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MANAGING

Will This Customer Sink Your Stock?

Here's the newest way to grab competitive advantage: Figure out how profitable your customers really are.

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Who are your unprofitable customers? We recently asked that question of top executives at one of America's biggest retailers. They responded defiantly that they had no unprofitable customers. Understand that this company was in trouble--it wasn't even earning enough to cover its cost of capital, Wall Street analysts were beating it up, and its stock was performing worse than the shares of most competitors. Yet its leaders insisted that through some dark financial voodoo, millions of profitable customers somehow added up to an unprofitable company.

The truth--which shocked them--was that some of their customers were deeply unprofitable. Simply doing business with certain customers was reducing the firm's profits and shareholder value. Other customers were fabulously profitable--but the effect of the bad-news buyers was overwhelming them. The retailer's managers didn't understand any of this. They didn't understand that their customer strategy--their whole plan for acquiring, maintaining, and developing customers--was determining their customer profitability, and crucially, that their customer profitability was in turn determining their share price. Because the company didn't understand these connections, it was, among other serious errors, aiming marketing efforts at customers who weren't profitable and probably never would be. Here's how ridiculous the situation was: This company was actually spending money to bring in customers who were reducing the value of the firm.

Get ready for a big idea that's about to sweep through most companies: managing the enterprise not as a collection of products and services, not as a group of territories, but a portfolio of customers. Of course, managers have always known that some customers are more profitable than others. But it's amazing how many executives, like those of that big retailer, haven't the least idea just how profitable (or unprofitable) individual customers or customer segments are.

Most managers don't understand how their customer portfolio determines their ultimate bottom line: the value of the company. Believe it or not, it's entirely typical to find that just the best 20% of a company's customers generate a huge portion of its share price--in some cases, all of it. The trouble is, the worst 20% may destroy a ton of value, with the middle 60% making up the difference. Until a company starts managing its highly diverse customer portfolio, it can't hope to maximize shareholder value.

That's a critical opportunity missed, because many companies are desperate for a new competitive advantage. Today about 60% of U.S. corporations, like the retailer mentioned above, are either chronically failing to cover their capital costs or just barely doing so. They can't hope to get their stock moving until they fix that problem. Cost cutting and Six Sigma quality programs are great, but when everyone in the industry is doing the same things, you're back to even. Now, in a tough economy and a brutal stock market, the hunt is on for a new source of advantage, one that can last a long time. Companies that find it early will build huge barriers against competitors.

A number of leading firms believe they've found such a competitive advantage. These truly customer-centric companies--including Dell Computer, Toronto-based Royal Bank of Canada, Fidelity Investments, and Canada's Hudson Bay Co.--are getting a grip on their customer portfolio and managing it to lengthen their lead over competitors. Why now? Because until recently trying to calculate the profitability of individual customers or even customer segments was too hard an infotech task for big companies to handle. Now the technology, which is getting more powerful and less expensive by the day, is finally up to the job. Here's a mind-boggling fact: Royal Bank calculates the profitability of every one of its ten million customers every month.

But infotech isn't the key. Many companies have spent millions on the needed software- including ERP (enterprise resource planning), CRM (customer relationship management), and many other applications--with little or nothing to show. That's because cashing in on customer profitability requires a deep change in corporate mindset, something no vendor can sell you. The customer portfolio needs to become the basis of how companies get organized, measured, and managed. Making this switch is tough. That's why even small firms, which don't require giant infotech systems to analyze customer profitability, have rarely done it. Yet companies that can make the shift are discovering huge advantages from managing their customer portfolio. Financial services firms, in particular, are leading the charge.

Consider Fidelity Investments, the world's largest mutual fund company. It realized that some customers were unprofitable because of the channels they used to interact with the company. When a customer who does limited business with Fidelity, and probably has limited potential, calls a service rep too frequently, the costs can easily outstrip any profits.

So a couple of years ago, when such customers called, Fidelity's reps began teaching them how to use the company's lowest-cost channels: its automated phone lines and its website. It also made its site friendlier and more enticing to use. These customers could still talk to service reps, but the phone system identified their calls and routed them into longer queues, so the most-profitable customers could be served more quickly; for the unprofitable customers, the longer wait would be a disincentive to call.

Fidelity couldn't lose. If the unprofitable customers switched to lower-cost channels, they became profitable. If they didn't like the new experience and left, Fidelity became more profitable without them. But Fidelity found that 96% of those customers stayed, about the same retention rate as in the industry overall, and most of them switched to lower-cost channels. Over time, customer satisfaction actually increased for the smaller customers as they learned how to save time and get faster service through the lower-cost channels, increasing Fidelity's operating profit within 12 months.

Note that because Fidelity could allocate resources based on customer profitability and potential, it could have its cake and eat it too: Unprofitable customers became profitable, and profitable customers got better service through shorter wait times when calling. This is typical of companies that make the kind of change Fidelity did. By contrast, when companies don't understand customer profitability, they suffer a double whammy. Resources get squandered on unprofitable customers, which means the profitable ones get short shrift and become less satisfied.

Here's another example. In late 1999, Royal Bank of Canada, the largest bank in that country, reorganized itself not around products or territories but around customer segments. This focus on customer profitability revealed a large opportunity the bank had been missing. When clients from its elderly and well-off "wealth preserver" segment died, their assets passed to their heirs, who tended to be concentrated in one of the bank's most profitable customer segments, which it calls "builders and borrowers." But the bank wasn't satisfied with its retention of those assets; many heirs were not Royal Bank customers, and others were transferring the assets to other institutions.

So last year the bank thoroughly revised the experience it offers current and potential customers who have to settle estates. The process can involve tons of paperwork, so the bank made it easier and more efficient. Since settling an estate is a chore that most people don't know much about, and one that can be emotionally draining, the bank offered financial advice and planning to guide them through it. In a test of the new offer, the bank increased its retention of assets from 30% to 50% and attracted new assets equal to another 25%. Rolled out nationally, the program would translate into $1.5 billion (Canadian) of net new balances. Royal Bank won't say how much extra profit that would create, but the amount is clearly substantial.

Because the bank calculates each segment's economic profit--that is, profit after a capital charge--management can figure out how much each contributes to the share price. The company is also telling stock analysts about segment profitability--valuable information that gives investors deeper insight into Royal Bank than they have into competing banks.

Financial services are one thing. But it's harder for many people to conceptualize how analyzing and acting on customer profitability might work in retailing. Retailers sometimes throw up their hands and ask, "What can I do--put a bouncer at the door to keep unprofitable customers out?"

Probably not, but retailers can do far more than they may imagine. We know a retailer that ran a loyalty program based on how much customers spent. Analyzing their profitability showed that many of the biggest spenders--the top tier in the loyalty program--were deeply unprofitable, often because they bought only sale items and made loads of returns. So the obvious first step for this retailer was to stop sending these customers announcements of big upcoming "private" sales. The company had been promoting such events heavily to its top-tier group, not realizing that actually doing less business with some of them would increase profits.

The retailer also found ways to do more business with its most profitable customers. For example, a woman who buys $10,000 of full-price dresses each year but buys no shoes is a clear opportunity--because she's probably buying a lot of shoes somewhere. So the company could promote its shoe department to her and make sure salespeople mentioned the department to her in the store. The retailer could also take steps to turn unprofitable customers into profitable ones by trying to bundle profitable products with the unprofitable ones that the customers typically buy, based on computer analysis of frequent product pairings. This is "You want fries with that?" on steroids.

If understanding customer profitability is so valuable, how could the top managers of the major retailer we mentioned earlier have felt so certain--and been so wrong--about all their customers' being profitable? These executives said that all their products had positive gross margins, and the company managed inventories well, so tons of capital weren't tied up. Thus, they reasoned, no matter what baskets of goods customers bought, they must all be profitable.

The trouble was that these managers were ignoring important costs. Start with the store's operating expenses: sales associates, rent, electricity, maintenance, and so on. If the shoe department uses 10% of those resources, it should bear 10% of the operating costs. When our retailer began to allocate those expenses earlier this year, the company found that 25% of its product categories were unprofitable, many very unprofitable. Applying charges for capital--inventories, plus things like store improvements--yielded what finance experts call economic profit. It turned out that more than half its product categories were generating negative economic profit!

Using credit card data and simple observation in stores, the company began to analyze baskets of goods bought by a varied sample of customers. It found that some of them chronically bought mostly unprofitable products. Those customers were unprofitable. The retailer also found that some customers made lots of returns, behavior that could make profitable baskets unprofitable; others bought only items that were on sale. Also unprofitable were customers who tied up sales associates but didn't buy anything.

When companies fail to understand customer profitability, they do worse than just miss big opportunities; they can also get themselves into deep trouble. We've observed two especially dangerous traps (for more, see "5 Ways to Fail ").

--The growth illusion. 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. (The company might spend $100 reaching each prospect but succeed with just one in ten.) 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.

Suppose this company typically holds its customers for three years, and it earns profits of $300 per year from each customer. Obviously the company is losing money; it's earning $900 on customers that cost $1,000 to acquire, and that's not even discounting the future earnings to reflect the time value of money.

Yet remarkable as it may seem, the company's investors and even its managers, looking at conventional operating results rather than at customer profitability, might not know for years that anything is wrong. Why not? Suppose that in its second year the company acquires just 1,000 more customers, again at a cost of $1,000 each, or $1 million. Since the 5,000 recently acquired customers bring in a profit of $300 each for a total of $1.5 million, the company shows a profit increase of $500,000. That's a nice change from the previous year's decline and the beginning of a good-looking trend line. It gets better. Suppose that in the next year the company again acquires 1,000 new customers for $1 million. Now it has 6,000 new customers bringing in profits ($1.8 million total) and shows a profit increase of $300,000 over the previous year. Repeat the pattern once more, and profits again rise $300,000 over the previous year.

This company looks like a star. Investors are frantic to buy the stock. The directors are paying management zillions. Yet every new customer is unprofitable. The more customers the company adds, the more value it destroys.

Obviously this situation can't last forever. The 5,000 customers acquired in the big campaign, having stayed for three years, leave; if the company keeps adding 1,000 customers a year, and the cost and profit characteristics remain unchanged, it suddenly falls into a steady state of losing $100,000 a year (that's before capital charges, which would make the value destruction even worse). The stock collapses, top management gets fired, and everyone is marveling at how a company could go into the tank so fast.

Does this scenario sound familiar? Leaving aside the simplified numbers, does it suggest Gap's recent experience as it furiously acquired new customers by opening new stores on every corner, then saw its stock collapse? Or WorldCom's spectacular run-up as it offered cash incentives to attract new customers, then crashed and burned? Or cellular phone companies nationwide that did the same thing? We hasten to add that we don't know for sure whether the scenario we describe is what afflicted those companies--and we suspect they don't know either. But the circumstances are certainly suggestive.

What scares so many managers we talk to is that they have no idea whether they're facing this disaster, because they don't know how to look across their firm's products, regions, and sales channels to understand customer profitability. They don't know what it costs them to acquire customers or how long they hold customers or what it costs to maintain them, so they have no idea how much money they make (or lose) on each one.

--The illusion of averages. In our growth illustration above, we assumed for simplicity that all customers were economically the same. In reality that's never the case. The profitability of a company's customers often varies radically. For example, at Royal Bank just 17% of customers account for 93% of the bank's profits. Occasionally a company will calculate a rough measure of average customer profitability, but because profitability is so unevenly distributed, acting on an average number may do more harm than good.

To see why, consider two struggling companies, A and B. The economic profitability of the average customer at each company is the same: -$15. Yet this average figure masks two radically different customer portfolios. Suppose that at company A, every customer is yielding this same dismal economic profit of -$15. But at company B, half the customers are generating economic profit of $80 each, while the other half are yielding economic profit of -$110 each, combining to create the -$15 average.

While the averages for A and B are the same, the implications are vastly different. Company A can't earn an economic profit with any customers and thus faces a bleak future. Company B, by contrast, is tremendously successful with half its customers and performing disastrously with the other half. If company B's managers can figure out which customers are in which group and why, and then focus on adding more great customers and doing more business with them, while converting or losing the terrible customers, they have a great story for investors. This type of customer de-averaging represents a powerful new way for companies such as B to allocate resources in ways that will turbocharge profits.

Managers aren't the only ones who need better knowledge of customer profitability. Investors do too. They'd love to screen their holdings with the kind of analysis outlined above, but they can't. In today's environment many companies are publishing far more data than before, but they're still excluding a few pieces of extraordinarily valuable information: customer-acquisition costs, maintenance costs, length of customer relationships, and some sense of how customer profitability is distributed.

Boards of directors will soon begin to demand customer-profitability data and will challenge management to act on it; investors will demand that companies report it. They will have to, because knowledge of customer profitability will enable them to attract investors away from competitors that don't have this knowledge. And that's an advantage that no company can safely ignore.

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