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Creating and Capturing value in KAM relationships

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Questions have recently been raised about whether key account management (KAM) pays off for suppliers. Previous research has been equivocal on this issue. Yet suppliers are increasingly adopting (or being forced by their customers to adopt) KAM, which could be problematic if the supplier is unable to capture value from the relationship. This research examines how suppliers capture value from KAM. First, supplier-influenceable aspects of the value of the customer are explored through an elucidation of the drivers of customer revenues and costs. Then, value capture in KAM relationships is examined through the lens of five research propositions. The first result of the research contributes to theory with a detailed model of the drivers of customer lifetime value. The second result contributes to KAM practice through a confirmation of the five propositions and an exploration of how ten good practice companies capture value from their KAM relationships.

KEYWORDS: Customer profitability; Customer lifetime value; Key Account Management; Value capture

INTRODUCTION

Marketing has been described in terms of social exchange theory (Bagozzi, 1974; Cannon and Homburg, 2001), in which exchanges are determined by causes endogenous to the exchange itself. From a value-based perspective, value is exchanged when transactions take place, resulting in customer and company value creation, the latter relating to the financial value of the relationship to the company (McTaggart, Kontes and Mankins, 1994). However, the amount of value exchanged may not be evenly distributed between buyer and seller (McTaggart, Kontes and Mankins, 1994) and may change over time (Slywotzky, 1995).

KAM is one of the most important issues to emerge in marketing (Homburg, Workman and Jensen, 2002), yet doubts have recently been raised about its payback (Piercy, 2005). From the suppliers' perspective, strategic customers have become more difficult to acquire and retain as markets mature and as such customers demand ever better service at ever lower prices (CIM, 1994). The proportion of business coming from key accounts is increasing (Wilson, 1996), but the increased power of these customers makes it more difficult for suppliers to capture value from the relationship. Yet industrial firms prefer to deal with known counterparties (Holmlund, 2004), suggesting that strategic or key account management is preferred by both supplier and customer. The benefits to the customer of being treated as a strategic account are clear; however, powerful customers may negotiate away the benefits to the supplier of entering into such relationships (Kalwani and Narayandas, 1995). Some studies have even suggested that relationships with very large customers may be unprofitable for suppliers (e.g. Cooper and Kaplan, 1991; Kalwani and Narayandas, 1995; Reinartz and Kumar, 2002). Therefore, suppliers need to understand how to capture value from their key customers.

LITERATURE REVIEW AND RESEARCH PROPOSITIONS

One approach to measuring the financial benefits to suppliers from a strategic relationship is to measure the period-by-period profitability of the customer portfolio. Such analysis may reveal that the firm obtains the majority of its profits from a very small proportion of its customers. Cooper and Kaplan, for example, find that 20% of US heating equipment company Kanthal's customers account for 225% of profits (Cooper and Kaplan, 1991). Wilson finds two instances in which 50% or more of a company's profits come from 10% or less of its customers (Wilson, 1996). Van Raaij, Vernooij and van Triest (2003) discuss a case in which 5% of customers account for 74% of corporate profits.

From the supplier's perspective, the risk of a customer base in which fewer, larger customers predominate is that the cost of satisfying and retaining these customers could be so great that it could lead to the destruction of profits and shareholder value (Anderson and Mittal, 2000; Doyle, 2000a; Kalwani and Narayandas, 1995; McTaggart, Kontes and Mankins, 1994; Rust, Zahorik and Keiningham, 1995). The larger the customer, the greater their ability to drive down prices, obtain favorable payment terms, and drive up profits, negotiating away profits from the supplier (Kalwani and Narayandas, 1995; Shapiro et al, 1987). Several studies have in fact found that business done with very large customers may increase revenues but not short-term profits (Bolen and Davis, 1997; Cooper and Kaplan, 1991; Rangan, Moriarty and Swartz, 1992; Storbacka, Sivula and Kaario, 2000; Van Raaij, Vernooij and Van Triest, 2003; Wilson, 1996).

Supplier preferences for KAM would therefore be inexplicable were it not for the evidence that long-term relationships with key customers pay off for suppliers as well as buyers (Kalwani and Narayandas, 1995; Narayandas and Rangas, 2004), even where power asymmetries are considerable.

Both suppliers and customers have a preference for relationships (Holmlund, 2004). Thus, positive value exchange must be taking place for suppliers as well as customers. This leads to the first research proposition:

P1: Suppliers who engage in KAM are able to capture financial value from their KAM relationships over the longer term as a result of a mutually beneficial collaborative relationship.

Because of the long-term nature of the value capture in KAM relationships for suppliers, longitudinal customer profitability analysis, either individual customer lifetime value analysis (Berger and Nasr, 1998; Mulhern, 1999) or at the customer portfolio level (customer equity), may be preferred for marketing decision-making (Blattberg, Getz and Thomas, 2001; Rust, Lemon, and Zeithaml, 2001; Zeithaml, Rust, and Lemon, 2001). However, KAM relationships are known to be complex (Campbell, 1997; Sengupta et al., 1997) because of product and process customization (Woodburn and McDonald 2001) as well as their geographical and product extent (Holt and McDonald, 2001). This leads to the second research proposition:

P2: Because of the complexity of the relationship, involving multiple products and geographies as well as product and service customization, the calculation of the profitability of key accounts is complex.

Value-based approaches to marketing stress the dynamic and interactive aspects of business relationships. In the context of capturing financial value from key accounts, it is clear that customer management affects the profitability of the customer relationship (Niraj, Gupta and Narasimhan, 2001; Ryals, 2005; Shapiro et al., 1987). Research into supplier-customer relationships suggests that longer-term relationships are not intrinsically profitable; it is the way that the relationship is managed that determines profitability (Doyle, 2000b; Kalwani and Narayandas, 1995).

This suggests that capturing financial value in KAM relationships is a complex, long-term process whose success hinges upon an understanding of CLV and profitable management of KAM relationships. Unfortunately, the field of customer profitability and lifetime value analysis remains under-researched (Reinartz and Kumar, 2002; Thomas, Reinartz and Kumar, 2004). If key accounts can negotiate away their value to the supplier, an important role of the key account manager is to develop an understanding of the way in which the nature and behavior of the key account and the way in which it is managed drives customer revenues and customer costs (Ryals, 2005). Following from this, the third research proposition is:

P3: Key account managers try to track the drivers of customer lifetime value; especially costs, the aspect they can most closely influence.

Despite the importance of CLV, many companies do not know what the profitability of their customers is (Reinartz and Kumar, 2002; Thomas, Reinartz and Kumar, 2004; Woodburn and McDonald, 2001). One explanation is the complexity of customer lifetime value calculations and the difficulty of obtaining data on customer profitability from existing, product-based management accounting systems (Zolkiewski and Turnbull, 2000). Attempts to analyze customer profitability often reveal surprising gaps in what firms know about the profitability of their customers (van Raaij, Vernooij and van Triest 2003). Thus the fourth research proposition is:

P4: The complexity of KAM relationships can lead to gaps and inaccuracies in the measurement of customer lifetime value.

Supplier gaps in knowledge about customer lifetime value and costs to serve reduce their ability to capture value from these relationships. Key accounts may attempt to capture all the financial value themselves and may exploit gaps in the supplier's knowledge about customer lifetime value (Ryals, 2005). The problem of powerful customers exerting a 'pincer' effect that puts upwards pressure on supplier service levels and downwards pressure on prices has been noted in previous research (Kalwani and Narayandas, 1995; Ryals and Knox 2005). This leads directly to the fifth research proposition:

P5: Powerful key customers use their power to try to extract more value from their suppliers by pressuring them to reduce prices and to increase service levels, often simultaneously.

The aim of this research is to develop a deeper understanding of customer revenues and customer costs that will help in financial value capture through the profitable management of KAM relationships.

CONCEPTUAL FRAMEWORK

The calculation of customer profitability is based on customer revenues minus costs (Caroll and Tadikonda, 1997). Four types of cost may be considered: product cost; cost to serve; customer-specific overheads; and general overheads. In the interest of simplicity, general overheads may be disregarded (Ryals, 2002b) so that the only costs that are considered are costs that differ by customer. Thus, a general formulation for the calculation of customer profitability in any one period is customer revenues minus customer-specific costs (Ahmad and Buttle, 2001). The first step in capturing financial value is to understand the drivers of customer revenues and customer costs.

Previous research into the value of customer relationships has discussed a number of drivers of customer revenues and customer costs. This previous research is conceptualized in Figure 1:

- bring in Figure 1 here –

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Methodology

To explore value capture in KAM relationships a two-part research process was used. Focus groups were used to validate the drivers of customer revenues and customer costs for key account relationships, to see whether additional revenue or cost drivers over and above those indicated by previous research were present. In-depth interviews were used to investigate the research propositions.

Two focus groups into customer lifetime value drivers were run. All participants were senior managers or directors of marketing or sales, working for UK, US or Scandinavian corporations, and all had considerable experience of KAM relationships. The first focus group consisted of five participants from four manufacturing companies. The second focus group comprised six participants from six business-to business services companies. Each focus group was asked to consider the lifetime revenues and costs of their major accounts and to compile a list of revenue and cost drivers.

For the in-depth interviews, an expert sample of 10 companies considered to represent best practice in key account management was selected. All were blue-chip global firms with their headquarters in the US or in Europe. The sample frame was membership of SAMA[1] in the US or of the Cranfield Best Practice KAM Club in the UK. To ensure robust and generic results, a spread of companies across different sectors was sought. Companies from the financial services, energy, technology, pharmaceuticals, food and beverage, credit services, logistics, and travel sectors participated.

[1] The Strategic Account Management Association.

Based on the literature and the five research propositions, a discussion outline was prepared covering some 15 topics related to customer lifetime value and value capture in KAM relationships. The face validity of the discussion outline was confirmed by a leading academic in this field. 18 interviews of between 1 and 2 hours were carried out with senior managers who either had responsibility for the participating company's overall key account management program, were themselves senior global account managers, or had a senior supporting role in the key account management program (such as finance or analysis). Whilst there were some differences in the details of how the KAM programs of participating companies functioned, all shared the common characteristics of being KAM programs with global reach, in companies who had been named by experts as demonstrating excellent practice, and in which there was some degree of measurement of customer lifetime value, although the precise method and sophistication of this measurement naturally varied.

FINDINGS

The findings are presented in two sections. First, the findings from the two focus groups on the drivers of customer revenues and customer costs are set out. Then, the results from the interviews are explored, proposition by proposition.

The drivers of customer lifetime value

The results of the two focus groups are summarized in Table 1.

- bring in Table 1 -

The revenue drivers identified by the two focus groups are relatively similar, suggesting that customer revenues are largely determined by a few major drivers such as customer size, product mix purchased, share of spend, and add-on products or services purchased. The service providers identified their brand

and market position as important, although this was not discussed by the manufacturers. Presumably, corporate brand is more important where the products are intangible.

The findings on customer revenue drivers support previous research in that pricing, account penetration (share of spend) and customer size are seen as important. Customer retention was mentioned by neither group, supporting Dowling's (2002) contention that it is total revenue rather than relationship duration that drives the value of the customer.

The list of cost drivers differed between the two focus groups, suggesting that cost drivers are more varied. Product or service customization and tailoring appeared on both lists, as did uncharged sales support or after-sales training or goodwill. The findings support previous research to the extent that product costs and costs to serve of various kinds appear on both lists, but neither group identified customer-specific overheads as a cost driver. It is probable that customer-specific overheads, which might include full-time on-site customer support, are relatively unusual.

Through a detailed exploration of the drivers of customer lifetime value, the findings from the focus groups set out the areas in which suppliers can capture or lose value in KAM relationships. How suppliers actually manage value capture in KAM relationships is explored through the five research propositions; the results from the interviews based on these propositions will now be discussed.

P1: Financial value capture in KAM relationships

The suppliers in our research described the value they gained from key account management in terms of business growth and cost reduction. Sources of business growth were: selling to new customer divisions; share of spend; customer retention; consistency (harmonization); speed of results; and identifying more opportunities with that customer. Sources of cost reduction were: learning curve; economies of scale; process development and supply chain management; avoiding formal tenders; improved forecasting; and quantified value exchange (Table 2).

- Bring in Table 2 here –

Much of the discussion around financial value focused on the supplier's share of spend, or on growth through selling to new divisions of the customer. Most, but not all, of the suppliers were aware not just of their share of spend but also of the likely ceiling. A ceiling could be defined in one of three ways: 100% of the business available; the maximum the supplier wanted to achieve; or a share seen as fair (or safe) by the customer. Interestingly, a 100% share of spend was not universally regarded as desirable. Some suppliers were keen to push their share of the customer's spend to 100% but others were not. In some cases, 100% share was viewed as impossible because the customer would prevent it happening but, in other cases, the suppliers themselves thought that a 100% share was undesirable because the kind of business available over some optimal level was likely to be loss making. One high-tech company, for example, said:

> "Our analysis shows that 70% share of wallet is best for us. At that level we maximize our profit and, beyond that, we start to lose money"

Customer retention tended to be linked to share of spend. In situations where the share of spend ceiling had been reached or where the relationship with the customer was perceived to be under threat from the competition, suppliers were unsurprisingly focused principally on customer retention and maintaining the stream of revenues and profits from their key accounts. Other suppliers who were close to, or at, the share of spend ceiling, targeted new divisions of the same customer using the advantages that the existing relationship gave them:

"With another division they didn't even go to tender - they didn't want to reinvent the wheel..."

Consistency and harmonization is attractive to key customers because of the potential for cost savings in training, stockholding, monitoring and operations through simplification and uniform quality worldwide. Because of is attractiveness to customers, suppliers able to deliver consistency and harmonization can substantially increase their volume with key accounts. The research revealed one example where a supplier obtained a 43% growth in revenue through consistency whilst avoiding the expected margin erosion. Other suppliers had seen volume increase but margins reduce as a result of consistency; several were unclear whether the overall impact on profits had been up or down.

Several suppliers noted that, in a key account management relationship, new initiatives were often implemented faster. This led to an acceleration in new business with a key account, which, in turn,

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