



Q&A: Discussing Today's Business Trends

Using the 80/20 Rule to Maximize Profitability

Peter Philippi is founder and President of Strategex, Inc., a Chicago-based research and consulting firm dedicated to providing direction and support for the sustainable, profitable and aggressive growth of business-to-business clients in the manufacturing and service sectors. The company's unique value proposition is the number of Strategex experts who have worked with the 80/20 Rule throughout their professional lives, with dramatic financial results every time. Much Shelist spoke to Peter about how companies can apply these principles to their own businesses.

Q Much Shelist: The 80/20 Rule is a fairly well-known principle. How do you define it in a business context?

A Peter Philippi: While the 80/20 Rule (also known as the Pareto Principle, after Italian economist Vilfredo Pareto) is mentioned frequently in business and other circles, it is also widely misunderstood. For example, when I'm speaking before a business group, I often ask, "How many of you have heard of the 80/20 Rule?" Virtually every hand in the room will go up. I'll then ask, "How many of you apply the 80/20 Rule?" Again, most of the hands remain up. But when I ask a few individuals to define the rule and how they apply it at their own companies, their responses will vary widely.

In a business context, the principle itself is fairly straightforward: approximately 80% of a company's value (measured by revenue or profit) is derived from only 20% of its resources or efforts (e.g., product lines and customers). This isn't just an easy-to-remember axiom; in study after study, the ratios between the top and bottom groups of customers (in terms of percentage of revenue they contribute to the company) remain strikingly consistent. Equally important, however, the amount of effort and cost involved in acquiring, serving and retaining those customers is virtually the same, no matter where they fall on the revenue side of the equation.

Put simply, most companies don't realize that 20% of their customers require only 20% of their cost resources, yet they provide 80% of the revenue. Hence, the same companies don't realize how tremendously profitable these clients are! Conversely, they don't realize that 80% of their customers require 80% of their resources while providing only 20% of the revenue. Understanding this truism is the foundation of business-based 80/20.

Pareto called this the "law of the trivial many and the critical few." Unfortunately, the simplicity of

the definition and the straightforwardness of Pareto's comments have led to overly broad or ineffective applications of the principle that ultimately cause more problems than they solve. However, when business leaders understand the nuances of the 80/20 Rule and learn how to apply it effectively across the entire organization, they will see positive results every time!

Q MS: What are some of the common mistakes you see businesses making when they attempt to act on the 80/20 Rule?

A PP: Many established businesses, whether or not they are focused on the 80/20 Rule, attempt to grow themselves into profitability. However, adding products, customers, employees and factories doesn't change the underlying situation: a minority of your customers are responsible for the vast majority of your profitability. On the flip side, simply getting leaner is an equally ineffective strategy when implemented without an underlying understanding of where and why your resources are being used.

Business leaders who have heard about the 80/20 Rule often botch the process because they get started and then stop because of internal objections. I've often heard, "We need a complete product line," "We need to absorb our fixed costs" and a long list of other excuses. When the going gets tough (as it always does), that's when people give up on 80/20. Our experts have lived it and thus are able to get our customers past those "tipping points" in execution, which is why they succeed.

I'm not saying that you shouldn't grow, or that you shouldn't reduce waste—or that you shouldn't act at all! Rather, an understanding of the 80/20 Rule and how to apply it to your own organization will help you streamline the business, focus your limited resources in the areas that offer the greatest return, and improve overall profitability—sensibly, incrementally and without alienating your most important customers.



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MS: How have you seen companies benefit from correct application of the 80/20 Rule?

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PP: Illinois Tool Works (ITW) is a well-known example of how a company can succeed through use of the 80/20 Rule. In 1980, ITW found itself facing rising costs and decreasing profitability. Company leadership decided to use the 80/20 principles to drive a complete overhaul of its policies, techniques and rules of operation. They understood that this was a long-term—even lifetime—commitment. Over the next 25 years, ITW not only perfected the application of the 80/20 Rule, but the company enjoyed annual shareholder returns of 19% without fail.

At Strategex, we follow a three-phase approach to helping companies achieve measurable business results using the 80/20 Rule. In Phase I, Assessment, we analyze client data and conduct initial training. In Phase II, Prescription, we work with senior and next-level managers to create specific initiatives that transform the organization and its relationships with customers. In Phase III, Execution, we roll out these initiatives, measure results and continue working with leadership to deliver lifetime performance improvements.

Clients ranging in size from \$3 million to \$1.2 billion in annual revenues have seen positive results from applying the 80/20 Rule. For example, after going through the first two phases, a \$14 million company created and has begun implementing initiatives that will increase profitability by \$500,000 in 2011. An \$85 million company created an initiative during Phase Two that revised its commission structure and handling charges on orders, reduced safety stock and improved inventory management—all of which is moving the business toward a positive bottom-line impact of \$2 million over 12 months.

After two years of 80/20 work, another client reported 20% annual sales growth, 98% on-time delivery overall (100% to “A” customers), a 300% reduction in finished goods inventory, a 60% increase in inventory turns and a 300% bump in cash flow and profits.

The important lesson is that data-driven, intelligent, organization-wide changes can have a huge, positive effect on performance without sacrificing customer relationships.

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MS: How can a company avoid misapplication of the 80/20 Rule?

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PP: First of all, the top leadership of the company must be fully engaged. I have seen honest attempts by division or unit managers to implement the 80/20 Rule, but selective application simply cannot engender the organization-wide change necessary for success.

The company should also gather at least three years of performance data so that an appropriate situation analysis can be conducted. Finally, senior management should be prepared to work hard and make tough decisions about their products, services, customers and employees.

Successful implementation of the 80/20 Rule is not a short-term project, nor is it something that should be entered into lightly. It requires a multi-year commitment of time and resources, and should be undertaken with the guidance of an experienced 80/20 consultant. That said, the rewards are well worth the investment for virtually any company, measured in many multiples of bottom line improvement. **MS**

Peter Philippi conducts 80/20 seminars all across the country. If you have questions about the 80/20 Rule and how to successfully apply it to your business, contact Peter at pphilippi@strategex.com or visit www.strategex.com.

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allowance and have the mortgagee agree that the monies will be available for the build-out, even if the landlord goes into default under the mortgage. Remember that the mortgagee, as the successor owner through a foreclosure, may not be obligated to honor any agreements made between the landlord and the tenant in a lease or lease amendment unless the mortgagee specifically agreed to be bound by those terms in writing.

Looking Ahead

In light of Chicago’s 10% unemployment rate, it is no surprise that space needs in the city have diminished. As is the case in many other U.S. markets, 2011 leases will continue to be affected by these challenging economic conditions. However, lease transactions can still be completed successfully if each party does its due diligence, is willing to be creative and communicates with the other side (and the mortgagee) in a frank and honest manner. **MS**