

Making Existing Customers More Profitable

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Increasing customer profitability can be tricky. Many companies offer customers discounts or free services to win or retain business. But if they find that the cost of providing those services or discounts exceeds customer profitability, the company has to make a difficult decision between cutting costs or losing customers. Using an approach like activity-based costing and pricing can help to clarify the decisions.

What You Need to Know

Are customer loyalty programs the best way to improve customer profitability?

Customer loyalty programs are designed to retain as many customers as possible, regardless of their real value. It is more important to understand the contribution individual customers make to profitability. This can provide the basis for retention programs that are more carefully targeted.

What to Do

Concentrate on Keeping Customers

Industry statistics indicate that keeping existing customers costs less than acquiring new ones

- Acquiring a customer costs 5 to 10 times more than retaining one.
- A 5 percent increase in retention yields profit increases of 25 to 100 percent.
- Repeat customers spend, on average, 67 percent more.
- Twenty percent of customers account for 80 percent of total revenues.

Trying to win new business can be stressful, expensive, and often unrewarding. Your resources would be better spent on improving profitability from existing customer relationships. As the cost of acquiring new customers increases, acquisition efforts must focus on those customers with the highest potential to become profitable.

Focus on Profitability

Retention is about more than keeping customers; it is also about maintaining their value. Customer “diminishment” accounts for up to 80 percent of value erosion. Although customer retention is critical, it is important to recognize that not all existing customers may be profitable. Historic sales policies may have created a wide range of scenarios in which profitability varies by customer or even by transaction. Profitability can be influenced by different types of discounts, penalties, and allowances, as well as rebates in kind or additional services given for free. Many companies have lost control of these factors as their business, product range, and customer base has grown. An ad hoc approach means that mistakes may pass unnoticed, discounts are no longer calculated on any logical scale, and additional services are distributed overgenerously. As a result, profitability levels may be compromised.

Get a Better View of Customer Profitability

Many companies have an incomplete view of customer value and profitability. With fragmented customer data, it can be difficult to consolidate varied data from internal and external systems into one place. That makes it difficult to predict customer behavior or measure the success of marketing campaigns or customer initiatives.

Software is available to help you analyze customer profitability by accurately analyzing revenue, direct costs, and indirect costs for individual customers and market sectors based on the unique transactions of those customers and the services that they consume. The software delivers a number of important benefits:

- identifies the profitability of individual customers and their profit drivers
- provides information to determine the processes that are driving customer profits
- delivers profitability reports that underpin marketing, sales, channel, and customer retention decisions
- provides income statement and cost driver reports for individual customers to support customer negotiations on terms such as such as number of deliveries, minimum order sizes, returns, payment terms, and services

Build a Long-Term Picture of the Customer

Most companies constantly look for ways to expand their pool of profitable customers, with the ultimate goal of optimizing each customer’s lifetime value. However, it can be difficult to match compelling offers with the right customers at the right time. Customers consume products and services via multiple channels, and they often have several products and accounts. Disparate

customer databases also make it difficult to construct a consistent, consolidated view of each customer. Without a complete view of the customer and an understanding of which customers are profitable and why, it is impossible to determine which types of customers you should acquire and which ones you should seek to retain. The key to improved customer acquisition and retention is gathering and analyzing all your customer data in order to understand customer behavior and develop more effective marketing strategies.

Analyze the Cost of Serving Customers

A key factor in analyzing customer profitability is the cost of serving individual customers. Customers fall into two main categories:

- high cost-to-serve customers
- low cost-to-serve customers

The factors that influence cost-to-serve include:

- orders of custom product or standard product;
- small order quantities or high order quantities;
- unpredictable order arrivals or predictable order arrivals;
- requirements for customized delivery or standard delivery;
- requirements for frequent changes in delivery;
- requirements for large amounts of presales support (marketing, technical, and sales resources) or little to no presales support (standard pricing and ordering);
- requirements for large amounts of postsales support (installation, training, warranty, field service) or no postsales support;
- requirements of the company to hold inventory;
- slow payments or on-time payments.

Concentrate on the Best Customers

Given the variable costs of service, it is important to concentrate on keeping and rewarding the most profitable and regular customers at the expense of everyone else. Some companies take this a stage further and get rid of their worst customers. This can influence the direction of marketing strategy. Instead of advertising to attract new customers with special offers, companies focus on loyalty programs to retain the small proportion of their customer base that provides the highest percentage of profits.

Differentiate Service

A customer loyalty program does not just help you hold onto customers, it can also shape the services you offer customers. Using data from loyalty programs, you can offer differentiated products and services based on customer preferences. A simple example would be customer mailings offering different discounts and offers based on individual spending levels.

Understand and Reward Your Best Customers

The starting point for differentiated service is to profile your best customers. Your sales records can provide insight but, if you lack a comprehensive view of your customers, ask them directly for the information you need using surveys and feedback. This can help to make customers feel appreciated and increase their loyalty. Your top customers are likely to buy more frequently, spend more money, cost less per sale, and refer others. This can make an important contribution to profitability. Do not overspend to attract new business for the short term. Gain the attention and make a one-time sale to win new customers but, once they are sold, drive additional sales and build relationship by treating every customer as your best customer. That way you will not have to keep spending 5 to 10 times more to bring new customers in once. A fraction of that investment can keep customers coming back repeatedly.

Implement Activity-Based Costing

Activity-based costing (ABC) software can help you challenge assumptions about customer profitability and decide which customer segments should be the focus of your marketing strategy. At the same time, you can decide what discount levels you can really afford to offer key accounts. Some measures can provide a false picture. For example, measures of satisfaction and loyalty might increase, but these increases are often accompanied by declining profits, especially when increased product functionality or enhanced customer service are not accompanied by increases in prices or order volumes.

As customer demands for higher and higher levels of service increase, there are two possible outcomes. First, the supplier incurs large losses in serving customers demanding large quantities of these special services. Or, second, to avoid the losses, the supplier decides not to supply the services requested by its customers. Activity-based costing can help to identify the true cost of delivering service and provide a basis for adjusting prices or levels of service to improve profitability.

Introduce Process Improvements

You may be able to deal with customer demands by improving your own supply process and reducing cost to serve. If, for example, customers are moving to smaller order sizes, you should look at your order handling processes, so that you can accommodate customer preferences at lower cost without raising overall prices. Electronic systems, for example, can lower the cost of processing large quantities of small orders. If customers like product variety, you could introduce modular designs so that you can offer greater variety and customization without cost penalties.

Offer Customers Menu Pricing

Customized or menu pricing policies should be at the heart of any strategy to manage customer profitability. By understanding the true cost of providing services, you can establish prices that transform unprofitable relationships into profitable ones. You can set the prices of special services to recover the cost of providing them and allow the customer to choose the menu of services they prefer. Pricing policies like this educates customers about costs and can help to improve relationships. Activity-based pricing enables you to recover costs and lower the cost of serving customers. You may also be able to gain additional market share by offering lower prices to customers who only want a basic level of services.

What to Avoid

You Focus on the Wrong Customers

Many companies invest considerable resources in marketing campaigns to attract new customers. If they do not understand what makes a profitable customer, they may waste a lot of that investment, because a high proportion may end up being unprofitable. By understanding the characteristics of profitable customers, companies can direct their marketing efforts to specific segments that are most likely to yield profitable customers.

Where to Learn More

Books:

Reichheld, Frederick F, *The Loyalty Effect: The Hidden Force Behind Growth, Profits, and Lasting Value*. Harvard Business School Press, 2001.

Web Site:

Harvard Business School Working Knowledge: <http://hbswk.hbs.edu/item/4938.html>

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