Customer Profitability

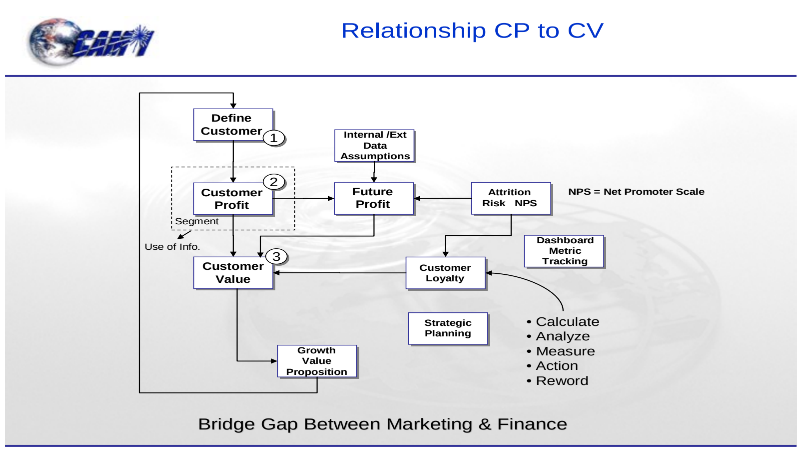
John A. Miller, Author

Profits earned on customers and customer segments may be one of the most important measures and yardsticks of organization performance. The bottom line on any customer (or customer segment) P/L statement represents the basic exchange of value between an organization and its customer. Value to the customer is reflected in the selling prices that comprise revenues. Value for the supplier is reflected in the profit (or loss) of the products and services provided. Add in the investment of working capital and property, plant, and equipment made on the customer’s behalf and the ROI on the relationship can begin to be understood.

This article is intended to provide an overview of Customer Profitability including application and use, benefits, methods for calculation, and best practices. Customer profitability looks backwards and provides a picture of the past. More important to many industries is Customer Valuation, the future value of the customer. The distinction of customer profitability and customer valuation is contained in the definitions below:

- ***Customer Profitability:*** The periodic reporting of the profits earned on individual customers/customer segments. It’s like the reporting the profits of a business and based on actual revenues and costs
- ***Customer Valuation:*** The lifetime value of individual customers/customer segments. It’s like valuing a business and based on projected revenues and costs (discounted)

A visual relationship of Customer Profitability and Customer Valuation, inspired by Charlene Harper of Charles Schwab, is illustrated below:



Whether the objective is Customer Profitability or Customer Valuation, both require a definition of the customer or customer segments and historical profitability. Forward looking Customer Valuation requires assumptions about future profit, attrition risk, customer loyalty, and economic and market growth (to name just a few). For customer profitability each of these assumptions are represented by what actual happened during the reporting period.

Projections of the future are significantly enabled with historical data and information. Without understanding the historic profitability of customer and customer segments, projections into the future would be difficult if not futile. There would be no historic verifications or guidelines for future assumptions. Customer Profitability is a perquisite for Customer Valuation. For that reason, this article focus is on the former.

Beyond answering the basic value question of the customer relationship, understanding the profitability of customers and customer segments provides significant benefits and is an enabling factor:

- Sales and marketing. Keeps the sales organization focused on the high value customers and identifies high value customer opportunities. Aligning sales/marketing costs to key customer segments. Focused customer service levels (not all customers are equal).

- Marketing. Enables marketing to reduce the risks of spending scarce marketing dollars to retain its least-valuable customers. Supports CRM and Customer Centric initiatives. Eliminate/reduce customer behaviors that impact cost. Target new customer development efforts. Target new market opportunities. Reduce customer churn. Organizing the business into customer segment business units. Customer-centered learning process to drive customer innovation

- Operations. Basis for developing and executing competitively dominant customer value propositions. Minimum order quantities. Aligning new product/service development to the most profitability customers (both current and emerging). Design and lay-out of retail operations.

- Pricing. Pricing decisions can differentiate services/offerings in a way that is commensurate with the value of each customer. Customer Profitability initiatives emphasize expanding services to existing customers through menu-based and service-level pricing. Increasingly customers are requiring alternative pricing models and the unbundling of services and costs instead of a one-price-fits-all approach. Knowledgeable and sophisticated customers recognize that their buying practices are cost drivers for their suppliers.

- Exposes unprofitable customers. Every organization has unprofitable customers who have a greater cost to serve and require special orders, special packaging, frequent deliveries, and other unique buying requirements. Organizations can work with their customers to change the conditions causing the costs: order size, order frequency, or delivery practices. In service companies the emphasis might be on getting customers to use their lower-cost internet web site for communications and ordering.

The overall effort and requirement for calculating customer profitability varies significantly between industries and companies. Depending on the company, sales and revenues come from a handful of customers buying million of dollars of a single product or from millions of customers spending a hundred dollars a week on a basket of groceries. In the first case, the company would know its customers by first name. The grocery store is unlikely to know the revenues of its customers (or the products/services they purchased).

Some companies have data and information about each of their customers, others no information and rely on focus groups and customer sampling to segment and understand the revenues, product/service mix, and costs and to calculate the profitability of the segment. Other companies with millions of customers, like utilities, telecom, and insurance, capture revenue and services for each individual customer in the monthly billing for electricity, mobile cell phone service, or insurance policy. The monthly billing also provides them with the information on the products and services purchased. The availability of reliable customer data and information is significant to the overall work and requirement for calculating customer profitably.

One way to illustrate the differences between companies is by their business model.

- B2B. Businesses selling to other businesses generally have a large amount of data about each of their hundreds or thousands of individual customers. Customer switching costs are high and customer/supplier relationship is often covered by short term agreements and contracts. B2B applications of Customer Profitability include contract negotiation and establishing minimum order quantities, order frequency and lot size. In times of tight supplies it provides information to align capacity with the most profitable customers. U.S. Steel, Halliburton, and Baker Oil Tool are examples

- B2C. Businesses that sell to consumers have millions of customers, some of which will be data poor, others data rich. The switching costs for the customer (consumer) are low. Wal-Mart (data poor) and Sprint/Nextel (data rich) are examples. B2C applications of customer profitability include targeted marketing, pricing for product/service bundle, and service levels. The location of retail items and the lay out of the floor space can be designed to appeal to the most profitable customers.

- B2B2C. Some businesses sell to other businesses who, in turn, sell to the consumer. Their customers, distributors and large retail operations, number in the tens of thousands: consumers in the millions. These businesses typically know a lot about their customers and little about their consumers. Customer switching costs are high and the customer relationship covered by long term contracts and agreements. General Motors and John Deere are examples. Example of B2B2C applications include optimizing distribution, product/service pricing, and to focus marketing and promotional efforts

Within a single company, its products and services could have elements of all three business models. The entire telecom industry is built about providing service to businesses, individual consumers, or through sale by a third party retail operation like Best Buy.

In making the customer profitability calculation it is best to start with the end in mind. What will customer profitability information be used for? What decisions would be enabled with this information? How accurate does the information need to be? Who will use the information? How often will they need it? What costs are to be included in the calculation? All these questions must be answered before the calculations are made.

The calculation of customer profitability itself is pretty straightforward. Revenues and cost (product/service cost and operating expenses) are assigned, traced, or allocated to customers or customer segments. For most organizations the cost of its products and services is a significant part (over 75%) of the total cost structure of the business. For these organizations, gross profit (sales minus the product/service cost), by customer may be sufficient to understand customer profitability. For many businesses, revenue information for each customer is available in the existing revenue and billing systems. The cost of its products and service costs have been studied, documented, and available in standard cost systems, Activity-Based Costing models, or embedded in the organizations ERP and BI systems. The operating expenses (selling, marketing finance, information technology, and general and administrative) attributable to customers may be more illusive. Part of operating cost is “Business Sustaining” with no cause and effect relationship to customers. These costs could be allocated arbitrarily (on revenues for example) or excluded from the calculation completely. There is a cause and effect relationship between other parts of operating costs (sales, marketing, retail outlets, and parts of finance and administration) and the customer. It will take a little work to appropriately assign these costs to customers.

More demanding is customer segmentation. Banks, insurance, telecom, utilities, and other companies can take revenues and a significant portion of their overall costs to individual customers and customer accounts. For decision making purposes, this information is of little value. It’s the segments the customer falls in that is important and necessary for decision. For example, health insurance companies know revenues and claims (90% of all costs) for each insurance policy they sell. Some policies will have more claims than others. That’s the nature of insurance, the sharing of risk over a broad population. What’s important to the health insurance company is the customer segment.

As one goes from a few customers you know to millions you don’t know, the identification of customers and customer segment gets progressively harder. Retail operations and other businesses servicing the consumer are constantly gathering sampling data to segment their customers into clusters that represent the products and services they want, buying habits and behaviors, and requirements of the segment/cluster.

From a competitive standpoint, the goal is to segment customers into groups with homogenous needs so they can approached, acquired, and insulated from competitive attack. The definition of a customer segment and trade-ff is as follows:

- **Definition**: Group of customers with sufficiently homogeneous needs that the segment members can be won with a common value proposition and common marketing. A low degree of homogeneity reduces the likelihood of finding a value proposition that will satisfy most of the segment

- **Trade-off**. Finer segmentation better focuses on customer needs that leads to better-crafted and more differentiated value propositions and greater acceptance, higher margins, increased loyalty, and higher economic profit. Too much segmentation leads to higher costs to maintain

Conventional customer segments of a B2C business include age, annual household income, average purchase size, revenues zip codes, occupation, and material status. Examples of customer segments for Dell Computer

- Small business
- Medium and large business
- State and Local government
- Federal government
- Education
- Health Care

Customer needs may not be apparent through their behavior and may not correspond with products and services currently offered. Segmentation is difficult because it is rarely possible to know with certainty a customer's needs based on the available information about the customer. Companies often look for customer traits that are best available proxies. In additional to conventional customer segmentation some people get creative. Take Wachovia Bank for example. They have five different segmentation programs, each with a key focus (in parenthesis).

- P$ycle or psychographic (market comparison)
- Behavioral (cross sell/up sell)
- Book of Business or value (cross sell/up sell and retention)
- Good to Great or prospective value (market comparison and positioning)
- Attitudinal (value proposition and design/development

The multiple segmentation programs for Wachovia are enabled by the ability to capture costs and revenues at the account level. A database of profitability, at the account level, can be aggregated and segmented in multiple ways.

In terms of the way they approach the market; most organizations have used segmentation to increase the revenue base with a focus on sales. Customer segmentation is not a new topic. With the segment profitability information, organizations can expand their capability to increase revenues *and* value to the organization.

A great reference for organizations that have achieved success in their Customer Profitability initiatives are the Best Practice Partners identified in the APQC/CAM-I consortium best practice studies. In two separate studies conducted in 2005 and 2007 eight companies were selected as best practice and participated and greatly contributed to the body of knowledge around the practice, application, and use of Customer Profitability information:

- FedEx: Created a customer “desirability” model that considers customer profitability and other dimensions which are weighted to derive a relative value of the customer

- Marriott: Approximates customer profitability through an analysis of relative customer spending

- North Shore Credit Union: Uses needs-based models (propensity) in conjunction with member profit scoring to derive a forward-looking measure of potential member value

- Wachovia Bank: Leverages account-level profit calculation from finance and aggregates this information at a relationship level. Uses a consistent approach and methodology regardless of line of business or customer segment

- Zippo: Calculates and reports customer profitability for each of its 3,500 customers; active proponent and user of ABC for both product and customer profitability calculations

- Charles Schwab: Calculates and reports client segment profitability monthly. Uses current profitability, as well as assumptions of future behavior, to calculate customer value over a 3-5 year time horizon

- Aon Risk Services: Aon’s client facing group track time spent on each of Aon’s 10,000 customers and factor in direct costs, support costs, back office costs and marketing costs to develop customer P/L statements and customer scorecards

- Sprint Nextel: Uses a model to determine a customer lifetime value (CLV) for its active customers. Updates CLV data monthly for its support analysis's and distributes executive-level reporting on a quarterly basis

Finance and accounting professionals should be interested in two practices consistent across the partners and identified as an enabler for Customer Profitability. The first is ownership and responsibility for customer profitability and the second is customer segmentation. As with any kind of change initiative buy-in from the users and upperlevel support for customer profitability initiatives and holding employees accountable for customer profitability was identified as a prerequisite for success.

Customer-facing functions are the primary consumers of customer value analyses. In many companies, these groups have already completed estimates of customer profitability and value. Such estimates may be true profitability analyses, or they may be based solely on revenue or proxies of customer behavior (such as points in a loyalty scheme). From the view of customer relationship management (CRM), a company that is making daily decisions regarding where to allocate scarce marketing, sales, service or support resources may find that even an imperfect estimate of value may be better than nothing. For those purposes, obtaining an *approximate* answer in a week may be more valuable than waiting a year for the perfect answer, particularly when the waiting period can be used to incrementally refine the initial estimate.

As the official owner of the enterprise's financial statements, and as the practical owner of many relevant operational applications (such as billing or cost allocation systems), the finance department is in the best position to understand the customer's profitability, and to establish a repeatable and rigorous process for updating this analysis. Finance is also the group with the most credibility to make its estimates acceptable to the rest of the company, by reconciling the company's profitability (reflected in financial statements) with the total profitability of its individual customers. Although finance can generate numbers that reconcile, the assumptions that drive overhead allocation are often subjective and are only vaguely linked to the behaviors of individual customers.

At the Best Practice companies, marketing and finance are jointly responsible for customer profitability. Each company had a dedicated group of 2 - 5 individuals are involved in calculating and reporting customer profitability. These groups work closely with technology IT team to calculate profitability including data warehousing, CRM system, data mining, external database, and predictive analytics

Clearly-defined customer segments and sub segments were another common practice among the best practice partners. Most have developed 5 - 9 macro customer segments and use multiple bases of customer segmentation such as needs, geography, and customer profitability. Every Best Practice partner could capture revenues and costs estimates at account level for individual customer accounts. As a general rule they include the majority but not all costs in customer profitability calculation.

In summary, long-term business success requires sustainable and profitable revenue growth. Customer/customer segment information provides an organization with the means to identify, create, and retain profitable customers, segments, markets, and channels. Understanding the cost of meeting unique requirements leads to more appropriate pricing decisions and value proposition for the customer. In looking at customer profitability, organizations use the information to define a profile and behavior of the kind of customers that are most profitable. With this information, advertising, marketing, and sales resources can be targeted to reach potential customers who fit the profile.