PROFITABILITY ANALYTICS CENTER OF EXCELLENCE

eBook

Managing Customer Profitability - Should you love them or leave them?

Part of the Profitability Analytics Framework

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CUSTOMER PROFITABILITY MANAGEMENT

The only value a company will ever create is the value that comes from its customers – current ones and the new ones acquired in the future. To remain competitive, an organization must determine how to keep customers longer, grow them into larger customers, make them more profitable, and serve them more efficiently, while acquiring additional profitable customers.

Many companies measure the profitability of their customers by the sales they generate, or the gross profit realized from those sales. Such measures can be misleading which it comes to enhancing a firm's profitability.

Customer profitability is defined as net revenue from a customer, less customer costs (including both product /service costs and costs to serve), indirect expenses (commonly referred to as overhead), and taxes. A useful alternative measure, customer lifetime value (CLV), is calculated as the present value of the future cash flow contribution of a customer. In our *Customer Profitability: How to Measure it and Why it Matters eBook*, we discussed why these are preferable metrics and how they should be measured.

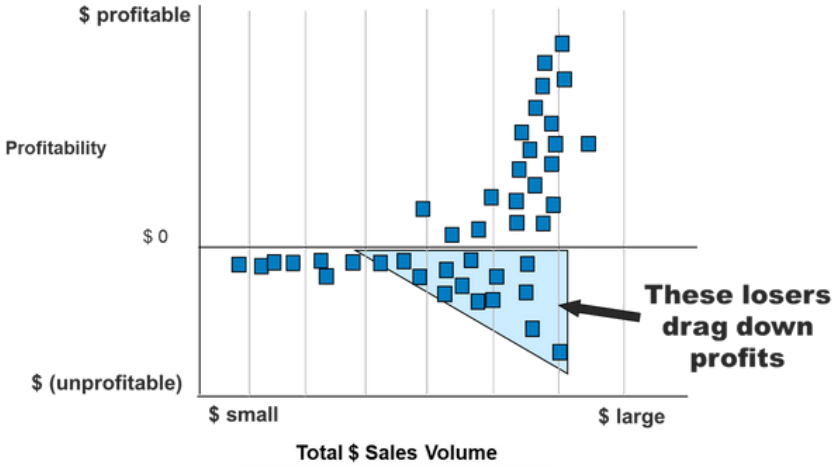
Once a company can measure the profitability of its customers it can then work to manage its customer efforts to generate greater profits, which is the subject of this eBook.

DISPELLING MISCONCEPTIONS

A common first step after implementing a customer profitability management (CPM) system is to rank order customers (or customer groups) from most profitable to least profitable and then plot the cumulative profit on a graph, popularly referred to as a whale curve. As mentioned in our customer profitability measurement eBook, such graphs typical show about 20% of customers generate from 150% to 300% of company profits, about 70% of customers are breakeven, and 10% of customers reduce or destroy from 50% to 200% of company profits.

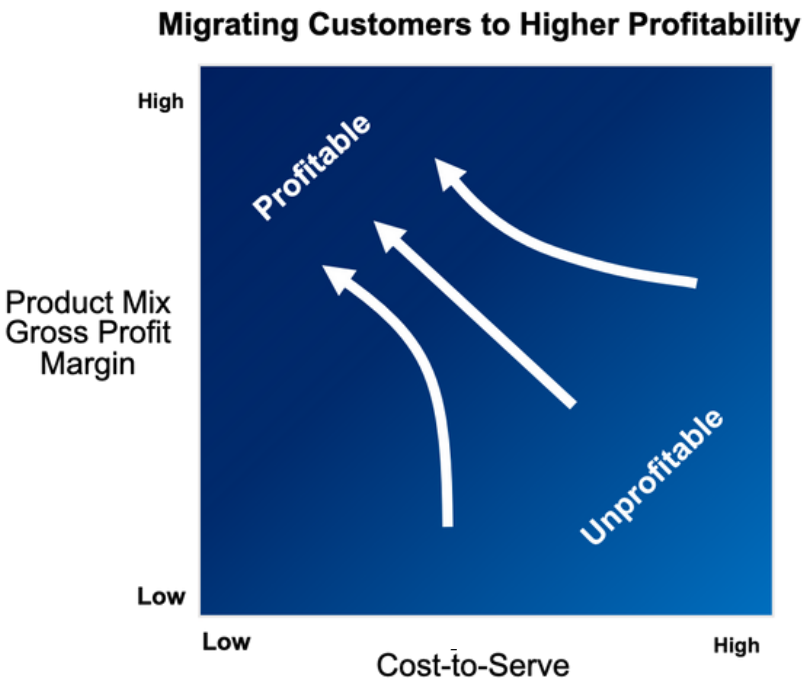
Another way to look at customer data is to plot customer profitability against customers' sales volume, as in the figure. The point farthest right represents the highest sales customer. But above that customer are customers that make fewer purchases but generate higher profits. And below profitable customers are many customers with substantially high sales volume that are unprofitable. The lesson here is that sales volume is not a proxy for, or indicative of, the profitability of a customer.

Sales Volume Not the Same as Profitability



In a similar way, measuring customer satisfaction and customer loyalty, frequently used marketing metrics, is not an effective profit-maximizing strategy without also measuring and managing customer profitability.

Another way to gain insight into the profitability of customers is by plotting them on a graph where one axis represents gross profit from sales to a customer and the other the cost to serve that customer (i.e., the distribution, selling, marketing, and customer service expenses), as in the following Figure.



The most unprofitable customers in the bottom right - hand corner of the figure buy low margin profit products/services while also being the most difficult to serve. The most profitable customers, in the upper left corner, buy high margin items while also being easy to serve.

All organizations have high- and low-maintenance customers. Examples of high-maintenance customers include those frequently shifting delivery schedules, purchasing special products or services rather than standard ones. They also frequently call the helpdesk or return purchases. Low maintenance customers, on the other hand, buy standard items, never shift schedules, don't call the helpdesk, and don't return goods. If a customer of each of these two types purchased the same volume and same product mix at the same price, they would not be equally profitable as the high-maintenance customers erode profits by causing much more work and associated expense.

"Customer is King," or so the saying goes, but can you accurately determine a customer's true profitability and how they help align your organization to its strategic objectives to create measurable value? The PACE CPM eBook outlines a straightforward approach to produce accurate customer profitability analytics that deliver actionable insights to ensure that organizations add value even in the most uncertain economic environments."

Andrew Laferla, Product Director,
Profitability & Cost Management

TARGETING CUSTOMER ACQUISTION

The goal of customer profitability management is to implement an optimal blend of differential levels of treatment so that over every customer's lifetime, the profits earned by the firm are maximized.

Once customer profitability is measured and customers are ranked according to their profitability, the most profitable customers should be identified. Given that it is much less expensive to hold onto an existing customer than it is to acquire a new one, an organization should strive to retain these customers. It should also seek to attract similar customers. Actions that might be pursued include [i]:

- Finding common characteristics or behaviors that make these customers profitable and leverage those findings into tangible actions to retain them.
- Providing personal attention from salespeople, relationship managers, or their superiors.
- Making price or service concessions to ensure the company remains competitive for these customers.
- Finding out what these customers like about the company and its products/services and promote those features to attract new customers with similar profiles; and
- Developing a partnership with these customers by assigning them a high priority in service or pricing.

When developing a customer acquisition plan, it is essential to include consideration of the distinction between fixed and variable costs and the implications of this difference on the profitability of newly acquired customers.

"The PACE eBook on customer profitability management illustrates how profitability inclusive of "below the line" product-based costs is an important undertaking to understand the drivers of many costs and to collaborate with customers to make mutually beneficial decisions. CPM solutions provide objective measurement of that which has historically been difficult to quantify, and in so doing, enable optimized outcomes."

Doug Paul,
Manager, PCMS

ACQUISTION & RETENTION PITFALLS

Retaining profitable customers increases the firm's overall profitability, and many firms focus on acquiring and retaining profitable customers. Pitfalls that can be encountered in this approach include:

- Looking to get the most out of each customer by focusing only on the short-term profitability or the next transaction and not on long-term profitability. This problem occurs when companies focus on targeting only those customers who are easy to acquire and easy to maintain, based on the false assumption that acquisition costs and retention costs are the major drivers of customer profitability. This assumes all customers are equally profitable, but that is usually not the case.

- Focusing on customer acquisition rate and customer retention rate as the sole metrics of marketing performance, while ignoring customers' long-term value. This may lead to diminishing returns on marketing and sales efforts. Managers can target customers who are easy to acquire and easy to maintain based on the false assumption that acquisition costs and retention costs are the major drivers of customer profitability. This approach assumes each classification of customers is equally profitable, but that often is not the case. Managers must look at customers who are most profitable to acquire and profitable to retain, optimize acquisition

and retention costs simultaneously, and link such efforts directly to overall profitability [ii].

- Treating acquisition and retention as independent activities and attempting to maximize both rates. Customers who are easy to acquire and retain may not be the most profitable customers. Besides consideration of these rates, the allocation of resources should be based on the level of choices between communication channels to ensure customer profitability.

"Financial data is associated with customers using the company's operational data so customer profitability can be a systematic and repeatable process. Customer profitability analysis should be a frequent activity, and implementing a customer profitability management system enables management to make timely decisions that improve overall company profitability."

Dan O'Toole,
Principal Consultant

INCREASING CUSTOMER PROFITABILTIY

Actions that can increase the profitability of customers include:

Revenue Management Practice	Action
Pricing	• Raising prices where appropriate • Establishing a surcharge for expensive cost-to-serve activities • Discounting prices to gain more business with low cost-to-serve customers • Link prices to desirable customer behaviour e.g., length of order period, order size, delivery size, etc.
Inventory allocation	• Prioritise inventory for high profitability customers over low profitability customers (i.e., reserving capacity for high-value customers)
Product configuration	• Introducing new products and service lines based on core inputs and processes. • Develop product offerings based on nonphysical differences e.g., terms and conditions • Abandoning unprofitable existing products or service-lines • Offering customers profit-positive service level options with varying prices • Reducing services; focusing first on labor intensive ones that add the least value-add yet cost the most • Managing customers' *costs-to-serve* to a lower level • Increasing investments on activities for which a customer shows a preference • Up-selling or cross-selling a customer's purchase mix toward richer, higher-margin products and service lines
Duration control	• Improving and streamlining internal business processes that help regulate customer arrivals (ordering patterns), discourage customised orders, and focus on encouraging more profitable customer behaviour.

In addition to these revenue management actions, operational improvement, such as improving and streamlining customer facing processes, adding self-service models where possible, should be considered.

"At Alithya, we not only implement profitability management solutions for our clients utilizing the Oracle SaaS EPM software, but we have also deployed these solutions ***internally*** *to gain insight into the types of industries and service lines to which our most profitable clients belong, resulting in year-over-year margin improvements."*

Mike Killeen, SVP,
Technology & Strategy

MANAGING LOYALTY & PROFITABILITY

An approach to managing customer profitability is to segment customers based on their CLV and loyalty and implement separate strategies for each group.

High profitability-High loyalty customers. These are the most valuable customers, satisfied with the company's products/services and purchasing steadily over time. In managing these customers, firms should engage in consistent, yet intermittently spaced, communication, striving to achieve attitudinal and behavioral loyalty.

High profitability-Low loyalty customers. These customers stay for only a limited time but generate high profits. They enjoy finding the best deals and avoid building a stable relationship with any single provider. Companies should avoid overinvesting in these customers, especially after they stop buying.

Low profitability-High loyalty customers. These customers offer low profits for a company despite being long-term customers. In addressing how to handle these customers, firms should determine whether the problem is a small "share of wallet (SOW)" (the amount customers regularly devote to a particular brand rather than to competing brands in the same product category) or a small size of wallet. If the size of wallet is small, then strict cost control measures can reduce loss to the firm. If the share of wallet is found to be low, specific up-selling and cross-selling can extract profitability.

Low profitability-low loyalty customers. These customers have little fit with a company's products and services. The key strategy in managing these customers is to identify them early and refrain from making any relationship investment as these customers have no loyalty toward the firm and bring in no profits. The firm's aim should be to extract maximum profit from every transaction with these customers.

BREAKEVEN & UNPROFITABLE CUSTOMERS

As discussed earlier, many of a firm's customers will be breakeven or unprofitable. It is critical that an attempt be made to bring such customer to the level of profitability. As a first step the reason for the lack of profitability should be identified. It may be due to one or more of the following:

- Low sales volume
- Low selling prices
- High product costs
- High costs to serve

Once the reason has been identified, appropriate actions can be implemented. In terms of the framework in PACE's eBook on revenue management, these may include:

Revenue Management Practice	Action
Pricing	• Increasing prices charged • Adding a surcharge for small orders or for product or service features frequently required • Offering discounts on large orders
Inventory allocation	• Changing availability or products/services based on demand and customer willingness to pay
Product configuration	• Encouraging customer behavior changes that increase long-term profitability
Duration control	• Discourage bespoke product/service requests and regulate customer order arrivals

Additionally, companies can work to improve their operational efficiencies/effectiveness and/or implement more effective cost management to reduce the cost of products/services and the cost to serve customers. The former of these can be an issue that affects all customers as when a product or service does not live up to customer expectations, it is likely to consume additional company resources and can also result in the gradual loss of profitable customers.

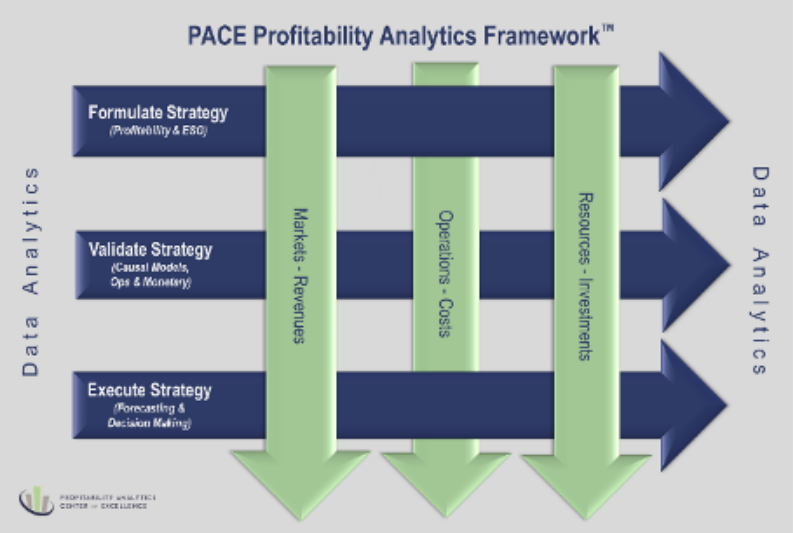
DROPPING MONEY-LOSING CUSTOMERS

After having consider the above actions and implementing those considered appropriate, a company may find some of its customers are still unprofitable and consider “firing” them. Rather than immediately proceed with the firing, the company should conduct a special analysis to determine whether firing these customers would actually increase profits.

It is important to recognize that often not all costs assigned to a customer are avoidable and would not be eliminated if money-losing customers were fired. If little or none of the fixed costs allocated to a “fired” customer are eliminated, customer deletion may in fact worsen the company’s overall profits as the customer’s contribution margin is eliminated but assigned fixed costs and vacated capacity are not eliminated. If the company cannot profitably utilize the unused capacity vacated or eliminate the unused capacity and its costs, it may be more profitable, at least in the short run, to retain unprofitable customers.

CPM AND THE PA FRAMEWORK

CPM should be integrated in every part of the Profitability Analytics (PA) Framework, which calls for a holistic approach to managing an organization's markets/revenues, operations/costs, and resources/investments.



In the strategy formulation stage, companies need to identify their key markets, products/services, and pricing strategies, how they will organize their operations to meet the demands of their customers, and the resources needed. Building causal models in the strategy validation stage will help ensure the validity of the strategy and its successful implementation. Finally, in the strategy execution stage, an organization's causal models can be used to monitor execution of the strategy and to tailor its relationship with individual customers or groups of customers.

NEXT STEPS

Customer profitability management is one of the key issues organizations face, yet most fail to do an adequate job in this area.

This eBook builds on our earlier eBook describing how to measure customer profitability. Now that you know the basics of how to manage customer profitability, it's time to get started! In a future eBook we will cover how to design CPM systems.

[i] Adapted from N. Ellis and D. Hill, "Customer Profitability Management", IMA, 2010.
[ii] See V. Kumar and B. Rajan, "Profitable Customer Management: Measuring and Maximizing Customer Lifetime Value", Management Accounting Quarterly, Vol. 10, No. 3, Spring 2009, pp. 1-18.
[iii] Adapted from W. Reinartz and V. Kumar, "The Mismanagement of Customer Loyalty," Harvard Business Review, July 2002.

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About Alithya

Proven Partner for Oracle Cloud Solutions

Alithya

Alithya is a trusted leader in strategy and digital transformation, employing a dedicated and highly skilled workforce of 3,900 professionals in Canada, the United States and internationally. Alithya's strategy is based on a plan of accelerated organic growth and complementary acquisitions to create a global leader. The company's integrated offer is based on four pillars of expertise: business strategies, enterprise cloud solutions, application services, and data and analytics.

NASDAQ ALYA | 3900 EMPLOYEES | 1200+ CLIENTS | 3500+ PROJECTS | 500+ CLOUD PROJECTS | 330+ ORACLE CONSULTANTS | ORACLE ACEs | 25+ YEARS

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