MODERN DISTRIBUTION MANAGEMENT The Newsletter for the Wholesale Distribution Channel

Think about your customer investment portfolio

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Executive summary: While activity based costing proved to be a successful measurement tool for manufacturers in the 1990s, this article suggests that distributors today should use customer profitability analysis as a more effective means to analyze and manage their ongoing investment in customers.

Although you'd probably rather not just now, please stop and think about your investment portfolio for a moment. Do you pick your stocks, bonds and mutual funds blindly – without any information about their recent performance or the outlook for future appreciation? Do you hold on to your portfolio investments indefinitely without regard to underlying financial information, value, yield and prospects?

Most successful investors read the Wall Street Journal, watch CNBC and check stock prices on the computer. Timely, useful information is the lifeblood of making sound portfolio decisions.

How much timely, useful information do you have to make critical decisions about your company's investment portfolio? The portfolio where you have invested millions of dollars in hundreds, or thousands, of companies -– your customers. Distributor management teams lacking information about their customers, and without analytical tools, fail to act. Like an uninformed investor, profit opportunities are missed and avoidable losses are overlooked.

Tracking the investment returns from your customer portfolio

Think of your company's customer list as a mutual fund. Each name on the list represents an investment your company has made, and continues to make. As a mutual fund manager, you would evaluate the annual yield of each company in relation to your investment, and compared to alternative investments you could make. You would evaluate which companies are long-term growth investments, which are cash flow generators and which should be harvested. Your performance as a mutual manager would be evaluated over time against various indexes and against your peer group of managers.

As a distribution manager, do you keep track of your investment in each customer in your portfolio – the money spent in finding and attracting the account, the dollars invested in developing the relationship and learning about the customer's business, product and service needs? The ongoing time and effort spent annually satisfying a major customer and building loyalty isn't small. How many dollars of receivables are currently invested in the customer? How many dollars of special inventory?

What is the current yield for each customer investment in your portfolio? How much operating profit (not sales revenue, not gross profit) is your company earning from each of these investments? What is the current market value of each of your customer portfolio investments? The total market value of companies you invest in is expressed in terms of a price/earnings ratio. The market value of each customer investment could also be stated in relation to its P/E ratio –assuming you know the earnings generated by each customer.

An excellent article in Fortune magazine (September 30, 2002) asks the question *"Will This Customer Sink Your Stock?"* The financial services industry is becoming proficient in determining how much profit each customer generates. In turn, the service offering to the customer is adjusted accordingly (e.g., service the most profitable accounts on the phone, refer others to the website).

Customer retention rates are proving to be within industry norms. What can distributors learn from this example?

ABC for manufacturers, customer portfolio analysis for distributors

Many distributors were swept under by the wave of activity based costing in the 1990's. "ABC" has become a valuable tool in the arsenal of many companies, especially in manufacturing. The same degree of success has not been enjoyed by many of the distributors who tried to apply ABC. Why not?

ABC was developed for manufacturers who have very large "fixed" costs – plant, machinery, dies and molds. These costs and production capacity must be depreciated over many years.

For most distributors, receivables and inventories make up 80% of total assets. Distributors have little in the way of fixed costs. I would argue that, beyond a year or so, nearly all distribution costs are variable. The most inflexible cost in distribution is warehouse space. Extra space can usually be rented on short notice and unneeded space can often be leased to others. So, some of the key principles upon which ABC is based have little relevance to distributors.

Some distributors who struggled with activity based costing discovered "customer profitability analysis." Those who stayed the course found the awareness of customer profitability very useful for making critical operating and strategic decisions.

With a reasonable effort, customer profitability analysis can transform data from the transaction processing system into calculations of operating profit from individual transactions. The data can be built into estimates of profitability of customers and groups of customers such as territories or industry segments.

With customer profitability data in hand, distributors can begin to analyze and manage their customer investment portfolios.

Four stages of analyzing distributor customer profitability

Level One – Quick and dirty

Compute the company's operating costs per transaction by dividing total operating expenses by the number of transactions. Determine operating profit for a transaction by subtracting the average expense amount from the transaction's gross profit.

Level Two – Separate warehouse transaction costs from the total

Isolate the company's operating costs per warehouse transaction by dividing operating expenses (for warehouse transactions only) by the number of warehouse transactions. Determine operating profit for a warehouse transaction by subtracting the average warehouse expense amount from the transaction's gross profit.

Level Three - Assign costs to carrying receivables, special inventories and extra services demanded by the customer

Capture data about a customer's average days outstanding and the turnover of special inventory carried for the customer. Consider adding a subjective "hassle factor" to account for extra services needed to support the customer.

Level Four – Bundle transactions together to estimate customer profitability; group customers together to estimate customer segment or territory profitability

Transactions, especially warehouse orders, are the building blocks of a distribution business. By determining profitability of individual transactions, the database can be sorted to estimate profitability of any combination of customers, groups of customers, sales territories, geographic markets, etc.

How to start customer portfolio analysis

- Capture basic data about transactions – customer, order type (warehouse or direct), order size, gross profit, delivery cost – from your transaction processing / sales analysis system and "port it over" to a spreadsheet program.
- Design a template with some simple formulas to assign operating costs to transactions (selling, sales support, administrative, office, handling, delivery and storage costs behave differently).
- Train your management team and sellers to understand how to interpret and use the results. Some customers (and groups of customers) are profitable; some are marginal – and, some are simply losers.

Execution: How to use the information

- Search for "common threads." Is there an underlying root cause, such as a poorly trained sales rep, an especially difficult competitor, or weak management supervision of a territory?

- Develop a corrective action plan for money-losing accounts. A checklist approach can be used to organize efforts of sales and sales management to devise win-win situations for customers where money is being lost.
- Reconsider strategic emphasis in terms of customer segments, product/service offerings and geographic markets where money is being lost. Search for alternative ways of servicing problem markets.
- Train staff to use the tools to evaluate new opportunities.
- Reevaluate the customer portfolio on a routine schedule, such as semi-annually, to check progress and look for new opportunities.

Real-life success stories

Unlike a theoretical concept (interesting, but now what?), customer portfolio analysis has execution potential for the alert and action-oriented leader. Examples of success from the distribution world:

- Design and implement an action checklist for customers that are actually losing money for the distributor. Reduce the number of deliveries, switch from slow-moving custom inventory to stock items, trade the customer up to other, better product lines. Penetrate the account further. Eliminate the consignment program. Collect faster.
- Stratify the accounts based on objective criteria and tailor the service packages according to customer profitability. Use proactive inside sales or reactive customer service instead of outside sellers for selected accounts. Eliminate slow-moving custom inventory.
- Segment the customers and find where the operating profits are. Reassign certain segments to service reps. Redeploy the ‘hunters’ on better opportunities.

Understand the root causes of profitability

To one distributor, health care industry customers appeared unprofitable. Analysis showed that most hospital accounts were losing money and, as a group, nursing homes were barely breaking even.

Further analysis revealed that for-profit chain nursing homes were big losers, but that charitable nursing homes were profitable. The distributor chose to refocus the sales force on philanthropic nursing homes and stop chasing volume at chain nursing homes. Also, the distributor decided to use service-oriented salaried reps to handle hospitals rather than commissioned sellers. The result: the health care industry customers are profitable and growing.