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Using Customer Profitability Information to Drive the Bottom Line

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By Mark Pickering

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This article utilises a case study of a textile manufacturer and distributor to demonstrate the use of customer profitability analysis to improve company profitability.

An increasing number of organisations are moving their strategies and businesses towards competing by focussing on their customers. Going by a number of names including, customer intimacy, customer dynamics and customer centric organisations, this represents a radical change for companies and industries that have competed generally on a product basis, or in some case, have not had to compete at all.

Understanding the profitability of customers and the drivers of profitability are vital ingredients to this customer focus. This understanding can provide insight into actions, which increase profitability through concentrating sales efforts on profitable/potentially profitable customers and reducing the cost of service. In some cases this understanding can lead to management totally re-evaluating the way the company does business.

"Understanding the profitability of customers and the drivers of profitability are vital ingredients to this customer focus".

While an increasing number of organisations have started to measure the profitability of customers, many are struggling to understand what to do with this information. This article uses the example of a textile manufacturing and distribution company\(^1\) to:
1. Identify a common customer profitability profile,  
2. Provide some insight on the analysis of customer profitability information,  
3. Identify common causes of profitability problems, and  
4. Indicate some of the methods available to raise customer profitability.

**CUSTOMER PROFITABILITY PROFILE**

A textile company, producing and distributing towels and sporting apparel, (TextCo\(^1\)) recently performed customer profitability analysis in order to improve profitability.

Activity Based Costing\(^2\) (ABC) identified the profitability profile of customer segments indicated in Figure 1. A number of customers can be seen to generate significant profits, which are substantially eroded by loss generating customers. This subsidisation is often found across companies and industries.

"Firing" customers should be a last resort after all efforts are made to move these customers into profitability.

ANALYSING CUSTOMER PROFITABILITY

The initial response to this profile is often to “fire” non-profitable customers. This can be a costly mistake as non-profitable customers often contribute to fixed costs and, in many cases, are potentially profitable on a lifetime value basis or through remedial action. “Firing” customers should be a last resort after all efforts are made to move these customers into profitability.

![Figure 1. TextCo Customer Profitability Profile](image-url)
Customer Profitability Analysis

Moving customers into profitability requires analysis as to why the customers are not profitable and to identify actions to rectify this. In analysing customer profitability it is useful to think in the following terms:

A customer will be profitable if the net margin of products and services purchased is greater than the cost of servicing the customer.

The net margin is used as many companies often subtract discounts and rebates below the gross margin, overstating each customer’s gross margin. The cost of servicing the customer usually includes selling, administration and delivery costs, often allocated using activity based costing. Figure 2 gives an example of the net margin, cost of service and profitability of a major customer segment of TextCo.

Mapping net margin vs cost to serve (see Figure 3), on a per order or percentage of sales basis, can provide significant insight into customer profitability. The diagonal line represents the break-even point where the net margin of a customer’s sales equals the cost of servicing the customer. Customers above this line are profitable, while customers below the line are not profitable, as sales are not generating a large enough net margin to cover the cost of servicing these customers.

Figure 3 highlights that the main strategies to improving customer profitable generally consist of:
1. Retaining existing and obtaining new profitable customers above the profitability line,
2. Moving the customer up the scale by increasing the net margin,
3. Moving the customer to the left by reducing the cost of service, and/or
4. Firing unprofitable, below the line, customers.

In order to determine the approach to improving the profitability of a customer segment, it is necessary to determine the causes for the negative profitability.

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**Figure 2. Customer Profitability Example**

<table>
<thead>
<tr>
<th>Segment A - Centralised Department Stores</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>$M</strong></td>
</tr>
<tr>
<td>Sales</td>
</tr>
<tr>
<td>Less Cost of Sales</td>
</tr>
<tr>
<td>Gross Margin</td>
</tr>
<tr>
<td>Less Discounts:</td>
</tr>
<tr>
<td>Volume</td>
</tr>
<tr>
<td>Early Payment</td>
</tr>
<tr>
<td>Total Discounts</td>
</tr>
<tr>
<td>Net Margin</td>
</tr>
<tr>
<td>Less Cost to Serve</td>
</tr>
<tr>
<td>Joint Advertising</td>
</tr>
<tr>
<td>Selling Expenses</td>
</tr>
<tr>
<td>Administration Expenses</td>
</tr>
<tr>
<td>Delivery Expenses</td>
</tr>
<tr>
<td>Cost to Serve</td>
</tr>
<tr>
<td>Profitability</td>
</tr>
</tbody>
</table>

 IDENTIFYING PROFITABILITY PROBLEMS

Understanding the drivers of profitability problems and the potential profitability of each customer/segment often involves understanding why:

- Sales and net margins are lower than possible,
- Some customers are more costly to service than others.

Figure 4. is an example of a high level activity analysis of the profitability of a profitable customer (a centralised department store chain – Segment A) and a non-profitable customer (a non-centralised department store chain – Segment B). This chart highlights the lower net margins and higher cost to serve of the non-centralised chain. Each order generates, on average, $50 net margin, however the average cost of servicing the order was $140, causing a $90 loss.

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**Figure 4. Sample Analysis**

<table>
<thead>
<tr>
<th>Segment A vs Segment B</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Centralised Depart. Stores</strong></td>
</tr>
<tr>
<td>Sales</td>
</tr>
<tr>
<td>Gross Margin</td>
</tr>
<tr>
<td>Net Margin</td>
</tr>
<tr>
<td>Net Margin % Sales</td>
</tr>
<tr>
<td>Cost To Serve</td>
</tr>
<tr>
<td>Joint Advertising</td>
</tr>
<tr>
<td>Selling Expenses</td>
</tr>
<tr>
<td>Administration Expenses</td>
</tr>
<tr>
<td>Delivery Costs</td>
</tr>
<tr>
<td>Total Cost To Serve</td>
</tr>
<tr>
<td>Profit</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>Number of Orders</td>
</tr>
</tbody>
</table>

Looking behind these numbers yielded the following insights:

- TextCo’s role as a secondary supplier to the chain, caused the lower segment B sales volumes and margins. Only lower margin products, not supplied by the primary supplier or products on sale, were purchased from TextCo.
Customer Profitability Analysis

- The relatively high cost of servicing segment B was related to the decentralised nature of the department stores. This was increasing costs as follows:
  - High joint advertising costs as TextCo was being asked to participate at the regional level as opposed to nationally for Segment A.
  - High selling costs as TextCo sent a salesman to each Segment B department store to check shelf levels and take orders on a weekly basis. Segment A department stores centralised purchasing with consolidated orders coming through head office. Monthly visits, as opposed to weekly, were paid to Segment A department stores.
  - Segment B had high administration costs as each department store required multiple invoices (one for each department) for each order and paid using a separate cheque for each department store. Segment A required only one invoice for each order and paid one cheque each month.
  - Higher delivery costs related to multiple deliveries to each department store per week. This compared to consolidated deliveries to a central warehouse for Segment A orders.

In summary, Segment B pricing and discounts had been based on TextCo achieving significant economies of scale benefits from the volume of purchases. These benefits were not being realised due to the need to deal with each department store independently and the costs that the chain had effectively pushed back on TextCo.

Large customers demanding low pricing and high levels of service are a common cause of customer profitability problems. Table 1 indicates some of the more common causes of unprofitable customers with examples from the TextCo analysis. These examples can be reviewed in terms of the profitability of the segments as shown in Figure 1 and 3.

**Figure 5. Types and Examples of Potential Profitability Actions**

1. **Retain & Obtain Profitable Customers**
   - eg: Retention efforts, pro-active pricing and service for profitable customers.
   - Target offerings, marketing and sales to potentially profitable customers and non-customers.

2. **Increase Net Margins**, eg:
   - a) Increase Net Prices:
     - Increase product/service prices.
     - Review discount structure.
     - Sales commissions on profitability.
   - b) Reduce Product/Service Costs
     - Action non-profitable products.
     - Reprice, redesign or eliminate.
   - c) Increase Customer Order Sizes
     - Focus offerings, marketing and sales on customer needs.
     - Minimum order sizes/charges.
     - Focussed sales effort.
     - Multiple product discounts.

3. **Reduce Cost of Service**, eg:
   - Reengineer sales, marketing and services processes.
   - Implement low cost channels, eg call centres and Internet.
   - Provide differential levels of service to different customers.

4. **Fire Non-Profitable Customers**, eg:
   - Option of last resort.
   - Migrate to wholesalers.
   - Increase prices to point of exit.
   - Migrate to alternate suppliers.
   - Notify of inability to continue supply.

**ACTIONS TO IMPROVE PROFITABILITY**

Numerous levers can be identified to improve profitability through the use of customer profitability information.

The appropriate action depends on the level of actual and potential profitability of customers/segments, the cause of profitability problems, the needs of the customer segment and competitor offerings.

Examples of the actions that customer profitability information provides significant input to are shown in Figure 5. The major types of actions identified are:

1. Retain and obtain profitable customers,
2. Improve net margins,
3. Reduce the cost of service, and
4. Fire unprofitable customers.

These will be illustrated through examining TextCo’s actions to improve customer profitability.

**TextCo’s Response**

TextCo’s responses to the customer profitability analysis were on a segment by segment basis. Some of the actions taken were relevant across all segments. Overall actions and those for some of the segments are discussed below.
Customer Profitability Analysis

Table 1. Common Causes of Non Profitable Customers

<table>
<thead>
<tr>
<th>Common Cause</th>
<th>Example</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Large customers demanding low prices and high levels of service.</td>
<td>Segment B department stores negotiated low prices, purchased lower margins goods and caused high selling, administration and delivery costs.</td>
</tr>
<tr>
<td>2. Undifferentiated service with low sales value customers receiving the same high cost service as large, high volume customers.</td>
<td>Segment C (small retailers) being serviced through costly weekly sales visits and deliveries. These retailers will never generate sufficient net margins to cover these costs.</td>
</tr>
<tr>
<td>3. Providing high service levels as a competitive differentiator, without being paid for them.</td>
<td>Management considered their ability to deliver to segment E (remote retailers) overnight was a competitive advantage. Unfortunately the high cost of delivery made every order unprofitable. The company’s sales process was costly relying on sales visits for all transactions and customers. No use of lower cost channels, such as call centres or EDI. Produces highly customised products for a number of small retailers (segment C). Particularly relevant in industries where the cost of obtaining and setting up customers is high and/or customers increase in profitability over time eg insurance and telecommunications.</td>
</tr>
<tr>
<td>4. Overall high cost sales, administration and delivery processes.</td>
<td>Not identified as a problem at TextCo.</td>
</tr>
<tr>
<td>5. Providing highly customised products/services.</td>
<td></td>
</tr>
<tr>
<td>6. High customer turnover.</td>
<td></td>
</tr>
</tbody>
</table>

Across Segments

An ABC analysis of products indicated that a number of products were not profitable. TextCo management realised that making customers profitable would not be possible with uncompetitive products. Some products were repriced, while others were redesigned and new raw material sourcing arrangements identified to move the majority of these products into profitability. TextCo’s sales process was found to be costly. Some segments would never generate enough sales to cover the cost of the sales force servicing them. A lower cost sales channel, a call centre, was established. The sales force was provided with information technology support to provide them with required information at point of sale and to free them from paper work. Sales commissions were adjusted to a profitability basis from the prior sales volume basis in order to encourage the right sales behaviour.

Centralised Department Stores and Mid/Large Retailers

These segments were seen to be the main drivers of TextCo’s profits. Retention of these customers was seen as the main priority and a customer satisfaction program launched. Pricing was reviewed and in some cases discounts increased. When a major department store was subsequently at risk to a competitor, TextCo had the cost information necessary to enable them to aggressively bid to keep the client.

TextCo targeted companies in these segments for sales effort. An understanding of the costs and therefore profitability associated with these companies enabled management to aggressively price and expand sales into existing customers as well as win a number of new profitable customers.

Non-Centralised Department Stores

These loss generating stores were targeted for profit improvement. Customer profitability information was used to renegotiate the price and discount structure as well as levels of service. The net price was increased slightly and service levels changed. TextCo’s contribution to joint advertising was reduced, sales force visits restricted, supplemented by the call centre, and delivery frequency was reduced.

While this segment did not become profitable, losses were reduced significantly and these customers now contribute to TextCo’s fixed costs.

Remote Retailers

The approach to these customers was profit improvement and in some cases exit. Net margins were increased through a 10% price rise and the introduction of a minimum order charge. Servicing these customers through the call centre and increasing delivery time from overnight to three days reduced the cost of service. These changes were consistent with TextCo competitors.

While a number of smaller and more remote customers were migrated to wholesalers and some customers moved to competitors, segment sales volumes remained constant and profitability increased.

TextCo Results

These actions resulted in TextCo tripling profits. TextCo now has a more solid focus on the profitable segments and reliable profitability information to enable competitive pricing for all customers based on actual service required.

CONCLUSIONS

Customer profitability information provides a basis for management to focus on the bottom line. It provides an understanding of the causes of profitability or non-profitability for each customer segment and the levers available to improve profitability.

This understanding is vital to efforts to become customer centric. Management can now focus retention, sales and new customer acquisition efforts on profitable and potentially profitable customer segments.

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Updated Author Details (March 2014)

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1 This disguised example is based on the analysis, findings and actions performed on actual assignments.


3 This analysis approach has been adapted from “Cost and Effect” page 193 Robert Kaplin & Robin Cooper, Harvard Business School Press 1998.