DISTRIBUTOR POWER TOOLS: CUSTOMER PROFITABILITY

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THE DISTRIBUTION TEAM

When we look at the breadth of our customer base, are they really all equal? I love it when I hear an order desk guy say that every customer is the same or I treat them all special. Really? Then why do we have different prices for some? The fact of the matter is that not all customers are the same. Some are more valuable to us than others. If we can all assume that this is basically true, how do we differentiate the good ones from the bad ones?

Here is a great exercise to do with your team. Gather everyone together and ask them to list the company's top ten customers on a sheet of paper. More often than not, volume will be the criteria used to determine status on the list. Some will go the extra mile and rank the customers by gross profit dollars. It is good to know where the mindset is currently. A couple of weeks later gather everyone again and ask them to list the top ten most profitable customers. There may be a few raised eyebrows and whispered suggestions that your memory isn't too sharp. Many people will think that you just asked them the same question and their list will be identical. If this is the case, it may be time for a quick discussion about the relationship between sales and net profit.

If you want to drive net profit improvement through the organization, then everyone needs to become part of the mission. By understanding who our most profitable customers are, the sales teams can make better decisions on how to allocate company resources. They don't have the authority to allocate company resources? I beg to differ. When a customer requests an item that needs to be transferred in from another location, the order taker is about to make a decision. The outcome of that decision can directly affect your bottom line. Is this customer worthy of the transfer? Are they a positive contributor to the bottom line, or do they string us out on payment? Chances are we have not armed our order taker with the customer information necessary to make a good net profit decision.
As I have discussed in previous articles, distributors tend to utilize only a fraction of their distribution software packages. Understanding the reporting capabilities and manipulating data can increase your return on this substantial investment. The customer profitability analysis report is simply a spreadsheet using data that your system captures on a daily basis. The magic occurs when you share the data with, and develop policies for, your front line decision makers.

This report will rank your customers by contribution to net profit. It is important that we are only looking at customers who have done business with us for at least 12 months. New customers should always be treated special until they prove themselves less than worthy.
Here are the columns on the spreadsheet:
Customer Name
Annual Gross Sales
Annual Cost of Goods Sold
Annual Gross Margin Dollars
Annual Number of Orders Processed for Customer
Cost of Processing an Order
Annual Cost of Processing Customer Orders
Contribution to Net Profit

The first question usually occurs with the 6th column. How do we determine the cost of processing an order? There are fancy ways to do it, usually involving additional software and cost accounting, and there is an easy way to do it. The more precise way to determine the actual cost of processing an order is to use something called Activity Based Costing (ABC). Using ABC tools, a cost is attached to each function associated with processing the order. Sometimes conflicts can occur between departments as to their relative value in the process. But, you will eventually get down to a fairly precise number. For those of you who are more interested in the getting a solid ballpark number, here is a quick method. Divide your annual operating expenses by the number of orders the company processed last year. Are there a few extraneous costs, like the twin engine floating delivery truck at the end of my dock, that get lumped in? Sure. As you will see, precision is not all that critical here. Depending on your vertical market, most distributors tend to come in between $35 - $65 per order. Plug the number in your spreadsheet as a constant.

The rest of the math in the spreadsheet is fairly simple. Multiply column 5 (number of orders) by column 6 (cost of processing an order) to get your answer for column 7 (annual cost to process customer's orders). Column 8 (contribution to net) is determined by subtracting column 7 (annual cost to process customer's orders) from column 4 (annual gross margin dollars). This contribution to net profit will either be positive or negative. Sort the spreadsheet by column 8 (contribution to net profit) in descending order. The result is a ranking of your customers by their contribution to your net profit.

Once you have created your ranking, you may need to take a step back and allow for a few deep breaths. This is not the time to panic. One of the more troubling observations for first time viewers is that a majority of your customers fall below the zero line. Stated another way, their contribution to net is a negative number. It isn't quite as bad as the old 80/20 rule, but most distributors find that 70-75% of their customers are in the negative territory. So what now? Do we just cut off everyone below the line? Of course not. The majority of these folks help us with volume purchasing and give us economies of scale. Our next task is to determine our threshold for pain.

About 25% of the way up from the bottom of the list, I like to draw a red line. I like to refer to them as blood suckers or bottom feeders. Behind closed doors you may be able to come up with more colorful names. Anyone below this line is a candidate for termination. Firing a customer is not something that most distributors relish. It's kind of against our sales code of conduct. The fact of the matter is that it really isn't the fault of the customer. We have done it to ourselves. In the name of customer service, we have given away company resources to those who are not deserving of our gifts. If you need a little more convincing that this bottom group is taking you for a ride, just lay down an accounts receivable aging report next to your list. There is a strong correlation between slow pay and negative contribution to net.

Let's go back to the goal of this exercise. We are trying to drive decision making based on contribution to net profit. The key to getting the most out of the information we just extracted is to share this with our front line decision makers. Additionally, we need to set some policies that help up align our resource expenditures with the customers that help contribute to our financial success.

The first group I would tackle is the blood sucker. For ease of use, let's refer to them as group C. We are giving everything, they are giving nothing. The sad part is that we just learned this. They have known for years. It is a sad fact that your worst customers know it. They take pride in their ability to beat you up on price, run you all over town, and string out your money. We clearly need to level the playing field when it comes to this group.

The first thing I would do is quit being their bank. Convert the slow payers to COD. If you have cash discounts, get rid of them. This goes for all customers, but that is for another discussion. Now that we are out of the finance business, it's time to raise prices.

These folks won a prize. Give them all list price. Whoa, Jason, you are being too harsh. Au contraire, it's time these folks paid their way. Will some of them leave you? Absolutely. In fact, give them a road map to your competitor's place. Let them be someone else's worst customer. The funny ones are the customers that stay. This is one of those forehead slapping moments where you rethink your whole pricing strategy.

Let's take a look at the services we provide. Do we provide free deliveries to this group? Do we have minimum orders? Are we transferring product at our own expense? Have I hit a nerve yet? Good. We have a finite amount of resources in the company. We should not waste them on customers who are not contributing. A good strategy is to require minimum orders for both credit purchases and delivered product. Do not order in special products for C customers. They get to buy what we have on the shelf. Above all, we do not transfer product at our own expense.

One of the final suggestions is to quit spending sales dollars on them. For those of you with an outside sales force, quit calling on these customers. Remove commissions on these customers, and make them house accounts. By removing the commissions, you remove the favorite word in the sales vocabulary used to describe an underperforming customer – potential.

The middle group, let's call them B customers, is a different animal. They do have a negative contribution to net profit, but I wouldn't want to lose them. As mentioned earlier, they provide us the volume to purchase more efficiently and allow us to enjoy certain economies of scale. Some slight adjustments to how we handle this customer group will allow many of them to rise up to positive contribution.

Most of these customers have a decent gross profit volume. The real trouble occurs in the frequency of order. We may find ourselves processing several low dollar orders in a single day. If we could get them to consolidate orders to once a day, they would slide up the profitability scale. This type of discussion will need to come from someone senior in the organization. They can speak in terms of reduction in the clerical costs of PO generation and payment processing.
Another strategy is to look at how we handle special orders and transfers for this customer group. I would ask this customer to bear the cost of expedited handling. In addition, I would be more apt to suggest the customer to accept a substitute rather than ordering in a special item. While we are talking about specials, make sure that we are getting a high margin on the product. We are spending company resources to bring this in. Be strict with your return

policies and be mindful of internal costs. Finally, I would look at modest price increases. This where a good pricing matrix guru can come in handy. Look for subtle increases to less popular items. You should be able to raise your overall margin by 1-2%.

Now we arrive at our best customers. To stay consistent, and a bit boring, let's call them A customers. These are the folks that make a positive contribution to our net profit. We love them. We need to tell them we love them. I'm serious here. If we lose one of these customers, it will often be the next most expensive sale we will ever make. We will throw all kinds of deals at them in order to woo them back. Unfortunately the cash impact of these deals will be felt for many years to come. Let's not lose them in the first place.

My brother and I discuss this all the time. Get close to the A customers. My brother is the heir apparent to my family business because yours truly has chosen to write articles and speak at trade shows. Note to self, ask mother if I was fond of paint chips as a child. The point is that I want the owners of companies to become close to this group of customers. Do not leave the relationship to your sales manager or salesperson. At least once a year, meet with the owner of each of these companies. Talk about what you are doing for them. They need to be reminded. Incidentally, this is an excellent utilization of sports tickets or that golf club membership. People still do business with people they know, like and trust.

Is it easier to go get new customers or sell deeper into your existing customer base? Nothing fancy here. We already have them on the books; let's sell them more product categories. It is always a blow to the ego when a long standing customer says, "I didn't know you carried that." Most sales managers I know would love to be able to analyze each customer and figure out where we are not selling them. The problem is that the task is just too daunting. There are just too many customers to really look at. Why not use the ranking report to help us?

Why would we want to sell more into companies that produce a negative contribution to net profit? Doesn't make a whole lot of sense to me. Let's focus on selling deeper into group A. I was presenting this in a private seminar recently. Fortunately, the sales manager was in the room and a grin spread across his face. At the break, he shared with me that he had been told to create a sales opportunity analysis for all the customers in the company. He was really sweating this assignment. I just cut his work load dramatically. It's better to work smarter than harder.

The customer profitability analysis is one of the most powerful tools in any distributor's arsenal. From an inventory management perspective, you will find several wins. A big part of inventory management is the allocation of resources. We have a finite amount of cash to invest in inventory. As good asset managers, we are charged investing our resources where we will receive maximum customer benefit and a strong financial return. When we use this customer ranking, it is easy to see where we want to invest our money. We need to make sure that our A customers are satisfied. One of the scarier outcomes of this analysis is realizing how much inventory dollars we are wasting on group C. Sometimes we carry entire lines of product for C customers. If I aim really hard, I can probably just shoot off my middle toe.

After all is said and done, the biggest win comes from educating the front line decision makers. At a customer service level, they have ability to make a tremendous impact on our bottom line. One of the final challenges is to make sure that everyone knows who the A, B, and C customers are. This is where our software can help us. Some of the more sophisticated pieces can actually have the customer code appear in a different color during the order entry process. Some user defined fields in the customer record can help; but they are not always seen. I ran across one distributor who came up with a simple code. He just added asterisks to the end of the customer name in the database. This worked well because the codes also appeared on the pick tickets. Because he chose to include the material handling team into the process, they understood the significance of the star codes. Customers with 3 stars were given special treatment. The key is to find a communication vehicle that works for you.

Understanding customer profitability will go a long way toward improving your bottom line. As you can see, this simple data extraction will provide several avenues to look for cash. Don't be afraid to lose some of your C customers. You have already given them enough of your money. I will explore additional power reports in the coming months. As always, I am here to help you get started. Good luck.

About the Author:
Jason Bader is the principal of The Distribution Team. He is a holistic distribution advisor who is passionate about helping business owners solve challenges, generate wealth and achieve personal goals. He can be found speaking at several industry events throughout the year, providing executive coaching services to private clients and letting his thoughts be known in an industry publication or two. He recently launched his first podcast, Distribution Talk. Episodes can be found at www.distributiontalk.com. He can be reached at (503) 282-2333 or via email at jason@distributionteam.com. You can find additional resources on his website: www.thedistributionteam.com