



Beyond Loyalty to Profitability – Prioritising Customers

The best customers are loyal ones. Fact or fiction? Generally they cost less to serve, they are usually willing to pay more than other customers, and they often act as word of mouth "unpaid salespeople" for your company. Win loyalty therefore and the profits will follow as night follows day.

But is it as simple as this? Does a loyal customer automatically mean that you have a profitable customer? Do we focus on our loyal regular customers and give them special attention because this is the most effective strategy and the most profitable?

This is a critically important issue for organisations in general, and for Account Managers in particular, who have to juggle the demands of several customers and the increasing pressure from their company to do more with less. How do we maximise the bottom line from our portfolio of customers? What are the priorities? Which of our loyal regular customers are the most important? Are our loyal regular customers all profitable?

There is evidence and research to show that the relationship between loyalty and profitability is weaker and subtler than it might appear on the surface. Not all loyal, regular customers are necessarily cheaper to serve, less price sensitive or particularly effective at advocating you and bringing in new business!

Instead of focussing on loyalty alone, successful companies (and Account Managers) have found ways of measuring the relationship between loyalty and profitability so that they can better identify which customers to attend to and which to ignore.

The most common way to sort customers is to rank them according to how often they make purchases and how much they spend. But a decision to continue to invest in a customer relationship needs to be based on the customer's profitability not just the revenue they generate.

Specifically we need to estimate the average profit earned on each customer in any typical purchase period. An estimate of pre period profitability is not hard to obtain especially in today's information rich age. You simply calculate the historical profitability of each of your customers from your database and then factor in any forecast changes to the trend for the period. (This would include a probability figure based on the probability that the customer will still be active at the end of the period.)



To see how this works consider how a simple version of this approach could help a company decide whether and how to invest in two ongoing customer relationships during the next year. From its sales data, the company determines that the first account, Alpha Pty Ltd, yielded an average profit of \$55,000 per quarter over the past two years, while the second account, Beta Pty Ltd, yielded an average profit of just \$10,000 per quarter. It is estimated that the probability that Alpha Pty Ltd will remain active is 85% in the first quarter, 60% in the second quarter, 35% in the third quarter and only 22% in the fourth quarter. Probabilities for Beta Pty Ltd are 100% for the whole year. For each account we now multiply the probability figure for each period by the historical average profit number and the sum of these calculations gives us the estimated profit for each account customer over the next year. (assuming no change in general sales trend)

Both accounts are clearly profitable. Alpha Pty Ltd is likely to generate \$110,000, while Beta Pty Ltd is likely to generate \$40,000. But how much should we invest in maintaining each relationship so that it will actually deliver the numbers? Clearly Alpha Pty Ltd warrants nearly three times as much attention as does Beta Pty Ltd.

If we estimate that a visit by the full sales team costs \$5,000 per visit and a single visit by the Account Manager costs \$2,000 we can estimate the ROI of our personal time and effort in maintaining the customer relationship.

So what is the next step?

Another important factor to consider is the level of value added that the account customer perceives that you can provide.

For some customers, perceived value is inherent in the product itself. They focus largely or exclusively on the cost elements of value. They generally already understand the product pretty well. They know how they want to use it. They see the product or service as a commodity that is readily substitutable by competitive offerings. They want a favourable cost - either in terms of price or ease of acquisition.

For them, because all the value is in the product, there's little or nothing that we can add. They even resent the time they spend with you or other people from your company. They see little value in building a relationship with you.

There are other customers who focus largely or exclusively on the benefits or added value that your product or service can provide. For them the value is not just related to the product itself but lies in how the product is used. They are interested in solutions and applications.



You can create a great deal of added value for them. They put a premium on advice and help. They expect you to give them new understanding of needs and options. They will willingly invest time, effort and cost in working with you to create a customised solution. They tend to build relationships with their suppliers that go beyond the immediate transaction.

The level of perceived value added that you can provide a customer will affect the level of true loyalty that the customer has to your company. If you are providing unique value added solutions then the customer is more likely to stay loyal long term. On the other hand, if the only strategy for building loyalty with your customers is to lower prices - well this is the easiest strategy to implement but the hardest to defend.

So after measuring your customer's profitability and their perceived level of value that you are (or can potentially) add, you can place each of them into one of four segments:

1. Low relative profitability/low perceived added value;
2. High relative profitability/high perceived added value (Core Customers);
3. Low relative profitability/high perceived added value;
4. High relative profitability/low perceived added value.

Now what kind of relationship management strategies should you apply to the different segments? For the first group of customers who generate lower levels of profit and who do not perceive that you can provide much added value the answer is simple: Identify early and invest little! (of your time and effort in building a relationship other than to minimise the cost to the customer and to yourself).

But for customers in the other three segments, the choice of strategy will make a difference to the segments profitability and to your effectiveness.

The focus should be on the Core Customers ie.. those customers who are highly profitable and who clearly perceive that you can add much value to the relationship. If this customer segment represents 20% of the customers but brings in 80% of the profits then we need to spend 80% of our time, \$\$ and effort in maintaining and strengthening the relationship ie.... moving from just loyal customers to devoted advocates (see previous issues).

Customers who perceive that we can offer added value but who are not as profitable as the Core Customer group are the most problematic. They do not generate satisfactory returns on our investment made in account maintenance and marketing because the size and volume of their transactions are too low. The first step is to determine whether the problem is a small wallet (the customers aren't valuable to begin with and are not worth



chasing) or a small share of wallet, (they could spend more and should be chased). This group will need to be cultivated and the relationship nurtured in line with the level of potential future profitability.

The final group of customers, who probably accounts for around 40-50% of sales, is highly profitable. They currently receive and perceive a high level of satisfaction and therefore have low perceived added value expectations in the future. These customers should not distract you from concentrating on your Core Customers.

There is no one right way to prioritise and effectively manage customers. Different approaches will be more suitable to different businesses depending on the profiles of their customers and the complexity of their distribution channels.

However we should not take for granted that managing customers for loyalty is the same as managing customers for profits. The only way to strengthen the link between loyalty and profits is to effectively manage them at the same time.



Article by **Tom Richardson**

For more information visit www.richardsonmanagement.com.au