the band where most middle-market companies operate and explains why variance reduction programs tend to deliver the largest per-point returns to operating partners managing companies in that range.

The linear form common in earlier literature is a local approximation:

$$M_{adj} \approx M_{adj}(CV_0) - 2 \lambda_{CV} CV_0 M_{adj}(CV_0)^2 \cdot (CV - CV_0) \quad (7.9)$$

Equation (7.9) is the one-term Taylor expansion of (7.6) around an operating point CV_0 . The effective slope rises with CV_0 (up to the peak at CV^*) and then declines, which is why the “constant per-point discount” form $M_0(1 - \lambda CV)$ holds locally and breaks at the extremes.

When combined with multiple expansion (the market’s re-rating of the company’s growth trajectory over time, typically modeled as a drift in y_0), the adjusted multiple becomes:

$$M_{adj}(t) = \frac{1}{y_0 \cdot (1 + g_M)^{-t} + \lambda_{CV} \cdot CV(E_t)^2}, \quad (7.10)$$

where g_M is the annual rate at which the zero-CV multiple expands. The two forces compound independently: improving predictability is more valuable when the base multiple is high (because the absolute dollar impact scales with M^2 through (7.7)), and multiple expansion is more valuable when variance is low (because a larger share of the expanded multiple survives the CV discount).

The reduced-form g_M in (7.10) aggregates two economically distinct components, $g_M = g_M^{\text{endo}} + g_M^{\text{exo}}$. The endogenous component, g_M^{endo} , is drift in the market’s priced-in g for this specific company as execution proves durability; it is earned by the operating plan and attributes to the company’s own track record. The exogenous component, g_M^{exo} , is drift in r_0 — the zero-CV cost of capital — arising from sector re-rating, risk-premium compression, or movement in the risk-free rate; it is received from the environment and is shared across all companies in the same exposure class. For single-company valuation the two fold into one drift parameter and (7.10) is sufficient. For portfolio construction the separation is load-bearing, because g_M^{exo} is a common driver that generates cross-company correlation in the holdings, while g_M^{endo} remains company-specific. Part V uses the decomposition to populate the off-diagonal of the portfolio covariance matrix from the same factor exposures that govern g_M^{exo} .

Ranges, Tails, and When to Trust Them 8.

In which the two-moment machinery is given its exact boundary of validity, and four tools carry the framework past it.

The earlier chapters compute a mean and a variance for every quantity in the valuation cascade: revenue, earnings, and valuation. When the operator asks for a range of possible outcomes, the framework turns those two numbers into a confidence interval by assuming the quantity is distributed approximately normal and reading the bounds off the standard normal at the desired coverage. This technique is called *moment matching*: a distribution is summarized by its first two moments, a familiar distribution is fitted to them, and the fitted stand-in is used in place of the unknown true distribution.

This chapter states where that substitution is trustworthy and equips the framework for the places it is not. Two facts organize everything that follows. First, the cascade’s variance attribution — the map from total uncertainty to the operational activities that produce it — uses only second-moment (mean and variance) algebra and is exact regardless of the underlying distribution’s shape. An attribution that names revenue at 60% of valuation variance and multiple uncertainty at 30% is correct whether the distribution is normal, lognormal, or heavier-tailed than either, and none of this chapter’s machinery is needed to deliver it. Second, confidence intervals inherit the normal assumption, and the assumption’s reliability depends sharply on which confidence interval percentile is being reported and how large the quantity’s CV has grown. The main takeaway: the central 80% interval is reliable across the regimes the cascade typically operates in; the 95% and 99% bounds, and tail probabilities generally, need the four tools this chapter builds.

The framework tracks only two moments by design. Carrying the full distribution for each variable through every tier multiplies parametric approximations at every step — the sorcerer’s-apprentice problem, in the metaphor Richard C. Grinold made memorable. Grinold’s 1999 paper, “Mean-Variance and Scenario-Based Approaches to Portfolio Selection,” appeared in *The Journal of Portfolio Management*. The design instead computes moments exactly at every tier and reserves the distributional commitment for the single moment a CI is reported.

8.1. The Boundary of Validity

A confidence interval reported from moment matching is the quantile of a hypothetical normal distribution with the same mean and variance, rather than of the actual distribution:

$$\sigma = \sqrt{\text{Var}(X)}$$

$$80\% \text{ CI} = [E[X] - 1.282 \sigma, E[X] + 1.282 \sigma]$$

$$95\% \text{ CI} = [E[X] - 1.960 \sigma, E[X] + 1.960 \sigma]$$

$$99\% \text{ CI} = [E[X] - 2.576 \sigma, E[X] + 2.576 \sigma]$$

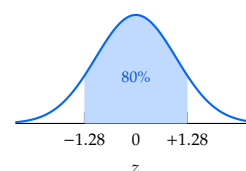


Exhibit 8.1.: The standard normal density with the central 80% shaded. The interval runs from $z = -1.28$ to $z = +1.28$, the multipliers the moment-matched CI substitutes in regardless of the underlying distribution.

Positive-support quantity. A random variable whose underlying process cannot place mass below zero, e.g. gross revenue.

Cascade leaf. The primary random quantity at the base of a tier, before composition with another quantity: revenue at the revenue tier, the multiplier at the valuation tier, debt service at the capital-structure tier. The framework specifies a distributional shape only at the leaves; compositions above them are produced by moment arithmetic.

Table 8.1.: Lower-bound distortion of the moment-matched CI as CV grows. Errors are fractions of the true lower bound, computed against a lognormal with the same first two moments; the specific percentages calibrate the regimes rather than predict cascade-specific errors.

These multipliers are standard-normal quantiles, substituted in regardless of X 's actual shape, so the result is exact when X is normal and degrades in a percentile-dependent way when the true distribution of the quantity at hand is not normal. The 80% CI lives in the body of the distribution, where almost any well-behaved distribution resembles the normal, and for the 15% to 25% CVs common in the cascade's intermediate tiers it matches the true 10/90 quantiles to within a few percentage points. The 95% CI sits at the boundary of body and tail, where right-skewed distributions begin to diverge; at moderate CVs the moment-matched lower bound can be off by 30% to 50%. The 99% CI is where the apparatus stops being useful: for moderately right-skewed quantities the moment-matched lower bound slides below zero on a positive-support quantity, a visible signal that the normal approximation has broken, and the upper bound understates the true upper quantile in the same regime.

In the main body of the distribution, the middle 80%, the cascade earns its reliability structurally. A compound Poisson with non-trivial event (λ) counts has skewness on the order of $1/\sqrt{\lambda}$ and excess kurtosis on the order of $1/\lambda$, so $\lambda \geq 50$ places skewness on the order of 0.15 (somewhat higher when deal sizes are widely dispersed) and excess kurtosis near 0.02, both appropriate for normal approximation. Aggregation across many independent or weakly-correlated revenue streams pulls the sum further toward normality regardless of any single stream's family, and AR(1) cumulative variance over many periods makes twelve-month aggregates far more normal than any single month's shock. This is the cascade's CLT shield: the aggregation the cascade performs at every tier is the operation that makes normality emerge in the body.

This shield has three known gaps, each is visible from the inputs. Multiplicative tiers; earnings as margin times revenue, valuation as multiple times earnings, produce distributions outside any named family, with distortion growing in each factor's CV. Heavy-tailed leaves can inject skew the aggregation cannot wash out.

Table 8.1 puts numbers on the degradation. For a lognormal with the same first two moments, skewness is $(3 + c^2)c$ where c is the CV, and excess kurtosis grows much faster; the practical effect on the moment-matched lower bound compounds with both CV and coverage level.

CV	Skew	Exc. kurt	80% err	95% err
0.10	0.30	0.16	<1%	~3%
0.20	0.61	0.66	~3%	~12%
0.30	0.93	1.57	~8%	~30%
0.40	1.26	2.97	~14%	~50%
0.50	1.63	5.04	~22%	~95%

At the 10% to 25% CVs typical of the cascade's intermediate tiers, the 80%-CI distortion stays below 5%. At 30% to 40%, the 80%

CI remains mild while the 95% CI has become severe. These thresholds compound across multiplicative tiers — per-tier CVs of 15%, 25%, and 35% produce total CVs of about 0.26, 0.45, and 0.64 respectively — so a modest per-tier CV at the bottom of the cascade can put the valuation tier in the unreliable regime even when no single tier looks alarming.

8.2. A Worked Valuation at Three Coverage Levels

A valuation with expected earnings of \$20M at 25% earnings CV, an expected multiple of 10 $\times$, and a 15% CV on the multiplier has $E[V] = \$200\text{M}$, total $\text{CV}(V) = 0.294$, and $\sigma(V) = \$58.8\text{M}$ — the moderate-CV regime that typifies well-calibrated middle-market PE. Table 8.2 compares the moment-matched intervals against a lognormal with the same moments.

Coverage	Error on LB	Moment-matched CI	True CI (lognormal)
80%	6%	[\$125M, \$275M]	[\$133M, \$278M]
95%	22%	[\$85M, \$315M]	[\$109M, \$338M]
99%	47%	[\$49M, \$352M]	[\$92M, \$403M]

Table 8.2: Three coverage levels for the moderate-CV worked example. The true CIs are computed against a lognormal moment-matched to $E[V]$ and $\text{Var}(V)$.

The 80% bound is off by 6%, inside the operational reliability band. The 95% lower bound is off by 22%, understating the worst-plausible case by roughly \$24M, and the 99% bound is off by 47%. Rerunning the same exercise with both CVs at 10% gives lower-bound errors of about 1%, 4%, and 8%: essentially right at routine coverage, mildly off in the far tail. The contrast is the operational rule. Modest CVs support moment-matched reporting at any coverage; the 25%–30% CVs of calibrated middle-market PE keep the 80% CI usable while the 95% CI misleads by tens of millions; CVs past 30%–40% break the tail bounds visibly. The CV of the reportable quantity tells the operator which regime they are in.

8.3. Four Tools for the Tail

Two endpoints cover the spectrum of choices to remediate the problem. At one end, moment matching uses two numbers and a multiplier. At the other end, full Monte Carlo specifies a distribution at every cascade leaf, propagates N sampled draws through every composition, and reads percentiles off the result — correct under any shape, at the price of a sample budget that grows as the tail thins (about $100/p$ samples for 10% relative accuracy at a p -level tail) and of a distributional commitment at every leaf. Between these endpoints sit four tool families, ordered from cheap-and-closed-form to fully general. The cascade’s structure makes a specific

one the natural reach for each kind of question. The mechanics of each tool live in the technical appendix; the remainder of the chapter explains what it does, when to reach for it, and a worked instance.

8.3.1. Cornish-Fisher: a skewness correction to the quantile

The Cornish-Fisher expansion adjusts the normal quantile multiplier with a polynomial correction in skewness. It is closed-form, samples nothing, and captures the asymmetry of moderately skewed distributions (skewness up to about 1) at a single tier. It needs skewness as an input; the appendix describes the three ways the cascade sources it.

A positive-support quantity with mean 100 and CV 0.30 has a true 2.5th percentile of about 53.9 when its distribution is lognormal. The moment-matched 95% lower bound, $100 - 1.96 \times 30 = 41.2$, sits more than twelve units below the true percentile. Cornish-Fisher, applied to the same two moments and a skewness estimate of 0.93, produces a corrected bound near 54.6 — within a unit of the true value. Under the cascade's aggregation, skewness scales as $1/\sqrt{n}$ across n sources and excess kurtosis as $1/n$, so correcting the dominant skewness term effectively suppresses the higher-moment deviation as well.

8.3.2. Saddle-point: closed-form tail probabilities for compound Poisson

The saddle-point approximation (Lugannani-Rice) computes tail probabilities from a distribution's cumulant generating function to high accuracy. It is the natural tool for compound-Poisson revenue tiers, because the CGF is available in closed form from the leaf parameters the cascade already specifies — the appendix gives the forms — and the user supplies nothing new.

A compound Poisson revenue stream with $\lambda = 12$ events per period and normally distributed event sizes ($\mu = \$200,000$, $\sigma = \$60,000$) has expected revenue \$2.4M and standard deviation about \$0.72M. The probability that revenue falls below \$1.0M is 2.65% under the moment-matched normal CDF. The saddle-point approximation gives 1.62%; a 200,000-trial Monte Carlo gives 1.61%. The moment-matched tail is wrong by nearly a factor of 1.7; the saddle-point answer is within 0.01 percentage points of the Monte Carlo result, in closed form.

8.3.3. Rao-Blackwellization: sample only the layer that carries the shape

The cascade's multiplicative tiers introduce randomness one conditional layer at a time — the margin at the earnings tier, the multiple at the valuation tier, debt service at the capital-structure tier — and the conditional moments given that layer are closed-form. Rao-Blackwellization samples only the conditional layer and integrates the rest analytically: N draws of the parameter, a mixture of N conditional normals, quantiles from a one-dimensional equation. The conditional layer is where the distributional shape distortion enters (the multiplicative composition with a lognormal-spread parameter is what the normal stand-in misses), while the CLT-shielded base carries most of the variance; sampling the one and integrating the other typically needs 10 to 100 times fewer samples than naive Monte Carlo for the same accuracy.

The two-tier worked example above — \$20M expected earnings at 25% CV, a 10× multiple with 15% CV — has a moment-matched 5th percentile near \$103M. The Rao-Blackwellized estimate, from 1,000 draws of the multiple and an average of the conditional CDFs, gives \$110M; a 200,000-trial naive Monte Carlo gives the same answer. The moment-matched bound is too pessimistic by about \$7M, and the Rao-Blackwell estimate matches the full Monte Carlo at one-two-hundredth the sample budget.

8.3.4. Importance sampling: spend the budget where the tail is

When the question is a small tail probability, naive sampling wastes almost every draw on the body. Importance sampling draws from a tilted distribution that concentrates mass near the threshold and re-weights by the likelihood ratio; the appendix gives the estimator and the exponential-tilting construction. The sample requirement at the 1% level falls from millions to thousands. The natural application for this technique is covenant breach probability when coverage is comfortable and the breach probability is small but worth quantifying.

With operating cash flow normal at mean 100 and standard deviation 30, the threshold for a 1% breach sits at 30.2. Naive Monte Carlo at 1,000 samples estimates that probability with a relative standard error near 30%; at 0.1%, the same budget typically produces zero hits and no estimate at all. Importance sampling from a tilted distribution centered at the threshold, at the same 1,000-sample budget, delivers a relative standard error around 5% — the same probability at one-thirtieth the variance per sample. For cascade outputs with multiplicative skew, the tilt composes with Rao-Blackwellization — sample the conditional layer, integrate the tilted tail analytically within each draw — and that composition is the framework's operational default for tail breach probabilities.

8.3.5. Full Monte Carlo, and the quasi-Monte Carlo discount

The fallback for heterogeneous structure with no clean specialization is general Monte Carlo: specify, sample, propagate, take percentiles. It is correct under any distributional shape at a cost of roughly 10,000 samples for percentile bounds accurate to a point. Substituting low-discrepancy sequences (Sobol, Halton) for pseudo-random draws improves convergence from $O(1/\sqrt{N})$ toward $O(1/N)$ and cuts the budget by orders of magnitude wherever sampling is already the plan.

8.4. Choosing the Tool

The default is the moment-matched 80% CI: two numbers and a multiplier, reliable to within a few percent for the CVs an operator would defend in a business review, and covering the bulk of operational queries — revenue forecasts, earnings ranges, comparative ranking, sensitivity analysis. The tail tools engage on specific triggers: a reporting tier with CV above 30% combined with a 95% or 99% requirement; two or more multiplicative tiers each above 20% CV combined with any tail probability; a moment-matched 95% lower bound on a positive-support quantity falling below 10% of the expected value (the negative-lower-bound signal); or a query that is itself a tail probability — covenant breach, value-at-risk, a distressed downside scenario.

When a trigger fires, the cascade's structure suggests the natural first reach at each tier.

Revenue tier (compound Poisson with a size distribution). Saddle-point, because the CGF is closed-form and the tail probability comes out at about 0.1% accuracy without sampling; Cornish-Fisher when the question is body-percentile refinement at modest skew.

Expense tier. Compound-Poisson expense models take saddle-point for the same reason; proportional and deterministic-margin models are closed-form in the cascade and need nothing; random-parameter expense models defer to the next tier as the conditional layer of an earnings composition.

Earnings tier (multiplicative or subtractive composition). Rao-Blackwellization: sample the conditional parameter — margin, multiple, expense ratio — and use the base's closed-form moments analytically.

Working-capital components (DSO, DIO, DPO). Cornish-Fisher for body-percentile refinement of a moderately skewed single

distribution; saddle-point when the component is compound-Poisson-shaped, such as a count of late payments times a per-event size.

Operating cash flow (earnings less working-capital build). Rao-Blackwellization through the working-capital composition, the same machinery that lifts revenue to earnings.

Breach probability ($P(\text{OCF} < \delta \cdot \text{DS})$). The moment-matched normal CDF on OCF for probabilities in the body (above about 5%), with saddle-point refinement when the OCF tail is heavier than normal; importance sampling below about 5%, where it cuts the sample budget by an order of magnitude.

The recipe is descriptive: an operator can sample more aggressively or stay moment-based throughout. What it names is the tool the cascade's structure makes cheapest at each tier for the accuracy the question demands.

8.5. What Travels Forward

We started the chapter asserting the utility of carrying two moments; mean and variance. These estimates are exact at each state of the cascade and are economical to calculate. Moment-matching gives us usable confidence intervals in a variety of situations without modification, particularly in the 80% of the distribution's body where most day-to-day decisions will be made.

Going forward, we will have more need to understand the likelihood of an event residing in the tails of the distribution. Capital structure works in operating cash flow directly: the breach probability is $P(\text{OCF} < \text{covenant} \times \text{DS})$, one normal-CDF call when debt service is deterministic, and a Rao-Blackwellized mixture over sampled debt service when rates float. Chapter 10 develops the reframing in full. And portfolio aggregation is exact in moments while tail reporting inherits the underlying tier distortions: one heavy-tailed company drags the portfolio's distribution toward heavy tails regardless of how many normal-tail companies sit beside it, a fact the monitoring discipline of Chapter 16 turns into a roll-up flag.

The chapter summary is short. Report the 80% CI as the routine default, watch the CV of the reporting tier, and when a trigger fires, take the tier recipe's first reach.

8.6. Technical Appendix

Cornish-Fisher inputs. The expansion corrects the normal quantile z_α with a polynomial term in skewness, $z_\alpha + \frac{1}{6}(z_\alpha^2 - 1)\gamma_1$, applied to the same mean and standard deviation the moment-matched CI uses. Skewness does not compose through products and ratios the way variance does, so the correction applies at a single tier rather than to a deeply composed distribution. The input can come from three sources: a sample-based estimate from historicals, comparables, or scenario draws; a closed-form structural value at leaves that admit one (compound-Poisson skewness falls out of the leaf parameters analytically); or an overlaid distributional assumption where neither is at hand, with lognormal-from-CV the natural default for a positive-support quantity.

Saddle-point inputs. Lugannani-Rice requires the cumulant generating function of the leaf. For compound-Poisson revenue the CGF is $K(s) = \lambda(M_X(s) - 1)$, with λ the event rate and M_X the moment generating function of the jump-size distribution — both cascade-structural parameters. Normal jumps give the closed form $M_X(s) = \exp(\mu s + \sigma^2 s^2/2)$; lognormal jumps require one-dimensional numerical quadrature on the jump density, which the cascade can supply because it specifies the jump shape.

Rao-Blackwellization mechanics. Sample N values of the conditional layer's parameter (the margin m_i , the multiple, the debt service), use the cascade's closed-form conditional moments $E[Y | m_i]$ and $\text{Var}[Y | m_i]$, and form the marginal distribution of Y as the mixture $\frac{1}{N} \sum_i \Phi((y - E[Y|m_i])/\sigma[Y|m_i])$. Quantiles solve a one-dimensional equation in the mixture. The conditional layer's distribution is part of the leaf-level specification the cascade maintains: multiplicative parameters are positive-support and right-skewed, sampled as lognormal moment-matched to the specified mean and CV (the multiple uses the 10% to 15% post-calibration spread of Chapter 7; the margin uses whatever the expense model specifies). The estimator's variance scales with the conditional-layer variance only, which is the source of the sample-budget advantage.

Importance sampling and the exponential tilt. The estimator is

$$P(X < t) \approx \frac{1}{N} \sum_i \mathbf{1}[\tilde{X}_i < t] w(\tilde{X}_i),$$

with $\tilde{X}_i$ drawn from a tilted distribution concentrated near the threshold and w the likelihood ratio. The tilt is chosen from the cumulant generating function (exponential tilting). The plain form assumes the node is approximately normal at its moments; for cascade outputs with multiplicative skew that assumption is systematically biased even when the moments are correct, and

the remedy is the composition described in the body: sample the conditional layer that introduces the skew, and within each conditional draw apply closed-form normal-tail integration on the CLT-shielded base.

Distribution tracking, and why the framework declines it. The alternative to sampling is carrying a parameterized distribution per cascade component and propagating analytically — lognormal-everywhere, in the common finance form. The cascade’s operations span addition, subtraction, multiplication, and ratio, and no single distributional family is closed under all four; lognormal is closed under multiplication and ratio only. Committing to a family at every tier forces an approximation at every aggregation and every cash-flow subtraction, stacking parametric error across the cascade — the sorcerer’s-apprentice accumulation the two-moment design avoids by reserving the distributional commitment for the single reporting step.

THE CAPITAL STRUCTURE CASCADE

Operating Cash Flow: From Accrual Earnings to Cash 9.

In which we discover that a profitable company can still run short of cash, and that the gap between earnings and cash flow has its own uncertainty.

The valuation cascade, developed in the preceding three chapters, traces uncertainty from revenue through earnings to enterprise value. It answers the growth question: what is the business worth, given its operating uncertainty? The capital structure cascade, which begins here, traces the same underlying uncertainty through a different path, one that terminates in the ability to service debt. The starting point of this second path is operating cash flow, and the first thing to establish is the relationship between operating cash flow and accrual earnings.

9.1. Why Cash Flow Matters

A company records revenue when it delivers goods or services, regardless of when the customer pays. It records expenses when it incurs obligations, regardless of when it writes the check. The result is accrual earnings, EBITDA, which measures economic activity over a period. Accrual earnings are the right measure for the valuation cascade, because investors value the economic activity.

Debt service operates on a different measure. Interest payments and principal repayments must be made in currency, on schedule, from actual cash in the bank account; the lender accepts no accrual substitute. A company that records \$25 million in EBITDA and collects \$20 million in cash during the same period has \$20 million available for debt service, not \$25 million. The \$5 million difference is working capital: cash tied up in receivables, payables, and inventory that has been earned on paper and not yet converted to cash.¹

For the capital structure cascade, the relevant quantity is operating cash flow: the cash actually generated by the business after accounting for working capital movements. The gap between operating cash flow and EBITDA is the subject of this chapter.

1: This is the reason leveraged transactions sometimes fail despite profitable operations. The company is growing, the customers are paying, and the economics are sound. The timing mismatch between earning and collecting creates a cash shortfall that the accrual earnings did not predict.

9.2. The Working Capital Bridge

Working capital is the cash absorbed by the operating cycle of the business. It has three primary components, each with its own dynamics and its own variability.

9.2.1. Days Sales Outstanding

DSO varies by industry, by customer type, and by collection practice. Enterprise software companies selling to large corporations may have DSOs of 60 to 90 days. Small-business service providers collecting by credit card may have DSOs under 10 days. The DSO matters for the cascade not because of its level but because of its variability.

Days sales outstanding (DSO) measures how long it takes, on average, to collect receivables after revenue is recorded. A company with 45-day DSO has, at any point in time, roughly 45 days worth of revenue sitting in accounts receivable, waiting to be converted to cash. The cash impact is straightforward: higher DSO means more cash tied up in receivables, which means less cash available for debt service in any given period.

For the cascade, the variability of DSO matters as much as the level. A company with a stable 45-day DSO has predictable cash conversion. A company whose DSO fluctuates between 35 and 55 days, depending on customer payment behavior and seasonal invoicing patterns, has an additional source of cash flow uncertainty that does not appear in the earnings numbers.

9.2.2. Days Payable Outstanding

Days payable outstanding (DPO) measures how long the company takes to pay its own suppliers. Higher DPO means the company holds onto cash longer, which improves the cash position. DPO is, in effect, the mirror image of DSO: receivables tie up cash, payables release it.

The variability of DPO contributes to cash flow uncertainty in the same way as DSO variability, with the opposite sign. A company that pays its suppliers on highly variable schedules, sometimes early to capture discounts, sometimes late when cash is tight, introduces additional volatility into operating cash flow.

9.2.3. Days Inventory Outstanding

For companies that carry physical inventory, days inventory outstanding (DIO) measures how long goods sit before sale. Inventory is cash that has been converted into goods and not yet converted back to cash through a sale. Higher DIO means more cash is locked in inventory, and variability in DIO (due to demand fluctuations, supply chain disruptions, or seasonal stocking patterns) adds another layer of cash flow uncertainty.

Many service businesses and software companies have negligible inventory and can set DIO to zero in the cascade. For manufacturing, distribution, and retail businesses, DIO can be a material component of working capital variability.

9.2.4. The Cash Conversion Cycle

The three components combine into the cash conversion cycle (CCC):

$$\text{CCC} = \text{DSO} + \text{DIO} - \text{DPO} \quad (9.1)$$

A company with 45-day DSO, zero DIO, and 30-day DPO has a cash conversion cycle of 15 days: on average, 15 days elapse between incurring the cost of a service and collecting the cash from the customer. A shorter CCC means cash is returned to the business faster. A longer CCC means more cash is required to finance the operating cycle.

For the cascade, the CCC level determines the expected gap between earnings and cash flow. The CCC variability determines the additional uncertainty that the working capital layer adds on top of the earnings uncertainty inherited from the tiers above.

Table 9.1: CCC by business type (days).

	DSO	DPO	CCC
SaaS	35	25	10
Svc	50	30	20
Dist	45	35	40

9.3. Variance of Operating Cash Flow

Operating cash flow inherits the variance of earnings, filtered through the working capital dynamics, and adds working capital-specific variance on top. The result is an OCF CV that is typically higher than the earnings CV, sometimes modestly and sometimes substantially, depending on the business model.

9.3.1. Propagation from Earnings

The simplest model of the earnings-to-OCF conversion is a cash conversion rate γ : the fraction of EBITDA that converts to operating cash flow after working capital effects. A company with a stable 85% cash conversion rate has $\text{OCF} = 0.85 \times \text{EBITDA}$. The variance of OCF is then γ^2 times the variance of EBITDA, which is a simple scaling. The OCF CV in this case equals the earnings CV, because both the mean and the standard deviation are scaled by the same factor.

The picture changes when the conversion rate itself is uncertain. A company whose cash conversion fluctuates between 75% and 95%, depending on receivables timing and growth-related working capital absorption, has a variable γ . The variance of OCF then

OCF variance = dampened earnings variance + working capital variance. The working capital layer adds its own uncertainty on top of what it inherits from earnings. For growing businesses, this addition can be substantial.

2: This is one reason high-growth companies sometimes have negative free cash flow despite strong profitability. The growth itself consumes cash through working capital expansion. The condition is temporary: once growth stabilizes, the working capital absorption declines. But during the growth phase, the gap between earnings and cash flow can be significant.

includes both the scaled earnings variance and an additional term from the variability of γ itself:

The additional variance from working capital depends on the variability of the DSO, DPO, and DIO components. Each contributes independently, and the total working capital variance is the sum of the component variances, adjusted for any correlations between them.

9.3.2. The Growth Effect

Growing businesses face a structural disadvantage in cash conversion. When a company grows, it acquires new customers who create new receivables. The cash from those new customers arrives 30 to 60 days later, depending on the DSO. In the meantime, the company has incurred the costs of servicing those customers (labor, materials, cloud infrastructure) and must fund the gap from existing cash or credit facilities.

This means that faster growth, while positive for the valuation cascade, can temporarily reduce operating cash flow relative to earnings. A company growing at 25% per year with 45-day DSO is creating new receivables at a rate that absorbs roughly one-eighth of the growth in revenue before it converts to cash.² The effect is deterministic (predictable from the growth rate and DSO) and contributes to the OCF level; the variance comes from the uncertainty in DSO, growth rate, and the interaction between them.

The two effects are easy to confuse, and the cascade helps separate them. A company with a 50-day DSO that varies between 45 and 55 has a different OCF variance than a company with the same average DSO that varies between 30 and 70, even though both look identical on a quarterly cash flow statement. Exhibit 9.1 shows the separation. The horizontal axis is the average DSO, swept across the range a typical middle-market company might consider. The vertical axis is the OCF CV. Three curves trace what happens to OCF variance as the DSO becomes more or less stable, holding the earnings CV constant at 18% throughout.

The exhibit makes a distinction the conventional working capital report obscures. Treasurers track DSO weekly and report the average to the board, but neither view supplies the curve a treasurer sits on, because neither translates DSO variability into a number that lives on the same axis as the earnings CV inherited from the tiers above. With the curves visible, working capital management has two interventions to weigh: shortening the cycle releases cash, and stabilizing the cycle reduces variance.

The variance reduction matters most for companies near a credit constraint. A company with ten percentage points of OCF CV recovered through receivables stabilization passes that improvement

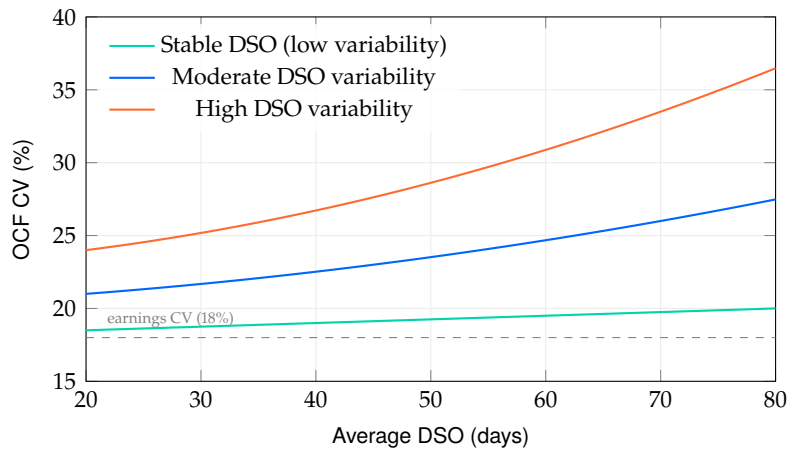


Exhibit 9.1: Working capital as a variance lever. OCF CV as a function of average DSO, at three levels of DSO stability, with earnings CV held at 18%. The dashed line marks the earnings CV that the working capital layer inherits from above; the curves show what the working capital layer adds.

directly to the DSCR distribution. The expected coverage ratio is unchanged, but the breach probability falls by something on the order of one-third to one-half, depending on the starting point. The cascade prices the receivables clean-up as a permanent reduction in covenant risk, in addition to the one-time cash release. The case study later in the chapter walks through both effects on the same company.

9.4. The Working-Capital Layer on Public Data

The chapter's claim about operating cash flow has a distinctive signature that public filings can check: the working-capital layer should add variance at short horizons and net out over longer ones. A receivables balance that swells in one quarter is collected in the next, so quarter-to-quarter cash flow carries dispersion that the year's total does not. If the layer is real, cash flow from operations should be noisier than earnings at quarterly frequency and roughly as noisy at annual frequency — and that is what the filings show.

The same companies from Chapter 6's amplification test supply the series.³ At quarterly frequency, cash flow from operations is noisier than operating income for about two-thirds of firms, with a median dispersion roughly 1.2 times the earnings figure, and the two dispersions correlate across firms at about 0.4 — cash flow carries the earnings variance and adds a layer on top. At annual frequency the fraction falls to barely more than half, and the median CFO dispersion sits within a few percent of the earnings figure: 22% against 21%.

The frequency contrast is the mechanism, observed. Within a year, DSO, inventory, and payables fluctuate and largely reverse — the mean-reverting working-capital behavior this chapter models — so their variance contribution is substantial at the quarter and mostly netted by the year's end. What survives at annual frequency is the increment the chapter's variance formula keeps: the working-capital build that scales with growth and with the level of the

3: Cash flow from operations reported in 10-Qs is a fiscal-year-to-date figure, so quarterly values are recovered by differencing consecutive cumulatives within each fiscal year; fourth quarters come from the annual figure less the first three. Dispersion is measured on year-over-year quarterly differences, which removes seasonality.

cycle, plus the earnings variance passing through. A treasurer who experiences violent quarter-to-quarter swings in operating cash flow and calm annual totals is seeing the same decomposition from the inside.

One caveat travels with the result. Reported cash flow from operations reflects some discretion — the timing of payables runs, collection pushes at period ends — so the quarterly layer measured here includes managed timing along with the underlying working-capital variance. The direction of the test is unaffected: managed timing, like the unmanaged cycle, adds short-horizon dispersion that annual totals absorb.

9.5. Case Study: Two Paths to the Same Debt Service Coverage Ratio Improvement

A PE-backed distribution company has a DSCR of 1.35x, with a covenant threshold of 1.20x. The headroom is uncomfortably thin. The operating partner is evaluating two approaches to improving the coverage ratio.

Path A: Improve earnings predictability. The revenue team focuses on pipeline diversification and contract restructuring to reduce the revenue CV from 16% to 12%. This flows through the cascade: earnings CV drops from 24% to 19%, OCF CV drops from 28% to 22%, and the DSCR distribution tightens. The expected DSCR stays at 1.35x, but the breach probability drops from 35% to 31%. Cost: \$1.5 million in sales process and contract management investments over 18 months.

Path B: Improve cash conversion. The finance team focuses on receivables management: tightening collection processes, offering early-payment discounts, and restructuring payment terms with the largest customers. DSO drops from 55 days to 42 days, which releases roughly \$1.2 million of cash from working capital; applied against the revolver, the release lowers debt service and lifts the expected DSCR from 1.35x to 1.47x. The breach probability drops from 35% to 22%. Cost: \$0.8 million in process improvement and minor revenue concessions from early-payment discounts.

Table 9.2.: Two approaches to improving debt service coverage. Path B is cheaper and produces the larger reduction in breach probability, and Path A has the additional benefit of improving the valuation cascade as well.

	Path A (Earnings CV)	Path B (DSO)
Investment	\$1.5M	\$0.8M
Revenue CV	16% → 12%	16% (unchanged)
OCF CV	28% → 22%	28% → 24%
Expected DSCR	1.35x	1.35x → 1.47x
Breach probability	35% → 31%	35% → 22%
Valuation impact	+\$8M (multiple)	None

Both paths achieve roughly the same breach probability reduction. Path B is cheaper and produces a slightly better credit outcome. Path A is more expensive and produces a slightly worse credit outcome, with one important additional benefit: the reduction in revenue CV also flows through the valuation cascade, supporting a higher exit multiple and approximately \$8 million in additional enterprise value.

The right choice depends on the sponsor's priorities and time horizon. A sponsor planning a near-term exit would weight the valuation benefit heavily and lean toward Path A despite the higher cost. A sponsor focused on covenant compliance during a period of macro uncertainty might prefer Path B for its lower cost and faster implementation. The cascade provides the quantitative basis for the comparison, and the judgment remains with the operator.

This is the Saliency Cascade at work. Path A improves both cascades because it addresses the shared root (earnings variance). Path B improves only the capital structure cascade because it addresses a factor (DSO) that sits below the divergence point.

9.6. Technical Appendix

9.6.1. The Law of Total Variance at the OCF Tier

The transition from earnings to operating cash flow is another application of the Law of Total Variance introduced in the Chapter 6 appendix. With $OCF = \gamma \cdot E$, conditioning on earnings gives:

$$\begin{aligned} E[OCF | E] &= \gamma \cdot E \quad (\text{treating } \gamma's \text{ mean as constant}), \\ \text{Var}(OCF | E) &= E^2 \cdot \text{Var}(\gamma). \end{aligned}$$

The Law of Total Variance yields $\text{Var}(OCF) = E[E^2] \cdot \text{Var}(\gamma) + \mu_\gamma^2 \cdot \text{Var}(E)$, where μ_γ denotes the expected cash conversion rate. Expanding $E[E^2] = \mu_E^2 + \text{Var}(E)$, with μ_E the expected earnings, produces the three-term formula below — structurally identical to the valuation tier's $V = E \times M$ decomposition, with γ in place of the multiple. The first term propagates earnings variance through the cash conversion rate; the second is the tier-specific working capital variance; the third is the interaction.

Same law, new tier. Each cascade boundary — revenue→earnings, earnings→valuation, earnings→OCF, OCF→DSCR — applies the same identity. The propagated variance from below is $\text{Var}(E[Y | X])$; the tier-specific variance is $E[\text{Var}(Y | X)]$. Only the variables change.

9.6.2. OCF Variance with Variable Cash Conversion

If operating cash flow is modeled as $OCF = \gamma \times E$, where γ is the cash conversion rate and E is EBITDA, and γ and E are independent, then:

$$\text{Var}(OCF) = \gamma^2 \cdot \text{Var}(E) + E^2 \cdot \text{Var}(\gamma) + \text{Var}(E) \cdot \text{Var}(\gamma) \quad (9.2)$$

This is the same product-variance formula used in the valuation tier. The first term is the earnings variance scaled by the cash conversion rate squared. The second term is the working capital

variance: the uncertainty in the conversion rate, amplified by the earnings level. The third term is the interaction.

9.6.3. Working Capital Component Variances

For the detailed working capital model, each component (AR, AP, inventory) has its own mean and variance:

$$\text{Var}(\text{AR}) = \frac{\text{DSO}_{\text{mean}}^2 \cdot \text{Var}(R)}{365^2} + \frac{R^2 \cdot \text{Var}(\text{DSO})}{365^2} \quad (9.3)$$

The first term captures the receivables variance from revenue uncertainty (more revenue means more receivables). The second captures the receivables variance from DSO uncertainty (slower collection means more cash tied up). The product form also carries an interaction term, $\text{Var}(R) \cdot \text{Var}(\text{DSO})/365^2$, which is second-order and omitted here. Similar expressions apply to AP and inventory. The total working capital variance is the sum of the component variances, which feeds into the OCF variance as the additional layer on top of the propagated earnings variance.

Debt, Covenants, and the Price of Breach 10.

In which we examine how debt amplifies both returns and risk, how covenants create binary events from continuous uncertainty, and why not all breaches cost the same.

The previous chapter established operating cash flow as the relevant quantity for debt serviceability. This chapter introduces the other side of the equation: the debt itself, the covenants that constrain it, and the consequences of failing to meet those constraints. Debt is the mechanism through which operating uncertainty, previously a matter of valuation and planning, becomes a constraint the company must meet on schedule.

Leverage amplifies both expected return and variance, the mechanism Chapter 12 develops formally when it constructs the risk-adjusted capital efficiency surface. The formal theory of capital structure, developed by Modigliani and Miller in the late 1950s, establishes that in perfect capital markets the mix of debt and equity does not affect firm value; debt and equity are simply different claims on the same operating cash flows. In the real world, capital structure matters because of frictions the perfect-market assumption excludes, the most consequential of which is financial distress: the waiver fees, restricted distributions, management distraction, forced asset sales, and reputational damage with lenders that accumulate when a company cannot meet its debt obligations. These costs rise with leverage and with the variance of operating cash flows, and the cascade provides a missing input to the calculation: a firm-specific, forward-looking estimate of the operating cash flow variance that drives distress probability. A firm-specific breach probability is what the sponsor is sizing leverage against.

10.1. Types of Debt in PE Capital Structures

PE-backed companies typically carry several types of debt, each with different mechanics, different risk characteristics, and a different position in the cash flow waterfall.

10.1.1. Senior Term Loans

The most common form of PE debt is the senior secured term loan, typically provided by a bank or a group of private credit lenders. The loan has a fixed principal, an interest rate (fixed or floating), and a scheduled amortization over five to seven years. It sits at the top of the capital structure, with first claim on the company's cash flow and assets in the event of distress.

SOFR, the Secured Overnight Financing Rate, replaced LIBOR as the standard reference rate for floating-rate debt in 2023. It is based on overnight Treasury repurchase transactions and is published daily by the Federal Reserve Bank of New York.

Floating-rate loans, which constitute the majority of PE credit, have an interest rate that adjusts with a reference rate (typically SOFR). This introduces interest rate variance into the capital structure cascade: the debt service itself becomes uncertain, because the interest component changes with the rate environment. The cascade captures this through the rate volatility parameter and the correlation between rate movements and operating performance.

10.1.2. Revolving Credit Facilities

A revolver provides a committed line of credit that the company can draw on as needed for working capital or other short-term requirements. The drawn balance fluctuates, which means the debt service from the revolver is variable. For the cascade, the revolver is modeled at its expected drawn balance, with the variability of draws contributing to debt service uncertainty.

10.1.3. Mezzanine and Second Lien

Junior debt sits below the senior term loan in the priority structure. Second lien debt has a claim on the same collateral as the senior, but the senior must be paid first. Mezzanine debt is typically unsecured, with higher interest rates reflecting its subordinated position. Both forms of junior debt carry higher risk of loss in a distress scenario, which is reflected in their pricing and in their covenant structures.

10.1.4. Payment-in-Kind (PIK)

PIK instruments accrue interest into the principal balance rather than requiring cash payments. A \$20 million PIK note at 12% adds \$2.4 million to the outstanding principal each year, with no cash outflow until maturity or conversion. The effect is to shift risk from the near term (lower current cash burden) to the medium term (higher future obligations). For the cascade, PIK tranches have zero cash debt service in the current period and are excluded from the DSCR calculation, though their accruing principal affects future leverage ratios.

PIK structures are common in highly leveraged transactions where the current cash flow cannot support the full debt service. They solve the near-term coverage problem at the cost of increasing the debt balance over time, which the company must eventually address through refinancing, conversion, or repayment from exit proceeds.

10.1.5. Revenue-Based Financing

Revenue-based debt ties the payment to a percentage of revenue: if revenue declines, the payment declines proportionally. This creates a natural hedge, because the debt service moves in the same direction as the cash flow that services it. The DSCR for a revenue-based tranche is structurally more stable than for a fixed-payment

tranche, because both the numerator (OCF) and the denominator (debt service) respond to the same revenue movements.

The trade-off is that revenue-based financing typically carries a higher effective interest rate than senior term loans, reflecting the lender's acceptance of variable payments, and that strong revenue periods result in higher payments, which reduces the cash flow available for other uses.

10.1.6. Asset-Based Lending (ABL)

ABL facilities are secured by specific assets, typically receivables and inventory, with borrowing capacity tied to the value of the collateral. As receivables and inventory fluctuate, the available borrowing base fluctuates with them. ABL introduces a procyclical risk: when the business contracts, receivables and inventory decline, which reduces the borrowing base at precisely the moment the company may need the liquidity most.

10.2. Preferred and Convertible Equity

Below debt in the capital structure sit instruments that share characteristics with both debt and equity. These instruments affect the cascade differently from debt because they do not create covenant breach risk.

Preferred equity has a fixed dividend (like debt interest) and priority over common equity in liquidation, but missed dividends do not trigger default. They accumulate (in cumulative structures) or are forfeited (in non-cumulative structures). For the cascade, preferred equity amplifies common equity returns and variance through the equity multiplier, the same way debt does, without contributing to the distress penalty that limits optimal leverage. The common equity base becomes enterprise value minus debt minus preferred, which produces a higher equity multiplier and more amplified returns, with the critical difference that the additional leverage from preferred carries no breach risk.

Convertible instruments add a further dimension. Below a conversion threshold, a convertible note or convertible preferred behaves like preferred equity: a fixed claim with priority but no default trigger. Above the threshold, it converts to common equity, eliminating the fixed claim but diluting the existing common holders. The conversion feature creates an asymmetric payoff for the common equity holder: full leverage on the downside (the convertible remains a fixed claim) and shared upside (the convertible participates as equity).

10.3. Covenants and the DSCR

Loan covenants are the mechanism through which continuous operating uncertainty becomes a binary event. A company's cash flow varies smoothly across a distribution of outcomes; the covenant creates a threshold within that distribution that separates technical default from compliance.

10.3.1. The Debt Service Coverage Ratio

The primary covenant metric in most PE credit agreements is the debt service coverage ratio: operating cash flow divided by total debt service. A DSCR of 1.5x means the company generates 50% more cash than it needs to service its debt. A DSCR of 1.0x means cash flow exactly equals debt service, with no margin for error. A DSCR below 1.0x means the company cannot service its debt from operating cash flow and must draw on reserves, raise additional capital, or negotiate with lenders.

Salience supports four DSCR definitions, each appropriate for different credit structures:

Table 10.1: Four DSCR conventions. The choice affects both the expected ratio and its variance, because different numerators and denominators have different uncertainty profiles.

Definition	Use Case
OCF / Total DS	Middle-market credit (default)
EBITDA / Total DS	Sponsor finance, where lenders evaluate on EBITDA
EBITDA / Interest	Bond covenants, interest coverage ratio
(EBITDA – CapEx) / Total DS	Fixed charge coverage, capital-intensive businesses

One architectural point comes first. For computational accuracy, Salience never directly computes the distribution of the DSCR ratio. The reported DSCR is a derived summary; expected operating cash flow divided by debt service. Every distributional question about coverage refers to the OCF distribution against a threshold expressed in operating-cash-flow units: the covenant ratio multiplied by DS. The DS is scalar when debt service is fixed-rate (deterministic) and sampled when it is variable-rate (random). The figures and tables that follow display the OCF distribution rescaled into DSCR units for visual continuity with the credit-committee headline.

The expected DSCR is a single number drawn from a distribution and both the shape and center of that distribution matter. Two companies with the same expected DSCR but different operating variance face very different breach probabilities. Exhibit 10.1 sketches the picture for three companies, all with an expected DSCR of 1.50x and a covenant threshold of 1.20x, differing only in their OCF CV.

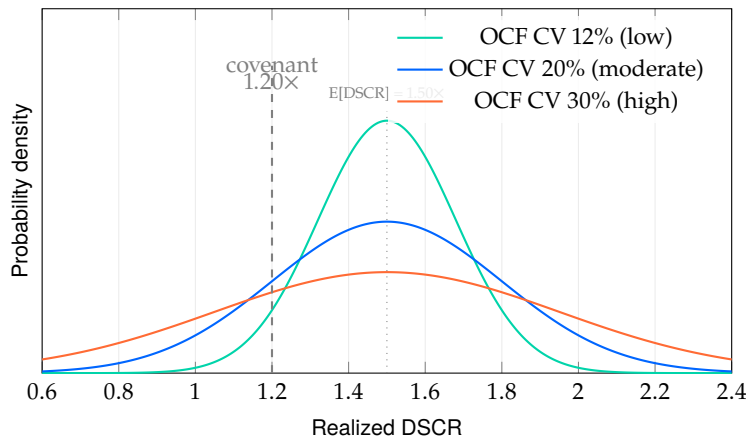


Exhibit 10.1: DSCR as a distribution. Three companies with the same expected DSCR (1.50×) and the same covenant threshold (1.20×), differing only in OCF CV. The breach probability is the area of the distribution to the left of the dashed line. For the low-CV company, that area is small (about 5%). For the moderate-CV company, it is meaningful (about 16%). For the high-CV company, it is large (about 25%). The expected DSCR alone does not distinguish the three.

The expected DSCR locates the center of the curve, but the breach probability depends on the shape around it. A 1.50× center can sit comfortably to the right of a 1.20× covenant for one company while the left tail of another crosses the line in roughly one year out of four. Two companies can share a coverage ratio and face materially different odds of breach, which is the coverage question the lender, the sponsor, and the operating partner are trying to answer.

The two standard improvements on the single-number view are scenario analysis and Monte Carlo simulation, and the cascade improves on both in ways worth naming. Scenario analysis prices a handful of named cases — base, upside, downside, perhaps a stress — so the breach probability is read off three or four points on a curve the analysis does not draw. Monte Carlo draws the curve by sampling thousands of paths, which answers the breach question numerically, and returns a distribution whose width is not connected to anything the sponsor or operating partner can adjust. Salience draws the same distribution analytically from the operational parameters the company already tracks, which means the shape of the curve decomposes into churn, deal size, expense variability, and rate volatility by name, each with a visible share of the total and each attached to a function and a budget line.¹

The breach probability the cascade prices is the probability that operating cash flow falls below the covenant-implied threshold. With the threshold expressed in operating-cash-flow units — the covenant ratio multiplied by total debt service — the calculation reduces to a single probability statement on operating cash flow. Chapter 8 develops the reframing in detail and shows that this operational form is robust across every CV regime.

This reframes the leverage decision. Sizing leverage to a target expected DSCR is the standard approach. The question the cascade makes available is what breach probability the sponsor is willing to accept, given the company's OCF CV. A sponsor prepared to accept a 5% breach probability can lever a low-CV company to a much lower expected DSCR than a high-CV company, because the curve at the lower CV is narrow enough to hold its left tail short

1: The cascade runs the breach calculation in both directions: forward from operational parameters to breach probability, and backward from a target breach probability to the operational improvements that would achieve it.

even when the center moves toward the covenant. The cascade computes the trade-off directly, and the leverage decision becomes a choice over the breach distribution, with the expected coverage number as one summary statistic among others.

10.3.2. What Breach Triggers

A covenant breach means the company has crossed a contractual threshold, short of failure, that gives the lender certain rights, the exercise of which depends on the severity of the breach, the relationship between the parties, and the alternatives available to each.²

The consequences of breach vary by severity and by the type of covenant. A DSCR breach typically triggers a cure period, during which the sponsor may inject equity to restore compliance. If the cure fails, the lender may restrict distributions (no dividends to the equity holder), require additional collateral, impose tighter operating covenants, or in extreme cases, accelerate the loan. The cost of these consequences is the distress cost that appears in the RACE³ calculation.

2: In practice, most covenant breaches in PE-backed companies are resolved through negotiation rather than enforcement. The lender agrees to a waiver or amendment in exchange for a fee, tighter terms, or a commitment to specific remedial actions. Acceleration of the loan (demanding full repayment) is rare because it often destroys value for both parties.

3: Risk-Adjusted Capital Efficiency, the subject of Chapter 12.

10.4. The Seniority Waterfall

In a capital structure with multiple debt tranches, the blended DSCR (total OCF divided by total debt service) does not represent the risk faced by any individual tranche, because senior debt has first claim on the cash flow and junior debt sees only the residual.

Each tranche sees a different available cash flow (ACF), the OCF remaining after all more-senior debt service has been paid. The senior tranche sees the full OCF. The second tranche sees OCF minus senior debt service. The third sees OCF minus senior minus second lien debt service. Each tranche therefore has its own DSCR, its own covenant threshold, and its own breach probability.

The available cash flows at the three tranches are perfectly correlated, since senior and second-lien debt service are contractually fixed and the only source of variance in each tranche's ACF is the common OCF. The dollar standard deviation therefore carries down the waterfall unchanged while the mean shrinks at each step, so the CV of ACF rises tranche by tranche.

The blended DSCR of 1.16x, applied against the most restrictive covenant (typically the senior's), produces a breach probability of 17%. The blended figure is also the least informative one in the table: the waterfall reveals that the senior tranche is comfortable at 2.40x with only 1% breach probability. The mezzanine, which sees the residual after the senior and second lien are serviced, has a tighter 1.78x with 11% breach probability.

Tranche	ACF	DSCR	Breach
Senior	\$30M	2.40x	1%
Second Lien	\$17.5M	2.19x	3%
Mezzanine	\$9.5M	1.78x	11%
Blended	\$30M	1.16x	17%

Table 10.2.: Per-tranche coverage in a three-tranche structure. ACF denotes available cash flow, the OCF remaining after all more-senior debt service has been paid. The blended DSCR of 1.16x sits below every per-tranche figure and reveals none of the structure: the senior's comfortable 2.40x and the mezzanine's tighter 1.78x.

The breach consequences differ by seniority as well. A senior breach is severe: cross-default clauses typically trigger default across all tranches, potentially leading to acceleration and forced sale. A mezzanine breach is more manageable: waiver negotiations, restricted distributions, or PIK conversion. The cost of distress is therefore a schedule that increases with the seniority of the breaching tranche, rather than a single number applied across the capital stack. Salience captures this through a nested breach cost formula that assigns the appropriate cost to each severity level without double-counting.

The seniority waterfall. Each tranche sees a different cash flow and faces a different breach probability. Senior debt is nearly always safer than the blended DSCR suggests. Junior debt is nearly always riskier.

10.5. Interest Rate Uncertainty

Floating-rate debt introduces a source of variance into the capital structure cascade that does not originate in the company's operations. The interest component of debt service depends on a reference rate (SOFR) that fluctuates with monetary policy and credit market conditions. For a company with \$80 million in floating-rate debt, a 100-basis-point rate increase adds \$800,000 to annual debt service, which reduces the DSCR and increases the breach probability.

The cascade captures rate uncertainty through two parameters: the expected rate and its volatility. Rate variance adds to the denominator of the DSCR, increasing the DSCR's variance and the breach probability. The effect is amplified for highly leveraged companies with predominantly floating-rate structures.

The interaction between rate movements and operating performance is economically meaningful. The cascade models this through the rate-revenue correlation parameter. Positive correlation (rates rise when revenue is strong) reduces the effective DSCR variance because the numerator and denominator move together. Negative correlation (rates rise when revenue is weak) amplifies it.

When debt service variance is meaningful relative to operating cash flow variance — typical for highly leveraged structures with predominantly floating-rate exposure — the breach calculation factors into two parts: a distributional treatment of OCF and a sampling treatment of debt service. The OCF part defaults to the

In a recession, revenue may decline (increasing operating stress) while central banks lower rates (reducing interest expense). This partial natural hedge means that rate and operating risks partially offset. In an overheating economy, the reverse occurs: strong revenue with rising rates. The correlation parameter captures this interaction.

moment-matched normal stand-in that Chapter 8 develops as the operational default; the CLT shield from the cascade's aggregation across revenue streams and AR(1) cumulative variance keeps the body of OCF close to normal, and covenant thresholds typically sit in the near-body where the normal stand-in agrees with a refined OCF distribution to within a percentage point. At high cascade CV — multi-tier multiplicative compounding, low-event-count Poisson at the revenue tier, or a heavy-tailed leaf — the conditional CDF on OCF is refined via Cornish-Fisher (a polynomial correction in skewness) or Rao-Blackwellization through the cascade's multiplicative layers, the techniques developed in Section 8.3. The DS part is then a Rao-Blackwellization over debt service: sample DS, evaluate the OCF CDF at $\delta \cdot DS_i$ for each draw, and average across the draws. The mixture inherits OCF's first two moments from the cascade.

For sponsors considering interest rate hedging (caps, collars, swaps), the cascade quantifies the benefit in terms of the breach probability reduction rather than the hedge cost alone. A rate cap that costs 50 basis points annually but reduces the covenant breach probability by 4 percentage points may be a rational purchase when the expected cost of a breach (waiver fees, restricted distributions, reputational damage) exceeds the cap premium.

Three sub-factor loadings sit behind the scalar rate volatility used in this chapter. The company's debt structure loads onto rate level (proportional to its floating share), rate slope (proportional to its refinancing-cycle position), and credit spread (proportional to its credit profile). Each loading is a $\beta_{i,s}$ that Chapter 13 reads off the same debt-structure inputs the per-company breach calculation already consumes, and the company's total rate variance is the bilinear form $\beta_i' F \beta_i$ in the factor covariance F developed in that chapter. The per-company breach probability depends on this scalar, and the sub-factor split is irrelevant to the univariate threshold-crossing event the breach calculation evaluates: whether the variance comes from level versus slope versus credit spread does not move $P(\text{DSCR} < \text{threshold})$. The decomposition surfaces only at the portfolio level, where the cross-company question — which holdings move together when rates move — depends on which sub-factors carry the loading. Chapter 13 uses the three-factor structure to populate the cross-company rate block of the covariance matrix, and Chapter 14's hedge-budget allocation uses it to rank instruments by which sub-factor each primarily addresses. The two chapters consume the same loadings the debt structure already supplies; what differs is the resolution at which the loadings are surfaced.

10.6. Technical Appendix

10.6.1. Breach Probability

The probability of covenant breach is the probability that operating cash flow falls below the covenant-implied threshold, where the threshold is the covenant ratio δ multiplied by total debt service over the period:⁴

$$P(\text{breach}) = P(\text{OCF} < \delta \cdot \text{DS}). \quad (10.1)$$

When debt service is deterministic (fixed-rate debt with known principal and interest), the operational form reduces to a single standard-normal CDF on operating cash flow:

$$P(\text{breach}) = \Phi\left(\frac{\delta \cdot \text{DS} - E[\text{OCF}]}{\sigma_{\text{OCF}}}\right) \quad (\text{DS deterministic}). \quad (10.2)$$

When debt service is random — typically because floating-rate exposure makes the interest component depend on a stochastic reference rate — the operational form is the mixture of conditional normals produced by Rao-Blackwellization over the debt-service distribution:

$$P(\text{breach}) = E_{\text{DS}}\left[\Phi\left(\frac{\delta \cdot \text{DS} - E[\text{OCF}]}{\sigma_{\text{OCF}}}\right)\right] \quad (\text{DS random}). \quad (10.3)$$

The OCF-vs-threshold form is the operational definition of breach probability the cascade uses across every CV regime. The conventional textbook alternative prices the DSCR ratio's tail directly — $\Phi((\delta - E[\text{DSCR}])/\sigma_{\text{DSCR}})$ — which requires an additional approximation on the ratio variance and stacks a second approximation on top when the threshold sits outside the body of the OCF distribution. The cascade does not invoke the DSCR-tail form for its breach computation; DSCR remains a derived headline summary (the ratio of expected OCF to debt service) when the credit committee asks for it.

10.6.2. Nested Breach Costs

For a capital structure with K tranches ordered by seniority, a breach of tranche k implies a breach of all more junior tranches $j > k$. The expected distress cost, accounting for this nesting, is:

4: Structural credit models price default from the same underlying quantity: Merton[13] treats default as the firm's terminal value falling below its debt, and Black and Cox[14] as the first crossing of a barrier during the debt's life. The covenant formulation here is single-period and cure-aware — a breach is a contractual threshold the borrower usually renegotiates — so the relevant object is the per-period headroom rather than a first-passage time.

$$E[\text{Distress}] = \sum_{k=1}^K [P_k(\text{breach}) - P_{k-1}(\text{breach})] \cdot C_k \quad (10.4)$$

where $P_0(\text{breach}) \equiv 0$ and C_k is the distress cost when the most senior breaching tranche is k . This formula assigns the appropriate cost to each severity level: the incremental probability of a senior breach times the senior distress cost, plus the incremental probability of a second-lien-only breach times the second-lien cost, and so on, without double-counting.

Managing Capital Structure Risk

11.

In which we size leverage against the breach probability the cascade produces, and find that the right debt structure is a property of the company rather than the sector.

Chapter 10 developed the covenant breach probability from the cascade's operating cash flow and debt service distributions. This chapter is about managing leverage given that calculation. Two capital structures with the same expected DSCR can produce different breach probabilities once operating uncertainty enters the picture, and two companies with the same breach probability can reach it through different combinations of leverage and operating CV. The sections that follow develop the tools that operate on the trade-off: a leverage table that locates the breach probability for each capital structure choice, a breach-reduction staircase that ranks operational levers by their breach-probability impact, a cash-flow waterfall with uncertainty that prices each tranche's exposure, and a worked case study that ties the elements together into a debt-structure design.

11.1. Covenant Breach Probability

The breach probability is the area of the OCF distribution that falls below the covenant-implied threshold $\delta \cdot \text{DS}$. A company with $E[\text{OCF}] = \$20\text{M}$ and $\sigma[\text{OCF}] = \$5\text{M}$ (a 25% operating CV), carrying \$13.3M of debt service against a 1.20 $\times$ covenant, has an expected DSCR of 1.50 $\times$ — comfortably above the covenant — and a breach probability of $\Phi((1.20 \cdot 13.3 - 20)/5) = \Phi(-0.81) \approx 21\%$ under the moment-matched normal CDF. The expected ratio looks comfortable, and the probability behind it tells a more complete story: roughly one year in five, operating cash flow falls below the level the covenant requires.

Leverage	DS	OCF Threshold	E[OCF]	DSCR view	P(br)
2.5x	\$9.5M	\$11.4M	\$20M	2.10x	4%
3.5x	\$13.3M	\$16.0M	\$20M	1.50x	21%
4.0x	\$15.3M	\$18.3M	\$20M	1.31x	37%
4.5x	\$17.1M	\$20.5M	\$20M	1.17x	54%
5.0x	\$19.1M	\$22.9M	\$20M	1.05x	72%

Table 11.1: The same company at different leverage levels. $E[\text{OCF}]$ and $\sigma[\text{OCF}]$ are constant across rows (operating uncertainty is a property of the business, not of the capital structure); what changes is the threshold the covenant implies. The DSCR view is the derived headline. All rows: $E[\text{OCF}] = \$20\text{M}$, $\sigma[\text{OCF}] = \$5\text{M}$ (CV = 25%), covenant $\delta = 1.20\times$.

Increasing leverage raises the threshold $\delta \cdot \text{DS}$ along the cash flow axis without changing the OCF distribution; the DSCR statistic

rescales by $1/DS$, which is the same calculation expressed two ways and leaves $CV[DSCR]$ equal to $CV[OCF]$.

The table traces a single company across leverage levels, holding operating uncertainty constant. At 2.5x leverage, the breach probability is 4%, which most sponsors and lenders would consider acceptable. At 4.0x, it rises to 37%. At 4.5x and beyond, the threshold sits above expected OCF and the breach probability crosses 50%, meaning the company is more likely than not to breach in a given year. The credit market may be willing to provide 5.0x leverage for a company of this quality, and the cascade prices that 5.0x at a 72% breach probability, which is the kind of gap between what the market will offer and what the operating uncertainty supports that the rest of the chapter is built to close.

11.1.1. Leverage Capacity Analysis

The breach probability table can be read in reverse: given a target breach probability, what is the maximum leverage the company can sustain?

This inverts the traditional leverage sizing conversation. The sponsor asks “how much leverage produces an acceptable breach probability?” which is a different question from “how much will the market lend?” and often produces a different answer.

A sponsor with a 10% breach ceiling would size leverage at approximately 3.0x for this company. A sponsor with a 5% ceiling would size at 2.5x. The cascade converts the abstract concept of debt capacity into a specific, quantified relationship between leverage and breach probability, parameterized by the company’s own operating uncertainty.

Two companies with the same EBITDA may have very different leverage capacities if their operating CVs differ. At $E[OCF] = \$20M$ and a 10% breach ceiling, a company with a 15% OCF CV (\$3M standard deviation) can sustain about 3.5x leverage; a company with a 30% OCF CV (\$6M standard deviation) reaches the same ceiling at about 2.7x. The cascade makes the difference visible, and the leverage decision follows from it.

11.2. The Breach Reduction Staircase

The breach reduction staircase is the credit analogue of the Sharpe Improvement Staircase introduced in Chapter 6 for earnings variance. It ranks variance reduction initiatives by their impact on breach probability rather than on earnings CV, and it orders them by cost to produce a sequenced action plan for improving the credit profile.

The mechanics are the same. Each variance source (churn count risk, deal size variability, expense ratio fluctuation, rate exposure, working capital timing) contributes a measurable share to the DSCR variance. Reducing any source by a given fraction (the staircase uses a default 20% reduction) changes the DSCR variance,

which changes the breach probability. The staircase computes the incremental breach probability reduction from each initiative and presents them in cost order: cheapest first.

Step	Initiative	P(breach)	Δ
0	Baseline	9.0%	—
1	Rate hedging (cap)	8.2%	−0.8
2	DSO improvement	7.1%	−1.1
3	Deal desk governance	5.8%	−1.3
4	Customer health scoring	4.0%	−1.8
5	Pipeline diversification	2.6%	−1.4

Table 11.2.: Sequenced initiatives for reducing Athena’s covenant breach probability. Each step shows the breach probability after a 20% reduction in that source’s variance contribution. Several of the largest reductions (customer health scoring, pipeline diversification, deal desk governance) operate on sources of revenue variance; the connection between revenue-tier operations and covenant-breach probability is something only the cascade makes visible, since conventional credit analysis stops at the earnings line.

The staircase starts from Athena’s post-improvement state (Chapter 4), where the annual breach probability stands at 9.0% rather than the original 17%. For Athena, the staircase begins with rate hedging (cheapest, modest impact), proceeds through DSO improvement and deal desk governance (moderate cost, growing impact), and culminates with customer health scoring and pipeline diversification (higher cost, largest cumulative impact). The total reduction from 9.0% to 2.6% is achieved through a sequence of five initiatives, each with a quantified marginal contribution to the improvement.¹

The operating partner can use the staircase to set targets and allocate budget. If the goal is to reduce breach probability below 5%, the first four steps suffice at a total cost determined by the operational details of each initiative. If the goal is below 3%, all five steps are needed. The staircase makes the cost-benefit trade-off explicit.

The rate-hedging entry at Step 1 collapses three sub-factor loadings the company carries on its debt structure — level (floating share), slope (refinancing-cycle position), and credit spread (credit profile) — into a single line. The per-company breach probability depends on the aggregate rate variance the three loadings produce against the factor covariance Chapter 13 develops, not on the sub-factor split: whether the variance comes from level versus slope versus credit spread does not move a univariate threshold-crossing event. The split surfaces only at the portfolio level, where Chapter 14’s hedge-budget allocation ranks instruments by the sub-factor each one primarily addresses. The debt-structure loadings are the same in both chapters; what differs is the resolution at which they are surfaced.

1: The staircase rests on the variance-to-activity attribution that Chapter 8 preserves under every distributional caveat the moment-matching framework raises. The level of the breach probability column may shift modestly at high cascade CV, where the normal-tail approximation is less reliable; the ordering of the initiatives and the marginal Δ each one delivers is exact in the second-moment decomposition and survives the caveat.

11.3. The Cash Flow Waterfall with Uncertainty

The cash flow waterfall traces operating cash flow through its successive claims: debt service, capital expenditures, cash sweep (mandatory excess-cash-flow prepayment), and residual free cash flow. At each stage, the cascade provides a confidence interval, showing the range of plausible outcomes.

The waterfall reveals where in the capital structure the uncertainty concentrates. For Athena, with expected OCF of \$10.5 million and debt service of \$5.6 million, the expected free cash flow after debt service and maintenance CapEx is approximately \$3.5 million. The 80% confidence interval for free cash flow runs from approximately \$0.3 million to \$6.7 million, which is the operational reporting band Chapter 8 Section 3 recommends across the cascade's CV regimes; the 68% interval is the tighter \$1.0 million to \$6.0 million. The moment-matched 95% interval — which extends from negative \$1.5 million to \$8.5 million in the standard normal calculation — sits in the regime where the normal-tail approximation degrades on a positive-support quantity, the visible signal Chapter 8 flags as the indication that 95% reporting is no longer reliable.²

2: Negative free cash flow after debt service means the company must draw on cash reserves, the revolver, or equity support from the sponsor to meet its obligations. The probability of this outcome is $P(\text{OCF} < \text{debt service} + \text{CapEx})$, the same OCF-vs-threshold form Chapter 10 develops for covenant breach, with the threshold raised to include capital expenditures alongside debt service.

The waterfall makes the cushion (or lack of it) visible at each stage. A company with a comfortable DSCR might still have thin free cash flow after CapEx, which means it has limited ability to absorb unexpected capital requirements, fund growth initiatives, or build a cash reserve for future debt service variability. The cascade quantifies this through confidence intervals at every stage of the waterfall.

11.4. Case Study: Designing the Right Debt Structure

A PE sponsor is evaluating a platform acquisition of a healthcare staffing company with \$18 million in EBITDA and a 20% earnings CV. The company has been offered three financing packages from different lenders, but the three packages are easier to evaluate against the wider set of structures the company could plausibly support. Exhibit 11.1 draws that wider set: every plausible mix of senior and mezzanine debt the company could carry, plotted in the space of senior breach probability against expected equity return. The three offered packages sit somewhere on the picture, as do many alternatives nobody bothered to draft a term sheet for.

The two curves describe two different families of structures. Senior-only structures (blue) trade leverage against senior breach probability along a single axis: more debt, higher return, more risk. Senior-plus-mezzanine structures (teal) sit above and to the left of the senior-only curve at every point, because the mezzanine tranche absorbs the marginal risk that would otherwise fall on

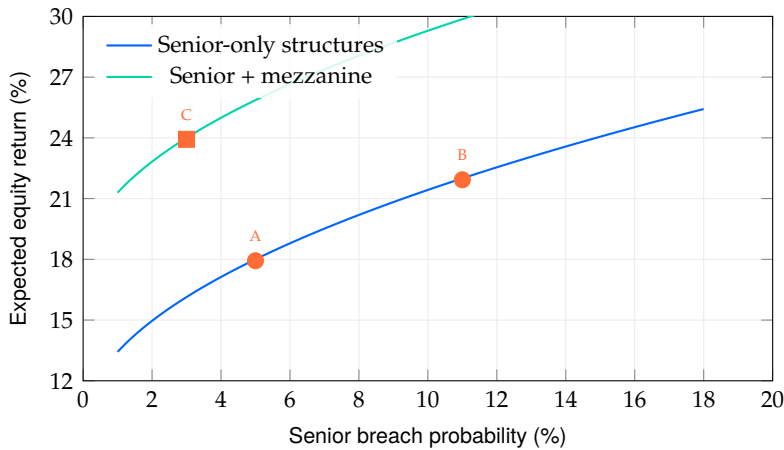


Exhibit 11.1: The tranche mix frontier. Two frontiers in the same space. The blue curve traces senior-only structures: more leverage produces a higher return and a higher senior breach probability. The teal curve traces senior-plus-mezzanine structures: the mezzanine absorbs risk, so the senior breach probability is lower at any given level of equity return. Structures A and B from the case study sit on the senior-only curve. Structure C sits on the senior-plus-mezzanine curve, dominating both alternatives in senior breach probability and equity return.

the senior. The mezzanine’s own breach probability is higher than the senior’s would have been, and mezzanine breaches are less expensive than senior breaches; the price difference is what makes the trade worth taking. Structure C illustrates the principle: it carries more total debt than either Structure A or Structure B and exposes the senior tranche to a smaller breach probability while producing a higher equity return.

This frontier exists for every company, computed directly from the company’s OCF distribution and the available tranche economics. With the frontier visible, the question becomes which point on it the sponsor would prefer, and which lender will write the term sheet that puts them there. The preferred point can be one of the offered structures or a structure no lender has yet proposed, which the sponsor can then go back and request.

	A	B	C
Senior debt	\$63M	\$72M	\$54M
Mezzanine	—	—	\$22M
Total debt	\$63M	\$72M	\$76M
Leverage	3.5x	4.0x	4.2x
Senior DSCR	1.75x	1.53x	2.04x
Senior breach prob	5%	11%	3%
Mezz breach prob	—	—	14%
Blended breach prob	5%	11%	8%
Equity required	\$81M	\$72M	\$68M
Expected equity return	18%	22%	24%

Table 11.3: Three financing packages for the same company. Structure C uses per-tranche seniority to carry more total debt at a lower senior breach probability than either alternative.

Structure A is conservative: 3.5x leverage, comfortable coverage, 5% breach probability. The equity requirement is \$81 million, and the expected equity return is 18%.

Structure B increases leverage to 4.0x, improving the expected equity return to 22% at the cost of an 11% senior breach probability. Many sponsors would find this acceptable. The cascade reveals that the 11% probability means roughly one year in nine will produce a covenant issue.

Structure C introduces a mezzanine tranche. Total leverage is 4.2x, the highest of the three, with a 3% senior breach probability, the lowest. The mezzanine carries a 14% breach probability, which the sponsor accepts because mezzanine covenant violations are more manageable (waiver negotiation, restricted distributions) than senior breaches (cross-default, potential acceleration). The expected equity return is 24%, the highest of the three, because the equity base is smallest.

Seniority unlocks capacity. Structure C carries more total debt than A or B with a lower senior breach probability and a higher equity return, because the mezzanine tranche absorbs risk that would otherwise push the senior covenant to uncomfortable levels.

The three structures differ on total leverage, equity requirement, return profile, and per-tranche risk. Without per-tranche breach probabilities, the comparison collapses to a blended DSCR check, which would rank Structure B above Structure C despite Structure C's superior senior protection and higher equity return.

11.5. Technical Appendix

11.5.1. Leverage Capacity as a Function of OCF CV

The maximum leverage L^* at a target breach probability $\bar{P}$ can be expressed as:

$$L^* = \frac{E[\text{OCF}]}{DS_{\text{unit}}} \cdot \frac{1 + z_{\bar{P}} \cdot \text{CV}(\text{OCF})}{\delta} \quad (11.1)$$

where DS_{unit} is the debt service per unit of leverage, δ is the covenant threshold, and $z_{\bar{P}} = \Phi^{-1}(\bar{P})$ is the z-score corresponding to the target breach probability. This expression shows that leverage capacity declines linearly in the OCF CV. Halving the CV raises capacity substantially without doubling it: in the example above, moving the CV from 30% to 15% raises capacity from about 2.7x to about 3.5x at the same 10% breach ceiling.

11.5.2. Multivariate Breach Probability

When a portfolio of companies is jointly financed, or when a sponsor needs to assess the probability of simultaneous covenant breaches across multiple holdings, the analysis extends to a multivariate setting. The cascade-native form runs on the OCF distributions: each company's OCF is approximately normal at its first two moments under the chapter's operational stand-in, and the joint distribution across N companies is approximately multivariate normal with a correlation matrix ρ supplied by the sponsor or estimated from shared-factor exposures. The probability that k or more companies simultaneously breach is

$$P(\text{simultaneous breaches} \geq k) = 1 - P(\text{breaches} < k), \quad (11.2)$$

The closed-form $z_{\bar{P}}$ inversion assumes operating cash flow is approximately normal at the cascade's body. The same inversion runs through the percentile machinery in Chapter 8 when the cascade's distribution has departed from normal — the leverage-capacity formula then reads off the $\bar{P}$ -quantile of the operational distribution rather than the closed-form z-score, with the rest of the formula unchanged.

computed via Monte Carlo simulation with correlated normal draws (Cholesky decomposition of ρ). Each draw produces a vector of OCF realizations, each compared against its own threshold $\delta_i \cdot DS_i$; a company breaches when its drawn OCF falls below its threshold. The result is a distribution over the number of simultaneous breaches, which the sponsor uses to assess portfolio-level distress risk. The DSCR view recovers the same probability under the same operational stand-in; the cascade-native OCF form is the one the multivariate calculation is most naturally written against.

INVESTING WITH SALIENCE

Risk-Adjusted Capital Efficiency

12.

In which the two cascades converge into a single measure, and the leverage debate acquires a common unit of account.

The valuation cascade, developed in Part III, tells you what a business is worth given its operating uncertainty. The capital structure cascade, developed in Part IV, tells you whether a business can reliably service its debt. Each cascade produces useful outputs for its respective audience: the investor cares about enterprise value, equity return, and their ranges, the lender cares about DSCR and breach probability. This chapter brings the two together into a single measure that captures both dimensions simultaneously: risk-adjusted capital efficiency, or RACE.

RACE answers a question the two cascades individually cannot answer: at what rate does the uncertainty in this company convert into return on investment given my preferences, and what capital structure improves that risk-adjusted return? The main deliverable is a quantity line that penalizes expected equity return by a penalty for variance, a penalty for expected distress, stated in the same units and priced at the investor's own risk tolerance. A committee that sees those three terms on one row conducts a different leverage debate because positions that used to be expressed as comfort levels become positions about prices. The RACE metric gives the investor a single number that prices return, risk, and distress.

12.1. The Equity Multiplier

The variable that connects the two cascades is the equity multiplier: enterprise value divided by common equity.

$$\frac{V}{CE} = \frac{V}{V - D - \text{Pref}}$$

The equity multiplier captures how much of the enterprise value is financed by equity versus other claims (debt and preferred). A company with \$100 million in enterprise value, \$60 million in debt, and no preferred has a 2.5x equity multiplier: each dollar of equity supports \$2.50 of enterprise value.¹

The equity multiplier enters the cascade in two places. In the valuation cascade, it amplifies the expected equity return: more leverage means the equity holder captures a larger share of the upside per dollar invested. In the capital structure cascade, it amplifies the variance of that return: the same operating uncertainty

1: The equity multiplier appears squared in the variance of equity returns, which is why leverage has such a powerful effect on the risk profile. Doubling the equity multiplier quadruples the variance of equity returns. This quadratic relationship is the fundamental reason that the RACE surface has a peak rather than monotonically increasing with leverage.

produces a wider range of equity outcomes when more of the enterprise value is financed by non-equity claims.

The amplification is quadratic. A company with a 24% valuation CV and a 2x equity multiplier has an equity return CV of roughly 48%, and the same company at 3x has an equity return CV of roughly 72%. The expected return rises roughly linearly over the leverage range that matters while the variance rises with the square, which means the variance penalty eventually overwhelms the return benefit; the crossover is the RACE peak.

12.2. RACE: The Measure

Risk-adjusted capital efficiency is a certainty equivalent measure: the expected equity return minus a penalty for variance minus a penalty for the expected cost of financial distress.

$$\text{RACE} = r_E - \lambda \sigma_E^2 - P(\text{breach}) \cdot c \cdot \frac{V}{CE}, \quad (12.1)$$

where r_E is the expected equity return and σ_E^2 the variance of that return, both annualized over the hold period, λ is the investor's risk aversion, c is the cost of a breach expressed as a fraction of enterprise value, and the equity multiplier V/CE converts that enterprise-level cost into equity-return units. This is the form Salience computes; the two preference scalars, λ and c , are the subject of the next section.

The expected equity return reflects the amplifying effect of leverage. More debt means less equity, which means the equity holder earns a higher percentage return on a smaller base. A company that grows from \$100 million to \$120 million in enterprise value delivers a 20% enterprise return. If the equity base is \$40 million (after \$60 million in debt), the equity grows from \$40 million to \$60 million, a 50% return. The leverage converts a 20% operating outcome into a 50% equity outcome.

The variance penalty reflects the quadratic amplification. The same leverage that converts a 20% operating return into a 50% equity return also converts a 24% operating CV into a 60% equity CV. The variance of equity returns grows with the square of the equity multiplier, which means each additional turn of leverage adds progressively more variance per unit of return.

The distress penalty reflects the probability and cost of covenant breach. At low leverage, the breach probability is negligible and the distress penalty is near zero. As leverage increases, the DSCR distribution shifts closer to the covenant threshold, the breach probability rises, and the expected distress cost (breach probability times the cost per breach) grows. For multi-tranche structures, the distress penalty is the seniority-weighted sum developed in

Chapter 10: each tranche's incremental breach probability times its severity-specific cost.

The three components move in opposite directions as leverage increases: the expected return rises roughly linearly, the variance penalty rises quadratically, and the distress penalty rises steeply once the DSCR distribution approaches the covenant threshold. The sum produces a curve with an interior peak, often with a flat stretch near it, at the leverage level where the marginal benefit of additional debt equals the marginal cost. This peak is the RACE-maximizing leverage.

RACE = expected equity return – variance penalty – distress penalty. The three terms move in different directions as leverage increases, creating a peak: the leverage level that maximizes risk-adjusted returns.

12.3. Preference Scalars

The RACE formula has two inputs that come from the investor. They are the channel through which an investor's mandate enters the calculation. The cascade supplies everything about the business; the preference scalars provide information about the person buying it.

The first is the risk aversion coefficient, λ , which sets the price of variance in the certainty equivalent measure. A larger λ indicates a more risk-averse investor. A sponsor with a large, seasoned fund, long LP relationships, and a diversified portfolio can absorb a single bad year without jeopardizing the next vintage, and carries a low λ . A first-time fund with concentrated exposure and LPs watching every quarterly mark carries a high one.²

The second is the breach cost fraction, c , which sets the dollar cost of covenant distress as a share of enterprise value. A lender with a relationship history and a sponsor with clean prior workouts may produce a breach cost of two or three percent of EV, paid in waiver fees, tighter terms, and a quarter of management distraction. A concentrated LBO with a covenant-lite structure that nonetheless trips may produce breach costs several times that, because acceleration becomes a live possibility and the secondary market sees what happened. The fraction has an empirical anchor: Andrade and Kaplan[15], studying highly leveraged transactions that became genuinely distressed, put the cost of financial distress at 10 to 23 percent of firm value. A covenant breach short of distress is the milder event, and the chapter's 3%-of-EV convention prices that milder event; a sponsor whose structures or sectors make the escalation from breach to distress more likely should carry a c that moves toward the published range.

The 3% convention does two jobs the portfolio chapters will separate. In the RACE surface it prices the *expected* cost of a breach, the mild waiver the convention describes, and that is the figure the leverage peak trades return against. When those chapters instead value a de-risking action — a hedge, a variance reduction, a turn of deleveraging — the cost that matters is the escalation the

2: Numerically, λ is the slope at which expected return and equity-return variance trade off: the additional expected return the investor demands for one unit of additional variance. A λ of 0.5 says the investor will surrender half a point of expected return to remove a point of variance; a λ of 2.0 says four times as much. The same range of values the valuation chapter used for the CV-discount parameter carries through here.

action insures against, and the same move is read at both the 3% convention and the Andrade–Kaplan range.

The practical objection to both scalars is that no investment committee knows its λ . The framework's answer is the one Chapter 7 gave for the market's risk price: calibrate from decisions rather than from introspection. A committee's own deal history carries its risk price. Running the cascade retroactively on the firm's last several deals, and pricing the leverage alternatives that were actually available at each closing, brackets the λ under which each choice was RACE-consistent: taking 4.0x when 5.0x was offered puts a floor under the committee's price of variance, and declining to drop to 3.0x puts a ceiling over it. Three or four deals typically bracket λ within a working range. The number that emerges is descriptive before it is prescriptive; it names the risk price the committee has been in past deals; and it can be used by the committee to decide whether that price still fits the fund's position.

Two scalars, one investor. Risk aversion λ prices variance. The breach cost fraction prices distress. Changing either moves the RACE peak without changing a single operating parameter in the cascade.

3: The academic treatment of optimal leverage under uncertainty descends from Leland[16], who derives the optimum in closed form from asset volatility, tax benefits, and endogenous bankruptcy on a diffusion process. RACE reaches the same trade-off from operational parameters: the variance and the breach probability come from the cascade rather than from a volatility estimated on asset prices.

Changing either scalar moves the peak. A more risk-averse sponsor sees a RACE curve whose peak sits at lower leverage, because the variance penalty bites sooner. A sponsor whose prior workouts have been expensive sees a peak that sits at lower leverage for the separate reason that the distress penalty bites sooner. The two forces can reinforce or offset, and the RACE surface accommodates both without changing anything the cascade computes about the company itself. The optimal leverage is therefore a joint property of the business and the investor.³

The exhibits in the remainder of this chapter hold the preference scalars constant at $\lambda = 0.5$ and a breach cost fraction of 3% of enterprise value, values consistent with mainstream middle-market private equity. Readers with a different mandate in mind can re-read each figure by shifting the peaks toward lower leverage for a more risk-averse or more distress-sensitive investor, and toward higher leverage for the reverse.

12.4. The RACE Surface

Operating variance, contributed by the company, sets how rapidly the variance and distress penalties grow with each additional turn of leverage; the preference scalars, contributed by the investor, set how heavily those penalties are weighed. Holding the preference scalars fixed and varying operating variance isolates the company's contribution: a company with low operating uncertainty can sustain more leverage before the penalties overwhelm the return benefit, and a company with high operating uncertainty reaches its peak at a lower leverage level. Holding operating variance fixed and varying the scalars isolates the investor's contribution, in the manner the preceding section described.

	3.0x	4.0x	4.5x	5.0x	6.0x
Equity return	12.5%	14.9%	16.5%	18.5%	24.6%
Equity volatility	26%	32%	37%	43%	64%
Breach prob	3%	9%	15%	22%	38%
RACE	9.0%	9.1%	8.7%	7.5%	-0.7%

Table 12.1.: RACE for a PE-backed company with \$30M EBITDA and 24% valuation CV, computed from equation (12.1): entry at 8.0x (\$240M enterprise value), expected exit enterprise value \$360M over a five-year hold, $\lambda = 0.5$, breach cost 3% of enterprise value. Returns and volatilities are annualized. The peak is at 4.0x despite the market's willingness to lend at 5.0x.

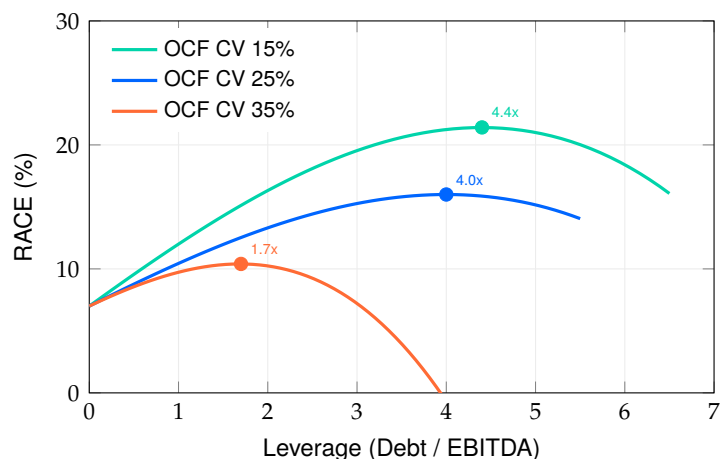
At 3.0x leverage, the expected annualized equity return is 12.5% and the penalties are modest: RACE is 9.0%. At 4.0x, the return increases to 14.9% and the penalties grow, but the net effect is still positive: RACE peaks at 9.1%. The top of the curve is flat — between 3x and 4x, each added turn of leverage buys return that the penalties almost exactly consume. Beyond the peak the roll-off steepens. At 4.5x, the return continues to rise but the penalties grow faster: RACE declines to 8.7%. At 5.0x, the breach probability reaches 22% and RACE drops to 7.5%. At 6.0x, the breach probability is 38%, the variance penalty alone consumes twenty points of return, and RACE goes negative.

The market may be willing to provide 5.0x leverage for a company of this quality, but RACE locates the efficient point at 4.0x. The sponsor who sizes at 5.0x accepts a higher expected return (18.5% vs. 14.9%) and a lower risk-adjusted return (7.5% vs. 9.1%), because the variance penalty and the 22% breach probability more than offset the return amplification. The flat top is part of the answer rather than a defect in it: within a turn of the peak the choice is close to indifferent, so the sentence the deal team most needs is less “the answer is 4.0x” than “beyond 4.5x this company's penalties grow faster than its return does.” The peak names the neighborhood; the roll-off names the boundary.

The RACE peak shifts with operating variance. A company with 15% OCF CV can efficiently deploy 4.4x leverage (the penalties grow slowly because the operating uncertainty is low). A company with 35% CV reaches its peak at 1.7x (the penalties grow rapidly because the operating uncertainty is high). Two companies with the same EBITDA may have very different optimal leverage levels, and the cascade computes this directly from their operating parameters.

This is the quantitative equivalent of the experienced deal partner's instinct that the business should not be levered to the maximum the market will bear. The cascade makes that instinct auditable: the peak is at 4.0x for this company's specific operating uncertainty, and the calculation shows why.

Exhibit 12.1: RACE as a function of leverage for three companies with different operating uncertainty. The optimal leverage (marked) decreases as OCF CV increases. The low-variance company can efficiently deploy 4.4x; the high-variance company's peak is at 1.7x. Beyond the peak, variance amplification and distress costs overwhelm the return benefit. Preference scalars: risk aversion $\lambda = 0.5$, breach cost fraction = 3% of EV, both held constant across the three curves; the peaks shift only because OCF CV changes. A more risk-averse or more distress-sensitive investor would see the same three curves with lower peaks at lower leverage.



12.5. Floating-Rate Exposure

The worked example above assumes deterministic debt service, the case where each leverage level translates into a fixed coupon over the hold. Under floating-rate exposure the distress penalty in RACE replaces the deterministic-DS breach probability with the Rao-Blackwellized mixture from Chapter 10 Equation (10.3), and the RACE peak shifts toward lower leverage by an amount that depends on the rate volatility, the rate-revenue correlation, and any rate hedging the sponsor purchases. For the running example at 24% valuation CV, typical SOFR-plus-spread exposure with 50 to 100 basis points of annual rate volatility moves the peak from 4.0x to roughly 3.7x to 3.9x; heavier rate exposure without hedging moves it further.

Rate hedging enters the framework as a RACE-improving purchase. A cap or collar reduces effective rate volatility, which compresses the breach mixture, which lowers the distress penalty. The premium cost reduces the expected equity return by a known amount, the breach-probability reduction lowers the expected distress cost by a quantified amount, and the difference is the hedge's RACE-denominated value. A 50-basis-point cap on a highly leveraged structure may produce a RACE improvement on the order of one to two percentage points; on a lightly leveraged structure where breach probability is already negligible, the same hedge produces little RACE benefit and the premium cost dominates. The framework prices the trade-off in the same risk-adjusted units that price the leverage decision itself.

12.6. The Modigliani-Miller Connection

The formal theory of capital structure identifies several frictions that make the mix of debt and equity relevant: distress costs, agency costs, information asymmetry, and tax shields. Of these, distress costs are the most consequential for RACE.

Tax shields (the deductibility of interest payments) provide a secondary benefit to leverage that can shift the optimal point modestly higher.⁴ The core trade-off between return amplification and the combination of variance amplification and distress costs exists independently of any tax assumption. The RACE peak is well-defined without taxes, which means the framework does not depend on a parameter that varies by entity structure, LP composition, and tax jurisdiction.

Salience provides a firm-specific, forward-looking estimate of the operating cash flow variance that drives distress probability. With this input, capital structure optimization becomes computable from the company's actual operating parameters, not inferred from comparable companies.

4: Many PE-backed companies use pass-through structures where the tax benefit depends on each LP's individual tax status rather than a single corporate rate. Section 163(j) of the Tax Cuts and Jobs Act further limits deductibility at 30% of adjusted taxable income. These complexities make a single tax rate assumption unreliable for most PE contexts.

12.7. Case Study: Two Deal Structures

A sponsor is evaluating an acquisition of a specialty chemicals distributor with \$22 million in EBITDA. The company has an earnings CV of 20% and a stable customer base with 300 active accounts. The sponsor's preference scalars match the chapter's running assumption: risk aversion $\lambda = 0.5$ and breach cost fraction of 3% of EV. Two deal structures are on the table.

Structure 1: Conservative. 3.5x leverage (\$77M debt), \$99M equity. The expected equity return is 13.6% annualized over a five-year hold. The breach probability is 5%. RACE is 9.9%.

Structure 2: Aggressive. 5.0x leverage (\$110M debt), \$66M equity. The expected equity return is 18.5% annualized. The breach probability is 18%. RACE is 9.3%.

	Structure 1 (3.5x)	Structure 2 (5.0x)
Equity invested	\$99M	\$66M
Expected equity return	13.6%	18.5%
Equity volatility	26%	39%
Breach probability	5%	18%
RACE	9.9%	9.3%

Table 12.2: Structure 1 produces a lower expected return and a higher risk-adjusted return, from equation (12.1) with entry at 8.0x (\$176M enterprise value), expected exit enterprise value \$264M over a five-year hold, $\lambda = 0.5$, and breach cost of 3% of enterprise value. Returns and volatilities are annualized. The five percentage points of additional annualized return from Structure 2 are more than offset by the variance and distress penalties.

Structure 2 offers about five percentage points more in annualized expected equity return. It also carries a 39% annualized equity volatility (compared with 26%) and an 18% breach probability (compared with 5%). The net effect, measured by RACE, favors Structure 1 by roughly 60 basis points.

Choosing Structure 2 is a defensible trade: the expected return is genuinely higher, at the cost of higher variance and a higher breach probability. The two structures sit at different points on the RACE surface in the same way two portfolios sit at different points on a mean-variance efficient frontier in public equity. Both points are efficient; the selection depends on the investor's risk tolerance.

The same logic applies here. Structure 1 and Structure 2 sit at different points on the RACE surface, and the "right" choice depends on the sponsor's risk aversion. A sponsor with high risk tolerance, perhaps managing a fund with ample reserves, a long track record that provides LP confidence through periods of volatility, and a portfolio large enough to absorb a single-company covenant breach, might rationally prefer Structure 2. The higher expected return is worth the additional variance and distress risk to this sponsor, because the consequences of a bad outcome are manageable within the broader portfolio context. A sponsor with lower risk tolerance, perhaps managing a smaller fund, a newer vintage, or a concentrated portfolio where a single covenant breach would consume disproportionate management attention, would rationally prefer Structure 1.

The investment committee reviewing these two structures now has a quantitative basis for the discussion. The traditional analysis shows a higher expected return for Structure 2 and a "still works" assessment on the stress case. RACE adds the dimension that has been missing: the risk-adjusted return at each leverage level, parameterized by the committee's own risk appetite — ideally the risk appetite its own deal history reveals, in the manner the preference-scalar section described. A committee that has located its λ can read the optimal leverage directly from the RACE surface, in the same way that an asset allocator with a stated risk tolerance can read the optimal portfolio from an efficient frontier.

The RACE frontier. Every point on the RACE surface is a valid capital structure. The selection depends on risk tolerance, not on a universal rule. Conservative and aggressive structures are both rational choices for different investors facing the same company.

12.8. RACE in the Order of Adoption

Within the framework, RACE is the destination; within a firm's adoption of the framework, it should come last. Every other number the cascade produces is a forecast that reality eventually scores: a goal risk is tested by the year that follows, a breach probability by the life of the loan, a z-score by next quarter's actuals. RACE is a decision criterion, a preference-weighted judgment that no realization ever grades, and a tool that cannot be checked should only be adopted after the tools that can be checked have earned

the framework its credibility. The cadence of the work points the same way: tracking runs weekly and the QBR quarterly, while the leverage decision arrives at entries and refinancing windows, a few times a year at most.

RACE therefore enters a firm the way Chapter 17 describes: as one added line in the IC memo, read alongside the IRR rather than in place of it, with the decomposition doing the early work. The committee that sees expected return, variance penalty, and distress penalty on one row is conducting the leverage debate in priced terms. What compounds over deals is the habit of asking what the extra turn costs in risk-adjusted terms, against the risk price the firm's own history implies.

The framework prescribes neither conservative nor aggressive structures universally. Companies with low operating uncertainty can support aggressive leverage efficiently, and sponsors with high risk tolerance should use it. Companies with high operating uncertainty reach their RACE peak at lower leverage, and even aggressive sponsors should respect that peak. Salience makes the distinction quantitative and the RACE surface makes the trade-off visible; the selection remains a risk-return choice the investor carries into the next chapter, where the same logic extends from a single capital structure to a portfolio of them.

In which the question shifts from how much variance each company carries to how much variance is shared between companies, and the answer becomes the covariance the portfolio chapters consume.

The chapters to this point have measured one company at a time; a per-company forecast, a per-company variance, and an attribution of that variance to named operational sources: inflow, outflow, seasonality, margin, working capital, the multiple.

A portfolio is a weighted sum of companies, and its variance needs to also consider the co-movement between holdings. This chapter builds that co-movement by asking which of the sources the cascade has already named are shared. We build up by starting with two companies.

13.1. Two Companies

Meridian Software and Clearview Analytics are two holdings the cascade has already measured. The cascade puts a CV of 28 percent on Meridian's enterprise value, and the attribution names where the variance resides: forty percent rides on churn, twenty-eight on the new-logo pipeline, seven on deal-size variability, and twelve on the multiple. Clearview's value CV is 24 percent, carried by usage contraction, new sales, and the multiple. Each attribution is complete on its own terms, a reader of either could act on it without knowing the other company exists.

The two companies also sell into the same SaaS-adjacent end-market. When that market catches cold, Meridian's churn rises, and so does the usage contraction Clearview books as outflow. A fund that holds both companies also owns something neither per-company attribution describes: the possibility that the bad quarter arrives at both companies at once. In this sense, outflow is promoted from a source of variance to a common factor in which both firms can partake. Whether the fund holds one bet or two is a question about co-movement. The chapter builds portfolio covariance from that raw material, starting with this pair.

13.2. The Sharing Question

In a returns-based factor risk model, the shared variance between two companies emerges from the calculations performed on price histories that produce the model. Model in hand, company risk is built up from factors and the residual component. In Saliency things are different. We already have the total variance of each company. We now want to determine the shared amount for each factor. Here we turn to the sponsor's judgment. The private equity general partner has a different perspective than the typical public equity portfolio manager. The portfolio manager using a risk model has to depend on the risk model vendor's assumptions regarding price history, fundamentals, and the resulting factor returns, the GP has access to actual operating data and in many cases, is setting the operational priorities of the firms under consideration. Accordingly, the sponsor is in a better position to determine how much variance is shared for a factor, say, outflows.

The sponsor supplies two things for each company that shares a driver of variance. The first is a magnitude: what percentage of this company's outflow variance is attributable to the market. Suppose sixty percent of Meridian's churn and forty percent of Clearview's usage contraction is market related. The second is a direction: does the driver push this company up or down. For Meridian and Clearview it pushes the same way, since a cold end-market raises churn at one and usage contraction at the other.

Write $a_{i,f}$ for the magnitude and $z_{i,f} \in \{+1, -1\}$ for the direction. The driver reaches company i 's source- s variance through a signed standard deviation,¹

$$\rho_{ij,ss} = z_i z_j \sqrt{a_i a_j}. \quad (13.1)$$

For the pair in hand the directions agree and the magnitude resolves to $\sqrt{0.60 \times 0.40} \approx 0.49$ on the outflow factor.

This blends sponsor judgment with measured facts. Each company carries variance from outflow determined by measuring its operations, and those are objective statements. The sponsor adds judgment about how much of that variance is shared and which way it runs. Do the two companies share a common customer base? Is the sector stable, or under pressure from an exogenous force? Does the driver help one company and hurt the other?

The direction question is what lets the elicitation carry a concentration or a hedge. A driver that compresses one holding's margin while expanding another's produces $z_i z_j = -1$ and a negative correlation on that source. Freight rates do this to a shipper and a carrier; a currency move does it to an importer and an exporter. The magnitude alone cannot express the case, because a variance fraction records how much of a company's variance a driver carries and not which way it pushes.

1: With $X_{i,s} = z_i \sqrt{a_i v_{i,s}} F + \varepsilon_i$ for a standardized driver F and independent ε_i , the covariance is $z_i z_j \sqrt{a_i v_{i,s}} \sqrt{a_j v_{j,s}}$ and the correlation reduces to (13.1). When holdings share more than one independent driver on the same source the implied correlations add, $\rho_{ij,ss} = \sum_f z_{i,f} z_{j,f} \sqrt{a_{i,f} a_{j,f}}$, with each company's magnitudes summing to at most one. Appendix B derives the same result geometrically.

What worked for one pair and one source extends to the inventory of sources. Each source of variance we've considered at the company level in prior chapters can be promoted to a common factor of variance shared by multiple companies. The cascade already attributes, for each company i and operational source s , a variance $v_{i,s}$ to that source. Table 13.1 names the seven operational sources and, for each, the kind of driver two companies would have to share.

Source	What it captures	Shared driver
Inflow	New revenue arrivals	End-market demand
Outflow	Churn and contraction	Customer-side stress
Seasonality	Calendar modulation	Calendar alignment
Margin	Earnings-tier propagation	Input-cost cycles
OCF	Earnings-to-OCF transformation	Credit cycle, working capital
Valuation	Multiple uncertainty	Sector repricing, discount rates
Rate	Floating-rate debt service	Treasury curve, credit spreads

Table 13.1: The seven operational sources, each with a variance contribution $v_{i,s}$ readable from the cascade output. The shared-driver column names what makes two companies co-move through the source; rate is the one source whose loading is computed from the debt structure rather than elicited.

Everything not named stays at zero. A correlation therefore enters only with a named driver behind it, between specific holdings. The scale of work is small by design, rather than the $N(N-1)/2$ pairs an unrestricted matrix would demand. A sponsor who can name twenty documented drivers across a dozen holdings has done the elicitation.

13.3. The Composition

The above pair's computation generalizes by arithmetic. A portfolio holds N companies with weights h_i summing to one. The portfolio variance is

$$\sigma_p^2 = \sum_i h_i^2 \sigma_i^2 + 2 \sum_{i < j} h_i h_j \sigma_{ij}, \quad (13.2)$$

where σ_{ij} is the covariance between companies i and j . The first sum is in hand for every company the cascade has been run on. The second sum is what the last section built, one factor at a time. The first term already carries every company's total variance, since σ_i^2 is the complete cascade output for company i , its idiosyncratic and shared contributions together. Building the covariance from the source factors therefore needs an index that adds only the co-movement between distinct companies and leaves that diagonal intact. Writing each company as the sum of its factor contributions and restricting the expansion to distinct pairs, the portfolio variance becomes

$$\sigma_p^2 = \sum_i h_i^2 \sigma_i^2 + \sum_{i \neq j} \sum_{s,t} h_i h_j \sqrt{v_{i,s}} \rho_{ij,st} \sqrt{v_{j,t}}. \quad (13.3)$$

The four-index correlation $\rho_{ij,st}$ is an ordinary correlation matrix once the company-source pairs are strung out on a single index: $(NK \times NK)$, one row per company-source combination, with the four indices kept for readability.

Here $\sqrt{v_{i,s}}$ is the source- s standard deviation at company i , and $\rho_{ij,st}$ is the cross-company correlation the elicitation produced. The $i \neq j$ restriction is that index: it collects shared variance across companies without re-adding the within-company response σ_i^2 already holds, so no contribution is counted twice.

13.3.1. Unnamed Correlation

To this point we have made two claims: the cascade captures the variance of a firm, and the sponsor can elicit the shared portion of variance by a named source in the cascade. However, there may be cases where the sponsor expects co-movement but is unsure of where in the cascade it will manifest.

A second elicitation mode covers this. The sponsor names a pair of companies and asserts a correlation on the *unnamed residual* — the variance the named drivers left unclaimed:

$$\rho_{ij}^{\text{res}} \in [-1, 1] \quad \text{on} \quad \sqrt{1 - c_i} \sigma_i, \sqrt{1 - c_j} \sigma_j, \quad (13.4)$$

where c_i is the share of company i 's variance the named drivers have already claimed. Placing the assertion on the residual rather than on the total is what keeps the two modes from colliding. The named drivers have taken their share, the unnamed correlation acts only on what is left, and no variance is counted twice.

13.3.2. The Residual Floor

Setting an unnamed correlation on every pair, rather than on selected ones, gives the framework a market effect. A floor of $\rho^{\text{res}} = c$ applied across the book says that every holding retains some exposure to conditions no named driver captures, which is the assumption a single-factor model makes as its starting point.

A sponsor who raises it is making a claim about the whole book at once: on the twelve-holding fund of Section 13.5, a floor of 0.05 carries fund CV from 8.3 to 8.7 percent, and a floor of 0.20 carries it to 9.7. It is the right home for a conviction that the fund is more correlated than its named drivers can explain. Whatever value it takes should be a visible choice with its contribution reported on its own line.

13.3.3. Two Conditions on the Result

The composition must return a variance, which constrains what the elicitation may produce. Two conditions do the work.

The matrix must be positive semidefinite. Named drivers satisfy this automatically: a driver enters as a signed loading on each company it reaches, its contribution to the matrix is the outer product

of those loadings, and an outer product is positive semidefinite for any real loadings, whatever their signs. A hedge elicited as a signed driver therefore cannot break the condition. Unnamed cells carry no such guarantee, since they are set pair by pair with nothing enforcing consistency across a triangle of three holdings, the smallest set on which two individually valid correlations can still contradict a third. The positive semidefinite condition can be checked on the unnamed cells alone and repaired there with a nearest-correlation projection, which is a smaller and more legible object than the full matrix.

Implied correlations must stay inside $[-1, 1]$. Each source composes a signed named term with an unnamed residual term, and both are bounded by the variance available to them, so the sum is bounded as well. The bound is nonetheless checked after all variance is accounted for rather than assumed, because it is the last point at which an elicitation error is still visible.

A portfolio analysis can run at any tier the cascade exposes, and the composition restricts cleanly. A revenue-tier analysis carries inflow, outflow, and seasonality. Earnings adds margin; OCF adds working capital; valuation adds the multiple. The same matrix therefore serves both sides of the book's dual structure. Equity analyses read the operational and valuation factors at the valuation tier. Capital-structure analyses read the operational set through OCF, plus the rate block.

13.4. Where a Classical Factor Model Would Stand

The public-equity answer to equation (13.2) is the statistical factor model Chapter 2 surveyed: regress observed return series on common factors — market, size, industry, momentum — and let the covariance fall out of the estimated loadings and the factor covariance matrix. Whatever co-movement the regression captures is systematic. The variance left unexplained is labeled specific, and a sophisticated model forecasts its magnitude in its own right through a separate structural model of idiosyncratic risk.

The cascade's construction inverts this. The total variance of each company is known bottom-up, fully attributed to named sources before any cross-company question is asked. Independence is where the construction starts, not a diagonal imposed on whatever a fixed factor set omits. Co-movement is the exception, admitted factor by factor, only where the sponsor can name and document the shared driver. The correlation is derived from shared-variance fractions rather than estimated from a return history that does not exist.

Context factors — size, growth, and industry — are classical return-based factors that sit downstream of the cascade sources.

The names are familiar to a reader who thinks in factors, so this section states the correspondence explicitly. A classical factor is a proxy for two things: a property of the cash flows, and the portion of the premium that property earns in the discount rate. Size names the magnitude of the recurring base and of the inflows arriving on it. Growth names the ratio of new inflows to that base. Industry names inflows drawn from a customer base that other firms share. Each of these properties is an input the cascade already holds. The classical factor is the statistical shadow of the cascade structure: a return regression detects that firms with similar cash-flow properties co-move, without ever directly observing the cash-flow properties. The cascade elicits the properties directly, so the factor exposure becomes a derived quantity rather than an estimated one.

This is why the Saliency composition carries no context block. Size, growth, and industry are not additional sources of variance sitting beside inflow, outflow, and the multiple; they are those sources described in the vocabulary of a return regression. Their variance is already in the operational rows, and their co-movement is already in the drivers elicited on those rows: two holdings that share an industry share an end-market driver on inflow and outflow, and two holdings that reprice together share a sector driver on the multiple. A separate context row would count the same variance twice and, worse, would enter the matrix as a blanket correlation across every pair — the one thing Section 13.2 rules out.

Rate sub-factors — level, slope, and credit spread — reach the operating P&L through interest expense and refinancing windows, and the cascade already carries their variance in the capital-structure tier. Floating-rate debt service enters each company's variance through its floating principal and rate volatility, so rate stochasticity sits inside σ_i^2 before any cross-company question is asked. The rate factor rolls that exposure up across the book, resolving into the level, slope, and credit-spread sub-factors. The loading is mechanical and requires no elicitation: the floating share weighted by reset duration sets the level loading, the refinancing-cycle position sets slope, and refinancing frequency and credit profile set spread. The factor process is observable from the Treasury curve and credit indices, and its covariance is estimable from a few years of daily data.

Table 13.2.: Each classical return factor proxies a cash-flow property the cascade carries directly, plus the premium that property earns in the discount rate. Every factor here resolves into cascade sources the composition already carries, which is why no context block appears in it. Momentum is omitted: it is a property of the price path rather than of the cash flows, there is no price path to carry, and nothing in the cascade corresponds to it.

Factor	Cash-flow property	Cascade location	Discount-rate leg
Size	Magnitude of the recurring base and its inflows	Revenue level; inflow and outflow sources; low revenue CV on a large base	Size premium; a slice of the multiple CV
Growth	Ratio of new inflows to the existing base	Channel split: base persistence vs. acquisition inflow	Priced growth via $M = 1/(r - g)$; duration sets the rate-level loading
Industry	Inflows from a shared customer base	Elicited cross-company correlation on inflow and outflow	Sector repricing term in the multiple
Profitability	Margin level and variance	Margin source; expense channels	Quality premium slice of the multiple CV
Value (distress leg)	Leverage against OCF headroom	Capital-structure tier; covenant headroom	Credit-spread exposure (rate block)

13.5. A Worked Example

A fund holding Meridian and Clearview runs to twelve companies at \$500M. Five carry the largest weights — Apex Industrial at 13 percent, Meridian at 11, Pacific Health at 14, Summit Logistics at 9, and Clearview at 12, with value CVs of 20, 28, 15, 32, and 24 percent from the cascade — and seven background holdings at four to seven percent each fill out the rest.²

The sponsor names four drivers, giving each a magnitude and a direction at every holding it reaches.

1. **The SaaS-adjacent end-market**, on outflow: sixty percent of Meridian's churn variance, forty percent of Clearview's, twenty-five percent of Summit's, thirty percent of Cobalt's, all in the same direction. Implied correlations run 0.27 to 0.49 across the four.
2. **The Q4 distribution calendar**, on seasonality: half of Apex's seasonality variance, forty-five percent of Summit's, thirty-five percent of Granite's, same direction throughout. This puts 0.47 on Apex–Summit.
3. **The working-capital cycle**, on OCF: thirty percent of Apex's, thirty-five percent of Summit's, implying 0.32 on the pair.
4. **The freight-rate cycle**, on margin: thirty-five percent of Apex's margin variance and thirty-five percent of Summit's, in *opposite* directions. Apex buys freight and Summit sells it, so a rate spike compresses one margin and expands the other. The magnitudes compose as any other driver's would and the opposed directions carry the sign, putting -0.35 on the pair.

Two further assertions carry no driver. The sponsor asserts 0.30 for Pacific Health and Elmcrest and also assigns 0.25 for Apex and

2: Every fund exhibit in this chapter and in Chapter 14 is generated from a single seeded scenario; the generator and its parameters live in the book's repository, so the numbers are reproducible and mutually consistent across the two chapters.

Granite. The residual floor stays at zero, since this sponsor makes no book-wide claim.

The remaining holdings carry no named driver and no assertion, so every cell they appear in stays at zero. Eleven magnitude-and-direction statements across four drivers, plus two unnamed cells, complete the elicitation. An unrestricted twelve-company matrix would ask for sixty-six pairwise correlations.

Apex and Summit are the pair to watch. The calendar and the working-capital cycle push them together, the freight cycle pulls them apart, and the composition nets the three: their company-level correlation lands at 0.08, against 0.16 with the freight driver removed. At fund level the freight hedge moves the CV from 8.28 to 8.20 percent, and it visibly redistributes the attribution, dropping margin from 7.1 to 5.3 percent of fund variance. The fund composes to a CV of 8.3 percent. The two unnamed assertions carry 15 basis points of that between them and 3.6 percent of fund variance, which is the shape the mode should have: available, used sparingly, and visible on its own line rather than folded into the named structure.

Table 13.3.: The twelve-company portfolio under the source-factor composition. Each row attributes total fund variance to a source, combining the source's within-company variance with the cross-company covariance its named drivers carry; sources with no named driver are within-company only. The margin row is net of the signed Apex–Summit freight driver, which subtracts from it. The unattributed row collects co-movement the sponsor asserted across a pair without nominating a source, so it belongs to no operational row. The final row collects the per-company variance not attributed to any named source or factor.

Factor	Share of fund variance
Operational outflow	22.0%
Operational inflow	13.9%
Margin variance	5.3%
OCF variance	6.8%
Seasonality	5.3%
Valuation variance	3.6%
Unattributed co-movement	3.6%
Rate: level	9.3%
Rate: slope	3.1%
Rate: spread	4.8%
Per-company diagonal S_{cascade} residual	22.3%

The decomposition reads by factor rather than by company, and outflow is the largest attributed entry at 22.0 percent, identifying the SaaS-adjacent cluster with Meridian the largest single contributor. Two structural features of the table are worth naming. The named operational factors are pairwise and specific, so their share dilutes as the book grows; a sponsor adding uncorrelated holdings watches these rows shrink. The rate rows do not dilute in the same way, because every levered holding loads on the same curve, and together they carry 17.2 percent of fund variance without a single elicited fraction behind them. The OCF row surfaces the working-capital seam between Apex and Summit that no per-company view would catch, and the margin row is the same pair's offset, sitting below the OCF row only because the freight hedge has been netted

into it. The unattributed row is the price of the two company-wide assertions, and at 3.6 percent it is legible but not significant.

13.5.1. How the Sources Project Back to Companies

The elicitation runs on sources, and the composition consumes sources, but the sponsor holds companies. Table 13.4 reads the same matrix at company scale.

	Apx	Mer	Pac	Sum	Clr	Cob	Elm	Gra
Apex	1.00							
Meridian	0.02	1.00						
Pacific	0.04	0.03	1.00					
Summit	0.08	0.11	0.02	1.00				
Clearview	0.03	0.13	0.03	0.06	1.00			
Cobalt	0.03	0.16	0.03	0.07	0.09	1.00		
Elmcrest	0.03	0.02	0.32	0.02	0.02	0.03	1.00	
Granite	0.30	0.02	0.04	0.08	0.03	0.03	0.03	1.00

Table 13.4.: Company-level correlations implied by the elicited source structure, lower triangle, for the eight holdings any assertion reaches. The four omitted background holdings correlate with nothing above 0.04. Source-scoped sharing arrives diluted: the SaaS end-market puts 0.49 on Meridian–Clearview outflow and the pair lands at 0.13, because outflow is one part of each company’s variance. The two company-wide assertions arrive nearly intact.

A correlation of 0.49 elicited on outflow becomes 0.13 between the companies, because outflow carries part of Meridian’s variance and part of Clearview’s and the rest of the variance of each company is unaffected. Every source-scoped statement contracts this way.

Holding	Weight	Variance share	Ratio
Meridian	11.0%	19.3%	1.75
Summit	9.0%	16.5%	1.83
Clearview	12.0%	16.5%	1.37
Apex	13.0%	13.8%	1.06
Pacific	14.0%	9.6%	0.68
Cobalt	6.0%	5.1%	0.84
Fairhaven	6.0%	4.3%	0.71
Elmcrest	6.0%	4.2%	0.70
Beacon	7.0%	3.5%	0.50
Granite	5.0%	3.0%	0.59
Dunmore	6.0%	2.3%	0.39
Harbor	5.0%	2.1%	0.43

Table 13.5.: Each holding’s share of fund variance against its share of fund value. Shares sum to 100 percent by construction; the printed column sums to 100.2 because each entry is rounded independently.

Table 13.5 completes the projection by attributing fund variance to holdings rather than to sources. Summit is the clearest case: 9 percent of fund value and 16.5 percent of fund variance, a ratio of 1.83, earned by a 32 percent value CV and membership in three of the four named drivers. Meridian runs at 1.75 on the same logic. Pacific is the mirror image at 0.68, carrying the largest weight in the fund and less than ten percent of its variance, because a 15 percent CV and a single company-wide assertion are the whole of its exposure. The ratio column is what a weights-only view of the book cannot produce, and it is the input the concentration audit of Chapter 14 consumes.

13.6. What This Chapter Leaves

The chapter that follows puts covariance to work in various reports that can inform and motivate decisions regarding concentration, follow-on funding, bolt-on acquisitions, and refinancing.

The elicitation discipline described in this chapter is stable enough to use as-is at the scale the framework's audience runs. Two potential refinements become possible as cascade history accumulates.

Panel estimation: a sector-concentrated book with fifteen or more comparable holdings, observed over four to six years, becomes a panel. A single-factor decomposition of that panel recovers each source's correlation block directly, the statistical convergence Section 13.4 anticipated. The difference between elicitation and estimation becomes a sample condition the sponsor can check.

Borrowed correlations: a book too thin or too generalist for its own panel can import a covariance structure from public comparables. The borrowed structure is adjusted with elicited corrections for the gap between public and private operational co-movement.

Managing the Fund

14.

In which the covariance of the preceding chapter meets the fund's calendar, and the portfolio analyses arrive as instruments of four recurring decisions rather than as a catalog of reports.

The preceding chapters developed Saliency at the company level: measuring uncertainty, tracing it through the Saliency cascade, and pricing capital structure through RACE. A fund holds several such companies, and the resulting portfolio has properties that emerge from shared characteristics of individual companies. Correlations link outcomes across holdings, risk concentrations hide behind position size, and the fund-level risk that matters to limited partners aggregates from operational sources in ways the per-company view does not illustrate.

A sponsor does not deal with these facts as a simple list of analyses. They arrive attached to moments on the fund's calendar: the annual meeting where an LP asks where the fund would hurt; the year three facilities maturing together and the resulting discussion of restructuring and redistributing debt; the budget round that sets next year's spending on operational improvement and hedging; the week a new deal wants an answer. This chapter takes the moments in that order, and at each moment it reads both sides of the cascade at once — the value side in fund CV and risk-adjusted return, the credit side in breach probability and expected distress cost. Table 14.1 maps the chapter.

Moment	The question in the room	The instruments
The audit	Where would this fund hurt, and is that where we said it would?	Concentration audits (value and distress); source drill-throughs
The refinancing window	Which company should carry the marginal turn of debt?	Leverage reallocation; rate positioning
The budget round	What does the risk-reduction budget buy first?	Breach staircase; hedge budget; the joint staircase
The next deal	Does the next dollar diversify or concentrate the fund?	Follow-on allocation; counterfactual screens; the offer frontier

Table 14.1: The four recurring decisions this chapter equips, the question that arrives with each, and the analyses that answer it. Each analysis runs on the cascade's per-company outputs plus the covariance of Chapter 13.

A sponsor thinks natively in equity value and leverage ratios, so each moment opens with the report the sponsor already runs — the equity-value view on one side, the coverage view on the other

— and then prices the same decision in RACE. The familiar reports quantify return well and gesture toward risk. Base, bull, and bear scenarios are discrete point estimates; a sensitivity table is a family of deterministic what-ifs; the discount-rate hurdle is a threshold with the price of risk bundled somewhere inside it; a covenant cushion is a distance, stated without a probability. None of these is a dispersion in return units, which is why none of them can be subtracted from the return the same report quotes. RACE's contribution at each moment is the commensuration: it renders dispersion as $\lambda\sigma_E^2$ and distress as an expected cost, both in the units of return, so the subtraction the familiar reports could not perform becomes arithmetic.

The exchange rate in that subtraction is the risk-aversion term λ . Most sponsors have unknowingly determined their own value for this term. Every time an investment committee demands more return for a riskier deal, or bumps the hurdle for a levered structure, it applies a price of risk — implicitly, bundled into the discount rate, re-guessed deal by deal. RACE asks the firm to state that price for a point in time, in the open, which gives the sponsor the luxury of applying it consistently across the near- to medium-term calendar.

14.1. The Ingredients

By the time a reader arrives here, the cascade has produced, for each portfolio company, an expected equity return and an equity CV drawn from operational parameters rather than from market histories, a RACE value that adjusts for leverage, variance, and distress, a breach probability with its schedule of expected distress costs, and an attribution of each company's variance to its operational sources: churn count, deal size variability, expense ratio fluctuation, rate exposure, working capital timing. The cross-company structure that turns these per-company outputs into fund-level quantities is the source-factor composition of Chapter 13. The same matrix serves both sides of the CV cascade: value-side analyses aggregate contributions to fund-level CV, credit-side analyses aggregate contributions to fund-level expected distress cost.

Table 14.2.: Twelve-holding fund, five featured and seven background. Fund-level CV of 8.3% against a 21.6% weighted average.

Company	Weight	Value CV	Industry
Apex Industrial	13%	20%	Distribution
Meridian Software	11%	28%	SaaS
Pacific Health	14%	15%	Healthcare
Summit Logistics	9%	32%	Transportation
Clearview Analytics	12%	24%	Data Services
Seven background holdings	41%	16–25%	Mixed
Weighted avg CV		21.6%	
Fund-level CV		8.3%	

Under that composition, the twelve-holding fund of Chapter 13 carries a portfolio-level CV of 8.3% against a weighted average of 21.6%. The diversification ratio of 0.39 ($8.3 \div 21.6$) is the gap the correlation structure opens between the two numbers.

14.1.1. Why No Mean-Variance Frontier?

The mean-variance efficient frontier as developed by Markowitz is the workhorse of public-equity portfolio analysis: each point on the frontier is a portfolio that maximizes expected return for a given level of expected risk. The chapter does not develop one for private-market portfolios, for one practical reason and one academic one. The two reasons explain why the chapter is organized around calendar moments instead.

The practical reason is transaction costs; both their level and asymmetric character. Adding capital to a position is cheap: a primary check at entry, a follow-on against reserves. Trimming one is prohibitive: there is no continuous market for a fraction of a control position, a partial sale is a bilateral negotiation conducted at a secondaries discount, and the sale surrenders part of the control premium the position was built to earn. The apparent exceptions do not restore a two-sided weight space — a dividend recapitalization pulls cash out via new debt, which is a leverage move; an exit is lumpy and terminal; a GP-led continuation vehicle transfers the whole position, expensively and infrequently. Between entry and exit, the equity position moves in one direction. The feasible set is add-only, and a frontier is a curve over a weight space the sponsor can traverse in both directions; with the sell side closed, there is no such space to trace. The same asymmetry that forecloses the frontier will do constructive work at the chapter's fourth calendar moment, where it fixes the form of the follow-on analysis.

The academic reason is the absence of a security market line. Mean-variance analysis is extremely sensitive to expected returns. In public equity, the SML anchors those returns against an empirical market portfolio observed at continuous prices, constraining how far above or below the line a given asset's expected return can plausibly sit. Private equity has no such anchor. Private holdings are valued bilaterally at long intervals against no clean market analogue, and the workarounds — Public Market Equivalent comparisons against benchmark indices, Cambridge Associates regressions, Hamada-style adjusted betas borrowed from public peers — do not tighten expected returns enough to keep a frontier from collapsing into a measurement of conviction.¹ The optimizer concentrates weight on the names the sponsor's view has already declared as winners, and the resulting frontier traces the intensity of that view rather than a risk-return trade-off. As private-market risk models mature and the data behind them deepens, the question can be revisited.

1: Using mean-variance to determine the implied strength of conviction is a worthwhile exercise in some cases, but we don't need the full frontier to measure the intensity of conviction.

The analyses below accommodate both problems. Each evaluates a discrete move the sponsor can actually execute — a re-split of the debt stack when the refinancing windows open, a budget funded in a chosen order, a reserve deployed dollar by dollar — and the expected returns inside each analysis remain the sponsor's own, moving mechanically as a move changes a firm's scale or leverage rather than being re-estimated against a market that is not there.

14.2. The Audit

The annual meeting's hardest question is rarely about any single company. "Where would this fund hurt, and is that where the strategy said it would?" is the question an experienced LP brings to the room. The Salience audit answers it twice, once in each cascade's units: which holdings carry the fund's variance, and which carry its expected distress cost. Nothing is optimized here — the audit is diagnostic, which is what makes it the right prologue. Its job is to establish the two lenses the decision moments will need, and to put on record the fact those moments have to manage: the lenses do not rank the book the same way.

The value side is a decomposition of the portfolio's variance into contributions from each holding. Risk share depends on the interaction of position size, standalone variance, and correlation with the rest of the book; a concentrated position in a low-variance, low-correlation company may contribute less portfolio risk than a smaller position in a high-variance, correlated one.

Table 14.3.: Position weight against risk contribution for the twelve-holding fund, five featured and seven background aggregated. The ratio is risk share divided by position weight; values above one flag concentrations, values below one flag diversifiers.

Company	Weight	Risk share	Ratio
Apex Industrial	13%	14%	1.06
Meridian Software	11%	19%	1.75
Pacific Health	14%	10%	0.68
Summit Logistics	9%	17%	1.83
Clearview Analytics	12%	16%	1.37
Seven background holdings	41%	24%	0.59
Total	100%	100%	

Meridian and Summit each carry a ratio of risk share to portfolio weight above 1.5, which is the pattern the audit is meant to surface. Meridian's 1.75 comes from a high standalone CV carried at a mid-sized weight; Summit's 1.83, the highest on the book, comes from the highest standalone CV of the featured five (32%) concentrated in the smallest featured position, so a modest weight carries an outsized share of fund variance. Pacific, by contrast, contributes noticeably less risk to the fund even though it is the largest single holding, because its 15% CV is the lowest of the five and its operational profile is close to uncorrelated with the rest of the book.

The credit side asks the same question in distress units, aggregating the per-company breach probabilities and distress costs of Chapters 10 and 11 into a fund-level expected distress cost by holding. The two audits do not rank the book the same way, which is the reason to run both — and, so far, the rankings arrive in different units, variance share on one side and dollars of expected distress on the other, with nothing yet to convert one into the other.

Company	Leverage	Breach prob.	Exp. distress	Fund share
Apex Industrial	4.8x	8%	\$1.2M	9%
Meridian Software	4.2x	15%	\$2.8M	20%
Pacific Health	5.2x	5%	\$0.9M	6%
Summit Logistics	3.5x	22%	\$3.4M	24%
Clearview Analytics	4.4x	10%	\$1.7M	12%
Seven back-ground holdings	—	—	\$4.0M	29%
Fund total			\$14.1M	100%

Table 14.4.: Fund-level expected distress cost by holding, weighted by leverage and breach probability. Summit and Meridian together account for nearly half of fund distress exposure on a book whose position weights are nearly uniform.

Summit's 24% share is the kind of finding a leverage-multiple view obscures. Its 3.5x is the lowest multiple on the book, and its breach probability nevertheless dominates because its 32% OCF CV is poorly matched to the covenant its credit agreement carries. The audit separates the two dimensions of distress risk — leverage and operating variance — and identifies the company where their interaction concentrates most sharply.

14.2.1. The Drill-Through

Both audits extend one level down, from the company to the operational source, and the drill-through is the analysis most specific to Salience's approach. Because the cascade decomposes each company's variance into its sources, the fund-level contribution traces through company allocation and company variance to a parameter a manager can name and manage. Meridian contributes 19% of fund variance, and within Meridian, churn count risk accounts for roughly 45% of the company's own variance; the combined statement — Meridian's churn is the largest single source of fund-level uncertainty, at roughly 8.5% of total fund variance — is precise, actionable, and monitorable, and the customer success investment the operating partner approved last quarter now has a portfolio-level return attached to it.

Read together, the two drill-throughs give the audit teeth. On the value side, the general partner can say "Meridian's churn rate is the

The cascade traces portfolio risk through company allocation, through company variance, to the specific operational factor. The alternatives stop at the company level and leave the operating partner without an actionable target.

Table 14.5.: Top ten company-source contributions to fund variance, sorted across the operational sources and rate sub-factors of Chapter 13. The full decomposition runs longer; the ten rows below cover roughly two-fifths of fund variance.

Company	Source	Fund
Meridian Software	Churn count	8.5%
Meridian Software	New logo pipeline	5.9%
Summit Logistics	Attainment variance	5.6%
Summit Logistics	Attainment (OCF leg)	3.5%
Apex Industrial	Working-capital cycle	3.5%
Apex Industrial	Contract count	2.9%
Summit Logistics	Deal timing	2.8%
Clearview Analytics	New sales	2.6%
Meridian Software	Multiple	2.5%
Summit Logistics	Outflow	2.4%
<i>Top 10 across operational and rate sources</i>		40.2%

Table 14.6.: Top ten company-source contributions to fund-level expected distress cost. The rate block's share is larger here than in Table 14.5 because debt service moves more directly with rates than equity returns do.

Company	Source	Co. share	Exp. distress	Fund share
Summit	Attainment variance	55%	\$1.87M	13.3%
Meridian	Churn count	40%	\$1.12M	7.9%
Summit	Deal timing	25%	\$0.85M	6.1%
Meridian	New logo pipeline	28%	\$0.78M	5.6%
Clearview	Usage volume	40%	\$0.69M	4.9%
Apex	Contract count	35%	\$0.42M	3.0%
Summit	Rate: level	9%	\$0.31M	2.2%
Meridian	Rate: level	10%	\$0.28M	2.0%
Summit	Context: industry	8%	\$0.27M	1.9%
Apex	Rate: level	21%	\$0.25M	1.8%
<i>Top 10 across operational, context, and rate</i>			\$6.84M	48.7%

largest single contributor to fund-level variance, and the customer success investment we approved last quarter is designed to reduce it by 20%, which the cascade projects will expand Meridian's multiple by roughly four-tenths of a turn — about \$12M of enterprise value on its EBITDA." On the credit side, the same table style reveals that Summit's attainment variance — the gap between contracted-volume bookings and delivered loads, the source Chapter 13's worked example traces through Summit's margin and OCF — contributes 55% of Summit's own breach probability and 13.3% of fund-level expected distress, a margin of roughly five percentage points over the next-largest contributor, because leverage and operational variance compound on the breach side. Meridian's churn appears near the top of both lists, and the initiative attached to it carries a quantified benefit in both sets of units, a coupling the budget round below turns into a ranking.

The rate block is computed into both audits but prints only in the second. On the value side its exposure is diffuse: split across three sub-factors and twelve companies, it is a 2.4% block of fund variance whose largest single cell is under three-tenths of a percent, so no company-rate pair earns a row in Table 14.5. Debt service takes the level factor directly on every floating-rate dollar, which is why the same factor concentrates into visible rows on the credit side and meets its instruments in the hedge budget below.

The audit produces value whether or not the sponsor acts on it.

Knowing where the risk sits changes the quality of every subsequent conversation with the LP base, and it changes the prompt list the investment committee brings to the next quarterly review. A GP who can quantify what “we manage concentration risk” means — in terms of sector exposure, correlation clusters, and risk shares — has a specific answer for the LP, and a GP who can describe where the fund’s distress exposure sits, and why, has an answer where the credit story previously amounted to per-company leverage multiples.

14.3. The Refinancing Window

The second moment arrives on the debt calendar. When three portfolio companies come up for refinancing in the same year, the sponsor has a rare chance to redistribute debt across the book, and the question in the room is direct: which company should carry the marginal turn, and which should give one up?

The word redistribute needs an immediate qualification, because almost none of this debt is fungible. Each facility is negotiated at the portfolio company, secured by that company’s assets, and ring-fenced from its siblings by the covenants that came with it; no fund-level treasurer can lift a turn off one balance sheet and set it on another. What the sponsor can do is size each company’s next facility when its own window opens — guiding Summit toward a smaller refinancing and Pacific toward a larger one through the boards it sits on — and a season of such windows, taken with the fund-level picture in hand, moves the book’s debt in aggregate even though every transaction is local to one company. The analysis in this section is guidance for those separate conversations: it tells the sponsor which direction to lean at each table, and by how much, so that each company’s capital structure improves on its own terms and the fund’s distress profile improves in turn.

Chapter 12 produced a per-company RACE that located each company’s own leverage peak. The refinancing window asks a different question, and it is the first moment the chapter prices in RACE terms. The familiar report here is the coverage view; leverage multiples and covenant cushions by company. RACE reads the same data through its two penalties, but only the distress cost responds. The variance penalty does not: redistributing a fixed pool of debt among portfolio companies is a repackaging, in which the fund holds claims on the same enterprises at the same total debt, so the distribution of its net asset value is unchanged and the fund equity variance is identical before and after. Each company’s own equity variance does move under the swap; the moves net to zero on the NAV distribution rather than being absent. The distress penalty does respond, because breach probability is convex in leverage: it rises slowly while a company has covenant headroom and steeply as the coverage distribution approaches the

Breach carries no offsetting weight. The threshold is crossed inside each firm — its own coverage against its own covenant — and the fund simply sums the expected costs, so the convexity that cancels out of the variance term survives intact here. Of RACE's two penalties, this is the only one a debt re-split can move.

threshold. A turn taken off a company sitting close to its covenant avoids more expected distress than the same turn adds when placed on a company with room to spare. The reallocation harvests that convexity at constant aggregate debt, and the value leg's degeneracy is the opportunity revealed and quantified by RACE: with return and variance pinned, the decision lives in the term the familiar report only gestured at.

The destination for the marginal turn is therefore the company with the most covenant headroom, which each company's operating-cash-flow variability sets. The assignment is computed, not eyeballed: Table 14.7 is produced by the same three-term objective, constrained to re-split the fixed pool exactly — and because the return and variance terms are invariant under the re-split, what the optimizer maximizes is distress reduction alone. Summit gives up over half a turn, Meridian a tenth, and the released debt spreads broadly across the book, led by Apex among the featured names and Beacon and Granite among the background. The coverage instinct that opened the section would have run part of the swap the other way, sparing Summit on the strength of its 3.5x multiple, the lowest on the book, and trimming the highest multiples first; coverage headroom, set by each firm's OCF variability against its covenant, prices the same names in the opposite order. The optimizer stops where the marginal distress saved by the next turn off Summit equals the marginal distress added where that turn lands. The equalization is of marginal distress rather than of breach probabilities themselves, which settle at levels each firm's volatility and covenant dictate. Execution is constrained by prepayment premiums, call protection, incremental-debt baskets, and covenant-path feasibility, and the credit-side instruments later in this chapter inform those constraints; the reallocation names where the sponsor should be aiming when the windows open.

Table 14.7.: Per-company leverage before and after the derived debt-neutral reallocation, all twelve holdings, sorted by the turn each takes or sheds. Aggregate debt is re-split under an equality constraint, so the fund's net asset value distribution — and its CV — do not move (the computed change is 0.000 pp). What moves is expected distress: the marginal turn flows from the companies closest to their covenants toward those with the most headroom, and the convexity of breach probability turns the swap into a net reduction. The distress avoided is shown at the median-breach cost convention and at the distress-conditional cost a covenant escalation actually carries.

Company (breach prob.)	Current	Reallocated	Δ
Apex Industrial (8%)	4.8x	5.08x	+0.28
Beacon (7%)	4.6x	4.83x	+0.23
Granite (6%)	4.8x	5.01x	+0.21
Pacific Health (5%)	5.2x	5.32x	+0.12
Harbor (8%)	4.2x	4.32x	+0.12
Clearview Analytics (10%)	4.4x	4.50x	+0.10
Dunmore (6%)	5.0x	5.08x	+0.08
Elmcrest (9%)	4.4x	4.47x	+0.07
Fairhaven (12%)	3.8x	3.86x	+0.06
Cobalt (11%)	4.0x	4.04x	+0.04
Meridian Software (15%)	4.2x	4.08x	−0.12
Summit Logistics (22%)	3.5x	2.95x	−0.55
Aggregate debt	held constant (equality)		
Fund CV	unchanged (+0.000 pp)		
Distress avoided (hold)	\$0.7M at $c = 3\%$		
	\$3.6M at distress-conditional c		

The reallocation moves rate exposure with it. The company taking

on the marginal turn picks up additional level exposure scaled to its floating share, additional slope exposure scaled to its refinancing-window position, and additional credit-spread exposure scaled to its credit profile. Each loading is mechanical from the debt structure, and the same analysis can be re-run with a rate-regime override; a sponsor anticipating curve steepening can target slope exposure deliberately; a sponsor expecting a parallel rate decline can target level; so the leverage reallocation doubles as a rate-positioning tool when the sponsor has a view on the curve.

The dollar figure is modest at the median-breach cost convention and becomes material once the cost is set to what a covenant escalation actually carries. At a breach cost of three percent of enterprise value — the waiver-and-distraction event of Chapter 12 — the reallocation avoids about seven hundred thousand dollars of expected distress over the hold. At the distress-conditional cost, the ten-to-twenty-three-percent range Andrade and Kaplan document for transactions that escalate, the same re-split is worth roughly three and a half million at the middle of the range and more than five at its top. The hedge subsection below reads the same way and for the same reason: a de-risking move on the credit side is a position on how far a breach would travel.

The reallocation is not a diversification tool. The two RACE penalties behave differently under a debt-neutral redistribution: the variance penalty repackages and nets to zero across the fund, because the sponsor owns the same enterprises either way, while the distress penalty is a real deadweight loss that the convexity of breach probability lets the reallocation reduce. Leverage reallocation is a distress-management tool. It is also the clearest case in the book for RACE's third term, since the distress cost is the leverage effect a mean-variance account does not capture.

14.4. The Budget Round

The third moment is the annual planning cycle. The fund has a budget for reducing risk — operational programs on one side, financial hedges on the other — and the budget must be spent in some order. The cascade provides the arithmetic for this ordering, first on each side separately, then jointly.

One convention governs every distress-cost figure in this section. For the purpose of insuring against breach escalation, we use the distress-conditional breach cost of Section 14.3 rather than the median waiver the three-percent convention prices. Because that cost multiplies every initiative's reduction by the same factor, it sets the size of the prize without reordering the list: a sponsor who prices breaches as mild waivers scales the dollar columns down several-fold and still funds the same initiatives in the same order.

The operational side is the breach reduction staircase of Chapter 11, aggregated to the fund: a sequenced list drawn from the union of candidate initiatives across all portfolio companies, each with a quantified reduction in fund-level expected distress cost. The fund-level sequence can surprise. A customer success program at a moderately levered company can outrank a rate-cap purchase at a highly levered one, because the leverage-linked distress cost at the first company responds more to the underlying OCF CV reduction than the second company's debt-service variance does to the hedge, and the cheapest fund-level risk reduction is not always at the company with the highest individual breach probability.

Table 14.8.: Ranked initiatives for reducing fund-level expected distress cost. Increments are sequential — each step is measured after the preceding steps — so a step's standalone benefit exceeds its increment here. The first three steps deliver roughly two-thirds of the achievable reduction against about half the total cost.

Step	Initiative	Cost	Cum. Δdistress
1	Customer success program	\$1.2M	−\$2.1M
2	DSO improvement	\$0.6M	−\$3.6M
3	Rate cap (SOFR +200)	\$0.4M	−\$4.4M
4	Deal desk governance	\$0.8M	−\$5.3M
5	Expansion playbook	\$1.5M	−\$6.0M
Total		\$4.5M	−\$6.0M

The financial side is the hedge budget. In principle it can a variety of instruments; the analysis here focuses on rate hedging, because rate instruments are standardized, transparently priced, and flow through the cascade's existing DSCR machinery without additional modeling. The budget allocates across the three rate sub-factors of Chapter 13. Level exposure is addressed by caps and fixed-for-floating swaps; slope exposure by collars and curve-position trades; credit-spread instruments are less standardized and less liquid, so exposure is typically addressed through credit-quality moves at refinancing. As such the table shows only level and slope instruments. The cheapest dollar of hedging addresses the sub-factor carrying the largest distress contribution in Table 14.6; the drill-through and the hedge allocation are coupled by construction.

Table 14.9.: Rate hedges ranked by expected distress-cost reduction per dollar of cost, each labeled by the rate sub-factor it primarily addresses. The final column is the cost per \$1,000 of expected-distress reduction. Annual budget: \$1.6M. The healthcare services cap leads despite the business being neither the most levered nor the highest-breach company on the book.

Instrument	Sub-factor	Company	Cost	Δdistress	\$ per \$1,000
Rate cap	Level	Healthcare services	\$0.4M	−\$2.4M	\$167
Rate collar	Level + slope	Summit Logistics	\$0.3M	−\$1.3M	\$231
Rate collar	Level + slope	Apex Industrial	\$0.5M	−\$1.2M	\$417
Swap (3y fixed)	Level	Clearview Analytics	\$0.4M	−\$0.6M	\$667
Total			\$1.6M	−\$5.5M	

The ranking should differ somewhat from an approach where one merely caps the rates on the most levered deals. The most effective hedge dollar may go to a company whose breach probability sits closer to a covenant threshold than the sponsor's instinct would have ranked it, because a modest cap there produces a dispro-

portionate reduction: the dollar's leverage against the objective is highest where the distribution is closest to its binding constraint.

A hedge's worth turns on the breach cost the sponsor assumes. A rate cap on Summit that trims the company's debt-service volatility avoids roughly \$0.6M of expected distress at the three-percent convention and roughly \$3M at the distress-conditional cost; net of the cap's premium it runs slightly negative at the former and clears at about \$2M at the latter. The purchase is a position on how far a breach would travel: worth little if breaches stay mild waivers, worth several times its premium if they escalate. The ranking, again, is the same either way — the breach cost lifts every hedge's benefit together — so the sponsor can defer the argument about escalation to the sizing of the budget and settle the order first.

The budget round's synthesis is the joint staircase. Most initiatives appear on both sides' lists, because the cascade links them: Meridian's customer success program cuts the churn variance that drives both its earnings CV and its OCF CV, and each cut carries a benefit. The value-side benefit is the one Chapter 7 priced — a lower earnings CV expands the multiple along the CV-to-multiple curve, and the enterprise value created is the company's EBITDA times the multiple's movement. This is the value side's compressing variable, the analog of the breach cost on the credit side: the same variance reduction that avoids a modest slice of expected distress re-rates the whole company, and the re-rating is the larger number by an order of magnitude. The credit-side benefit is the distress the cut avoids, priced at the distress-conditional cost. A joint ranking by the sum of the two is the single list the operating partner should actually run; the alternative, running the value and distress staircases independently and reconciling by judgment, is the workflow most sponsors are forced to carry without the cascade on hand.

Initiative	Company	Value	Distress	Combined
Customer success	Meridian	\$12.5M	\$1.7M	\$14.2M
Expansion playbook	Meridian	\$8.6M	\$1.2M	\$9.8M
Deal desk governance	Summit	\$8.0M	\$1.5M	\$9.4M
Rate cap (SOFR+200)	Summit	—	\$2.6M	\$2.6M
Reimbursement discipline	Pacific	\$2.1M	—	\$2.1M

Table 14.10.: Initiatives ranked by combined benefit. **Value** is the enterprise value created by the re-rating a lower earnings CV earns through the Chapter 7 multiple curve — the company's EBITDA times the multiple's movement. **Distress** is the expected distress avoided by the same variance cut, at the distress-conditional breach cost. A rate cap carries no value leg because it does not touch operational CV. The operational programs lead because their re-rating is an order of magnitude larger than any initiative's distress leg.

The two columns are not close in size. An operational program's value leg is a re-rating: cutting Meridian's churn variance lowers its earnings CV, expands its multiple by roughly four-tenths of a

turn, and adds about \$12M of enterprise value on the company's own EBITDA — an order of magnitude more than the same cut removes in expected distress. The rate cap has no value leg at all, because it leaves operational CV untouched and earns nothing on the multiple; it holds its place entirely on the credit side. So the joint list is led by the operational programs that move both cascades, and the hedges sort below them. These are the initiatives where the cascade's dual structure pays off, and they are the ones the operating partner funds first.

The breach cost still touches one thing: the position of the hedges. A sponsor who prices escalation near the top of the Andrade–Kaplan range lifts the rate cap toward the operational programs, and one who treats breaches as waivers settles it further down.

14.5. The Next Deal

The fourth moment is capital deployment. It arrives in two forms: reserves into companies the fund already owns, and a check into a company under consideration for investment. Both forms face the same question; where does the next dollar do the most risk-adjusted work? The feasible set is add-only: a dollar can enter any position but can leave none. Over an add-only set, portfolio RACE is a concave objective — each of its three terms has diminishing marginal benefit in the dollars added to any one firm — and the exact optimum of a concave objective over an add-only set is a greedy water-fill on the gradient. Deploy the next dollar wherever the gradient is highest, recompute, and repeat until the budget is gone or no positive gradient remains. What follows is that single allocation, run once over existing holdings and candidate deals together.

14.5.1. Follow-On Allocation

The reports the sponsor may be familiar with typically focus on conviction or diversification. The conviction view deploys the next tranche behind the highest-confidence names, which for this fund concentrates the reserve on the featured five. A diversification reading of the same book sends the reserve instead to the names that cut fund-level CV the most — the quiet background holdings the conviction list never mentions — and buys a full point of fund CV at no cost in reserve. Each ranking prices one signal and ignores the other's.

The RACE allocation report prices three terms. The gradient $\partial \text{RACE} / \partial \delta$ at each firm is the sum of three marginal effects: the return the dollar earns by scaling the firm, which moves mechanically as the position grows; the correlation cost of adding weight to a name the book already co-moves with, which is the diversification

signal; and the marginal distress relief, which is steepest at firms sitting close to their covenants, where a dollar of growth against a fixed debt service buys an outsized drop in breach probability. The third signal is a return neither familiar ranking prices — conviction does not see coverage, and diversification actively avoids the high-CV names where the harvest is largest. The water-fill adds to the top-gradient firm only until its marginal gradient falls to the runner-up's, then feeds both; funded firms end at a common marginal gradient, which is the shadow price of the reserve. When no firm's gradient is positive, deployment stops and the remainder returns to LPs; a stop below budget is itself an allocation answer, stating that no remaining deployment clears the book's shadow price.

Company	Conviction	Diversification	Joint analysis
Meridian Software	\$25M	—	\$3M
Clearview Analytics	\$20M	—	\$4M
Pacific Health	\$15M	—	\$12M
Apex Industrial	\$10M	—	\$2M
Summit Logistics	\$5M	—	\$17M
Beacon	—	\$17M	\$7M
Cobalt	—	—	\$4M
Dunmore	—	\$30M	\$9M
Elmcrest	—	—	\$5M
Fairhaven	—	—	\$3M
Granite	—	\$7M	\$4M
Harbor	—	\$21M	\$5M
Deployed	\$75M	\$75M	\$75M
Fund CV after	8.8%	7.8%	8.3%
Δ fund RACE	+7 bps	+4 bps	+23 bps

Table 14.11.: A \$75M follow-on reserve allocated three ways, with each allocation scored by the same objective in the summary rows. Conviction concentrates on the five featured names, with Meridian taking \$25M on the strength of its thesis. Diversification, reading the covariance structure alone, sends the entire reserve to the quiet background holdings and cuts fund CV from 8.8% to 7.8%. The joint analysis spreads the reserve by marginal gradient, and its largest check — \$17M to Summit, the name diversification zeroed and conviction nearly skipped — cuts Summit's breach probability from 22% to 15.7%, because coverage there sits in the steep region of the breach curve. The water-fill pays back part of the diversification ranking's variance saving to collect a distress surplus neither baseline prices, and triples either baseline's RACE improvement.

Table 14.11 sets the three allocations side by side and prices each in both units. The joint analysis approach reads as a correction to each baseline in turn. Against conviction, it moves money off Meridian and Clearview — names whose theses remain intact — because their marginal gradients are carried mostly by return the fund already holds in size. Against diversification, it funds Summit where the CV-only reading gave it nothing, and accepts half a point of fund CV above the diversification optimum as the price of a distress reduction worth more per dollar. The allocation equalizes marginal gradients across every funded name, respects the position-size limits the sponsor already enforces, and the sponsor remains free to override it on grounds the analysis does not see.

Reserves can also enter a company in a second form. A follow-on equity dollar grows the firm against a fixed debt service, so cover-

age improves and breach probability falls while the dollar earns the firm's return. A cure-basket dollar buys covenant headroom directly: it stands ready against a breach, cuts breach probability harder per dollar than growth does, and earns nothing while it waits. The two forms price the same convexity at different exchange rates, and committed cure cash is still committed capital — it enters the fund's base at zero return, an opportunity cost the comparison has to carry. Table 14.12 scores a \$20M reserve at Meridian in three deployments under the same objective. All equity roughly breaks even at the fund level, the return and variance effects of scaling an already-sizable position offsetting the modest breach relief. All cure cuts breach from 15% to nearly zero and clears a substantial gain even after the cash drag. The derived split of \$11M equity and \$9M cure does better than either, because the basket's protection is convex in its own size: the first cure dollars do most of the insuring, and the equity dollars then earn return on a position the basket has already made safer.

Table 14.12.: A \$20M reserve at Meridian Software deployed three ways, each scored by the same three-term objective, with committed cure cash carried in the fund's capital base at zero return. The derived mixed split beats both sequential instincts: most of the breach reduction comes from the first cure dollars, and the remaining dollars earn equity return on the protected position.

Approach	Equity	Cure basket	ΔBreach	ΔRACE
Sequential (equity first)	\$20M	\$0M	−3.9 pp	−1 bps
Sequential (cure first)	\$0M	\$20M	−15.0 pp	+28 bps
Joint (mixed, derived)	\$11M	\$9M	−14.3 pp	+44 bps

14.5.2. The Counterfactual Screen

A candidate new deal is reviewed on its standalone merits, and in the allocator's terms it is simply a holding at zero: it enters the eligible set beside the incumbents, carrying its own per-dollar return, CV, and breach profile at the proposed leverage, and it wins reserve only if its gradient clears the same shadow price the funded holdings settled at. Follow-on and deal screen are one allocation run over one eligible set. The screen below is the threshold form of that computation, where we vary the size to read the fund contribution against a pass/fail threshold. Two patterns recur: a deal attractive in isolation that concentrates a factor the fund already carries heavily may be worth passing, or pursuing only at reduced size; a deal marginal on its own merits may be worth pursuing because it diversifies an existing concentration.

The credit side runs the same screen in distress units, measured at the median-breach cost that sets the fund's expected-distress baseline rather than the escalation cost that prices a hedge: the candidate enters at the proposed leverage, and the fund's expected distress cost is recomputed. At the seller's proposed 1.0× size and 5.0× leverage, the cloud-infrastructure candidate adds \$3.5M of

Scenario	Weight	ΔFund CV	ΔExp. return	Decision
Without deal	—	0	0	baseline
Proposed 1.0×	7%	+0.52 pp	+0.4 pp	fails
0.75× size	6%	+0.34 pp	+0.3 pp	marginal
0.5× size	4%	+0.19 pp	+0.2 pp	passes

Table 14.13.: A candidate cloud-infrastructure deal (34% CV, overlapping the SaaS drivers Meridian and Clearview already carry) evaluated at three sizes against the existing fund, on the value side. The 1.0× proposal fails the sponsor's threshold of +0.30 pp fund CV for any single deal; a half-sized check passes.

fund-level expected distress against the sponsor's stated \$1.0M single-deal threshold; the same business at 1.0× and 4.0× adds \$1.4M for 40 basis points of expected return, and at half size the distress cost falls inside the threshold up to 4.0× leverage.

The screen's full output treats both size and leverage as negotiable and sweeps the plane, with a frontier of acceptable offers rather than a yes-or-no.

Size \ Leverage	3.5x	4.0x	4.5x	5.0x
0.5×	\$0.4M	\$0.7M	\$1.1M	\$1.7M
0.75×	\$0.6M	\$1.1M	\$1.7M	\$2.6M
1.0×	\$0.9M	\$1.4M	\$2.3M	\$3.5M

Table 14.14.: Incremental fund-level distress cost (\$M) across the (deal size, leverage) grid for the cloud-infrastructure candidate. The sponsor's distress threshold is \$1.0M; cells at or below the line describe the acceptable frontier, which the negotiation opens with.

The bolded cells mark the acceptable frontier: the sponsor can accept the seller's 1.0× check at 3.5× leverage, a 0.75× check at 4.0×, or a 0.5× check at up to 4.5×. The original proposal sits at \$2.8M, well outside it. The sponsor walks into the negotiation with specific alternative terms the analysis underwrites.

14.6. The Calendar Repeats

The four moments share one covariance matrix and one set of cascade outputs, and a change made at any of them propagates to the others through the inputs they share. The GP's decisions become a coordinated portfolio activity, supported by outputs the cascade already produces. This coordination costs nothing beyond re-reading the same matrix as it changes over time.

One downstream effect is on the LP conversation. An LP base raised on public-market reporting has a vocabulary the private equity asset class has not historically met them in, and the calendar's analyses produce that vocabulary natively, with operational anchors — inflow, churn, deal size variability, working-capital timing — underneath each headline number. The audit trail runs in both directions, giving the LP a path back from a fund-level number to the operating decisions that move it, and giving the GP a defensible answer when the LP asks why the book is sized the way it is. The quarterly review changes shape, spending less

time on narrative about a few high-conviction names and more on decomposition of where the fund's risk and return sit and what the operating partners are doing about it.

Two chapters complete the calendar. The bolt-on acquisition, most naturally evaluated by the portfolio company itself and checked against the fund context developed here, is the subject of Chapter 15. The monitoring discipline that runs between the moments — tracking each quarter's actuals against the bands the cascade drew — closes the part in Chapter 16.

In which we evaluate bolt-on acquisitions through both cascades simultaneously, and find that the best acquisition is not always the one with the highest standalone return.

The previous two chapters operated at the portfolio level, with the sponsor at the top of a fund looking down at the holdings and making fund-wide decisions about concentration, leverage allocation, follow-on capital, and deal screening. This chapter steps back down to the single-company perspective for a decision that lives most directly there: a bolt-on acquisition at a portfolio company. The mechanics of evaluating the deal — whether the cascade improves, whether the combined entity services the new debt — are most naturally run by the portfolio company itself, advised by the sponsor's operating partner. The decision, however, is not purely a single-company one. The combined entity sits inside a fund, and its correlation with sister holdings, its consumption of reserve capital, and its concentration of fund-level exposures all matter at the portfolio level. The chapter develops the single-company mechanics first and closes with the cross-portfolio checks that should accompany them.

Platform-and-bolt-on strategies are among the most common value creation playbooks in private equity. A sponsor acquires a platform company, then adds smaller businesses through a series of bolt-on acquisitions to build scale, diversify revenue, expand geographic reach, or consolidate market share. Each acquisition changes the combined entity's financial profile in ways that are straightforward to model on a spreadsheet (add the revenue, add the EBITDA, compute the blended multiple) and difficult to evaluate through the lens of risk (how does the acquisition change the combined entity's variance, its breach probability, and its risk-adjusted value?).

The Saliency cascade provides a framework for this evaluation. Each bolt-on acquisition is assessed through both paths simultaneously: the valuation cascade asks whether the combined entity's risk-adjusted enterprise value rises, and the capital structure cascade asks whether the combined entity can service the additional acquisition debt. The two assessments share the same variance inputs and produce complementary outputs; Chapter 12's RACE measure consolidates them into the single risk-adjusted figure the bolt-on test resolves to at the close of this chapter.

15.1. Evaluating a Bolt-On Through the Salience Cascade

The traditional analysis of a bolt-on acquisition is accretive or dilutive: does the acquisition's EBITDA contribution, divided by the acquisition cost, exceed or fall short of the platform's existing EBITDA yield? If the bolt-on is acquired at a lower multiple than the platform, the transaction is accretive on a blended basis. If not, it is dilutive.

This analysis captures the first-order effect on expected earnings, but it does not see the second-order effect on variance, which flows through the cascade to affect both the valuation multiple and the credit profile of the combined entity.

15.1.1. The Valuation Cascade

1: The combined CV follows the portfolio variance formula: the weighted sum of squared CVs plus the weighted cross-terms. When the correlation between the platform and the bolt-on is less than perfect (which is almost always the case), the combined CV is lower than the weighted average, reflecting diversification.

A bolt-on acquisition changes the combined entity's revenue CV in a way that depends on the bolt-on's own CV and its correlation with the platform's existing revenue streams.¹ A bolt-on with low correlation to the platform provides diversification that reduces the combined CV, potentially justifying a higher blended multiple even if the bolt-on's standalone economics are modest.

The cascade traces this effect through the tiers. A lower combined revenue CV produces a lower combined earnings CV (filtered through the blended expense structure), which supports a higher combined valuation multiple (through the CV-multiple relationship developed in Chapter 7). The valuation impact of the acquisition is therefore the arithmetic of adding EBITDA at a given multiple plus the variance effect, which can be substantial when the bolt-on diversifies the platform.

15.1.2. Mix Shift and Exogenous Re-rating

The cascade-driven valuation effect just described — lower combined CV, higher combined multiple — is one of two valuation mechanisms a bolt-on can trigger. The second is independent of the cascade. A bolt-on can change the *type* of business the combined entity is, and therefore the multiple regime the market applies to it.

Consider a capacity-based consulting firm acquiring a SaaS company. The consulting platform scales linearly with billable headcount and is priced on services multiples that recognize this capacity ceiling. The SaaS bolt-on scales with software gross margin and is priced on revenue or EBITDA multiples that recognize a different growth ceiling and a different operating-leverage profile. Even if the cascade produces no CV change at the combined entity, the mix shift between services revenue and recurring software

revenue moves the blended multiple toward the SaaS regime: $M_{\text{blended}} = w_c M_c + w_s M_s$, where w_c and w_s are the EBITDA shares of the consulting and SaaS components and $M_c < M_s$ are the regime multiples each would command standalone.

This is the same exogenous multiple expansion mechanism developed in Chapter 7: drift in the zero-CV cost of capital the market applies, here driven not by a sector tailwind but by the company actively shifting its mix into a different regime. The two valuation effects compound. A SaaS bolt-on at a consulting platform delivers diversification through low correlation *and* multiple expansion through mix shift, and both contribute to enterprise value at the moment of sale.

15.1.3. The Capital Structure Cascade

The capital structure effect is parallel. The bolt-on adds revenue, earnings, and operating cash flow to the combined entity. It also adds debt service if the acquisition is debt-financed. The question is whether the diversification benefit in cash flow, which tends to make the combined DSCR distribution tighter, more than offsets the additional debt service.

When it does, the combined entity has a lower breach probability despite having more total debt. An acquisition that increases total leverage can reduce credit risk, because the diversification in operating cash flows is worth more than the incremental debt service costs.

Multiple from CV, multiple from mix. A bolt-on can move the combined multiple by reducing variance (cascade) or by shifting the company into a different valuation regime (mix). Both effects compound.

15.2. The Diversification Effect

The magnitude of the diversification benefit depends on three factors: the relative size of the bolt-on, its standalone CV, and its correlation with the platform.

Size matters because a very small bolt-on, regardless of its correlation properties, has a negligible effect on the combined entity's variance. A bolt-on that represents 5% of combined revenue contributes at most a few tenths of a percentage point to the combined CV reduction. A bolt-on that represents 20% or more of combined revenue can move the combined CV by several percentage points.

Standalone CV matters less than correlation. A bolt-on with a high standalone CV (say, 30%) but low correlation with the platform (say, 0.15) provides more diversification than a bolt-on with a low standalone CV (say, 15%) but high correlation (say, 0.60). The first bolt-on brings risk that is largely independent of the platform's risk, which the portfolio effect absorbs. The second brings risk

Correlation matters more than standalone CV. A high-variance bolt-on with low correlation diversifies the platform. A low-variance bolt-on with high correlation does not. The cascade quantifies the difference.

that moves in the same direction as the platform's risk, which the portfolio effect cannot absorb.

Correlation depends on operational overlap: shared customers, shared end markets, shared macroeconomic sensitivities, and shared revenue model dynamics. A facilities maintenance company acquiring a fire protection services company (overlapping customer base, different end market) might have a correlation of 0.30. The same company acquiring a competitor in the same geography and the same service line might have a correlation of 0.70. The cascade takes the correlation as an input — a judgment call for the deal team — and propagates the chosen value through to its consequences on combined CV, valuation multiple, and breach probability.

The single number ρ is a roll-up. Chapter 13 resolves it into source-level overlaps — inflow through shared end-markets, outflow through shared customer pools, seasonality through calendar alignment, margin through input-cost cycles, OCF through working-capital timing, and valuation through sector repricing — each elicited as a named shared driver between the specific pair, with cells the deal team cannot defend by a named driver staying at zero. The deal team can work at either level: a scalar ρ as this section does for exposition, or the per-source decomposition when each channel can be tied to a specific overlap. The decomposition also sharpens the sequencing question of the next section, which becomes a question about which source overlap is added first rather than which scalar correlation moves first.

Exhibit 15.1 draws the relationship between correlation, standalone CV, and the combined entity's resulting CV. The setup is a platform with \$100 million in revenue and a standalone CV of 18%, acquiring a bolt-on of \$25 million. The horizontal axis is the bolt-on's correlation with the platform; the three curves show what happens to the combined CV at different bolt-on standalone CVs (15%, 25%, 35%). The platform's pre-acquisition CV is marked as a dashed reference line.

The picture sorts bolt-on candidates into three regions. In the lower-left quadrant of each curve, the combined CV falls well below the platform's pre-acquisition CV: low correlation buys diversification regardless of the bolt-on's standalone CV. In the upper-right region, the combined CV rises above the platform's pre-acquisition level: a high-CV bolt-on with high correlation makes the combined entity riskier than the platform was alone. In between sits the transition zone, where the correlation threshold determines whether the bolt-on is additive or destructive to the platform's variance profile.

The crossover correlations (where each curve meets the dashed line) are the practically interesting numbers. For the 15% bolt-on, the crossover sits at a relatively high correlation, which means the deal team has wide latitude to acquire predictable businesses

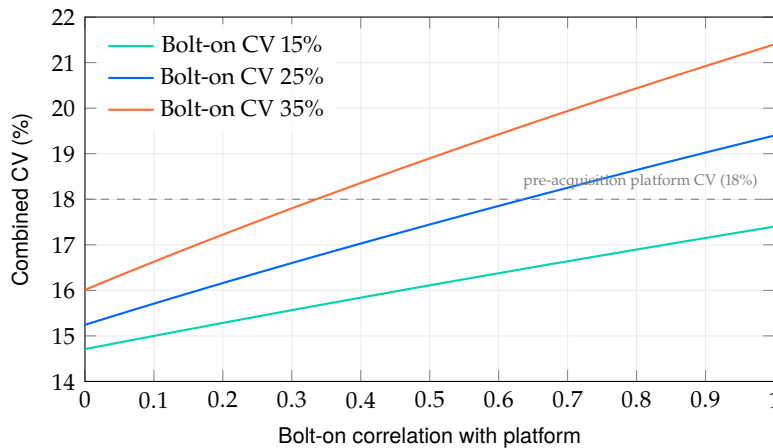


Exhibit 15.1: Where the diversification value lives. Combined CV after adding a \$25M bolt-on to a \$100M, 18%-CV platform, plotted as a function of the bolt-on's correlation with the platform. Three curves show what happens at different bolt-on standalone CVs. Below the dashed reference line, the bolt-on improves the combined CV; above it, the bolt-on worsens it. The crossover point on each curve marks the correlation at which the bolt-on becomes neutral. Lower curves dominate higher curves at low correlation. The high-CV bolt-on becomes the worst choice at high correlation, where its variance and the platform's variance reinforce each other.

without worrying much about overlap. For the 35% bolt-on, the crossover sits much lower, which means a high-variance acquisition is only a good idea when its operational overlap with the platform is small. The standalone CV determines how much correlation the platform can tolerate before the acquisition becomes destructive.

15.3. Sequencing Acquisitions

When a platform plans multiple bolt-on acquisitions, the order in which they are executed affects the cumulative variance profile. Each acquisition changes the combined entity's CV, which changes the diversification benefit of the next acquisition. The first bolt-on has the largest marginal impact because it diversifies a single-company platform. Subsequent bolt-ons diversify an entity that is already partially diversified, so each provides a smaller incremental benefit.

The implication for sequencing is that the bolt-on with the lowest correlation to the current platform should come first, because it provides the most diversification per dollar of revenue added. A platform that acquires a highly correlated competitor first and a diversifying adjacency second captures less total diversification benefit than one that reverses the order, because the diversifying adjacency provides a larger CV reduction when applied to the undiversified platform.

In practice, sequencing is constrained by deal availability, seller willingness, and integration capacity, so the cascade does not dictate the order; it quantifies the variance consequence of each sequence, information the deal team has not previously had.

This is analogous to the ordering logic in the Sharpe Improvement Staircase: the cheapest high-impact intervention comes first. Here, "cheapest" is the bolt-on with the lowest correlation (most diversification per unit of integration effort), and "high-impact" is the resulting reduction in combined CV.

15.4. Case Study: A Three-Acquisition Buy-and-Build

Athena Industrial Services, the PE-backed facilities maintenance platform introduced in Chapter 4, is executing a buy-and-build strategy. Athena enters this chapter in its post-improvement state: the improvement program of Chapter 4 has run, the annual breach probability stands at 9% rather than the baseline 17%, and the multiple has re-rated to 8.5x. The sponsor plans three bolt-on acquisitions over two years, each adding revenue and geographic reach while changing the combined entity's variance profile.

Table 15.1: Three bolt-on targets and their characteristics. Revenue correlations with Athena reflect geographic and customer overlap.

Target	Rev	CV	Corr	Price
Alpha Mechanical	\$25M	22%	0.45	6.5x
Bay Area Fire	\$18M	28%	0.20	7.0x
Southeast Janitorial	\$32M	16%	0.35	6.0x

Alpha Mechanical is a regional HVAC specialist; its 0.45 correlation lives in inflow (shared facilities-services end-market) and seasonality (overlapping building cycle). Bay Area Fire Protection serves a different end market entirely (fire suppression systems); the 0.20 correlation reflects residual margin overlap through shared labor-cost cycles rather than any inflow channel, despite the relatively high standalone CV. Southeast Janitorial is a large, predictable cleaning services business; its 0.35 correlation comes from outflow (shared customer-side stress when facilities budgets tighten) more than from inflow.

15.4.1. Cumulative Impact Through Both Cascades

Table 15.2: The build-out improves the combined entity's valuation and credit profile, with the benefit arriving through the lower-correlation acquisitions. Lower combined CV supports a higher multiple and a lower breach probability.

Stage	Rev	CV	E CV	Mult	Breach
Athena alone	\$56M	14.0%	22%	8.5x	9%
+ Alpha	\$81M	14.1%	22%	8.5x	9%
+ Bay Area Fire	\$99M	13.5%	21%	8.7x	8%
+ SE Janitorial	\$131M	12.1%	19%	9.0x	6%

Two of the three bolt-ons reduce the combined revenue CV despite carrying higher standalone CVs than Athena; Alpha, with the highest correlation (0.45), leaves the combined CV essentially unchanged. Diversification here is governed by correlation rather than by standalone volatility: Bay Area Fire, with the highest standalone CV (28%) and the lowest correlation (0.20), contributes the most diversification per dollar of revenue added.

The multiple expands as the combined earnings CV declines, from 8.5x to 9.0x. The half-turn expansion, applied to the growing EBITDA base, represents value creation beyond the arithmetic of adding the bolt-ons' standalone EBITDA.

The breach probability declines over the build-out, from 9% to 6%, despite the fact that each acquisition adds debt to the capital structure. The diversification benefit in operating cash flow more than offsets the incremental debt service.

15.4.2. The Sequencing Decision

The sponsor considers the sequencing question. The end point is the same portfolio in every order — the combined CV of the completed build-out does not depend on the sequence — so what the sequencing decision governs is the variance profile along the path. If Bay Area Fire (lowest correlation, most diversification) is acquired first, the combined CV drops from 14.0% to 13.7% after the first acquisition. If Alpha Mechanical (highest correlation) is acquired first, the combined CV holds at 14.1%, and the diversification arrives only as the later acquisitions close. A sponsor who needs credit headroom early in the build-out prefers the diversifying acquisition first.

In practice, the sponsor acquires Alpha first because the deal is available and the integration is straightforward. The cascade prices the interim cost of that pragmatic choice: roughly half a point of combined CV carried until the second acquisition closes, worth a fraction of a turn on the multiple over that interval. The availability and integration considerations still dominate the sequencing choice, and the cascade's number sharpens the discussion and sets expectations for the variance trajectory of the build-out.

15.5. The Sponsor and the Portfolio Company

A bolt-on decision sits at the intersection of two perspectives, and the analysis above leans toward one of them. The cascade mechanics — standalone CV, combined CV, breach probability, valuation impact, sequencing — are most naturally run by the portfolio company itself, with help from the sponsor's operating partner. The company's CEO and CFO know the operating realities, the integration challenges, and the customer overlap with first-hand precision the sponsor cannot match.

The sponsor brings a perspective the company does not have: the fund-level view developed in Chapter 14. Three threads from that chapter bear directly on the bolt-on decision and should be re-run before the deal closes.

First, the concentration audit (§14.2) should be re-run with the combined entity sized in place of the standalone platform. A bolt-on grows a portfolio company; that growth concentrates the fund's exposure to whatever drivers the company already carries. The resulting concentration should sit inside the fund's stated limits. A bolt-on that adds variance the platform does not already have can

be a clean diversifier; one that doubles down on existing fund-level exposure deserves scrutiny.

Second, the follow-on allocation (§14.5). Reserve capital used for a bolt-on is reserve capital not available for follow-ons elsewhere. The marginal-contribution ranking measures the per-dollar fund-level value of follow-on capital across the live portfolio companies. If the bolt-on's marginal contribution to fund-level value falls below the best follow-on opportunity, the bolt-on competes badly inside the same capital constraint, and the sponsor should weigh that competition explicitly rather than committing to the bolt-on on company-level reasoning alone.

Third, the leverage allocation (§14.3) and the breach concentration audit of the same chapter. A debt-financed bolt-on changes the platform's leverage and therefore its position in the fund-level leverage reallocation; it also changes the platform's breach contribution at the fund level. The combined entity's RACE and breach contribution should be recomputed in the fund context after the bolt-on, not just at the company level, so the cross-portfolio implications surface before the deal closes rather than at the next quarterly review.

The recommended workflow is a joint review. The portfolio company runs the cascade analysis on the bolt-on; the sponsor runs the three cross-portfolio checks. The decision is approved at both levels, with each level's view documented. A deal that creates value at the company level but pushes the fund through a concentration limit, or competes badly against an existing follow-on opportunity, is reconsidered or restructured. A deal that clears both reviews proceeds with both signatures.

Two views, one decision. The portfolio company brings the cascade mechanics. The sponsor brings the fund-level context: concentration, capital allocation, leverage. Both reviews are necessary, and a deal that clears one without the other is not yet approved.

15.6. When to Walk Away

Some bolt-ons fail the risk-adjusted test. A target with high correlation to the platform, high standalone CV, and a purchase price that reflects the platform's premium multiple may be dilutive on a risk-adjusted basis even if it is accretive on an expected EBITDA basis.

Chapter 12 developed RACE as the certainty-equivalent measure that consolidates the two cascades into a single risk-adjusted figure that serves as a bolt-on test. If the combined entity's RACE is lower after the acquisition than before, accounting for the acquisition debt and the change in variance profile, the acquisition destroys risk-adjusted value: the expected EBITDA may be higher, the expected equity return may be higher, and the risk-adjusted equity return, which accounts for the variance amplification and the distress cost, is lower.

This is the same logic that the efficient frontier applies to portfolio construction: adding a high-return, high-variance, highly-correlated asset to a portfolio can reduce the portfolio's risk-adjusted return even though it increases the expected return. The cascade makes this test computable for acquisitions, providing the deal team with a structured basis for the discipline that experienced sponsors apply intuitively: the willingness to walk away from an accretive deal that does not improve the risk-adjusted profile.

Monitoring, Tracking, and the Quarterly Business Review

16.

In which we discover that the framework's most practical value may lie in the discipline it brings to evaluating what actually happened, beyond the plan it produces in the first place.

The preceding chapters describe the measurement of uncertainty and its propagation through the cascade into capital structure decisions. Each is a planning exercise, performed before the year begins or at the time of a transaction. This chapter addresses what happens afterward: the ongoing cycle of tracking actual results against the forecast and translating departures into operational decisions. The framework's value is not fully realized until it is embedded in the management rhythm of the business, which in most PE-backed companies means the quarterly business review.

16.1. Tracking Actuals Against the Forecast

Chapter 5 introduced the tracking framework on the revenue side: confidence bands that scale with the company's own CV, a confidence fan visualization (Exhibit 5.4), and the principle that the same dollar shortfall can be unremarkable at one company and a serious departure at another, depending on the underlying variance. This chapter picks up that framework and develops it as a management discipline that runs across all three cascade tiers and across the full quarterly review cycle. The mechanics generalize: the bands are still functions of the company's CV, the elapsed time, and the seasonal pattern of the underlying process. The framework now applies to earnings and capital-structure outcomes as well as revenue, and runs on the QBR's quarterly cadence.

16.1.1. The Z-Score

The core metric for tracking is the z-score: the distance between the actual result and the expected result, measured in units of the forecast's standard deviation at that point in time.

A z-score of zero means the actual result is exactly at the expected value. Half a standard deviation from the mean is unremarkable; above 1.28 sits outside the 80% confidence interval and merits a review; above 1.96 sits outside the 95% interval, which is rare under the forecast model and strongly suggests a genuine departure from the plan. The thresholds the operational tracking discipline below builds on are the 80% and 95% boundaries, in line with the operational reporting default Chapter 8 establishes.¹

The partial-period standard deviation is not the annual one prorated by time. For count-based revenue it grows with the square root of elapsed time, so a \$7.8M annual figure becomes roughly \$3.9M at the end of Q1, not \$1.95M.

1: Judging a result against the process's natural variation rather than against the plan has a long lineage in statistical process control; Wheeler's *Understanding Variation*[17] is the classic management treatment. The z-score applies the same discipline with the forecast distribution supplying the control limits.

16.1.2. Tiered Response

The z-score enables a tiered response protocol that avoids both premature intervention and delayed recognition.

Table 16.1: Response tiers based on the z-score of actual results. The thresholds correspond to the 80% and 95% confidence intervals — the operational reporting bands Chapter 8 recommends as the routine default and the tail-sensitive escalation level.

Zone	z-score	Response
Green	within ± 1.28	Note and monitor. Normal variation.
Amber	± 1.28 to ± 1.96	Review. Examine operational drivers.
Red	beyond ± 1.96	Investigate. Likely a genuine departure.

The green zone covers 80% of outcomes. A company in the green zone is performing within the range that its own uncertainty predicts, and intervention is not warranted by the data. The amber zone covers outcomes that are possible under the forecast and unusual, meriting a review of the operational drivers without triggering an emergency response. The red zone covers outcomes that the forecast model considers unlikely, which means either the model is miscalibrated or something has genuinely changed in the business.

The protocol prevents a common and costly pattern in PE portfolio management: the quarterly pipeline scrub triggered by a revenue shortfall that is well within the range of normal deal-timing variation. The investigation consumes management time and produces anxiety that is, in statistical terms, unwarranted. The bands reserve management attention for the cases where the data warrants it.

16.2. Variance Attribution After the Fact

2: The attribution schemes below — count-size, sequential waterfall, Shapley, variance-weighted, three-tier cascade — are second-moment decompositions, and Chapter 8 preserves their reliability across the cascade's distributional regimes. The heavy-tailed flag the next section introduces affects the confidence bands an actual-vs-forecast comparison sits inside; the attribution of any departure to its operational sources is exact regardless. One caution on the component z-scores: they do not add. The dollar effects sum to the total gap, but each z carries its own denominator, and the total's z is the σ -weighted combination of the components' — which is how two green components can make an amber total, and how two departures in opposite directions can make a green one.

When actual results diverge from the forecast, the next question is why. Saliency provides several attribution schemes that decompose the gap between actual and expected into its operational components, and each component arrives with a z-score of its own: the same variance model that set the response bands carries a forecast dispersion for every source, so a churn gap can be read against churn's own band exactly as the total was read against the company's. Conventional budget-versus-actual reporting cannot produce this number, because it never modeled component dispersion in the first place. The component scores run every quarter, whatever zone the total lands in. The total's z assigns the response tier; the component scores catch what the total cannot, since two genuine departures in opposite directions can leave the total serenely inside its band. A component in the red zone merits a review even under a green total. One honesty note calibrates the scan: reading five components at the 80% band produces roughly one amber per quarter by chance alone, so ambers earn attention when they persist, and reds immediately.²

16.2.1. Count-Size Decomposition

The simplest attribution, and the one most directly connected to the count-size framework in Chapter 5, decomposes the revenue gap into count and size components, each read against its own band. The quarter in Table 16.2 came in a million dollars ahead of plan, a total z of +0.5 that no protocol would flag. The decomposition shows what the total is made of: deal count slipped half a band while the average check rose two and a half — \$290K against an expected \$260K, on a standard error of \$12K. The beat is a composition event, fewer and much larger deals, and the z column is what turns a pleasant total into a pointed question: pricing power, or two whale contracts carrying a softening pipeline? The management response to a count departure (pipeline generation, conversion rate) differs from the response to a size departure (pricing, qualification), and this quarter the lever that moved hardest is the one the celebratory total conceals.

	Expected	Actual	Effect	z	Lever
Deal count	75	71	−\$1.0M	−0.5	Pipeline, conversion
Deal size	\$260K	\$290K	+\$2.3M	+2.5	Pricing, qualification
Total	\$19.5M	\$20.6M	+\$1.1M	+0.5	

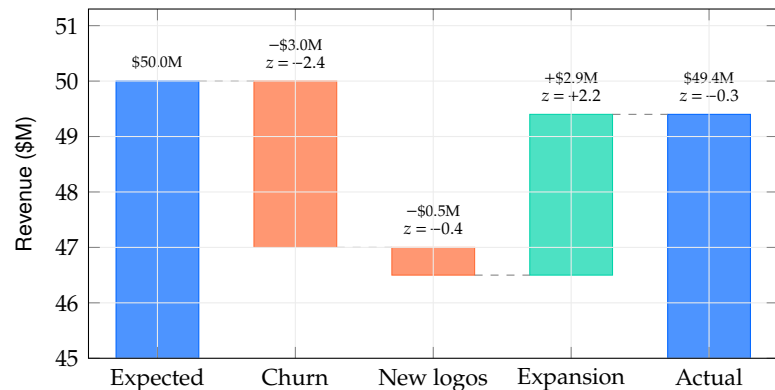
Table 16.2.: Decomposition of a quarter that beat plan, for a transactional business. Each component is computed by holding the other at its expected value; the small interaction term between count and size is suppressed. The z column reads each effect against that component's own forecast dispersion — the count on its Poisson band ($\sqrt{75} \approx 8.7$ deals), the size on the standard error of the mean at a 40% deal-size CV. The total is comfortably green; the size lever is deep in the red, and the pleasant quarter is a composition event.

16.2.2. Sequential Waterfall

For subscription businesses with the ARR waterfall structure (base, minus churn, plus new, plus expansion), the sequential attribution walks from the expected total to the actual total through each component in order. Base revenue came in at plan. Churn ran well ahead of plan, removing \$3.0 million. New logo revenue was \$500,000 below target. Expansion beat its target by \$2.9 million. The net shortfall is \$600,000, decomposed into three components with different operational owners.

The z -scores tell a different story from the net. Churn's \$3.0 million miss, against its \$1.25 million band, is a $z = -2.4$ event: a genuine retention departure, deep in the red zone. Expansion's \$2.9 million beat is a $z = +2.2$ event of its own. The two nearly cancel in dollars, so the total arrives at $z = -0.3$, and a review that read only the total would file this among the most ordinary quarters of the year. What actually happened is that the company re-earned its churned revenue from the customers that stayed: the top line held while the

Exhibit 16.1: A sequential waterfall, each bar read against its own band. The bridge from expected revenue (\$50.0M) to actual revenue (\$49.4M) for an ARR business. The blue anchors show expected and actual; orange bars are negative components, teal is the positive one. The dollars nearly cancel and the z-scores do not: churn's \$3.0M miss is a $z = -2.4$ event against its own band, expansion's \$2.9M beat is $z = +2.2$, and the total lands at $z = -0.3$, deep in the green zone. A total-only review files this as an ordinary quarter; the component scores show a retention departure being paid for by the survivors — the top line holding while the customer base narrows.



16.2.3. Additional Schemes

Salience supports several additional attribution schemes for different analytical contexts. Shapley attribution distributes the gap fairly across all parameters, accounting for the interactions between them. Variance-weighted attribution assigns each parameter's share of the gap in proportion to its predicted variance contribution. Three-tier cascade attribution traces the gap through the full cascade, separating revenue-tier effects from expense-tier effects from valuation-tier effects.

Each scheme produces a different decomposition of the same total gap. The "right" scheme depends on the business model, the organizational structure (who owns which parameter), and the question being asked. A sales organization that assigns responsibility by channel benefits from the compound Poisson decomposition. A subscription business that assigns responsibility by waterfall component (retention team owns churn, growth team owns new logos) benefits from the sequential waterfall.

16.3. Reporting

The analytical outputs of tracking and attribution are only valuable if they reach the right people in a usable form. Salience generates structured reports from the same analytical engine that produces

The choice of attribution scheme depends on the question being asked. Compound Poisson is best for transactional businesses where count and size are the natural decomposition. Sequential waterfall is best for subscription businesses with the ARR structure. Shapley is best when fairness across multiple parameters matters.

the cascade metrics, ensuring that the numbers in the quarterly review are identical to the numbers in the underlying analysis.

16.3.1. Confidence Fan Charts

The primary visual for revenue tracking is the confidence fan introduced as Exhibit 5.4 in Chapter 5. The same construction extends to earnings and DSCR plots, where an expected path and matching confidence bands answer the same kind of “is this within the range we already priced?” question on the other two cascade tiers. The default fan band is the 80% interval, in line with the operational reporting recommendation Chapter 8 develops. The 95% band is available as a secondary view, with the caveat that at high cascade CV it degrades on positive-support quantities.

16.3.2. Variance Waterfall

The attribution analysis is visualized as a waterfall chart: a bridge from expected revenue to actual revenue, with each component shown as a step up or down. The visual makes the decomposition immediately legible. A bar that drops \$1.6 million for “churn above plan” followed by a bar that drops \$800,000 for “new logos below plan” tells the story of the quarter in a format that a board member can absorb in seconds.

16.3.3. Portfolio-Level Aggregation

For multi-company portfolios, the reporting extends to the fund level. The portfolio-level view aggregates individual company results into a single combined forecast, with confidence bands that account for cross-company correlations. A quarter in which three companies miss their individual targets by modest amounts might still fall within the fund-level confidence band, if the shortfalls are uncorrelated and offset by strong performance at other companies. The portfolio view distinguishes between a fund that is on plan (despite individual company variation) and a fund that is off plan (because the variations are correlated or concentrated in the largest holdings).

The portfolio-level confidence bands carry a tail-drag caveat. Mean and variance compose cleanly across companies; the portfolio’s left tail does not, when one holding carries a high cascade CV. Chapter 8 establishes that a heavy-tailed company drags the portfolio left tail regardless of how many normal-tail companies sit beside it. The QBR responds with a heavy-tailed flag at the roll-up whenever a holding’s CV sits in the regime that chapter marks as moment-unreliable. The flag does not change the green/amber/red call on any individual company; it records that the fund-level band was drawn under a moment-matched assumption the high-CV holding

does not fully support, and that the holding warrants a tail-honest follow-up.

16.4. How Reporting Changes the QBR

The traditional quarterly business review for a PE-backed company centers on a comparison of actual results to the operating plan, presented as a table: budget versus actual, with a column for the difference. The conversation that follows is typically about explaining the gap and assigning responsibility for it. Salience shifts this conversation in two ways.

The first shift is from explanation to significance. Before discussing why the company missed by \$2 million, the QBR establishes whether the \$2 million miss is statistically meaningful. If the z-score is -0.6 , the miss is well within the range of normal variation, and the answer to “why did we miss?” is “because the process has variance, and this quarter’s outcome fell slightly below the mean, which is what happens roughly 30% of the time.” The conversation can then focus on whether the underlying parameters have changed: whether the churn rate is trending higher or the pipeline coverage is declining. The gap itself is secondary to whether the parameters that produced it have shifted.

The second shift is from backward-looking to forward-looking. The attribution analysis identifies which parameters drove the deviation, and the sensitivity analysis identifies which parameters matter most for the remainder of the year. The QBR conversation moves from “why did we miss by \$2 million?” to “given what we have learned this quarter, what should we do differently in the next two quarters?”

The combination of significance testing and forward-looking attribution transforms the QBR from a performance review into a management tool. The operating partner leaves the meeting with a prioritized list of actions for the next quarter, each with a quantified expected impact on the full-year outcome.

16.5. Case Study: A Quarterly Review for a Five-Company Portfolio

A PE fund holds five portfolio companies. At the end of Q2, the operating partner reviews the results.

The conventional report ranks these companies by the size of their dollar gap. Meridian is at the top of the list, Apex second, Pacific is the only positive performer and is therefore last. The implicit logic is that bigger gaps deserve more attention. Exhibit 16.2 plots the

Company	Target	Actual	Gap	z
Apex Industrial	\$28M	\$26.5M	-\$1.5M	-0.7
Meridian Software	\$40M	\$37.2M	-\$2.8M	-1.8
Pacific Health	\$36M	\$37.8M	+\$1.8M	+0.9
Summit Logistics	\$28M	\$27.0M	-\$1.0M	-0.4
Clearview Analytics	\$20M	\$19.5M	-\$0.5M	-0.3
Featured total	\$152M	\$148.0M	-\$4.0M	-0.8

Table 16.3.: Mid-year results for the fund's five featured holdings. The z-scores distinguish normal variation from genuine departures.

same five companies in a different space, with the absolute dollar gap on one axis and the z-score on the other.

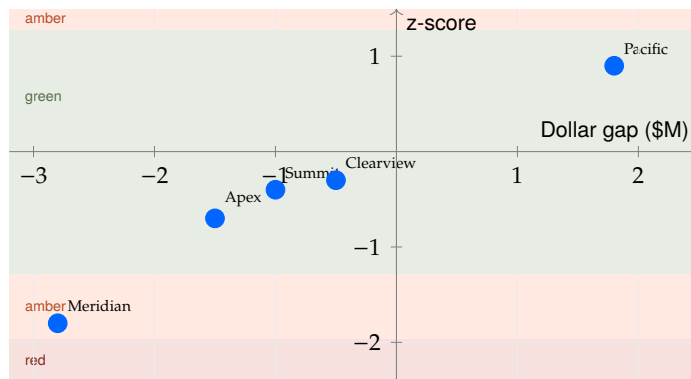


Exhibit 16.2.: The z-score and the dollar gap rank the same companies differently. Five portfolio companies plotted by signed dollar gap and signed z-score.

If signed gap and signed z agreed, the five points would fall on a straight line through the origin, but each company has its own forecast standard deviation and the slope between the two metrics is one over that standard deviation. Apex's z of -0.7 is closer to zero than Pacific's $+0.9$ even though the two dollar gaps are similar in size, because Apex's forecast is wider and a \$1.5 million shortfall fits comfortably inside its expected range. Pacific's tighter forecast pulls a comparable \$1.8 million surprise to a z farther from zero, because the same dollar movement is statistically more meaningful at Pacific's CV. The conventional report would have ranked these two in the opposite order. Meridian's z of -1.8 crosses the lower amber threshold of -1.28 ; no other company crosses either. Meridian also carries the largest dollar gap, and the two rankings coincide for this portfolio without coinciding generally.

Four of the five companies are in the green zone (z within ± 1.28 , the 80% confidence band). Their shortfalls and overages are within the range of normal variation. Apex missed by \$1.5 million, which looks concerning in isolation and sits comfortably inside the range of normal variation for a company with its 20% revenue CV. Pacific's \$1.8 million overperformance partially offsets the shortfalls elsewhere.

Meridian is in the amber zone with a z-score of -1.8 , comfortably between the amber threshold of -1.28 and the red threshold of -1.96 . The \$2.8 million shortfall is unusual for a company with Meridian's CV profile. The attribution analysis decomposes the gap: \$1.9 million from higher-than-expected churn (12 accounts

lost versus 8 expected) and \$900,000 from slower new logo closing (timing-related, with several deals expected to close in Q3). The churn component warrants attention, while the new logo component reads as timing noise that will self-correct.

The operating partner's response is targeted. Meridian's customer success team investigates the churn acceleration along three candidate explanations: a cohort effect from a single vintage of customers reaching renewal, a competitive issue, or a product satisfaction problem. The attribution points to churn count, with the lost accounts at average size, which locates the issue in how many customers are staying.

Across the five featured holdings, the aggregate z-score is -0.8 , in the green zone. Despite four of them missing their individual targets, the featured shortfall of \$4 million is within the expected range, because the individual shortfalls are largely uncorrelated and partially offset by Pacific's overperformance. The seven background holdings each printed inside their own bands that quarter, so the featured subtotal carries the fund-level read.

The QBR concludes with three action items. First, a deep review of Meridian's churn cohort data, to be completed within two weeks. Second, a monitoring flag on Meridian's churn rate for Q3, with an escalation trigger if the z-score remains below -1.5 at the end of the quarter. Third, no changes to the other four companies, whose results are consistent with their forecast parameters. The Q3 review will re-run the same procedure with that quarter's actuals, with Meridian's flag carried forward until the churn pattern resolves.

Company-level and fund-level views can diverge. A fund can be on plan even when most companies are below target (diversification absorbs the shortfalls). A fund can be off plan even when most companies are near target (if the few that are off are the largest or most correlated holdings).

SALIENCE IN YOUR ROLE & CONCLUSION

By Role 17.

In which the framework is handed to four practitioners — the revenue manager, the owner or C-suite executive, the management consultant, and the private equity investor — and each finds the cascade fits inside documents and decisions they already produce.

The four sections that follow are the practitioner's view of the framework the rest of the book has been describing. Each identifies the documents and decisions the role already produces, names the cascade additions that fit inside them, and walks through the worked situation the reader is most likely to recognize. The sections can be read in any order, and most readers will read only the section that matches their position. A cross-cutting adoption pattern runs through all four: start with a single conversation, augment the existing model rather than replacing it, and let the numbers earn their place in documents the role already produces. Chapter 18 closes with the other half of the argument — what adoption is worth, to the firm that moves first and to the market once the rest have followed.

17.1. The Revenue Manager

The annual planning cycle reaches the head of revenue with the same question every year: a single number for next year, destined for the operating plan, the board deck, and the LP letter. What the number leaves out is the shape of the distribution around it. Salience adds a place for that information — a goal risk, the standard deviation of the annual forecast expressed as a percentage of the target.

A \$60M plan at 15% goal risk is a different plan from the same \$60M at 25%. The two imply different ranges of plausible outcomes, different probabilities of meaningful misses, and different consequences further down the cascade. Goal risk on the slide gives the planning conversation a second number to negotiate, alongside the target.

What the head of revenue controls. The cascade's first parameters are ones the head of revenue already manages, in slightly more formal vocabulary. Count is the expected number of deals; size is the average deal value, with a size CV capturing its dispersion; churn rate and its CV extend the set to the renewal book; a seasonality parameter captures how deal arrivals cluster within the period. These six parameters specify the cascade's revenue-tier input.



Exhibit 17.1: Two \$60M plans at different goal risk. The 15% plan (teal) sits in a \$51M–\$69M band; the 25% plan (orange) in a \$45M–\$75M band. Same mean, different shape.

Table 17.1.: Sales lexicon, translated.

Sales term	Cascade term
Pipeline coverage	Count CV
Deal mix shift	Size CV
Retention rate	Churn rate
Renewal vol.	Churn CV
Quarter-end push	Seasonality

The controls sit one level upstream, in operational practices. Pipeline generation and territory coverage set the count; pipeline coverage ratios and lead-source diversity set its CV. Pricing and segment mix set the size; deal desk discretion and contract-length variation set the size CV. Customer success investments and renewal cadence set the churn rate. Contract-term staggering shapes seasonality. Each is a lever the head of revenue already pulls, and the cascade quantifies the variance consequence of each.

The annual negotiation acquires a second variable. A reach target of \$70M is a different point on the same risk-return curve as the \$60M base, reachable in exchange for a wider admitted range. The head of revenue can invert the conversation, accepting the reach goal in exchange for the wider range. The discussion shifts from whether the head of revenue will accept sole responsibility for the reach goal to what the company is willing to pay, in variance, for the extra ten million of expected revenue. The CFO has a defensible basis for choosing between them rather than a pair of point estimates that look identical on the slide.

The forecast call, reformed. The most regular ritual in any sales organization is the forecast call. The cascade reframes it: each deal in the forecast has a probability of closing, a value, and a value variance, and from these Salience can produce a forecast distribution rather than a point estimate. The connection to the count-size framework is developed in Section A.5 of the back-of-book mathematical companion (Appendix A).

Table 17.2.: Eight deals on a quarterly forecast call plus residual and renewals. The rightmost column ranks each by size and by variance. The conventional walk-down is by size; the cascade walk-down is by variance. The two rankings disagree.

Deal	Value	p	E[Rev]	Var	Sz/Vr
Acme Corp	\$1.20M	0.90	\$1.08M	0.13	1 / 6
Beta LLC	\$0.80M	0.50	\$0.40M	0.16	4 / 3
Carter & Co	\$0.95M	0.85	\$0.81M	0.12	2 / 7
Delta Group	\$0.60M	0.30	\$0.18M	0.09	5 / 8
Echo Systems	\$0.90M	0.40	\$0.36M	0.19	3 / 1
Foster Inc	\$0.45M	0.55	\$0.25M	0.06	7 / 9
Granite Co	\$0.50M	0.70	\$0.35M	0.05	6 / 10
Helix Health	\$0.35M	0.60	\$0.21M	0.03	8 / 11
Pipeline residual	—	—	\$2.36M	0.42	— / 2
Quarter-end inbound	—	—	\$0.95M	0.18	— / 4
Renewals	—	—	\$1.45M	0.09	— / 5
Total			\$8.40M	1.52	
Std dev				\$1.23M	
CV				14.6%	

The deal-level variance contribution column ranks the deals differently than the deal-size column. Acme Corp is the largest deal in the pipeline and most sales coaching would treat it as the deal that demands the most attention. The cascade ranks Acme sixth in variance contribution, because its 0.90 close probability leaves only small residual uncertainty around an already-committed outcome.

Echo Systems, third by size, ranks first by variance contribution, because its 40% close probability leaves a large uncertain swing on a substantial value. The deals the head of revenue should work most actively, in terms of forecast accuracy, are the deals whose outcomes are still uncertain. The pipeline residual, the catch-all bucket for deals not yet individually identified, often dominates total variance, which gives the sales operations team a quantitative argument for converting more of it into named deals.

The first move. Compute goal risk for the current annual plan retroactively. The count, size, and CV parameters are already in the CRM and the historical data; the calculation produces the goal risk that has been implicit in the plan all along, which rarely matches intuition and sets the baseline for future plans. The variance attribution for the most recent quarter follows from the same parameters and names the sources of the gap between plan and actual. The change to the planning cycle itself is a single row added to the annual plan: goal risk, sitting beside the target on the same slide.

17.2. The Owner or C-Suite Executive

The CEO of a private company arrives at most strategic decisions through a procedure closer to diplomacy than optimization. Positions converge on the room from every direction: CFO, head of revenue, COO, chair, lead director, each with its own constraints. The decision that emerges is the one the CEO can defend to all of them. The standard frameworks (NPV, ROIC, the strategic plan template) do not quite capture the question the CEO is trying to answer.

The question is about the company's capacity to absorb surprise. Every strategic decision worth an opinion creates exposure to outcomes the plan cannot verify: a growth investment whose landing depends on demand, a market entry whose traction depends on customer behavior, an acquisition whose integration rarely matches the deal as signed. The capacity to absorb surprise is itself a quantity, and Salience helps to quantify it.

The variance budget. A company has a variance budget: the total uncertainty it can carry without breaching covenants, missing earnings guidance, disappointing the board, or losing key employees. The bound is real even when nobody has written it down. The capital structure cascade gives the maximum earnings CV consistent with a target breach probability at the chosen leverage; the valuation cascade gives the maximum earnings CV consistent with the multiple the board expects. The lower of the two is the

Table 17.3.: The variance budget meeting.

Initiative	ΔCV
Sales target	+3.2
Geo expansion	+2.4
R&D shift	+1.8
CAC push	+2.1
Sum	+9.5
Combined	+6.3
Headroom	1.7

binding variance constraint, and everything the company does that creates earnings variance has to fit inside it.

The variance budget is shaped differently from the capital budget. Capital is fungible: a million dollars committed to R&D comes out of the same pool as a million committed to sales. Variance is not. A point of variance committed to a new market entry is different from a point committed to an aggressive growth target, because the two carry different correlations with each other and with existing variance. Two initiatives that each contribute three percentage points of earnings CV in isolation may combine to four (correlated) or two (offsetting). The cascade computes the combined number, which makes the variance budget meeting a portfolio optimization over the company's strategic initiatives, with every argument stated in the same units.

Growth and predictability. Boards reward growth heavily, and a CEO proposing to trade growth for something else faces a skeptical audience. Salience supplies a quantitative argument that the trade is sometimes worth making. A growth initiative that adds two percentage points to the topline while adding five points to the earnings CV can destroy enterprise value through multiple compression; a predictability initiative that leaves the topline alone and removes four points of earnings CV creates enterprise value through multiple expansion. Both effects resolve to dollars on the same axis, and the CEO can put two numbers in front of the board. Boards presented with this quantitative argument may prefer the predictability initiative more often than the room's instinct would predict.

The communication problem. The cascade creates a problem the CEO has not had before: the company now has quantitative answers to questions the audiences expect qualitative answers to. "We expect to grow 18 percent next year, with a goal risk of 11 percent" is more accurate than "we expect strong growth," but it may confuse a board member and alarm a lender who aren't conversant in the language of the cascade. The middle path is to use the cascade's outputs to inform a sentence that does not contain cascade vocabulary. "We expect to grow 18 percent next year, and the plan has been stress-tested against the operating uncertainties that have historically driven the largest year-end surprises" is a sentence the CEO can say with confidence, because the cascade has in fact been used to do the stress-testing. Over time the board notices that the CEO's stress-tested plans land closer to the plan than the previous ones did.

The first move. Add a goal risk number to the annual budget. It is a one-line change to a single slide, produced from data the CFO already has. The historical version of the same number, computed

for the prior three or four years, is usually the more interesting figure, because it reveals the variance the company has been carrying without naming it.

17.3. The Management Consultant

A management consultant arrives at a client engagement in a different posture from the people who work there. The consultant has not been with the business for years, does not own its relationships, and will leave when the engagement is over. What the consultant brings instead is a set of analytical tools, a benchmark library from previous engagements, and the detached attention the client's own people cannot afford while running the business.

What the consultant brings that the client cannot. The consultant brings three things the client cannot supply internally: comparison against peers, sustained analytical attention, and freedom to ask uncomfortable questions. The cascade reinforces each. Comparison improves because the cascade produces standardized variance metrics that travel from one client to the next; a consultant who has built a CV benchmark across twenty middle-market software companies has a comparison set that applies to the next software client immediately. Discipline becomes procedural, since the cascade gives the consultant an ordered list of questions to answer on every engagement: what is the revenue CV, where does it originate, how does it propagate to earnings and valuation and cash flow, where are the largest controllable contributors. Freedom to ask uncomfortable questions is underwritten by quantitative weight: an internal manager suggesting the company's earnings quality sits below the industry median can be disputed by other internal managers; a consultant presenting the cascade's decomposition alongside benchmarks from twenty comparable companies is presenting a number that is harder to dismiss.

The diagnostic engagement, reformed. A typical diagnostic engagement begins with a problem the client has noticed but cannot fix — earnings below plan, the board asking why, the leadership team giving different answers. The conventional approach interviews leadership, dives into the financial statements, and constructs a hypothesis from the patterns the consultant identifies. The cascade inverts the order: the consultant starts with the company's CRM, billing, and accounting data, computes the cascade, and arrives at the first leadership interview already knowing where most of the variance lives. The interviews then validate the cascade's findings against the institutional knowledge of the people who run the business.

Table 17.4.: The conventional procedure spends most of its time generating a hypothesis; the cascade-based procedure spends most of its time validating one, which shortens the engagement and makes the deliverable more defensible. The week counts are illustrative rather than measured.

Stage	Conventional	Cascade-based
Data collection	Wk 1–2	Wk 1
Hypothesis generation	Wk 3–5	—
Variance computation	—	Wk 1–2
Interviews	Wk 3–6	Wk 2–3
Hypothesis validation	Wk 5–7	Wk 3–4
Synthesis	Wk 7–8	Wk 4–5
Total	8 weeks	5 weeks

The reframed engagement produces a quantitative attribution rather than a narrative supported by selected data: specific percentages of the company’s earnings variance assigned to specific operational sources, ranked by contribution. The client can still dispute the result, but the dispute now turns on the underlying data, which the client provided. The cascade also becomes part of the client’s analytical infrastructure, computed quarterly from data the company is collecting anyway, and the client can track variance over time without bringing the consultant back.

The cross-industry benchmark. A consultant has access to the CV of every company in their engagement history, computed by the same procedure with the same definitions. The benchmark library that emerges is, after enough engagements, a useful asset. It lets the consultant walk into a new client and say, within the first week, “your earnings CV is in the seventy-fifth percentile for healthcare staffing companies of your size; the largest three sources are these.” Conventional benchmarks are about levels: revenue per employee, gross margin, sales productivity. The cascade benchmark is about variability around those levels, which an individual company cannot easily measure on its own. The library compounds; the economics resemble a research firm’s, where value depends on the depth of the archive.

17.4. The Private Equity Investor

A private equity professional spends most of their working hours producing documents. The investment committee memo justifies a deal to the partners, the sourcing screen filters thousands of candidates down to the few worth pursuing, the hundred-day plan tells the operating partner what to do after closing, and the quarterly LP letter explains what has happened in the portfolio. Each of these documents has a stable format, a recognizable cadence, and a fixed audience that has read hundreds of similar documents. A PE professional who wants to bring a new analytical framework into their work has to do it through these documents, because the documents are where the conversations of the PE business take place.

The cascade is well suited to this kind of insertion, because most of what it produces is a number rather than a process. A new number can be added to a document without redesigning the document. The IC memo acquires one more line, the sourcing screen one more filter, the hundred-day plan one more column, the LP letter one more sentence. Each addition is small in isolation; the aggregate effect, after several deals and a few quarters of letters, is that the PE professional has shifted the analytical foundation of their work without ever announcing that they were doing so.

The IC memo. The cascade adds three lines to the standard format, in the sections where they fit naturally. The financial summary acquires an earnings CV row alongside the EBITDA and growth rates the section already contains. The returns section acquires a RACE number alongside the IRR and MOIC projections, computed at the proposed leverage level using the same operating parameters that drive the IRR. The risks section acquires a breach probability over the hold period and a sensitivity table showing how the breach probability changes if the company's CV is one or two points worse than the central case. The reader who is not looking for them will read the memo as they have always read it. The reader who is looking for them, which over time becomes the entire IC, will use them to ask questions the previous version of the memo did not invite: why the earnings CV is so much higher than the comparable companies the firm has owned, whether the RACE at one turn less leverage justifies the larger equity check, and where the CV threshold sits beyond which the firm's acceptable breach probability is crossed.

The sourcing screen. Most PE firms see far more deal candidates than they can pursue. The cascade adds a screening criterion that most firms have not used because the underlying number was hard to compute from publicly available data: the candidate's earnings CV, estimated from three to five years of quarterly EBITDA available in a CIM or teaser. Candidates above a threshold (say, 35 percent earnings CV for middle-market businesses) are flagged as high-variance, prompting the deal team to consider whether the firm's typical leverage profile is appropriate. A candidate with a 20 percent earnings CV can support the firm's standard 4.5× leverage; a candidate with a 40 percent earnings CV cannot. The filter has a second use that is less obvious: candidates with low estimated earnings CVs that the firm's existing screening criteria would not have flagged are the predictable middle-market businesses producing modest growth and reliable cash flow, which tend to produce strong risk-adjusted returns over a hold period. The firm that systematically pursues them is competing in a less crowded part of the market.

Table 17.5.: Three lines added to the IC memo.

Section	New line
Financials	Earnings CV
Returns	RACE
Risks	Breach prob.

The hundred-day plan. After closing, the operating partner produces a hundred-day plan listing initiatives by expected impact on EBITDA. The cascade adds a column: each initiative gets an estimate of its impact on earnings CV alongside its expected EBITDA impact. The two columns answer different questions. The conventional plan ranks initiatives by expected EBITDA contribution per dollar of investment; the cascade-aware plan ranks by combined effect on expected EBITDA and earnings CV, with the CV effect priced in dollars through the multiple expansion path the cascade computes. Some initiatives that ranked highly on the conventional list rank lower on the cascade-aware list because their CV effect is neutral or negative. Other initiatives that did not appear on the conventional list — variance-reduction interventions like deal desk standardization, churn analytics, customer concentration mitigation — rank highly on the cascade-aware list because their dollar value through the multiple is meaningful even though their EBITDA contribution is modest.

The LP letter. The quarterly LP letter is the document the firm uses to maintain its relationship with its limited partners. The cascade lets the firm say something the standard vocabulary does not. “Apex Industrial finished the quarter at \$26.5 million in revenue against a target of \$28 million, with a quarter-end z-score of 0.7, which is well within the range of normal variation for the company’s current variance profile” is a sentence the firm can write because the cascade has computed all of the inputs. The LP who reads this sentence understands three things: the company missed by a small dollar amount, and the miss is not statistically significant given known variability, which means the firm is not concealing a problem behind a small reported gap. Finally, the LP also understands that this GP is using sophisticated risk management techniques and is speaking the language the LP is accustomed to in other conversations.

The quiet adoption path. The PE professional who wants to introduce the cascade does not need anyone’s permission and does not need to convene a project. The firm has documents the professional already produces; the cascade adds a small number of lines that fit at natural points. After two or three deals, the professional’s IC memos look slightly different from the firm’s other IC memos in a way the partners come to find more useful, and the professional is asked to share their template. After two or three quarterly cycles, the firm’s LP letters have acquired a paragraph the LPs cite as a reason they are leaning toward a re-up in the next fund. This is the way analytical frameworks have always entered the PE business — through a partner who started using the framework on their own deals, found it useful, and kept going — and the cascade is well suited to it because its outputs fit cleanly into documents the firm is already producing.

Changing What You Can See

18.

In which we step back from the machinery, consider what it means in practice, and ask what adoption is worth — to the firm that moves first, and to the market once the rest have followed.

This book has covered a substantial amount of ground. It began with two companies that looked identical on paper and commanded different prices, and it ends with a framework that traces the source of that difference through revenue, earnings, valuation, operating cash flow, debt service, capital efficiency, portfolio construction, acquisition analysis, and the ongoing management cycle. The question that remains is the one the histories of Chapter 2 put to every domain in turn: what does the firm that adopts first stand to gain, and what does the market gain when the rest follow?

18.1. What We Covered

The Saliency framework rests on a small number of ideas that compound as they propagate through the cascade.

Revenue uncertainty can be measured from operational data. Every revenue process generates discrete events, and the uncertainty in those events reduces to two observable factors: how many occur and how large each is. From these the cascade derives a coefficient of variation that captures the degree of uncertainty as a single, scale-free, interpretable number.

That uncertainty cascades through the financial structure of a business. Revenue uncertainty propagates through expense structure into earnings uncertainty, and through valuation models into enterprise value uncertainty. The same uncertainty propagates through a parallel path, through working capital into operating cash flow and through debt service into covenant compliance. Each tier inherits the uncertainty from above and adds its own.

The CV is the number that “earnings quality” has always pointed to. A low CV means an earnings stream reliable enough to plan against; a high CV means one whose outcomes depend on a small number of large events. The market prices the difference, and the cascade traces the price back to its operational sources.

Because the two cascades share a common root, reducing operating uncertainty improves both the equity outcome (higher multiple) and the credit outcome (lower breach probability) simultaneously. This dual benefit creates a compounding return on variance reduction that traditional planning frameworks, which evaluate growth and risk separately, cannot capture.

These five ideas, restated from the chapters where they were developed, are the structural core of the framework. Everything else is application.

Capital structure has an optimum determined by operating uncertainty. RACE combines the expected equity return, the variance penalty from leverage amplification, and the expected cost of financial distress into a single measure that peaks at the leverage level where the marginal benefit of additional debt exactly equals the marginal cost. This optimum is company-specific, derived from the cascade rather than from market convention.

These five ideas, taken together, provide a framework that measures uncertainty at its operational source and traces its consequences through the financial structure, pricing predictability and locating the capital-structure optimum along the way. The framework applies to any company with a sales process and a chart of accounts, and it extends naturally to portfolios, acquisitions, and the ongoing management cycle.

The same machinery points past the boundaries of this edition. Once the cascade is in common use, its volatility output becomes the missing input to contingent-claim pricing for private companies, and its cross-sectional panel becomes the basis for a factor model that measures private-equity beta and alpha directly. Both extensions are forward-looking and depend on prevalence; their analytical preconditions are in place, and they are left for separate treatment.

18.2. Why It Matters

The practical significance of the framework lies in what it makes visible that was previously invisible.

An investor evaluating a company once had to say that its earnings quality was “high” or “low” on qualitative grounds. The same investor, using the cascade, can now say that the earnings CV is 22%, that 24% of the valuation variance comes from churn count risk, and that a \$1.2 million customer success investment is projected to reduce the CV by 4 percentage points and support a 0.5x multiple expansion worth \$15 million in enterprise value.

Leverage sizing follows the same pattern. Until recently a sponsor could say only that “the market will go to 4.5x for a business of this quality.” With the cascade, the same sponsor says that 5.0x produces an 18% breach probability and a RACE of 9.3%, while 3.5x produces a 5% breach probability and a RACE of 9.9%, making the 60 basis points the explicit risk-adjusted cost of the extra leverage.

For a portfolio manager reviewing quarterly results, a \$2 million miss used to be a \$2 million miss that triggered a review. The cascade supplies a z-score: a 0.7 that lands inside the range of normal

variation and needs no intervention, or a 1.8 that warrants investigation because it signals unusual behavior, with the attribution pointing to churn acceleration rather than pipeline timing.

The lending side of the same transactions moves with it. Pricing a loan to a private borrower once meant inferring cash-flow volatility from sector rules of thumb and pricing the covenant package defensively. Working with cascade outputs, the lender sets the covenant threshold and the spread against a computable breach probability and headroom distribution, with the terms reflecting the borrower's measured operating variance rather than the sector average.

In each case, the information was unavailable because the analytical framework did not exist. The judgments that investors, sponsors, and managers made were sound but imprecise. The cascade makes them precise and decomposable, connected to specific operational actions with quantifiable consequences.

18.3. The Firm That Adopts First

Chapter 2 traced four domains through the same transition: a framework arrives that expresses uncertainty in a small number of estimable parameters, and for a period — a decade in some domains, a generation in others — the practitioners who adopt it trade against practitioners who cannot distinguish underpriced risk from overpriced risk. The advantage was structural rather than intellectual. The early adopters did not have better judgment than their peers; they could price what their counterparties could only sense. The same window is now open in private markets, and a few specific gains are immediately available.

The first gain arrives at entry. A buyer who can measure a target's operating variance prices predictability directly: it pays a quality multiple where the CV supports one, declines to pay where the CV isn't accounted for properly, and bids with conviction on the low-CV business the market has priced at its sector multiple. Each pricing decision the firm gets right is a decision some counterparty on the other side got wrong, and the selection compounds across a fund the way the historical adopters' selection compounded across a book of policies or a loan portfolio.

The gains continue through the hold. Leverage sized at the RACE peak carries an extra half-turn where analysis supports it and loses one where it does not, so the adopting firm's vintages breach less often per turn of debt, and its lenders gradually price accordingly. The improvement budget flows to the variance reductions whose re-rating is computed rather than asserted, and reserves flow by marginal gradient rather than by conviction alone, so the same dollars of operating spend and follow-on capital produce more enterprise value than the growth-only budget across town. At

The framework's strongest argument remains a number that changes a decision. A breach probability of 18% that sizes leverage at 3.5x instead of 4.5x is worth more than any presentation about the merits of variance analysis, and the firm that adopts first collects a portfolio of such numbers.

exit, the variance record built over the hold converts “quality of earnings” from an assertion into a documented history, and the seller captures more of the predictability premium the multiple curve of Chapter 7 prices. None of this requires new data. The operating plan already contains the counts, sizes, churn rates, and expense ratios; the cascade is a different computation on inputs the firm already collects, so the advantage is available at the cost of analysis rather than of infrastructure.

These are early-adopter rents, and Chapter 2’s histories are clear about their trajectory: they are largest while adoption is rare and they erode as it spreads. What replaces them is potentially worth more, though it belongs to everyone at once.

18.4. The Market That Adopts

The book opened with two companies at the same EBITDA commanding different prices. This gap was real information, but priced crudely. That is the state of the private market at large: predictability is priced, but in wide and noisy bands, so that multiples for businesses of the same risk are incorrectly dispersed, and part of every spread is inefficient compensation for uncertainty that nobody can practically measure. Salience changes this and gives practitioners the ability to efficiently measure risk. As measurement spreads, the dispersion narrows around the differences that are real. Valuation becomes efficient in a specific, limited sense — prices track measured operating risk — and the two-company gap survives with its explanation attached.

Aggregate returns on equity improve through channels this book has already priced one firm at a time. Capital structures sized to measured variance breach less often, so the deadweight costs of distress — the ten-to-twenty-three percent of enterprise value that Andrade and Kaplan document for escalations — burn up less of the capital stock per turn of debt it carries. Improvement capital and reserve capital flow toward computed marginal returns, variance reduction where the re-rating is largest and coverage where the convexity is steepest, instead of toward the loudest narrative in the budget round. Lenders price spreads against measured breach probabilities rather than sector priors, and the uncertainty premia bundled into equity hurdles compress wherever measurement replaces guesswork. The sum of these is a capital stock that carries its risk where risk is cheapest to carry, which is what a rising aggregate return on equity looks like from underneath.

Markets also deepen when risk becomes legible. Insurance capacity grew when actuarial pricing made treaties tradable, and the derivatives market existed at all only after a pricing framework did; Chapter 2 treats both. The private-market analogue is visible from here: transaction discounts that partly compensate unmeasured

uncertainty shrink, secondaries and continuation vehicles price against measured books, and the cross-sectional panel that prevalence creates becomes the basis for measuring private beta and alpha directly — the missing anchor whose absence Chapter 14 cited when it declined to build a frontier. The extensions this book left for separate treatment are not waiting on mathematics; they are waiting on adoption.

No firm adopts for these reasons. The firm adopts for the rents described above, and the ratchet converts private rents into public efficiency, the same mechanism Chapter 2 documented in every domain that now takes its risk tools for granted.

18.5. A Final Observation

What the framework changes is what can be seen; the facts of the business; revenue, renewals, expenses; and whether or not the uncertainty around them is measured. An investor who can read the CV of a company's earnings sees information an investor without the cascade does not; the same is true for a sponsor comparing breach probabilities across leverage levels, and for an operating partner deciding where to allocate improvement resources against a decomposed variance profile. Each of them makes a different decision than their counterpart without the framework, because the framework exposes a dimension of the business that was previously implicit.

The cascade makes uncertainty visible and decomposable, connected to specific decisions with quantifiable consequences. The history of every domain in which similar tools have been introduced suggests that once practitioners can see this information, they do not choose to unsee it, and the tools ratchet up over time until they become the standard of practice.

The framework is available, and the data it requires is already being collected inside most companies. Whether the ratchet engages at a given firm is now a question of use rather than of availability.

APPENDICES

The specialist extensions of the revenue count-size model, collected from Chapter 5: the non-homogeneous Poisson process for smooth periodic seasonality, the calendar-event indicators and variance blending for concentrated spikes, the pipeline coverage penalty via Little's Law, the Hawkes self-exciting amplifier, the bottom-up construction of cascade parameters from a named-deal pipeline, and the defective Gamma arrival distribution for pre-revenue milestone models. The division of labor is deliberate: the chapter's own technical appendix carries the core derivations its empirical claims stand on, and every extension of that core is developed here.

A.1. Non-Homogeneous Poisson Process for Periodic Seasonality

The non-homogeneous Poisson process is the Cox-decomposition tool that absorbs the deterministic, calendar-driven portion of rate variability into a smooth function of time. Under the Cox decomposition of Section 5.10.2, $\text{Var}(N)$ splits into a within-rate Poisson baseline and a rate-uncertainty term that captures the rate's own period-to-period variability. The over-dispersion parameter ϕ developed in Section 5.10.3 fills the rate-uncertainty bucket as a single dimensionless number, which is the right tool when the rate's variability has no clean calendar source. The NHPP is the right tool when it does. NHPP takes the deterministic portion of the rate's period-to-period variability — the part that follows a known seasonal cycle — and reclassifies it: $\lambda(t)$ becomes a deterministic function of time rather than a stochastic process around an annual mean, which moves the seasonal contribution out of the rate-uncertainty bucket and into a now-time-varying Poisson baseline. After $\lambda(t)$ is fit, the rate-uncertainty bucket holds only the residual stochastic component, which a smaller ϕ can capture if needed.

The compound Poisson model in equation (5.7) assumes a constant arrival rate λ throughout the forecast period. When the calendar imposes structure on the rate (quarter-end pushes, retail seasonality, fiscal-year-end deal compression), the constant-rate assumption no longer fits, and a non-homogeneous Poisson process (NHPP) is the natural extension.

Let $\lambda(t)$ be a deterministic function of time. The cumulative count over $[0, T]$ is then Poisson with parameter

$$\Lambda(T) = \int_0^T \lambda(t) dt, \quad (\text{A.1})$$

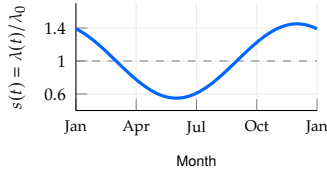


Exhibit A.1: A smooth annual cycle $s(t) = \lambda(t)/\lambda_0$ with a Q4 peak. The dashed line is the constant-rate baseline; the solid curve is the seasonal index the NHPP fits with one Fourier harmonic. The curve integrates to the period length T , so λ_0 remains the annual mean.

which is the time-varying analogue of the constant-rate quantity λT . Mean and variance of the count are both $\Lambda(T)$, and the compound-Poisson derivation carries through unchanged with $\Lambda(T)$ in place of λT :

$$\text{Var}(R) = \Lambda(T) \cdot E[S^2]. \quad (\text{A.2})$$

The constant-rate case is recovered when $\lambda(t) = \lambda$, in which case $\Lambda(T) = \lambda T$ and equation (A.2) reduces to equation (5.7). The seasonal structure has moved out of the rate-uncertainty bucket — where over-dispersion would have placed it — and into a now-time-varying Poisson baseline that the deterministic $\lambda(t)$ absorbs.

The natural parameterization for monthly or quarterly seasonality is the multiplicative form

$$\lambda(t) = \lambda_0 \cdot s(t), \quad (\text{A.3})$$

where λ_0 is a baseline arrival rate and $s(t)$ is a normalized seasonal index that integrates to the period length. For monthly data, s is a length-twelve vector with $\sum_t s(t) = 12$; the seasonal index for January is the ratio of January's typical arrival rate to the annual average. The decomposition lets the cascade attribute revenue variance to its operational sources independently of seasonal level shifts: λ_0 captures the underlying business, and $s(t)$ captures the calendar.

In practice, a small number of Fourier harmonics produces a smooth seasonal index from observed data:

$$\log \lambda(t) = \beta_0 + \sum_{k=1}^K [\alpha_k \cos(2\pi kt/T) + \beta_k \sin(2\pi kt/T)]. \quad (\text{A.4})$$

$K = 1$ captures the dominant annual cycle. $K = 2$ adds a half-year harmonic that reaches quarterly structure. Higher harmonics tend to overfit on single-year data. The parameters are estimated by ordinary least squares on log-counts, or by Poisson regression for low-count regimes.

The seasonal index $s(t)$ does not enter the regression as a separate quantity. Comparing equation (A.3) in log form, $\log \lambda(t) = \log \lambda_0 + \log s(t)$, with the Fourier form (A.4), the intercept β_0 corresponds to $\log \lambda_0$ and the harmonic sum corresponds to $\log s(t)$. Both pieces are recovered from the same fit by exponentiation: $\lambda_0 = \exp(\beta_0)$ and $s(t) = \exp(\sum_k [\alpha_k \cos(2\pi kt/T) + \beta_k \sin(2\pi kt/T)])$. The harmonics each integrate to zero over $[0, T]$, so $\int_0^T \log s(t) dt = 0$, but Jensen's inequality makes $\int_0^T s(t) dt$ slightly exceed T for non-trivial amplitudes. A small post-fit renormalization scales $s(t)$ so that $(1/T) \int_0^T s(t) dt = 1$ exactly, with a compensating shift in λ_0 . The renormalization preserves the convention that λ_0 is the time-averaged arrival rate rather than the log-mean rate.

The model has a documented boundary. Smooth Fourier harmonics cannot reproduce sharp discrete spikes that occupy a small share

of the period (Black Friday week, end-of-quarter compression, conference-driven bursts in enterprise software). For businesses with strong discrete-event seasonality, the NHPP is augmented with calendar-event indicators of the form $\beta_e \mathbf{1}\{t = t_e\}$, where t_e is the period containing the event. The augmented model adds one parameter per named event and remains within the same NHPP framework. The variance-side counterpart of the indicator augmentation is developed in Section A.2. For businesses whose seasonality is broadly periodic, the smooth NHPP with two harmonics is sufficient.

A.2. Calendar-Event Indicators and Variance Blending

Calendar-event indicators are the Cox-decomposition tool for absorbing concentrated discrete-event rate structure that the smooth NHPP cannot resolve. Where the NHPP of Section A.1 handles smooth periodic variation by making $\lambda(t)$ a deterministic function over the year, the indicator partitions the year into named event regimes (Black Friday week, fiscal-year-end compression, conference-driven bursts) and their complements, treats the regime assignment as deterministic, and fits separate compound Poisson parameters within each regime. The across-regime variation in λ that would otherwise inflate the Cox rate-uncertainty bucket is now absorbed into the deterministic regime classification (which days belong to the event, which days do not), leaving only within-regime stochastic variation for that bucket. The mechanics differ from NHPP — a partition into discrete regimes rather than a smooth function of time — but the structural role in the Cox decomposition is the same: deterministic structure moves out of the rate-uncertainty term and into a now-conditional-on-regime Poisson baseline.

The NHPP indicator from Section A.1 adds a coefficient on the rate at the period containing the named event. The variance attribution requires a parallel construction: a partition of the year into the named-event window and its complement, and an additive blend of regime-specific variances into the annual variance.

Let $W_e \subset [0, T]$ be the set of days inside a named event of length T_e , and let W_e^c be the complementary $T - T_e$ days. The compound Poisson parameters are estimated within each window independently:

$$\begin{aligned} \lambda_e &= \frac{1}{T_e} \sum_{d \in W_e} N_d, & \sigma_{\lambda_e}^2 &= \text{Var}_{W_e}(\lambda_d), \\ \lambda_{e^c} &= \frac{1}{T - T_e} \sum_{d \in W_e^c} N_d, & \sigma_{\lambda_{e^c}}^2 &= \text{Var}_{W_e^c}(\lambda_d). \end{aligned} \quad (\text{A.5})$$

The deal-size moments $E[S]$, $\text{Var}(S)$ may be estimated globally or per regime; the empirical UCI Online Retail data shows little regime variation in the size distribution, but a discount-driven event might.

Within a regime, the count variance under the Cox decomposition (Section 5.10.2) carries both the within-rate Poisson term and the rate-uncertainty term:

$$\text{Var}(N_e) = \lambda_e T_e + T_e^2 \cdot \sigma_{\lambda_e}^2. \quad (\text{A.6})$$

The regime's revenue variance follows from propagating $\text{Var}(N_e)$ through the law-of-total-variance identity (5.3), exactly as in the over-dispersion case (5.13):

$$\text{Var}(R_e) = \lambda_e T_e \cdot E[S_e^2] + \mu_e^2 \cdot T_e^2 \cdot \sigma_{\lambda_e}^2, \quad (\text{A.7})$$

where $\mu_e = E[S_e]$. The first term is the regime's Poisson-baseline revenue variance; the second is the within-regime rate-uncertainty contribution.

Annual revenue is the sum of regime revenues across the disjoint day sets:

$$R_{\text{annual}} = R_e + R_{e^c}. \quad (\text{A.8})$$

Under independence across regimes, annual variance is the sum of regime variances:

$$\text{Var}(R_{\text{annual}}) = \text{Var}(R_e) + \text{Var}(R_{e^c}). \quad (\text{A.9})$$

This is the days-weighted blend the framework uses for the concentrated-calendar-event (Black-Friday) case. Equivalently, in per-day variance rates $v_e = \text{Var}(R_e)/T_e$ and $v_{e^c} = \text{Var}(R_{e^c})/(T - T_e)$,

$$\text{Var}(R_{\text{annual}}) = T_e \cdot v_e + (T - T_e) \cdot v_{e^c}, \quad (\text{A.10})$$

which is the formulation an operator may find more natural to compare regimes.

The partition pulls structural across-regime variation into the deterministic component (which regime each day occupies) and leaves only stochastic variation inside the regime-specific count-variance estimates. The pooled compound Poisson without a calendar adjustment makes the opposite bargain: it treats deterministic monthly seasonality as random sampling noise, which inflates $\text{Var}(N)$ and produces an annual variance prediction that exceeds the truth by a factor proportional to the seasonality strength. The cost of the partition is one indicator parameter per named event and a doubling of the count-size estimation work — one set of parameters within the event window, one outside it. The benefit is that the framework attributes variance to the named event explicitly, which surfaces in the variance attribution as a separate row the operator can target.

The estimator's empirical performance has two parts. On a synthetic process calibrated to the UCI Online Retail II invoice statistics — where the analytical annual variance is known by construction — the partition-and-blend recovers it essentially exactly across eight independent year realizations, with the Black-Friday window's variance contribution recovered to within thirteen percent, while the pooled compound Poisson with no calendar adjustment over-predicts annual variance by roughly twelve times: the cost of treating deterministic calendar concentration as ordinary noise. On the real two-year UCI Online Retail II data, applied leave-one-year-out across 2010 and 2011, the predicted variance bands cover all twenty-three monthly observations at two standard deviations and seventeen at one, with binomial coverage p -values of 0.63 and 0.66 against the predicted rates.

A.3. Pipeline Coverage via Little's Law

A second amplifier of count variance, structurally distinct from temporal clustering, comes from pipeline depth. The compound Poisson model treats the arrival rate as a property of the process; in practice, the rate the company can sustain depends on the pipeline of opportunities feeding it. When the pipeline is short, the same target close count is being drawn from a smaller and slower base, and the count variance amplifies.

Little's Law from queueing theory provides the bridge. In steady state, the average number of items in a queue equals the average arrival rate times the average time each item spends in the queue. Applied to a sales pipeline with $\bar{L}$ active opportunities and an average cycle time $\bar{W}$ from entry to close, the implied close throughput is $\bar{L}/\bar{W}$. The coverage ratio compares this throughput to the period's target deal count λ_{target} :

$$R = \frac{\bar{L}/\bar{W}}{\lambda_{\text{target}}}. \quad (\text{A.11})$$

When $R \geq 1$, the pipeline can deliver the target at its current depth and velocity. When $R < 1$, it is short, and the framework applies a multiplicative penalty to the count variance:

$$P(R) = 1 + c \cdot [\max(0, 1 - R)]^2, \quad (\text{A.12})$$

with c a curvature parameter (default $c = 2$). P collapses to one in the adequate regime and rises quadratically as the gap widens. The amplified count variance enters the compound Poisson formula in place of $\text{Var}(N)$ from equation (5.7):

$$\text{Var}(N)_P = P(R) \cdot \text{Var}(N). \quad (\text{A.13})$$

The functional form $P(R) = 1 + c \cdot [\max(0, 1 - R)]^2$ is a parsimonious heuristic rather than a closed-form derivation from a specific queueing model. It captures the right qualitative behavior — unilateral, smooth at $R = 1$, unbounded as $R \rightarrow 0$ — and the curvature parameter c is adjustable from data when an organization has enough historical pipeline-coverage observations to fit it. A rigorous derivation would require committing to a specific stochastic model of the pipeline (M/M/1 with finite buffer, branching-process funnel, GI/G/1 with abandonment) that the framework does not pin down. The penalty is the cascade’s working substitute for a result the queueing literature does not supply in closed form for the finite-period sales setting.

Propagating to revenue variance. The amplified $\text{Var}(N)$ enters the law-of-total-variance identity (5.3) on the count-risk side; the size-risk side $\sigma^2 \cdot E[N]$ is unchanged because pipeline depth does not affect size dispersion. Under the Poisson baseline:

$$\begin{aligned}\text{Var}(R)_P &= \sigma^2 \cdot \lambda T + \mu^2 \cdot P(R) \cdot \lambda T \\ &= \lambda T \cdot E[S^2] + (P(R) - 1) \cdot \mu^2 \cdot \lambda T.\end{aligned}\tag{A.14}$$

The first term is the Poisson-baseline revenue variance from equation (5.7); the second is the pipeline-deficit add-on. The add-on scales with λT rather than with $(\lambda T)^2$ as over-dispersion does, because pipeline depth amplifies count variance multiplicatively rather than introducing rate uncertainty across periods, and the count variance under the Poisson baseline is itself λT . The add-on vanishes when $P(R) = 1$.

The penalty is unilateral. An over-covered pipeline does not reduce variance, because the binding constraint is the number of closes, not the number of opportunities sitting upstream of them. The variance attribution exposes the gap as a separate component named the pipeline coverage gap, and the variance reduction advisor identifies the corresponding lever as pipeline generation or cycle-time compression.

A.4. Hawkes Self-Exciting Clustering and the Branching Ratio

The over-dispersion parameter ϕ in equation (5.11) captures temporal clustering whose source is exogenous to the sales process: the calendar, the customer’s budget cycle, the seasonal demand pattern. A separate kind of clustering originates inside the process itself, when a closed deal raises the probability of further closes in its temporal neighborhood through referral chains, sales-team

energy effects, or reference-account flywheels. The trigger is endogenous, and the clustering compounds within the period rather than appearing on a fixed calendar.

The standard model for this dynamic is the self-exciting point process, of which the Hawkes process is the canonical example.¹ A Hawkes process has a baseline arrival rate plus an excitation term that increases the rate following each event, with the excitation decaying over time. The branching ratio n summarizes the long-run effect: it is the expected number of follow-on events triggered by each parent event over the process's history. When $n = 0$, the process reduces to the Poisson baseline. As n approaches one, the process approaches a critical regime in which variance diverges, and the framework restricts n to the subcritical range $0 \leq n < 1$.

Within the subcritical regime, the Hawkes amplifier on count variance is:

$$H(n) = \frac{1}{(1 - n)^2}. \quad (\text{A.15})$$

H equals one at $n = 0$ and rises sharply as n approaches the critical boundary. At $n = 0.5$, $H = 4$; at $n = 0.7$, $H \approx 11$; at $n = 0.9$, $H = 100$.

The amplifier $H(n) = 1/(1 - n)^2$ is the standard count-variance result for the stationary linear Hawkes process in the subcritical regime, derived from the cluster-process representation in which each baseline immigrant spawns a Galton-Watson cluster of expected size $1/(1 - n)$ (Hawkes 1971; Hawkes & Oakes 1974).² The result holds asymptotically when the observation window is long relative to the excitation kernel's decay time, which the cascade's quarterly-and-longer horizons satisfy for typical referral and reference-account dynamics that decay over weeks to a few months. Unlike the pipeline coverage penalty of Section A.3, $H(n)$ is not a constructed heuristic; the framework's contribution is the application — using $H(n)$ as a multiplicative correction on $\text{Var}(N)$ within the compound Poisson formula, which composes cleanly because the Hawkes amplifier acts on the count alone and leaves the independent size distribution untouched.

The amplifier multiplies the count variance term in the compound Poisson formula. Combined with the pipeline coverage multiplier from Section A.3, the count variance under both adjustments is:

$$\text{Var}(N)_{P,H} = P(R) \cdot H(n) \cdot \text{Var}(N). \quad (\text{A.16})$$

Propagating to revenue variance. The stacked count-variance amplifier propagates to revenue variance through the same identity, again leaving the size-risk side untouched. Under the Poisson baseline:

1: Hawkes processes have prior art in this exact domain: Yan and coauthors modeled sales pipelines with mutually exciting point processes to forecast win propensity at IBM[18]. The framework uses the same process family for a different output — the count-variance amplification $H(n)$ that self-excitation adds to a period forecast.

2: Hawkes, A. G. (1971). "Spectra of some self-exciting and mutually exciting point processes." *Biometrika* 58. Hawkes, A. G. & Oakes, D. (1974). "A cluster process representation of a self-exciting process." *Journal of Applied Probability* 11.

$$\text{Var}(R)_{P,H} = \lambda T \cdot E[S^2] + (P(R) \cdot H(n) - 1) \cdot \mu^2 \cdot \lambda T. \quad (\text{A.17})$$

Both amplifiers enter as multiplicative factors on the count channel; neither touches size dispersion. The combined add-on collapses to zero when both amplifiers sit at their identity ($R \geq 1$ and $n = 0$), recovering equation (5.7).

The multipliers stack because the two mechanisms are mechanistically independent: pipeline depth concerns the input side of the process, while Hawkes excitation concerns the dynamics of close events themselves. The variance attribution exposes each as a separate component, and the framework treats them as separately addressable through different operational levers, with pipeline generation addressing P and deal-flow architecture and reference-program design addressing H .

A.5. From Named Deals to Compound Poisson Parameters

Chapter 5's main text described the intuitive connection between CRM pipeline data and the cascade's revenue-tier parameters. This section develops the connection formally and works a numerical example.

A quarterly pipeline contains n named deals, each characterized by a close probability p_i and a contracted value V_i . Some deals also carry value uncertainty: the final contract may land above or below V_i depending on negotiation, scope changes, or discount approvals. Let σ_{V_i} denote the standard deviation of deal i 's value, conditional on closing.

Each deal is a Bernoulli trial. Deal i contributes to period revenue an amount R_i that equals V_i (plus noise) with probability p_i and zero with probability $1 - p_i$. The expected value and variance of R_i are:

$$E[R_i] = p_i \cdot E[V_i] \quad (\text{A.18})$$

$$\text{Var}(R_i) = p_i(1 - p_i) \cdot E[V_i]^2 + p_i \cdot \sigma_{V_i}^2 \quad (\text{A.19})$$

The first term in (A.19) is the close-or-not uncertainty: the Bernoulli variance of whether the deal happens, scaled by the deal's value squared. The second term is the conditional size uncertainty: the dispersion of the final value around the contract, weighted by the probability that the deal closes at all. A deal with $p_i = 0.90$ and no value uncertainty contributes almost all of its variance from the residual 10% chance it does not close. A deal with $p_i = 0.40$ and

moderate value uncertainty contributes substantially from both sources.

Total period revenue is the sum across named deals plus a *pipeline residual* term R_{res} for pipeline not yet individually identified:

$$R = \sum_{i=1}^n R_i + R_{\text{res}} \quad (\text{A.20})$$

Assuming independence across deals (a reasonable approximation for most pipelines, since individual deal outcomes depend on buyer-specific factors rather than shared market conditions; the bottom-up treatment of self-excitation when this approximation breaks down is developed in the paragraphs that follow), the period variance is:

$$\text{Var}(R) = \sum_{i=1}^n \text{Var}(R_i) + \text{Var}(R_{\text{res}}) \quad (\text{A.21})$$

The connection to the compound Poisson is direct. The named-deal count $\lambda_{\text{named}} = \sum p_i$ is the sum of close probabilities. The expected size $\mu = (\sum p_i E[V_i]) / \lambda_{\text{named}}$ is the probability-weighted average deal value. The size variance σ^2 is the probability-weighted second moment of the value distribution. Substituting these into the compound Poisson variance formula $\lambda_{\text{named}} \mu^2 + \lambda_{\text{named}} \sigma^2$ approximates the named-deal contribution to (A.21): the Poisson form carries a count variance of p_i per deal where the Bernoulli sum carries $p_i(1 - p_i)$, so the approximation overstates the named-deal variance by $\sum_i p_i^2 V_i^2$ and converges to the exact sum as individual close probabilities shrink. The bottom-up formula is the exact treatment, with the compound Poisson form as its small-probability limit. The pipeline residual contributes an additional $\text{Var}(R_{\text{res}})$ that the next paragraph expands into count and size terms of its own.

Relating the three counts. The development so far has worked with a single count, the named-deal count λ_{named} . Two additional counts complete the reconciliation the main text developed in prose, and all three relate to each other in a simple algebra.

The *pipeline-residual count* λ_{res} is the expected number of deals from the pipeline residual — the unidentified pipeline the company expects to materialize from late-stage activity, inbound leads, and quarter-end urgency. The pipeline residual's expected revenue $E[R_{\text{res}}]$, its count λ_{res} , and its expected deal size $\mu_{\text{res}} = E[R_{\text{res}}] / \lambda_{\text{res}}$ are all directly estimable from historical conversion data. A sales operations team that carries the pipeline residual as a single plugged revenue number is aggregating both count and size without naming either, which is the usual reason its variance contribution ends up unmeasured.

The *target-implied count* $\lambda_{\text{target}} = R_{\text{target}}/\mu$ comes from the top-down view the book has used when discussing revenue plans, where R_{target} is the revenue target and μ is the expected deal size. The *total bottom-up count* is the sum of the named-deal and residual counts:

$$\lambda_{\text{total}} = \lambda_{\text{named}} + \lambda_{\text{res}} \quad (\text{A.22})$$

The ratio of the two bottom-up-versus-top-down views is the pipeline coverage metric the main text referenced:

$$\text{Coverage} = \frac{\lambda_{\text{total}}}{\lambda_{\text{target}}} \quad (\text{A.23})$$

A coverage below one indicates a pipeline that does not yet underwrite the target and calls for additional demand generation. A coverage above one indicates over-coverage, which sometimes reflects deliberate conservatism in the plan and sometimes reflects sandbagging the organization should surface. Either way, the pipeline residual is the component the sponsor can move most quickly, because it represents deal activity already under way rather than deals that need to be sourced from nothing.

The worked example below carries named-deal variance and pipeline-residual variance as separate additive contributions to the period total, consistent with (A.21). When the reader interprets the example's CV as a scale-free measure of forecast uncertainty, λ_{total} is the count that sits in the denominator of expected revenue.

Seasonality in the bottom-up view, mapped to the top-down hierarchy. Each of the three counts in equations (A.22)–(A.23) carries its own seasonality treatment, and the three taken together are the bottom-up counterpart of the top-down rate-uncertainty hierarchy in Section 5.10.2.

The named-deal count λ_{named} inherits its seasonality from the close probabilities. A Q4-push deal carries a higher p_i in Q4 than in Q1 because the CRM's stage model absorbs fiscal-year dynamics through rep history and deal age. The named-deal variance terms therefore need no explicit seasonality adjustment in the bottom-up view; the period-specific p_i values play the role that the smooth NHPP $\lambda(t)$ from Section A.1 plays for the rate.

The target-implied count λ_{target} inherits its seasonality from the operating plan it was derived from. If management set a Q4 target that reflects the company's usual Q4 weighting, λ_{target} is already seasonally appropriate, and no further adjustment is required.

The pipeline residual is where explicit treatment is needed. It aggregates unidentified pipeline whose timing is not yet known,

and that activity clusters toward the end of the period — quarter-end urgency enlarges λ_{res} and inflates $\text{Var}(R_{\text{res}})$ in a way that varies systematically across periods. The operational form is period-matched historical estimation: fit the pipeline residual to prior Q4s when forecasting Q4, rather than to an annualised blend. Period-matched data absorbs the seasonality implicitly, because the historical distribution already reflects it. This is the bottom-up counterpart of the top-down NHPP $\lambda(t)$: it absorbs deterministic period structure into the model rather than pushing it into the rate-uncertainty bucket. When period-matched data is not available, the ϕ adjustment from Section 5.10.3 applies to $\text{Var}(R_{\text{res}})$ as a second-best correction; this is the same residual rate uncertainty ϕ as in the top-down view, applied at the bottom-up's sole rate-uncertainty surface.

A bottom-up counterpart of the top-down calendar-event indicator from Section A.2 appears the same way: a discrete-event spike that smooth periodic seasonality cannot resolve (Black Friday, fiscal-year-end compression) is handled by fitting a separate pipeline residual for the event window and the non-event window, and adding the two contributions to the period total. The cost and benefit of the bottom-up partition match the top-down case described in Section A.2: one extra named-event parameter and a doubling of pipeline-residual estimation work, in exchange for an explicit named-event row in the variance attribution.

The pipeline coverage adjustment from Section A.3 requires no parallel paragraph because it emerges naturally from the bottom-up view: the coverage ratio in equation (A.23) is a direct measurement of pipeline depth, and a coverage shortfall absorbs into $\text{Var}(R_{\text{res}})$ as more of the period's expected revenue is asked to come from unidentified pipeline. The Little's Law penalty's role in the top-down view — amplifying $\text{Var}(N)$ when pipeline is short — is played in the bottom-up view by the residual carrying a larger expected count and a correspondingly larger variance contribution.

Self-excitation in the bottom-up view. The Hawkes amplifier from Section A.4 captures self-excitation across deals — a closed Acme deal raising the probability that Beta also closes through a referral chain, sales-team momentum, or a reference-account flywheel. The deal-level independence assumed in equation (A.21) holds for most pipelines, where buyer-specific factors dominate cross-deal coupling, but two routes address the cases where it does not. The first is to adjust individual close probabilities directly: the CRM's stage model carries a post-close lift on downstream deals, raising p_j for deal j once a parent deal i closes by an amount the sales operations team estimates from prior referral data. This is the deal-level analogue of the NHPP's per-period p_i adjustment for seasonality — structure absorbed into the close-probability inputs themselves rather than added as a separate amplifier — and it is the right tool when the company can identify which downstream deals

benefit from each parent close. The second is to apply $H(n) = 1/(1-n)^2$ from Section A.4 as a multiplicative correction to the named-deal variance contribution in equation (A.21), with the branching ratio n fit from the company's historical close-clustering data — the typical post-close burst in the days following a major win. This second route is the right tool when self-excitation is diffuse rather than tied to specific downstream deals, and it composes with the existing bottom-up variance the same way the top-down Hawkes amplifier composes with the compound Poisson formula.

Table A.1.: The five top-down rate-and-dependence adjustments, with their bottom-up counterparts.

Top-down tool	Bottom-up handling
NHPP $\lambda(t)$ (smooth seasonality, Section A.1)	Period-specific p_i ; period-matched fit for $\text{Var}(R_{\text{res}})$
Partition-blend (discrete events, Section A.2)	Separate residual fit per event window
ϕ over-dispersion (residual rate uncertainty, Section 5.10.3)	ϕ on $\text{Var}(R_{\text{res}})$ when period-matched data unavailable
Pipeline coverage $P(R)$ (Section A.3)	Coverage shortfall absorbs into $\text{Var}(R_{\text{res}})$
Hawkes $H(n)$ (self-excitation, Section A.4)	Post-close lift on downstream p_i , or $H(n)$ on named-deal variance

Worked example. A quarterly pipeline contains eight named deals, a residual bucket for late-arriving pipeline, and a renewal stream. The table below computes expected value and variance contribution for each source using (A.18) and (A.19), with $\sigma_{V_i} = 0$ for simplicity (no value uncertainty conditional on close).

Table A.2.: Eight named deals, a pipeline residual, and renewals. Total expected revenue: \$7.45M. Forecast standard deviation: \$1.15M. Forecast CV: 15.4%. The variance contribution column ranks deals differently from the size column: Echo Systems (third by size) leads in variance contribution because its 40% close probability leaves the largest uncertain swing.

Source	Value	p	E[Rev]	Var contrib
Acme Corp	\$1.20M	0.90	\$1.08M	0.130
Beta LLC	\$0.80M	0.50	\$0.40M	0.160
Carter & Co	\$0.95M	0.85	\$0.81M	0.115
Delta Group	\$0.60M	0.30	\$0.18M	0.076
Echo Systems	\$0.90M	0.40	\$0.36M	0.194
Foster Inc	\$0.45M	0.55	\$0.25M	0.050
Granite Co	\$0.50M	0.70	\$0.35M	0.053
Helix Health	\$0.35M	0.60	\$0.21M	0.029
Pipeline residual	—	—	\$2.36M	0.420
Renewals expected	—	—	\$1.45M	0.090
Total			\$7.45M	1.317
Std dev				\$1.15M
CV				15.4%

The eight named deals contribute a combined expected count of $\sum p_i = 4.80$ closings at a probability-weighted average value of \$757K. The pipeline residual, estimated from the company's historical late-pipeline conversion using the period-matched form of the previous paragraph, contributes the largest single variance term (0.420) because it aggregates a set of unidentified events each with their own close uncertainty. The renewal stream, by contrast, contributes modestly (0.090) because renewal probabilities are

high and the values are known from existing contracts.

The exercise produces the same three numbers the compound Poisson works with — expected count, expected size, size CV — derived from the bottom up rather than assumed from the top down. The head of revenue who runs this computation on the quarterly pipeline has, without additional modeling, a goal risk for the quarter and a variance attribution that ranks every deal by its contribution to forecast uncertainty.

A.6. The Defective Gamma Distribution for Pre-Revenue Models

Pre-revenue companies are modeled through a defective Gamma arrival process. Each milestone has a random arrival time T drawn from a Gamma distribution, gated by a feasibility probability q that captures the chance the milestone is achievable at all.

The probability of achieving the milestone within the forecast horizon H is:

$$P(\text{achieved}) = q \cdot F_{\text{Gamma}}(H; k, \theta) \quad (\text{A.24})$$

where k is a shape parameter (controlling how concentrated the timing uncertainty is around the expected month) and $\theta = E[\text{month}]/k$ is a scale parameter. The expected months of revenue production within the horizon is $E[(H - T) \cdot \mathbf{1}(T \leq H)]$; dividing by the achievement probability of equation (A.24) gives the expectation conditional on achievement, which determines how much revenue the company generates if the milestone is reached.

The variance of the milestone's revenue contribution has two layers: arrival variance (the uncertainty in whether and when the milestone is reached) and magnitude variance (the uncertainty in revenue conditional on achievement). Both are computed from the Gamma distribution's moments and combined through the law of total variance.

The Geometry of Shared Variance

B.

The signed shared-fraction rule of Chapter 13 derived as a statement about angles rather than about square roots, and a scenario-based cross-check on any correlation the elicitation produces.

B.1. Correlation as an Angle

The correlation between two standardized variables is the cosine of the angle between their vectors.¹ That reading turns the elicitation rule into a fact about geometry, and it explains the two features of the rule that are otherwise hard to motivate: the square root, and the sign.

Write company i 's source- s contribution against a standardized shared driver F , with ε_i independent of F and of every other company's residual:

$$X_i = \sqrt{a_i} F + \sqrt{1 - a_i} \varepsilon_i. \quad (\text{B.1})$$

The correlation between X_i and the driver follows immediately:

$$\text{corr}(X_i, F) = \sqrt{a_i} = \cos \theta_i, \quad \text{so} \quad a_i = \cos^2 \theta_i. \quad (\text{B.2})$$

The elicited fraction is the squared cosine of the angle between the company's source and the driver. This is the same quantity a regression would report as the proportion of variance accounted for, which is why the sponsor's question — what share of this company's churn is market-driven — is answerable at all. It asks for an R^2 , in the units practitioners already use.

Two companies each tilted toward F , with residuals independent of one another, compose by direction cosines:

$$\cos \alpha_{ij} = \cos \theta_i \cos \theta_j, \quad \text{that is} \quad \rho_{ij} = \sqrt{a_i a_j}. \quad (\text{B.3})$$

The square root in the elicitation rule is not an algebraic convenience. It is the projection of two vectors onto a common axis, and the rule is the statement that their correlation is the product of what each retains along it.

1: Rodgers and Nicewander (1988) collect thirteen readings of the correlation coefficient; this is their eighth. The vectors live in the space whose axes are observations rather than variables, so two variables measured on n observations are two vectors in n -space, and the angle between them is the object of interest.

B.2. Why the Fraction Loses the Sign

The geometry also shows what the fraction discards. A holding that responds against the driver sits at an angle near 180° , and

$$\cos^2(180^\circ) = \cos^2(0^\circ) = 1. \quad (\text{B.4})$$

A variance fraction is the square of a cosine, so it is blind to reflection through the origin. Perfect alignment and perfect opposition produce the identical elicited number, and every intermediate pair of opposed angles collides with its aligned counterpart in the same way. The information is not lost in the composition; it is lost in the question, before the composition ever runs.

Restoring it requires one bit, the sign of $\cos \theta_i$ rather than its magnitude, which is the direction z_i the sponsor supplies alongside the magnitude. The loading becomes $z_i \sqrt{a_i}$, and the composition (B.3) becomes $\rho_{ij} = z_i z_j \sqrt{a_i a_j}$, which is equation (13.1).

Carrying a sign outside the radical is the standard form for identities of this shape rather than a repair to this one. The classical relation between the correlation and the two regression slopes is written

$$r = \pm \sqrt{b_{Y \cdot X} b_{X \cdot Y}}, \quad (\text{B.5})$$

with the sign supplied by the covariance and not recoverable from the two slopes, which are both non-negative whenever the relation is monotone in either direction. The geometric mean fixes the magnitude; something outside it fixes the sign.

A further consequence is worth recording. Because a driver enters as a signed loading on each company it reaches, its contribution to the covariance matrix is an outer product of the loading vector with itself, and an outer product is positive semidefinite for any real vector. Signs cannot break the condition, however many drivers are elicited and however they are directed. Only cells set pairwise, with nothing enforcing consistency across three holdings at once, can do that.

B.3. A Scenario Cross-Check

Any correlation the elicitation produces can be checked against a question the sponsor answers from memory rather than from arithmetic. The check is Galton's original reading of the coefficient, as a ratio of two conditional means.²

For standardized X and Y , select on X above some threshold X_c and average the induced Y :

$$r = \frac{\mu(Y \mid X > X_c)}{\mu(X \mid X > X_c)}. \quad (\text{B.6})$$

2: Rodgers and Nicewander's thirteenth reading, and the one on which Galton's own calculations were based. The identity requires bivariate normality of the standardized pair; the check is a sanity test on an elicited number, not an estimator.

The correlation is the fraction of the selected deviation that carries across. In the sponsor's terms: *in the quarters where Meridian's churn ran unusually badly — the worst tenth, say — how badly did Clearview's usage contraction run, measured in Clearview's own standard deviations?* If the answer is that Meridian was two standard deviations out and Clearview typically a fifth of one, the implied correlation is about 0.1.

The check has three uses. It is stated in scenarios rather than in fractions, so it draws on a different part of the sponsor's judgment than the elicitation does, and agreement between the two is evidence rather than restatement. It returns a signed answer natively, so a hedge appears as a negative response to an ordinary question. And a sharp disagreement between the scenario answer and the composed correlation localizes the problem: either a driver's magnitudes are wrong, or the sponsor's recollection of the joint history is, and knowing which of the two is at issue is worth more than either number alone.

It is a check and not a substitute. The identity assumes bivariate normality and is conditioned in the tail, where that assumption is weakest. It returns a company-level correlation rather than a source-level one, so it cannot populate the composition, which needs the decomposition by source that only the driver route supplies.

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