HARVARD | BUSINESS | SCHOOL
WORKING Knowledge

Which Customers Don't Fit?

HBSWK Pub. Date: Oct 7, 2002

Asking yourself which customers, products, and services don't fit your business model can reveal quickly whether your company is managing profitability effectively, and whether your key managers' actions are aligned, argues Jonathan Byrnes. How to start? Get an earful from your managers.

by Jonathan Byrnes

Part II

Try this today. Sit down for thirty minutes with the managers who run your company's major departments (sales, operations, etc.), and ask each one to write down the names of five significant customers who shouldn't be sold to, five products that shouldn't be carried, and five services that shouldn't be provided.

Surprisingly, in many companies, the managers' lists would be so different that an outsider would think they were from different companies.

Why? Because most companies don't manage profitability on a day-to-day basis—coordinating sales and operations to maximize profits to the fullest potential. Consequently, they have a few islands of high profitability, but lots of unprofitable accounts, products, and transactions.

As the president of a healthcare company said, "We see the same thing in our company. I worry about the risk of having so much riding on such a small portion of the business."

The questions of which customers, products, and services don't fit are penetrating diagnostics.

—Jonathan Byrnes

The questions of which customers, products, and services don't fit are penetrating diagnostics. They tell you quickly whether your company is managing profitability effectively, and whether your key managers' actions are aligned.

Startling profit opportunities can be found in their answers. This was the message of last month's column, which gave examples of the 30 percent or more profit increases available.

When you think about it, though, the question of fit really has two parts: *what fits?* and, *fits what?* A company has to get both right to manage profitability effectively, and they are closely related.

A manager answering *what fits* needs to think about customers, products, and transactions in a methodical way. To answer *fits what* the manager must focus on the company's business model (internal business processes and the way the company engages the market), shaping it to maximize the company's profit potential.

These *what fits* and *fits what* questions are answered through a process involving the three key profit management elements I mentioned in last month's column: profit map, profit levers, and profit management process.

The *profit map* shows which accounts, products, and transactions fit the business model (and are profitable). *Profit levers* are elements of a company's business model that can be adjusted to improve profitability, turning "bad" customers into "good" customers. And the *profit management process* is the organizational procedure by which the company aligns its day-to-day business activities with its business model.

A company that got it right

Let's look at how one national trucking company got it right. Three years ago, this company had no good process to manage profitability. Today, it has more than doubled its profit margins. As one key manager put it, "Now our sales reps know exactly what to sell."

Profit map. In the first step, a small group of key sales and operations managers, called the Yield Management team, thought hard about what was driving their costs.

They had an insight—the sales department had been selling individual point-to-point movements, but the real cost driver was the whole route, including backhauls. So a sales rep might charge a price for the primary movement (headhaul) that appeared to make a profit, but the company would lose money if the backhaul price were too low.

They developed a set of cost models for their routes. They also saw that each cost model divided into three components: fixed costs (daily cost of a truck), variable costs (mileage), and special costs (handling, etc.).

Next, they put together a database of all of their transactions over a six-month period. They applied the cost models to the transactions to see which customers, services, and routes were profitable and which were not.

> **Profit levers are elements of a company's business model that can be adjusted to improve profitability.**
>
> **—Jonathan Byrnes**

They found a few islands of customers that were very profitable—20 percent to 30 percent margins. Shockingly, fully 40 percent of the business was unprofitable. Just like the lab supply company in last month's column.

Profit levers. While the Yield Management team was analyzing profitability, the company pushed hard for a general cost reduction—but this was not nearly enough. To increase profitability, they had to engage several profit management levers.

First, the team moved aggressively to secure the highly profitable customers, ensuring that they received flawless service, including first priority on capacity.

The next lever was pricing—and it wasn't simply a price increase. In the past, when the company had sold a point-to-point movement to a customer, the sales reps had to scramble to sell backhaul movements at low rates (often on the spot market). If the customer cancelled the pick-up, the company had to scramble to find a new headhaul—very reactive and inefficient.

Under the new regime, the team did two things. First, they decided to charge rates with fixed and variable components. The customer who ordered a truck had to pay a fixed daily charge whether it used the truck or not; the customer's mileage charge reflected actual use. Second, they incorporated forecast accuracy in pricing. The customer had to forecast its needs a month in advance, and pay an additional charge if the usage was greater than 110 percent of forecast (causing uncovered backhauls) or less than 94 percent of forecast (causing uncovered headhauls).

This changed the customer/company relationship to shared risks and rewards, and created a strong incentive for joint planning. Now the trucking company could presell the whole route, receiving a much better price, and could get much better equipment utilization. In return, the company awarded the customer priority on capacity—crucial at peak times of the year—and passed on some of the savings as a price *decrease*.

In a series of meetings, the team sold the concept to the key customers. Most of the best customers saw the need for a stable supplier and the wisdom of focusing on joint cost reduction. To further reduce costs, the company scheduled monthly safety meetings with these customers, and agreed to reduce prices even more if safety targets were met.

Also, the trucking company sought to increase its integration with these key customers, offering services such as spotting, loading, and inventory processing—further reducing customer costs while building differentiation and switching costs.

Most importantly, according to a key team manager, the company "stopped saying yes to everyone." With the new bottom-line focus, the team took hard stances. They walked away from customers who were not willing to participate in joint cost reductions and risk/reward sharing. As it turned out, many of these customers came back and accepted the new pricing terms because the company offered the opportunity for them to reduce costs and lock in capacity.

Profit management process. The profit management process featured three key components. First, the Yield Management team continued periodic reviews of account and service profitability, ensuring that profit management was permanently built into the company.

Second, the company strengthened day-to-day profit management at the account level. Previously, account management was primarily a sales task. Now, a high-level sales team sets the relationship and pricing, and operations personnel manage the day-to-day account relationship. Sales became so productive that the company was able to reduce its sales force by 50 percent over time.

Third, the company used training to drive bottom line awareness down to the grassroots level. The goal was to ensure that the frontline sales and operations people understood the profit drivers, and that they managed the details of the account relationship to achieve its full profit potential.

The training sessions were held in five-member groups. They were very interactive with lots of "what would you do if?" examples and quizzes. In the first wave, the company trained the dispatchers and customer service reps; in the second wave, the support groups, such as billing.

One manager on the Yield Management team described the change. "At first, the customers thought I was the bad guy. Now, it's very rewarding. The hard feelings went away. Before, customer meetings were about price increases; now, they're about cost reductions. We start every meeting with a business review of cost takeouts, and only adjust prices if necessary."

What changed?

What changed here? These managers had the clarity to answer the two key questions *what fits?* and *fits what?* They did this through a three-step process. First, they analyzed which customers and services were profitable and which were not, and *why*. Second, they changed the company's business model to realign the pricing mechanism and customer relationship, focusing on joint cost reductions to benefit both parties. Third, they modified account selection and account management to drive the new efficiencies through every service, in every account, every day.

They changed the company's business model to realign the pricing mechanism and customer relationship, focusing on joint cost reductions to benefit both parties.

—Jonathan Byrnes

In other words, they managed profit on a day-to-day basis, driving profits up to the fullest potential: No big investments, just clarity and great management.

One SVP of sales responded to last month's column: "I guess I have two ways to get a 30 percent profit increase: Boost my sales by 40 percent, adding a lot of new low-margin business, or focus on managing the day-to-day details of the business. It's a pretty easy choice."

Next month, we'll look at more examples of companies that manage profitability effectively, and talk about how they use the three key elements—profit map, profit levers, and profit management process—to do it.

By the way, as to the question of which customers don't fit? The answer should be, NONE! Now our sales reps know exactly what to sell!

See you next month.

Jonathan Byrnes is a Senior Lecturer at MIT and President of Jonathan Byrnes & Co., a focused consulting company. He earned a doctorate from Harvard Business School in 1980 and can be reached at jlbyrnes@mit.edu.