How Profitable Are Your Customers?

Companies that understand total customer profitability can move from decisions based on gut feeling to those based on facts. To be a truly customer-centric business, it's vital that you understand the profitability of every customer.

A key to releasing the value of CRM lies in differentiating your services and offerings in a way that's commensurate with the value of each client. If you don't know the client's value, your company may be misallocating valuable resources. Very profitable customers may be underserved, while marginally profitable or even unprofitable customers may be receiving too many services. If this happens, your most-profitable customers essentially subsidize those less so—an environment ripe for attrition by those most valued.

But simply knowing the profitability of individual customers—while a good start—isn't enough; it's what the company does with the information that counts. So the second requirement of being a customer-centric company is to share customer-profitability information throughout the enterprise. Then, it's essential for all participants in the customer experience to use that information effectively and in the best interest of the overall company—not just a single department.

No business can afford to offer the highest possible level of service to all its customers. The airlines have epitomized this with their first-class/business-class/coach model. As they've shown, it's all about delivering an appropriate level of service based on what a customer contributes to your company.

The evolution toward a customer-centric company requires knowing the current and future value of all your clients. Without this information, a company is essentially flying blind. What level of service or special offers should a customer receive? Which products should receive additional marketing support and budget? Which services should be discontinued? Lacking customer-profitability data, many companies answer these questions by gut feeling. But today, that's simply not good enough. And with high-powered software, it's no longer necessary.

Value not volume
One huge flaw with management by intuition—and a problem that calculating customer profitability can overcome—is the tendency to equate sales volume with success: "We're selling a lot, so we must be making money." This can be extremely dangerous. If a product or segment is unprofitable, then every new customer is actually hurting the bottom line.

Many businesses have had this experience, and it's what happened at one large bank in the early '90s. The bank, working on instinct, dedicated just 5% of its marketing budget to attracting small-business clients, but 15% to attracting college students, which the bank thought would become lifelong customers with high-income potential. The bank also paid its branch sales teams higher commissions for bringing in new students than it did for attracting small businesses. When it actually analyzed the relative profitability of these customers, the bank found it had gotten things exactly backward: The small businesses were actually the bank's most-profitable clients, while the college students were money losers because they tended to use the services of bank tellers on a daily basis, taking out small sums of money. In fact, the bank's internal forecasts showed that the students were costing the bank far more in losses than they'd ever be likely to earn back in profits as nonstudent bankers.

To reallocate its resources, the bank used this customer-profitability data to replace its gut-feel approach. The next year, small-business recruitment efforts received much more of the marketing budget, and the sales force was incented to bring in small-business customers. Within a year, the program to attract college students was shut down.

The extra profitability gained from such programs can be impressive. One bank turned an $18 million loss into a $4 million profit simply by analyzing the profitability of individual clients. The bank had offered retail banking accounts to employees of large corporations who were entitled to low minimum balances, low fees, and other benefits. The bank picked up a lot of customers, and because they were all on direct deposit, these were customers who would rarely be in the branches consuming the tellers' time. Based only on the volume of this program, managers estimated their annual profits at $18 million. But after installing a customer-profitability system, the bank discovered the program actually resulted in an $18 million loss. The basic technology used was a database, calculation engine, and reporting capability.

The bank's profitability system also provided the information needed to fix the problem. It showed that the group was losing money due to lower-than-average balances, lower revenue, and higher expense. Because the profitability system tied every transaction to the account/client level, it discovered that only half the
customers had signed up for direct deposit; the other half visited their branches regularly. Having the tools and information, the bank could diagnose, understand, and change the program's costs and offerings. Within a year of the fixes, the program was earning a profit of $4 million. So the bank enjoyed a $22 million turnaround on a problem it would have never even known existed without the ability to measure customer profitability. These systems are usually part of an integrated analytical CRM application.

How many pockets of unprofitable customers are hidden in the customer numbers of every industry you deal with? That's a question you need to ask in relation your own company.

A detailed explanation of customer-profitability implementation follows, but first, a quick definition. Basically, it's the ability to identify all revenue and expenses that can be attributed to a client or customer. But two views of customer profitability need to be considered:

**Current:** The amount of profit an individual customer contributes to the company during the current month, quarter, or other unit of time.

**Forward-looking:** Also known as the "lifetime value" of a client, this measure considers attitudinal and demographic data—along with economic, growth, and attrition projections—to forecast the likely profits from the customer in the future. For example, a retailer may have two customers with the same current profitability, but one is a 30-year-old surgeon who's just about to launch a lucrative practice, while the other is 65 years old and about to retire. From a potential-profitability point of view, there's a huge difference. Statistical modeling is often applied to the above attributes to derive a lifetime value for a client.

It's critical to understand both the current and future profitability and value of each client. In fact, it's impossible to run successful CRM initiatives without this information. This may be one reason for some highly publicized CRM failures. If you can't differentiate among your customers and you've spent a lot for contact-management software, you can't tell the support staff how to treat one client versus another.

The measurement of customer profitability—determined by subtracting the total cost of serving a particular customer from the total revenue derived from that customer—shouldn't be confused with the measurement of customer loyalty. Loyalty is about attitudes—a client's feeling toward a company (see "The Value Of Loyalty"). That said, profitability and loyalty are two of the most important customer-focused metrics, and they should be evaluated in tandem. The goal is to achieve the highest level of customer-loyalty and customer-satisfaction scores from your company's most-profitable customers or customer segments. The ability to report this information at the customer or segment level, rather than for the total customer base, is critical for a true assessment of the franchise's health.

**Silos to households**

There's a huge barrier to analyzing the relative profitability of each customer: Most large, multiproduct companies store their product and customer data in data silos. A financial-services company, for example, might have one silo for credit-card information, another for mortgage data, and others for checking-account data, investments, loans, and so on. These silos are great for the individual groups—for example, the credit-card group understands its customers, at least within the context of the credit-card relationship. Yet for calculating the profitability of individual customers, this simply won't do.

Instead, companies need a holistic view of each customer. Aggregating this customer information is known as householding. People have talked about this for years, often under the heading of the "single view of the customer," but implementation is still rare because information on various accounts is...
often stored in separate databases. Imagine that you're a bank client with a $1 million investment account and a credit card. With your level of wealth, you're not likely to be "revolving" the credit card; rather, you're a "max payer," usually paying the entire amount when it's due. You're not very profitable to the credit-card company and, from the credit-card department's perspective, it makes sense to give you a fairly low level of service. But remember, you're a $1 million client to the whole company. If the credit-card group had the holistic view, it would give you the royal treatment—even though you're not one of that group's top clients. This ability to calculate a customer's profitability is critical. Here are the basic ingredients:

- Put all the accounts and associated data in one place—for example, a data mart or data warehouse.
- Identify all associated revenue at the individual-account level.
- Tie all transactions to individual accounts.
- Apply unit costs and account-maintenance costs for each transaction to gain the total cost of maintaining the account.
- Calculate account-level profitability.
- Household the accounts via a householding algorithm to the customer level.
- Calculate the profitability at the customer level.
- Reconcile the customer-profitability results with the financial-management reporting systems.

Taken one step at a time, first, you must build or customize a data warehouse or data mart that extracts the account-level information and gathers it into one place. This pulls across all the silos; retrieves all the account information, including names, addresses, and transactions; and consolidates it in one place. Again, this is something that companies have been working on for years, with varying degrees of success.

Next, identify all revenue that should be properly assigned to each account. In banking, for example, this consists of the net-interest income generated by the loan and deposit balance, along with any account-related fees.

Then identify and assign all transactions at the individual-account level. This step provides critical input for calculating the true cost to serve. For example, a retail bank would ask: How many times did the customer visit a teller, use the ATM, contact the call center, transact through on-line banking? All these transactions must be attributed to the customer with the appropriate unit cost. That's how you understand the cost of serving the client or customer. Two clients could have the same balances and revenue profile, but if one is constantly in the local branch while the other is doing all his or her banking online, the latter will be much cheaper to serve. Gut feeling won't show you that.

Once that's done, it's time to implement accepted costing methodologies that assign the proper acquisition, transaction, and account-maintenance costs to each account. If your company has implemented a state-of-the-art activity-based costing system such as one offered by SAS Institute, you're already hitting on all cylinders. But few companies have, and that means they don't have the latest information on their costs. Either way, use the best cost information available to take all your expenses—IT costs, operations, sales force, branches, development, and others—and truly allocate them down to the lowest possible level. Sadly, cost allocation can seem dull, and senior management doesn't often consider it a high priority. Yet, without this information, the quality of customer-profitability data—information that should be used to run the business in a customer-centric company—will be limited.

With all the information available, a customer-profitability "calculation engine" can calculate the profitability (revenue - expense) for each individual account. You can then aggregate those accounts up to any level you deem appropriate, whether it's a pricing relationship, customer, household, or customer segment. If you start too high, however, you can't disaggregate below that level. So the best practice is to start with the individual account.

But don't let this simple explanation fool you. A large retail company might need to calculate customer profitability for millions of accounts. To do this, you need a powerful calculation capability such as that found in SAS' customer-analytics application.

The next step is to apply a householding algorithm that looks across the name, address, and social-security number of every account to match all accounts owned by an individual customer. Algorithms can be custom developed by an IT department or bought as part of commercial application. The commercial solution has to be flexible for each individual company's needs. Next, the householding process assigns a unique customer identifier to each client. So first we discover that John Doe has three accounts with the company; then we
assign a common customer-identifier number to each account for a holistic view of the customer. Then, by adding up the profitability of John's three accounts, we know his individual-customer profitability.

If your company has adopted a customer-segmentation approach, and each customer is classified into a segment, you can calculate the segment's profitability instead. Do this by grouping the customers in each segment and adding up their associated customer-profitability figures.

The final step is to reconcile the results. Since there will probably be no comparative numbers at the individual-account or customer level, make sure that what you show as the total profits from all customers is close to, or reconcilable with, the number your company is showing through its financial reporting. This is your reality check. Senior management will not accept and manage by customer-profitability information if the totals don't reconcile with the numbers they're used to seeing.

If the customer-profitability results, for example, show customers are bringing in a total of $10 million of monthly profits, and the financial-management reporting system shows only $5 million, you have a problem. If your results are more than 5% to 10% off from the officially reported profit, then you probably need to adjust your cost-allocation model. Here's where the value of a powerful calculation engine comes in again. You don't want technology to be the limiting factor. Back in the '90s, one bank had an early calculation engine that needed more than 200 hours to run the complete customer-profitability monthly process. It was later replaced with a more advanced engine that needed only 54 minutes. That let the bank work with the cost-allocation model until the finance department was comfortable with the results. The technology was no longer the inhibitor to getting the right results.

Share the wealth

Once you've calculated the profitability of customers, it's time to share that information within your company. There are three main groups that need this data: customer service, call-centers, and other "touch point people"; marketing, product, and segment groups; and senior management. Most companies believe that giving the first group the exact profitability figures is unnecessary. Instead, it can suffice to classify customers, create rules for how each class of customers is treated, and then share the classifications.

For example, you might decide to classify customers as A, B, C, and D, with A the most-profitable customer and D the least. Next, set rules for what sort of service, fees, and privileges each class of customer can receive. Finally, give a class rating to each customer. This way, when a customer phones the call center, the service representative types in the account or customer number and sees the customer's class—A, B, C, or D. The service representative would then review the rules to see what level of service, fees, and privileges the customer is entitled to. The second group—people in marketing, product, or segment departments—generally receives more-detailed profitability data. In many companies, this is information they've never had before. For example, say your company is planning a new marketing campaign. This data should help workers target various clients based on their relative profitability. You can also combine this with data mining to make campaigns more effective. The same is true for your product managers. You can aggregate the data so they can see—often for the first time—exactly what's happening with their product. For senior management, this information will clearly show how different customer segments, regions, and sales channels contribute to the bottom line. They can then use these findings to allocate resources to maximize overall profitability: in essence, to run the business.

For managers throughout the company, the information provided by analyzing customer profits is invaluable. If managers have the information, most will make the right decisions. Lacking this information, they go with gut feeling—and sooner or later, get it wrong.
90 Day Plan

Sidebar to "How Profitable Are Your Customers?"

To help your company make the right decisions concerning the allocation of its resources to customers, you need to start replacing "gut feeling" with hard facts. The first thing that's needed is a foundation for a customer-profitability system. Here are the ideal starting points:

First month: Turn insight into action

- Meet with senior management to understand your company's customer-profitability issues, concerns, and goals.
- Identify team members and subject-matter experts in the finance, IT, marketing, product, sales, and segment departments.
- Review internal studies and reports on your company's unit costs.
- Conduct meetings and discussions to begin developing revenue and expense methodologies.

Second month: Get moving

- Begin to identify the gap between the information required by your methodologies to calculate profitability and the information available.
- Identify a process to move source data into a data mart or data warehouse.
- Gain consensus with your subject-matter experts on which methodologies and formulas to use in allocating revenue and expense components to the individual-account level.

Third month: Gain momentum

- Identify financial-management reporting systems and results. These figures will be critical later, when you reconcile the customer-profitability application's results with the company's reported profits.
- Begin a review of vendor-provided and internally developed tools for both the calculation of customer profitability and the distribution of this information throughout the company.
- Prepare a proof-of-concept report for senior management using live data and the allocation-of-revenue-and-expense components at the account or customer level.