Delivering Profitability

A Consultant's View

Chapter 3 - Understanding Customers and Their Impact on Profitability

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The best way to lose customers? Keep them satisfied.

Satisfaction is overrated. Keep your customers satisfied and they are still only one click away from finding a new service provider or a new product.

It may seem so obvious that customers are a critical component of profitability that this chapter doesn't even need to be written. Yet it is remarkable how often managers forget there is no business without customers and develop unfriendly customer policies and practices. They often neglect consideration of the impact their policies actually have on growth, reputation and profitability.

We have all experienced interaction with companies that seem to put their own interests ahead of the customer's, such as:

- Voice Response Units (VRU's) which make it impossible to reach a "real" person,
- Inexpensive employees (often offshore) that make communication difficult, or
- Policies which promote high turnover of employees, resulting in customer service representatives who may be less knowledgeable of the product or service than the customer.

No one answer fits all situations. These policies may work for a few businesses where customers are more price-sensitive than quality-focused, but even in those instances the practices should be reviewed to determine their impact on growth and profitability.

While these are somewhat obvious examples, some are even more complex or subtle. Managers or departments may drive results tied to their own bonuses rather than what is in the company's and customers' best interests. The attitude in these situations becomes, "the company provides me a bonus to do X so that's what I'll do." The danger in bonus-driven results is that employees or departments often ignore that the incentives are intended to drive specific behaviors, not to be the sole focus of the employee or department.

You may think that you can't always just give the customer everything he or she wants, and that

I remember one poignant meeting with a client who asked, "How can your recommendation to improve our business profitability be good for both our business and for our customers?"

It's a fair question and interesting that it would occur that those two items could not co-exist. At times one might have to choose, but in this case the client, a bank, had two issues which, when changed, added benefit for both its customers and its shareholders.

The first issue was the process by which new accounts were opened. The bank's customer service representatives (CSRs) opened new accounts as order takers. They filled in the appropriate forms for the customer and opened the account the customer chose based on a brief account overview provided by the CSR. In the revised business process we had the CSR ask the customer to describe their financial life and any finacial concerns they currently faced, or anticipated facing in the next few years. This simple question opened a dialog between the customer and the bank's representative. Customers felt that the bank cared and understood their needs. It also provided the CSR the opportunity to cross-sell many additional products and services such as mortgages, student loans, retirement accounts and other financial products. In some cases it even provided leads for the business banking team to address concerns for small and mid-size business owners.

The second issue addressed was a pricing policy which employees found difficult to explain to customers. Additionally, the policy had a negative impact for shareholders, as it encouraged unprofitable small dollar accounts while discouraging larger, more profitable accounts.

While changing the pricing structure to improve profitability did mean that some customers where going to pay more for their services, ultimately the pricing made more sense to both employees and customers. The customers who were going to pay more for services (literally pennies more) were customers who were not profitable. While all customers benefited from the new clarity in pricing, the larger, more profitable customers also benefited financially. The new policy made a big difference for shareholders; the revised pricing nearly doubled the bank's profitability.

It's worth noting that in each of these examples, what appeared to be a minor operating procedure change had a huge impact on profitability, which we will discuss more in our chapters on Product and Business Unit Profitability.

is true. When a company is so focused on its customers' wants, or their perception of those wants, it risks shortchanging its shareholders and ultimately may limit the ability to serve its customers. We once found that a client's employees were waiving fees for customers at a rate that exceeded their income. Customers appreciated this, but action was needed to limit the loss of revenue. Simply by the executives letting the employees know the company allowed waiving fees but were going to start tracking the number waived per employee, the net income of the company was doubled.

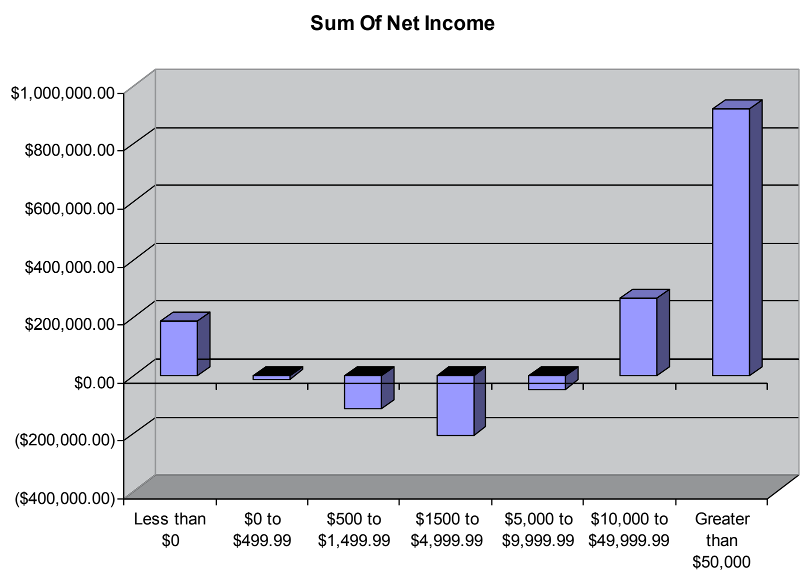
Understanding Customers

We have established that customers are vitally important to profitability. How can managers drive profitability while keeping the customer front and center? We can accomplish this by having a much deeper understanding of both the business strategy and its customers.

- Is the business model one which relies on many equally balanced customers in terms of sales and profitability, or is it a model that relies on a few customers who produce the majority of revenue or profitability?
- What do customers view as your strengths and weaknesses?

- Are customer revenues predictable and steady, or characterized by large swings or seasonality?
- How much does it cost to obtain new customers?
- How long do customers remain customers?
- Are customers advocates for your business, or are they simply customers because it is difficult to change provider?
- For what services or product attributes are customers willing to pay and for what are customers not willing to pay? For example, are customers willing to pay for faster turnaround time?

As you start exploring your understanding of customers, other questions may naturally arise. Keep in mind that while your company has commonality with others, it is also unique.



Surprisingly, there is not always a straight line between size of a customer or their purchases and their profitability. It often seems that 80% of a company's profitability comes from 20% of the customers. But those customers may be at the large purchases end of the scale or at the smaller end of the scale. The example to the left is of the profitability of checking accounts at a community bank.

Be aware that a company should consider the total relationship before making customer decisions based on the profitability of a single product. And while more difficult to measure, consider the value of the customer referring business.

In a reversal of traditional thinking, I saw one client literally run off thousands of customers only to see profits skyrocket. While a few key profitable customers or customer segments can make a business, unprofitable customers can be extremely expensive and may use many valuable resources and take a disproportionate amount of management attention. A key lesson here is that each business and each situation is unique. Following the crowd can be a disaster. The best solution is to look at the big picture and the details of the situation, including complexity of interrelated elements of the business.

Learn from successes and failures.

When you make a change to your business, write out what you expect to happen and then track the changes and compare them to your original expectations. Tracking these changes and the results produced will help you in refining your strategy and help you in understanding your customer. Celebrate your successes and learn from your failures. I'm always amused when someone tells me "We tried that 10 years ago." My response is, "Great; do you have the results documented so we can learn what worked and what didn't? Do you know why it didn't work? Have things changed in the past 10 years that would make a difference in the results today? What could you change about how it was done previously that would make it work now?"

Studying Customer Value

One of my favorite things to study when seeking to expand a company's profitability is the value of their customers. Do a few customers produce the majority of the profitability? If so, what are the characteristics of those customers?

Relationship Between # of Accounts and Profit

# of Accounts	1 Account	2 Accounts	3 Accounts	4 Accounts	5 Accounts	6 Accounts	7 Accounts	8 Accounts	9 Accounts	10 Plus Accounts
# of Customers	3,166	892	288	145	80	50	30	16	30	68
# Deposit	2,370	425	103	37	16	7	11	5	2	12
# with at least 1 Loan	595	190	135	72	37	29	10	8	10	27
# with at Least 1 Insurance	197	83	46	34	25	14	9	2	2	3
Other	4	1	4	2	2	0	0	0	0	8
Approx Dep + Other Acq Cost	$ 82	$ 82	$ 82	$ 82	$ 82	$ 82	$ 82	$ 82	$ 82	$ 82
Approx Loan Acq Cost	$ 2,850	$ 2,850	$ 2,850	$ 2,850	$ 2,850	$ 2,850	$ 2,850	$ 2,850	$ 2,850	$ 2,850
Avg Acq Cost	$ 857,048	$ 529,381	$ 361,979	$ 191,955	$ 98,864	$ 75,990	$ 26,256	$ 21,861	$ 27,509	$ 71,328
Total Profit	$ 1,781,084	$ 1,318,033	$ 1,101,190	$ 737,611	$ 597,632	$ 560,666	$ 216,431	$ 199,178	$ 359,743	$ 1,475,078
Net Income	**$ 1,044,036**	**$ 986,200**	**$ 739,211**	**$ 545,656**	**$ 498,768**	**$ 484,675**	**$ 190,175**	**$ 177,317**	**$ 664,469**	**$ 1,964,580**
Average Profit	**$ 329**	**$ 1,105**	**$ 2,569**	**$ 3,775**	**$ 6,199**	**$ 9,694**	**$ 6,437**	**$ 10,836**	**$ 22,149**	**$ 28,891**
Average Profit Per Account	**$ 329**	**$ 552**	**$ 856**	**$ 944**	**$ 1,240**	**$ 1,616**	**$ 920**	**$ 1,355**	**$ 2,461**	**$ 2,408**
Approx Total Deposit Acquisition Cost	$ 134,424	$ 30,551	$ 7,417	$ 2,647	$ 1,176	$ 523	$ 784	$ 392	$ 163	$ 850
Approx Total Loan Acquisition Cost	$ 508,182	$ 492,818	$ 351,000	$ 186,727	$ 95,727	$ 74,455	$ 24,818	$ 21,273	$ 27,182	$ 69,727

We study the relationship between a customer's quantity of products purchased and their profitability. We also study the average length of time a customer had been a customer and the cost to acquire that customer. In both cases, the value of a customer with many relationships and products and the value of longer-term customers dramatically increase as longevity and number of products increase. The chart above shows for the first product a business customer acquired, the bank earned about $408 per year. For the second product the average profitability increased to $565. For customers with 10 or more products, the average product profit was $2,383 and the total value of the customer increased from $408 for a customer with one product to $28,595 for a customer with 10 or more products. While there may be several explanations for this the point, a loyal customer typically produces far more value than one-off customers. And that doesn't even include softer issues, such as the value the customer generates through referrals.

There are many topics related to customers that could be studied at much greater depth. Because this presentation is a broad survey of profitability, we encourage the reader to find other books or studies focusing on the specific topics below, or simply call us for additional discussion.

- Customer experience,
- Customer life cycle and onboarding (an ounce of prevention is worth a pound of cure),
- Acquisition and channel strategy,

- Customer research understanding and markets,
- Customer value proposition and profitability analysis,
- Top 10%, top quartile, bottom 10%, bottom quartile -- analysis and trending customer strategy,
- Customers and their interaction with the competition, and
- Longevity of customers and turnover.

About ClarityFI

Clarity FI is a financial business management consulting firm offering Strategic and Financial Consulting, Part-time / Time Sharing Chief Financial Officer (CFO) Services and Financial Dashboards. We help organizations understand financial decisions and mine information and data to chart the clearest path to success. We partner with management to optimize customer experience, optimize product pricing, reduce costs, and engage employees and customers to produce tangible, achievable results. The bottom line? We want to help you increase income, save costs, and watch your profits soar.

About the Author

Mr. David Wagstaff has twenty years of leadership, financial management and consulting experience providing business insights, strategic financial analytics, and executive leadership.

He is the Managing Principal and Founder of Clarity FI, focusing on strategic financial management, CFO Services and financial dashboards, analysis and insights. He has experience working with companies that range from large Fortune 100 businesses to entrepreneurial start-ups. Previously, Mr. Wagstaff served as a Managing Consultant, Senior Manager, Enterprise Business Solutions. His corporate responsibilities have been well balanced with successful personal ventures.

Mr. Wagstaff earned his MBA from the University of Maryland, Smith School of Business in College Park, MD, with a concentration in Finance, Accounting and New Venture Creation. He earned his BS in Economics and Business Management from Ithaca College in Ithaca, NY. He is an outstanding member in his community as an active member of the social services organization having served on the Board of Directors and Executive Committee of the board at both Time Out Youth and Family Services of Montgomery County. He is also proud to have been a NJ Foster Parent.

He currently resides in Collingswood, New Jersey with his Partner. He enjoys hiking in the mountains, the beautiful scenery of nature, swimming, water and snow skiing and sailing.