How much is your key account worth?

Richard Ilsley

Customer Lifetime Value and Customer Profitability

Companies – and Key Account Managers - must consider the long term profitability of their key accounts. Anything less could be considered a dereliction of duty to their shareholders.

Ability to deliver differentiated value to the customer determines how successful you will be. Because if the customer does not see any unique value - if they do not see that you are doing anything different from your competitors to make them better off - then their selection will be based on price, and that's a miserable downward spiral whether you win the business or not.

You must be aware of the value key customers bring to you. Although if your company is not better off as well, then there is little point in doing business with them at all. The aim is not to sell products, the aim is to make profit. Which is why we are so interested in Gross Profit Margin and the costs incurred in serving the customer. Focus only on gross sales and you will find that some key customers are loss-making.

Customer Lifetime Value

Customer Lifetime Value (CLV) is a useful measure, i.e. the value the customer brings over the longer term, which is helpful because it enables us to think about:

- what type of customers are most interesting over the longer term
- the ideal customer profile
- the mix of customers we want to have in the future.

There are various interpretations of Customer Lifetime Value, so you need to understand exactly what you mean by it. 'Lifetime' is the length of the relationship with the customer, not the lifetime of the customer! And 'value' means the contribution or net profit gained from the customer, i.e. gross profit (sales less cost of goods) less the cost to serve. It's worth finding out the

> The aim is not to sell products, the aim is to make profit.

cost to serve each key customer (they can be very different) while the exact cost to serve other customers is generally not calculated. You can work out an approximate figure for different types of customer based upon the number of deliveries; the complexity of the business; the intensity of the customer support and so on.

The higher the gross margin and the lower the cost to serve, the more profitable the customer's business is. However, a customer with a lower gross profit may still be interesting if the cost to serve is low and, conversely, a customer with a high gross margin may be less profitable if the cost to serve is very high, e.g. when a lot of services are given away without collecting a fee for them.

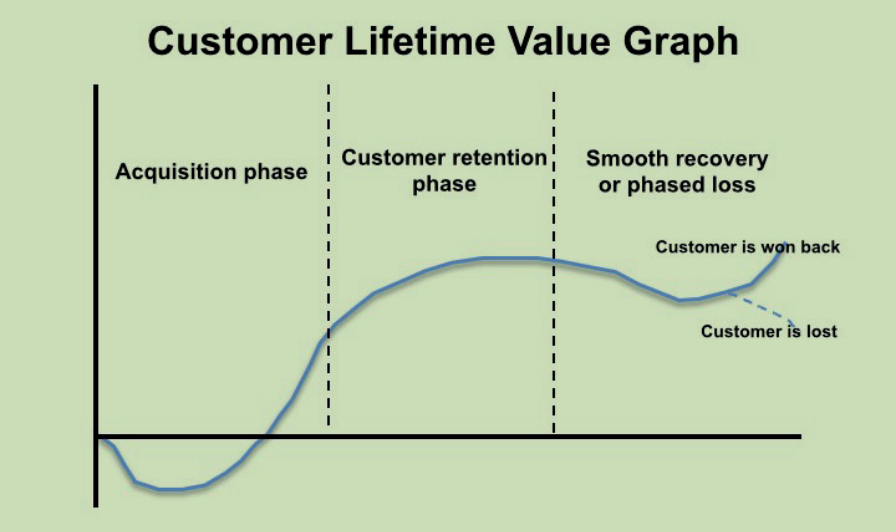
Customer Lifetime Value is the amount of net profit gained from the customer over the life of the relationship with the customer.

An awareness of the potential lifetime value helps us think about which customers are most interesting over the longer term and so which customers should be targeted over the coming period. Not all customers are equal and simply targeting large customers - or perhaps just waiting for the customer to come to us with an RFP/RFQ - is unlikely to result in the best mix of customers.

The first graph suggests that you must constantly look for ways to develop your value position with key customers. Otherwise you may become complacent and take large, long-term customers for granted. It is dangerous to assume that even a great relationship with a customer that the company has had for years means you will always have their business.

Furthermore, just as you target your competitors and their high-profile customers, they will target your key customers. If your competitors are smart, they will be looking for opportunities to show that they can bring more value – just like you. The danger is that, over time, you shift your focus away from long-term profitable customers, allow a competitor in and perhaps lose some business, which reduces overall customer profitability. Everyone has seen such examples. You must use value development to protect existing business as well as target new business with the customer.

A graph of time v profit shows that, while it costs a substantial sum of money to win a key customer (more later), if successful, a period of strong profitability follows. However, if you are not careful, this profitability may decline or even disappear under competitive pressure. (Figure 1)



(Figure 1)

How much is your key account worth? (cont.)

Acquisition costs

The costs of winning a new customer can be very high, especially a potential key account. You might be talking with a potential customer, making presentations, sourcing products, testing samples and so on for many months or even years before you actually make a sale. All this costs money and if you don't win the customer then you will not see any return on this investment of time and effort. So being aware of the cost of winning a new customer is important. Then the longer you can retain a customer, the better off you should be. (Figure 2)

Of course, your business is more complicated than the car-dealer, which is good news because you have more opportunities to gain value from the customer. However, the fictitious but realistic car-dealer example suggests that:

- if you fail to retain long-term working relationships with your customers
- if you are constantly churning customers (winning business one year but then losing it the next year – which is typical for business won on price)
- if you have lots of small opportunity customers (high cost to acquire but low revenue potential)

- then a successful profitable long-term business is unlikely, even though your revenue might look good.

Case example: cars

Car-dealers and car manufacturers spend a huge amount of money to advertise and promote their cars, but do how do they get a return on that expenditure?

The dealer can calculate the cost of acquiring one new customer as total costs of acquisition (all the costs of marketing and selling) divided by the number of cars sold to new customers.

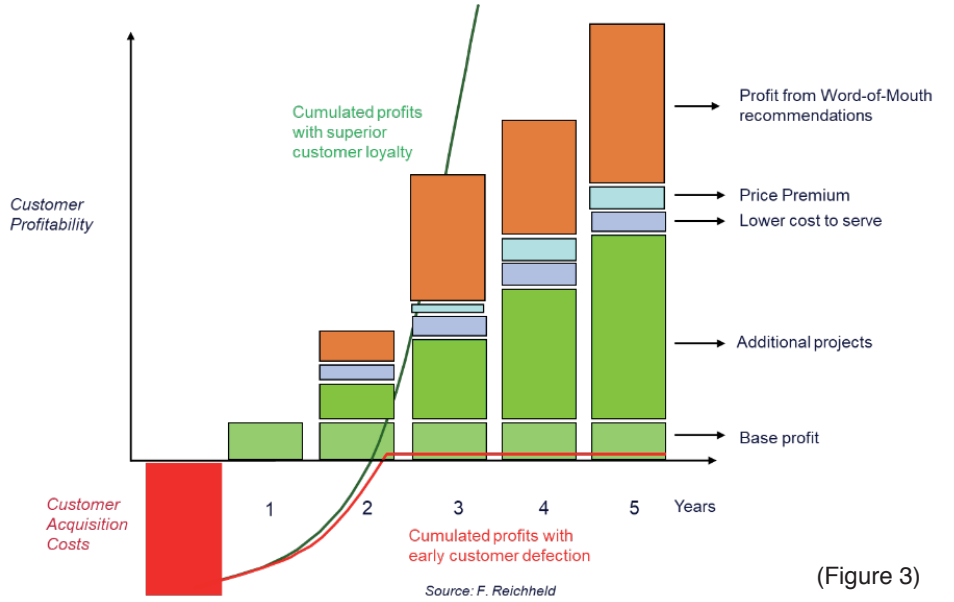
Then if, for example, the car-dealer makes €2,500 of profit on selling a new car but the cost to acquire a new customer is also €2,500, then the dealer makes no profit on new customers.

But suppose the dealer has great after-sales service and really looks after their customers, so that 80% go on to buy a second new car and perhaps 50% go on to buy a third new car from them. Now the cost of acquisition for the second and third purchase is very little and the dealer starts to make profit from these customers.

Note that the dealer does not make any profit until the customer buys a second car.

(Figure 2)

Incremental profit growth over time



(Figure 3)

The Loyalty Effect

= Total value delivered by the customer over the lifetime of the relationship

In the 1990s Fred Reichheld from Bain strategy consultants developed a model that considered all the profit benefits available from a long-term loyal customer.

The graph (Figure 3) is a hypothetical example to illustrate a point which maps time v incremental profit. As it takes time and effort (= money) to win a new customer, you actually lose money before the customer buys anything. This shows in the graph as a loss in Year 0. There is some operating profit in the first year of trading but it may not be enough to cover costs already incurred. This example shows no net profit from the customer (trading profit less acquisition costs) until the end of Year 2. So if the customer were lost at the end of Year 2 then you would not have made any real profit at all.

But if the relationship is successful in Year 1, there should be additional business and therefore profit in subsequent years as you gain more of the customer's 'wallet'.

How much is your key account worth? (cont.)

Lower costs As your relationship and share grows, you should experience lower costs to serve through gaining a greater understanding of how best to service the customer and becoming more efficient, e.g. leveraging greater purchasing power with your own suppliers.

Price maintenance At the same time you should be working hard to identify incremental value to bring to the customer from service support solutions, and that will help you protect and increase your price. Once a certain share of the customer's business is gained then the cost of switching suppliers for the customer may be high, allowing price maintenance despite competitive pressure.

Recommendations If you establish very strong working relationships across the customer, you should find that the customer will either recommend your company to other divisions or be prepared to act as a reference site for you, which supports profitability indirectly.

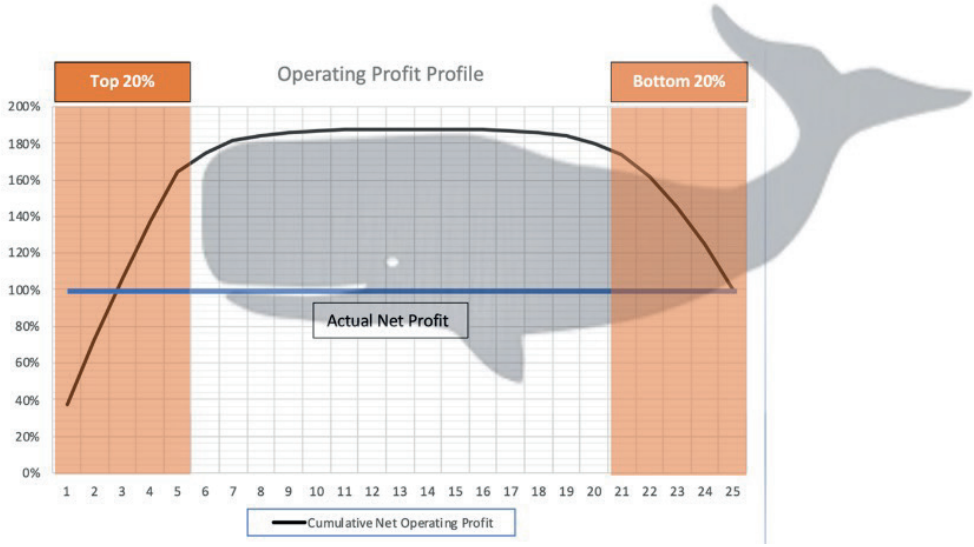
This analysis shows that the longer the customer relationship, the greater the profit from a customer should be, provided that you continue to work hard to support and service them and constantly identify new ways to add customer value. Long-term customers tend to be more profitable than newer customers. Whilst you may be able to replace the revenue if you lose a long-term customer, it is much more difficult to replace the profit.

The Whale Chart

Overall profitability

The business is made up of many customers which together deliver the profit of the sector or the region and ultimately the company, hence the 'Whale Chart'.

To construct a Whale Chart, calculate the individual profitability for each key customer, but you may assess customer profitability for the rest based on gross profit and an estimate of the cost to serve for this type of customer. Then graph the customers starting with the most profitable on the left of the x-axis, running through to the least profitable (most often loss-making) customers on the right. The resulting curve could be said to resemble a whale coming up for air - hence the name. (Figure 4)



(Figure 4)

> You may be able to replace the revenue if you lose a long-term customer, it is much more difficult to replace the profit.

It is not uncommon to find that:

- 20-30% of customers make 2-3 times the total profit
- 50-60% of customers make no profit
- 20-30% are losing money for the company.

This simplified example shows a company with 25 customers which is making nearly double its total profit with 20% (7!) of its customers, but then losing half of that profit with 20% of its customers and making no profit with 60% of its customers. So 100% of the profit is made up of 25 customers but 180% of the profit is delivered by 7 customers. All actual figures will depend on the specific situation and exactly how the company measures profit.

The main point is that some of your customers are highly profitable and some will be highly loss making. Understanding which are more likely to be profit making helps you target and apply resource to the right customers.

Conclusion

Business is about making a profit, and in many cases sales does not equal a profit. Of course, if you don't sell anything, you can't make a profit, but you can easily make a loss, especially with key customers. You have to work very hard to make big losses on small customers, but you can do it quite easily with a key customer. Which makes fully understanding the profitability of the business – costs of acquisition and costs to serve as well as costs of sale – is essential, and not as common as it should be.

Richard Ilsley
Sales & Marketing Consulting Group
richard.ilsley@smcg.net