MARKETING IN THE 21st CENTURY

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CHAPTER 9

When Do You Get Rid of the Customer?

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All customers are equal but some customers are less equal.

—Adapted from George Orwell's *Animal Farm*

Marketing is about managing profitable customer relationships. The basic premise of marketing is to identify a segment of customers, to identify their needs and wants, and to supply the goods and services that match those needs. It is about meeting the needs and wants, but also exceeding their expectations in order to create satisfied customers.

Managers believe that when customers are satisfied, they are more likely to return to the firm. They will continue to buy goods and services and thereby develop an ongoing relationship with the company. Satisfied customers are also more likely to recommend both products and the company to others. The firm thereby grows its business by supplying products and services to existing customers, as well as to new customers. Thus, the marketing activity is an exchange process.

This exchange process contributes to profit when the supplier collects payments. As a result, the company's market share grows and the number of customers increases. This in turn should cause the firm to experience higher revenues and higher profits. In view of this, managers put premiums on strategies that lead to both new customer acquisition and higher market share, which thereby positively contributes to business growth. The underlying assumption is that more customers mean higher profits.

Unfortunately, this is not always true. The reality is that all customers do not necessarily contribute to profit. Having more customers does not necessarily

mean more profits. In fact, some customers can create losses. For example, maximizing market share may not lead to higher profits if this increased market share was achieved through large price reductions. So, while providing great service and creating satisfied customers is considered a good strategy to grow business, trying to please all customers may not necessarily be a sound business decision. Firms are finding that some of the customers who are being wooed by great products and service promotions are, in fact, distracting from profit.

Recent industry reports showed that while the top 20 percent of the customers generate most of a firm's profit, the bottom 20 percent may actually be taking it away.[1] A recent analysis of customers in a major bank in Australia revealed that 12 percent of its customers contributed to the bulk of the profits, 60 percent were at a break-even level, and the remaining 28 percent cost the bank money.[2] In the case of one of the largest banks in the United States, only 6 percent of the customers were the most profitable. On average, they produced $1,600 in revenue and cost $350 to serve. Compared to this, 14 percent of customers contributed to loss and produced only $230 in revenue while costing $700 to serve.[3] The percent of profitable customers varied from a mere 7 percent of the customers for a software company to 16 percent for a media company.[4] Unprofitable customers are present in almost all industry segments.

The previous chapters have discussed various strategies used by the companies to increase market share and grow the business through successful sales and sales management strategies. These strategies include programs such as relationship marketing and key account management programs with views on how to acquire and retain customers. These processes require companies to make resource allocation decisions in order to implement these programs. Firms have to differentiate themselves in providing customized solutions to their target markets. Good marketing is about selecting target segments based on need and potential value, then aligning segment needs with specific offers that can be profitably delivered.

The effectiveness of managers and their sales strategies is ultimately reflected in the profitability of the firm. However, if the company's cost of serving the customers exceeds the margin from that sales revenue, then increased retention will decrease the value instead of adding to the profitability of the firm. Keeping this in mind, in order to be effective, it is not enough to have a sound customer acquisition policy. Managers should also consider dumping unprofitable customers as a viable strategy for improving profitability.

In this chapter we take a closer look at customer profitability and its impact on business results. We also examine why getting rid of some customers is a practical option for improving overall profitability of the business. This closer look at customers should help marketers realize that to be effective, they have to be selective about whom they serve. In order to be more selective, they will need to implement a number of initiatives to ensure this selectivity. They have to be able to group customers by profitability. They need to identify and separate profitable

from unprofitable customers. They have to devise programs to convert unprofitable customers into profitable customers. They also have to develop programs to get rid of customers when they cannot be made profitable. They have to devise strategies to make unprofitable customers voluntarily walk away from the firm and its products without creating negative publicity.

In particular, we explore the following questions:

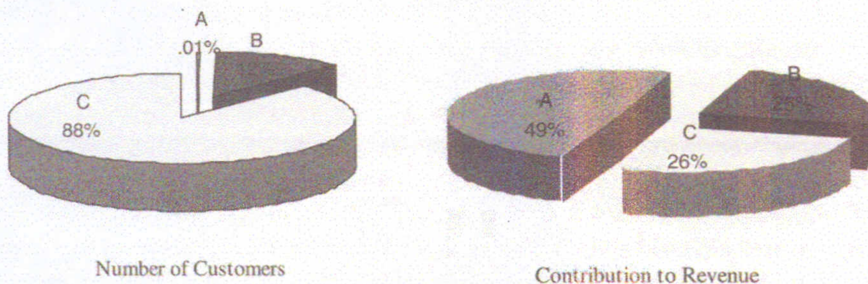
- Why do some customers not produce any or adequate profits?
- Who are these unprofitable customers?
- What should the managers do with unprofitable customers?
- What are the strategies to convert unprofitable to profitable customers?
- Is getting rid of unprofitable customers the only option?

THE ABC'S OF CUSTOMERS

As described in the previous chapters, the focal point that drives the idea of segmentation is that not all *customers* are equal. *Customers* have to be different in order for segmentation to work. As a general practice, businesses divide their customers into A, B, and C categories by the amount of business each of these customers generates. Firms build their marketing plans and resource allocation decisions based on this grouping. Group A customers are a few very large customers that contribute significantly to company sales. Group B customers are a more substantial number of customers that contribute moderately to sales revenues. Group C customers are very large in number, but with very low per capita purchases. The pie charts in Figure 9.1 show the number of customers and their contributions to the revenue in 2005 for a company that supplied energy products to customers in a city located in the western United States.

In this company, customers in Group A account for less than 1 percent by number, but contribute about 49 percent of the sales revenue. These customers deserved and are provided with special treatment by the firm. The marketing

Figure 9.1
The ABC's of Customers



department develops special programs and offers for them while assigning their top salespeople to these firms in order to provide the best service. Group B customers account for about 12 percent of total customers and contribute about 25 percent of sales revenue. They are generally treated well, but are allocated less senior salespeople and are dealt with only on an as-needed basis. Group C customers account for about 88 percent of the total number of customers and generate about 26 percent of revenue. While not entirely ignored, these customers get the minimum necessary amount of attention.

While we just saw this approach explained in the previous chapter, there is a missing piece of the puzzle. The above approach overlooks one important criterion: profitability of the customers. This grouping just by sales revenue or by size alone can represent misdirected attention. While large customers and higher revenues are generally associated with higher profits, this is not necessarily the case. This is especially true if these big customers are more demanding, insist on onerous levels of service, or are chronic late payers. It is also possible that some of the very large accounts may require heavy sales support with experienced account managers, participation by high-level executives, and custom design services. Each of these demands can contribute to erosion of margins if not managed properly.

To address this, in addition to grouping customers by revenue, some firms have now decided to further differentiate between profitable and unprofitable customers within each of these groups. Then managers can customize services in an effort to provide a higher standard of quality to their best and most profitable customers to preempt their defection. They also have to understand why some of the customers are unprofitable in order to possibly convert them into profitable customers. If such efforts do not succeed, then managers have to decide how and when to let unprofitable customers go.

CUSTOMER PROFITABILITY

> I run my company with this saying: volume is vanity, and profit is sanity.
>
> —Brad Skelton, Managing Director, Skelton Tomkinson, a shipping, earthmoving, mining, and construction machinery company

Customers differ by the size and number of orders, the number of required sales visits, and the use of customer service, returns, and follow-ups. Even when they are buying the same product, at the same price and volume, and generating the same overall margin, two customers may provide different profitability due to differing costs. Research showed that at the individual customer level, the cost of selling can vary from 3.6 percent to over 300 percent of the revenue. At the same time, customer profitability can vary from about –260 percent to +60 percent of sales revenue.[5]

Profit is the difference between the net revenue realized and the total cost of actually providing and serving the customer with the product or service. At a broad level, total cost includes cost of goods sold and selling costs.

Profit = Sales Revenue – Total Cost.

We define gross margin as sales revenue minus the cost of goods sold (COGS).

Gross Margin = Sales Revenue – COGS.

Profit margin is calculated as the difference between gross margin and the selling costs.

Selling Costs = Sales Costs + Service Costs + Cost of Credit.

Profit Margin = Gross Margin – Selling Costs.

Suppliers make a profit when the net sales revenue realized is more than the total cost. Profit becomes negative or the firm loses money when the total cost exceeds the sales revenue. Generally, firms set a selling price above these costs in an attempt to generate a profit.

Let us illustrate this with a simple example. Take the case of customer A in the illustration below. The sales revenue from the customer is more than the total of cost, which includes COGS and selling costs (sales cost + service cost). A transaction with this customer produces a profit for the company because the overall margin exceeds the selling costs. Thus, customer A is a profitable customer. In the case of customer B, the sales revenue is less than the total of COGS plus sales plus service costs. Because of this we can classify customer B as an unprofitable customer. While COGS is the same in both transactions, the second transaction loses money because of higher selling costs. These could be due to any number of reasons including too many service calls, bad customer credit, customer delinquency, and so forth. Therefore, depending on the customer, a firm may make a profit on one customer and lose money on another.

For example, let us assume that customer A and customer B both have a contract with the firm providing revenue of $100,000 per year. Let us also assume that the estimated overall margin is the same at 15 percent or $15,000 from each of these customers. Customer A negotiates this contract once a year, requiring one sales call and one presentation and contract negotiation in a year. Customer A also pays on time. On the other hand, Customer B makes you bid every three months and requires four contract negotiations per year requiring four sales calls and four sales presentations. In addition, customer B never pays on time, requiring a somewhat lenient credit policy. If we assume that each of these sales calls costs about $4,000, then the sales and service costs associated with this contract exceed $15,000. The costs of sales calls and the extra cost of credit result in negative margin from customer B. While the company can have a good control over COGS, its ability to manage sales costs, service costs, and cost of credit will depend on

how well the target customer segment is chosen, how well the customer transactions are managed, and the soundness of its credit policy.

UNPROFITABLE CUSTOMERS

> You can not make on volume what you lose on margin.
>
> —Anonymous oil trader on the Chicago Oil Trading Floor

In general, marketing is centered on the concept of managing profitable customer relationships. To achieve this, the supplier identifies the target customer segment with the needs and wants as well as the resources to pay for the provided goods and services. Marketers spend resources in qualifying customers to make sure that they have the money, the authority, and the desire to buy products and services before focusing their sales efforts. However, in spite of these strategies to ensure profitable business through qualifying and screening customers, industry sources estimate that on average about 15 percent of all customers are unprofitable.[6] Banking industry sources state that on average banks make money only on about 20–40 percent of their customers.[7] Unprofitable customers are a drain on the firm and can suck the firm's resources dry like parasites.

Customers can be considered not profitable when they either pay late or do not pay at all. These are customers who want lenient credit terms. They never pay on time. Their checks bounce. They are chronic complainers and take undue advantage of the return policy. They are bargain hunters with minimal loyalty, buying only those items on sale or waiting for even better deals later. They tend to "nickel-and-dime" the firm to death with every transaction. They tie up the salesperson's time and make last-minute changes to the product specifications or to delivery schedules.

Transactions with these customers can become not only unprofitable but also unpleasant. Then, a lot of time and effort may be necessary in order to attempt collecting payment. They create negative margin to the firm's operations and are rude and disrespectful to a firm's sales and service people. This in turn can cause low employee morale and higher turnover of employees. Many of these customers often have unrealistic expectations. This causes them to have lower customer satisfaction and thereby causes them to generate negative word-of-mouth advertising.

Take the experience of a clothing retailer in any city. A customer picks only those clothes that are on sale and writes a check for that amount. The check is returned and a collection agency must be involved in order for the firm to collect its payment. Another variation to this situation is one in which the customer returns the merchandise. The retailer senses that the clothing has been worn by the customer and has no choice but to mark the item down substantially, repackage it, and place it on the "sale" rack. This contributes to losing profit margins as

well as potential sales. In addition, there is an opportunity cost in terms of lost sales to more profitable customers.

A customer can also become unprofitable because of the lower volume of sales and/or the lower frequency with which purchases are made or the services are used. At some point, the margin does not justify the service demands of these customers. Imagine that you work for an airline company. You have customers with frequent flyer cards; however, they fly only once a year at best, at the lowest price offered. Yet they expect a statement every month concerning their frequent flyer status. This adds to your overall cost without corresponding revenue benefits. This is not limited to small buyers. As we discussed before, a large buyer may also become unprofitable, based on too many demands on a salesperson's or firm's time, schedule changes, delivery frequencies, or for nonpayment.

In spite of these kinds of experiences, companies are reluctant to cut loose from loss-making customers. It is interesting to note that companies will often implement budget cuts or fire employees in order to improve profitability, while not addressing the problem of no-profit customers. While customer acquisition is a constant mantra, dumping customers is seldom considered a viable option. In fact, in a world where the customer is considered the king, getting rid of an unprofitable customer is considered a sacrilege. Companies bristle at the idea of getting rid of a customer as an option to improve profitability. Managers generally make the mistake of equating revenues or the number of customers with success and/or profit. They believe that if the revenues are increasing, then the profits should follow. This theory can be attributed to the lack of individual customer profitability information that could have helped to determine the folly of continuing to serve customers contributing to loss.

ALL CUSTOMERS ARE NOT EQUAL

> We will no longer conduct operations that don't produce profits.
>
> —Toshimasa Iue, President, Sanyo Electric Co.
> (quoted in *International Herald Tribune*).
> The company said that in a break with tradition,
> it would put profit before market share.

Sanyo, like many other companies, has painfully awakened to the one corporate strategy almost guaranteed to lead to failure—the quest for market share at any cost. Other companies have also learned that seeking market share as a strategic goal can hurt profitability. General Motors Corporation is probably the best-known example of a firm that suffered from pursuit of this strategy. A recent *Fortune* article[8] on unprofitable customers illustrates such dismal experiences. Gap, Inc. went on an aggressive campaign to acquire new customers by opening new stores and lost money. Telecommunication companies have offered so much in cash incentives to attract new customers that many firms have failed. Some of

these customers just took the cash incentives and switched again and again to an alternate provider, leaving the companies with negative returns on their investments.

Using a simplified example, the article provided the following scenario:

> Imagine a company that launches a big push for new customers and acquires 5,000 of them at a cost of $1,000 each. That amount is what the company spends on advertising, promotion, sales calls, and so forth to get those customers in the door. To keep things simple we'll assume that the new customers don't produce any business in the year in which they're acquired, so the company's operating profit is $5 million lower than it otherwise would have been. That is, it has invested $5 million in the hope of realizing much more than $5 million in future profits.[9]

Now let us see this from another angle. In the above example, the firm has to recover $1,000 from a single customer just to break even in the next five years, without considering the time value of money. (This revenue requirement will be higher if the cost of capital is considered.) In other words, this customer has to be a *profitable customer* for at least the next five years with a profit margin of at least $200 per year. Assuming 10 percent as a typical margin, this company then expects that this customer will spend a minimum of $2,000 every year for the next five years for the firm just to break even. If the customer spends less, makes too many returns, defaults on payments, or switches to another firm after the second year, then there is a net loss for the company. In the face of this customer acquisition cost, a firm's hope for profitability rests on the probability of customers spending more than $2,000 every year for five years or more. In the current competitive environment, this would mean that the company has taken steps to make sure that each and every customer it has acquired has not only the need and the desire, but also the resources to pay. In addition it has to ensure that the value provided by its goods and services continues to keep the customer loyal to the company.

Firms are beginning to take a closer look at the impacts of market share when the real cost of serving customers exceeds the margin generated. They are also coming to the realization that all customers are not equal. As firms juggle their resources to maximize profitability, they are beginning to sense that they will not be able to serve *all* customers equally. They understand that an undifferentiated service strategy can reduce the service level quality for the profit-producing customers, thus making them vulnerable to defection. The realization that all *customers are not equal* is leading to the strategy of selective acquisition and the provision of an extra level of service to a select group of customers in hopes of achieving long-term profitability.

MBNA America Bank is well known in the industry for its ability to retain customers in a very competitive credit card market and remain profitable. It does so by carefully choosing a segment of customers based on their excellent credit

histories and who demand above average service. Interestingly, these MBNA customers do not have the most favorable interest rates. Their loyalty to MBNA is not because of lower rates, but because of the excellent service. They stay with MBNA because they get customer service that is based on fairness, respect, and appreciation of their business by MBNA. These customers know that their phone calls will be answered on the second ring by a polite and helpful customer-service agent who is able to solve the problem.[10] MBNA on its part can afford to maintain this service level to its profitable customers by being selective about its choice of customers. This selective strategy has meant that its resources are not tied up serving unprofitable customers.

IDENTIFICATION OF UNPROFITABLE CUSTOMERS

In a recent *Fortune* article,[11] top executives of the largest U.S. retailers responded firmly that they did not have unprofitable customers even while these firms were reporting huge losses. They were unable, however, to explain how millions of all these profitable customers led to such financial losses. The truth was that some of their customers (unprofitable customers) were destroying shareholder value, and yet the retailers were continuing to spend money serving them. This clearly indicates the some executives lack the information needed to make better strategic choices.

The first task to improve profitability is to identify unprofitable customers. But most companies cannot do this because traditional accounting systems are centered around product profitability, which does not provide customer contribution. Profitability by broad aggregates of customer segments or average margin by customer type is not very useful. Identification of unprofitable customers requires margin analysis at the individual customer level. This is because using an average margin on a customer type can be deceptive and misleading. The average margin of customer groups masks the difference between profit-making and loss-generating customers. In the aggregate, the margin from the profit-making customers usually (hopefully!) covers the loss incurred from serving unprofitable customers.

A manager's use of this average margin or margin by customer groups to make resource allocation decisions would lead to an undifferentiated allocation of resources that can be counterproductive. Firms will end up spending the same amount to attract and serve a profit-producing customer as they do for a customer who is contributing to the companies' losses within each segment. While the average margin across a customer group may be positive, taking this analysis to the individual level displays the wide difference in margins across individual customers. This is because companies make higher profits on some customers, lower margins on others, and negative margins on yet others.

To understand customer profitability, it is important to examine customer revenue and the breakdown of the costs for serving each of these different customers. Thus, when the margin is analyzed at the customer level, there is a sudden realization that a higher market share or larger number of customers does not necessarily mean higher profits. This is because the cost of serving some of the customers may be very high. As stated before, reasons that could increase the cost include a higher number of sales calls, too many small or low-margin orders, high service costs due to wrong use of products, time-critical operations, and high cost of credit due to lenient credit terms. Customers can also differ in terms of service demands, paying behavior, and so forth.

Thus, understanding the profitability of individual customers is important because it helps understand how to identify the impact of problem customers, as well as helping to make decisions about resource allocations. Once identified, the firm should "demarket" to its low-margin and unprofitable customers by seeking lower cost methods for fulfilling their orders. If defection to the competition occurs, count your blessings and refocus resources on serving your profitable customers. This elimination of unprofitable customers can help margin in three ways. First, it eliminates loss-making transactions. Second, the redirected resources toward more profitable customers can improve their service satisfaction and thus prevent their future defection. Third, the resulting increase in inelasticity of demand also enables price increases.

NEW APPROACHES TO CUSTOMER GROUPINGS

To be effective and to avoid inappropriate allocation of resources, firms should develop customer lists organized by profitability. This listing ranks customers from the highest to the lowest based on the amount of profit each customer has generated. At the bottom of the rung are customers with negative margins. The profitability grouping can be based on margin percentage or on absolute dollars. This customer profitability ranking helps the firm to focus efforts on the right customers to improve business performance. This listing helps to identify heavy hitters in terms of contribution to the bottom line and those who are average contributors. It also brings to light those customers who cost rather than make you money with every transaction. This listing can also be used to help differentiate services, decide on which customers to retain, decide which clients will be directed to lower-cost forms of services, and decide what strategies can be used to encourage some customers to seek alternative suppliers.

FedEx Corporation, General Electric Capital Corporation, Bank of America Corporation, and Hallmark Cards, Inc. all group their customers by profitability and vary their services to their customers based on how much each of these customers contributes to their bottom line. Customers of FedEx are grouped as the Good, the Bad, and the Ugly.[12] Good customers are provided with special

privileges and benefits. They discourage unprofitable customers by withdrawing special privileges that are given to good customers. Thus, for example, while a "Good" customer may see her late fee waived for a missed payment, an "Ugly" customer would face a hefty penalty for his bounced check.

Separating customers by the 80:20 grouping is also a well-known and useful practice. This grouping is based on the observation that 80 percent of the sales or value often come from only 20 percent of the customers. This two-tier grouping is a valuable categorization, but it overlooks the dissimilarities of the customers within each group. To address the inadequacy of the 80:20 two-tier scheme, a prominent research group suggested a customer pyramid that groups service to customers into four levels: Platinum, Gold, Iron, and Lead.[13] Factors used in this grouping include profitability, difficulty or ease of doing business, time and effort requirements, the associated returns for these efforts, and potential for spreading positive word-of-mouth advertising about the company. Using these factors, the four categories of customers can be described as follows:

- *Platinum* customers are the company's most profitable customers. They use large quantities of product, are less price sensitive, are willing to try new offerings, and remain loyal customers.
- *Gold* customer profitability is not as high as it is for platinum customers, but they are heavy users of the firm's products. They are not quite as loyal and look for price discounts. These customers would like to have alternate supply sources to minimize risk, as well as to use this to negotiate price discounts with the company.
- *Iron* customers buy enough products to utilize the firm's capacity, but their purchases are not large enough to warrant special treatment. Like the Gold-tier customers, they have multiple supply sources.
- *Lead* customers produce negative profit and are a drain on company resources. They can be chronic complainers and demand more resources than they are worth. They can also be a source of negative word-of-mouth advertising about the company and products, thus causing the company to lose potential business from better customers. Companies are generally better off finding a way to get rid of Lead customers.

Consider the following hypothetical example of this grouping. A Platinum customer for a real estate company could be one who is planning to sell a home of $500,000 or more, willing to pay full commission, has purchased more than two homes in the past, plans to buy a home within the next six months, and is part of the personal network with similar characteristics. Most likely, this customer will refer the real estate company to other Platinum prospects within her network. Compared to this, a Gold customer may sell and buy in the same price range but is likely to negotiate with the company to lower his selling costs. Iron customers would be selling a less expensive house, but have the potential to become a member of the Gold group. Lead customers, on the other hand, are seen as shoppers who generally tie up an agent's time looking for houses in different

price ranges, but are most likely to buy in the $100K range. Lead customers are difficult to upgrade to higher levels, can reduce profitability, and tie up resources that could be used on Platinum or Gold customers. The strategy for Lead customers is obvious: discard them or avoid them.[14]

Banks generally consider customers who do not have a home loan or the potential to own a home as unprofitable customers. Some of the other characteristics of these "questionable" bank customers include lack of access to the Internet, no regular income, no assets, and no savings. Interestingly, these customers seem to prefer the more expensive face-to-face teller transactions in banks over ATMs. Another example involves insurance. Agents try to stay away from home owners in high-risk areas (hurricane, flood, or burglary), as well as car owners in high-theft areas and other frequent claimants.

DEALING WITH UNPROFITABLE CUSTOMERS

What should the company do with unprofitable customers? Say good-bye? Can you afford to lose these customers? "Firing" customers is still considered bad even when firms are losing money on unprofitable customers. However, this mind-set of "can never lose a customer" is changing. Companies are finding that by culling unprofitable customers, they can better serve the remaining customers, thereby growing the business and increasing shareholder value. Survival in a competitive market requires businesses to understand who their customers are, what their needs are, and how they can best meet those needs. Furthermore, they need to decide whether or not they should continue to serve all customers. When a customer is not profitable in the short run and does not show the potential to be profitable in the future, then the company has to consider its options. One of the options clearly is firing that customer. Culling the customer base to get rid of unprofitable customers is a viable strategy and should not be ignored if the manager is interested in maximizing shareholder value.

Firing the customer should not be automatic nor should it be done without considering its overall impact on business operations. For example, firing an unprofitable customer is a better option when this customer can be replaced with a profit-making customer. Take an example of a customer who accounts for a large portion of sales, but is not profitable. While this unprofitable customer may not be covering its total cost, this customer may still be contributing to the firm's fixed cost, thus allowing the company to stay price competitive.

When a firm decides to fire an unprofitable customer and is unable to replace it with another revenue-producing customer, the firm is losing the ability to recover some of that fixed cost. In the absence of a customer to recover this fixed cost, the firm may have to spread the fixed cost over other remaining customers. This can result in raising the price for all customers, thus becoming uncompetitive on price. The other available alternative would be to reduce some fixed costs in

proportion to the contribution of the lost business. If this cost reduction leads to deterioration of service quality for the remaining customers, then the firm faces the possibility of defection among its best customers. Thus, company action to get rid of an unprofitable customer (based on total cost) without first reducing the fixed cost or without finding a customer to replace the lost one can lead to lower total profit.

In addition, before firing a customer, things beyond immediate profit need to be taken into account. Firms have to include strategic considerations in making customer firing decisions. Managers should evaluate both financial measures as well as nonfinancial values in assessing customer worth. For example, a customer could generate additional income by bringing in other more profitable customers. This could also be based on customers' ability to serve as a reference for the product or service. Given the importance of word-of-mouth promotion and the critical role of early adopters, these criteria could be particularly important when a company is entering a new market or when a company is in the process of introducing new products or services. Of course, there can also be legal, ethical, or regulatory issues relating to firing a customer that must be considered.

Most firms instead first explore opportunities for improving profits with the loss-producing customer by way of raising revenues or by lowering costs to serve them. On the revenue side, actions could include traditional price increases as well as cross-selling and up-selling. If the margin cannot be increased on the revenue side, then the firm should explore options for reducing costs or minimizing loss-contributing transactions. This can be done by adjusting the service level downward or by taking out some of the product or service features. Finally, directing customers toward alternative solutions may also be an option.

ROUTES TO PROFITABILITY

There are two primary routes to profitability for a company faced with loss-making customers. These are (1) converting an unprofitable customer to a profitable customer or (2) firing the unprofitable customer. As stated before, conversion strategies mainly focus on price increases or cost reductions. Here are some additional and more detailed ways to succeed.

1. Increase Revenue by Raising the Price

This is the best option since it increases profit by increasing the overall margin. Price increases can be direct or indirect such as eliminating discounts to unprofitable customers.

Unprofitable customers who refuse the new price will walk away. This is an indirect way to off-load them without overtly firing them. Industry experts estimate that a 1-percent increase in price could lead to an 11-percent increase in

customer equity. Most customers accept price increases and continue to do business with the seller. Price increases can also be accomplished in an indirect way by eliminating discounts based on purchase volume or order size. The seller could also implement price increases by tightening credit policies or eliminating grace periods.

For example, many customers place a lot of small orders and then ask for a price discount based on the total volume. Since several small orders can increase total processing costs, it would be beneficial to eliminate discounts under this condition. The elimination of discounts could be explained by the increased costs of frequent deliveries and the processing costs. Generally, most customers understand this logic, accept the elimination of the discount, and will continue to do business at the increased prices.

As a case in point, an owner of a small company was supplying a large international conglomerate with key component parts. The seller was losing money because the buyer kept changing the delivery dates and product specifications. Even though these changes were increasing the supplier's cost of meeting this order, the seller did not raise prices for fear of losing this large chunk of business. After several months of suffering losses, the supplier finally met with the buyer and explained the situation of increased costs associated with product specification changes along with the last-minute demand for deliveries. The buyer was sympathetic and agreed on a minimum order size, regular delivery schedules, and surcharges for any changes. This resulted in the hoped-for increase in the seller's profitability.

2. Reduce Costs by Changing Packaging, Shipping Policies, Credit Terms, and So Forth

A firm's policies should be differentiated across profitable customers and unprofitable customers. This differentiation helps the firm to provide treatment that is appropriate and expected by the profitable customers while discouraging unprofitable customers. For example, while profitable customers may be forgiven for a late payment, unprofitable customers could be charged very high fees. Profitable customers get discounted shipping while unprofitable customers are charged normal prices to recover full costs. Prices can be restructured by offering a la carte services at higher prices so less profitable customers can pick what they need at a price that reflects the full cost to serve them as well as providing reasonable profits.

3. Lower the Costs to Serve/Plug the Profit Leak

This is a very popular strategy adopted by several investment brokers and financial institutions such as Fidelity Investments, The VanguardGroup, Inc., and the Charles Schwab Corporation. These firms use automated phone systems to

identify unprofitable customers and then direct them to their Web sites or to longer queue phone lines. This has lowered the costs of serving them and has resulted in positive margins. Banks found that tellers were the most expensive way to service customers and encouraged online banking and ATM systems to turn around unprofitable customers. Banks, such as First Chicago Bank and Canadian Imperial Bank of Commerce, found that they increased their return on customers after some were directed to ATM and online banking options. Airlines such as Southwest Airlines and American Airlines have lower fares when tickets are bought on line.

Recently, a wholesale distributor of HVAC (heating, ventilating, and air conditioning) and plumbing systems in Connecticut found that many of its customers were unprofitable because of the associated inside selling expenses. This distributor also realized that converting its unprofitable customers to profitable customers offered the greatest opportunity for improving the firm's bottom line. The supplier strongly encouraged these customers to place their own orders on the firm's Internet order entry system. This change resulted in a 90-percent reduction in the firm's inside selling costs, and these customers became profit makers for this distributor.

4. Stay with Core Offerings and Strengths

At times, a profitable business starts losing money when it steps outside its area of strength based on special requests from customers. This may result in increased activities and expenses because the firm lacks the skills to provide these other products or services. Firms should resist the temptation to accept a customer request that is outside of the firm's area of strength and expertise. It may be possible to improve profitability by eliminating products/services that are outside of core competencies.

5. Encourage Customers to Fire Themselves

Firms should offer different levels of service and assign worst customers to the lowest level of service that can be offered. For example, while the most profitable customers are pampered with senior sales representatives and face-to-face technical help, the worst customers can be directed to phone-based support. Even with the phone-based support, the worst customers can be allowed a certain number of free calls. Beyond this, each additional call results in a fee for services provided. This should either reduce the number of requests for service or result in customers leaving the firm.

A bank in the southeastern United States adopted this strategy. Like many other banks, it was suffering from the high costs associated with customers who come in frequently and kept tellers busy with small transactions. The bank was

reluctant to cut these customers off for fear of bad word-of-mouth publicity. The bank implemented a tiered service plan, including a $2 charge for every in-person transaction. The least-profitable customers voted with their feet and left the bank. Bank tellers were then able to focus their time on the more profitable large accounts, thus improving service levels to these customers as well as increasing profitability.

CUSTOMER CULLING AS AN OPTION

Just as one manages a business or a stock portfolio, firms should manage their customers like investments because they are. Customers who are not providing adequate returns and who have no strategic value or future profit potential should be divested. They not only contribute to loss, but also tie up resources that could be used to service better customers.

Firing a customer should generally be the last option, but it is nevertheless an alternative that needs to be exercised as needed. Not using this option will continue to drain the firm. Worse still, continuing to serve these unprofitable customers can rob the resources required to meet requests from profitable customers. This can lead to a defection of profitable customers to the competition, thus exacerbating the loss potential.

The important thing when involved in the firing of customers is to do it gracefully in order to avoid negative word-of-mouth publicity. In certain cases, businesses may have to contend with regulations before choosing the firing option. The best strategy is to encourage the customer to walk away voluntarily by directing it to self-service rather than full service, by making the process more complex, or by raising the price to match the additional demands on resources from this customer. Managers exercising the culling option should do the following:

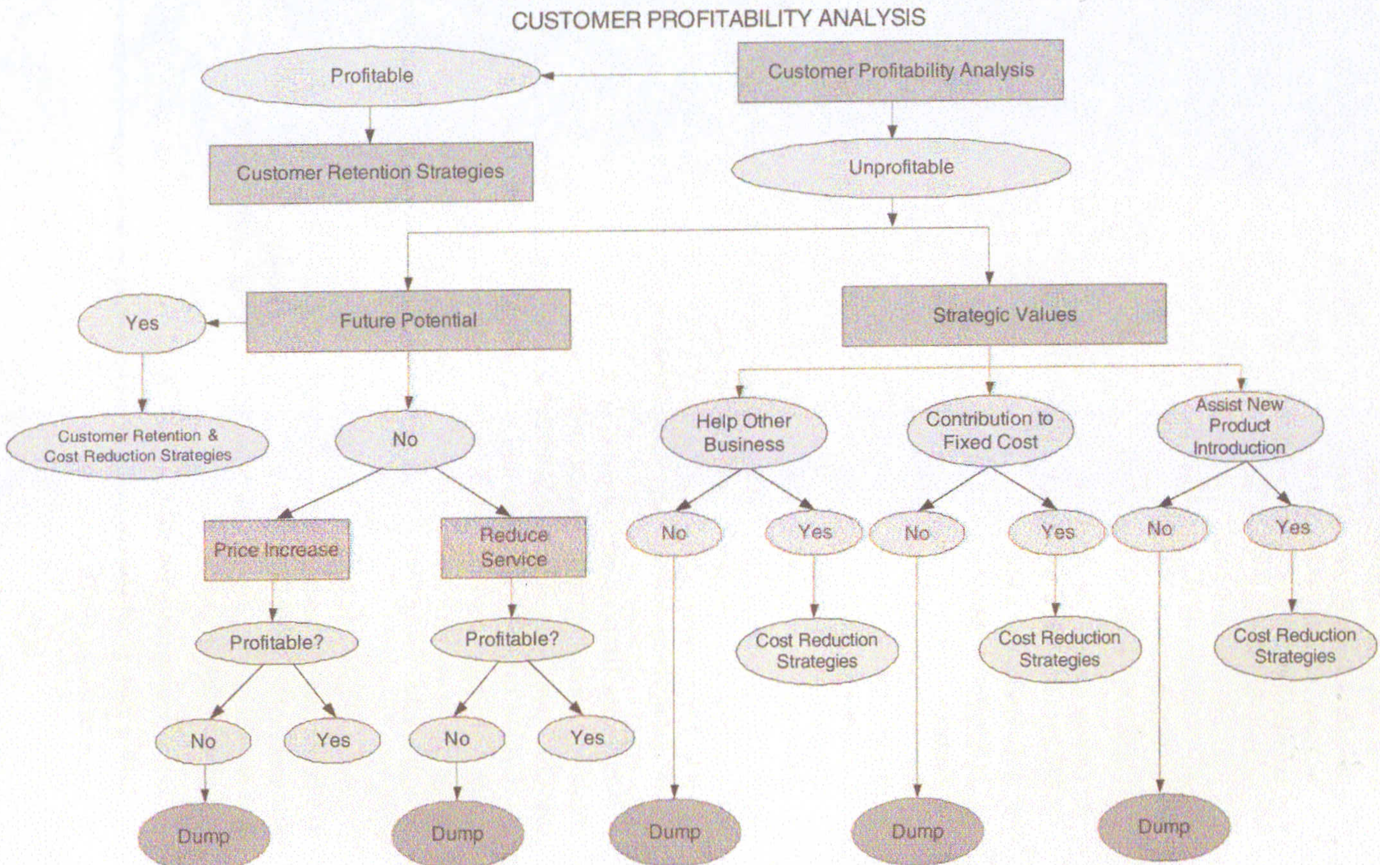
1. Involve the senior management team and get its commitment to the strategy.
2. Evaluate the financial, nonfinancial, and strategic contributions of the customer.
3. Make sure new business is in hand to replace the customer to be dumped.
4. Evaluate the strategic and marketing implications of dumping the customer on other products as well as the impact on other customers.
5. Consider any regulatory implications of customer dumping.

Figure 9.2 illustrates the process firms should use in deciding their customer portfolio.

The following steps could be used in the process of getting rid of customers.

1. *Gathering data:* Managers resorting to the "culling" strategy should start by getting all the facts and figures and gathering empirical data. Detailed customer transaction information should be collected to identify various drivers of profitability. These data

Figure 9.2
Customer Profitability Analysis



include how recent the purchase was, past customer value, frequency of purchases, contribution margin, and so forth. Ideally, the data should be as detailed as possible to account for seasonality and should span several periods of time. Generally, firms are able to collect two to three years' worth of data. Some of the questions to consider include the following: When was the last time the customer bought something? How often and in what way did this customer buy? What was the average dollar amount per transaction for this customer? What was the total value of money this customer spent each year?

2. *Calculate the various cost components for supplying the product to the customer.*
3. *Estimate the profit for this customer,* in a manner similar to the calculation of customer lifetime value just described in the previous chapter.
4. If the customer is unprofitable, *examine the component of the costs to see how these can be managed or reduced to improve the margin.*
5. *Examine whether this customer has the potential to grow and contribute profit in the future.* It is possible that the customer may be unprofitable now, but has the potential to grow and contribute to profit later. For example, a small business may be unprofitable now as it is in the growth stage, but it has the potential to soon become a lucrative customer. In this case, the firm should not automatically fire the customer, but rather manage the costs to minimize the current loss potential.
6. *Examine whether the customer has a strategic value.* For example, during the introductory stage of the product life cycle, some products and services are naturally unprofitable. The customers who buy at that time help the firm introduce the product to the market by being innovators and profits come later from the early adoptors.

While some firms are open about culling, other firms do it quietly. Many firms regularly review their low-end customers' contributions and compare that to the cost of keeping them. They shed those that cost more than they generate in margin. On the other hand, banks and airlines are concerned about the negative image of firing customers and do it in an indirect way. For example, airlines charge fees to customers to stay in their frequent flyer program if they do not earn enough credits. Those who provide frequent business and miles are exempt from these fees.

Customer profitability analysis should be an ongoing exercise using financial and nonfinancial measures. Identification of the traits that are common to profitable customers should help managers focus effort on this segment to avoid defection as well as to explore cross-selling opportunities. Managers can do profit optimization by the following:

1. carefully recognizing and satisfying the needs of most of the more profitable group,
2. finding more profitable customers,
3. converting unprofitable customers into profitable customers, and

4. getting rid of customers who have no profit potential and drain company resources. The strategy of "fewer and deeper" customer relationships enables more profitable growth.

To be effective, managers must understand that having more customers is not necessarily a good thing. They have to understand that there are certain customers who can never create value for the organization in the present nor in the future. Firms are better off without these customers, and managers should stay away from them. Acquisition and retention of customers can help the company grow only if profitable customers are targeted.

NOTES

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