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Managing customers profitably

In recent years there has been a growing focus on understanding the profitability of customers. Alarmingly, as companies learn more about the value of their relationship with their customers, they quite often also become aware that some customers are unprofitable. In hard times, companies need to think about the customers they acquire, and the way in which they manage and retain them, to make sure that they are getting the best possible return from each relationship.

To manage customers profitably, managers need to follow these three rules:

Rule 1. Understand the profitability of customers

Measuring the profitability of customers is more complex than measuring the profitability of products. The reason for this is that a customer's relationship with a company may extend across a number of business units, so getting an overall picture of the whole relationship can be difficult. Unlike products, customers are not standardised. The cost of looking after each customer can vary from relationship to relationship.

There are three main ways in which companies can calculate the profitability of their customers. These are: customer profitability analysis; customer lifetime value; and customer equity. Customer profitability analysis usually refers to the value of a customer to the firm in the previous year. Customer lifetime value is the net present value of the future streams of profit (or cash flow) from a customer. Customer equity is usually used to describe the net present value of a customer portfolio.

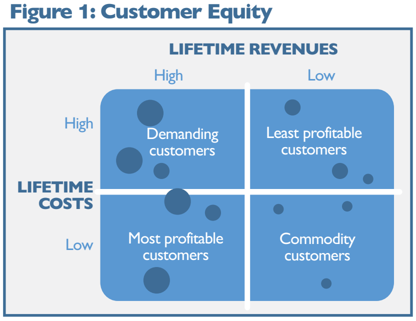
When calculating customer profitability analysis, or forecasting customer lifetime value, the most important area to consider is Costs-To-Serve (CTS). The reasons that CTS are usually high are customer-specific. Some customers just need more management effort or 'hand-holding' than others. Typically, this is what makes the difference between a profitable and an unprofitable customer. CTS may include sales and account management costs, customer service, administration, and logistics costs. To measure CTS, the company needs to use an activity-based technique.

Activity-based costing is a precise and painstaking costing technique. However, a full activity-based costing exercise is not necessarily needed for customer profitability analysis. A good estimation of customer management costs can be obtained by analysing where account managers and sales people spend their time. Diary analysis can give this information, which is then multiplied by the costs of the manager or sales person involved. Some companies even have software systems that can record activity costs.

Similar principles apply to calculating customer lifetime value, although this is a forecasting exercise. Customer-by-customer, the account manager has to forecast the products they will buy and the prices they will pay; and the costs to serve and direct costs in the future.

Where companies have hundreds or thousands of customers, a customer-by-customer calculation of lifetime value is impossible. In this situation, some organisations use a customer equity approach. A few key questions are used to establish the likely future revenues from a customer and estimate their costs (see figure 1 below).

Figure 1: Customer Equity



The most valuable customers are, by definition, those that combine high lifetime revenues with low costs to serve. The least valuable are those with low revenues but higher costs.

The customer equity concept will often incorporate estimates of products that customers may buy several years into the future. If the company is a bank or a mobile phone company with a sophisticated CRM system, it can use this to help it forecast the probable value of a customer.

Rule 2. Manage the customer portfolio for profit

If the value of a customer is known, the company is in a position to decide what offers it should make to that customer to maximise its chances of retaining them and capturing the lifetime value it has forecast. More importantly, understanding the value of customers enables decisions about when to say 'no' to customers. One of the big problems in trying to manage a customer portfolio profitably arises when sales people or account managers develop fabulous value propositions for their customers but fail to understand the cost of delivering them. This issue is exacerbated if sales people are rewarded on their top line sales, and not on the bottom line profits of those sales. In hard times, it is tempting to increase the incentives for customers to remain with the company. However, doing so could render them unprofitable if the company does not understand the cost implications of its retention strategies.

This raises the question 'how much customer satisfaction is enough'? After all, some companies have worked hard to drive satisfaction levels up and up, only to find that customer retention is not following suit.

Research has shown that customers who declare themselves to be satisfied often still defect. Other studies have found that customer satisfaction levels are broadly in decline, even in places like the US where companies have been pumping lots of money into service. The sad truth is that a company will go bankrupt long before its customers are 100% satisfied.

In fact, there is a trade-off between creating shareholder value and delivering customer satisfaction. At lower levels of performance, the two are positively related. If you start from poor service and improve, customers will tend to stay longer, buy more and recommend you, which increases shareholder value. However, when customer service levels are high, further increases in service may actually cost the company money, because the rapidly-increasing costs of moving from good to great are higher than the incremental value gained from customers. In other words, companies can spend too much on looking after their customers. There's no point having fantastically happy customers if the company is losing money on them.

This is where careful management of customer lifetime value or customer equity comes in. Take the high-revenue, low-cost customer. These are customers who, by definition, have the highest lifetime value. They are also the customers who are most likely to be attractive to the competition, so the correct customer management strategy here is to retain them.

Some companies do this by offering longer-term contracts to these customers; others tie them in with shared information systems, longer-term pricing or shared processes.

Another group is the high-revenue but high-cost group of demanding customers. These are large customers (high revenues) but the high costs of looking after them might mean that they are not particularly profitable. The trick with this type of customer is to retain the high revenues, but manage them with less cost. This might mean incentivising them to move to cheaper channels (such as internet ordering); or it might mean renegotiating terms.

Most companies have a large number of customers who fall into the 'commodity customer' category. These are low-revenue but low-cost customers. In other words, they generate relatively little business, but their costs are low. The most effective strategy with these customers is to contain the costs of doing business with them. It is bad strategy to develop costly new value propositions for customers and then to offer them to this group. Either they cannot afford them, in which case it is a waste of sales and marketing time; or, perhaps worse, they flock to the new offer in droves, reducing the company's ability to service its more valuable customers. Marketing needs to be targeted to ensure this does not happen.

Finally, there is the fourth group, which has relatively low lifetime revenues but reasonably high costs to serve. An example of this occurs in retail banking, where low-profit or no-profit current account customers make heavy use of the branch network.

Some retail banks have chosen to shut down branches or to charge these customers for costly services, effectively either reducing their service levels or putting up their prices. Other companies have re-routed this least profitable group through intermediaries rather than continuing to service them directly.

Rule 3. Acquire more profitable customers

'Only acquire customers who are profitable' is simple advice, but implementing it is difficult. All too often, sales people are measured and paid by the volume or revenues they bring in, rather than the bottom line. If the sales people are also able to give discounts, it is very tempting for them to do so, especially towards the end of the quarter when they are striving to meet targets. Not infrequently, customers become aware of this pattern and start to delay placing orders until the end of the quarter, when they can be sure of an attractive offer.

So, ensuring that sales people understand the profit impact of giving a discount is important. The second consideration is to recognise that, just because a customer is a good customer, does not mean that all of their business is good business. Not all opportunities are good ones, and suppliers should be mindful that they don't need to chase every opportunity that comes along.

A useful technique for helping sales people and customer managers to sort out the good opportunities from the bad is the technique of calculating Expected Monetary Value (EMV). This involves thinking about the possible risks and their probability.

Table 1: Expected Monetary Value (EMV)

Possible outturn	Profit forecast	Probability	EMV
Runaway success supplier has to work overtime	£3,000	0.1	£300
Turns out ok	£10,000	0.6	£6,000
Not a success: supplier has held finished goods, scale back production etc	£2,000	0.3	£600
		1.0	**£6,900**

In the example shown in table 1(above), although the most likely outcome is a profit of £10,000 if all goes well (row 2), there would be substantial additional costs for the supplier if the project was an unexpected success, and also if there was an unexpected failure. When these are taken into account, the EMV of this opportunity is not £10,000 but £6,900. The supplier should take this into account when considering how to price this tender. Too often, what looks like good business turns out to be unprofitable because of unanticipated changes to circumstances. Thinking about the risks up-front introduces a measure of objectivity into the tendering process.

The third rule for acquiring customers who are more profitable is to use a rule of thumb, which is that the most profitable customers tend to share certain characteristics. These might include their behaviour patterns, demographics and purchasing processes.

Once the company understands what profitable customers typically look like, sales people can try to locate more customers like these. Smart companies also use this technique to filter customers through their call centres and websites. Key questions are used to establish what kind of prospects are contacting the company and whether they are likely to prove profitable. Based on these key questions, the incoming customer can be steered towards certain products and services.

The main messages are clear. The more that a company knows about the profitability of its customers, the more targeted and effective its retention marketing can be. Some simple techniques for identifying profitable customers can help sales people avoid acquiring customers that turn out to be unprofitable. Companies will survive this recession if they: keep their most profitable customers; avoid acquiring unprofitable ones; and take action to manage existing customers that are unprofitable. It's not enough to think in terms of 'selling more products'. Many companies who go bankrupt have just had their best-ever year in terms of sales. In hard times, the trick is to focus on getting and retaining profitable business. MF

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