

Profiting from Customer Profitability Measurement

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Customer Relationship Management: At the Core of Customer Profitability

A well-thought-out Customer Relationship Management (CRM) strategy requires companies to optimize their knowledge about their customers to better anticipate customer needs for products and services, develop those products and services with the benefits and features most valued, and ensure that preferred delivery channels are developed and maintained. An effective customer profitability process contributes to that understanding and provides a way to measure the impact of CRM strategy.

Customer focus is most meaningful when there are relatively few opportunities for companies to make a substantial profit from each customer relationship. This occurs when the usual interaction between company and customer consists of low or zero margin transactions (telephone usage, financial payments, and retail sales). In these cases, the company needs to focus on expense control to stay in business, but needs the infrequent high margin transaction to achieve profitability. The fact that these opportunities are relatively few and far between makes it crucial to have preferential access (or the right of first refusal) to the opportunity to offer the customer the product or service required, right when it is needed. When these opportunities are missed, the potential of many customer relationships goes untapped, loyalty is not leveraged, and relationships often remain a net drain on the company's profitability.

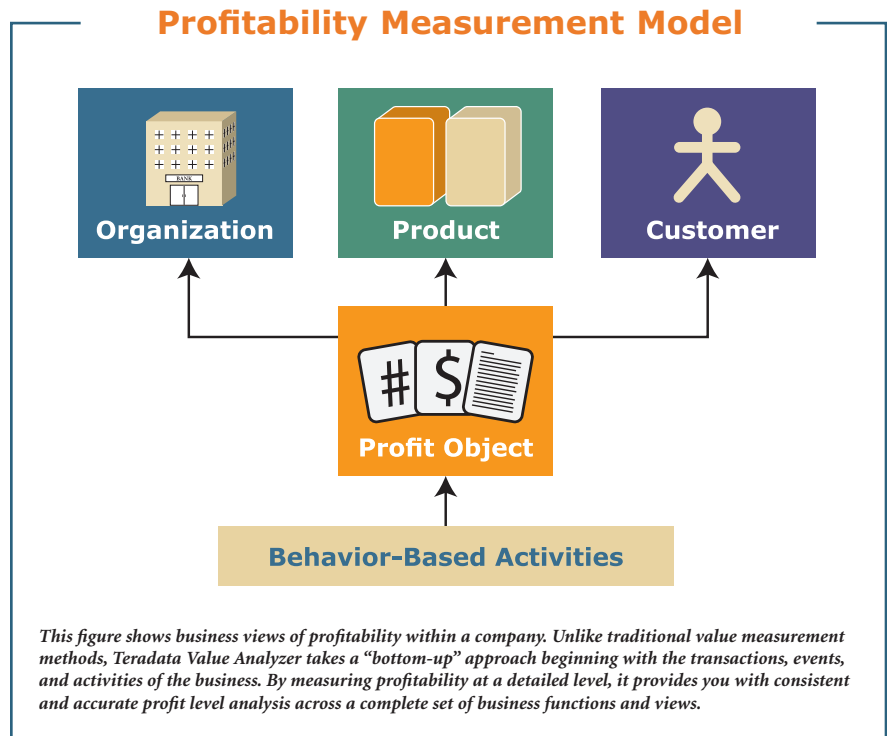
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Many companies claim to be customer focused, but how many companies have effective processes for measuring customer profitability? What is customer profitability measurement really about, and how can it drive meaningful, value-adding behaviors within a company? What types of insights can help firms interact more effectively with their customers and build long-lasting relationships that grow the bottom line?

The first thing to understand about measuring Customer Profitability is that it does not measure customer profitability. What we refer to as Customer Profitability is actually company profitability at the point where customer and company intersect. Failure to understand this fundamental fact is the primary reason why companies fail to get full value from their investment in profitability measurement. The measurement of customer profitability provides a window on the management of the customer relationship – a sign of how, when, and where they are failing to manage it profitably, as well as of when and where they are getting it right.

Getting it Right

A Customer Profitability measurement process that fails to accurately differentiate between customers is of little value. To be useful the process must capture the profitability impact of customer behavior. A CRM-oriented profitability measurement process has to meet the needs of Customer Relationship managers. The process must provide:



- > A level of detail sufficient to provide understanding of how the customer comes into contact with the company and the expense and revenue associated with it.
- > A comprehensive view of the customer's relationship with the company so that the true contribution or cost is understood.
- > A consistent view so that changes in the relationship can be properly understood.
- > Timely information so that the company can act before the opportunity is lost or risk has been fully realized.
- > Credible results that reflect the company's own costs and revenues reflecting their unique business practices.
- > Flexibility so that as the business environment changes, the measurement process can easily change.

The key question is: *what should companies be doing to maximize the return from their investment in customer profitability measurement?*

Teradata's wealth of industry and data warehouse experience has enabled us to formulate six points of 'best practice' that can help a company achieve this goal.

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1. Understand why some customers maintain relationships profitable to your organization.

Typically, there is a core group of loyal, highly motivated customers that should be the focus of your attention as you learn about value propositions, right offers, and delivery channels. Stable, profitable customers have found value in their relationships with specific companies, and are delivering value in return. Since industry estimates indicate that it costs companies between six and ten times more to acquire new customers than to keep the existing ones happy, it is important to establish what value propositions are working for its loyal customers – and examine how these can be exploited more widely. By determining what works for your most highly motivated customers, you can start to build on proven success and extend those propositions into the larger base.

2. The underlying drivers of profitability are more important than the resulting Customer Profitability metric.

Profitability models must be designed to be detail driven. Knowing why a customer is profitable is meaningful information that can guide channel investments, product developments, and staffing decisions. Any process that is not detail driven or that hides the details from the information user is not going to provide value to the company.

As an example, a company may have two customers who show the same level of profitability. However, if the data don't

provide details about expense as well as revenue, the company will not have true insight into the nature of those relationships. One customer may require significantly more staff time, higher levels of one-on-one service, and repeat communications; even for a loyal customer, this level of activity can be costly. To properly analyze customer relationships, assessing the costs associated with particular behaviors is just as important as measuring the revenue.

3. Be very cautious about “undervaluing” customers.

In the goal to understand customers and identify those who are profitable, companies should be cautious about undervaluing customers earmarked as less profitable or treating them as less critical to your business than others. While it may be going too far to say that there is no such thing as an unprofitable customer, it is probably true that every customer has the potential to be profitable over the course of his or her life. Finally, the negative feelings generated by undervaluing customers spreads by osmosis throughout the population of current and potential customers.

Companies should instead focus efforts on improving the customer relationship. If an institution is not making money, it is likely mismanaging the relationship, by selling the wrong product (that is, not suited to the customer's needs or behavior), selling the right product at the wrong price, or failing to educate the customer about more appealing alternatives.

Rather than migrate customers out, what companies should be aiming for with their profitability measurement is the creation of a positive relationship so customers enjoy doing business with them and want to do more of it.

4. Keep one eye on current profitability and the other eye on future profitability.

Understanding the customer is the key to building profitable relationships, and a good customer profitability model will help the company understand what is happening at each interaction and with each relationship in the current time period. The challenge then is to interpret and apply that information to maximize the value of the relationship going forward.

There are two types of profitable customers – those that are currently profitable and those that might be so in the future. Combining historical profitability figures with other customer information can help you anticipate the future.

5. Do not overestimate the company's relative importance in its customers' lives.

However important a company is to its employees, in practice it occupies precious little of its customers' attention. In general, the most effective way to maintain and build this relationship is through direct person-to-person contact. However, this is not the only way – and many customers, usually the more sophisticated and time-constrained ones, are very happy with a remote relationship via whatever channel is most convenient. However, whatever the channel or the nature of the interaction,

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every contact has to be consistent and of high quality, and if human intervention is needed, then that touch-point must be consistent and of high quality.

6. Build a model that will accurately reflect the impact of a broad spectrum of management decisions.

It can be risky – and even counter-productive – to approach the construction of a profit measurement program with preconceived actions already in mind: for example, which products could be re-priced, or which facilities should be closed. A well-built profitability model, proactively maintained to reflect continuing changes in the business and its customer relationships, will be of far greater use to the company than a model biased toward justifying a specific management objective.

The design of the model will lead to certain predictable results that should be understood in the process of building the model. Assessing operational or marketing costs as incurred rather than amortizing

them will cause most new customers to appear unprofitable. Amortizing those costs will hide the costs. Both approaches are legitimate, and both have weaknesses. It is important that the user of the information understands the implications of the model.

When constructing the model, it is important to recognize that each customer/corporate intersection is in fact a micro-business in its own right that needs to be managed just like any other business. A good profitability model will allow the company to measure the success of its efforts on that basis, and also in terms of the ongoing customer relationship. Both are crucial to a successful customer management strategy.

True Customer Relationship Management is the Long-Term Goal

The goal of CRM is to develop the corporate/customer relationship to the point where the customer volunteers his or her needs for satisfaction to the company. The

company that succeeds in achieving this goal at an acceptable cost will improve profitability through revenue growth.

Only with an effective and comprehensive customer profitability model can a company understand which of its customers is contributing, how much, and why. Success through CRM requires a consciousness of costs. A strategy to delight each and every customer regardless of cost would quickly bankrupt the company. Knowing the costs of customer activities and the value of the customers provides essential insights about where to expand, economize, and improve operating efficiency.

Customer profitability does not provide a valuation of the customer. What it does provide is a measure of an organization's success in managing the business-customer interface. Understood in this way, the process of profitability measurement is an essential part of any CRM strategy.

This article is an edited version of the longer original.