

## 10 minute '80/20 rule'

### *Introduction*

This item shows how you can use a technique known as the 80/20 rule to analyse your business' sales and profits from customers, products and service and channels to market. This information helps you to make decisions about allocating scarce business resources to achieve the best available returns and deciding how the business should grow.

### *What it is*

The '80/20 rule' is a simple way of looking at your sales and profit figures and identifying the largest sources of contribution. We will show here how to use this technique for finding which of your customers are profitable, which channels to market you use are most profitable and which products and services are profitable.

### *Why it is important*

Just as people aren't all the same, neither are your customers. Some are more important than others and some cost you more than others. Knowing which customers are the most profitable helps in a number of ways:

- \* You can make sure you are really looking after those customers.
- \* You can understand what it is about them that is making them profitable.
- \* You can then use that information to go out and find other customers who are like them.
- \* You can gradually build up the number of profitable customers and reduce the number of less profitable ones.

We have used the example of customers here. We will show here how this technique can also be applied to your channels to market and products and services.

### *What you need to know*

You may have come across the Pareto principle on which this technique is based. Very simply, it says that 80% of the outcomes will come from about 20% of your effort. It can be applied to many aspects of your business such as profits and sales. For example:

- \* 80% of your profits may come from just 20% of your customers
- \* 80% of your sales may come from just 20% of your products and services.

This simple rule has little scientific basis but it invites you to analyse how productive your marketing effort is. It often leads to some interesting and useful insights into how you operate now and where you should be focusing your efforts in the future.



The 80% and 20% are not magical figures that work out exactly in all situations, nor do they need to add up to 100%. Ratios such as 80/35, 80/25 or even 80/10 may equally apply, although you will be surprised to find just how close to 80/20 the relationship often is. The principle is that, in each case, we are seeking to find the source of the majority of whatever activity is being measured.

There are two obvious conclusions from this relationship.

- \* A small proportion of your efforts provide most of the result.
- \* A large proportion of your efforts provide a relatively small result.

You may be able to think of personal situations where you have seen this rule apply, whether it is how you spend your leisure time, your relationship with your partner, or the time you spend with your children.

A word on the limitations of the 80/20 rule. If you use historical data, this may not provide an accurate or realistic indication of the future sales or profit potential from customers, products and services or distribution channels. You need to take a view on how representative the data used is. Using data from more than one period can be more representative.

### ***What you should do***

So how do you apply this to your business to achieve a better understanding of your marketing activities?

There are several key areas of your marketing activities that you should consider analysing. These include:

- \* sales per customer
- \* profitability of customer accounts
- \* sales of products or services
- \* margins of products and services
- \* sales and margins per channel to market (direct sales force, catalogue sales, web sales, etc)

Here are the steps to follow to analyse any of these activities:

1. Calculate the values (sales or profit) contributed by each of these activities (customers, products/services or channels) over a given period and add to give a total. The period of analysis may be a year, but could equally be a quarter or even a month. What is important is that the customer activity in this period is representative of the norm, eg it is not biased by seasonal fluctuations in ordering patterns.
2. Arrange the values for each activity in descending order.
3. Calculate the value of each activity as a percentage of the total for the period.



4. Calculate the cumulative percentage in descending order.
5. Find the row in your data where the cumulative percentage is approximately 80%. Sometimes you may only be able to get 70% or 85% rather than 80% but this is not that important. Then look across to see what proportion of the activities account for the 80%. For example, if 5 out of 24 customers account for 80% of sales,  $5/24 = 21\%$ . The ratio in this case is 80/21: 80% of sales come from 21% of customers.
6. If possible, compare this information with results from other periods (say a previous year) or with an average for the industry. You should be able to obtain statistics for your industry from a trade association or market research companies like Mintel and Keynote.
7. Analyse and interpret your results.
  - \* What distinguishes the high contributors from the low contributors?
  - \* What do the results tell you about groups that your customers might fall into? For example, what are the common characteristics of your current key customers (eg size, local depot, central purchasing)? Which other customers base have similar characteristics? Can these customers then be developed into higher contributors?
  - \* What can you do to find more high contributors?
  - \* What can you do to convert low contributors to high contributors? If you cannot convert the low contributors, do you need to replace them?
  - \* What do the results tell you about your business' strengths and weaknesses?



### *An example in practice*

A fictitious haulage company, called Hargraves Haulage, currently has 50 customers. It begins by calculating the total value of sales to each of these customers over the last 12 months. This period is representative of the norm.

The sales for each customer are arranged in descending order as shown in the table below. For simplicity in our example, the sales for groups of five customers have been added together.

<b>Hargraves Haulage</b>				
<b><u>Ltd</u></b>				
<b>Customers</b>	<b>Sales (£)</b>	<b>%</b>	<b>Cumulative (%)</b>	
5	185000	35%	35%	
10	135000	26%	61%	
15	100000	19%	80%	
20	40000	8%	87%	
25	20000	4%	91%	
30	14500	3%	94%	
35	11250	2%	96%	
40	9500	2%	98%	
45	7000	1%	99%	
50	4000	1%	100%	
<b>Total Sales</b>	<b>526250</b>			

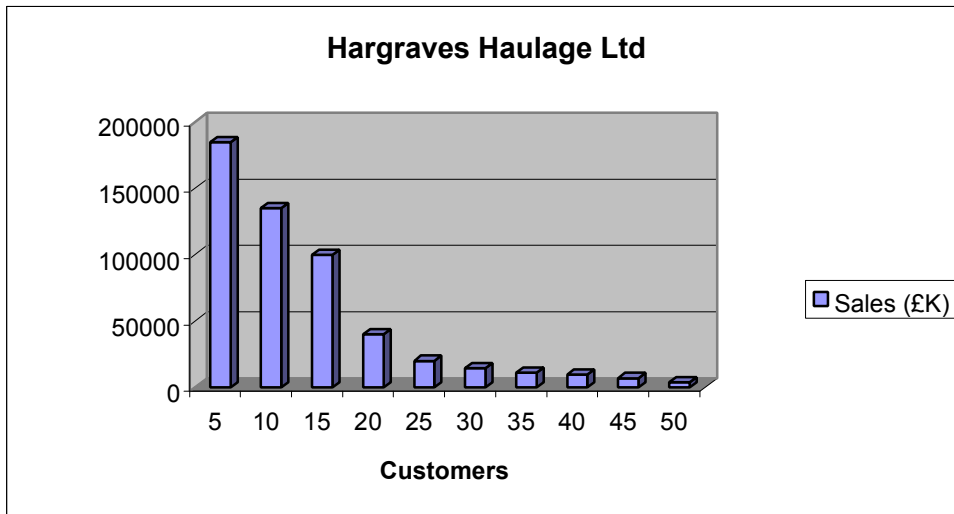
The second column shows the percentage of total sales from each group of five customers, with the final column cumulating this percentage.

The table tells us that Hargraves Haulage's largest five customers (the top 5 out of a total of 50 - that is 10% of all its customers) contributed 35% of total sales. Similarly, Hargraves' top 15 customers (30% of all customers) contribute 80% of total sales. The ratio for Hargraves Haulage is therefore 80/30. Notice that, although the 80/20 rule does not apply exactly, it still illustrates that a relatively small number of total customers represent a relatively large proportion of sales.

These 15 customers may be considered 'key customers' in terms of their sales value in this period. It is therefore particularly important that Hargraves Haulage seeks to develop and maintain good working relations and service levels with these customers. In other words, they should devote a much higher proportion (80%) of effort to these fifteen, and less (20%) to the remaining thirty-five.

The sales distribution is shown in the graph below. It shows that the contribution of the largest groups of customers is much more significant than that of the smaller groups. The shape of the curve is typical of a 80/20 relationship.





Now, Hargraves Haulage may consider that sales are only one measure of their customers' worth. They may also want to examine:

- \* profitability, particularly if margins are known to differ from customer to customer. In this case they should repeat the exercise using profit rather than sales.

- \* sales or profit contribution from different distribution channels.

The value of sales (or profit) of their product or services can be analysed in a similar way. The sales of Hargraves Haulage's services are shown in the table below:

<b>Hargraves Haulage Ltd</b>		
<b>Services</b>	<b>Sales (£)</b>	<b>%</b>
Regional (within 50 miles)		
Priority	21050	4%
Economy	194712	37%
National		
Priority	31575	6%
Economy	57887	11%
Public Service Contracts	189450	36%
Other haulage companies	15787	3%
Customers bring to depot	15787	3%
<b>Total Sales</b>	<b>526250</b>	<b>100%</b>



This analysis shows that the services that generated most sales over the last 12 months were regional economy deliveries (37%) and public service contracts (36%). Taking the two together, this shows that 73% of sales come from 28% (two out of seven) services, giving a ratio of 73/28.

It would be useful for Hargraves Haulage to consider whether their sales distribution between services was representative of the overall demand across the industry. For example, if either of Hargraves Haulage's two leading services represented a much higher proportion of sales than the industry norm, this may indicate that the company had a particular strength in these areas. The company should then consider how it might further exploit these particular strengths, for example using this information to increase sales to key customers.

The reverse may also be true: areas in which the company is performing significantly below the industry average could indicate weaknesses that may need to be addressed. Apply a little caution here though, as it may simply be that the company is not well geared to provide services in this area, in which case it should seek to improve and develop in those areas in which it is successful.

### **What to do now**

Try applying the 80/20 rule in your business, and see what new insights you can find. You may wish to analyse sales or profits generated by:

- \* Individual customers or groups of customers – This may help to increase sales or identify the more profitable groups of customers that you want to target in future.
- \* Individual products or services – This may help to focus your product development resources, to increase production of more profitable products or to remove less profitable products from the range.
- \* Channels to market – This may help to identify the more profitable channels and to focus promotional effort to increase throughput or margins.

When you are using this technique to calculate profit, there are some points to bear in mind:

- \* Gross profit or gross margin is probably the best measure to use. Simply take the invoice totals and deduct the cost of producing a product or providing a service, excluding overhead costs.
- \* 'Contribution', a term used in accounting and management, is the incremental profit generated by the sale of a product or unit of service. It is calculated by sales *minus* cost of production or providing the service *minus* the cost of servicing the customer in providing that unit (including sales, marketing and distribution expenses). This is particularly valuable when trying to establish which activities are genuinely profitable. For example:



	Product A	Product B
Sales	£75,000	£100,000
Less production costs	£45,000	£55,000
= Gross margin	£30,000	£45,000
As % sales	40%	45%
Less distribution costs	£3,000	£15,000
Less order handling costs	-	£5,000
Less sales promotion	£2,000	£5,000
= Contribution	£25,000	£20,000
As % sales	33%	20%

This shows that Product B sells better than Product A and yields a better gross margin, both in £ terms and as a % of sales. Most businesses would conclude that B is the better product because this is what their management information would tell them. However, B needs considerably higher distribution costs (perhaps because it is heavier or travelling further) and has required a sales promotion costing £5,000 to achieve the level of sales. When these other costs, often treated as indirect or overhead costs, are taken into account, then Product A is the more profitable. Given equal demand and the choice of producing more of Product A or Product B, the better business decision is to produce more of A.

\* Profit should be represented as an absolute value in £ rather than as a percentage. While the percentage margin is an indicator of profitability, it is the value of profits in the bank that counts. The danger is that a business may concentrate on high margin yet low sales volume customers.

### ***Where to find out more***

Further information on obtaining market research is available in a Directors' Briefing. Click here to access it (See Business Hotline publication MA 12).

Industry statistics like these may be available from trade associations. Alternatively try market research companies who publish industry surveys such as Mintel ([www.mintel.co.uk](http://www.mintel.co.uk)) and Keynote ([www.keynote.co.uk](http://www.keynote.co.uk)).

