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Profit from Customer Operating Partnerships

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Need to increase profits? Consider creating "customer operating partnerships" that involve tightly linked extended supply chains. The payoff? Start with share increases even in your most profitable accounts.

by Jonathan Byrnes

Part IV
Customers do not contribute equally to the bottom line. In my November column, I explained how a manager can use profit mapping to identify the 20 to 30 percent of accounts that contribute most of a company's profits. Once identified, the manager's prime objective is to secure these accounts and increase penetration in them. Customer operating partnerships can accomplish this.

Customer operating partnerships are customer-vendor arrangements that involve tightly linked extended supply chains. They offer tremendous gains, including (1) 20 to 35 percent share increases even in the highest-penetrated, most profitable accounts; (2) a shift to a strategic positioning as a highly service-differentiated supplier, even for companies who are stuck as commodity providers subject to constant price wars; (3) a direct-sales relationship with value-oriented top customer executives, rather than price-oriented purchasing managers; and (4) a highly-defensible competitive position with switching costs.

Most leading companies are now reducing their supplier bases by 50 percent or more. The most desirable customers are seeking more intensive operating partnerships with fewer, more capable suppliers. Price is no longer the primary deciding factor. This is creating an historic opportunity for managers who develop and offer these arrangements.

Conversely, managers who fail to initiate customer operating partnerships with their best customers run the risk of losing them, and the lion's share of their company's profitability, to competitors who move first.

While customer operating partnerships are different from ordinary customer relations, most company managers have the capability to develop these arrangements with their highest-profit customers. It is crucial, however, to understand that appropriate management measures must be put in place.

The case of the hospital supply company
Let's look at the case example of how a major national hospital supply company developed one of the first vendor-managed inventory systems. This type of customer operating partnership gave it sales increases of over 30 percent in several of its highest-penetrated, most-profitable accounts.

At the onset, the company was facing an increasingly untenable situation. It manufactured and sold a variety of hospital supplies, but its anchor categories were relatively undifferentiated and subject to constant price wars. For example, if the price of a liter of a typical IV solution were about $1.00, a five-year contract would hinge on whether the quoted price was $.97 or $1.03.

The company's sales reps called on hospital pharmacists and purchasing staff, who focused on minimizing price. They only rarely interacted with high-level hospital executives.

The hospitals' order pattern fluctuated severely, causing the company great inventory, service, and production problems. This fluctuation had three causes. First, the ward nurses ordered from the hospitals' stockrooms infrequently, in large amounts. Second, although the hospital had agreed to an order and delivery schedule, it placed orders almost every day and expected next-day delivery. Finally, quarter-end sales drives by the company's sales force was common.

The company's operations managers had been careful to control operating costs and keep staff levels lean in order to maintain margins. But the company was stuck trying to respond efficiently to an inherently inefficient situation.

Mowing the lawn around Stonehenge

I remember sitting with the division president, who said, "We're getting very good at mowing the lawn around Stonehenge, without ever asking why the stones are there."

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At one point, several hospitals asked this division president to consider becoming a prime vendor, a "master supplier" who would funnel supplies from a variety of sources through one warehouse to the hospital dock with consolidated invoicing. The president assembled a small team and asked them to follow the supplies downstream from the DC, across the hospital dock, to the actual points of patient consumption in several large hospitals.

When the team developed a systematic channel map, they saw a very disjointed, redundant supply channel. In the first segment, within the DC walls, the company received hospital orders, picked the supplies, packed them, shipped them to the hospital, and invoiced for them. In the second segment, the team saw the mirror image once the supplies reached the hospital: The hospital issued the orders, received the supplies, unpacked the boxes, put the supplies away in the stockroom, and paid the invoices. In a third segment, the hospital wards ordered from the stockroom and put away the supplies.

The team conducted in-depth studies of several large hospitals, mapping product flow and measuring hospital operations. They found that the materials management organizations were costly, but they also found very large pockets of hidden costs in areas such as nursing. When the team checked these findings, the hospital personnel were amazed at the true costs.

When the team assembled the true picture, they found that the total cost of a "delivered" product at the patient's bedside was about $5.00, contrasted with the $1.00 sales price at the hospital dock. Of the $4.00 increment, the internal hospital supply chain costs comprised about half, while the other half represented other factors.

A startling new perspective emerged: *Over 80 percent of the business was outside the company's traditional business definition*.

The company had tacitly defined the boundary of its supply chain as the hospital receiving dock, and had always assumed this business definition. New communications and computer technologies, however, had given it the capability to extend that boundary far into the customers' operations for their mutual benefit. But this possibility was simply not seen before.

The Stockless System

The team saw a great potential for joint hospital-company economies by (1) eliminating redundant steps and stock; and (2) altering the picking, materials management, and information processing systems. Between one-third and one-half of the $2.00 in internal hospital materials costs could be eliminated even while providing the hospital with a substantial increase in service levels.

After discussions with target hospitals, the team developed the initial operating partnership model, which they called the Stockless System. As a first step, the team analyzed each ward's product usage patterns and specified the stock requirements. Next, they implemented this process: An on-site company employee counts the stock in each ward each day or few days; the employee transmits this information to the company's DC, where a replenishment order is derived and packed into ward-specific containers; then it is delivered directly to the ward, where the company employee puts the stock away; finally, the company invoices the hospital.

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The Stockless System had a huge impact on the company: It moved the domain of its value creation to the whole extended supply chain, and enabled the company to shift its selling focus from the $.97-$1.03 negotiation to mutual value creation on a much larger scale. It enabled the company to build a new competitive position as a highly service-differentiated supplier.

Great benefits
The Stockless System gave the company great strategic benefits in four areas.

Cost reductions. The Stockless System created large cost reductions in both channel partners. The hospitals eliminated several steps in the supply chain, and greatly reduced their inventory levels. Valuable space was released, and hospital personnel were redeployed into patient care. The company gained large, unexpected operating benefits because the Stockless System eliminated the erratic hospital order pattern. Moreover, the Stockless System business unit was now being paid to take and process the orders that were previously processed by the company's customer service department.

Sales increases. The company's sales increased dramatically, even in highly-penetrated accounts. This increase was directly driven by (1) the operations-to-operations relationship that formed between the head nurses on the wards and the company ward coordinators, who were personable lead hands from the warehouse, not sales reps; and (2) the near-perfect service levels that allowed the sales reps to focus on selling new products, rather than on solving supply problems.

CEO relationships. The division president was able to establish close working relations with the CEOs of the major hospitals because The Stockless System involved large savings and major changes. Several important new joint business initiatives resulted.

Competitive advantage. The company developed immediate strategic advantage over its competitors, enabling it to secure its largest, most profitable accounts. The Stockless System operating partnership rested upon four essential elements: (1) confidence of the customers; (2) demonstrated ability to perform; (3) company commitment and resources; and (4) joint end-to-end business understanding and operations-to-operations relationships. Once the company established this new way of doing business, its competitors could not easily follow.

Quantum change
Both the company and the hospitals had to make significant changes in five areas.

Account selection. The company's management realized early on that account selection was crucial to success. They had to be very careful in their choice of partners because these relationships were very intensive. The top managers carefully screened and prioritized their customers according to their willingness to change, potential gain, and operating fit.

Account coordination. In the old paradigm, the sales rep was the primary link to the account, sales plans were confidential, and operations personnel were largely excluded. In the new relationship, the division president formed a set of multi-functional account teams to plan and develop partnerships with important target accounts. Once this account planning process was stabilized, he invited the customers to send managers to participate. Rather than having an adversarial tenor, account planning became a process for jointly moving the partnership forward.

Selling the Stockless System. The process of selling an operating partnership to a hospital CEO was very different from the normal product sales process. Because the partnership entailed a new customer-supplier relationship, a close CEO-to-CEO link was needed. The company made its first sale to a smaller hospital that was run by a particularly innovative CEO, and then brought others to view the "showcase." At one point, the division president assembled a focus group of hospital CEOs, and asked them for suggestions on how to sell the Stockless System.

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Operations. Operations changes were needed in several areas. First, operations managers were integrally involved in developing the new operating process and estimating the gains. They had to understand internal hospital operations even better than the hospital's personnel did. Second, the operations staff had to learn to manage sensitive, scatter-site operations within customer premises. Third, the supply channel had to be restructured to deliver near-perfect service without incurring additional cost, and this required that the Stockless System inventory be protected from the rest of the company, even large strategic accounts. Fourth, the operation had to become more flexible to adapt to the changing customer-partnership mix, and the operations managers had to master the complexity of a dual-distribution system. Finally, the operations team had to learn to participate in the multi-functional account planning process.

Management. Because the Stockless System represented a new way of doing business, the company's management had to take the lead in developing new, more open relationships with key customers. The operating partnerships increased the risk and stakes for management because the relationships were more complex, the standards more stringent, and a failure could mean the loss of a major account. Important management control and sales incentive changes were needed because Stockless eliminated quarter-end sales drives, which led to significant short-term sales reductions as inventory was drawn down, and required new incentives to encourage operations involvement in the sales relationship.

An historic opportunity

The case of the major hospital supply company shows how customer operating partnerships can dramatically improve a company's market share in its most desirable customers, its strategic positioning, and even its asset productivity. However, in crafting these arrangements, one size does not fit all. In later columns, I'll talk about how to select the operating partnership that fits best.

As the best customers move aggressively to reduce their supplier bases, many leading companies are now finding that customer operating partnerships are crucial to maintain and grow the profitability of their highest-profit accounts. And, there are important first mover advantages: Once a company secures its key accounts with operating partnerships, it is very difficult for competitors to encroach or for profitability to erode.

Important changes are required. To be successful, a manager must carefully segment the account base, understand that these intensive relationships can only be developed with fewer partners, systematically qualify the target accounts, and explicitly accept a multi-tiered account relationship system. The top manager also must understand the parallel changes that must occur in the company's sales, operations, and management processes.

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By the way, who should profit from customer operating partnerships? The answer is *you*—and your best customers!

See you next month.

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