To Pareto or Not To: Changing the Profitability of Your Business

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Certain key insights in strategy seem to be continually important. Flanking a competitor is often a better strategy than attacking them head on is one example.

In many business and economic analysis, 20% or so of a market, customer group or products seems to account for a disproportionate result, often characterized as 80% of the results sought (revenues, profits, etc.). This Pareto or 20:80 rule became very popular in the 80s when activity based costing exercises revealed that for many companies profitability was driven by a small number of customers. The less intuitive conclusion, one that frequently has to be explained to first time readers is that if 20% of your customers account for in excess of 100% (say 150-200%) of your profits, then you are losing money on the other customers.

What is challenging about the Pareto insight is that it offers a universal rule of thumb, frequently and consistently important, but the prescription from the insight is often less obvious. And sometimes simple minded conclusions can be wrong. The Pareto insight leads to one of two conclusions:

1. The 20% of customers represent a unique group and lessons learned from them are not directly applicable to the rest of the market. In other words, you need to alter how you do business with the remaining customers.

2. The 20% of customer represent a model for my future business and I should focus on them.

Business Model Revision

The Pareto rule is often difficult to apply is where a new business model is introduced. It is never 100% clear whether a potentially disruptive technology at the low end of a market will change market requirements or provide a platform for an initially insignificant competitor to build upon. In a parallel way, migration of high end features from premium products and services to the mass market is also difficult to predict in some markets.

The concept of Track and Trace (making parcels and envelopes trackable though out the logistics process), offered by FedEx and UPS was extremely threatening to the Canadian Post Office. They could see no way of matching the capability given the volume of mail and packages they delivered.

The internal debate revolved around whether they should take a Pareto approach and focus a Track and Trace capability only on parcels and high value added packages, or whether this would be a long term capability for all logistic operations. Their eventual conclusion was they needed to have more presence in the premium package and envelope business and Track and Trace would largely be restricted to the high end of the market. To this end, they bought a courier company, Purolator.

Dropping Customers

One potential prescription from learning that 20% of your customers account for 150% or more of profits is to slim down the business and focus upon the profitable customers. However this strategy is often emotionally very difficult for many managers and often pursued too late. Managers have spent so much time investing in acquiring customers that given up the customers is distressing.

Raising Prices

Raising prices for the less profitable customers seems like an obvious solution to a 20:80 insight, but resistance from the sales force, inadequate systems for tracking discounting behavior and negative feedback from customers are likely barriers that will need to be overcome. Slightly more clever approaches change the basis of pricing in ways that are more palatable to customers. Leasing and usage based pricing are particularly attractive to capital constrained customers and change the nature of the evaluation process.

Reducing the Cost of Delivery for Unprofitable Customers

Financial services organization frequently have used self service with ATMs and online banking to reduce the cost of less profitable services and less profitable customers. In contrast, wealth management services offer higher levels of service and advice.

Reducing Marketing Costs

A less obvious approach to making many customers profitable is to delight customers so that they become your sales agents. Strong word of mouth can significantly reduce a required marketing budget. Amazon uses daily specials in e.g. the MP3 download market to encourage daily visits to their site, a low cost way of generating traffic. Heavy users may tell their friends about hot music they have found a deal on.

Life Cycle Management

As with most costing decisions, it turns out that pricing is often a strategic decision. As a result, the time frame over which you measure customer profitability is critical as are the implications for organizational capacity.

- Mature software companies like Oracle will often discount their software significantly to obtain sales (with the largest discounts occurring at quarter and year end when sales reps are under pressure to meet their goals). Part of their willingness to do so, is their knowledge that software is actually more a service than a capital expenditure with maintenance revenues a critical part of the annuity relationship with a customer.
- The success of the Apple iPhone is based in part upon the fact that that a $600 cost of purchase by AT&T is resold to a subscriber for $200 in return for a two year contract that might add up to

$2400 of revenues and a strong probability of retention at the end of the contract. These high ARPU (average revenue per user) clients are likely some of AT&Ts most profitable.

- The challenge for AT&T is to how to grow their business. Are these customers atypical, i.e. a 20% that is atypical or do they represent a different business. Research suggests that there is a large gap between the number of subscribers that would like an iPhone-like service (i.e. with easy to use Internet access) and the actual number of data subscribers. One interpretation is that subscription rates would increase with lower data plan prices. A move in this direction would have significant implications on network architecture for AT&T mobile network capacity by reducing the revenue per user from data plans and lowering revenues per byte transmitted.

Increasing Value Propositions

Bundling is one example of changing value propositions. Companies like Hyperion (now Oracle) and Microsoft have used bundling to reduce the cost of individual applications, but create more value for customers. In telecom, triple and quad plays (combination of voice services, broadband, TV services and mobile services) are a common marketing approach.

In some ways, bundling can be slightly unintuitive. Most purchasers of e.g. MS-Office probably don't use most of the features they purchase, but the incremental cost of having compatible features available has value. Most fixed rate pricing programs e.g. Netflix make this same tradeoff. Netflix may lose money on some customers who are heavy users of the service, but the reality is that most people are at or close to the limits of time they can devote to viewing videos. Value perceived is not necessarily usage.

Changing the Basis of Competition and Cost of Delivery

The Pareto insight is one that many companies are facing in the current recession. When demand for a product category drops dramatically, downsizing assumptions are often affected by assumptions about demand and profitability distributions.

In the automobile industry, the politically unspoken "elephant in the room" is that gasoline prices will in the future be maintained at a far higher level than previously for reasons of balance of trade, security and global warming. This increase in the total cost of ownership of a car will make likely make small cars more popular and more expensive than they have been historically. It will also make driving more expensive reducing total demand for cars. Auto companies are faced, as a result, with downsizing, a cyclical downturn of unusual size and a longer term secular shift in purchase patterns.

As with many markets, the automobile market is likely to become far less homogenous. The market may evolve towards predominantly electric powered microcars for in city driving, hybrids for trips requiring greater range, and larger hybrid capacity vehicles for transporting larger groups of people.

For automobile companies, their cost structure, traditional assumptions about profitability, scale and scope economies are all open to question. If ever there were a situation, where scenario analysis needs to be combined with Pareto analysis, the automobile industry today provides it.

In the same way, telecom service providers faced with demand for low priced unlimited data plans are having to rethink their network architecture to divert home and office data traffic away from cell towers to home fixed broadband connections.

Summary

The key take-away from any Pareto analysis is that it is a useful rule of thumb that inspires important questions about making money in your business. Making the right decision means not only looking at product and customer profitability, but also your delivery process and value chain from the perspective of both current and emerging usage patterns.