Zachary Scott
INVESTMENT BANKERS

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The Vital Few and the Trivial Many

Can "Pareto's Principle" be an effective management tool for your company?

by Mark D. Working

In the very early 1900s, an Italian economist by the name of Vilfredo Pareto created a mathematical formula describing the unequal distribution of wealth he observed and measured in his country. Pareto found that roughly 20 percent of the people controlled or owned 80 percent of the wealth. In the late 1940s, Dr. Joseph M. Juran, a Quality Management pioneer, built upon Pareto's work to coin the "80/20 Rule", whereby 80 percent of the effects are derived from just 20 percent of the causes. Dr. Juran christened his simple tenet as "Pareto's Principle" and it has been applied in the business world as an effective tool to help managers focus on the "20 percent that matters."

This concept may be seen in any given set of observations (workers, customers, products etc.), where a few are vital and many are trivial. While it is rare that the proportions are precisely 80 and 20 percent, common examples in business include:

1. 80 percent of profits come from 20 percent of the customers;

2. 80 percent of revenues will be the result of sales made by 20 percent of the sales staff;

3. 80 percent of time and resources are consumed by 20 percent of project work (usually the first 10 percent and the last 10 percent);

4. 80 percent of warehouse space is occupied by 20 percent of inventory on hand; and

5. 80 percent of inventory line items (Stock Keeping Units or SKUs) come from 20 percent of vendors.

OBSERVATIONS

In our work, business value, which reflects the relationship between profits earned and capital employed, is the preeminent concept. We have often observed that an outsized share of profits is generated with less than a proportionate amount of capital invested. This, of course, leads to the corollary that significant capital is being wasted by utilizing it to produce sub-standard returns. If that is the case, one can only conclude that a smaller, highly profitable enterprise lies buried within a much larger, less productive business.

As the old adage goes, "first, get a customer, then you have a business." Firms succeed by satisfying customer needs more effectively than their competitors do. Early success typically evolves from a formula, and the organization pushes forward to add customers and replicate that achievement through expanded application of its formula. Along the way, capital is employed to buy tools, facilities, and inventory. Unfortunately, formulas only work within distinct parameters. Ongoing success requires constant fine-tuning as conditions change.

('000s $)	Total Company	Product One	Product Two	Product Three	Revised Performance
Revenues	$125,000	$62,500	$31,250	$31,250	$93,750
COGS	81,250	36,250	18,125	26,875	54,375
Gross Margins	43,750 35.0%	26,250 42.0%	13,125 40.0%	4,375 14.0%	39,375 42.0%
Direct Sales/Distribution Costs	24,375 19.5%	10,938 17.5%	5,156 16.5%	8,281 26.5%	16,094 17.2%
Product Line Contribution	19,375	15,313 24.5%	7,969 25.5%	(3,906) -12.5%	23,281
SG&A and Operating Expenses	13,375				13,750
			the "Drag"		
Operating Profit	5,625 4.5%				9,531 10.2%
Working Capital	17,859	8,809	4,405	4,645	13,214
Common FF&E	16,800				16,800
"Invested Capital"	34,659				30,014
ROI (pre-tax)	16.2%				31.8%
Value	39,375				66,719
Indicated Value Ratio (EV/EBIT)	7	With the "Drag"		Without the "Drag"	7
Excess Assets	0				4,645
Total Value	$39,375				$71,364

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Savvy managers are able to drill down to understand the profit contributions, capital requirements, and returns on capital of the discrete components (e.g., units, products, customers) of a business. And, they do so in recognition that sub-standard return on capital diminish business value.

Unfortunately, routine financial statements rarely provide sufficient detail to analyze segment profitability and the returns on capital employed. To get behind these summary statements, we have often replicated a client's general ledger accounts and remapped the relationships between asset and activity accounts in order to delve into where and how capital is employed and profits are earned.

The simple example above illustrates the type of analysis that may unmask value hidden in a business. In this situation, the owners contemplated selling the business and identified a buyer who proposed a price of roughly 7x operating earnings, a slight premium to book value ($39.4MM vs. $34.7MM). Our analysis concluded that a specific product (#3) was a major "drag" on performance for a couple of reasons:

- Inferior gross margins relative to other products (14% vs. 42% and 40%); and

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- Higher marketing and distribution expenses.

The direct impact of the product line was a $3.9MM negative contribution, consuming $4.6MM of capital. By eliminating this marginal product line and recouping the working capital supporting it, a very profitable core business is unveiled. Rather than a $125MM sales company with operating earnings of $5.6MM on invested capital of $34.7MM, we found a $94MM sales company earning $9.5MM on $30.0MM of capital. Using the same metric of 7x operating profit and then adding back the recovered working capital, the implied value of the restructured business was approximately 80% higher. The owners put the sale on hold to complete the restructuring, thereby laying the groundwork for a much higher price.

WHY NOW?

Every sector of the financial markets is telling us that capital is dear. As has been chronicled in IN$IGHT over the past few issues, the cost-of-capital curve has shifted upward as the market's perception of risk has increased.

Capital utilization is even more critical in today's environment, and business managers need to know precisely how their business makes money and how much capital is invested to generate that return. The economic tradeoff has always been the same, but when cheap and easy capital was readily available, it was easier to ignore. Now, with capital costly or even unavailable, this exercise becomes critical.

Do you know where the Pareto Principle is active in your business? Business owners and managers need to compare the elements of their operations with the lowest returns to their highest marginal cost of capital and prune the non-contributing segments of the business. Value can be created by emphasizing the vital and setting aside the trivial. ❖

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ABOUT ZACHARY SCOTT

Zachary Scott is an investment banking and financial advisory firm founded in 1991 to serve the needs of privately held, middle-market companies. The firm offers a unique combination of in-depth knowledge of the capital markets and industry competitive dynamics, sophisticated analytical capabilities, and proven expertise in structuring and negotiating complex transactions. For more information on Zachary Scott, please go to ZacharyScott.com.

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