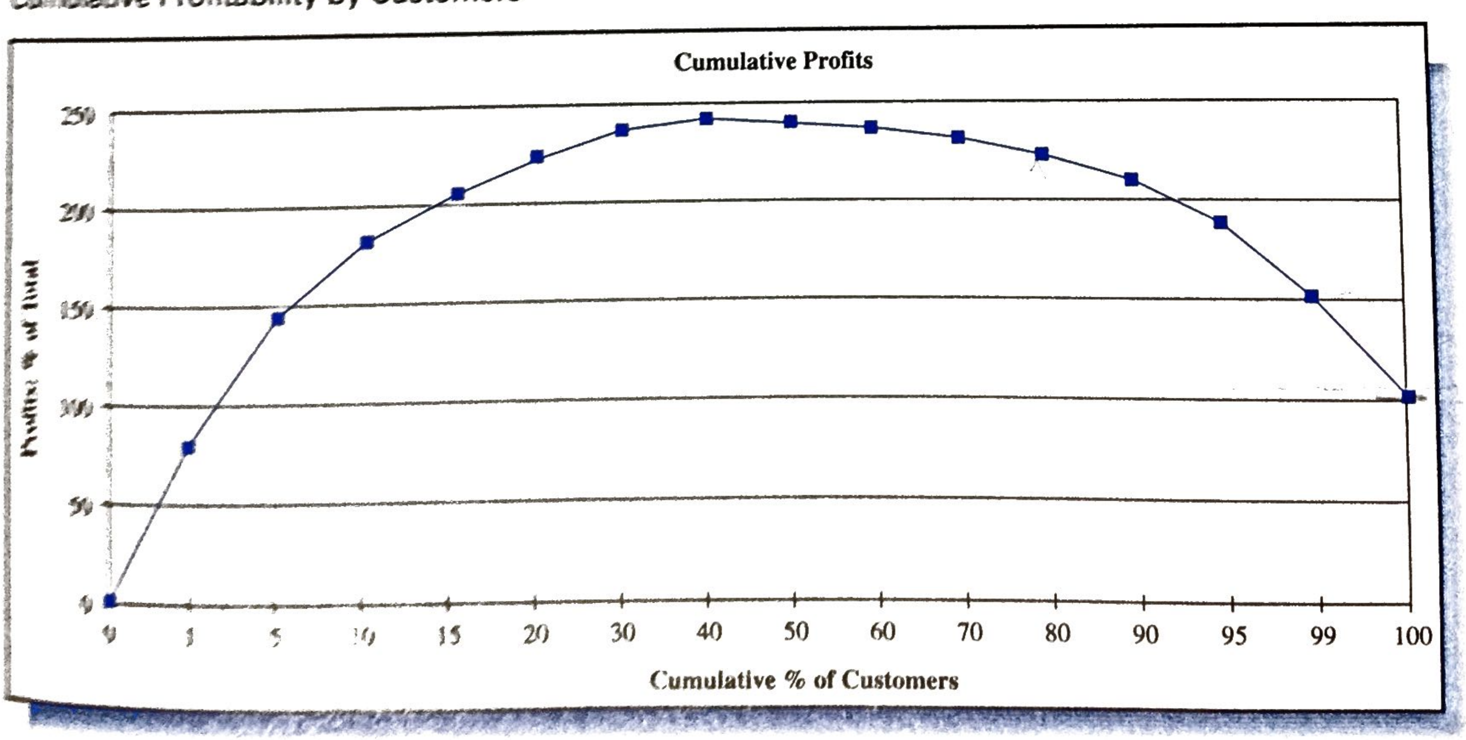
## Managing Customer Profitability

The output from an ABC customer analysis is often portrayed as a whale curve (see Exhibit 4-10), a plot of cumulative profitability versus the number of customers where customers are ranked on the horizontal axis from most profitable to least profitable (or most unprofitable). While cumulative sales follow the usual 20–80 rule—20% of the customers provide 80% of the sales—the **whale curve** for cumulative profitability typically reveals that the most profitable 20% of customers generate between 150% and 300% of total profits (this is the peak, or hump of the whale above sea level). The middle 70% of customers about break even, and the least profitable 10% of customers lose 50% to 200% of total profits, leaving the company with its 100% of total profits ("sea level" in the whale curve represents the company's actual reported profits). In addition, it is not unusual that some of the largest customers, such as Delta, turn out to be the most unprofitable. The largest customers are either the company's most profitable or its most unprofitable. They are rarely in the middle.

High-profit customers, such as Carver, appear in the left section of the profitability whale curve (Exhibit 4-10). Companies can celebrate the high margins they earn on products and services sold to such customers. These customers should be cherished and protected. Because they could be vulnerable to competitive inroads, the managers of companies serving such customers should be prepared to offer discounts, incentives, and special services to retain the loyalty of these valuable customers, particularly if a competitor were to threaten.

Customers like Delta appear on the right tail of the whale curve, dragging the company's profitability down to sea level with their low margins and high cost to serve. The high cost of serving such customers can be caused by their unpredictable order patterns, small order quantities for customized products, nonstandard logistics and delivery requirements, and large demands on technical and sales personnel.

**Exhibit 4-10**
**Cumulative Profitability by Customers**



The opportunity for a company to identify its unprofitable customers and then transform them into profitable ones is perhaps the most powerful benefit that a company's managers can receive from an ABC system. Managers have a full range of actions—process improvements, activity-based pricing, and managing customer relationships—for transforming unprofitable customers into profitable ones.

## Process Improvements

Managers should first examine their internal operations to see where they can improve their own processes to lower the costs of serving customers. If most customers are migrating to smaller order sizes, companies should strive to reduce batch-related costs, such as setup and order handling, so that customer preferences can be accommodated without raising overall prices. For example, Ericson Ice Cream could strive to become more efficient in handling customer orders by installing greater online capacity and migrating their customers to ordering over the Web. This would substantially lower the cost of processing large quantities of small orders. If customers have a preference for suppliers offering high variety, manufacturing companies can try to customize their products at the latest possible stage as well as use information technology to enhance the linkages from design to manufacturing so that greater variety and customization can be offered without cost penalties.

## Activity-Based Pricing

Pricing is the most powerful tool a company can use to transform unprofitable customers into profitable ones. **Activity-based pricing** establishes a base price for producing and delivering a standard quantity for each standard product. In addition to this base price, the company provides a menu of options, with associated prices, for any special services requested by the customer. The prices for special services on the menu can be set simply to recover the activity-based cost to serve, allowing the customer to choose from the menu the features and services it wishes while also allowing the company to recover its cost of providing those features and services to that customer. Alternatively, the company may choose to earn a margin on special services by pricing such services above the costs of providing the service. Price surcharges could be imposed when designing and producing special variants for a customer's particular needs. Discounts would be offered when a customer's ordering pattern lowers the company's cost of supplying it.

Activity-based pricing, therefore, prices orders, not products. When managers base prices on valid cost information, customers shift their ordering, shipping, and distribution patterns in ways that lower total supply-chain costs to the benefit of both suppliers and customers.

## Managing Relationships

Companies can transform unprofitable customers into profitable ones by persuading such customers to use a greater scope of the company's products and services. The margins from increased purchases contribute to covering customer-sustaining costs. Consider a commercial bank with a basic entry-level product: commercial loans. The interest spread on such loans—the difference between the bank's effective borrowing rate and the rate it charges the customers—may be insufficient to cover the bank's cost of making and sustaining the loan because of intense competition and the customer's low use of the lending relationship. However, the bank may make enough profit on other services that the customer uses—for example, investment banking services and corporate money management—that in aggregate the customer is a highly profitable one. Alternatively, however, a small borrower who uses no other commercial banking or investment banking services may be quite unprofitable. In this case, the bank would ask the customer to expand its use of the loan facility (that is, borrow more) and use other and more profitable services offered by the bank's services. If these efforts fail, the bank may then contemplate "firing" the customer by encouraging it to take its demands for a commercial loan to another institution.

Some customers may be unprofitable only because it is the start of the relationship with the company. The company may have incurred high costs to acquire the customer, and the customer's initial purchases of products or services may have been insufficient to cover its acquisition and maintenance costs. No action is required at this point. The company expects and hopes that the customer's purchases of products and services will increase and soon become profitable, including recovering any losses incurred in the start-up years. Companies can afford to be more tolerant of newly acquired unprofitable customers than they can of unprofitable customers they have served for 10 or more years.

## IN PRACTICE

### Strategic Change at Kemps LLC

Kemps, headquartered in Minneapolis, is a full-line dairy, producing and distributing milk, yogurt, sour cream, cottage cheese, and ice cream products to retailers and distributors as large as Super-Valu and Target and as small as convenience stores. Kemps markets these products under its own branded portfolio along with products sold through private label and copacking contracts. Like most dairies, Kemps was experiencing consolidation in its customer base. It decided to shift from its former customer relationship strategy—willing to do whatever the customer asked—to a lower-total-cost strategy. The new strategy clearly required an accurate understanding of cost by product and customer that Jim Green, chief executive officer of Kemps, would use to instill a "low total cost" culture throughout the organization.

As a critical component of the cost-to-serve model, Kemps implemented a time-driven ABC system so that it could track the costs of changeovers in producing and packaging all its products and the costs of picking, loading, and delivering products to its diverse customer base. The model captured differences in how it entered orders from customers (customer phone call, salesperson call, fax, truck-driver entry, electronic data interchange (EDI), or Internet), how it packaged orders (full stacks of six cases, individual cases, or partial break-pack cases for small orders), how it delivered orders (commercial carriers or its own fleet including route miles), and time spent by the driver at each customer location. The extra time for changeovers to clean out allergens (nuts, eggs, soy, or wheat) used in certain ice cream products could now be accurately assigned to those products. The model also captured the extra packaging costs for special promotions and customer-specific labels and promotions.

The company soon learned that it was losing money with one of its customers, a chain of specialty high-end shops, because of the low volume and high variety of products ordered and the small just-in-time deliveries it requested. The vice president of sales of Kemps called on the customer, explained the situation, and offered three options: (1) accept a price increase and a minimum order size; (2) eliminate its private-label ice cream, replacing it with the Kemps standard branded product that was already being produced in efficient, high volumes; or (3) find another ice cream supplier. When the customer inquired why Kemps was making the change, the vice president responded that for 25 years, Kemps didn't understand its true manufacturing costs and the impact that specialty production had on its margins. The customer accepted a price increase of 13%, agreed to the elimination of two low-volume products, and agreed to accept full rather than partial truckload orders, thereby eliminating internal storage charges for Kemps. The changes produced immediate benefits of $150,000 per year, and the customer has been a strong profit contributor.