

KILLER CUSTOMERS

The Trillion \$ Opportunity

Calculating and Reporting
Customer Profitability

Cost Management Advanced Practices Symposium
May 13, 2005

Workshop Topics

- Overview and Background
- Customer Segmentation
- Cost to Serve
- Tracing Assets
- Valuation and Economic Value Added

Agenda

Time	Agenda Item	Responsibility
8:30 to 9:00	Welcome and Introductions	Miller Workshop Participants
9:00 to 10:00	Overview	Miller
10:00-10:30	Workshop #1. Customer Segmentation	Workshop Participants
10:30-10:45	Break	
10:45-11-15	Workshop #2. Cost to Serve	Workshop Participants
11:15-11:45	Asset Allocation and Economic Value Added	Miller
11:45-12:15	Workshop #3. Customer ROI	Workshop Participants
12:15-12:30	Summary and Wrap-Up	Miller

Participant Introductions

- Your name and responsibility
- Company background (products/services, annual revenues, number of employees, competitive environment, number of customers)
- Does your company calculate and report the profitability of individual customers or customer segments?
- If yes to the question above, briefly describe how your organization calculates and reports customer profitability

Principles of Customer Profitability

- Principle No. 1: Think of your company not as a group of products or services or functions or territories, but as a *portfolio of customers*
- Principle No. 2: Every company's portfolio of customers can and must be managed to produce *superior returns for shareholders*—meaning a consistently better than average share price appreciation—not just to produce earnings per share or EBITDA or revenue growth or customer satisfaction or anything else
- Principle No.3: Companies enhance customer profitability and drive their stock by creating, communicating, and executing competitively dominant customer value propositions

Overview and Background

- To improve profitability, the typical corporate executive looks for troubles in the organization's products, business units, territories etc. This kind of conventional analysis is no longer good enough because it's often applied to all customers, profitable or not, high potential or low, in the same way.
- Because of history and habits, most managers behave as if profit comes from products (Yogurt is up 13% this year) or places (Europe is off this quarter). Profit doesn't come from products. It comes from customers and facing this reality is a bigger change than most managers realize
- Top 20% of customers typically account for 120% of profit. Winning with the top 20% will kill your competitors. Not dealing with the bottom 20% will kill you

Customer Centricity

Education Workshop

Get an Executive Education from Wharton
in Customer Profitability Management:
Building Competitive Advantage

- The Wharton School's Executive Education, University of Pennsylvania, is offering a three-part educational program in Customer Centricity. It is based on teaching found in the best selling business book [Angel Customers & Demon Customers, Discover Which Is Which and Turbo-Charge Your Stock Price](#) by Larry Selden, Professor Emeritus of Finance and Business, Graduate School of Business, Columbia University and Geoff Colvin, Fortune Magazine Editorial Director and host of Wall Street Week.

Creating Superior Share Price Performance Through Customer-Centricity™

Every company today, whether public or private, is under unprecedented pressure to increase its value. Generating consistent, sustainable, profitable, organic, double-digit revenue growth is extraordinarily difficult, but truly Customer-Centric companies do so, even against powerful, larger competitors.

[This course explains how creating true Customer Centricity](#) involves six very specific steps:

1. Measuring customer profitability and understanding the key drivers
2. Creating operationally meaningful customer segments that represent the greatest value creation opportunities for a company
3. Developing, communicating, and executing competitively dominant customer value propositions
4. Organizing the business into customer segment business units
5. Creating a customer-centered learning process to drive customer innovation
6. Communicating key customer performance metrics to enable investors to understand how to evaluate shareowner value creation



Test of Customer Centric

- Who in the company “owns” the customer?
- Who is accountable for the profitability of any given customer or customer segment?
- How significantly does the company differentiate its interaction with different customers?

XYZ Company

GAAP Financial Statement

P/L Statement

Sales	\$100
Cost of Sales	60
Gross Profit	40
Sales and Marketing	15
General & Administrative	10
Operating Income	15
Interest expense	-
Income before tax	15
Income Tax	5
Net Income	\$10

Balance Sheet

Accounts Receivable	\$ 10
Inventory	20
Fixed Assets, net	100
Total Assets	\$120
A/P and accruals	\$ 20
Stockholders equity	100
Total liabilities and equity	\$120

Performance Measures

Net income as a % of sales	10%
Operating income % of sales	15%
Gross margin	40%
ROI	10%

Customer Profitability 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 %		



Zippo Manufacturing Co.

Product/Service Revenues by Customer Segment

Product/Service Line	A	B	C	D	E	Total
Drill Collars		\$10	\$5	\$5		\$20
Drill Pipe	\$10				\$10	20
Rental Tools		15	5			20
Fishing Tools					20	20
MWD Services	20					20
TOTAL	\$30	\$25	\$10	\$5	\$30	\$100

Typical Product/Service Line Profitability

Product/Service Line	Sales	Cost of Sales	Gross Profit	G/M
Drill Collars	\$20	\$16	\$4	20%
Drill Pipe	20	14	6	30
Rental Tools	20	12	8	40
Fishing Tools	20	10	10	50
MWD Services	20	8	12	60
Total	\$100	\$60	\$40	40%

Product Costs by Customer Segment

Product/Service Line	A	B	C	D	E	Total
Drill Collars		\$8	\$4	\$4		\$16
Drill Pipe	\$7				\$7	14
Rental Tools		9	3			12
Fishing Tools					10	10
MWD Services	8					8
TOTAL	\$15	\$17	\$7	\$4	\$17	\$60

Cost to Serve

Cost to Serve	A	B	C	D	E	Total
Sales and Marketing Expense •Advertising •Personnel •Travel & Entertainment	\$8	\$2	\$	\$-	\$5	\$15
General & Administration •Personnel •IT Equipment •Compliance	6	1	1	-	2	10
TOTAL	\$14	\$3	\$1	-	\$7	\$25

Cost to Serve Assignment

DESCRIPTION (Expense Type)	PROPOSED METHOD OF COST ASSIGNMENT/ALLOCATION
Salaries (includes benefits)	ABC cost tracing methodology. Costs traced to activities and activity costs traced to customers (or to other departments) based on consumption of activities
Commissions	Trace directly to customers based on sales
Advertising*	Various methods can be utilized from a simple approach (based on sales) to a more comprehensive approach where advertising costs are segmented and individual segments traced to customers or products.
Co-Op	Co Op costs by customer are currently captured. Trace directly to customers
Displays	Display costs by customer are currently captured. Trace directly to customers
Licensing Fees	Licensing fees are based on specific products. Assign to customers based on products subject to license
Legal Expense	Paid to outside law firms and consist primary of three types of costs, general corporate matters (\$851), IP (\$250), and litigation (\$185). Method for each type of cost to be determined.
Promotions	Promotions consist of two types. Promotional allowances to DM wholesalers (\$972) directly traceable to customers and promotional allowances to retailers (\$681) also directly attributable to customers
Outside Services	Major components of outside services include security (\$202), Japan Okamoto Trading (\$263), and Til Evigheten OG Forb (\$150). Method for each type of cost to be determined. Many may be directly traceable to customers

Investment Allocation

Investment Category	A	B	C	D	E	Total
Accounts Receivable	\$5	\$2	\$-	\$-	\$3	\$10
Inventory	\$5	-	-	-	\$15	20
Fixed Assets, net	20	35	3	2	40	100
A/P and accruals	(10)	(12)	-	-	(8)	(30)
TOTAL	\$20	\$25	\$3	\$2	\$50	\$100
ROI	5%	20%	67%	50%	12%	15%
EVA (millions)	(\$2.0)	\$1.25	\$1.55	\$0.7	(\$1.5)	ZERO

Customer Segmentation

- Definition: A customer segment is a group of customers with sufficiently homogeneous needs that the segment members can be won with a common value proposition and common marketing. A low degree of homogeneity reduces the likelihood of finding a value proposition that will satisfy most of the segment
- Trade-off. Finer segmentation better focuses on customer needs that leads to better-crafted and more differentiated value propositions and greater acceptance, higher margins, increased loyalty, and higher economic profit. Too much segmentation leads to higher costs to maintain
- Segment customers into groups with homogenous needs so they can be approached, acquired, and insulated from competitive attack

Conventional Wisdom Customer Segmentation

- Age
- Annual household income
- Average purchase size
- Revenues
- Zip codes
- Occupation
- Marital status

Customer Segmentation

- It's important to remember that customer needs may not be apparent through their behavior and may not correspond with products and services currently offered
- Segmentation is difficult because it is rarely possible to know with certainty a customer's needs based on the available information about the customer
- Companies often look for customer traits that are best available proxies
- An important principal of segmentation is that segments are mutually exclusive: Every customer is assigned to one and only one segment

Segmentation

New thinking

- Segment on the basis of customer needs
- Customer behaviors
- Profitability

Dell Computer Business Segments

- Small business
- Medium and large business
- State and Local government
- Federal government
- Education
- Health Care

Customer segmentation

- Defining customer segment is where the rubber meets the road
- Done properly, it confers enormous competitive advantages