Improving Business Worksheet #4

Introducing the 80:20 rule

It's a remarkable thing, but throughout the world of business, and into the wider society around us, and even in nature itself, there is a rule which breaks down to an 80:20 ratio. What does this mean? In business terms it means that probably 20% of your customers will generate 80% of your turnover. Unfortunately this also means that probably 80% of your effort is spent selling just 20% of your turnover.

You can have a look throughout your business and see if this same ratio holds true. Probably 20% of your products produce 80% of your revenue. Perhaps 20% of your suppliers are handling 80% of your requirements.

Why does any of this matter?

It is because there are only three ways to improve your bottom line. Either we must sell more, do business more efficiently, or sell more cheaply.

If we are spending 80% of our time dealing with customers who only actually provide us with 20% of our revenue then we are wasting time. We are doing business inefficiently. And inefficiency loses money. What we need to be doing is finding more of the customers who provide us with most of our revenue. There are a variety of ways a business can find out how valuable each customer is. But one easy way is to create a spreadsheet with all of your live customers, the number of transactions or orders each customer has placed, and the average and total value of each order.

You can easily rank the customers by the total value of the sales they have received. Those customers who have only made one or two small orders are of low value to your business, unless you know more about particular customers, some of whom may be valuable for other reasons.

Those who have bought the most from you will probably be your most valuable customers. But it is still worth considering the average transaction value. If you have a customer who has spent quite a lot of money with you, but has actually placed a large number of small orders, all of which have required individual handling, then you might discover that they are less valuable than you thought, and might actually not have produced a great deal of profit, even if they represent quite a lot of turnover.

You are looking for the 20% of your customers who produce 80% of your profit. It is quite possible for a company to have a high turnover but not to make any profit. In fact you might discover that the customers at the bottom of your spreadsheet are actually costing you money.

I worked for a company that took on a lot of subcontracted manufacturing projects. It had a reasonable monthly turnover but was losing huge amounts of money. One of the main reasons was that each subcontracting project needed a great deal of engineering resources to get it to the state where it could be manufactured on the shop floor. The customer would provide some drawings and specifications, but they were usually not of a good enough quality and so a team of engineers and buyers would have to work out what all the components should be and where they could be bought from. All of this would often take place after the price had already been agreed with the customer. So it was a regular occurrence that it proved impossible to build the product and still make a profit. Yet the turnover still looked quite good.

The only solution to a problem like this is to drop those customers that are not making enough profit and seek to find more customers just like the ones that are producing most of the profit.

Look at your list of customers again. Highlight the bottom 5%. How much does each order cost you to administer? What are the costs of sales order administration, warehouse handling, packing etc. If it costs you £50 to process an order then you need to have at least that much margin in your sale to even begin to make a profit.

Why not consider introducing a minimum order charge so that you can always be sure of making a profit? If there is no profit in the bottom ranked customers then it doesn't matter if they decide not to buy from you. While each one who is happy to accept a minimum order charge will actually increase your profits.

At the other end of our listing of customers, those who produce the most profit, we should be asking how we can encourage them to buy even more. What would you need to do to achieve just that? These are the most important people to your business. They deserve more of your time and attention, while those who use up most of your time, but produce least profit, must not be treated in the same way and with the same investment of effort. They are not worth it in bald business terms.

Do these important customers have something in common? Can you find other potential customers that have the same characteristics?

If you stopped dealing with your bottom 5% of customers how many customers like your top 5% of profit producers would you need to replace the profit? Would you even need to replace them?

Your time and effort are valuable. Wasting them on customers who produce little or no profit, just sales turnover, is an inefficient strategy. No business should ever feel that it must accept any customer just to keep busy. It is always better to spend the limited resources of a business in finding the right customers, the best customers.

Think about dumping your least profitable customers.

The 80:20 rule points us in the right direction. It is up to us to decide what we do with our customer analysis. Only you know the intangible value of even your smallest customers

Nevertheless, sometimes it is best to say 'No'.