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With thousands of golf courses needing to be mowed, watered and fertilized, the U.S. West Coast looked like the perfect new market for one Midwest-based lawn care products manufacturer. Initial forays into the region yielded strong sales, high market penetration, and a 26 percent gross margin. So why was the company's bottom line still stagnating? Because the cost of freight to the West Coast, which the company provided free as a standard industry practice, was not being factored into the company's profitability metrics. When it was, leaders realized that the company was actually losing six to eight percent on every West Coast transaction. If it had not looked more closely at these customers' *real* profitability before finalizing plans to expand its West Coast operations, the company could have literally grown its way into bankruptcy.

No company can afford a flawed understanding of customer profitability, least of all in a recession when the margin for error (as well as profit) is whisper-thin. The flip side is that improvements in this area can be a very effective way of bolstering the bottom line — and companies can often make those improvements with only a modest initial investment. In fact, because employees tend to be more accepting of change in a downturn, now may be a good time to invest in changes that can not only deliver a badly needed revenue boost, but help your company better take advantage of the eventual recovery.

POCKETING THE PROFITS

A customer profitability analysis, done right, tells you not just which customers are profitable, but why certain customers are more or less profitable than others. At a strategic level, this information can help guide decisions on everything from growth initiatives to marketplace segmentation. And, tactically, the information can suggest a variety of ways to improve profitability, such as lowering the cost to serve, improving the sales force's bargaining position, and developing more effective prices and promotions.

Pocket margin refers to the amount left in a company's "pocket" after all of the costs related to a transaction, as well as the cost of goods sold, are subtracted from the list price.

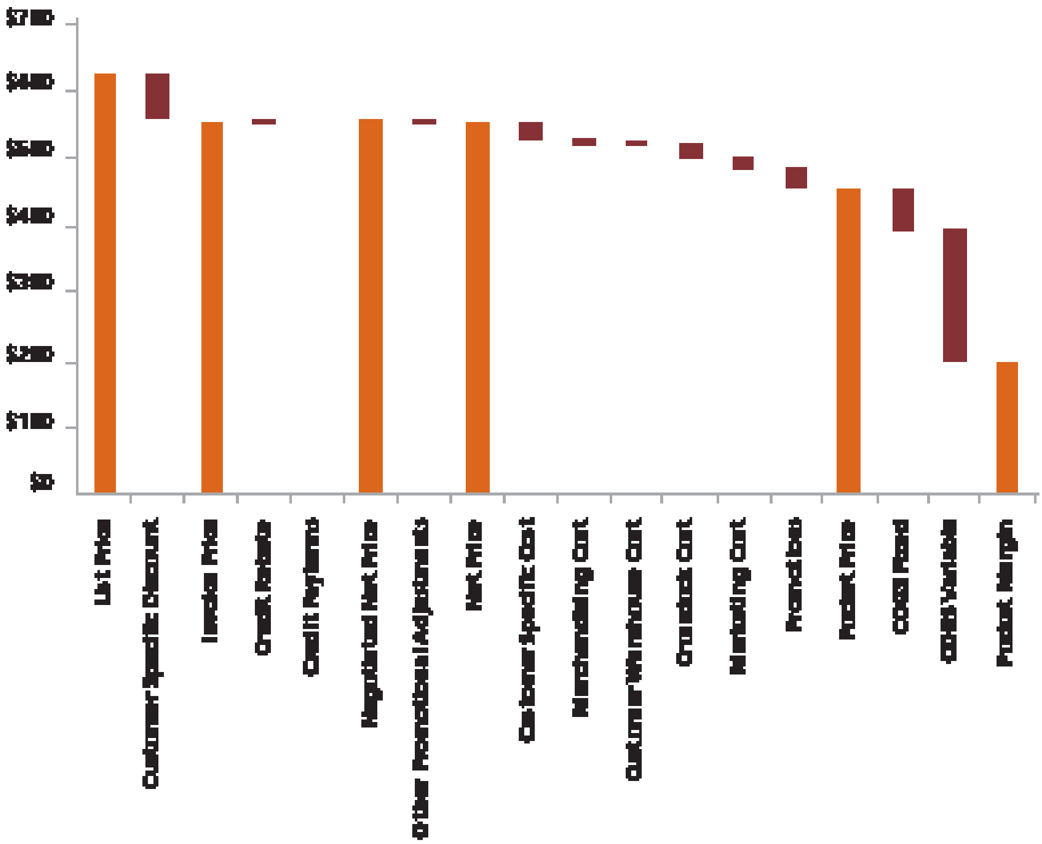
However, many companies that believe they understand customer profitability are actually working with the wrong information. Most use aggregate measures of profitability, typically gross margin, that fail to account for costs that are difficult to measure or that can't be attributed to individual transactions (such as marketing expenses or distribution costs).

Even when these costs are considered, they're often computed at an aggregate level using metrics that ignore the nuances of serving particular customers, segments or other populations of interest. One $10 billion U.S. retailer, for example, subtracted a flat "cost-to-serve" percentage from each transaction's gross margin to calculate the transaction's profitability. But because the same percentage was applied to all stores regardless of their efficiency, this metric ignored important variations in store selling costs. Adjusting the calculation to reflect individual stores' cost to serve gave leaders better information on which to base a number of decisions, such as whether to close a certain store or where to place a regional office.

In fact, when it comes to specifics, more is always better. That's why companies should analyze profitability on a transaction-by-transaction basis, looking not just at every customer but at every transaction each customer completes. But the drill-down shouldn't stop there. To gain true actionable insight, companies need to examine each transaction's profitability based on its "pocket margin" — the fundamental metric on which all higher-level profitability metrics are based.

Pocket margin refers to the amount left in a company's "pocket" after all of the costs related to a transaction, as well as the cost of goods sold, are subtracted from the list price. These costs can range from the obvious, such as off-invoice discounts and promotions, to the easily overlooked, such as costs associated with freight,

Figure 1. An illustrative price waterfall. A price waterfall portrays the progression from list price to pocket margin for a specific "slice" of the business — such as a customer or customer segment — based on cost-to-serve data collected at the transaction level.



warehousing and other activities that may be generally classified as "overhead." The costs incurred at each point in a transaction are often graphically represented in a "price waterfall," a bar chart that depicts the impact of each successive cost-to-serve element on the list price (Figure 1).

Unlike measures that gloss over differences among customers or omit cost-to-serve elements, pocket margin gives a company a clear view of how much revenue each transaction generates, how much it costs the company to generate that revenue, and — crucially — when and why those costs are incurred. And because pocket margin is measured for every transaction, metrics based on pocket margin can provide insight into costs and revenues at any desired level of detail, from individual clients all the way up to broad marketplace segments.

WHAT YOUR CUSTOMERS WON'T TELL YOU (BUT POCKET MARGIN CAN)

Metrics based on pocket margin can give companies a wealth of insight into what they spend to make how much from whom — and how they might be able to improve the outcome. Here are some of the ways we've seen it work.

"You're losing money on me"

One obvious use of customer profitability metrics is to identify the customers who cost more to serve than they generate in revenue. Once a company knows who those money losers are, it can either try to transform them into profitable buyers or attempt to flush them out of the business altogether.

Best Buy, the U.S. consumer electronics retailer, took just such an approach in its efforts to boost the bottom line. As described in the *Wall Street Journal*, the company used customer profitability analyses to differentiate between "angels" — customers who buy high-definition televisions, portable electronic devices, and other items at full retail price — and "devils" — customers who only buy sale items or loss leaders, return a large fraction of their purchases, and generally "wreak enormous economic havoc" on margins, according to then-CEO Brad Anderson. The company then made changes designed to attract more business from angels, such as stocking more merchandise and enhancing customer service, and to discourage sales to devils, such as removing them from marketing lists. The company also took steps to reduce the negative impact of the devils it couldn't shed, such as enforcing a 15 percent restocking fee on returned merchandise.[1]

"You're spending too much to serve me"

Many times, relationships with large customers that are presumed to be profitable actually have special terms, unusual shipping conditions, or other "below the radar" idiosyncrasies that erode profitability until those idiosyncrasies are addressed. Price waterfall information can help companies identify such accounts by flagging "outlier" customers whose cost to serve in certain areas is disproportionately high or whose pocket margin across transactions is consistently lower than average. The company can then look more closely at those customers to uncover and address the reasons for their atypical profitability profile.

In one extreme case, a $9 billion global manufacturer discovered that one of its largest customers was arbitrarily reducing the invoice amount every time orders were not filled 100 percent correctly. These unilateral adjustments had gone unnoticed until the company delved into the details of the relationship to build a price waterfall. Not wanting to make waves with what was assumed to be its most profitable customer, the company's accounts payable staff had been crediting the difference to an "outstanding clarifications" expense account that was not included in the calculation of the customer's specific profitability metrics. (In fact, when the adjustments were factored in, the customer turned out not to be the company's most profitable buyer after all.) The company is considering ways to address this issue in its future negotiations with the customer, on the principle that such penalties should be agreed upon by both sides before being imposed.

"I'm in the wrong segment"

Companies often segment their customers along demographic lines or according to how much revenue each customer generates for the business. But while these approaches are suitable for some purposes, such as marketing and product development, segmenting customers according to profitability can be much more useful in managing margins. Examining the differences between customers at different levels of profitability can give companies valuable insights into what their more profitable customers look like — what they buy, how they buy, what it costs to serve them — and guide efforts to change their less profitable relationships to better fit a profitable mold.

A revised segmentation approach based on customers' overall value to the business helped the lawn care manufacturer mentioned previously focus its plans for making the West Coast profitable. The company drew heavily upon its improved understanding of customer profitability to create its new segmentation scheme, which also considered factors such as location ("How badly do we want to establish a presence in this area?") and customer brand (e.g., "Is this customer Pebble Beach or a no-name public course?"). The company then evaluated the probable impact of various pricing and service changes on each segment's profitability. For some segments, the company decided that going against industry tradition by charging its customers for freight — in exchange for more frequent sales visits, extended warranty terms, and other concessions that customers valued but cost the company less to provide — would be the most feasible way to boost profits. For other segments, the company decided to continue to offer free freight, but charge higher prices or adjust the terms of service to compensate.

Another company, an international beverage distributor, used customer profitability data to refine a segmentation approach that classified customers into "large" and "small" buyers based on each customer's contribution to revenue. After dividing each category into profitable and unprofitable sub-segments, the company discovered that the drivers of profitability differed markedly between its large and small customer groups. Large customers' profitability depended on product mix, while small customers' profitability depended on the cost of sales visits. This insight helped the company understand that it would need to use different tactics with each segment to increase overall profitability. It launched a tailored, two-pronged improvement effort aimed at changing the product mix among large customers and reducing sales costs among small customers, which is expected to increase profits by $10 million annually — an improvement of more than one percent in profit driven by relatively small changes.

FIXING THE MIX

"33 percent more in every bottle!" That's the offer that played havoc with profits at the international beverage distributor described in the main text. On the surface, the issue seemed simple enough: Unprofitable large customers were buying too much of the company's low-margin value brand and too little of its high-margin premium brand. Leaders were mystified, however, as to why many large customers had only recently switched to this unprofitable buying pattern after a long history of acceptable profitability.

A review of the company's promotional efforts solved the puzzle. In a bid to boost sales of its value brand, the company had increased its serving size by more than 30 percent while keeping its price almost the same. But while volume of the super-sized value brand did indeed rise, the net effect was to reduce overall profits due to extensive cannibalization of the premium brand.

How could the company direct its large customers back toward a more profitable balance? A detailed analysis of transaction-level data helped leaders tailor its tactics to suit specific markets. By examining historical purchase patterns, the company discovered that the super-sized value product actually was driving new volume in certain areas of the country. In other regions, however, cost-conscious customers were merely "trading down" to the value brand. The eventual fix involved first adjusting prices on a region-by-region basis to drive customers' product mix back to profitability, and then using the introduction of a new product to reset all relative prices and restore volume to the premium brand.

PHOTO: RUNE THORSTEIN

"You should be charging me more for ..."

Price isn't all that matters to most customers. Many also have definite preferences about aspects of the transaction process that affect your cost to serve, such as how often they place orders or the way products are shipped. It's not unusual for salespeople, especially in a business-to-business context, to oblige such requests gratis or for a nominal fee. They may be worried about preserving the customer relationship, or they simply may not know how much extra to charge to cover any additional costs. By clarifying the impact of customer requests on individual cost-to-serve elements, a customer profitability analysis can help your company avoid leaking margin through such missteps, giving salespeople the information they need to negotiate more profitable prices and terms of service.

By the same token, a detailed breakdown of costs to serve can help you identify opportunities to improve profits by changing buying behavior in ways that are relatively unimportant to the customer, but drive large cost-to-serve savings for you. Companies may need to make concessions on price or other factors to gain customers' acceptance for such changes. Here again, a cost-to-serve analysis can guide negotiations by quantifying the impact of various price and service adjustments on profit. For example, the international beverage distributor mentioned previously is planning to cut sales costs by reducing the frequency of sales visits to some of its less profitable small customers. To offset the impact of asking customers to consolidate their purchases, the company may consider lowering prices, extending credit terms, or other steps that would accommodate customers' needs while still delivering a net profit increase to the company.

To execute tactics like these, a company needs two types of information. First, it needs to identify the elements that go into the cost to serve, determine the impact of any changes on pocket margin, and assess the feasibility of making those changes. It's essential, too, to get this information to the people in a position to use it — with technology that gives salespeople instant, dynamic access to price waterfall information, for instance.

Second, a company needs to understand what its customers value about their relationship with the business and how much they're willing to pay — or what concessions they might demand — for any changes. Sometimes, a salesperson may be able to make this call based on his or her personal knowledge of a customer. A "voice of the customer" survey, supplemented by interviews as necessary, can also help clarify customers' priorities. Business-to-consumer companies often conduct market research for just this reason. And if asking one's actual customers isn't practical, publicly available industry and marketplace data can often serve as a proxy.

"This promotion costs more than it's worth"

An accurate understanding of customer profitability can shed important light on the value of sales promotions, growth initiatives or any other activity that depends on profitability to produce the desired results. For example, one consumer packaged goods company ran a promotional program in which it paid for product display cases and associated electrical costs at some of its customers' retail stores. The company made plans to add up to 2,000 more stores to the program based on initial calculations that showed that the expanded program would yield a profit of 15 percent. However, this estimate overlooked the fact that the program's existing infrastructure could not absorb a 2,000-store increase — the company would need to make significant new investments in overhead and distribution capabilities to support such a large jump. When these additional infrastructure costs were included, leaders realized that the program would actually lose money if it were expanded as originally intended. Based on its improved understanding of program costs, the company is now taking steps, such as consolidating in-program stores and weaning unprofitable accounts off the program, that are expected to improve the program's current profitability by up to 30 percent and put the program's future expansion solidly in the black.

Depending on a company's strategic goals, of course, an unprofitable program may still be worth continuing for broader business reasons. Take the case of one large soft drink manufacturer whose leaders wondered whether they should maintain the company's exclusive contract to place vending machines in a professional sports venue in one of its key markets. A profitability analysis showed that the machines at that location were less profitable than what the company normally considered acceptable. Yet, after seeing the analysis, management decided that the branding value of owning the venue was worth the trade-off in profitability — gaining a comfort level with the decision that they had lacked before quantifying the extent of the investment in the brand.

"Sell me _____ now, and I'll keep coming back for more"

Every salesperson in the world understands the time-honored "bait and hook" technique for driving repeat sales. The problem is, it's not always obvious which products are effective "hooks." That's where a historical view of customer profitability can help. By examining customers' transaction histories, a company can determine which products are likely to drive profitable add-on sales. Conversely, a company can also use historical customer profitability data to identify product/price combinations that tend to encourage unprofitable "cherry-picking" by customers that pay no dividend in future loyalty.

One major U.S. boutique retailer drew on historical customer profitability information to reclassify its products into four categories — "invest," "develop," "preserve," and "harvest" — that reflected the role of each product in driving margins and revenue. The new classification model allowed the company to improve its pricing, promotion and store layout efforts in several ways. For instance, the company realized that some "hot" products that were being heavily promoted during the holiday season were actually items that appealed primarily to "cherry-pickers" and hence did not drive profitable long-term customer relationships. The company therefore de-emphasized those products by moving them closer to the back of its holiday circulars. The analysis also helped the company's merchants develop bundles of products for promotion in ways that had been demonstrated to drive customer loyalty and profitability (such as by offering discounts on accessories instead of rebates in the form of gift cards). All of these insights helped align the strategy for managing each product more closely to its actual contribution to company performance.

WHY YOU CAN'T AFFORD *NOT* TO ACT NOW

A widespread myth about establishing a pocket price-based view of customer profitability is that it's expensive, impractical and time-consuming — certainly not something most companies can afford to do in a downturn. It's true that making improvements can require a certain amount of upfront investment. But many companies we've worked with find that even a modest investment can yield substantial returns. A company can start small, focusing first on a portion of revenues or a single product line, business unit or location, and then expand the effort as resources permit.

In fact, a pilot project can be both a useful proof of concept and also yield increases in profitability that can help fund further improvements. One global chemical company, not wanting to put all of its eggs in one basket, ran a pilot program at three of its poorest-performing business units, reasoning that they would be more willing to try something new than would better-performing divisions. During the pilot, the participating business units made many minor adjustments — including "firing" customers, rationalizing products and offerings, and raising prices in certain segments — that increased their profits by $165 million within 12 months. This amount represented a greater than 1000 percent return on initial investment, surprising even the initial project sponsors and yielding more than enough cash to fund the project's subsequent global rollout. As an additional welcome surprise, the company discovered that many customers that had initially been "fired" for unprofitability returned to buy from the company again under more profitable terms, showing that a company that knows how to sell its value to customers, and has the data to know when to hold the line, can afford to take bold steps with customers to improve their value to the business.

Contrary to popular belief, a company doesn't need activity based costing or a customer loyalty program to gather detailed cost-to-serve data, assign costs to individual transactions, or create a customer transaction history. Most companies routinely collect much of the information needed to analyze customer profitability for other purposes. A little digging in the right places — salesperson time and expense reports, freight systems, marketing budgets, documentation of payment and collection terms — can allow them to piece together enough information for at least a rudimentary customer profitability analysis. Even information that was never explicitly collected can sometimes be derived from primary data. For instance, one retailer that originally thought that its lack of a loyalty card program would preclude a customer profitability analysis was able to construct customer purchase histories by combing individual transactions for linkages between credit card numbers, phone numbers and e-mail addresses customers gave as part of their warranty information.

> So consider viewing the recession, not as a barrier, but as a catalyst for transformation in the way you treat customer profitability.

How long does it take for a company to benefit from customer profitability improvements? In our experience, many companies start to see results in as little as 8 to 12 weeks, often as a result of relatively simple changes. One automotive manufacturer, struggling to find a silver lining in a down economy, realized that significant profit-enhancing opportunities could exist in the hundreds of thousands of parts the company sold in the aftermarket. During a 12-week analysis of the market and of supplier costs, the company found that many parts were overpriced, reducing the competitiveness of the dealers that sold them, while others were underpriced and losing money for each sale. The company quickly adjusted these prices to more appropriate levels while the analysis was still underway and experienced a significant revenue lift in the very next reporting period.

Finally, one of the strongest arguments for starting now is that a recession can make it easier to push through organizational changes that might be difficult to make in times of growth. Your customers, your sales force, and your operations people are probably much more willing to accept tough decisions today than they might be in a strong economy. Their greater receptivity can not only speed adoption of new processes and procedures, but allow you to make much more sweeping changes than might be feasible in better times.

So consider viewing the recession not as a barrier, but as a catalyst for transformation in the way you treat customer profitability. Start with the low-hanging fruit, think about ways to reinvest the benefits, and aim high with respect to organizational change. The sooner you begin, the faster you'll start to understand how profitable your customers *really* are — and the better equipped you'll be to pursue renewed growth when the economy recovers.

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Endnotes

1. Gary McWilliams, "Analyzing Customers, Best Buy Decides Not All Are Welcome," *The Wall Street Journal*, November 8, 2004,