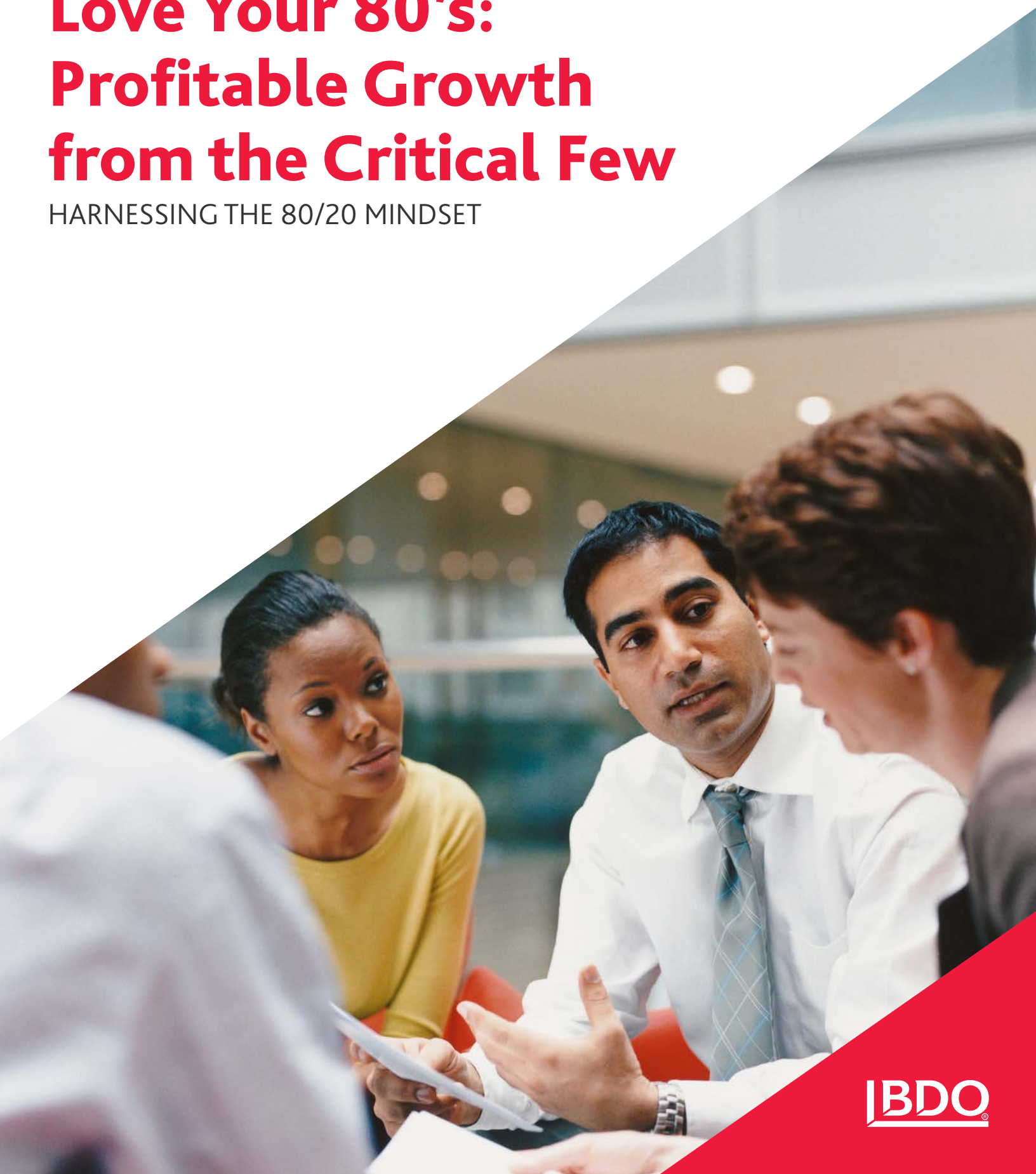# Love Your 80's: Profitable Growth from the Critical Few

HARNESSING THE 80/20 MINDSET

BDO

GROW YOUR BUSINESS WITH THE 80/20 PRINCIPLE

Imagine you harvest fruit from an orchard, and you notice that just 20% of the trees produce 80% of the fruit. This surprising result demonstrates unequal distribution, and it likely occurs day after day in your business. You can follow the 80/20 principle to identify areas where your business could improve, and then use that data to streamline operations and optimize the organization to create profitable growth.

Also known as the Pareto principle, its namesake, Italian economist Vilfredo Pareto, did not envision that his principle would recur across so many different industries. A century later, the 80/20 distribution has been studied in a wide range of fields, from sales to human resources and betting odds to computing coding, and even in which clothes get picked from the closet.

Data reinforces the 80/20 principle, and it yields powerful insights about the profitability of a business. This approach can highlight many issues, such as variability in profit levels for different customers, products and services. It also provides insights about where to develop and retain talent, invest in digital transformation and improve organizational effectiveness. Harnessing these insights to inform strategic decision making helps to better align an organization's precious resources and focus on goals that drive profitable growth.

IDENTIFYING PROFITABILITY

If everything is a priority, then nothing is a priority. The 80/20 mindset provides a lens to help your business determine where the focus should be.

When you become attuned to this principle, you realize that a similar distribution surprisingly appears again and again across a business. For example:
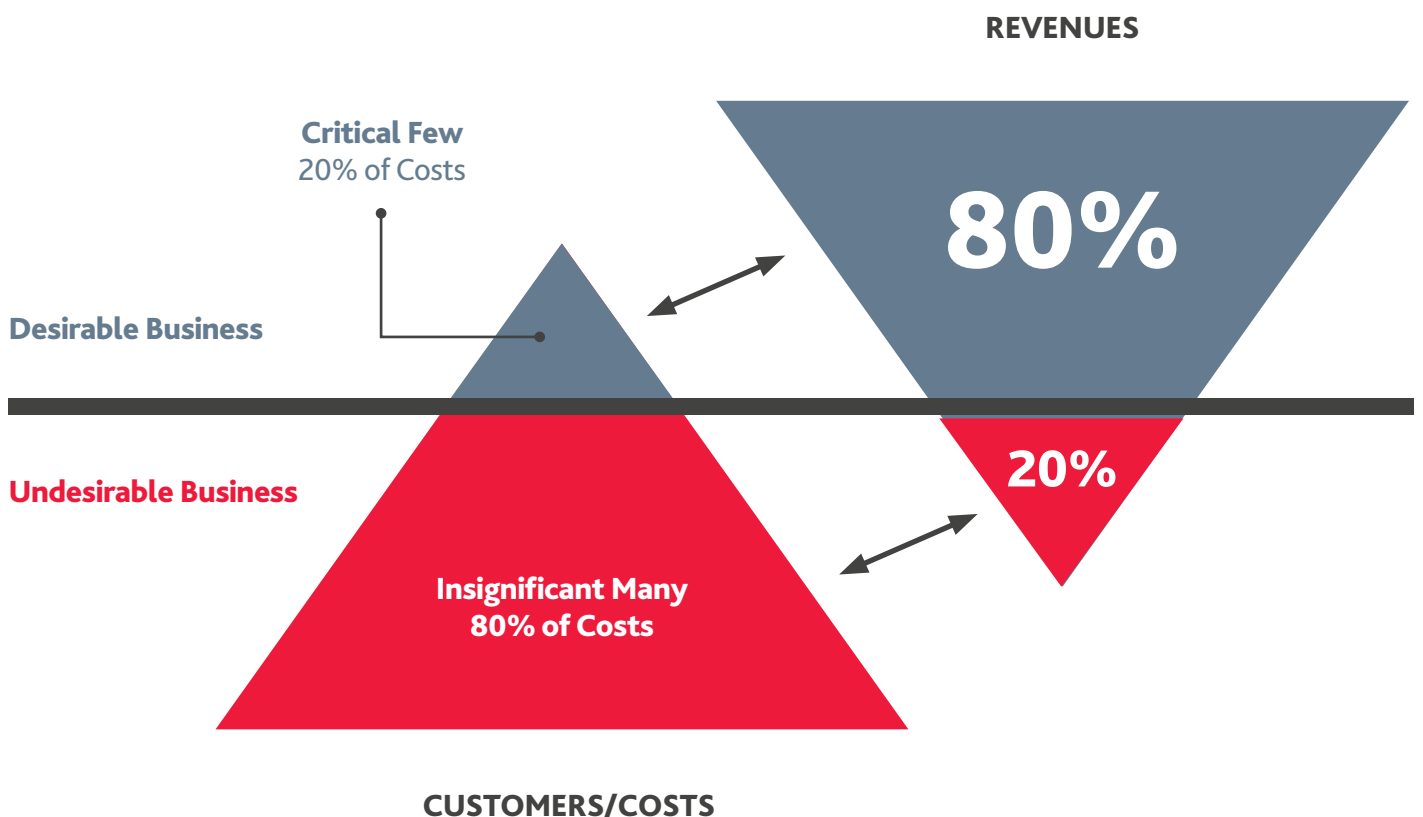
▶ 80% of sales come from 20% of customers

▶ 80% of sales come from 20% of products/services

▶ 80% of sales come from 20% of salespeople

▶ 80% of purchases come from 20% of vendors

▶ 80% of customer complaints come from 20% of products/services

With this knowledge, you can focus on growing the most profitable segments of the business to improve both the top and bottom lines exponentially. After realizing that 80% of outcomes often result from just 20% of causes, you can begin to develop targeted strategies backed by data.

Analyzing your business with this methodology will prompt pivotal questions that impact sales, marketing, hiring, training and much more:

▶ How can you implement precision sales tactics for the customers that are most profitable to gain more of their spend?

▶ How can you identify commonalities and trends among those top customers to cultivate more prospects that fit the profile?

▶ How can you create a level of service that caters to those top 20% of customers to increase their satisfaction and accelerate growth?

▶ How can you set the right expectations for customers to avoid devoting too much time to those outside the top 20%?

▶ How can you determine where to deploy your sales resources?

To harness data-driven insights from these questions, the data collected by your business must be processed with quality and consistency in mind. Master data management can facilitate better data analytics, which yield meaningful insights to inform the entire organization and drive profitable growth.

REVENUES

Critical Few
20% of Costs

Desirable Business

80%

Undesirable Business

20%

Insignificant Many
80% of Costs

CUSTOMERS/COSTS

TREAT THEM DIFFERENTLY

To demonstrate areas for opportunity, analyze revenues for one year with customers sorted in descending order, broken into quartiles. You'll see that the potential for reallocating your efforts is even more significant than the 80/20 principle indicates. If a business sold to 1,000 customers last year, when sorted on a top-down basis and separated into quartiles, the breakdown would look something like the following:

QUARTER	CUSTOMER COUNT	% OF SALES	% OF EFFORT
Q1	250	89%	25%
Q2	250	7%	25%
Q3	250	3%	25%
Q4	250	1%	25%

You'll notice this breakdown shows effort distributed evenly across all customers. That's because the phone doesn't ring any differently when the #1 customer calls as opposed to when customer #999 calls. This also holds true for accounting functions, such as invoice creation and collections. By completing a cost-to-serve analysis, businesses can better understand overheads associated with each customer quartile, and then reallocate resources accordingly.

Through a quartile analysis, most companies also find that 50% of customers account for less than 4% of sales. Without implementing data-driven strategies and precision selling informed by the 80/20 approach, a business could run the risk of devoting half of its resources to 4% of sales revenue.

This underlines an important way to restructure the resources devoted to customers: **Treat them differently.** Think of the enhanced customer support lines for frequent flyers, premium credit card members or longtime insurance policyholders. Shifting resources away from time-consuming customers that aren't profitable allows the business to refocus on top customers with targeted precision. Instead of devoting 25% of effort to each customer quartile, the organization's resources should align with the percentage of overall sales. Focusing 89% of resources on the top quartile, followed by 7%, 3% and 1% for the remaining 75% of customers, will make the business' efforts more effective and drive profitable growth.

The quartile data looks the same when one looks at products, jobs and purchases. The revenue distributions tend to follow the margin distributions. Analyzing this reveals opportunities for you to look at all areas of the business differently, from operations to purchasing to the back office, and everything in between.

ENGAGING YOUR COMPANY'S CULTURE IN THE 80/20 APPROACH

The 80/20 approach clearly has much to offer in terms of maximizing resources and improving organizational effectiveness, but it's not a turnkey solution. To implement it successfully, that mindset needs to become part of the overall culture, so that you achieve buy-in throughout the organization. Establishing belief in a new mindset will change behaviors and produce long-lasting results.

This process begins at the top and should be championed by those in the C-suite, with a vocal advocate helping lead the way. Weaving the 80/20 methodology throughout the business requires communicating the purpose and measurable goals that motivate the effort, and showing how these work to the benefit of all employees. It's also important to encourage input from staff and support open communication, which provides valuable insight.

The specifics of implementation will vary depending on the type of organization, the capabilities of its people and what processes need to be optimized. But concentrating more resources on the most profitable areas will produce significant results. Overall, businesses that implement the 80/20 approach see average revenue growth of 16% and an average operating income increase of 114%.

Through widespread adoption, a culture centered around this principle can have cascading results throughout the business. It helps improve organizational alignment, streamline decision-making processes and accelerate profitable growth.

AVERAGE REVENUE GROWTH
16%

COST BASE
6% | 7%
Margin/S&GA

AVERAGE OPERATING INCOME INCREASE OF
114%
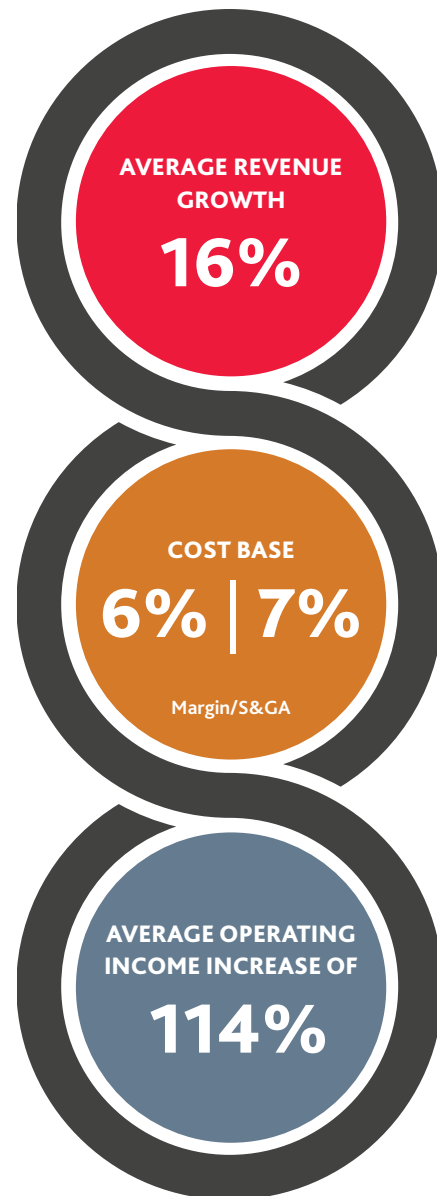
> *From our knowledge and experience with 80/20, its powerful tool can transform a business into a higher-margin and faster-growth company in only a couple of years.*

NOT DISCLOSED, STOCK ANALYST, NYSE

## GROWING ORGANIZATIONAL EFFECTIVENESS

80/20 provides a holistic business approach that allows everyone in the organization to see the business through a different lens, and there are numerous ways that you can integrate the principle into data analytics and business processes for continued effectiveness.

By extension, 80/20 also provides an outline for the digital transformation journey, because the needs of the "80's" (those critical few responsible for 80% of results) are generally different from the needs of others. The customer interface presents one example of this: What do your "80's" customers value in terms of capabilities? Another example comes from the plant and Industry 4.0, the fourth industrial revolution in manufacturing. Organizations can find improved margin per investment dollar by focusing on those critical few products and automating their "80's" first. Similarly, businesses should be wary of over-investing in solutions that address the "20's" (those many customers and products that produce less significant results).

From an operations standpoint, it's crucial to analyze back office functions as well. To stay competitive and manage costs, maintaining a lean back office makes a significant difference. Instead of trying to streamline everything, you can improve organizational effectiveness by focusing only on those critical few processes, customers, products or services.

The supply chain is another aspect of operations that naturally uses 80/20 to improve margins and service levels. The systems for logistics, storage and fulfillment must be continually monitored for effectiveness. 80/20 guides decision making about which areas to focus on first, both in terms of cost savings and improving service levels. Capital can be used more effectively through better management of inventory and capacity, and service can be improved for the critical few customers through practices like shortened fulfillment lead time.

As your business grows, you may choose to expand the organization through acquisition, and 80/20 is a proven tool to drive greater return on investment in the M&A environment. As part of the journey, it's vital to understand how an acquisition can introduce new inefficiencies. You may anticipate reducing costs by combining resources and taking advantage of existing infrastructure. 80/20 can help an organization understand the areas that need resources allocated to them, and those that do not. This ensures the critical few areas of the business continue to be supported, limiting the risk of reduced value.
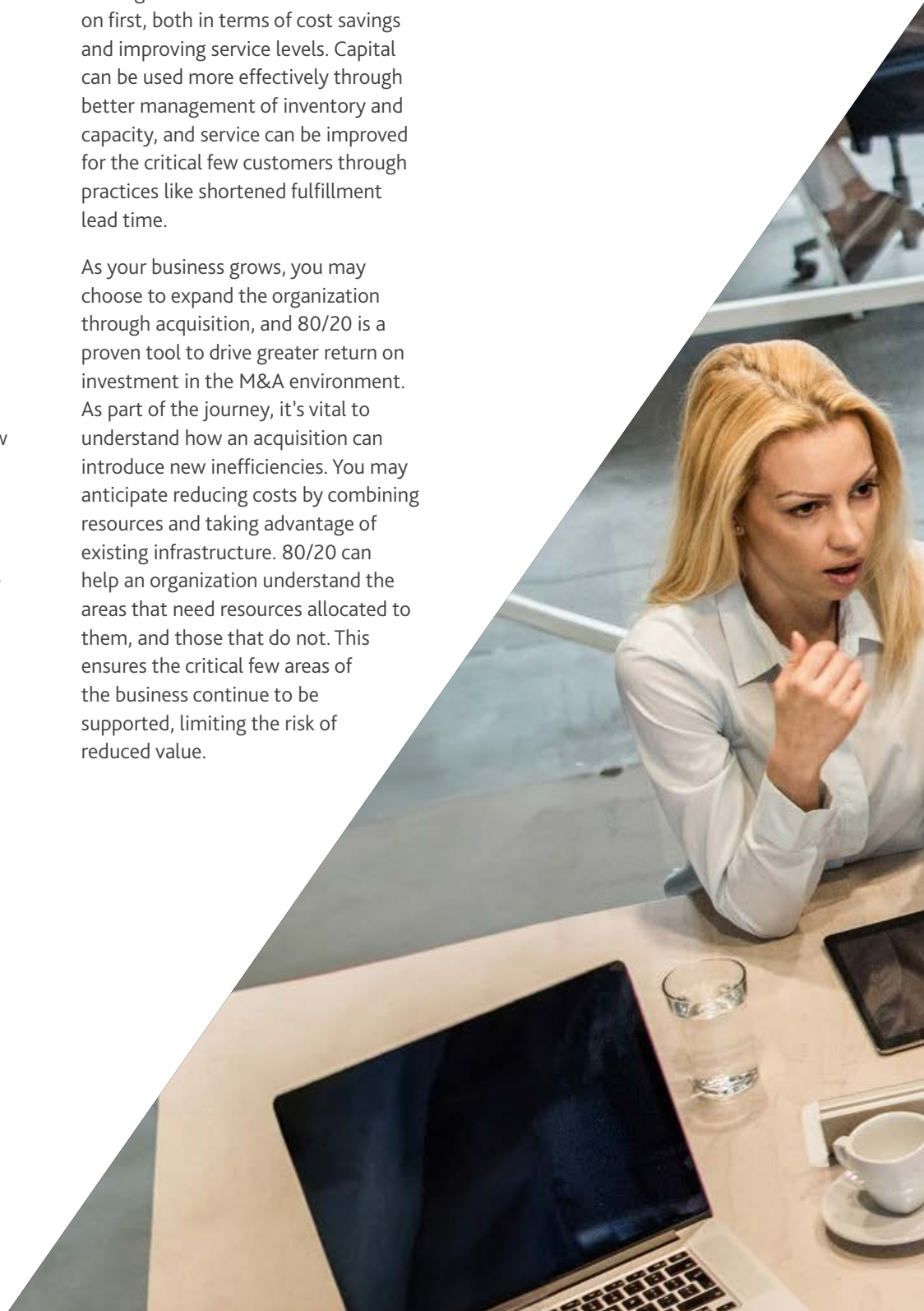
Strategic thinking with the 80/20 mindset creates alignment and focus across all business functions to increase profitability. Taking this holistic approach toward growth produces fruitful results with less organizational stress.

You can find more resources **here** to learn about how BDO can help your organization throughout its lifecycle.

CONTACT US

VAL LAUFENBERG
Management Consulting Principal
608-828-3151 / vlaufenberg@bdo.com

IBDO