Calculating and Reporting Customer Profitability

Final Report

A Consortium Benchmarking Study Jointly Conducted By:

APQC

And

CAM-I

Subject Matter Expertise Provided By:
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ARKONAS

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EXECUTIVE SUMMARY

> *We're not everything to everybody as a community credit union. We expect the relationship to be mutually beneficial.*
> —CIO, North Shore Credit Union
> (Source: "Profits, One Customer at a Time," *CRM Magazine*, January 1, 2005)

Not all customers are created equal. More and more, leaders are viewing business as an investment portfolio of customers, some more valuable than others, with the level of investment delivered commensurate to the level of customer value. The profitability of the customer mix is becoming more important than profits of the individual products. This approach is a significant shift from traditional product-, service-, geography-, territory-, and function-based organizations. Executives are discovering the benefits of enhancing their customer investment portfolio by creating and executing competitive customer value propositions.

In their book *Killer Customers: Tell the Good from the Bad—Crush Your Competitors* (Portfolio, 2004), authors Larry Selden and Geoffrey Colvin estimate that the top 20 percent of customers (by profitability) typically generate more than 120 percent of an organization's profits. By comparison, the bottom 20 percent of customers typically generate losses equaling more than 100 percent of profits, leaving a net 20 percent for all customers combined. Sustaining the top 20 percent and improving the bottom 20 percent will significantly improve the bottom line of any organization.[1]

While many organizations see the potential value of calculating and reporting customer profitability, not all areas are equally problematic to the organization. Once an organization can identify their customer segments, then what? Typically, the organization will want to know which customers in the segment are profitable and which ones are not. Without understanding how different customers consume costs and resources, organizations cannot successfully calculate customer profitability.

The purpose of the "Calculating and Reporting Customer Profitability" consortium benchmarking study was to identify and share best practices for customer profitability models, cost allocation methodologies, communicating customer profitability information, and using customer profitability to make more effective business decisions. Analyzing the profitability of the customer portfolio and understanding each customer and customer segment is fundamental for the management of the business and is a critical part of being customer-centric.

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[1] Source: *Killer Customers: Tell the Good from the Bad—and Crush Your Competitors*, by Larry Selden and Geoffrey Colvin, Penguin Group Inc., 2003

STUDY SCOPE

Drawing on input from the subject matter expert and secondary research, the APQC study team identified three key areas for research. These areas guided the design of the data collection instruments and were the basis on which the study findings have been developed.

1. **Segment customers.**
   - Sort with various segmentation techniques to identify the "winners" from the "losers."
   - Target marketing and sales efforts to customer segments that improve return on investment.
   - Understand the assets and investments required to service customers and customer segments.
   - Execute competitive customer value propositions in each customer segment.
2. **Understand the cost to service customer segments through the use of cost-tracing methods.**

- Recognize the cost differences for servicing customers. Customers purchase online; by mail, telephone, or fax; or by visiting a physical location. They will frequently order in small lots or place large, single orders. The cost-to-serve differences can be substantial.
- Determine the appropriate level of customer support. Some customer segments require substantial support, while others require very little.
- Determine methods to calculate the cost to serve and the incentives that can change customer behavior.

3. **Report customer profitability.**

- Use customer profitability information to make effective business decisions.
- Establish customer profitability reporting as the foundation for being customer-centric.
- Use customer profitability as a method to drive organizational change.

This final report is organized to correspond with these study scope areas as depicted in Figure E.1, page 3, which is also a high-level model for how to calculate and report customer profitability. **Chapter 1** summarizes background information and describes the approaches for customer profitability calculation and reporting at study best-practice partner organizations. **Chapters 2, 3,** and **4** correspond to the study scope. Finally, **Chapter 5** describes how customer profitability information is made actionable at study best-practice partner organizations. Greater detail on the practices at any individual study best-practice partner can be found in their corresponding site visit summary.

Organization of Final Report

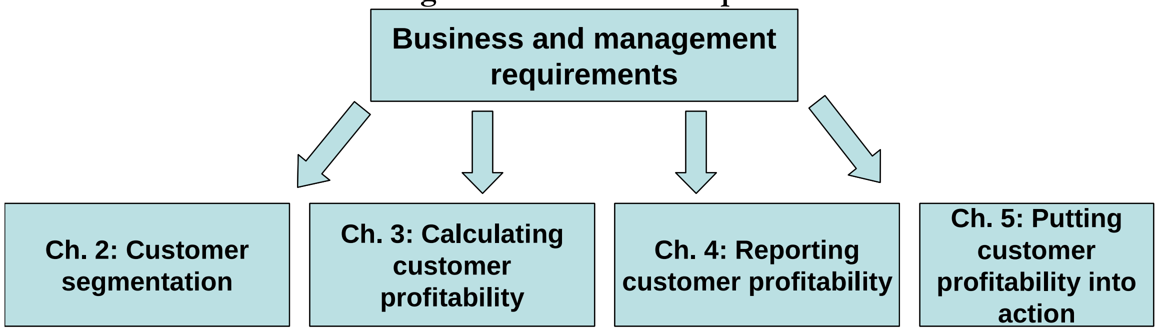

Figure E.1

The following key findings, or themes, emerged from this consortium benchmarking study.

Chapter 1: Background and Overview of Customer Profitability Initiatives at Participant Organizations

- **Key Finding 1:** At best-practice organizations, customer profitability is owned by marketing, with finance as a key stakeholder.
- **Key Finding 2:** Study participants have defined a small, dedicated group of anywhere from two to five individuals who are involved in calculating and reporting customer profitability.

Chapter 2: Customer Segmentation

- **Key Finding 3:** Best-practice partners have developed an enterprise-wide view of the customer.
- **Key Finding 4:** Best-practice partners have clearly defined customer segments and subsegments. Most have developed five to nine macro customer segments.
- **Key Finding 5:** Best-practice partners use multiple bases for customer segmentation such as needs, geography, and customer profitability.

Chapter 3: Calculating Customer Profitability

- **Key Finding 6:** Best-practice organizations capture revenues and costs at the transaction level for each specific customer account.
- **Key Finding 7:** Best-practice organizations take a holistic view of customer profitability and include lifetime value and customer valuation metrics in the calculation.
- **Key Finding 8:** Best-practice organizations include the majority, but not all, of their costs in the customer profitability calculation. Best-practice organizations use appropriate methods for cost assignment.
- **Key Finding 9:** Best-practice organizations all work closely with IT. Enabling technologies for calculating customer profitability include data warehousing, CRM systems, data mining, external databases, and predictive analytics.

Chapter 4: Reporting Customer Profitability

- **Key Finding 10:** At best-practice organizations, customer profitability information is used as an input in many areas.
- **Key Finding 11:** Best-practice organizations emphasize intelligence (e.g., decision support), not routine reporting, in customer profitability information dissemination.

Chapter 5: Putting Customer Profitability into Action

- **Key Finding 12:** Best-practice organizations secure buy-in from the users and upper-level support for customer profitability initiatives.
- **Key Finding 13:** Best-practice organizations hold employees accountable for customer profitability.
- **Key Finding 14:** Best-practice organizations use customer profitability and segmentation to appropriately align sales and marketing resources.
- **Key Finding 15:** Best-practice organizations have specific programs/sales efforts geared to their most valuable customers.
- **Key Finding 16:** Best-practice organizations successfully convert unprofitable customers to profitable customers.

The knowledge transfer session final report binder includes the detailed best-practice partner site visit summaries as well as charts and tables from the study's quantitative detailed questionnaire.

APQC's Consortium Benchmarking Methodology

The APQC consortium benchmarking study methodology (Figure E.2) was developed in 1993 and serves as one of the premier methods for successful benchmarking in the world. It was recognized by the European Center for Total Quality Management in 1995 as first among 10 leading benchmarking organizations' models. It is an extremely powerful tool for identifying proven successful practices and for facilitating the transfer of these practices.

APQC's Four-phased Benchmarking Methodology

Figure E.2

Phase 1: Plan

The planning phase of this study began in the summer of 2005. During this phase, research conducted by APQC was used to help identify successful organizations to participate as best-practice partners. In addition to this research, APQC staff members, the subject matter expert, and sponsoring organizations identified potential participants based on their own experiences and knowledge. Each recognized organization was invited to participate in a screening process. Based on the results of the screening process, as well as organization capacity or willingness to participate in the study, a list of eight potential partner candidates was developed.

The study kickoff meeting was held August 9, 2005, during which the sponsors refined the study scope, gave input on the data collection tools, and rank-ordered the top five potential partner organizations, which were asked to host a site visit: FedEx (Memphis, Tenn.), Marriott (Washington D.C.), North Shore Credit Union (North Vancouver, B.C., Canada), Wachovia (Charlotte, NC), and Zippo Manufacturing (Bradford, Pa.).

Phase 2: Collect

Three tools were used to collect information for this study:

1. **screening questionnaire**—qualitative and quantitative questions designed to identify best practices within the candidate partner organizations;
2. **detailed questionnaire**—quantitative questions designed to collect objective, quantitative data across all participating organizations; and
3. **site visit guide**—qualitative questions that parallel the areas of inquiry in the detailed questionnaire and serve as the structured discussion framework for all site visits.

The five partner organizations selected for continued participation in the study responded to the screening questionnaire as well as the detailed questionnaire. The six study sponsors (plus two additional sponsor business units, for a total of eight sponsoring organizations) completed the detailed questionnaire.[2] Additionally, all five partner organizations hosted site visits attended by sponsors, other partners, members of the study team, and the subject matter expert. The APQC study team prepared site visit summaries and submitted these to the partner organizations for approval or clarification.

Phase 3: Analyze

The subject matter expert and APQC analyzed both the quantitative and qualitative information gleaned from the data collection tools. The analysis concentrated on examining the challenges organizations face in the study focus areas and key themes and enablers in calculating and reporting customer profitability. An analysis of the data, as

[2] Please note that when considering a relatively small total detailed questionnaire participant pool (or "n") of 13, the focus of the detailed questionnaire analyses was directional, rather than absolute, in nature. In other words, analysis of the aggregated detailed questionnaire responses searched for key themes and trends, triangulated against what was noted as key themes in the site visits and from sponsor input, to generate the final study list of key findings.

well as site visit summaries, is contained in this report. Additionally, the knowledge transfer session meeting binder includes aggregated responses to most questions in the detailed questionnaire.

Phase 4: Adapt

Adaptation and improvement, stemming from identified best practices, occur after the sponsors apply key findings to their own operations. APQC staff members are available to help sponsors create action plans appropriate for the organization based on the study.

Participant Information

The following organizations and individuals participated in this consortium study.

Sponsor Organizations

Baker Oil Tools
Blue Cross Blue Shield of Florida
Cisco Systems
CNH Global N.V.
CHN Capital
John Deere—C&CE Division
John Deere Credit
SAS Institute

Selected Best-Practice Partner Organizations

FedEx Services
Marriott International
North Shore Credit Union
Wachovia
Zippo Manufacturing

Subject Matter Expert

John Miller, director, Arkonas

APQC Study Team

Rachele Williams, project manager
Angelica Wurth, project support
Peggy Newton, project support
Kimberly Lopez, market developer

Participant Demographics

Eight sponsors and all five best-practice partners completed the detailed questionnaire. Figure E.3 below depicts the industry breakdown for these 13 organizations.

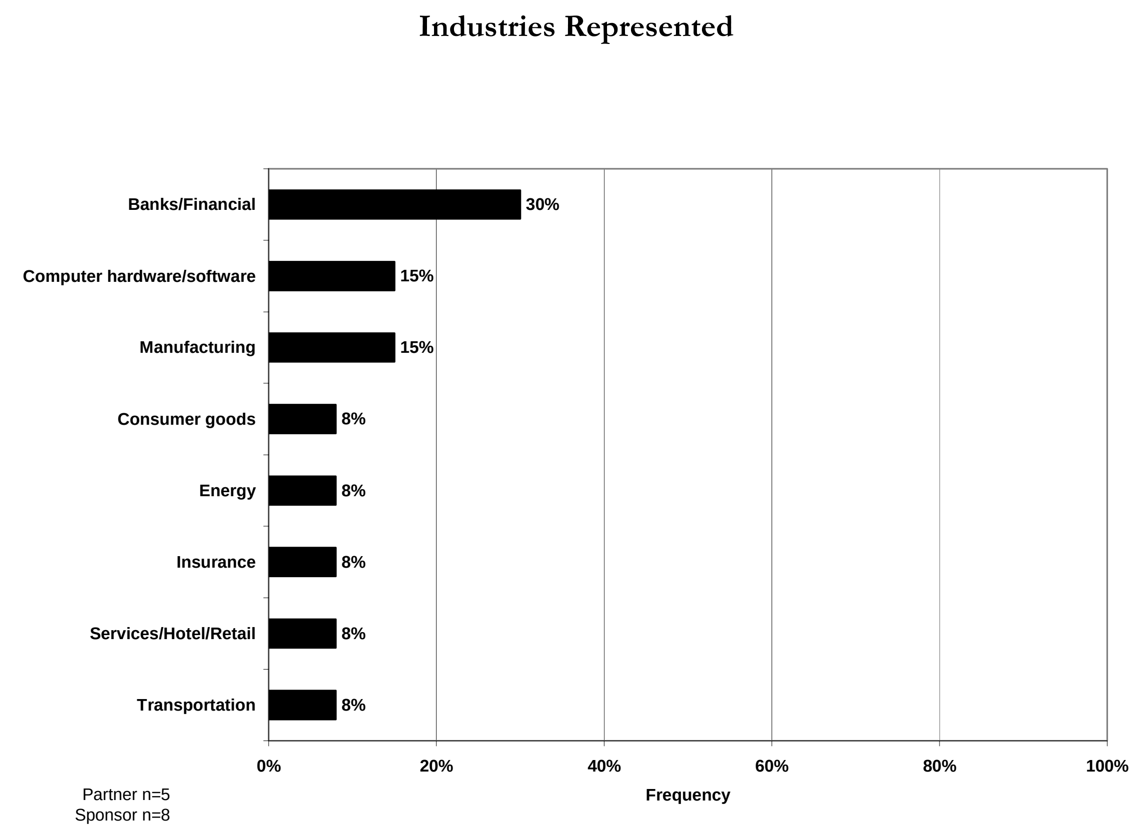

Figure E.3

Figure E.4 illustrates the unit of participation for the organizations that completed the study's detailed questionnaire—be it the entire organization; a single division, agency, or business unit; or both.

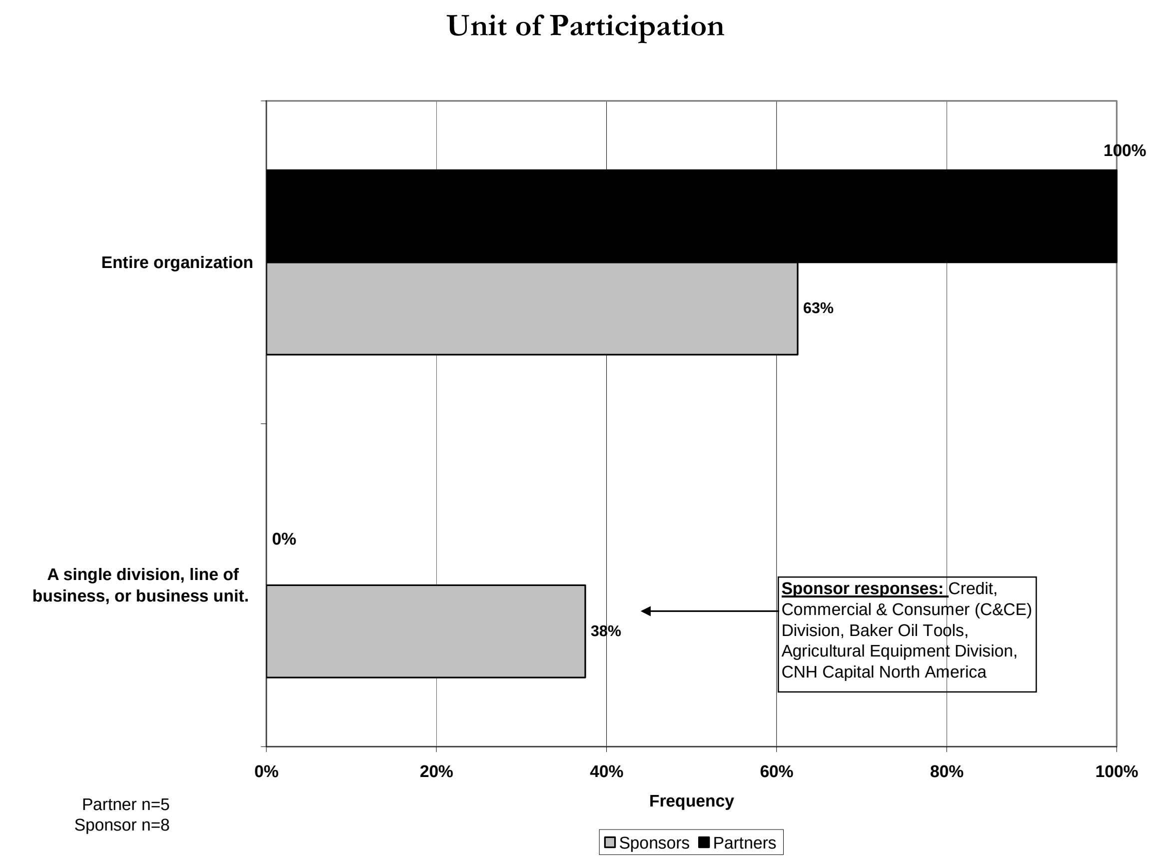

Figure E.4

Participant organizations sell to both businesses and consumers, as indicated by Figure E.5.

Primary Customers

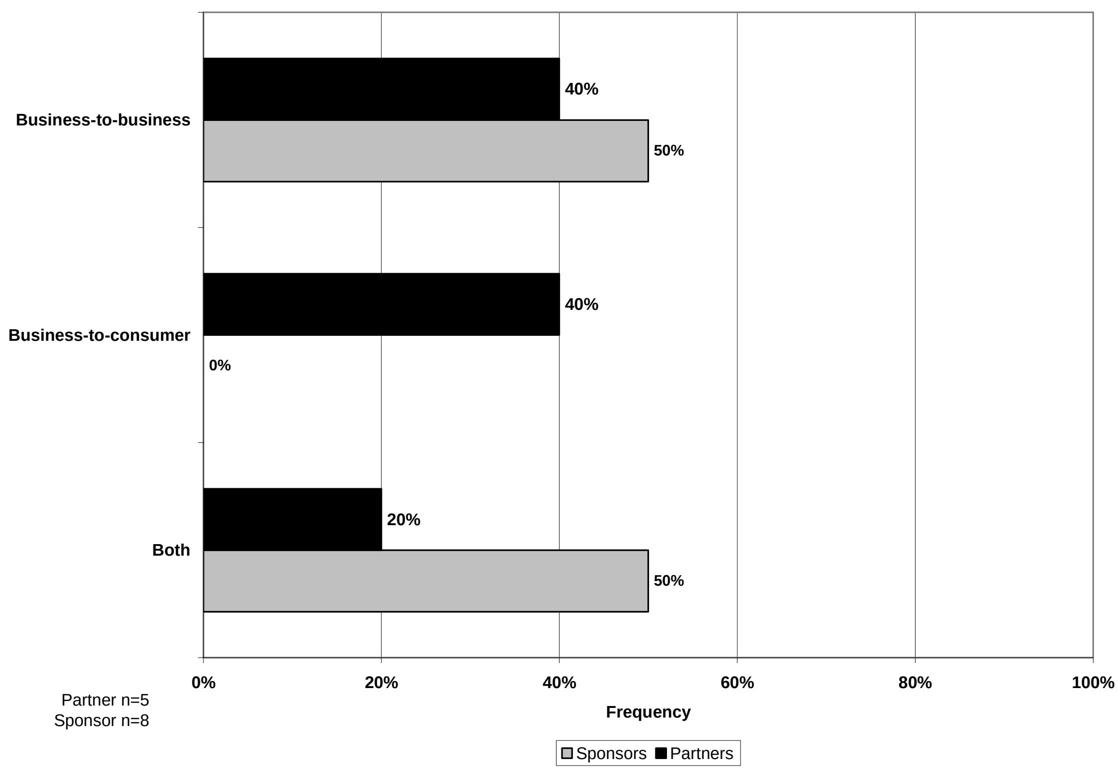

Figure E.5

Figures E.6 through E.7 on the following pages depict the relative size (in terms of revenues and number of employees) of the organizations participating.

Estimated Annual Gross Revenues for Most Recent Fiscal Year

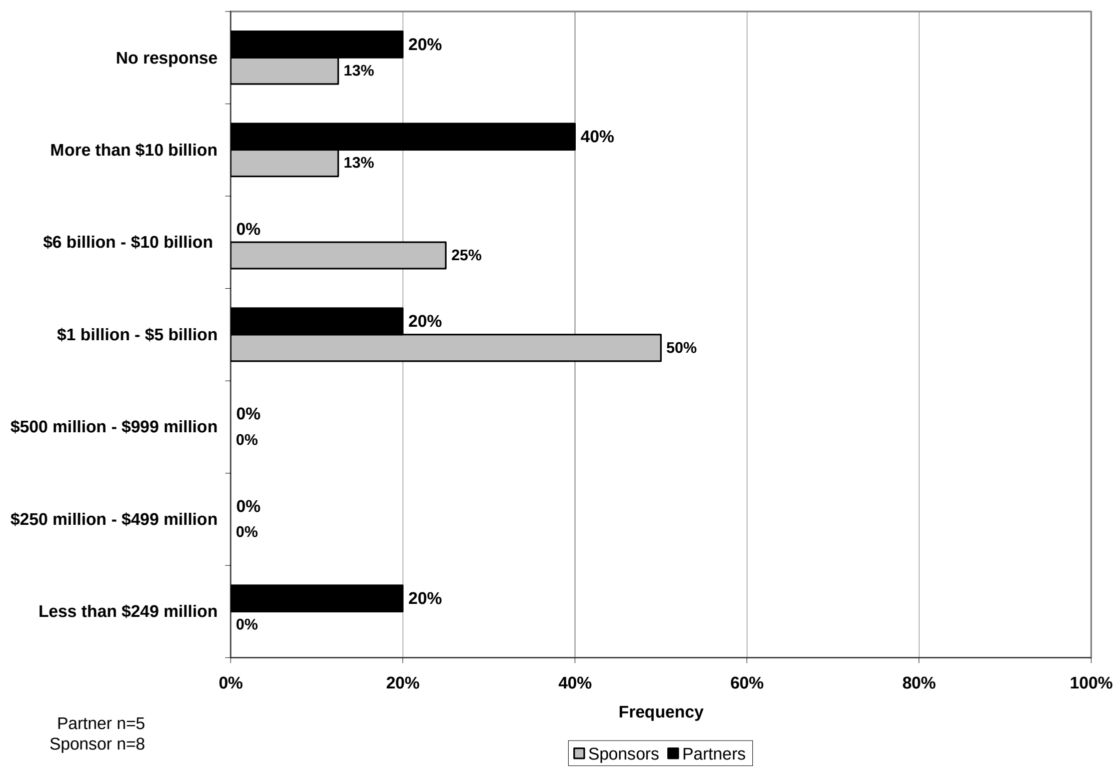

Figure E.6

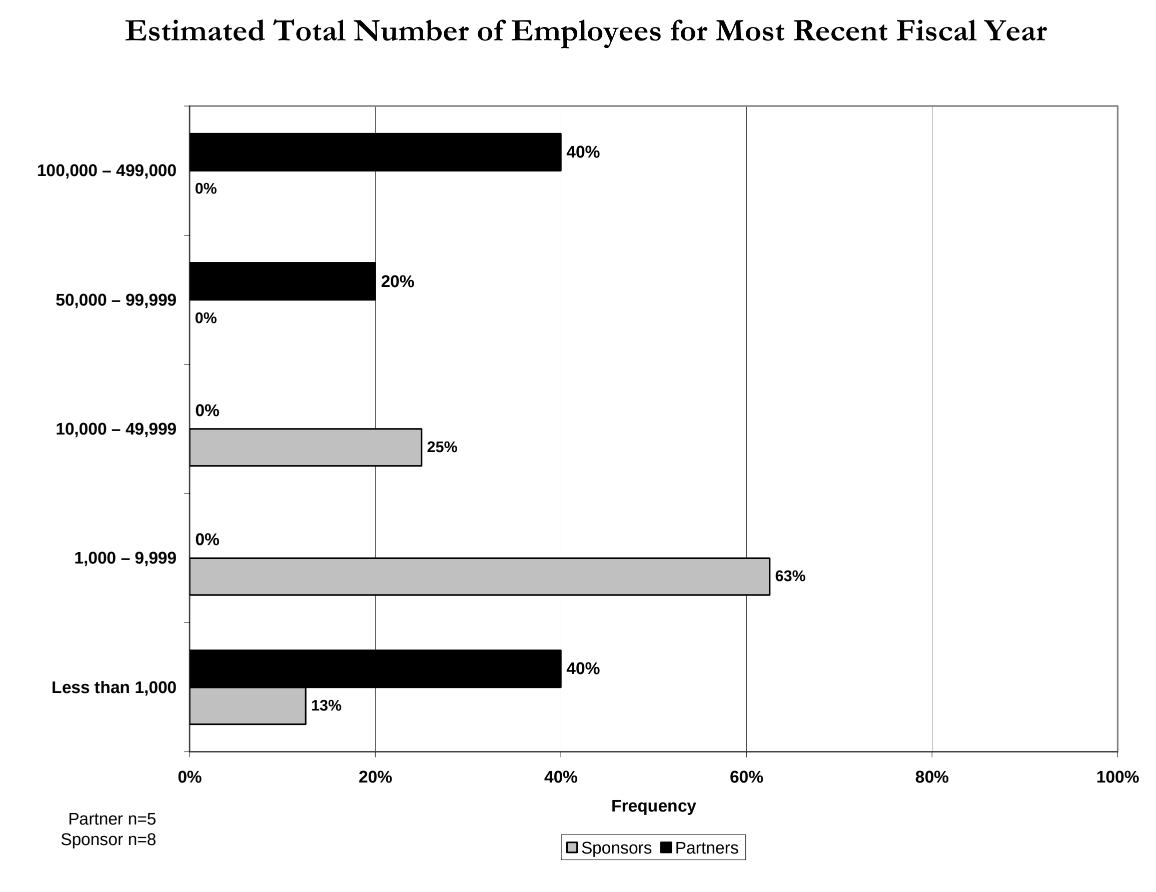

Figure E.7

Figures E.8 and E.9 on pages 12 through 13 summarize the number of products and frequency of purchase at participant organizations.

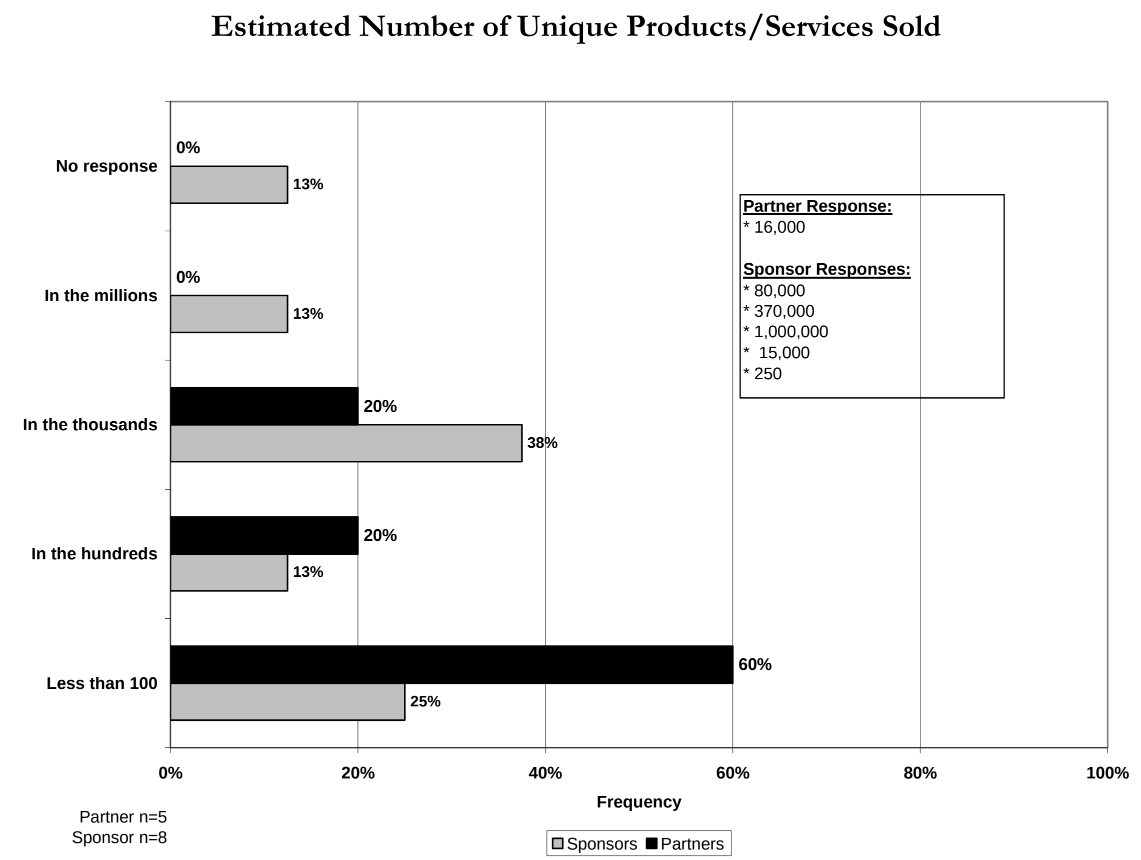
Estimated Number of Unique Products/Services Sold
No response
In the millions
In the thousands
In the hundreds
Less than 100
0%
13%
0%
13%
20%
38%
20%
13%
60%
25%
Partner Response:
* 16,000
Sponsor Responses:
* 80,000
* 370,000
* 1,000,000
* 15,000
* 250
0%
20%
40%
60%
80%
100%
Frequency
Partner n=5
Sponsor n=8
Sponsors
Partners

Figure E.8

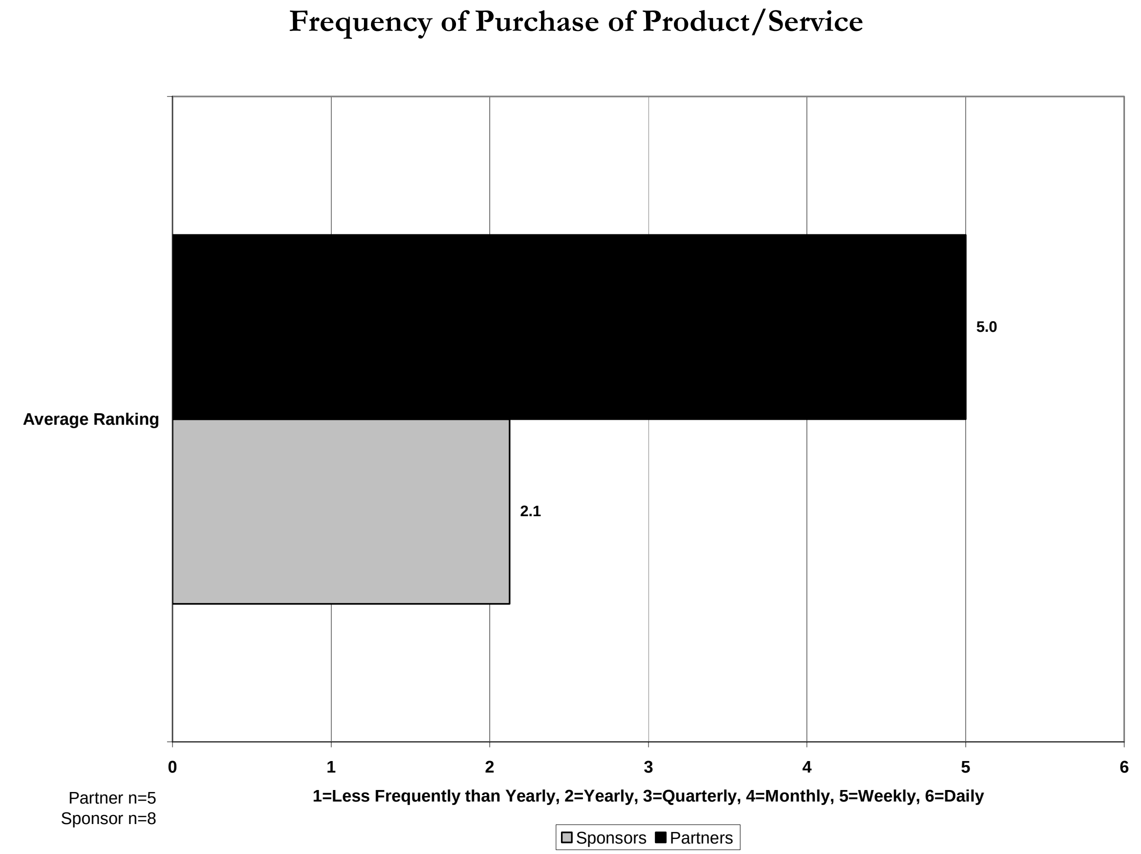
Frequency of Purchase of Product/Service
Average Ranking
5.0
2.1
0
1
2
3
4
5
6
Partner n=5
Sponsor n=8
1=Less Frequently than Yearly, 2=Yearly, 3=Quarterly, 4=Monthly, 5=Weekly, 6=Daily
Sponsors
Partners

Figure E.9

Subject Matter Expertise

John Miller, Director, Arkonas

John A. Miller, director, Arkonas, served as subject matter expert for this consortium benchmarking study. Miller is a nationally recognized expert in the areas of cost management, performance measurement, and process improvement. He is the author of *Implementing Activity-Based Management in Daily Operations* (1996), and his articles have appeared in leading publications including *Management Review*, *Journal of Cost Management*, and *Practical Accountant*. As a former partner at Arthur Andersen & Co. and founder of Arkonas, Miller has been the project director and principal author of three joint consortium benchmarking studies in conjunction with APQC and CAM-I related to Activity-Based Costing (ABC) and Activity-Based Management (ABM).

CAM-I Alliance

The "Calculating and Reporting Customer Profitability" consortium benchmarking study was conducted in alliance with CAM-I, an international consortium of manufacturing and service companies, government organizations, consultancies, and academic and professional bodies who have elected to work cooperatively in a pre-competitive environment to solve management problems and critical business issues that are common to the group. CAM-I is a nonprofit, cooperative membership organization established in 1972 to support research and development in areas of strategic importance to industries, such as issues in cost resource management and process-based management. For more information about CAM-I, visit www.cam-i.org.

About APQC

APQC employees served in a market development and project management capacity for this consortium benchmarking study. A recognized leader in benchmarking, knowledge management, measurement, and quality programs, APQC helps organizations adapt to rapidly changing environments, build new and better ways to work, and succeed in a competitive marketplace. For more than 25 years, APQC has been identifying best practices; discovering effective methods of improvement; broadly disseminating findings; and connecting individuals with one another and with the knowledge, training, and tools they need to succeed. APQC is a member-based nonprofit serving more than 500 organizations around the world in all sectors of business, education, and government. Learn more about APQC by visiting www.apqc.org or calling 800-776-9676 or 713-681-4020.

Acknowledgments

The project team and APQC would like to thank the participants in the "Calculating and Reporting Customer Profitability" consortium study. Throughout the study, the sponsor representatives provided valuable input into the data collection tool design, partner organization selection, and site visit participation. The enthusiasm and dedication of the sponsor group ensured a successful study.

A special thank-you is extended to the partner representatives who have taken time out of their busy schedules to participate in this study. The representatives receive no compensation or reimbursement for their time or travel. Each member of the partner group has gone out of his or her way to ensure the success of this study.

CHAPTER 1: BACKGROUND AND OVERVIEW OF CUSTOMER PROFITABILITY INITIATIVES AT PARTICIPANT ORGANIZATIONS

Prior to discussing the details of customer profitability methodologies and the technicalities of calculating cost-to-serve at participant organizations, it is first helpful to "set the stage" in terms of their current state, evolution, governance, and accountability for customer profitability calculation and reporting. This chapter answers the question "Who *are* the participants in this study?" and provides background information which "colors" the more detailed technical discussion in the remaining chapters and overviews the customer profitability initiatives in place at the five study best-practice partner organizations.

THE "CURRENT STATE" AT PARTICIPANT ORGANIZATIONS

In order to interpret the findings from this benchmarking study, it is first helpful to understand the study participants: what level of sophistication they had achieved in terms of calculating and reporting customer profitability and what they were seeking to learn from this consortium benchmarking study. The eight consortium benchmarking sponsors were, for the most part, in the beginning phases of calculating and reporting customer profitability, with all but one having done this for two years or less, and three stating that they currently have no systematic formal process in place (Figure 1.1, page 17). Naturally, these sponsors joined the study to incorporate best practices from those who have been identified as successful in calculating customer profitability and who have established processes in place.

Study best-practice partners, on the other hand, have, for the most part, been calculating and reporting customer profitability for longer than two years, with two partners involved in doing this for five years or longer. Not surprisingly, industry plays a factor in study participants' experience: For the most part, organizations in the financial services industry have been calculating customer profitability longer than others due to the wealth of customer data that they have been collecting and the relative ease of access to detailed transactional customer information in comparison to other industries. Secondary research conducted in the planning phase of this study corroborated that those in financial services tend to be leaders in this space.

Length of Time Calculating and Reporting Customer Profitability

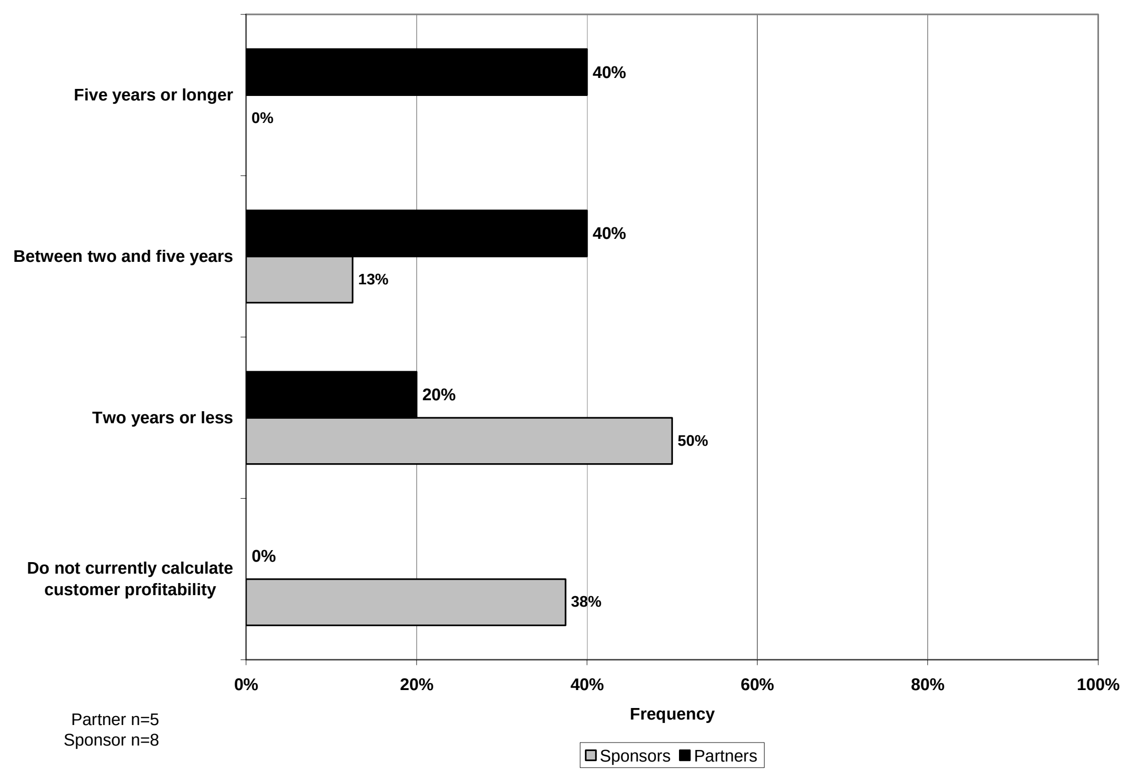

Figure 1.1

CATALYST FOR CUSTOMER PROFITABILITY INITIATIVES

> *To get the most out of our investment dollars, we need to be able to identify which customers give us the most value in return.*
> —FedEx site visit

Generally, it is intrinsically understood by study participants that not all customers are equal. Eighty percent of partners (e.g., four out of five) and 72 percent of sponsors estimate that the top 20 percent of customers provide more than 50 percent of organizational profits (Figure 1.2, page 18). This is a powerful business case for calculating and reporting customer profitability in and of itself.

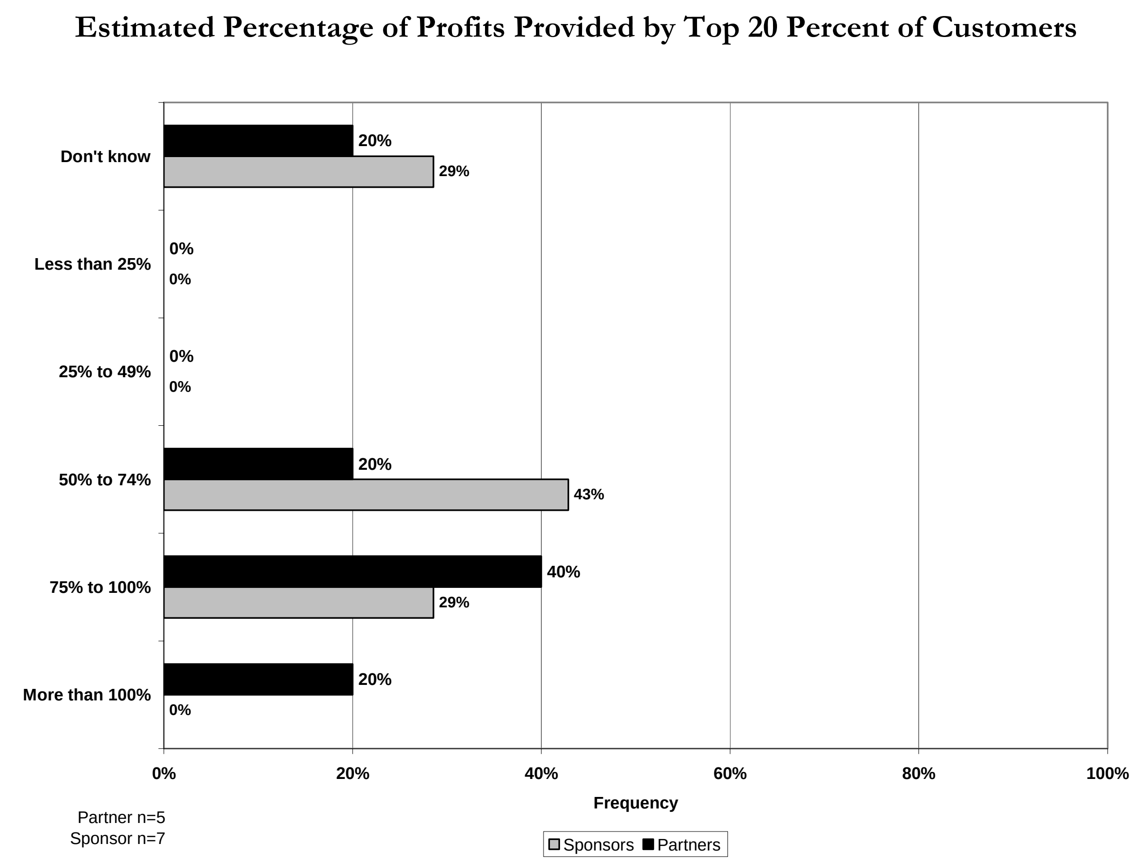

Figure 1.2

Armed with this awareness, over half of study participant organizations were driven by a compelling business case or senior-level mandate to establish a formal systematic initiative for calculating and reporting customer profitability (Figure 1.3, page 19). **FedEx,** for example, has been calculating customer profitability since 2003. The initiative began as a specific project around OneCall, a preferred customer service program. Tangible favorable results from this program provided the business case for the initiative to evolve into a broader scope throughout the organization.

Marriott's initiatives, on the other hand, were primarily driven by senior-level mandate. Marriott has been calculating customer profitability on an "experimental" basis since 2001. The company's customer profitability focus began as an initiative in brand management spurred by the current executive vice president of brand management who was deeply influenced by Fredrick Reicheld's *The Loyalty Effect: The Hidden Force Behind Growth, Profits, and Lasting Value.*[3] The vice president of customer relationship strategy was chartered by brand management to apply the methodologies outlined in this book at

[3] Harvard Business School Press, 1996.

Marriott. After initially focusing on customer behavior at the cohort level, his research eventually shifted to focus more on unique customers with staying power. As a result of this research, the vice president ultimately found that among frequent travelers, approximately one percent of customers were providing 20 percent of the sales. This was an eye-opening statistic for many within the company and provided the catalyst for the organization's current focus on customer profitability.

Wachovia, as the partner with the most experience and greatest commitment (at least in terms of organizational resources) devoted to customer profitability calculation, was also catalyzed to formally calculate customer profitability by senior-level mandate. What today is known as CART (Customer Analysis, Research, and Targeting) evolved over time as the organization evolved (through a series of mergers and acquisitions) from primarily a product- and transaction-driven group to a customer-centric business partner and center of excellence for customer analytics throughout the organization.

Primary Catalyst for Customer Profitability Initiative

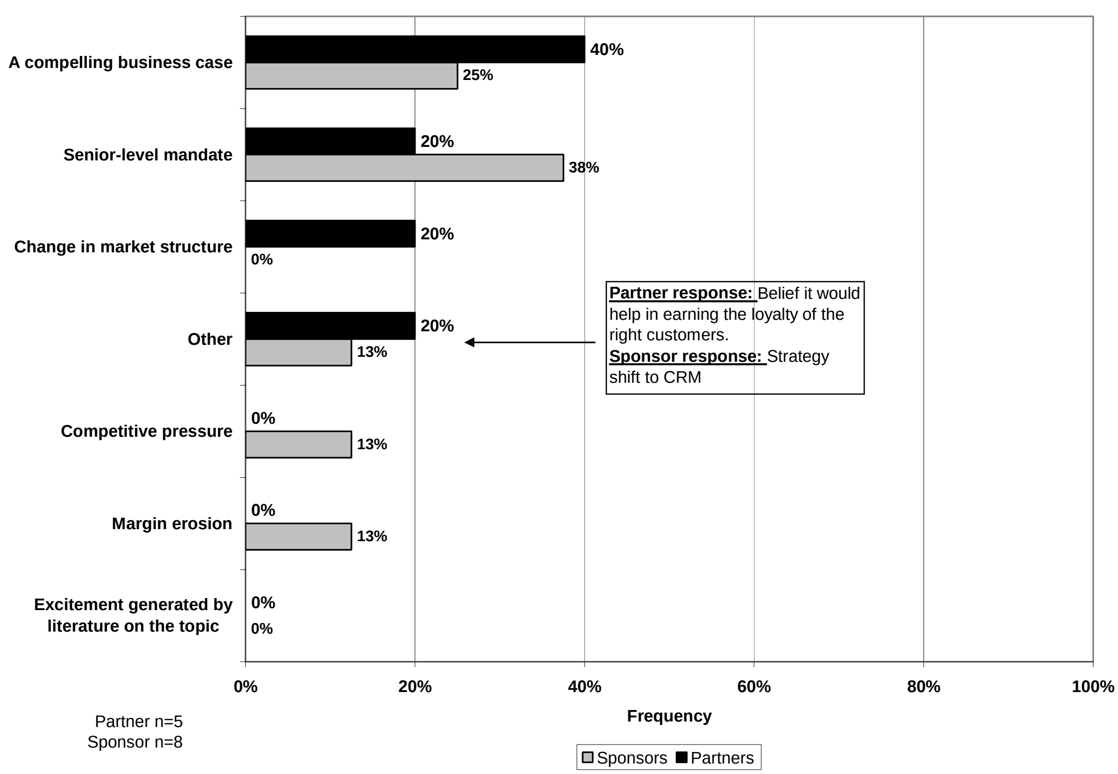

Figure 1.3

GOVERNANCE AND ACCOUNTABILITY

Key Finding 1: At best-practice organizations, customer profitability is owned by marketing, with finance as a key stakeholder.

While primary accountability for calculating customer profitability at participant organizations fell across the board (Figure 1.4, page 21), ultimately those responsible for calculating and reporting customer profitability at most of the best-practice organizations report through marketing, with finance as a key stakeholder. Customer profitability at study best-practice partners represents a bridge between customer and financial intelligence. Culturally and organizationally, it provides the opportunity for the chief marketing officer and the chief financial officer to collaborate on common value delivery.

> *Marketing claims ownership to customer insight, while finance believes it owns profitability analysis. To improve the value of your customer profitability analysis, ensure that these two departments are aligned by focusing on how the analyses will be used.*
> — Garth Herschel. "Marketing and Finance Must Collaborate to Define Customer Profitability." Gartner Inc., July 6, 2005.

The importance of marketing and finance working together to calculate customer profitability should not be underestimated. Marketing has a requirement for customer value analysis and finance has legitimate concerns about the accuracy of the analysis. According to a Gartner research paper published July 6, 2005 titled "Marketing and Finance Must Collaborate to Define Customer Profitability," both of these functions should work together and reach mutual agreement in three areas.

1. Hierarchy of customer valuations that incrementally includes more of the indirect costs associated with the relationship. For this study, we found that best-practice organizations include the majority of their costs (but not all) in the customer profitability calculation and use appropriate methods for cost assignment (Key Finding 9).

2. Collaborate on an evolving, multiple-phase effort to determine customer profitability. The study team observed and documented multiple-phase efforts at each of the study best-practice organizations.

3. Recognize that customer value is composed of many aspects and that different decisions will require different aspects to be considered.[4] This was a major theme throughout this best-practice study and includes clearly defined customer segments and subsegments (Key Finding 4), multiple bases for segmentation (Key Finding 5), holistic view of customer profitability with lifetime values and potential in the calculation (Key Finding 7), and customer profitability used as an input in many areas (Key Finding 10). Key Finding 11, "best-practice organizations emphasize

[4] Source: "Marketing and Finance Must Collaborate to Define Customer Profitability." Gartner Inc., July 6, 2005.

intelligence (e.g., decision support), not routine reporting, in customer profitability information dissemination," is exactly on point.

Function with Primary Accountability for Customer Profitability Calculation and Reporting

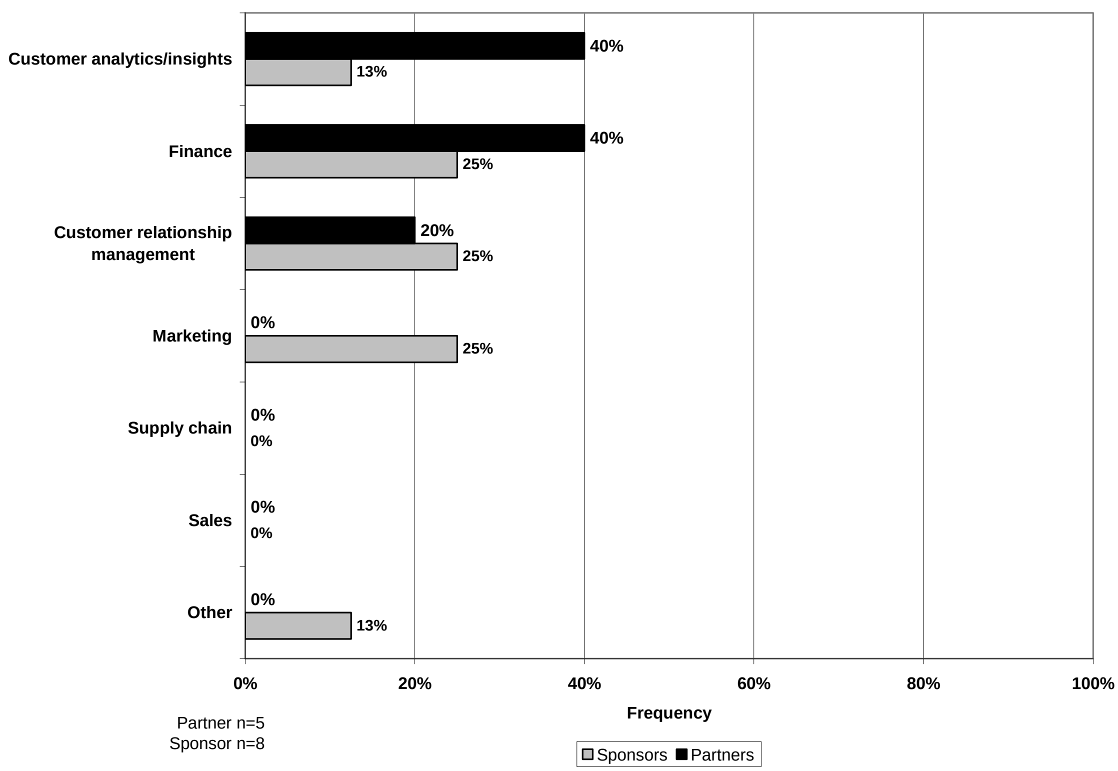

Figure 1.4

FedEx has formed a dedicated customer management analytics (CMA) group within FedEx Services (a support organization for the FedEx operating companies) that provides customer analytics decision support for the rest of the organization. Ultimately, CMA is part of the marketing—worldwide planning and analysis—group at FedEx Services. Customer profitability analysis at **Marriott** occurs within the customer relationship strategy function under the marketing senior vice president as part of the company's loyalty program, Marriott Rewards. The vice president of customer relationship strategy is responsible for the strategy of the company impacting individual customers. All customer-related functions roll up to the executive vice president of sales and marketing. At **North Shore Credit Union** (NSCU), the treasury department is responsible for calculating the profitability of each member. The manager of market segments and products is responsible for propensity models used in conjunction with member profitability information that create campaigns and business processes to deliver products and services with appropriate pricing to members. He, in turn, reports to the vice president of HR and marketing at NSCU. Finally, at **Zippo Manufacturing**, continuous improvement is responsible for calculating and reporting product and customer profitability and for the overall process improvement initiative in the organization. Continuous improvement works with the product and customer improvement teams and "reports" in a matrix fashion to finance, sales, marketing, and manufacturing.

Wachovia is the exception to the rule in terms of governance for customer profitability at best-practice partner organizations. Similar to FedEx, Wachovia has created a dedicated customer analytics center of excellence (CART). What is today considered CART evolved over the years as the organization evolved from a marketing group that served retail customers to a corporate-wide group that supports the entire organization. CART is today considered a sister organization of corporate marketing. The managing director of CART reports to the head of HR and corporate relations.

Finance is a key stakeholder for customer profitability analysis at participant organizations, along with marketing, sales, and customer analytics (Figure 1.5, page 23).[5]

[5] Note: Figures 1.3 and 1.4 are not mutually exclusive. In other words, if an organization checked "marketing" as primarily accountable for customer profitability, it was also checked again as a key stakeholder.

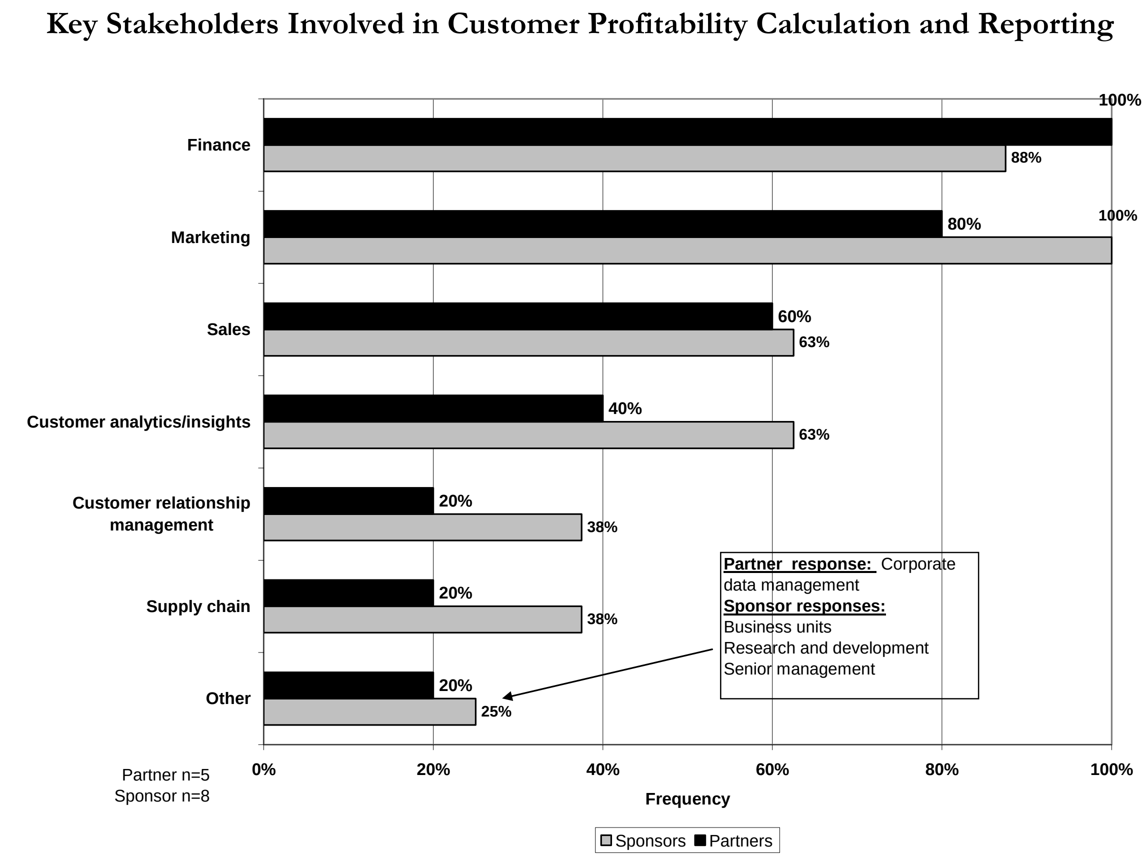

Figure 1.5

Key Finding 2: Study participants have defined a small, dedicated group of anywhere from two to five individuals who are involved in calculating and reporting customer profitability.

As depicted in Figure 1.6, page 24, customer profitability calculation at most study participants (both sponsors and best-practice partners), regardless of organizational size, is performed by a small group of anywhere from two to five individuals. The exception on the partner front is Wachovia, who made the organizational commitment over the years to form an in-house center of excellence for analytical customer research and decision support. CART's 100 employees support the entire organization of more than 90,000 employees.

Approximate Number of People Involved in Customer Profitability Calculation and Reporting

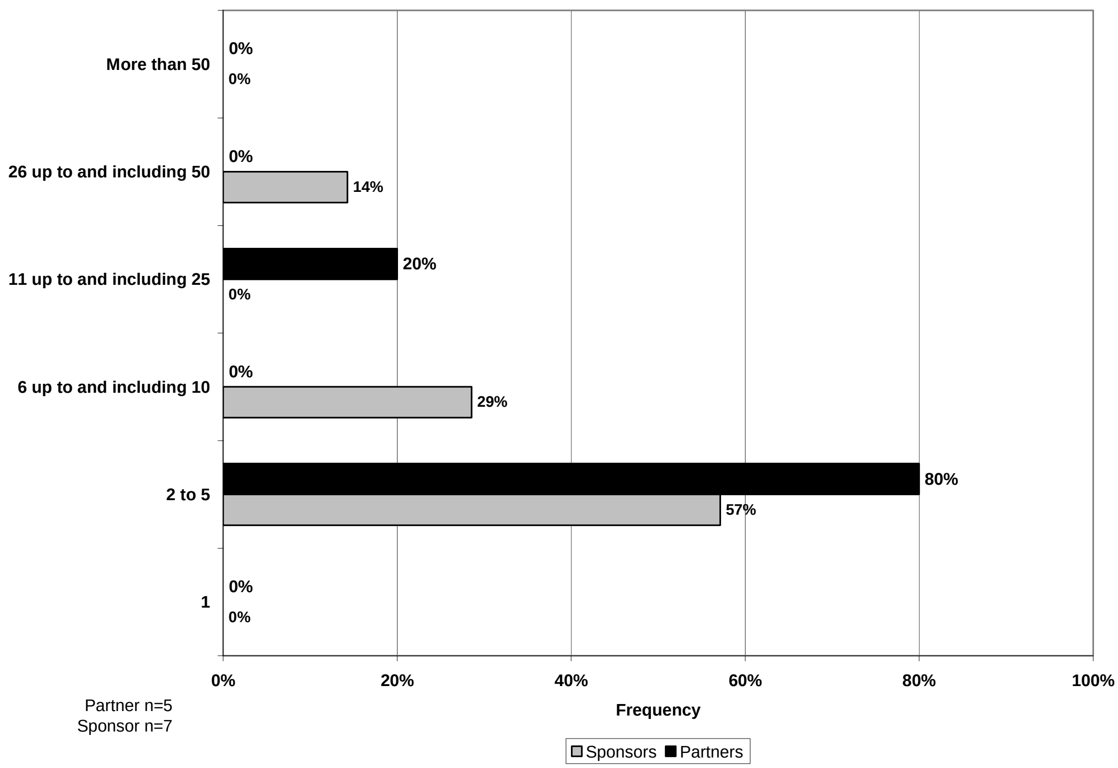

Figure 1.6

APPROACHES AT BEST-PRACTICE PARTNERS

Although they have been referenced in examples throughout this introductory chapter (and will continue to be throughout the rest of the final report), it will be helpful to briefly summarize the approach that each of the five study best-practice partners has taken to calculating and reporting customer profitability prior to launching into specifics beginning with Chapter 2. The following paragraphs present a brief synopsis of the approach taken at each study best-practice company.

FedEx

The mission of CMA within FedEx Services is to provide strategic and tactical quantitative analysis and decision support to FedEx Services, the FedEx operating companies, as well as to senior/executive management. CMA has created a customer "desirability" model that considers customer profitability and other dimensions that are weighted to derive a relative value of the customer. This model is then used to help prioritize and make more informed and effective business decisions regarding customer investments by FedEx.

Marriott

At Marriott, the emphasis on calculating and reporting customer profitability is for its Marriott Rewards program. Marriott approximates customer profitability through an analysis of relative customer spending—a term that refers to comparing an individual customer's spending on a property against the spending of other customers who stay at a property under roughly the same circumstances (e.g., same hotel, same day of week, in the same season, in the same month, etc.). This relative spending approach is a "shortcut" that has worked well for Marriott and provides the information it requires. Not only has this measure informed customer segmentation efforts (even though segments are not necessarily based on it), it is used along with behavioral markers of a profitable customer to approximate customer profitability and has justified continued work and refinement in this area at Marriott.

North Shore Credit Union

NSCU uses needs-based models (propensity) in conjunction with member profit scoring to derive a forward-looking measure of potential member value (i.e., dollar value based on likelihood to increase or decrease profitability).

Wachovia

Customer profitability is viewed by Wachovia as an integral part of understanding the economics of current and prospective customer relationships, and CART ensures a consistent approach and methodology for calculating and reporting customer profitability, regardless of line of business or customer segment. CART partners very closely with the corporate finance organization; there is a unit within the finance department that is accountable for developing account-level and organizational profitability and ensuring that there are consistent methodologies for such processes as cost attribution and allocating risk capital. CART leverages the account-level profit calculation from finance and aggregates this information at the relationship level to reflect the holistic view of the entire client relationship.

Zippo Manufacturing

Zippo calculates and reports customer profitability for each of its 3,500 individual customers. The company is an active proponent and user of Activity-Based Costing for both product and customer profitability calculations. The emphasis at Zippo is to use product and customer profitability to drive improvement initiatives. A dedicated team, reporting through the finance organization, works with sales, marketing, and manufacturing on projects to reduce product cost, increase customer profitability, and to improve internal processes.

Prelude to Chapter 2

Armed with the context provided by Chapter 1, Chapter 2 will delve into study findings around customer segmentation, a necessary first step to calculating and reporting customer profitability.

CHAPTER 2: CUSTOMER SEGMENTATION

A logical first step in calculating customer profitability is determining who is considered the "customer." Once defined, customers can be grouped into segments. This chapter explores how study participants define their customers and how they segment them into natural groupings. Once customers and segments are defined, the next step is attributing revenues and costs to the customers and segments, and then calculating customer and/or segment profitability.

DEFINING THE CUSTOMER

In order to begin thinking about customer profitability, it is first necessary to answer the question, "Who are our customers?" At Wachovia, a client (customer) in its consumer business is an aggregation of individual accounts like a checking account, a savings account, and a loan. The customer is not an individual account. At NSCU the customer is a member and, like Wachovia, includes all of the member accounts. For Zippo, customers are large retail accounts and dealer distributors, not the individual consumer of the product.

Many study participants—including the best-practice partners—seemed to wrestle, to some extent, with the question "Who is our customer?" In defining the customer, best-practice partners continuously emphasized the importance of soliciting the feedback of key stakeholders, such as sales, in order to ensure buy-in. As discussed in the executive summary, most study participants have both corporate and consumer customers (Figure E.5, page 9). Some have the additional layer of working with dealers and distributors (Figure 2.1, page 27), so the question for them was whether "customer" denoted a dealer or a distributor, or the ultimate individual consumer. As indicated by Figure 2.2, page 28, channel complexity was particularly an issue for study sponsors in defining their customer.

> *"What matters most is who is making the final purchasing decision."*
> —Marriott vice president, customer relationship strategy

Best-practice partner **Marriott** readily admitted to struggling with conflicting views of the customer across the organization. For example, different Marriott properties tend to view customers as meeting planners or transient and extended stay guests, whereas Marriott account managers tend to view corporate representatives (e.g., IBM) as customers. Sometimes even intermediaries (like the Internet channel) may be viewed as customers by Marriott. The vice president of customer relationship strategy at Marriott resolves this conflict by focusing on the individual who is making the final purchasing decision as the "customer" (with the rest viewed as influencers to various degrees) and viewing individuals/entities as having value (realized, expected, potential) in the context of the product or service provided by Marriott. Value is further described in terms of frequency (room nights), margin, or influence (personal and positional).

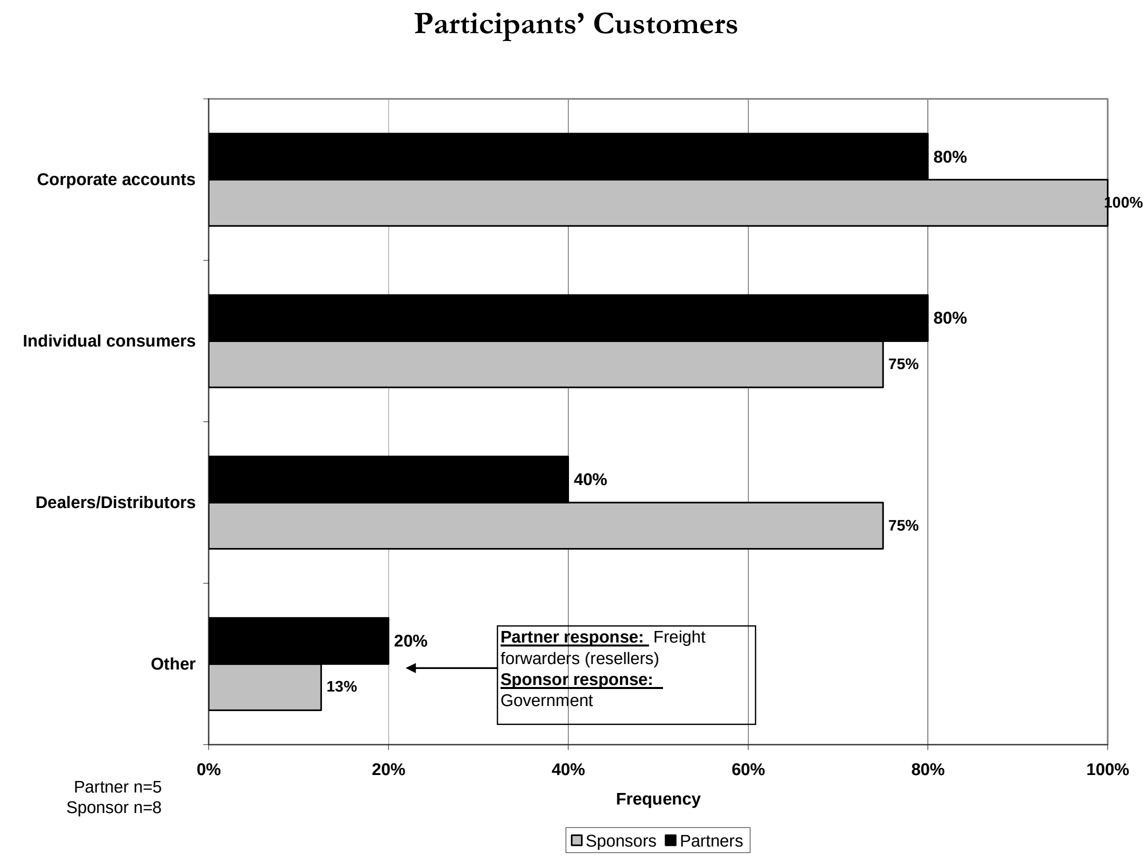
Participants' Customers
Corporate accounts
Individual consumers
Dealers/Distributors
Other
80%
100%
80%
75%
40%
75%
20%
13%
Partner response: Freight forwarders (resellers)
Sponsor response: Government
0%
20%
40%
60%
80%
100%
Frequency
Partner n=5
Sponsor n=8
Sponsors
Partners

Figure 2.1

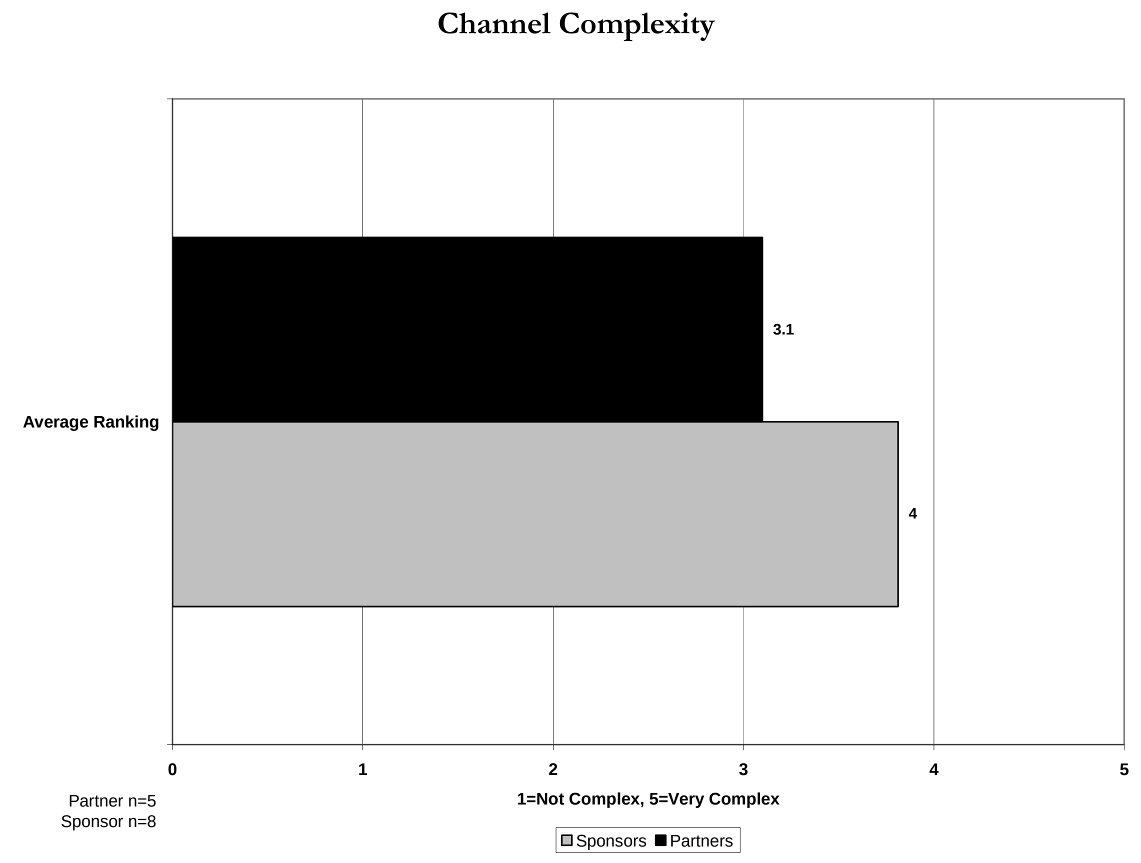

Figure 2.2

Key Finding 3: Best-practice partners have developed an enterprise-wide view of the customer.

The "Calculating and Reporting Customer Profitability" study found that best-practice organizations strive to create a common definition for "the customer" across the organization as the initial step to customer segmentation. **FedEx** provides a case-in-point. FedEx Corp. comprises eight operating companies: FedEx Express, FedEx Ground, FedEx Freight, FedEx Kinko's Office and Print Services, FedEx Custom Critical, FedEx Trade Networks, FedEx Supply Chain Services, and FedEx Services. While a work-in-progress, FedEx tries to ensure that it has an integrated end view of the customer across all of its operating companies rather than a fragmented, operating view of the customer. The foundation of customer relationship management at FedEx is this integrated customer view, as depicted in Figure 2.3, page 29.

Integrated Customer View as Foundation of CRM at FedEx

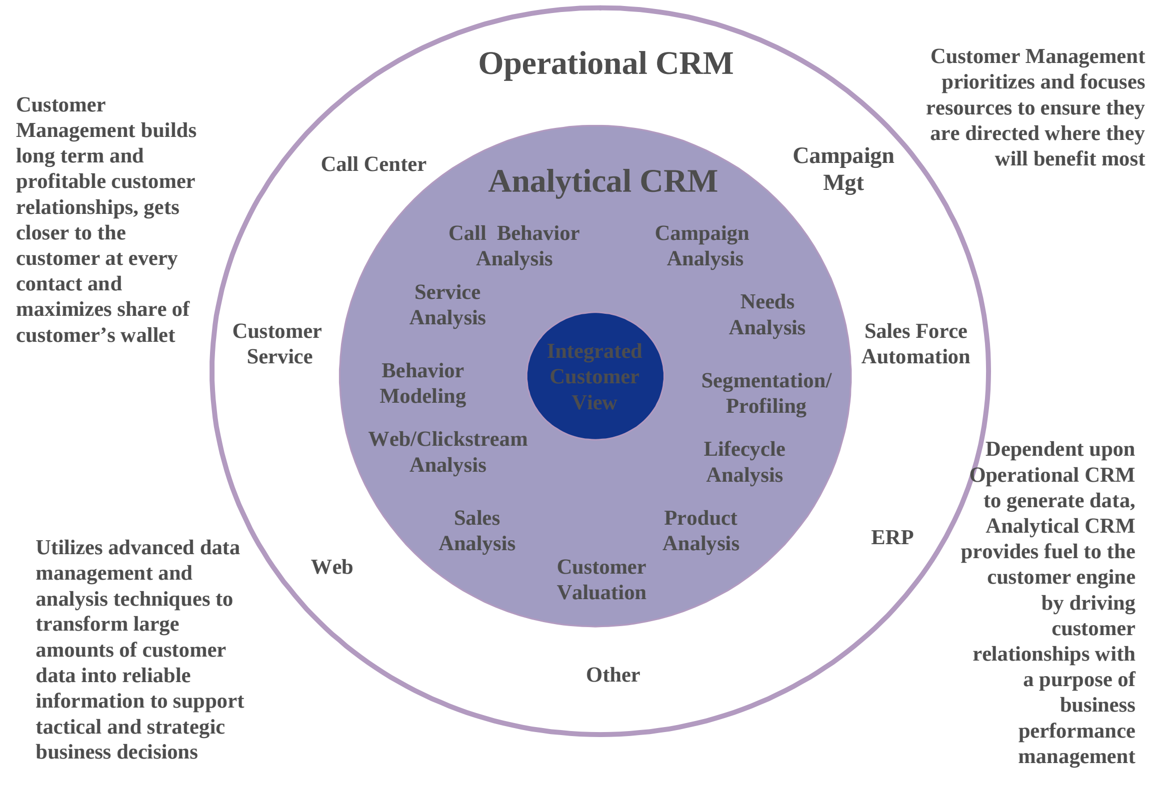

Figure 2.3

As with many companies, creating a common, enterprise-wide view of the customer for FedEx is challenging. A large customer, for example, may have millions of account numbers. At the transactional level, FedEx looks at account numbers and aggregates them by location and then by entity (Figure 2.4, page 30). It uses outside data to create the enterprise view so that it can focus on the right data and try to do the best matching with its account number to identify which company location will be assigned. The entity, then, is the common, consistent customer view across FedEx operating companies.

Customer Aggregation into Entities at FedEx

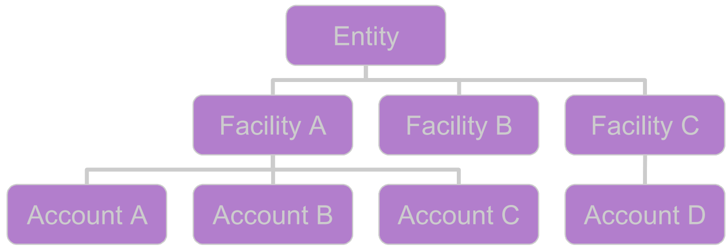

Figure 2.4

From this integrated view of the customer, CMA within FedEx Services does analysis to segment/profile customers, determine their life cycle and value to FedEx, assess the effectiveness of marketing campaigns, analyze product and service usage, etc. All of these efforts support how FedEx deploys its sales force, markets to customers, and provides customer service support.

> *"Part of the company's journey since 1995 has been to build a common definition of customer relationships so that it can look across the entire corporation and speak a common language. Everyone needs to understand what our market position, trends, and opportunities are."*
> —Director of CART, Wachovia

In the past, **Wachovia** has not been consistent in defining customer relationships; each business unit had its own definition. This has changed over time as Wachovia has worked to develop a consistent enterprise view of the customer across the organization via enterprise client groupings (ECGs, Figure 2.5, page 31). Referring to Figure 2.5, from the bottom of the pyramid to the top, there are three steps in aggregating accounts into ECGs: (1) Accounts are owned by clients, (2) clients roll up to a client group, and (3) client groups roll up to an enterprise client group. The ECG is the common denominator at Wachovia: It consists of the clients and their accounts. It is a discrete buying unit and marketing group, and finance develops profitability figures regarding it. The ECG is the basis for CART's analysis of customer behavior in support of strategy development and marketing programs.

NSCU's customer profitability efforts were ignited in the late 1990s by senior management when the first profitability model was launched along with the company's CRM implementation. The goal for the CRM implementation was to obtain a single view of the customer: NSCU sought to create a consolidated view of customers that would include all of their data and be delivered or presented in easy-to-understand interfaces.

Defining Customer Relationships at Wachovia

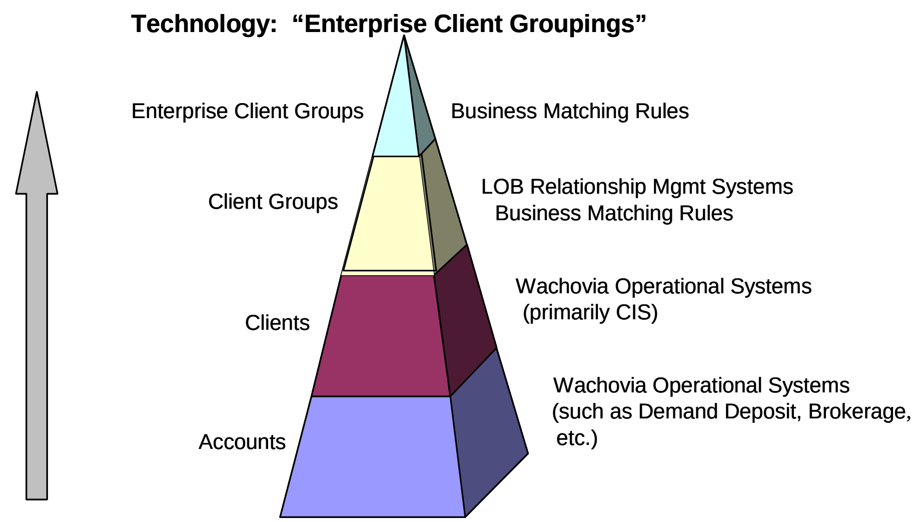

Figure 2.5

GROUPING CUSTOMERS INTO SEGMENTS

Customer segmentation can be defined as a marketing technique that targets a group of customers with specific characteristics or, alternatively, identification and grouping of customers with similar needs and buying propensities.[6] All study participants reported that they segment their customers, and most take that to a further degree of granularity by subsegmenting the macro segments (Figure 2.6, page 32).

[6] Definition provided by FedEx at their site visit.

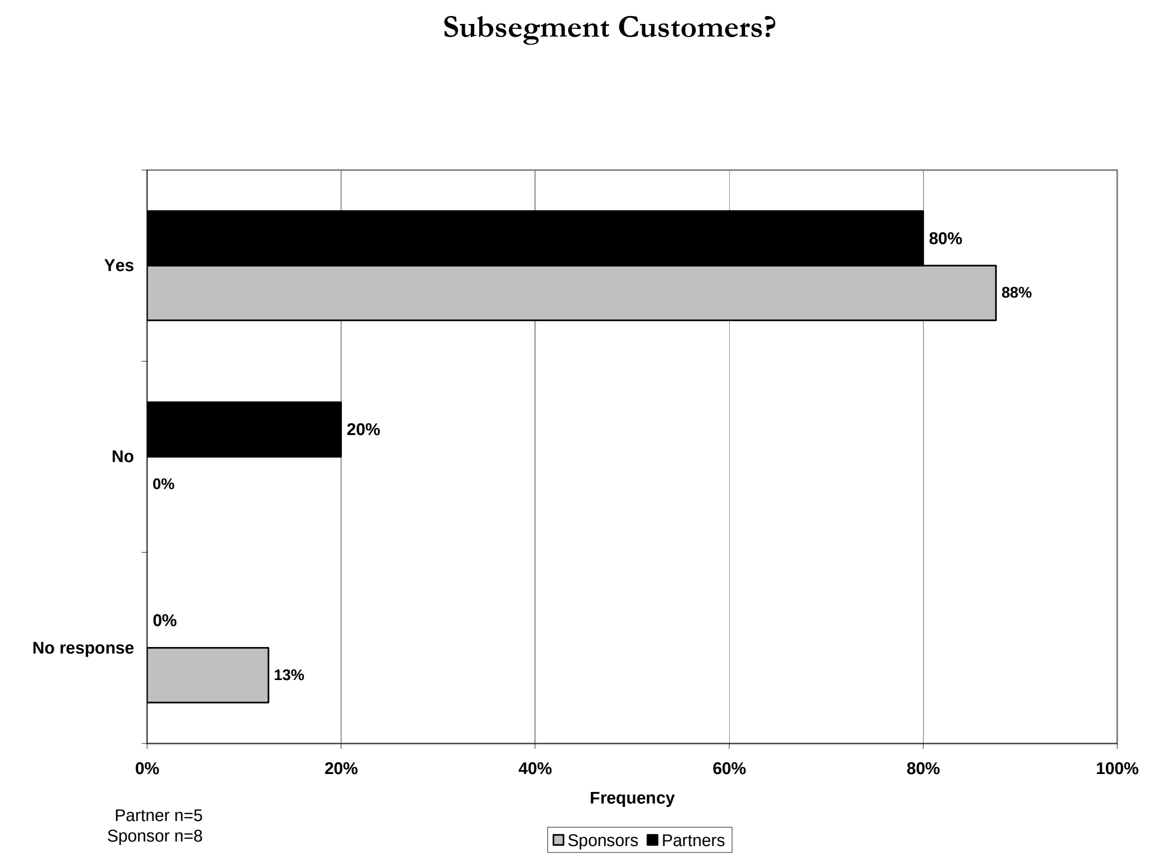
Subsegment Customers?
Yes
No
No response
80%
88%
20%
0%
0%
13%
0%
20%
40%
60%
80%
100%
Frequency
Partner n=5
Sponsor n=8
Sponsors
Partners

Figure 2.6

Examples of segments and subsegments used at participant organizations include those outlined in the following table.

Example Macro Segments	Example Subsegments
• WWS—largest customers with dedicated sales at the national level	• Government—a subset of WWS with special needs
• Retail—investable assets less than $1 million	• Affluent—investable assets $250,000 to $1 million
• “Steady Eddies”—customers meeting threshold of stays over an extended number of years	• Relative spending—customer’s level of spending relative to other people in the same hotels in the same day of the week
• LPO—Large Property Owners	• Horse owners
• Farmer	• Corn/soybeans
• Manufacturing automotive parts	• Geography—western region

Key Finding 4: Best-practice partners have clearly defined customer segments and subsegments. Most have developed five to nine macro customer segments.

The “Calculating and Reporting Customer Profitability” study found that most best-practice partners had established in the range of five to nine clearly defined macro customer segments (Figure 2.7, page 34), and four out of five best-practice partners had further segmented their macro customer segments into a number of clearly defined subsegments (Figure 2.6, page 32).

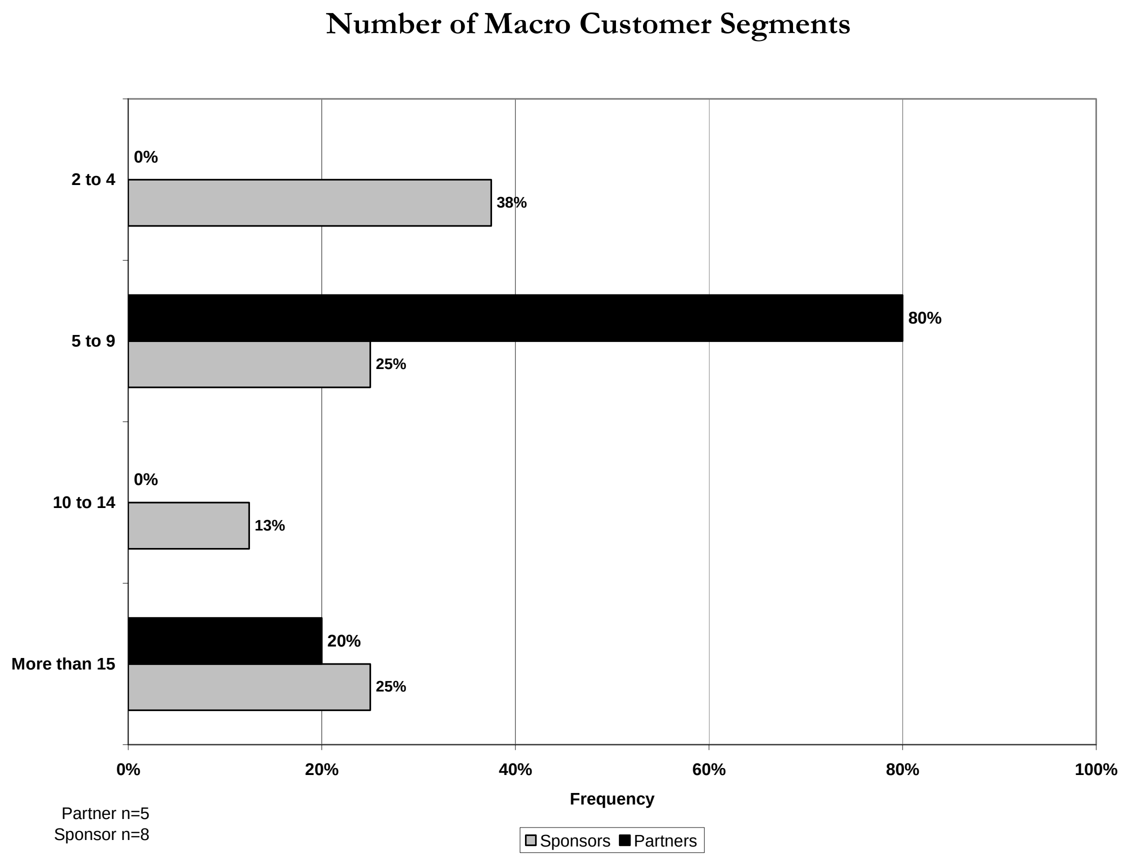

Figure 2.7

Marriott has identified approximately six to seven macro customer segments based on customer behavior. Each customer segment is categorized by relative spending (a calculation designed to determine how much a member spent relative to other members on the same day of the week in the same hotel during the same month). For example, a high-value behavioral customer who may not be a big spender at the hotel could be viewed favorably in a low-occupancy environment but less favorably in a high-occupancy environment. Segments include customers who, through behavioral characteristics, are anticipated to be more profitable. The macro customer segments are subsegmented based on a variety of factors. For example, extended stay customers and transient stay customers may both be very high-value customers.

In **Wachovia's** physical network of 3,000 financial centers, there are two primary, mutually exclusive consumer segments: (1) wealth (a relationship with $2 million or more in investable assets, defined as a combination of deposits and investments, and the ability to bring $1 million or more to Wachovia) and (2) retail. Retail is further subsegmented into affluent, mass affluent, and mass. On the wholesales side of the business, the branch banking network is segmented into macro segments such as small business, business banking, commercial, commercial real estate, and community banking. At the national level, the following are served: corporate banking and investment banking.

Key Finding 5: Best-practice partners use multiple bases for customer segmentation, such as needs, geography, and customer profitability.

Study best-practice partners segment customers based on a number of parameters, most commonly customer needs, geography, and customer profitability (Figure 2.8). For example, **FedEx** defines customer segments along various dimensions like current revenue, total potential, customer needs, buying tendencies, industry, and customer value.

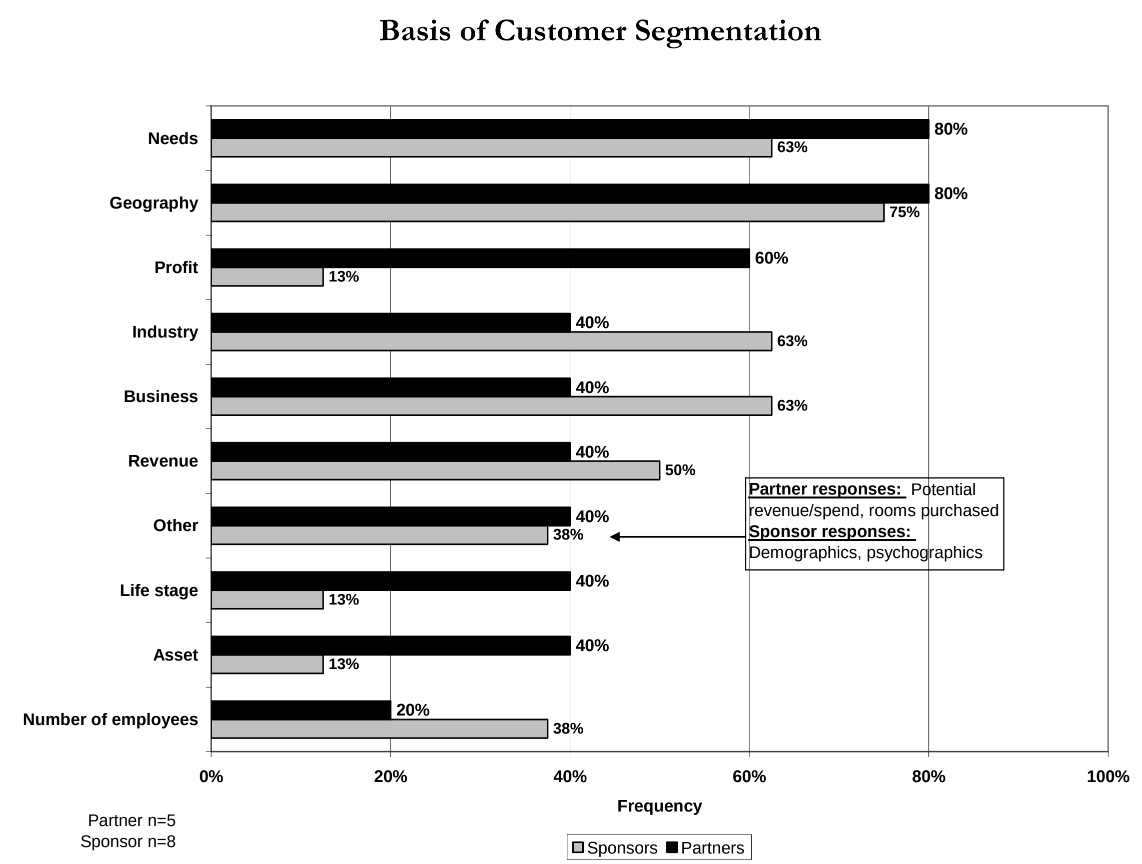

Figure 2.8

Wachovia employs various types of consumer segmentation, including psychographic, behavioral, profitability, demographic, prospective value, and attitudinal (Figure 2.9).

Wachovia Consumer Marketing Segments

Segmentation Program	Types of Segmentation	Key Focus
P$ycle	• Psychographic	• Market Comparison
Behavioral	• Behavioral	• Cross-Sell/ Up-Sell
Book of Business	• Behavioral (Channel) • Profitability (Value)	• Cross-Sell/ Up-Sell • Retention
Good to Great	• Demographic • Prospective Value	• Market Comparison • Market Positioning
Attitudinal	• Attitudinal	• Value Proposition Design/ Development

Figure 2.9

> *No one measure for segmentation is complete and comprehensive in and of itself.*
> —FedEx site visit representative.

Partners recognize that segmentation schemes must be organic and nimble so that they can change over time as the needs of the market and the organization change. **FedEx**, as a pioneer in customer segmentation, provides a good example. The CMA group within FedEx drives the organization's segmentation strategy and determines the potential of customers. This group recognizes that no one measure for customer segmentation is complete and comprehensive in and of itself: While there is data to support all of the customer potential calculations, there are always exceptions. Therefore, CMA employs several means to make adjustments for non-quantifiable inputs.

Some best-practice partners have strategically segmented their customers in a tiered approach to identify the most valuable customers on which to focus efforts to maximize their return on investment. For example, **FedEx** uses a multi-tiered segmentation approach (Figure 2.10, page 37). Tier 1 segmentation is based on the potential value/revenue of customers, drives the sales organization, and determines specific tactics employed. Tier 2 segmentation is used to supplement Tier 1 segmentation. There are various forms of Tier 2 segmentation (such as customer life cycle, industry, customer needs) that are used in combination to support different corporate strategies and tactics. For example, a specific marketing campaign might be built around winning back small and medium customers who have lapsed (e.g., stopped using FedEx services). The campaign might utilize several levers, and those might be offered to different customers based on the customer's relative value to FedEx. This example uses two versions of Tier 2 segmentation (life cycle and FedEx internal value) in conjunction with Tier 1 (small and medium) segmentation. This application follows the premise that no one measure for segmentation is complete and comprehensive in and of itself; rather, segmentation filters are applied in layers at FedEx to address each new challenge.

Tiered Segmentation at FedEx

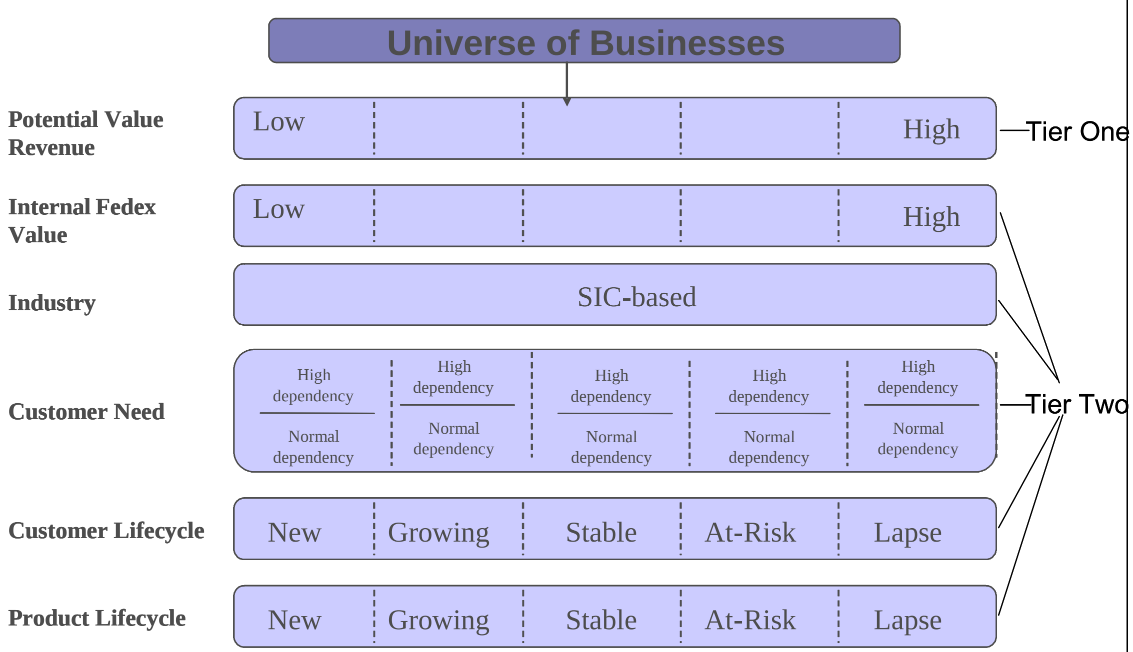

Figure 2.10

PRELUDE TO CHAPTER 3

Once companies have defined their customer and appropriate segments, the next step is to attribute revenues and costs to the customer and customer segments and to make the customer profitability calculation. Chapter 3 will discuss the methodologies that study best-practice partners use to calculate cost-to-serve and ultimately customer and/or segment profitability.

CHAPTER 3: CALCULATING CUSTOMER PROFITABILITY

In the previous chapter we learned the methods best-practice organizations use to define their customers and segment their customer base. Segmenting customers into groups with similar needs, wants, behaviors, requirements, and desires is the critical first step in calculating customer profitability. The focus of Chapter 3, then, is to answer the question "How is customer profitability calculated at study best-practice organizations?"

There are essentially two paradigms within which to view customer profitability: from a finance/accounting perspective and from a sales and marketing perspective. Finance and accounting traditionally define profit as sales minus costs, calculated and reported for a specific period of time (month, quarter, year). In terms of customer profitability, sales for customer segments minus the costs to serve that customer segment is the profit. For purposes of this chapter, cost-to-serve includes all of an organization's operating costs. Given that a business exists because of its customers, most costs of a business are attributable to customers. Operating costs include direct and indirect product and services costs, sales and marketing costs, distribution, promotion, and even the general and administrative expenses of the business. Driving customer profitability from a profit and loss perspective tends to be top-down and works to incorporate all capital and infrastructure costs associated with the business in the customer profitability calculation. The customer profitability calculation at Zippo could be characterized as coming from a finance/accounting perspective, for example.

Sales and marketing, on the other hand, define customer profitability more broadly, in terms of customer valuation, and think of customer profitability in terms of share of wallet, relative spend, potential spend, and lifetime value. Sales and marketing are less interested in customer profitability at a point in time and more interested in the value of a customer over a lifetime. When catalyzed by marketing, the customer profitability solution is being driven for communications or marketing purposes. Organizations that take this approach are usually less inclined to try to assign every dollar associated with a customer and are really looking for the directional focus. Customer profitability at Wachovia and Marriott take more of a sales and marketing perspective, for instance.

Another way to look at this same difference in perspectives, which is so important, is included in the recent Gartner report "Marketing and Finance Must Collaborate to Define Customer Profitability":

> *An analysis of customer profitability depends on two sets of data:*
>
> ***View from the Finance Organization***
> *As the official owner of the enterprise's financial statements, and as the practical owner of many relevant operational applications (such as billing or cost allocation systems), the finance department appears to be in the best position to understand the customer's profitability, and to establish a repeatable and rigorous process for updating this analysis. Finance is also the group with the most credibility to make its estimates acceptable to the*

rest of the company, by reconciling the company's profitability (reflected in financial statements) with the total profitability of its individual customers. Although finance can generate numbers that reconcile, the assumptions that drive overhead allocation are often subjective and are only vaguely linked to the behaviors of individual customers.

View from the Marketing Organization
Customer-facing functions are the primary consumers of customer value analyses. In many companies, these groups have already completed estimates of customer value. Such estimates may be true profitability analyses, or they may be based solely on revenue or proxies of customer behavior (such as points in a loyalty scheme). From the view of customer relationship management (CRM), a company that is making daily decisions regarding where to allocate scarce marketing, sales, service or support resources may find that even an imperfect estimate of value may be better than nothing. For those purposes, obtaining an approximate answer in a week may be more valuable than waiting a year for the perfect answer, particularly when the waiting period can be used to incrementally refine the initial estimate. [7]

Organizational cost structures differ significantly by industry and by organization. Some industries are labor intensive; others are capital intensive. Sales and marketing expenses are huge in some businesses and small in others. Most of the methods used for associating costs to customers are specific to the type of cost. Direct assignment and standard cost methodologies work well for direct labor, material, and other costs of the product/services purchased by customers. Activity-Based Costing works well for indirect and support costs.

Chapter 1 provided background on each of the five study best-practice organizations to make the reader familiar with the customers, products, and services provided by each partner and the environment in which they operate. Chapter 2 provided the background on how best-practice organizations define their customers and customer segments. Prior to launching into the details, this chapter first provides the context with a summary of the overall methodologies that study participant organizations use to calculate customer profitability.

FedEx

FedEx includes all of its operating costs in the customer profitability calculation and uses a wide variety of methods to link these costs with transactions and individual customers. Depending on the nature of the cost, FedEx uses direct assignment, general allocations, standard costs, or Activity-Based Costing. In addition, FedEx uses survey-based modeling asking multiple internal organizations to rank a sample set of customers based on a set of pre-defined metrics. They then use the model to develop a relative score for each customer within each segment. This provides the company with a relative customer value score.

---

[7] Source: Herschel, Garent and Lee Geishecker. "Marketing and Finance Must Collaborate to Define Customer Profitability." Gartner Inc., July 6, 2005.

Wachovia

Wachovia includes most of its operating costs in the customer profitability calculation and uses Activity-Based Costing and allocations and estimates (some of which are cause and effect) to associate costs with transactions and customers. Aggregate account-level profitability (revenue net of attributed cost using Activity-Based Costing and capital charges) is at the household/relationship level.

Zippo

With the exception of research and development costs, Zippo includes all of its operating costs in the customer profitability calculation. Product costs (lighters) were charged to the customer segment that purchased the product. Product cost is derived by using standard cost of material and direct labor. The manufacturing overhead component (indirect labor, supplies, machine maintenance) was derived by using Activity-Based Costing.

Zippo defines its cost-to-serve as sales and marketing expenses and used the ABC cost tracing methodology to trace these costs to customers. General and administrative costs were allocated to customers based on the number of lighters purchased.

Marriott

Marriott includes only product/service costs and certain hidden costs like customer problem resolution in the customer profitability calculation. Sales, marketing, advertising, promotion, and general and administrative costs are excluded. For Marriott, the customer profitability calculation is a process of estimation.

- They estimate the proportion of revenue coming from room rate and ancillary (other sources).
- Finance calculates the fixed and variable expense associated with serving guests at various brands.
- They create blended estimates of hotel cost to serve customers for the room and ancillary revenue, creating net profit.
- Revenue management calculates the probability of the customer as well as the rate at which it could have sold the room to another guest had the guest in question not had the stay.
- Net profit provides a contribution to hotel profit net of displacement.

North Shore Credit Union

NSCU uses cause-and-effect allocations to associate product/service costs to individual members (customers). Only deposit account transaction costs are included in the calculation. Member profitability is calculated and ranked on a scale from one to 20, with 10 being the breakeven point based primarily on the spread from the hurdle rate.

Sponsor Organizations

As indicated on Figure 1.1 on page 17, three of the eight sponsors do not currently have formal systematic processes in place to calculate customer profitability. For those sponsors that do calculate customer profitability, their methodologies are summarized as follows.

- **A:** Potential is estimated from key demographic data elements and profitability is calculated from future returns estimated from actual historical pricing models by product.
- **B:** Defines customer profitability as revenue less cost of goods sold (product cost) and cost to serve. (As a side note, this organization was one of the first organizations to experiment with the then emerging ABC methodology in the late 1980s, documented in a Harvard Business School case study that also featured the first appearance of the term "Activity-Based Costing." [March, A and R. Kaplan. "John Deere Component Works." Harvard, 1987.])
- **C:** Determining cost per customer job using activity rates in SAP.
- **D:** Depth of product relationship, number of active products, revenue driven by products.
- **E:** Currently looking at segment profitability only. Beginning to integrate its own customer and financial intelligence products into strategic and performance measurement and reporting.

ATTRIBUTING REVENUES AND COSTS

Key Finding 6: Best-practice organizations capture revenues and costs at the transaction level for each specific customer account.

One of the more surprising findings of the "Calculating and Reporting Customer Profitability" study was the ability of best-practice and sponsor organizations to capture revenues and costs at the transaction level for each specific customer account, regardless of how many customers they had. What was unexpected was the ability to capture individual customer profitability, especially in organizations with millions of customers (for example, Wachovia and FedEx). Figure 3.1, page 42, summarizes the number of customers served by study participant organizations.

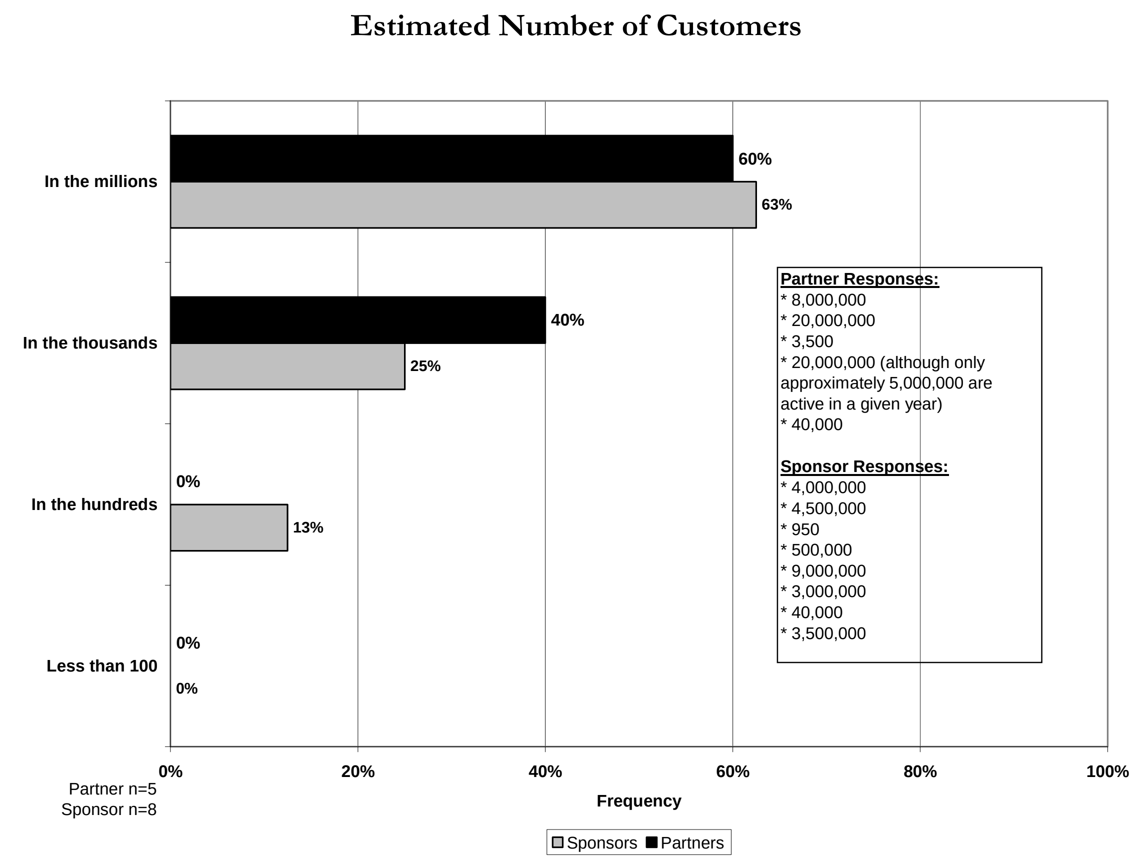

Figure 3.1

The advantages of capturing revenue and cost at the individual customer level are significant. First, it gives the organization the ability to roll up individual customers in many different ways and in many different segments. The second advantage is that segments don't have to be mutually exclusive, and the customer profitability history follows any roll up to segments, unlike top-down models that assign costs to specific segments. If the segments change, the model is invalid.

There are two primary enablers for capturing revenues and costs at the transaction level. The first is enabling technology, a best practice reviewed and discussed under Key Finding 9. The technologies needed to process, calculate, and store the data required to produce customer profitability at the individual customer level simply was not available 10 years ago. Best-practice partners now talk in terms of terabytes of data.

The other enabler is a unique identifier for an individual customer or a specific customer account. For example, for Zippo, it's the customer number; for NSCU, it's the member number; for Wachovia and FedEx, it's the account number, and for Marriott, it's the

Marriott Rewards customer number. This unique identifier provides the ability to drive revenues and costs to specific customers and specific customer accounts.

As illustrated in Figure 3.2, all best-practice partners and 83 percent of the sponsors capture costs at the individual customer level.

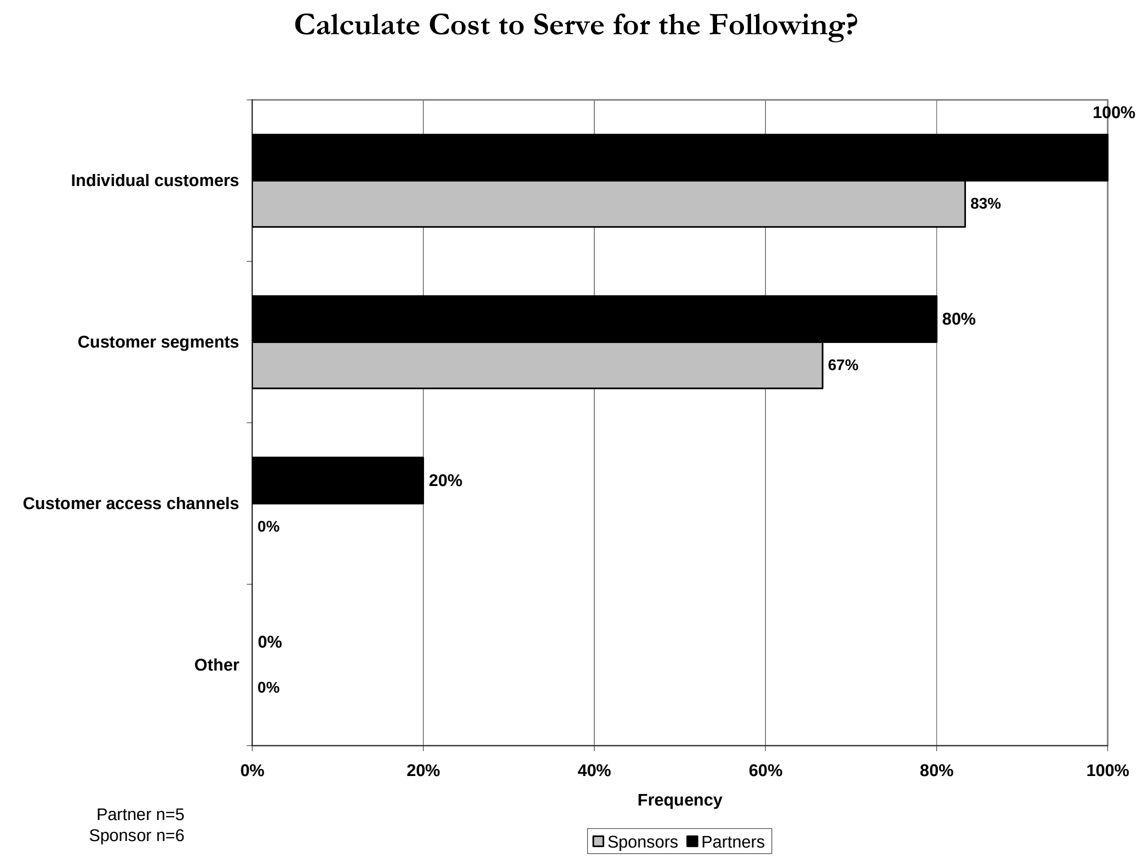

Figure 3.2

At **FedEx**, revenue and cost information is captured at the account level. As described in Chapter 2 (Figure 2.4, page 30), at the transactional level, FedEx looks at account numbers and aggregates them by location and then by entity. It uses outside data to create the enterprise view so it can focus on the right data and try to do the best matching with its account number to identify which company location will be assigned. The FedEx entity in these terms includes the Express and Ground services, and in the near future, it will include Freight as well.

NSCU segmentation information is leveraged to drive investment decisions, pricing, account management, and marketing strategies. NSCU has the ability to review costs and revenues on an individual member basis and transactional level and assign the individual customer to a particular segment. Each individual member has a customer information file (CIF) identifier based on the VisionWest banking system that enables the company to identify each individual member. Key information is updated daily so the company is able to obtain a data snapshot of all the products a member is using and how each relate to one another. Trending is reported on a monthly basis.

At **Wachovia**, wholesale segmentation is based on the same principles as consumer segmentation; the "atoms" are at the account level, and they can be formed into various types of molecules that can be used for making service or marketing decisions.

HOLISTIC VIEW OF CUSTOMER PROFITABILITY

Key Finding 7: Best-practice organizations take a holistic view of customer profitability and include lifetime value and customer valuation metrics in the calculation.

> *When you just consider customer profitability, that is really backwards-looking. It tells you where you have been but not where you are going.*
>
> —NSCU site visit representative.

It's one thing to calculate and report customer profitability on an historical and current basis. All of the best-practice organizations do that. It's quite another to project and forecast customer activity as a way to determine a more holistic customer valuation. Customer profitability is just one input to the larger consideration of "customer value" or "customer desirability" at the partner companies.

Gartner, for instance, describes a number of customer profitability metrics that organizations can use to feed into customer value considerations:

- accumulated value,
- current value,
- market value,
- potential value,
- future value, and
- lifetime value.

Other, less financial aspects of the value a customer can deliver to a business include educational value and network value.[8]

[8] Source: "Define the Value of Your Customer." Gartner Inc., October 29, 2004.

Four out of the five best-practice partners use some form of customer valuation in calculating customer profitability, even when looking at individual or segment profitability. **FedEx**, for example, uses potential-based valuation and segmentation first developed as a theoretical concept**.** Its key principle focuses on the holistic customer entity. FedEx believes that the "right" sales resource is determined by the potential revenue of the account. This also ensures that the call cycle leverages the right opportunities. The overriding goal of potential-based valuation and segmentation is to use performance (FedEx internal metrics), business potential (sales survey process), and firmo-graphic (Duns) data to arrive at potential customer value, as depicted in Figure 3.3.

Determining Potential Customer Value at FedEx

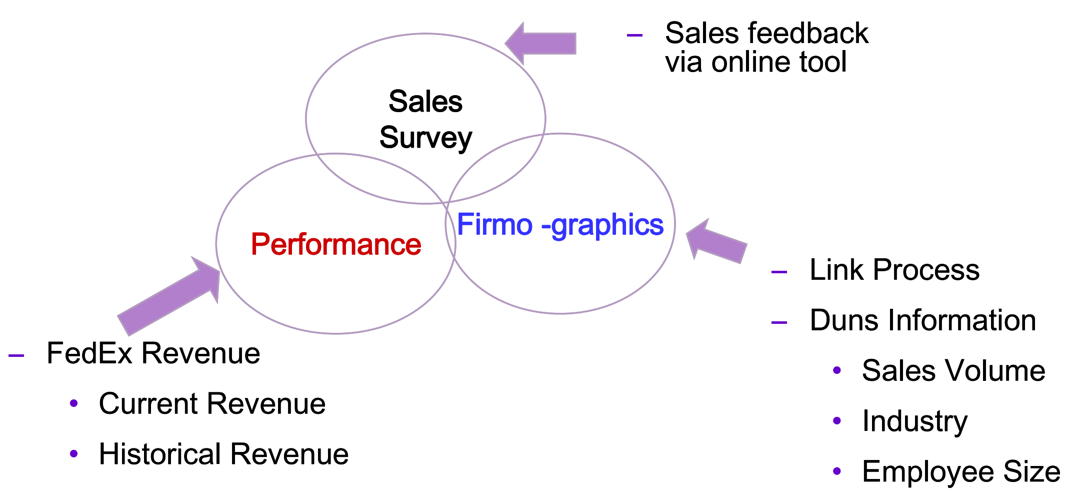

Figure 3.3

From FedEx transaction data, the company can determine what each customer spent with FedEx during each of the past several years. The peak revenue generated by the customer, calculated by comparing each of the years included in the analysis, becomes the starting point. This is generally considered to be the minimum potential for any given customer. The theory is that if they spent that much once, they have the potential to ship that much again.

The challenge then becomes determining whether a customer spends shipping dollars with another carrier and, if so, how much? This information would allow FedEx to calculate its market share, or share of wallet, with any given customer. To help determine the missing customer spend data, FedEx employs two techniques.

1. The first, and preferred technique, is by acquiring this directly from the sales force. While a salesperson is calling on customers, they naturally try to determine the net worth of the customer to FedEx and how much business is going to a competitor. In order to collect this data from sales, CMA built an interactive Web site that sales can

access to provide the information by answering a few basic questions. The survey process takes less than one minute to complete. To ensure data quality, CMA has developed several business rules around survey validation.
2. To further supplement the potential calculations, CMA has employed the use of customer models, whereby they use a combination of internal FedEx data and external data provided by Dun & Bradstreet to predict how much a customer might spend on transportation services (as described in Figure 3.3).

This methodology also works well for businesses that do not already have a relationship with FedEx. These businesses are known as "prospects."

NSCU is an example of an organization using multiple value measures in tandem. In the past, the company just considered the treasury view; now, the view of customer value is much broader: The company integrated Pivotal across 10 lines of business to score profitability on the full context of the relationship.[9]

NSCU recently implemented a new segmentation process based on "current value" (CV) and "potential value" (PV) of the member. These measures were created by combining the customer profitability and utilizing propensity models to calculate member potential value. Figure 3.4, page 47, outlines this process. NSCU understands that profitability is only indicative of present conditions, as it does not really provide any insight into future member value.

[9] Source: "Profits, One Customer at a Time." *CRM Magazine*. January 1, 2005.

Determining Potential Member Value at NSCU

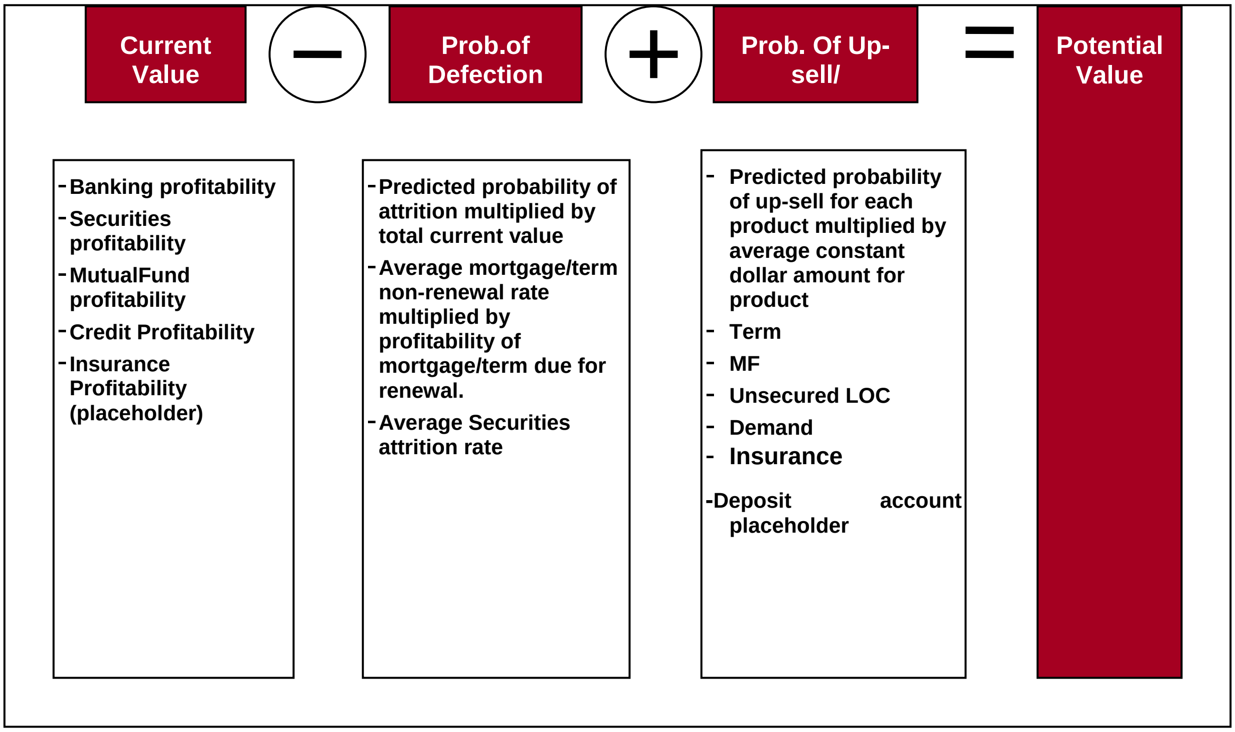

Figure 3.4

Wachovia realizes that customer lifetime value is an important measure, and it aspires to know and optimize it. However, it does not use it as an individual measure; front-line agents do not serve the customer with customer lifetime value in mind. Instead, the company focuses on optimizing the value and increasing the loyalty of the entire customer base. **Wachovia's** consumer segmentation scheme also accounts for potential. It not only looks at the customers who have the potential to be affluent, but it also looks at the customers who have more money in their wallets to invest with Wachovia.

Marriott uses the relative spending measure described earlier in the report to get a more holistic view of the customer. The data is gathered based on isolated members with one or two day stays at each hotel, assigning the daily spending by day. The relative spending calculation determines which days each member was in each hotel, creating a custom "average member spend" for each stay. Then a ratio is created of the member spend to the normalized average spend. Lastly, the data is normalized again for the length of the stay (up to seven days). Relative spending calculations enable Marriott to identify highest spending customers while ensuring a well-distributed portfolio in terms of brands and markets. Further, the company believes that frequency data only tells part of the story and relative spending provides a more well-rounded analysis.

Ideally, a holistic view of customer profitability includes estimating the profitability of prospects and potential leads. About 40 percent of study participant organizations estimate the profitability of prospects, as set forth in Figure 3.5, page 49.

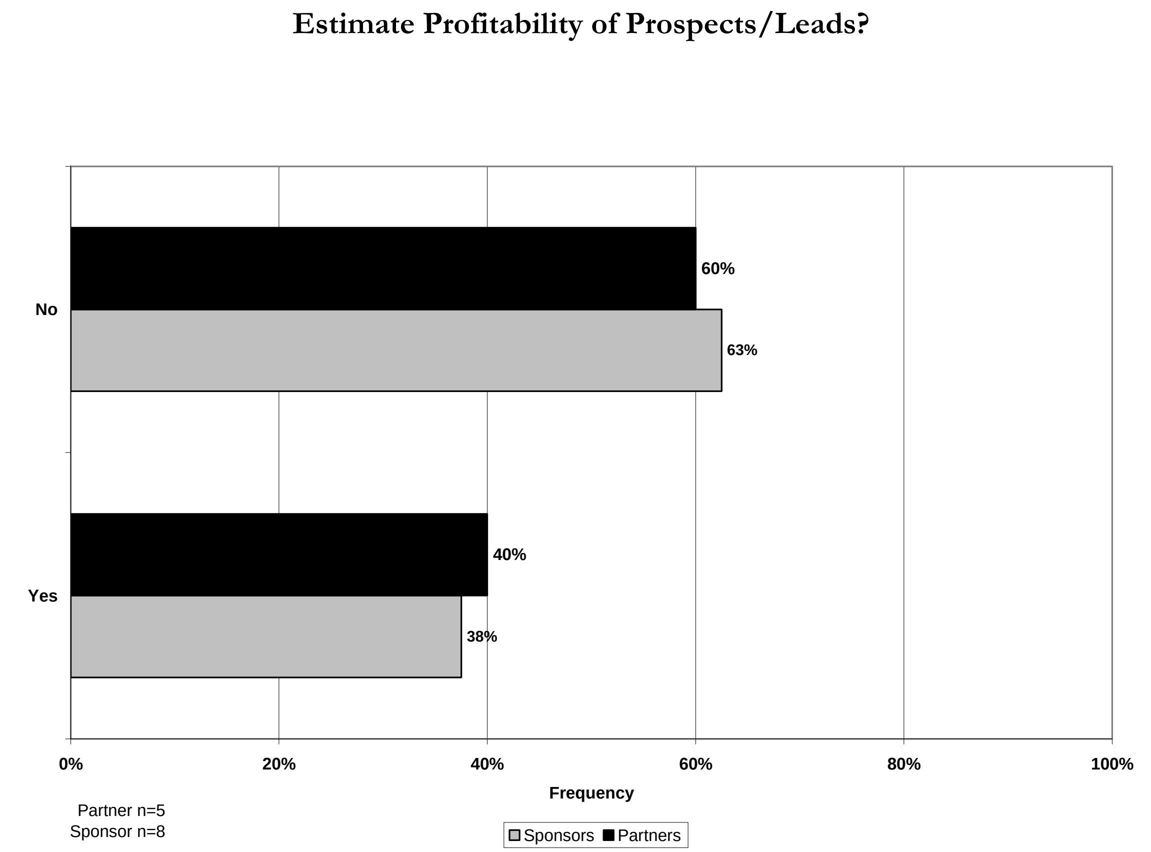

Figure 3.5

HANDLING INDIRECT COSTS

Key Finding 8: Best-practice organizations include the majority, but not all, of their costs in the customer profitability calculation. Best-practice organizations use appropriate methods for cost assignment.

While the goal is to get a "true profit" picture by customer, partners have not necessarily been able to successfully allocate all indirect costs to customers/segments (Figure 3.6, page 50). Handing indirect costs in the customer profitability calculation is an area in which every organization can improve. All of an organization's resources consumed in creating, designing, producing, delivering, supporting, selling, and marketing are ultimately attributable to customers. Most organizations would benefit from the application of Activity-Based Costing tracing methodologies and Activity-Based Management principles for indirect cost allocation and to identify activities, processes, cost drivers, and performance measures in conjunction with CRM systems.

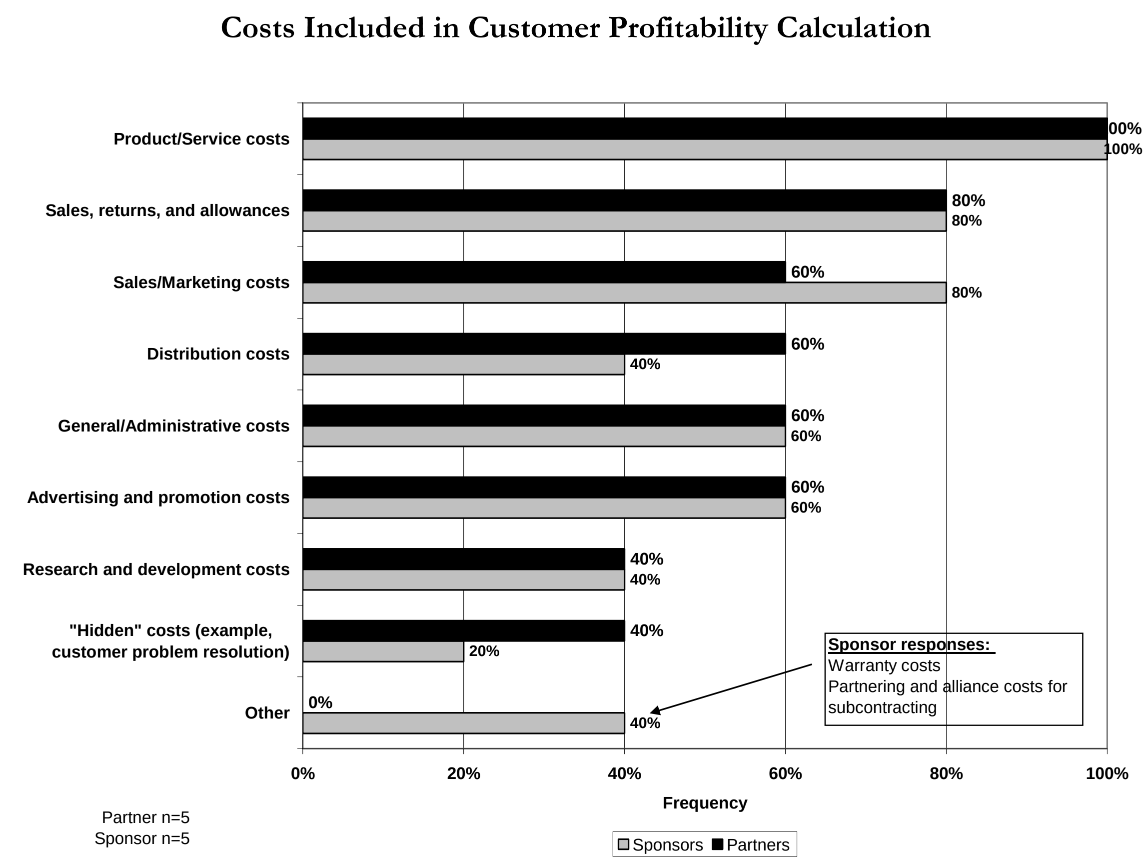

Figure 3.6

The following are some examples of costs *not* included in the customer profitability calculations at study best-practice partners.

- **FedEx**: Large capital equipment expenses are not included in customer profitability calculation.
- **NSCU**: The company only allocates direct customer expenses in customer profitability calculations.
- **Wachovia:** For policy reasons, a certain group of expenses are not included in customer profitability and valuation at Wachovia. The cost figures used are not the full cost of doing business. The rationale for the cut-off point in including expenses in the calculation of cost is a determination of how the business intends to use the data.

  Wachovia reported various challenges in reporting the full cost to serve customers, including the following.
  - Building agreement across organizational units as to consistent definitions of client relationship and profitability is difficult.
  - The application development capacity to build inputs to the COMPAS system is limited. For example, the company has had some estimates of the profit of the brokerage area, which is becoming more important to the company, but it did

not have the degree of input that the other businesses have. Input regarding the brokerage area is complex and requires a high level of information technology. Work has been completed in calculating the costs and account profitability of the majority of its business units. The remaining areas of the company are more complex, such as brokerage, and will need a relatively great number of resources to build input capability.

  - Mergers draw resources away from activities that lead to calculating, reporting, and using customer profitability. In mergers, accounts are integrated, and cost structures are different. At times the data from the acquired company does not line up with the Wachovia data.
  - Tracking and attributing costs to contacts and calls coming into the call centers is difficult. Currently, the cost of general contact is covered by a cost pool. Attributing them will take time and resources. For example, if a customer calls the bank, the cost can be captured and charged back or not. If a customer calls to ask about the location of the nearest branch, the call would be answered in a general pool and the cost would be considered "maintenance cost" and not allocated. If the customer needed more extensive help, he or she would give an account number, and the cost would be calculated from the account. A corollary problem is determining appropriate levels of disaggregation of cost and revenue information. If every call coming into the call center could be attributed, it may not be wise to do so. Accounting for every interaction would require the COMPAS platform to be three times what it is now.

- **Zippo**: Zippo does not include product development and research and development costs in customer profitability calculations.

COST ASSIGNMENT

As indicated at the beginning of this chapter, cost structures and costs differ significantly between industries. Methods of cost assignment differ between type of costs and cost structures. As would be expected, best-practice partners used a variety of methods for cost assignment, as summarized in Figure 3.7, page 52.

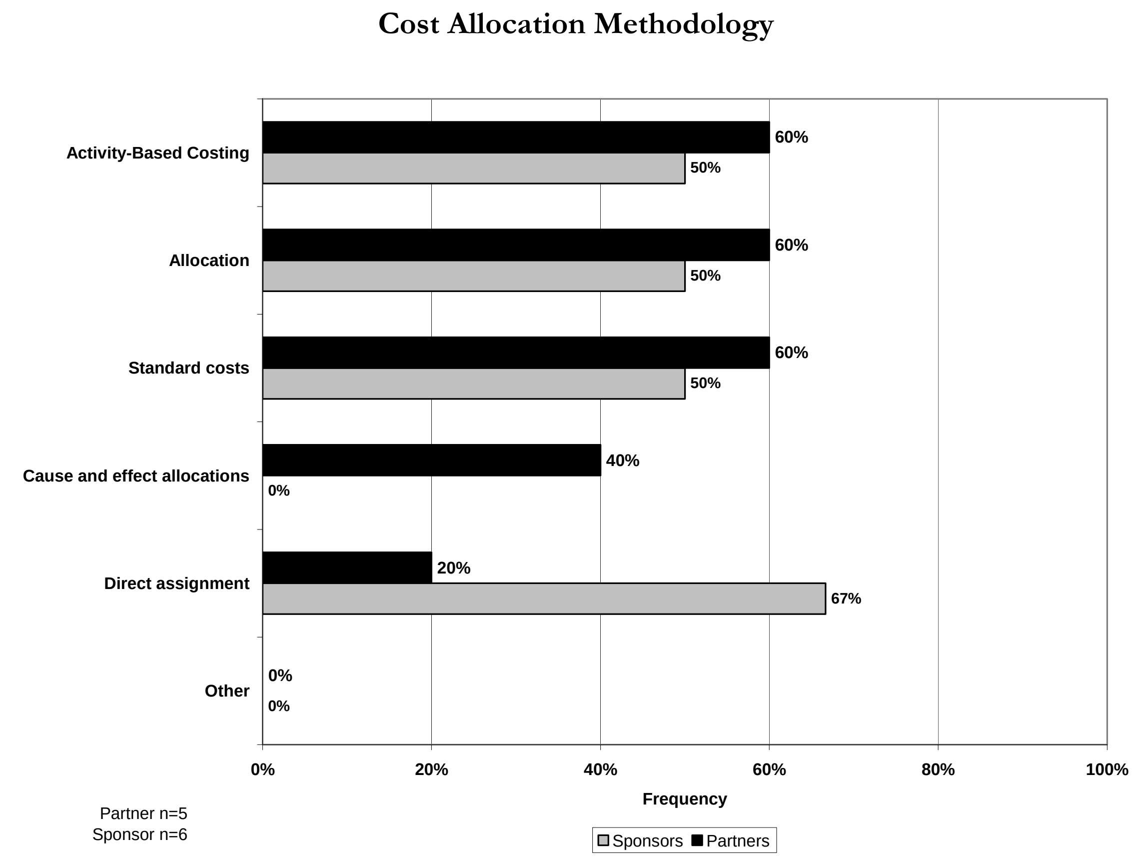

Figure 3.7

ENABLING TECHNOLOGIES

Key Finding 9: Best-practice partners all work closely with IT. Enabling technologies for calculating customer profitability include data warehousing, CRM systems, data mining, external databases, and predictive analytics.

As discussed at the beginning of this chapter, there are two primary enablers for capturing revenues and costs at the transaction level: enabling technology and a unique identifier for the individual customer. Enabling technologies cited in the site visits to the best-practice partners included data warehousing, CRM systems, data mining, and external databases. Marriott, for example, leverages external databases from companies like Acxiom who provide information on United States individuals, such as marital status, net worth, income, etc. In addition, companies like Acxiom create segment systems that categorize households on various demographic dimensions. Figure 3.8 (page 53) summarizes some of the enabling technologies listed by study participants to facilitate customer profitability calculation and reporting.

Vendors of Enabling Technologies for Customer Profitability Calculation and Reporting

Process	Partners	Sponsors
Enterprise resource planning (ERP)	Epicor - Dataflo	SAP, Oracle 11i, Oracle
Customer segmentation	In-house calculation using SAS, Angoss	Internal marketing databases via business objects,BCG/BVA, SAS, Path and Copernicus
Revenue accounting		Oracle 11i, SAS
Cost assignment	In-house.	No vendor, SAP, SAS
Profitability calculation	Oracle,Data warehouse (SQL server and Crystal Reports), In-house calculation using SAS, SQL Server 2000	No vendor, Peppers & Rogers Group (PRG), SAS
Profitability reporting requirements and reports	Data warehouse (SQL server and Crystal Reports), Crystal reports	SAS
Customer interaction		No vendor, SAS
Customer relationship management	IBM/Informix data warehouse, Pivotal	SAS
Predictive analytics modeling	SAS eMiner, SAS, In-house calculation using SAS, Angoss	No vendor, SAS Enterprise Miner, SAS, SAS
Marketing		Data mining, aggregation, and modeling - Harte Hanks, SAS
Other	BAE - Fast Track	

Partner n=5, Sponsor n=8

Figure 3.8

CMA at **FedEx Services**, for example, works very closely with the IT organization to leverage leading technology. Most of the analysts are equally adept in analytics and marketing. This presents a challenge when recruiting from universities because, while the organization is interested primarily in marketing students, it must find candidates that have strong technical skills as well.

> *We will leverage leading-edge technology to deliver this in a fast cycle, innovative, accurate, and objective fashion. We will accomplish the above mission by attracting and retaining a diverse workforce with world-class talent and by maintaining the finest environment for individual professional learning and growth.*
>
> —CMA Mission Statement

Five separate systems are linked and integrated via a warehousing system at **NSCU**. The data is obtained at a granular level, and the company then has the ability to allocate costs at different levels and analyze accordingly.

The company leverages technology to identify profitability from various products. NSCU states that from a process engine environment, CRM, warehousing, information center environment (ICE), and content engine are the key engines used for calculating customer profitability. The CRM engine is Pivotal, and the other product engines are purchased or offered via service provider models. The company uses an FTP engine starting with the funds transfer pricing system gathering information account by account and transaction by transaction, and FTP allocations. This gets rolled up with the FTP component, resulting in a view of the spread over the cost of money. Next, transactional costs and revenues are analyzed that provide actual net income for each member. With this technology, the company is able to know with a specific level of certainty and on a relative basis which member is earning the company more and hence is more valuable. A key element of effectively leveraging technology for NSCU is the relationship marketing has with ITS. The ITS group has a very in-depth understanding of corporate strategy resulting in the two groups working together toward a common goal.

Wachovia uses two third-party vendors for information regarding the potential of the customers. Their information, which covers all 10 million households and concerns deposits and investments, is brought into the data warehouse environment. The bank pulls all of this information in to understand its share of wallet. Additionally, Wachovia takes the protection of sensitive information very seriously. As such, Wachovia has comprehensive policies, procedures, and systems in place to protect customer information.

At **Zippo**, FastTrack ABM is used to develop the cost objects that make up all the overhead. The ERP system determines the standard material and labor costs and then applies the calculated overhead. A Web interface is linked to the SQL server database, which uses Crystal reports to present the data in the form of product and customer profitability reports. In effect, Zippo leverages three technologies to enable it to calculate costs and profitability:

1. Epicor-Dataflo—ERP package,
2. SQL Server and Crystal reports—data warehouse, and
3. BAE Fast Track—ABC.

Prelude to Chapter 4

Once customer profitability has been calculated, the next area of interest for the study was understanding how (and to whom) best-practice organizations report this information (Chapter 4) and, finally, how this information is made actionable and used in business strategy and to grow the business (Chapter 5).

Chapter 4: Reporting Customer Profitability

Chapter 4 addresses how (and to whom) study participants communicate customer and segment profitability information to the organization via reports, reporting capability, the Web, and access to information contained in databases. The reporting of customer profitability/value information, combined with accountability and performance measurement for customer profitability, is a key driver of action and change at best-practice organizations. Accordingly, appropriate reporting is an integral part of the success of any customer profitability initiative.

Overview of Customer Profitability Reporting at Best-Practice Partners

To preface this chapter, the following paragraphs overview customer profitability reporting practices described by the five study best-practice partners.

Zippo

Zippo defines its customer as the retailer or the distributor/wholesaler that purchases their product for resale, not the end consumer of the product. The profitability of each of their 3,500 customer accounts is reported on a quarterly basis using a standard formatted report that includes revenues and product cost by individual product line, product-related costs (licensing fees, arts, graphics, etc.), cost-to-serve (defined as selling and marketing expenses), and general and administrative costs. Key operating statistics like units sold, average selling prices, product margins, and operating margins are reported on this same standard formatted report. Individual customer accounts, rolled into segments, are reported in the same standard format. An example of the basic, standard report generated from the company's enterprise resource planning system for each customer/customer segment at Zippo is illustrated in Figure 4.1, page 56. This sample report is for a sales region and comprises a number of individual customers.

Sample Zippo Customer Profit and Loss Statement

Sales Region: Sample

For Sales from January 2003 through December 2003

Profit and Loss Statement

Sales	Units	$$$ Sales
- Regular Lighter Sales	2,500,000	20,000,000
- Slim Lighter Sales	250,000	2,000,000
- MPL Sales	15,000	85,000
- Fuel Sales	250,000	4,700,000
- Promo Product Sales	200	1,000
- Display Sales	2,000	15,000
- Promotional Material Sales	20,000	1,000
- All Other Sales	375,000	1,200,000
Net Sales	**3,412,200**	**28,002,000**
Product Cost		
- Regular Lighter Costs		15,000,000
- Slim Lighter Costs		1,700,000
- MPL Costs		100,000
- Fuel Costs		4,000,000
- Promo Product Costs		700
- Display Costs		350,000
- Promotional Material Costs		100,000
- Other Costs		900,000
Total Product Cost		**22,150,700**
Gross Profit		**5,851,300**

Product-Related SG&A	
- Manufacturing IT Support	250,000
- Purchasing Support	125,000
- Human Resources Support	213,000
- Licensing	270,000
- Arts & Graphics	150,000
- Legal	340,000
Total Product-Related SG&A	**1,348,000**
Cost to Serve	
- Selling	1,500,000
- Marketing	2,100,000
- Other	75,000
Total Cost to Serve	**3,675,000**
General & Administrative Expense Allocation	
- SG&A Executive OH	400,000
- SG&A Financial OH	500,000
- SG&A General OH	325,000
- SG&A IT OH	125,000
Total General & Administrative Expenses	**1,350,000**
Total Operating Expenses	**6,373,000**
Operating Income	**(521,700)**

Key Operating Statistics

Units Sold	**3,412,200**	**Gross Margin**	**20.9 %**	**Operating Margin**	**(1.9 %)**
Average Sales Price (Lighters)	**8.00**	**Product SG&A/Sales**	**4.8 %**	**Operating Income per unit**	**(0.15)**
Average Sales Price (Non-Lighters)	**9.06**	**Cost to Serve/Sales**	**13.1 %**		
MCA-R-Z17 - Processed 07-14-2004 10:49am		**G&A/Sales**	**4.8 %**	*Proprietary and Confidential to Zippo Manufacturing Co.*	

Confidential - Property of Zippo Mfg

Figure 4.1

In addition to the standard formatted reports for individual customers and customer segments, Zippo also reports the top 25 customers (for focus) and the bottom 50 customers (for improvement purposes).

The next step for Zippo is to introduce additional customer profitability metrics for each individual customer. Almost all of the additional metrics are intended to report trend information such as sales trends and backlog and operational information like number of returns, average sales per order, and number of quick ships. An example of the customer trends and measures report is depicted in Figure 4.2, page 57.

Customer Profitability Metrics Reported at Zippo

Trends and Measures

Sales Trend (Current Q v same Q last year)	2%
Backlog $'s	$87,000
$ of Returns	$3,500
$ Amount 60+ Days Receivable	$40,000
# of Special Orders	5
# of Quick Ships	16
Average # of line items per order	3
Average $ per order	$2,600
Order Frequency/Wk	1
On-time delivery rate	96%
Order Fill rate	92%

Figure 4.2

North Shore Credit Union

All employees at North Shore Credit Union have access to the company's CRM system, which reports profitability for each of their 40,000 members. An example of a CRM screen shot with detailed information on member profitability can be found in NSCU's associated site visit summary. The screen shot of each member provides product mix as well as transaction information. Reports are easily accessible and easy-to-understand. A member of the marketing team reports segmentation information that quantifies member value to the executive team and the account management team to assign portfolios. Reports are provided to other stakeholders reactively on an "as-needed" basis.

The company uses Microsoft's SQL Server for financial warehousing and Crystal Reports enterprise level for reporting. Reporting directories provide a large number of reports based on selected criteria. The reports have security permissions built in so that there is some control associated with the reporting of the profitability information.

FedEx

CMA makes the relative customer value scores available on a limited basis within the organization's database structure. This information is also reported and included in an online sales application to help screen customers' eligibility for special programs.

Wachovia

Quarterly, CART produces corporate metrics for the highest levels of management to provide some consistent views of each client segment: retail, small business, business banking, commercial, and wealth. These reports focus on customer life cycle. For the next level of management, CART produces quarterly segment metric reports. Finally, and most importantly, CART produces profitability analysis reports specifically for strategic decision support. Reports are generated from an integrated platform in which the customer top-level data builds into product profitability and the same data supports business segment profitability. Reports are distributed approximately two weeks after each month ends.

Marriott

Marriott's customer profitability information is disseminated to marketing and customer service resources through customer contact systems. Customer profitability information is used to differentiate service levels between segments to target marketing and sales efforts, design new products, and to set strategy. The company's communication of customer profitability is not yet a routine aspect of Marriott's business practices. This condition will likely change in the 2006/2007 time frame.

DISSEMINATION OF CUSTOMER PROFITABILITY INFORMATION

Key Finding 10: At best-practice organizations, customer profitability information is used as an input in many areas.

As illustrated by Figure 4.3, page 59, best-practice organizations make pertinent customer profitability information available to those who need it, specifically marketing, sales, customer service, and product/service managers. In terms of sponsor responses in Figure 4.3, they may be partially explained by the fact that several of the study sponsors' customer profitability initiatives are new or in the planning stages, so details of what and to whom will be reported have not yet been finalized. The areas in which customer profitability is used an input at the best-practice partner organizations is also addressed in Chapter 5.

Employees Receiving Customer Profitability Information

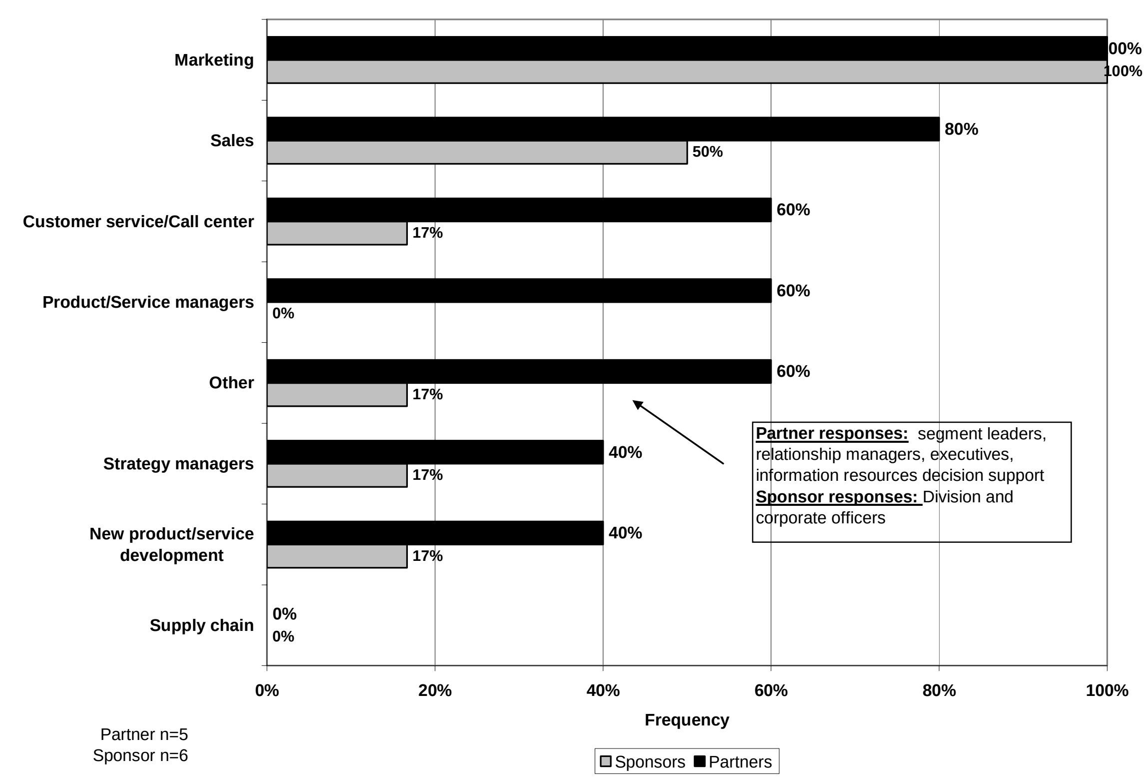

Figure 4.3

For example, at **FedEx**, enterprise segmentation is actionable and easily accessible to sales for information. It is also accurate and relevant for both sales and marketing. FedEx's online sales support tool provides sales access to all pertinent information on customers and their interactions at FedEx stores. When a sales person clicks on a customer, he/she is able to see what the customer's shipping habits have been, where they ship to, what other parts of Fed-Ex they are working with, and so on. The sales person can also view different programs in place for each customer, along with industry-based programs. The sales team is able to use this tool to discern customers' needs and make appropriate needs-based sales calls. The online tool also includes industry descriptions for customers: Sales can click on a link, and it will take them to a page that details the industry set-up and a description of the customer supply chain, along with "tips" on how to sell to that customer. The tool is personalized by salesperson and helps sales track their scheduled sales calls and leads as well.

At **NSCU**, all employees have access to the company's CRM system. Reports are prepared to show the detailed profitability for the different lines of business (LOBs) at an individual level. Other reports are prepared for detailed information on member profitability, including product mix and transaction information. Reports are easily accessible and also easy to understand. Reports are also available and provided to other stakeholders on an "as-needed" basis reactively. Employees are able to "pull" any report they want as long as they have the permission to view that specific information; it is a self-service system.

> *Special attention must be given to craft the customer profitability message in a way that each organization is able to identify the significance of it (what's in it for them).*
>
> —Marriott site visit representative

A key aspect of Key Finding 10 is how the customer profitability and segmentation information is disseminated by best-practice organizations in order to make it understandable and actionable: Study best-practice partners distill only the most critical information that various groups need to see so that they can deepen customer relationships and engagement. The two financial services partners provide good examples of this: **NSCU** has converted profit per member dollar amount to a "profit score" and reports this score to applicable staff via the CRM system. The score ranges from one to 20, with 20 being highest profitability, one being the lowest, and 10 being breakeven. NSCU admits that it still has some work to do in terms of improving communications for sales staff on how to interpret the profitability score of its members. For 2006, the company will be revising the profit measure reported to staff on the CRM system to include the combined profitability and segmentation value measure of each member. Business rules will also be derived from this information and delivered via CRM to provide staff differentiated offers for members.

One of **Wachovia's** key lessons learned in customer profitability reporting is that concepts should be simplified when they are presented to the front line. To that end, the company has determined that the most loyal customers are those that are transactors ("Ts"), savers/investor ("Ss"), and borrowers ("Bs"). Any financial service representative knows when interacting with a customer whether he or she is a "T," "S," or "B" and knows the plan to move him/her to the next level. Everyone in the company speaks the language of this segmentation; upper management often refers to this "sweet spot" (e.g., the intersection of T, S, and B).

Key Finding 11: Best-practice organizations emphasize intelligence (e.g., decision support), not routine reporting, in customer profitability information dissemination.

> *A key attribute of today's successful decision maker is that they do not sit and wait for an analyst's report to tell them what has happened. Instead, they are sophisticated knowledge workers who know how to use technology proactively to get the information they need, whether it is surfacing patterns through data mining, or running other real-time analytics to get the information they need.*
> —Sponsor representative

The "Calculating and Reporting Customer Profitability" study found that best-practice partners do not produce reams of reports detailing customer profitability for reporting's sake, rather, the emphasis is on providing decision support and information on an as-needed basis to those individuals who need the information most. Figure 4.4, page 62, illustrates the mechanisms for disseminating customer profitability information at study participant organizations. Note the lack of use on behalf of partners of formal "customer profitability reports" as a mechanism to disseminate customer profitability information en masse. In general, best-practice partners discussed at their site visits how they very carefully disseminate actionable information to the masses and how they partner with business units/lines of business to provide them the right level of information when they need it.

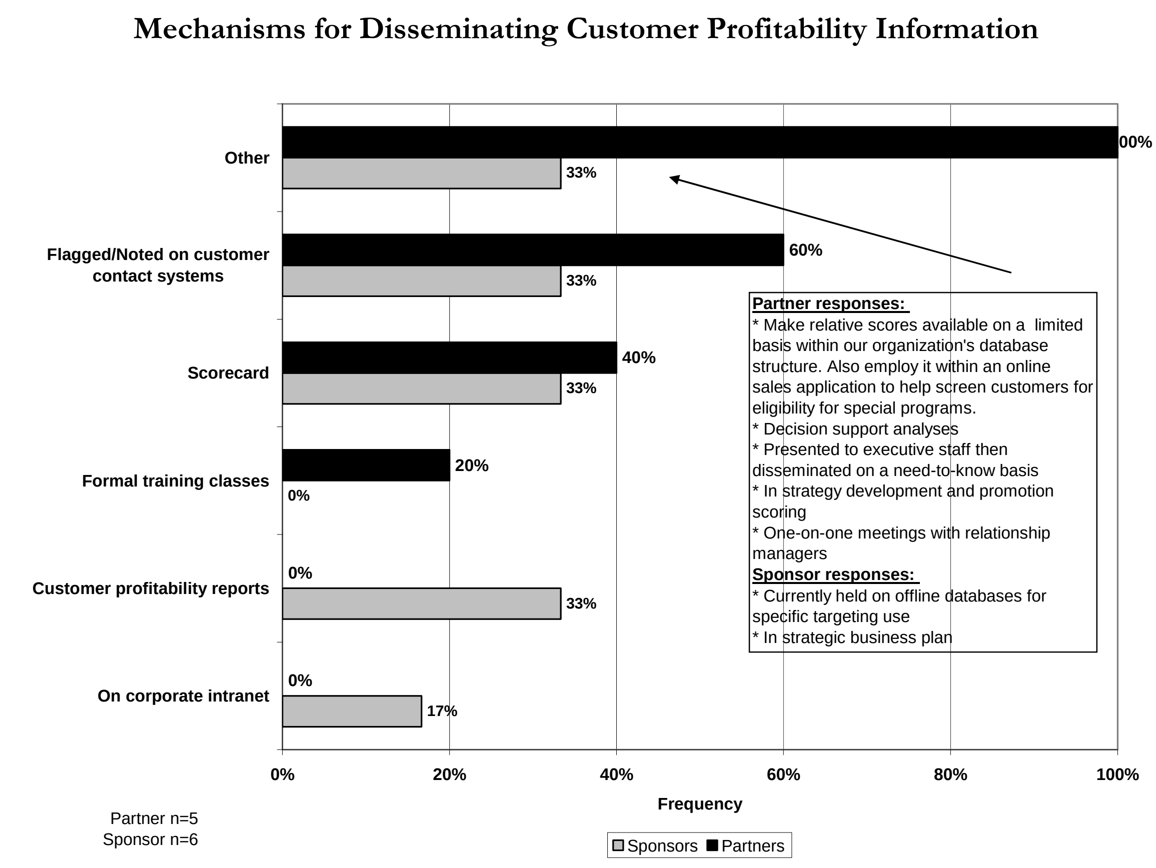

Figure 4.4

For example, **Wachovia** does not generate reams of reports on segment profitability. Customer profitability information is "intelligence" rather than "reporting." The information is held in a repository; some people want to look at the consistent views on a quarterly summary level. Most access is controlled by decision support need—the information that teams need to make decisions.

NSCU provides member profitability information to management for decision support purposes via internal online systems using Crystal Reports. Pertinent member profitability and segmentation information is communicated to relationship managers on a one-on-one basis in the form of personal demographic reports for their books of business (a set book of 400 members that each relationship manager is required to maintain and grow). The information helps the relationship managers understand what the profitability profile of their member set looks like, who would be better targets than others for different initiatives, and perhaps who may best be transitioned out of the account-managed process because of their profitability or other factors that point to an unwillingness to engage in a relationship with NSCU.

PRELUDE TO CHAPTER 5

The first four chapters of the "Calculating and Reporting Customer Profitability" report have summarized how best-practice partners are organized to calculate customer profitability, how they define and segment customers, the methodologies that they use to calculate customer profitability, and finally how this information is reported and communicated to those in the organization who need it to make more effective business decisions. The next and final chapter of this study report—Chapter 5—summarizes how best-practice organizations use customer profitability information both strategically and tactically to grow the business.

CHAPTER 5: PUTTING CUSTOMER PROFITABILITY INTO ACTION

Only when people take action and make decisions based on the knowledge and information gained from calculating and reporting customer profitability can the efforts be declared successful and impactful. Absence of action or the decision to make changes and improvements produces no value to the organization. The purpose of Chapter 5 is to answer the question "How do best-practice organizations use customer profitability information?", including how employees are held accountable for customer profitability; how this information is made actionable in sales, pricing, and marketing strategy; how best-practice organizations handle customers deemed to be "unprofitable;" and finally, what has been the return on investment (if they have been able to calculate a formal ROI) from customer profitability initiatives.

THE IMPORTANCE OF SECURING BUY-IN FROM KEY STAKEHOLDERS

Key Finding 12: Best-practice organizations secure buy-in from the users and upper-level support for customer profitability initiatives.

One of the key critical success factors cited across the board—from both sponsors and study best-practice partners—was the importance of securing buy-in from key stakeholders for customer profitability efforts and ensuring their confidence in the inputs into and the outputs resulting from the effort. Figure 5.1, page 65, summarizes overall challenges and lessons learned in calculating and reporting customer profitability reported by study best-practice partners—note that securing the buy-in of executives and other critical stakeholders is a key theme.

Lessons Learned and Challenges in Customer Profitability Calculation and Reporting Cited by Study Best-practice Partners

Lessons Learned	Critical Success Factors
Various organizations have different views on what makes a customer valuable - it is a very subjective measure	Getting active participation on the front end from each organization involved
Gathering the necessary data to create a customer value model is a very large task	Getting sales' buy-in to the process and results
Communicating the results of such a model is tricky	Communication of what customer value is and isn't is critical to gaining acceptance and ensuring proper usage throughout the organization
Importance of the breadth of relationship in driving profitability; multiplicative impact on profit ("sweet spot")	Single view of the client relationship across the organization
Simplify concepts and align with the front line	Senior level champions of a customer-centric approach and information-driven decision making
Need for continual learning/evolution; cultural change required to accept test/control and willingness to experiment	Granular data enabling aggregation into relationship views that align with organization and product views
Keep models simple.	Executive buy-in and support
Need appropriate reconciliation tools	Timely/accurate reporting of profitability
Realized value and potential value are two very different things	An ability to put the right data together from people and departments which are in a position to know the right answer
Purchase frequency and/or quantity can be misleading in some cases as an indicator of customer value	Focusing on solutions, which, though not perfect, are useful and cost effective
Future customer behavior at the individual level is relatively hard to predict, but at the segment level is relatively easy to predict	NR
Make every employee aware of what the profit measure means and how it should (or should not) be used when making relationship decisions about the member	Employee training on using profit information
Make sure all inputs to the profit score are accurate. Try to eliminate the need for human input for reporting and calculation.	Automated data collection and regular data warehousing.
Make the profit measure scaleable from corporate profit sheet to branches.	NR

NR= No Response

Figure 5.1

For example, **FedEx** believes that the key to successfully integrating differing opinions of what makes a customer valuable is to secure active participation from each stakeholder on the front end. Clear communication on customer value (what does and does not make a customer valuable to the organization) is critical to gaining acceptance and ensuring proper usage of segmentation information throughout the organization, as is obtaining the buy-in of the sales organization to the process and the results.

To that end, FedEx created a survey to generate consensus of what makes a customer valuable. In the survey, 50 customers in each segment were identified solely by their performance in the chosen metrics—no other identifying information was provided. Two participants each from the sales team, the U.S. marketing group, CMA, finance, and accounting were asked to rank the value (high, medium, or low) of the 50 customers based on the information given. Through this process, key departments were able to express what they valued most in their customers. In this way, FedEx was able to leverage the input of its stakeholders to create and refine its customer valuation model.

In another example of obtaining key stakeholder buy-in, **Wachovia** first developed the business rules for segmentation and calculating customer profitability, then hosted enterprise-wide meetings to solicit feedback from stakeholders. It asked questions such as "What rules do you use now?" and "What types of infrastructure do you use to support the rules?" Now that the rules are developed, the team "keeps its ear to the ground" to ensure the rules continue to be effective.

Key Finding 13: Best-practice organizations hold employees accountable for customer profitability.

While most study participants do not tie customer profitability to employee performance objectives (Figure 5.2, page 67), buy-in for customer profitability initiatives is reinforced at three out of five best-practice organizations by directly tying customer profitability to employee compensation (Figure 5.3, page 68).

> *[Customer profitability] drives our world. I think our profitability system and CRM have combined to be the two most valuable tools organizationally. As we evolved into this organization that believes in mutually beneficial relationships, the profitability system has become absolutely critical. It drives our pricing decisions right down to the retail level; it is a measurement system for branch performance so they understand how well they are doing based on the profitability modeling that has been done, so it has helped us create an accountability framework. It has helped us to drive behaviors right down to the individual level.*
>
> —NSCU site visit representative

Customer Profitability Tied to Employee Performance Objectives at the Following Levels

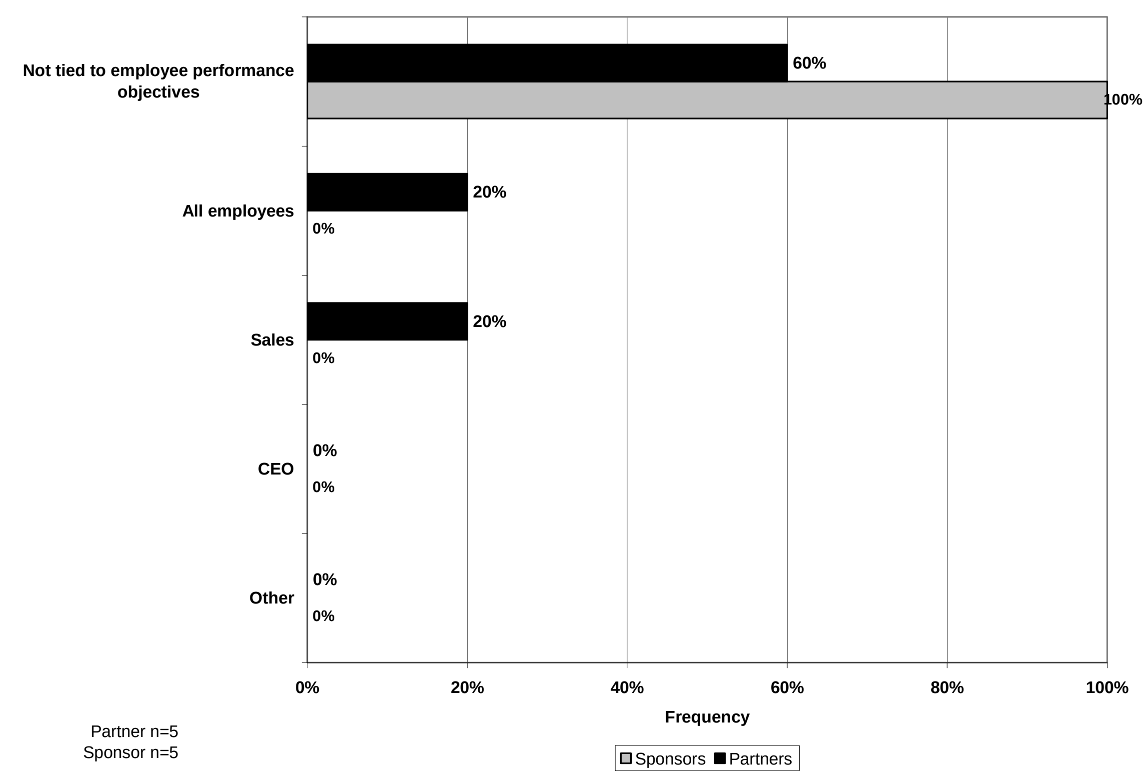

Figure 5.2

At **North Shore Credit Union**, for example, portfolio profitability is one of the key drivers of compensation for the company's account management group. The company looks at how account managers are growing their portfolios and uses growth as one of several measures to calculate bonus compensation to those account managers that meet or exceed target growth levels. The account managers have performance standards around relationship management, and they use a member advocacy index to understand their assigned customer base.

In addition, NSCU engaged a human capital expert in Ontario who will be creating a causal model to uncover specific relationships between the company's human capital capabilities and its financial outcomes. The company administers extensive employee engagement surveys because it believes that engaged employees are productive, innovative contributors and are therefore critical to the company achieving its goals. The study will analyze the raw data from employee engagement surveys and other human capital metrics such as turnover and combine it with the company's financial results. The result will be a relational model that will enable the company to understand how the company's human capital impacts profitability.

Customer Profitability Tied to Employee Compensation at the Following Levels

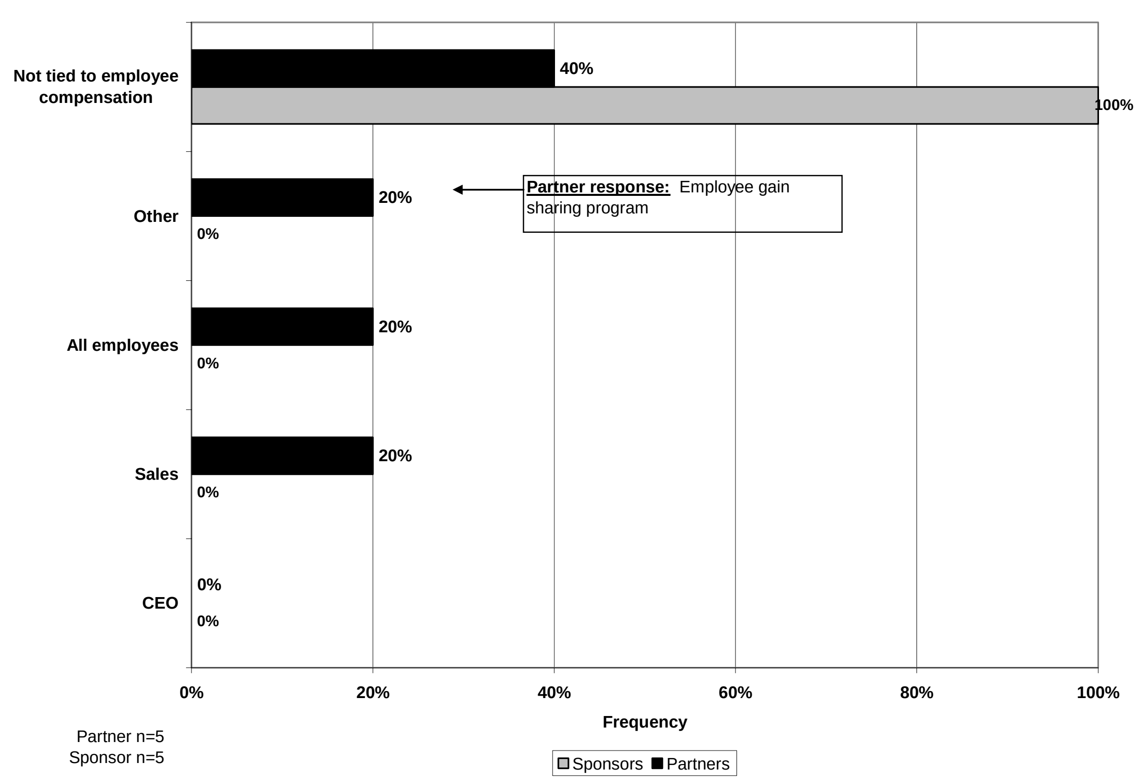

Figure 5.3

DEPLOYMENT OF CUSTOMER PROFITABILITY INFORMATION INTO STRATEGY AND TACTICS

Key Finding 14: Best-practice organizations use customer profitability and segmentation to appropriately align sales and marketing resources.

As alluded to in Chapter 4, not only do best-practice organizations appropriately distribute the "right" customer profitability information to the "right" people, but they also use it as an input in a variety of areas/functions, such as marketing, sales, and customer loyalty analysis (Figure 5.4). Almost all study participants responded that they incorporate customer segmentation research into business strategy. Following are some examples of how study partners put customer segmentation and profitability information into action.

> *[Measuring and acting on the profitability of each individual customer is] the top of the playbook in terms of CRM strategies to understand customer profitability and segmenting, using that to drive the behavior of sales and marketing.*
>
> —Vice president, CRM product marketing, Oracle (Source: "Profits, One Customer at a Time." *CRM Magazine.* January 1, 2005.)

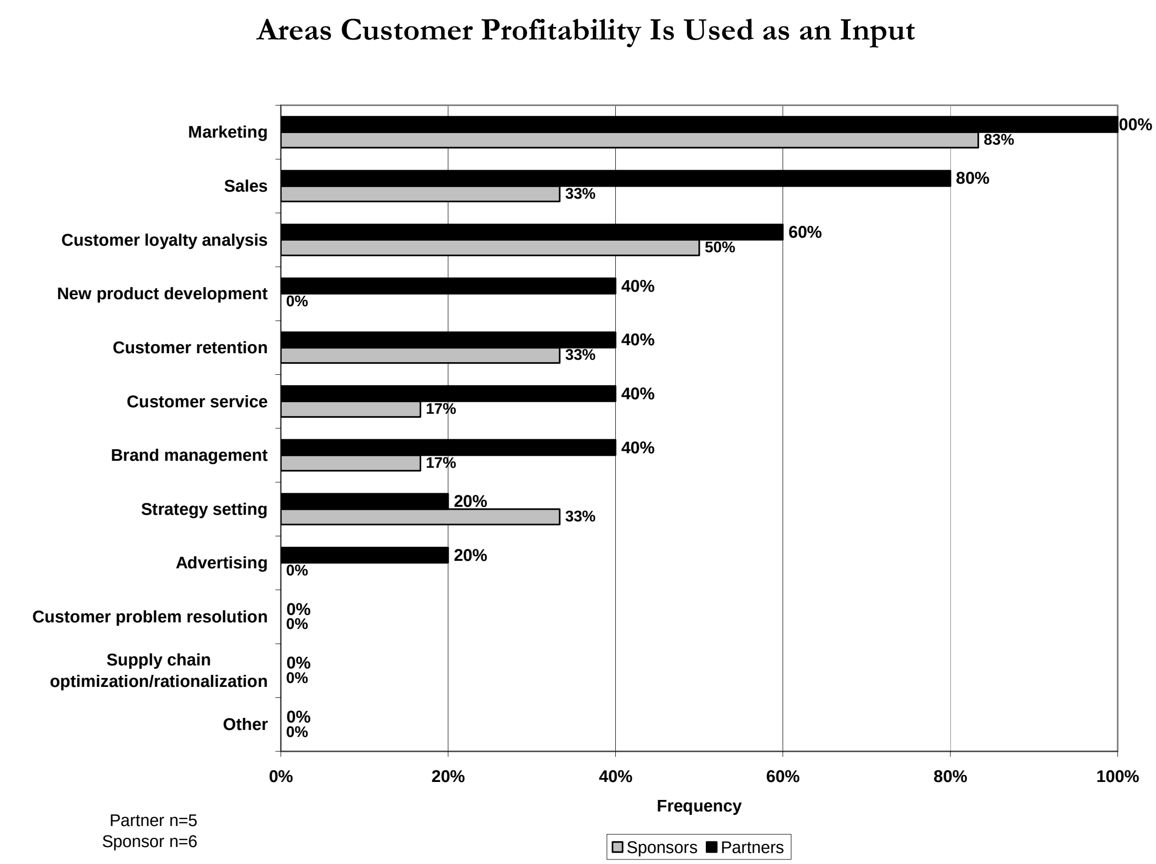

Figure 5.4

FedEx's enterprise segmentation has impacted sales, marketing, pricing strategies, and other areas. For example, in terms of sales, it has made compensation consistent for the sales team. It also allows the sales team to better focus their sales efforts. FedEx's segmentation is fairly easily defined and communicated and is a basic business tool used worldwide. The sales force can focus on selling instead of handling administrative issues.

From a marketing standpoint, FedEx uses enterprise segmentation to focus communication on the most appropriate customers. Segmentation also assists with goal setting and stabilizing the customer base within a territory. When FedEx implemented enterprise segmentation it realized that constantly changing account owners through the years can cloud sales efforts to customers. One of the business rules that it added was not to change the owner of an account for certain time period so that customers get to know their account managers.

From a pricing perspective, pricing has integrated enterprise segmentation into many of its models for specialized pricing. Enterprise segmentation offers more leeway in pricing to customers based on their customer values. Figure 5.5 summarizes the various impacts of enterprise segmentation at FedEx.

Impacts of Enterprise Segmentation at FedEx

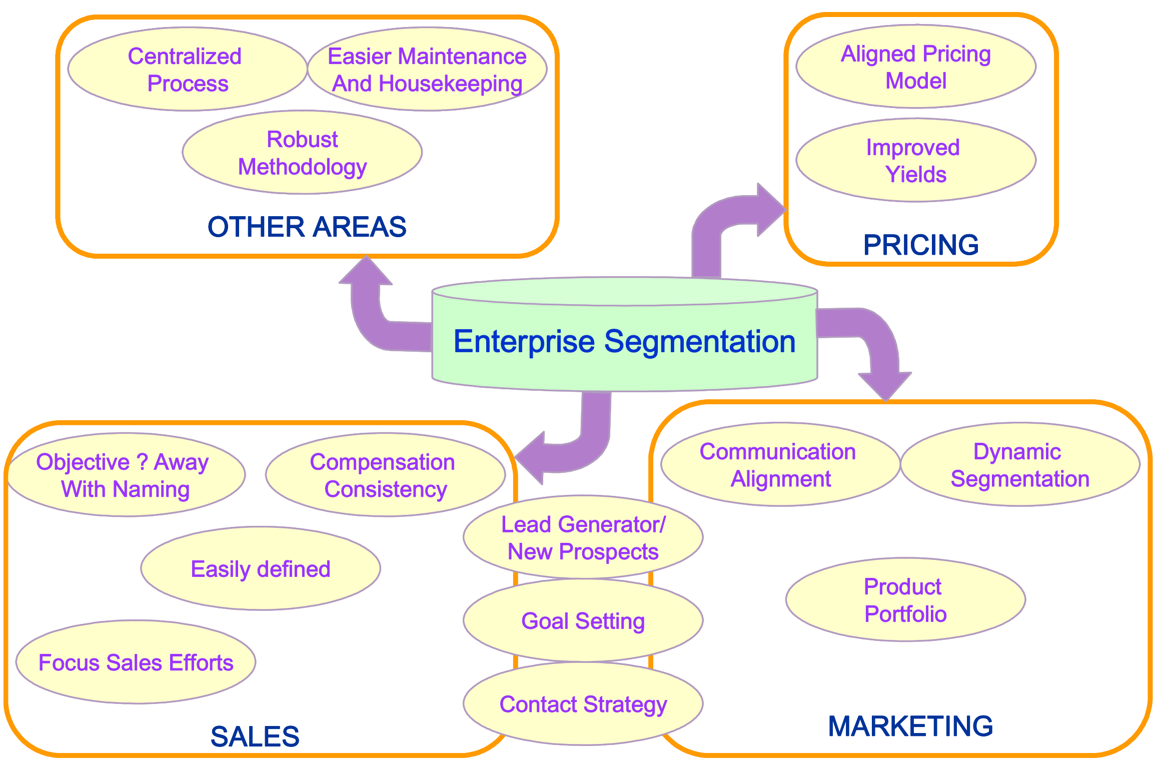

Figure 5.5

In another example, customer profitability information drives the strategy and operations of **NSCU**. The company cites that both the CRM system and customer profitability information are the two most valuable tools the company leverages. The customer profitability information drives pricing decisions down to the retail level; it drives sourcing decisions down to the staff level at the retail branch, and it is a measurement system for branch performance, as it enables the branch to understand how well the organization is doing based on profitability modeling.

Further, the customer profitability information has enabled NSCU to drive behaviors down to the individual level. For example, a retail profitability report is created at the branch level that includes profitability margins and controllable expenses that consequently drives behavior. Hence, the branch manager is able to view branch profitability, and the individual account manager is looking at individual client profitability and making changes at that level to drive branch profitability, so the accountability framework flows down to the account manager level. The performance targets are the profitability measures; they are not exclusive but provide a balanced approach with leading and lagging indicators.

In 2004, NSCU implemented a new segmentation process that included customer profitability as one of its components and utilized propensity models to calculate member profitability scores. An application for segmentation information is in formulating campaign strategies. The company is able to review its member base and apply propensity models and income estimators to generate a target base for the campaigns. Segmentation results are also used to select members that should be assigned to a portfolio overseen by a personal account manager to be sure that the members that have the greatest current and potential value are given the attention they require to maintain and grow their business with the company.

Using the book of business technique, management at **Wachovia** assigns a “book” of selected customer portfolios to a team of front-line and call center employees. The idea is to allow the employees to increase the deposits and the retention of those in the book because they are clients that the company would like to keep and grow. The content of the book is segment driven. While detailed analysis goes behind the decision of which customers to include in the book and what targets are appropriate, the front line sees only simple, easy-to-understand information and is trained to understand the actions to take with the customers. The results of employee performance regarding the book are reported monthly, and the employees receive an annual incentive based on their performance.

Key Finding 15: Best-practice organizations have specific programs/sales efforts geared to their more valuable customers.

> *CMA builds long-term and profitable customer relationships, gets closer to the customer at every contact, and maximizes share of the customers' wallet.*
>
> —FedEx site visit

Best-practice partners all spoke at their site visits in terms of building relationships with customers: Marriott talked about deepening customer engagement, and NSCU about its strategy of member intimacy. One way in which best-practice partners utilized customer profitability information is by designing specific programs tailored to keep their most valued customers satisfied and loyal and enhance the relationships with these customers. The **FedEx** OneCall program is such an example. CMA at FedEx works to build long-term and profitable customer relationships. The goal is to get closer to the customer at every contact so that the company will maximize wallet share. To support this strategy, FedEx developed the OneCall program for its high-value customers. OneCall is an easy-to-use personalized service designed for FedEx preferred customers. In the OneCall program, the preferred customer dials a toll-free number and talks to the same customer service representative each time. These representatives are wholly at the customer's disposal. This gives a customer direct access to a person knowledgeable about Ground and Express services. OneCall representatives have access to account history information and get to know the customers on a personal basis. The OneCall customers are tracking packages, making claims—all of which the OneCall representative can help with.

FedEx implemented its customer value model with its OneCall program—customers are selected, deleted, or swapped from this program based on their perceived value to the company.

- **Customer selection**: Only high-value customers can enroll in OneCall. FedEx designed a process for enrolling these customers. The first step was to develop a user-friendly Web site where the sales team can insert their comments regarding which customers should be included. Customers nominated must meet a value threshold (low-value customers need senior management approval to enroll).
- **Customer deletion:** Another process in place is customer deletion. Low-value customers in the OneCall directory are removed from the program. To keep a low-value customer in the program requires senior management approval.
- **Customer swap:** Directors have responded well to the customer deletion process because once they removed a low-value customer, they were able to enroll a truly high-value customer in a "customer swap."

Due to limited capacity in the OneCall program, FedEx must strike a balance between enticing high-value customers to opt into the program and graciously removing low-value customers. Overall results from OneCall have been very positive in terms of increased customer revenue, customer penetration, and retention. Customer valuation is the main driver behind the success of OneCall. FedEx definitely sees higher revenues for those customers participating in the OneCall program; however, today, the OneCall program is at capacity. FedEx must determine how to excise low-value customers from the program in order to re-administer that cost toward high-value customers.

At Marriott, customer profitability analysis is being conducted on Marriott Rewards members who are more than 10 percent of meeting attendees, 50 to 60 percent of transient and extended stay room night stays, and overall $4 billion in annual revenue from 5 million active members. The frequency of purchase for these customers varies extensively in that the average purchase is nine room nights per year with some customers staying more than 200 room nights in a year. While most customers stay at multiple brands, most of them concentrate stays on one brand.

Marriott Rewards primarily segments customers behaviorally. The company has published or public segments which are mutually exclusive such as:
- platinum—75 room nights in a calendar year,
- platinum premiere—a select group of platinum-level members,
- gold—50 room nights in a calendar year, and
- silver—10 room nights in a calendar year.[10]

Using a book of business technique, **Wachovia** management assigns a book of selected customer portfolios to a team of front-line and call center employees. The idea is to allow the employees to increase the deposits and retention of those in the book because they are clients that the bank would like to keep and grow. At **Zippo**, preferred customers are the handful of large accounts that generate more than a significant part of the overall company operating revenues and profits.

Key Finding 16: Best-practice organizations successfully convert unprofitable customers to profitable customers.

The "Calculating and Reporting Customer Profitability" study found that, for the most part, best-practice organizations do not "fire" unprofitable customers; rather, they arm themselves with this information to analyze the root causes of the lackluster profit and make adjustments in pricing, packaging, and/or levels of service accordingly. Four of five of the study best-practice partners, and half of the study sponsors, stated that they have been able to use their customer profitability knowledge to convert unprofitable customers to profitable customers, per Figure 5.6, page 74. Study participants have been able to accomplish this via:
- appropriately modifying service levels and/or pricing,
- re-assigning relationships to different cost-to-serve delivery solutions,
- deepening relationships across product families,
- an analysis of primary cost drivers and associated changes in product/service delivery as a result (for example, developing more economical packaging alternatives if packaging is determined to be the primary cost driver),

[10] Work is underway to change these groupings based on most recent 12 months or calendar year, whichever is in favor of the customer.

- an analysis of risk and pricing factors on portfolio performance,
- target marketing and cross-selling, and
- discussing cost-to-serve activities and rationalizing them.

NSCU, for example, manages unprofitable customers by being selective in terms of providing rate discounts, or in how the members are serviced and managed. For instance, member profitability information is leveraged to assign accounts relationship managers in the retail banking group who are better able to manage the interest spread given to the member and therefore manage their profitability to the company.

Successfully Convert Unprofitable Customers to Profitable Customers?

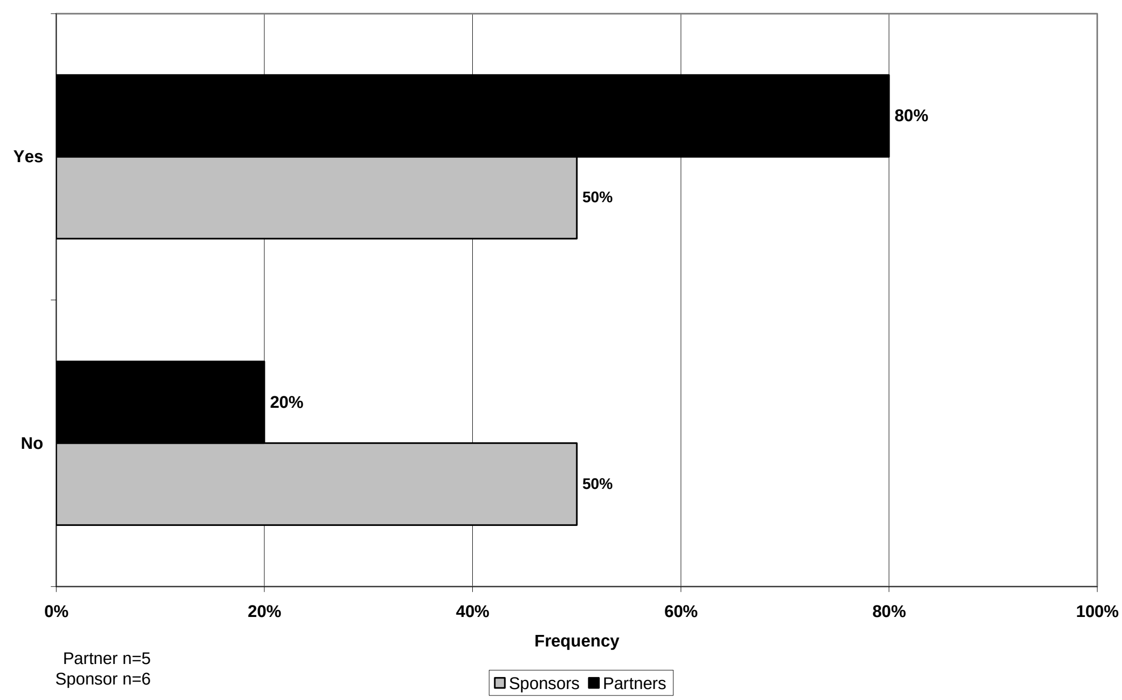

Figure 5.6

When **Zippo** reviews unprofitable customers, the first element it must uncover is what is making the customer an unprofitable customer. The company reviews product costs, selling or marketing expenses, and method(s) of distribution. Establishing minimum order quantities and changing customer behaviors like ordering electronically rather than by telephone improves the profitability of the customer account. In many instances, Zippo had to increase prices in order to convert its customers from unprofitable to profitable.

ROI ON CUSTOMER PROFITABILITY INITIATIVES?

As illustrated by Figure 5.7, most organizations have not been able to calculate a formal ROI on their customer profitability initiative(s). Those three (two partners, one sponsor) that have state that the ROI has taken the form of increased organizational revenue, increased customer satisfaction, and increased organizational profit. Informally, however, best-practice partners noted positive proof that their customer profitability initiatives were, at least indirectly, contributing to growing the business, as justified by their significant investment in this effort, specifically at Wachovia and Fedex (in terms of dedicated customer analytics groups responsible for customer profitability) and Marriott (in terms of an expansion of customer profitability initiatives planned for 2006).

Demonstrate Worthwhile ROI on Customer Profitability Efforts?

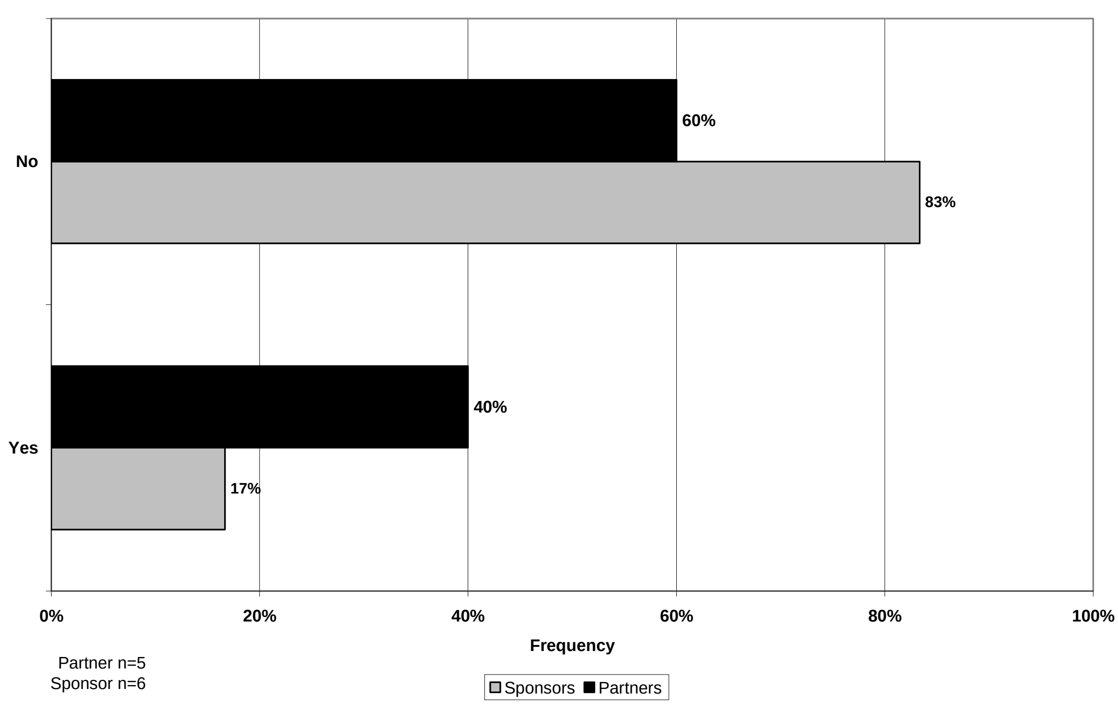

Figure 5.7

FedEx, for example, has experienced very positive results from the deployment of customer value information into the OneCall program, both from the company's and from the customer's standpoint. From the company's standpoint, the high-value customer selection criteria to participate ensures that investment resources are appropriately aligned to the most valuable customers. In addition, customer shipping volume and revenue have increased, customer retention and penetration rates have increased, and the customer attrition rate has decreased. The program is valued by customers as well: Customers indicate that they are highly satisfied with the program and are more likely to stay with FedEx if they are a participant in OneCall. In addition, participation in OneCall has influenced the majority of customers to shift business to FedEx when cost was not a factor.

Wachovia has found that calculating and acting on customer profitability and segmentation has greatly decreased customer attrition. **Marriott** estimates that predictive modeling has enabled it to increase incremental revenue by at least 0.5 percent to 0.75 percent. This is a significant number to the company: Because this number represents pure profit, incremental increases are quite impactful. **NSCU** has also experienced positive results in part due to its initiatives around customer profitability: Since the credit union reoriented its business model around a profitability-minded yet customer-centric approach, profitability rose 40 percent and assets more than doubled, with just a 2 percent increase in membership.[11]

Conclusion and Future of Customer Profitability

Referring back to Figure E.1 from the executive summary, Chapter 5 brings us full-circle in the study's exploration of calculating and reporting customer profitability, from understanding governance and structure of customer profitability initiatives in Chapter 1 (not pictured), to the necessary first step of defining and segmenting customers (Chapter 2), to allocating revenues and costs to customers and calculating customer profitability (Chapter 3), and finally, to reporting/communicating the information and how information is deployed in strategy and tactics.

[11] Source: "Profits, One Customer at a Time," *CRM Magazine*. January 1, 2005.

Organization of Final Report

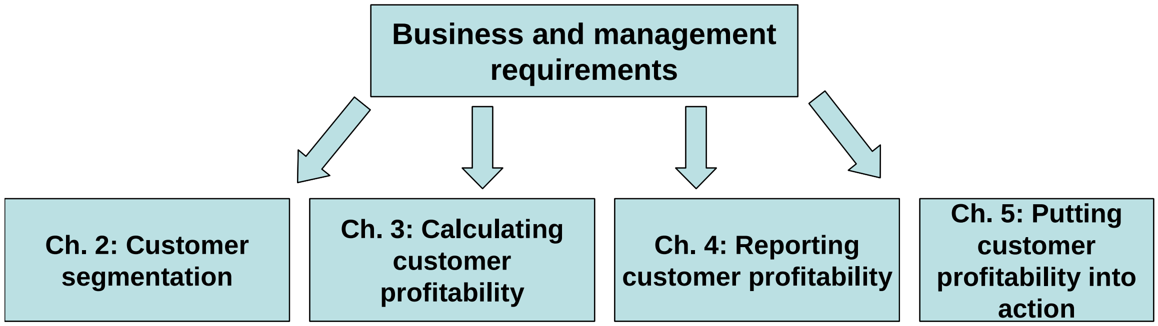

Figure E.1

What does the future hold for customer profitability efforts at the study best-practice partners? One of the common threads of study best-practice partners (and inherently of study sponsors as well as indicated by their participation in this benchmarking study) is their adherence to continuous improvement and the ready admission that there is more work for them to do in the areas of customer segmentation and profitability analysis. For example, the next step for CMA at **FedEx** in terms of customer valuation is incorporating additional metrics that it can use to determine value and discover methods to incorporate those metrics. FedEx hopes to incorporate at least two additional metrics within the next year. The company is also investigating the possibility of a cross-segment ranking methodology (right now, rankings are kept within the general salesforce categories) so that it can compare customer types.

Zippo plans to continue with its analysis of customers and products and identifying them as either "winners" or "losers." It also plans to incorporate this effort into the establishment of performance objectives.

Marriott's future plans for customer profitability analysis include creating a better science of developing engagement among targeted customers based on their potential value, their propensities, and relevant demographics and/or psychographics characteristics. The company also wants to further the classification of top customers by stay patterns to aid in better serving them.

NSCU's future efforts regarding customer profitability include a cross-functional committee working on integrating customer profitability information and financial information to obtain more reports that focus on the financial side. This work will better support capital investment decisions. In addition, for 2006, the company will be revising the profit measure reported to staff on the CRM system to include the combined profitability and segmentation value measure of each member. Business rules will also be derived from this information and delivered via CRM to provide staff differentiated offers for members.

In general, according to the Bain & Company 2005 management tools survey, the customer is in the driver's seat, and innovation is the next big challenge for the future. Bain found that executives are becoming more customer-centric and feeling they do not know enough about their customers. Two-thirds of survey respondents agreed with the statement "insufficient customer insight is hurting our performance," for example.[12]

Another major theme emerging from the survey was that information technology is coming of age. Executives are feeling that IT is not just a computing tool; it can make their company stronger. Nine out of 10 executives agree that "information technology can create significant competitive advantages." As noted in Key Finding 9, best-practice organizations make extensive use of enabling technology including data warehousing, CRM systems, data mining, external databases, and predictive analytics and work closely with their IT departments.

The Bain & Company survey, conducted annually since 1993, collects both usage and satisfaction information for 25 specific management tools. While calculating and reporting customer profitability was not specifically identified as one of these tools, customer segmentation and CRM both were among the top five most used tools and significantly above the mean in executive satisfaction with the tool.

Calculating and reporting customer profitability is an important part of customer segmentation and customer relationship management. The insights that customer profitability and valuation bring to segmentation and relationship management are enormous. The insights help to shape strategy, focus marketing, match sales resources to potential, and to reward the organization's best customers. Customer segmentation and CRM are the tools and calculating and reporting customer profitability is the oil that keeps them running.

[12] Source: "Management Tools 2005." Bain & Company. Copyright 2005.