

ASSESSING CUSTOMER PROFITABILITY

It's a standard business adage that it is easier (and less expensive) to sell to a current customer than to acquire a new one. Determining which of your customers is most valuable to your business – not just now but over the lifetime of your relationship – can give you a leg up in retaining them, selling them more and finding other customers like them.

To be successful, you must provide value to your customers, but the reverse is also true – your customers must provide value to you. Understanding customer profitability – i.e. which customers generate profit for you and which customers may actually be costing you money – can be critical to the long term success of your business.

Knowing how each customer (or if you have a lot of customers, each customer segment) affects your company's bottom line can help you determine:

- **WHICH CUSTOMERS TO FOCUS ON** —
When you know that a customer is profitable, you can justify investing more to enhance the relationship (and ensure you don't lose the customer to a competitor).
- **HOW TO SELL BEST CUSTOMERS MORE** —
Dedicating your efforts to your most profitable customers can help you identify cross-sell and up-sell opportunities that can further cement your relationship.
- **HOW TO FIND MORE BEST CUSTOMERS** —
Once you know the profile of your best customer, you can focus your sales and



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marketing efforts on prospects that match those characteristics, helping you get more impact from your prospecting dollars.

- **HOW TO IMPROVE PROFITABILITY AMONG LESS ATTRACTIVE CUSTOMERS** — It's expensive to acquire a new customer, so it makes sense to do whatever you can to make an existing customer more profitable. When you understand which of your customers are less profitable and why, you may be able to make adjustments to your marketing, sales, service and/or fulfillment processes to make the relationship work better for you.



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You may not always be able to turn an undesirable customer relationship around (see “How to Fire a Customer” on page 5), but getting a handle on customer profitability can help you avoid a common business pitfall: spending time, energy and money on low-return customers.

Customer profitability analysis is especially important to service-oriented industries, where the cost of servicing different customers can vary dramatically. If a higher-than-expected level of servicing is required, profitability can take a huge hit. Similarly, manufacturing companies need to assess if the production and operating costs required to meet a customer’s demand is being offset by the revenue generated by that customer.

— CUSTOMER PROFITABILITY ANALYSIS

Calculating customer profitability can be daunting, which is partly why many companies avoid even attempting it. Rigorous, in-depth customer profitability analysis requires detailed information about how your company’s costs should be allocated to each customer, as well as your best guess as to how much that customer will spend with you over time.

THE “SOFT” VALUE OF CUSTOMERS

As you build the revenue side of your customer profitability analysis, it is tempting to consider only the hard dollars that come in from that customer. It’s important, however, to think more broadly. The cost of acquiring a new customer far exceeds the cost of retaining an existing one, so you want to be sure you’ve applied proper valuations.

- **Factor in customer “lifetime” value** — Lifetime value is a view of customer profitability that considers what the customer relationship is worth to your business over its full course. If you’re unsure what that duration might be, it’s still useful to consider how much that customer will bring in, and costs you think you will expend, over the next 3 to 5 years. Because it takes a longer-term view, lifetime value highlights aspects that a simple annual profitability assessment might not.
- **Consider strategic value** — Value can encompass more than just revenue. Consider the non-monetary assets of each customer. A customer who may not contribute revenue directly to the bottom line might still have value in providing referrals, industry insight, competitive knowledge or strategic partnerships. Or it may be that their logo in your sales materials has “marquee value” with other prospects and business partners. Also examine how important your company is to each customer. Are you the sole source of an essential product or service? Building strong and mutually beneficial relationships is one of the keys to long-term success.

Because it is expensive and time-consuming, many companies don't track or allocate costs by customer. However, a less rigorous but still useful analysis can be done at a higher level. All it takes is estimating time and cost allocations based on each customer or customer segment (see the worksheet on page 6).

— **PUTTING YOUR ANALYSIS INTO ACTION**

Once you've estimated customer profitability, you can assess your business model to identify areas for improvement, focusing on the areas where costs are driving down profitability. Here are some key questions to consider as you assess your cost structure and ways to improve profitability:

- Which customer acquisition methods have been most effective at pulling in the most profitable customers? Does it make sense to reallocate acquisition dollars? Are there some channels or customer acquisition vehicles you can eliminate entirely to reduce costs?
- Do you offer custom products? Are your standard products customizable? Does any pricing differential adequately cover the costs involved in the customization?
- How much pre-sales support is required by each customer/customer segment? Are there ways to reduce the amount of pre-sales time and effort involved for some or all of your customers/segments?
- Is there a minimum order quantity? What economies are lost with small order quantities? Can that be addressed through pricing or fees?

THE "SOFT" VALUE OF CUSTOMERS - (cont'd)

— **Take reliability and financial stability into account**

Some customers routinely place orders that require minimal effort on your part. Others always ask for multiple versions of proposals, have a special request, need a rush order or require extraordinary involvement to complete a project. As you examine profitability, consider all these aspects. For example, how long it takes you to collect an invoice can impact profitability – slow payers may require your time and energy dunning them for payment. Many times customers demand more because they know you will respond accordingly without charging. So it is important to set expectations about servicing levels from the outset, for example, the number of revisions that are included in your rate, additional costs for rush charges, extra fees for late payment, etc.

— **Don't forget the "warm fuzzy" factor**

One of the joys of running your own business is the freedom to be selective about your customers. Think about the customers that you most enjoy serving, as well as the ones you dread. While this factor may not directly impact the bottom line, it is important to consider the stress that demanding or unreasonable customers can place on you or your team.

- How are your orders processed – manually or electronically? If they are entered manually, can you migrate to an electronic system to reduce errors?
- What other processes that you handle manually can you automate? Are there any other very labor-intensive processes that you can make more efficient?
- Do you offer multiple delivery options? Are alternative/premium delivery options covered by a price differential?
- How much post-sales support is required by each customer/customer segment? Are there less expensive ways to support customers?
- How quickly do customers pay? Are there ways to encourage faster payment?

Be persistent in your efforts to reduce costs and adjust the profitability equation for your customers. In almost any business, there is room for improvement, and you'll see the effect directly on your bottom line. ■



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HOW TO FIRE A CUSTOMER

The flipside to focusing your energy on your best customers is identifying your worst customers – the ones who place only small or infrequent orders, are tough to deal with or fail to pay on time. Should you cut these customers loose? If so, how do you do it?

— **Consider replacement costs**

Before you decide to end a client relationship, consider how expensive or time consuming it will be to make up the lost revenue. Because it is costly to acquire a new customer, first look for ways to boost the profitability of the relationship. Can you raise prices or fees, lower the costs of the goods or services you provide, or reduce customer service? With some creativity, you may be able to find a way to turn things around.

— **Be up front**

Some customers realize that they may be difficult to work with, perhaps for reasons that are beyond their control. And many times, they value a healthy

supplier relationship as much as you do a healthy customer relationship. As a result, an open conversation may be surprisingly effective at addressing your profitability issues. Explain the situation – for instance, how additional demands are creating a cost burden that makes it hard to keep the relationship profitable. Transparency is becoming increasingly valued in business today. You may want to mention that you may not be the best supplier for their particular needs; this admission may even have the boomerang effect of making you appear more desirable as a business partner. Be prepared, though, for the worst case, since you may not be able to come to terms that work for you.

— **Offer alternatives**

If you do determine that breaking up is the right thing to do, explain to your customer why you will no longer be able to serve their needs – and be sure to offer alternative suppliers. While driving customers to your competitors might sound ill-advised, it can be make business sense. Offering your customer an alternative is a gracious way to wind down the relationship, and helps to keep doors open in the future. As is always true in business, it's advisable to avoid “burning bridges,” as situations can change over time. A former customer could one day become a great prospect, or one of their employees might be hired by a current customer. Also, if you create good will with alternative suppliers, they might just return the favor sending new customers your way as well.

WORKSHEET

ANALYZING CUSTOMER PROFITABILITY

This worksheet will help you analyze each customer or customer segment for profitability. You may want to make copies of this worksheet and use one copy for each major customer or customer segment. (Customer segments can be grouped by such things as annual order volume, industry, types of products they purchase, etc.)

To evaluate customer profitability, begin with total revenues by individual customer or segment over the last full year, making note of any strategic or future sources of value that may be derived. Obviously, you will have to take your best guess as to future value, but if it's too daunting to consider the "lifetime" of your customers, consider the next year or three years. You can always adjust your calculations over time.

Costs for a service versus manufacturing company will probably differ, so be sure to think in terms of hours or staffing needs required for servicing, or hard costs associated with production and distribution, depending on the nature of your business.

Customer/Customer Segment Name:

1. CUSTOMER REVENUE —

What value does this customer/customer segment bring to your company? Use your best estimates for the soft values, or simply list them as high, medium or low if you're unable to quantify them.

Year:

"Hard" value

Product revenue	\$	.....
Service revenue	\$	.....
Fee / paid support revenue	\$	.....
Other revenue: .....	\$	.....

WORKSHEET

ANALYZING CUSTOMER PROFITABILITY

CUSTOMER REVENUE — (cont'd)

"Soft" value		
Referrals	\$	.....
Industry / competitor insight	\$	.....
Strategic partnerships	\$	.....
Marquee value	\$	.....
Other: .....	\$	.....
Total	\$	.....

Once you assess customer revenues, evaluate the costs involved for each customer or customer segment.

2. BUSINESS DEVELOPMENT

How much do you spend annually on developing the relationship with this customer or segment? Use your best allocation of broad expenses if they aren't easily attributable to this customer or segment. For example, if you have four key customer segments and use the same expenditure of advertising to reach them all, just indicate 25% of this amount for each segment.

Advertising	\$	.....
Direct mail	\$	.....
Telemarketing	\$	.....
Brochures & other collateral	\$	.....
Tradeshows & events	\$	.....
Sales Presentations/Calls	\$	.....
Promotions & incentives	\$	.....
Travel & entertainment	\$	.....
Online marketing	\$	.....
Website maintenance/ online fulfillment	\$	.....
Other: .....	\$	.....
Total	\$	.....

WORKSHEET

ANALYZING CUSTOMER PROFITABILITY

3. PRODUCTION/DISTRIBUTION COSTS

How much do you spend in order to get your product or service to this customer or segment? The items to assess will vary based on whether your deliverable is a product, a service, or a combination.

It is very important for a service-based business (e.g. professional or consulting services), to consider total staff hours plus expenses (e.g. travel and entertainment) applied to each customer.

For a products-based business, you'll also want to consider production and labor costs such as:

Product costs	
Manufacturing cost (COGS)	\$
Customization (if any)	\$
Delivery/distribution	\$
Other:	\$
Labor costs	
Direct labor	\$
Subcontracted services	\$
Other:	\$
Total	\$

4. ONGOING SERVICE AND SUPPORT

Post-sale, the servicing involved to maintain certain customers can dramatically impact the profitability of a customer. It's important to consider how those needs vary across customers and within customer segment.

In-person support	\$
Phone support	\$
Web support	\$
Other:	\$
Total	\$

WORKSHEET

ANALYZING CUSTOMER PROFITABILITY

5. OTHER EXPENSES

This section is to account for any other current or anticipated expenses specifically incurred to serve this customer or segment. For example, you may need to open an office to service a large client, or purchase special equipment to manufacture items exclusively for them. If all of your expenses on behalf of this customer or segment are already covered in the sections above, then leave this section blank.

Rent / mortgage	\$
Utilities (electricity, water)	\$
Phone, Internet access	\$
Insurance, employee benefits	\$
Equipment and supplies	\$
Other:	\$
Total	\$

6. THE BOTTOM LINE

With both revenues and costs allocated as accurately as possible, you have a measure of profitability by customer or customer segment.

Total customer revenues (section 1)	\$
Less total customer costs (sections 2, 3, 4 and 5)	\$
= Customer profitability	\$

These figures will give you a way to compare the value of different customers or segments in order to determine your “best customers.” Rather than make any assumptions based on the dollar amounts alone, be sure to factor in any “soft” costs that you may not be able to quantify, such as marquee value or possible referrals, when comparing customers. You can also use the figures to identify trends in profitability over time, helping you determine if a customer is becoming more or less profitable.



NOTES

A series of horizontal dotted lines for taking notes.