

Customer Profitability Analysis

by Leonard Brown

Do you know which of your customers are unprofitable - and why?

Each year, many businesses return profits much lower than they otherwise might - had their potential profits not been significantly eroded by a group of their customers. Many business managers remain unaware of the 'tug-of-war' that goes on in their 'bottom line' between two distinct groups of their customers: those that contribute positively to their business' profits (profitable customers) and those that erode potential profits by failing to cover the costs associated with servicing them (unprofitable customers).

Often, even managers who do understand the issue still can't identify 'which is which' or 'why' that is. As one writer describes it, they can't identify their 'profit makers' from their 'profit takers'¹.

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While some business managers believe their 'large' customers are automatically profitable, evidence suggests that is not so. A study of customer profitability undertaken by Harvard Business School Professors, Kaplan and Narayanan² found "...often, some of the largest customers turn out to be the most unprofitable."

Large customers can be found at both ends of the profit spectrum: large customers can be amongst the most profitable or most unprofitable in the customer base. Less frequently are they found in the middle/break-even.

Revenue and Gross Margin can be unreliable indicators of profitability

Traditional accounting methods provide little help in calculating profitability at individual customer level. Customer Profitability Analysis (CPA) has therefore become an important tool in helping businesses identify their 'profitable' and 'unprofitable' customers and understand why that is.

CPA recognises that each customer is different and that each £1 of revenue or gross margin does not necessarily contribute equally to the profits of the business.

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Customers use resources differently, therefore the 'costs to serve' them (CTS) can vary from one customer to another. On their own, Revenue and Gross Margin can be unreliable indicators of profitability.

	Rev £'000	Gross Margin £'000 %	CTS £'000	Net Profit £'000 %	Feature
Customer A	500	68 14%	91	(23) -5%	Best Revenue
Customer B	379	67 18%	54	13 3%	Best Profit
Customer C	319	85 27%	121	(36) -11%	Best Margin

CPA Uses 'Activity Based Costs' to establish the 'Cost to Serve'

CPA uses the principles of Activity Based Costing to establish the 'Cost to Serve' for each customer or customer segment. Expenses of the business are attributed to 'activities'; the 'drivers' of those activities are identified, and the resulting costs charged against products, customers, channels, etc. dependent upon their use.

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Where possible, these costs are calculated and attached at individual transaction level for the period analysed.

The 'Cost to Serve' a customer results from a combination of characteristics, behaviours and the resultant activities they consume. 'Characteristics' tend to be the fixed and more up-front obvious factors such as product range purchased and delivery location. 'Behaviour' tends to be more about the way a customer chooses to operate.

	Cost to Serve	
	High	Low
Products Ordered	Custom	Standard
Order Quantities	Small	Large
Order Arrivals	Unpredictable	Predictable
Packaging	Customised	Standard
Delivery	Customised	Standard
Delivery Location	Far	Near
Delivery Requirements	Changes	No Change
Pre-Sales Support	High	Low
Post-Sales Support	High	Low
Payments (A/Cs Rec)	Slow	On-Time

Understanding the 'Whale Curve' for your business

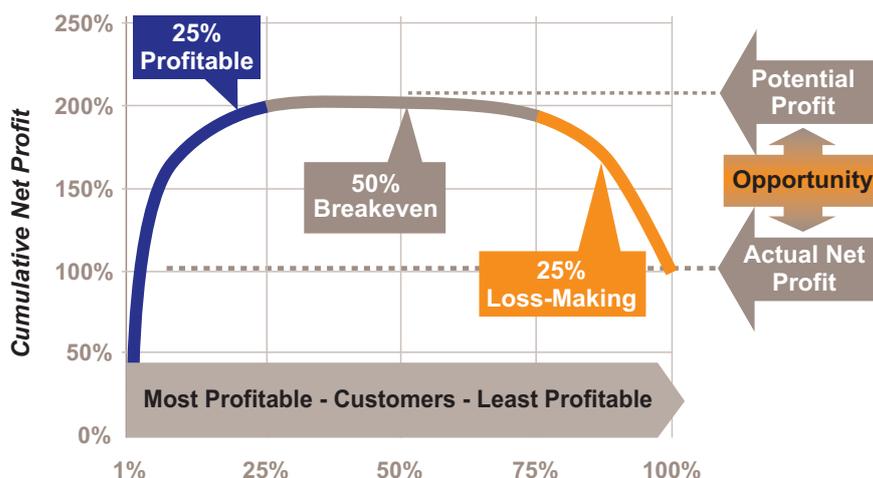
Presenting cumulative customer profitability on a 'Whale Curve' can help improve our understanding of how profits are earned and lost across the customer base of a business - and to what degree 'profitable' customers are subsidising the 'unprofitable'.

The first surprise for many businesses is that seldom does Pareto's Law or the '80:20 rule' apply to profits. Instead of 20% of the customers generating 80% of the profits, CPA studies record many instances in which 20% of the customers provide over 100% of the profit - and sometimes 200% or even 300% of the final profit.

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Although the numbers vary from business to business, experience suggests 20-25% of customers generate the potential profits; 50-60% roughly break-even and 20-25% are distinctly 'unprofitable' and reduce the potential profits of the business to its 'actual' or final (100%) level.

The difference between 'Potential Profit' and 'Actual Profit' represents the 'Opportunity' for a business to improve its profits by focussing on its unprofitable customers.

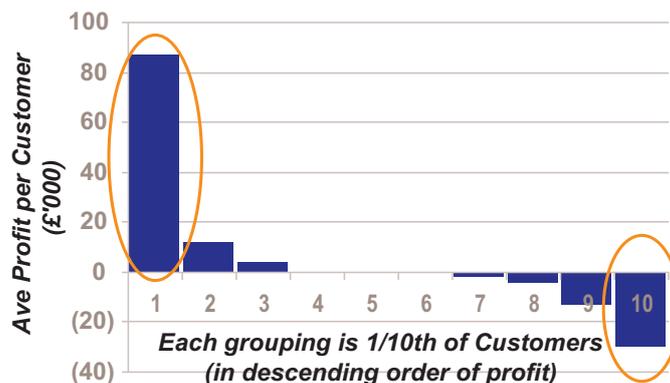


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The 'Critical Few'

Presenting differently the data in the Whale Curve - this time striking an average profit per customer for each of ten groups of customers - helps visually identify the critical few customers at both ends of the profit spectrum on which focus will provide the greatest impact.

The business will want to be doubly sure it can retain - and if possible further develop - the few most profitable customers at the top end of the chart. At the same time it will want to stem or at least reduce the profit erosion at the bottom end - emanating from the few most unprofitable customers.

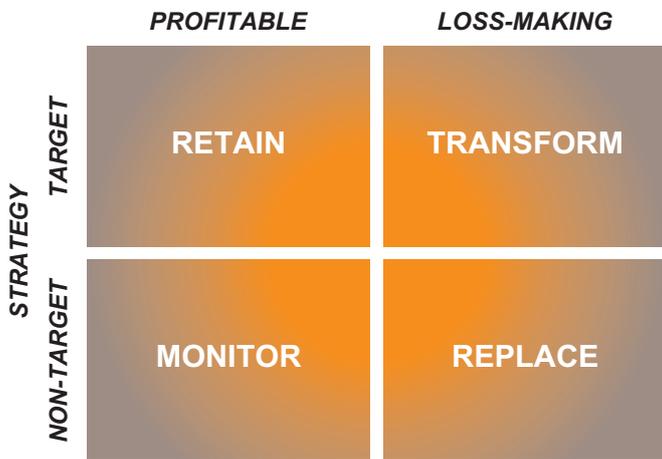


Once each customer's profitability has been established - what next?

The results of a profitability analysis often contain many surprises and the phase of the process immediately following the analysis needs carefully managed. Adopting a '4-Box' model³ can help provide a simple, structured approach to segmenting customers and the preparation of action plans.

Customers are allocated to one of four boxes dependent upon a combination of two factors (i) whether or not they are 'profitable' and (ii) whether or not they 'fit' with the competitive strategy of the business - i.e. are genuinely 'target' customers. A generic action is suggested according to the 'box' in which the customer sits, i.e. 'Retain', 'Monitor', 'Transform' or 'Replace'.

For 'Target', 'Profitable' customers (Top Left), the action is to try to **RETAIN** them - and if possible increase their business (so long as the additional volume is similar to the existing business).



For 'Target', 'Loss-Making' customers (Top Right), the thrust of any action is to **TRANSFORM** them to be 'profitable' and move them to the Top-Left box – or at worst, move them to breakeven. The specific action(s) required for each customer will depend upon individual circumstances.

'Non-Target', 'Profitable' customers, (Bottom Left), are customers that don't 'fit' the customer profile described within the strategy - yet still provide a source of profit for the business. For these customers, the action is to continue trading but to regularly **MONITOR** the orders and service levels to ensure nothing changes that causes them to become both 'Non-Target' and 'Loss-Making'.

No effort would be spent developing customers within the 'Non-Target' 'Loss-Making' box (Bottom Right). The overriding action is to **REPLACE** the volume and contribution of these customers with that of customers from within the Target segments. As this replacement is achieved, trade with customers in the **REPLACE** box would discontinue. Selling price would likely be selectively increased up to the point where the customers either become profitable and move 'leftwards' to the **MONITOR** box - or take their business elsewhere.

“Without a clear understanding of who is making or losing you money and why, your strategy could take you in dangerously unprofitable directions”

Difficulty in deciding whether a customer is 'Target' or 'Non-Target' suggests the lack of a clear strategy and clearly identified customer segments. Too many customers in the 'Transform' box, too few in 'Retain' might indicate a review of strategy would be advisable: targeted customers are not profitable. The link between strategy and CPA is ably identified by one contributor to the debate⁴: “Without a clear understanding of who is making or losing you money and why, your strategy could take you in dangerously unprofitable directions”

References:

- 1 Converting Customer Value: From Retention to Profit. John A Murphy. John Wiley & Sons Ltd, 2006
- 2 Customer Profitability Measurement and Management. Robert S. Kaplan and V.G. Narayanan. Harvard Business School, 2001
- 3 Customer Profitability Measurement and Management. Robert S. Kaplan and V.G. Narayanan. Harvard Business School, 2001 (Diagram Modified)
- 4 AcornSystems, Houston, Texas

Leonard Brown FCMA, MSc, is founder and Director of Profit Analytics Limited, a niche consultancy helping clients gain fresh insights that enable them to improve the profitability and effectiveness of their business. He has considerable experience leading, managing and facilitating change. Before establishing his own business improvement consultancy in 2007, for more than 20 years he had successfully undertaken senior management roles in Finance, Operations, Business Improvement and General Management. His experience spans private companies - small and large, and an FTSE 100 plc.



For more information contact:

Leonard Brown
 Profit Analytics Ltd
 M: 078 0230 0642
 T: 028 9061 4649
 F: 028 9061 4661
 E: Leonard.Brown@ProfitAnalytics.co.uk