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## Don't Fire That Customer – Yet!

These extraordinary economic times have forced many companies to take every opportunity to cut costs and arrest declining revenues and margins. Many experts have recommended firing unprofitable customers as a key step in profit improvement. Studies have shown for many businesses the most profitable 20% of customers are highly profitable and account for 300% of the company's profits. The next 60% of the customers break-even and the poorest performing 20% cause the company to lose more than 100% of its profits. So, the logic is seemingly straightforward but, if done incorrectly or for the wrong reasons, can have devastating long-term impact on the business and its reputation.

In last month's article, "[Don't Let a Good Downturn Pass You By](#)", I suggested one area for improved performance is to "boost the activities that drive sales and passionately focus on your existing customers. They are your bread and butter. New customers often take more resources and a long time to develop and you need to focus your energy on maximizing your existing relationships now."

Firing customers is a legitimate strategy for accounts that abuse services, intimidate salespeople and don't pay their bills. But if you're planning to fire a customer because they aren't profitable, be careful. Much of the causality for unprofitable customers resides with your own business practices. Firing the customer for something your company is doing, or the customer is doing as a result of the incentives your company has created, can actually cause you to lose more money because you forego future profits from that customer. It could also permanently damage the relationship, or worse, incite a negative word-of-mouth campaign directed at other customers. Your company's reputation can suffer irreparable harm.

The breakdown in relationships between suppliers and customers, and often a lack of profitability, occurs when the supplier does not measure and manage customer profitability. Before firing any customer, company's need to fully understand the cost-to-serve each customer and correct their service and pricing policies.

A major issue in controlling service costs is the model of **sales compensation**. Typical compensation schemes are based on sales or gross margin dollars with no constraints on pricing or on committing to extraordinary services. If the true costs-to-serve a customer are hidden from the salesperson's compensation, they are likely to

- offer lower pricing in order to 'get the business' and
- extend offers for extraordinary services that burden the company like special freight terms, smaller, more frequent deliveries, drop ship to end-users, complex rebate & pricing schemes, customization, customer specific inventory.

Another, and often more significant issue controlling customer profitability is the pricing policy itself. This is often the most strategic and yet misunderstood issue companies face. I've encountered numerous situations where the dominant pricing model is a cost-plus approach; an 'acceptable margin' is applied as a mark-up on the standard cost of the product. In addition, there is often no provision for special services which may be requested by customers. The misaligned incentives between suppliers and customers resulting from this type of pricing policy can result in predictable consequences that adversely impact the company's bottom line including

- item level pricing that is not in line with the market, causing customers to cherry pick your line
- demand for special services that are provided at no extra charge can be enormous

Actions taken to mitigate these customer decisions can make matters worse. Valid pricing, based on the cost-to-serve, provides a critical parameter for mediating conflicts between suppliers and customers and should be at the heart of any strategy to manage customer profitability.

Lastly, in their zeal to eliminate unprofitable relationships, some companies fire customers they thought to be unprofitable only to find out they're losing more money and they cannot eliminate fixed costs as quickly as the margin dollars disappear. Traditional accounting and financial reporting provides no requirement or incentive for companies to assign their operating expenses to customers. When fixed costs are included in the analysis it has the effect of inflating the cost-to-serve a particular customer. The typical analysis often ignores the impact changing volume has on costs and overall profitability of the company as well. So it's crucial to use the right information in the analysis.

The difference between a business model that directs profits by managing customer profitability and instructing current customers to change their transaction habits (without giving them a reason to do so) can be subtle. Too often, customers are over-served, under-priced, or given promotional inducements with no expiration, which can lead to an unprofitable relationship. At the same time, the excess demand for unpriced services they are requesting can mask higher costs that customers themselves are incurring. Pricing based on the cost-to-serve actually has the potential to enhance profits for both suppliers and customers simultaneously.

Start with internal process improvements to allow customer preferences to be accommodated at a lower cost. Then begin to tackle areas to improve profitability across segments of customers. You'll have the hard, indisputable facts and cost/profit information you need to effectively negotiate relationships for improved profitability. Policy decisions tend to avoid the need for clumsy negotiations with individual customers. These could include:

- Service charges for special freight requests
- Reducing outside call frequency
- More strategic pricing on slow-moving or special-order items
- Separating and charging for extraordinary services
- Moving unprofitable customers to lower-cost solicitation methods including telesales and e-commerce

If your customer's choose not to comply with your new policies and you conclude you must still fire the customer, do so with the utmost professionalism. Chances are they'll be coming back to you once they realize the advantages of doing business with you.