



Improving Profitability Management in Customer-Centric Organizations

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Customer Profitability Analysis

In their zeal to delight customers, [companies] actually lose money with them. They become customer-obsessed rather than customer-focused. When the customer says “jump,” they ask “how high?” They offer additional product features and services to their customers, but fail to receive prices that cover the costs for these additional features and services. – Dr. Robert Kaplan, Baker Foundation Prof., Harvard Business School

Customers may be king but they are not always profitable. When companies are able to analyze profitability at the individual account level, most find the majority of their customers are not contributing to the bottom-line.

These findings can be puzzling to executives in organizations where functional groups are seemingly operating in-line with corporate objectives. Sales teams are meeting revenue goals. Marketing is supporting sales with product, promotions and pricing. And customer service is maintaining retention levels. Yet, the fact remains – more than half of the customer base is unprofitable.

This condition is often rooted in the inadequacies of current finance and reporting systems to support meaningful profitability metrics and analytics. These systems aren't equipped to draw the linkages between transaction and customer data necessary to provide the level of granularity required for this type of analysis. Organizations can't manage what they can't measure. As a result, companies have found it difficult to systematically manage profitability across the organization on a day-to-day basis.

However, as companies increasingly recognize the value of interpreting the success of customer-related initiatives in terms of profit contribution, they are exploring new systems that enable them to do so with more insight and accuracy.

This paper examines the challenges of analyzing profitability with existing systems and how leading companies are adopting new technology and processes to improve the way they manage the profit performance of individual deals, customers, segments and products.

The customer-centricity movement

During the past decade, most large companies have made major investments in technology and processes to improve the way they track and respond to customer-related elements such as purchasing and shipping preferences, buying behavior and satisfaction ratings. The learning gained in these areas has been used to deliver specialized products and/or services aimed at keeping customers from switching to competitive offerings.

When executed properly, CRM technology and other service-oriented processes can have a positive impact on revenue, volume and market share. **However, impressive returns in these areas can distract companies from tending to their primary objective – profitable growth. In the final analysis, companies must understand how customer-focus translates to profit contribution in order to measure the true effectiveness of such initiatives.**

Examples of key areas where customer focus often detracts from margin performance:

- Relationship marketing – technology now enables businesses to leverage customer touch points to learn how they can strengthen customer relations with more up sell and cross sell. However, there is often little intelligence in pricing and promotion of these bundles or visibility into whether this new business is profitable.
- Loyalty – customer retention has become paramount. Deal and contract pricing ignores acquisition costs, cost to serve, and plummeting customer profitability.
- Competitive pressures – companies are under pressure to match competitive offerings or add extra features/services without making the appropriate price adjustments to recoup costs.
- Segmentation - companies are now better able to identify micro segments within the market. This has led to a proliferation of SKUs or product/service bundles that are unprofitable.

For the organization to benefit from these critical initiatives they need visibility into customer profitability, cost to serve, and what the customer values. This insight needs to be used in price setting, customer negotiations, and managing the overall customer portfolio.

Accounting for service-related elements

The challenge of gaining an accurate read on customer profitability has been compounded in today's customer-centric organizations where an increasing number of service-related expenses must be factored into the equation. These costs often stem from indirect sources that are not included in the gross margin metrics most business managers and analysts track on a regular basis.

Examples include:

- More frequent deliveries of smaller orders
- Management of numerous custom SKUs
- Holding/managing inventory for customers
- Post-sales support

Companies have long recognized this as a problem, but few have been able to implement the process improvements necessary to accurately allocate costs back to individual customers, deals or products. Over the past decade, some companies have attempted to use activity-based costing (ABC) methodologies to address the problem, but most of these efforts failed, as they proved to be too large and complex for organizations to sustain over the long run.

Other organizations have resorted to using a simple top-down cost allocation process to gain a better idea of customer profitability. In this method all customer-related costs are aggregated across the business and apportioned to accounts based on the percentage of revenue they represent. However, this practice is inherently flawed in determining the true cost-to-serve, as the relationship between total account revenue and the rate at which services are consumed is not directly proportional.

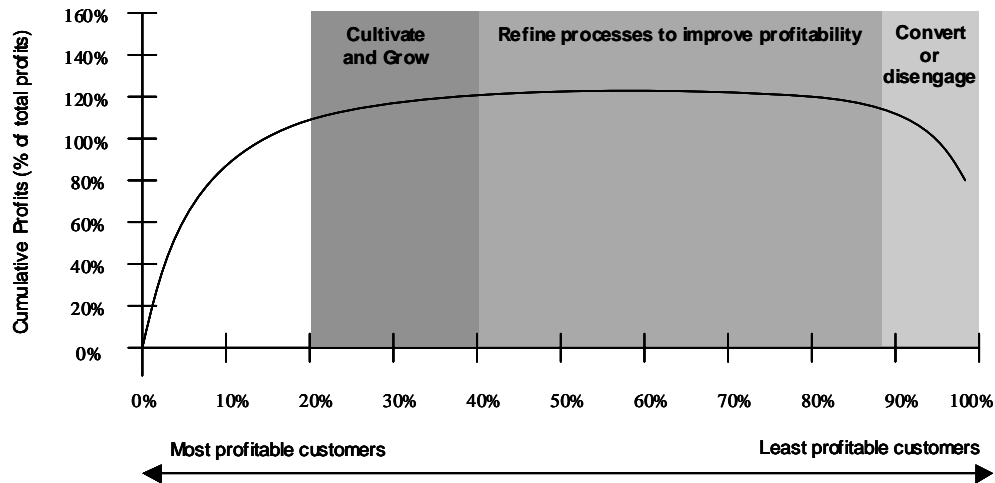
So as a result, most organizations still manage costs and revenues without a true profit-based context for determining how activities should be prioritized for certain customers or segments. Consequently, companies continue to spend scarce resources in areas of the business that do not deliver positive returns.

Customer profitability distribution

The chart in *Figure 1* presents a typical customer profit distribution curve found at many businesses across diverse industries. Customers are ranked by absolute profitability on the X axis then plotted in terms of the cumulative profitability of the company on the Y axis. The results represent another example of the ubiquitous 80:20 rule that applies to so many areas of business.

It's widely accepted that 80 percent of revenues are generated by 20 percent of customers. However, when viewed from a profitability perspective, we see that 20 percent of customers generate 100 percent or more of profits, while the remaining 80 percent just break even or detract from profits. Armed with this kind of insight, companies can develop specific strategies for improving the profit potential of individual accounts that fall within defined segments of the distribution.

Figure 1.



Looking beyond existing systems

Given the scope of the issue and the significant opportunity it represents, more companies are beginning to include customer profitability initiatives in their pricing, product planning, and deal negotiation strategies. However, in order to achieve the level of process integration and companywide adoption necessary for long-term success,

corporate leaders must look beyond their current systems and traditional accounting procedures.

Much of what makes up today's general accounting practices has evolved from an early manufacturing mindset where material costs and direct labor were the largest portion of the total costs with the rest considered overhead. As a result, existing accounting systems do not generate the proper reports required to measure profitability accurately at the customer level, nor do they provide the analytics needed to gain meaningful insight from the data. In short, existing accounting systems do a good job of tracking financial information for external reporting, but fall short in providing the type of information that can help manage the company on a daily basis.

CRM systems and business intelligence tools, with their volumes of customer and transactional data, are another source that many businesses turn to for insights on customer, deal or segment level profitability. Unfortunately, while these systems excel at collecting data and displaying standardized reports, they lack the versatility and analytical rigor business users require for effective profitability management.

A new approach

What has been missing in organizations is a system that enables users to move beyond managing profitability in isolation towards a process that is seamlessly integrated across all sales, marketing and pricing activities. This process must be viewed as an ongoing activity where managers are expected to analyze not only which customers are profitable, but also determine why some are more profitable than others. This insight can fundamentally change the way companies manage relationships with customers, as remedial action plans can be employed (and measured) over time to bring underperformers in line with profit objectives.

In most companies, much of the data required for this level of analysis already exists in various repositories throughout the organization such as ERP, CRM and SCM systems, data warehouses and Excel spreadsheets. The missing link has been finding a way to give regular business users on-demand access to relevant portions of this information in a format that is easy to manipulate and analyze without IT involvement.

Fortunately, today there are solutions available that provide a layer of technology that sits on top of existing systems to unlock the full potential of the vast amounts of data held within them. These solutions enable information from disparate sources to flow into a single analytical and planning environment. Geographically dispersed stakeholders can then access this unified system through a web-based interface that presents data in a way that is most relevant to their function or view of the business. Additionally, some systems are capable of simulating results for proposed actions using what-if scenario planning. This helps managers gauge the impact various options will have on financial and operational metrics before moving forward with them.

Process ownership

As with any business process, successful customer profitability management requires clearly defined roles and responsibilities across all participants. The first step toward establishing this is to determine who will own various parts of the process. Some argue that one group such as marketing or sales should have primary responsibility for monitoring and delivering profitable results from customers. However, most large companies find that it is best to establish cross-functional teams with shared accountability and on-going collaboration. This approach enables each group to manage an area of the process for which they can contribute the most value.

The three groups typically involved in customer profitability management include sales, marketing and finance. Each group holds a unique perspective on the business that should be considered when aligning functional responsibility with various elements of the process. *Figure 3* highlights specific areas of strength and weakness for each group.

Figure 3.

	Strength	Weakness
Sales	Frontline contact with customers, direct day-to-day involvement with deal negotiations	Lack big picture view across business, closing sales is still primary objective
Marketing	Budget accountability, closest to pricing and product development decisions	Disconnected with post sale service costs, somewhat less focused on financial results than other two groups
Finance	Best understanding of financial data and accounting methods, view profitability in terms of impact on overall corporate performance	Lack awareness of non-financial factors that impact profitability, less ability to take action on profitability information

Improved business management

The ability to more accurately measure and analyze profitability metrics at the customer level can significantly improve the effectiveness and efficiency with which companies manage the following key areas:

- Optimize promotional spend and resource allocation
- Define customer and market segments
- Establish and maintain profitable price levels

Optimize resources

Customer profitability analysis provides the insight needed to understand the level of marketing, sales and service investment necessary to generate a certain level of revenue. This information can help identify situations where good money is being used to chase bad (unprofitable) money. Companies can then take the necessary actions to modify service levels or resource allocations accordingly. For example, cost to serve

rates can be reduced by imposing stricter credit terms or delivering services through lower cost alternatives, such as online ordering and web-based product support.

Profit-based segmentation

The learning gained from customer profitability analysis can also be a useful component in creating customer profiles from which market segmentation strategies are developed. Once a company can accurately define the characteristics of their best customers, it can more easily develop a marketing plan that targets other prospects that fit the profile. Conversely, prospects that resemble those in the least profitable segments can be avoided.

Once customers have been segmented according to profitability, this data can be used to develop targeted value propositions that are best suited for specific audiences. This segment-specific approach considers customer needs, company capabilities and the cost of service delivery to create an attractive offering that is more likely to produce desired results.

Establish and maintain profitable price levels

Providing cross-functional groups with enhanced insights into the profit contribution of each customer, deal and segment enables organizations to move beyond general volume-based pricing towards a more strategic and segmented approach. Additionally, exception deals can be evaluated based on the true value opportunity they represent, rather than on instinct, timing and the persuasiveness of the respective account manager.

This shift in the way deals are managed can have a significant and immediate impact, as stakeholders are empowered with meaningful data that increases their negotiating leverage (both internally and externally), as well as their ability to make more informed decisions.

As an example, when a large customer pushes for an additional discount at the end of a quarter, the field rep and pricing manager can both evaluate the deal in the context of similar transactions in the segment, or based on how it will impact the profit performance across the business during a given period. This type of insight provides a big picture view that ultimately results in more consistent price enforcement and higher margin contribution.

Vistaar Profitability Analysis Technology

“On average enterprises miss the equivalent of 10% of total annual sales in “lost opportunity revenue” due to weak analysis of customer, market, and internally available information.” – Gartner Group

Companies are finding new technologies can enable them to evolve profitability management from a process that is bound by organizational silos, to one that is integrated across all sales, marketing and pricing activities.

Vistaar provides a comprehensive solution that enables business users to systematically manage customer and product profitability across the organization. Cross-functional stakeholders are provided with on-demand access to the data they need to perform in-depth collaborative profitability analysis on an on-going basis. And they can do so at any level of the business using a simple web-based application that’s configurable to reflect their requirements.

Vistaar empowers users to leverage existing data to create “on the fly” groupings that can be analyzed for any measure such as revenue, margin, discounts, costs and receivables. Customers can be classified based on contribution to revenue and profitability, buying patterns, and demographic, firmographic or behavioral attributes. All this can be viewed with the granularity required to investigate the causal factors that lead one group to produce more profitable results than another.

Additionally, the solution includes unique scenario planning capabilities that provide an immediate understanding of how proposed actions will impact specific areas of the business. For instance, multiple scenarios can be created to view how remedial pricing, promotions, or other changes impact key financial and operational metrics.

This kind of analysis provides real insights that allow pricing, product marketing and sales operations groups to plan with customer and product contribution in mind, as they set prices, allocate resources and manage deals.

World-class companies in the high-tech, industrial manufacturing and media industries are using the Vistaar approach to profitability management to dramatically enhance revenue, margin and return on invested capital.

About Vistaar

Vistaar Technologies (www.vistaar.com) provides analytical software for pricing, product marketing, and sales operations groups. Customers use Vistaar solutions to improve price realization, increase customer and product profitability, and maximize product portfolio margin contribution.

Vistaar offers unique value to hi-tech and industrial companies selling configured products and bundled offerings. By being able to accurately model products, components, configurations, and bundles, Vistaar allows these companies to set prices, manage deals, and plan their product portfolio to maximize profitability.

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