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The Customer Profitability Conundrum: When to Love 'Em or Leave 'Em

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The customer may always be right, according to the old adage. But here is a not-so-old adage that is just as true: The customer may not always be profitable. That is why many companies these days are taking a hard look at their customers to determine which of them are worth serving and which should take their business elsewhere. The notion of eliminating customers may seem counterintuitive but in many industries - consumer products manufacturing, health insurance, banking and telecommunications among them - analyzing customer behavior and responding with strategies to make them as profitable as possible is essential to long term success.

The customer may always be right, according to the old adage. But here is a not-so-old adage that is just as true: The customer may not always be profitable. That is why increasing numbers of companies are beginning to look more closely at their customers to determine which of them are worth serving and which should take their business elsewhere. Put simply, it is sometimes necessary to identify and get rid of your worst customers -- preferably by encouraging such customers gently but firmly to migrate to your competitors.

The idea of eliminating customers seems counterintuitive, almost sacrilegious: What company wants to lose customers? But faculty members at the University of Pennsylvania's Wharton School and consultants at Booz Allen Hamilton say in many industries — consumer products manufacturing, health insurance, banking and telecommunications among them — analyzing customer behavior and responding with strategies to make them as profitable as possible is essential to improving overall corporate profitability and making the most efficient use of scarce resources.

These experts caution, however, that terminating a relationship should be a last resort, after all efforts to transform a bad customer into a profitable one have been tried and failed.

"Some of my clients now tell me they're sorry they listened to consultants five years ago when we told them to get rid of unprofitable customers," says Chris Dallas-Feeney, senior vice president in Booz Allen's New York office. "In banks, where I spend a good bit of my time, executives in the 1990s were told to get out of the mass market and focus on more affluent, profitable customers. Today, they're saying, 'To heck with that, we want to serve every customer we can.' As consultants we have to amass significant evidence to prove a particular customer segment is a dog and therefore you shouldn't bother."

One Wharton marketing researcher, Peter Fader, goes even further, challenging the very idea that a company can know when to reward good customers and fire unprofitable ones, especially in the business-to-consumer sector. "Despite our desire to explain everything that a customer does, much customer behavior is very random," he says. "You might have a hot period where a customer is buying a lot of your product, then a cold period. People's tastes and habits evolve over time. It's hard to look at the past and say with a great sense of confidence, 'This will be a good customer and this will be a bad one.'"

Although most marketing strategists argue that managing relationships based on customer profitability is both possible and beneficial, it is surprising how few marketing departments collect even basic data. "It's amazing to me how many large corporations track their sales but don't do a very good job of tracking sales to whom," says Wharton marketing professor David J. Reibstein. "Shipping departments handle some of that information, but knowing who bought what hasn't always been tracked closely by the marketing people."

But that is changing as companies across industries have reorganized and restructured their businesses to be less product-oriented and more customer-focused. Notes Wharton marketing professor Barbara Kahn: "When companies were product-focused, they would prune unprofitable products. Now, they also look increasingly at the profitability of customers."

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What's a Bad Customer?

Gary Ahlquist, a senior vice president of Booz Allen Hamilton, based in Chicago, says: "In most industries bad customers are those who do three things: they order rarely, they pay slowly or not at all, and they make unreasonable demands. They want a product or service but they don't want to pay for it. So they end up being tough to deal with or unprofitable."

Mitch Rosenbleeth, a vice president in Booz Allen's Dallas office and co-author of a recent report titled "Capturing Value Through Customer Strategy," says the process of identifying unprofitable customers is challenging for companies to embrace because the value is not obvious and it is painstaking.

"We just finished a project for a client where, when we looked at customer profitability, 30% of the customers created 200% of the client's profits," Rosenbleeth says. "About 50% of the customers weren't very profitable and the remaining 20% destroyed profits. So should the client have cut those 20% loose? That wasn't the answer."

Instead, the solution was to segment customers into what Rosenbleeth calls tailored business streams. "You structurally change the way you serve different customers to make each segment as profitable as possible," he explains. For example, a company might continue to serve the best 30% of its customers as it always has, but create different business models for the others. For the unprofitable bottom 20% of customers, it could create a model that either makes those customers profitable or encourages them to go elsewhere. For the 50% in the middle, the company could create a model that drives their profitability higher. Too few companies "take the trouble to obtain a true customer profitability picture," Rosenbleeth says, "and even those that do rarely have a view of the customer's present profitability, let alone the total lifetime value of a customer."

If customers are fired, should a company ever try to get them back? "It's more expensive to acquire a new customer than to retain an existing one," Kahn says. "It's even more expensive to bring back a customer that you've gotten rid of. It's costly and it's a mistake you don't want to make. That's why I believe firing customers should be a last resort."

Love 'Em or Leave 'Em

Much is at stake in being able to manage customers effectively. By failing to winnow the good customers from the bad ones and deal with them accordingly, companies that are dominant in an industry expose themselves to withering competitive attacks by new entrants, according to Eric Clemons, professor of operations and information management at Wharton. This can be illustrated by developments in recent years in the financial services industry, specifically credit-card companies, perhaps the most-studied sector when it comes to customer segmentation.

Clemons is co-author, with Matt Thatcher of the University of Arizona, of a case study analyzing how a small, relatively unknown institution called Capital One became one of the world's largest — and most profitable — credit-card issuers in a few short years during the late 1980s and 1990s. The company, a pioneer in customer segmentation, achieved its robust growth by exploiting an innovative approach to targeted marketing, based on customer profitability analysis.

Capital One attributes its success to efforts in applying information technology tools to customer acquisition and retention. Specifically, the company has relied on what it calls its Information-Based Strategy (IBS), a proprietary set of analytical tools, to tailor its products to the appropriate customers and ensure that each customer is serviced efficiently.

In the case study, Clemons and Thatcher coined colorful terms for two groups of customers — *love 'ems* (the customers who are profitable) and *kill yous* (the unprofitable customers). Most retail banks in 1988 charged uniform prices to all consumers for banking services despite major differences in costs in serving the love 'ems and the kill yous. That situation provided an opportunity for a new entrant, like Capital One, to go after the love 'ems of entrenched banks that were failing to segment customers. The new entrant's strategy: offer fees that were lower than the love 'ems were charged by their current bank, but high enough to generate profits for the new entrant.

A breakthrough for Capital One took place when the company used what it called "test and learn" models to determine which combination of product, price and credit limit could be profitably offered to customers who could be segmented by a wide range of publicly available credit and demographic information. Through the test-and-learn tools, Capital One found that it could offer a balance-transfer product, which offers a lower initial annual percentage rate (APR) to card applicants who transfer balances from a competitor's card.

"It turns out that this transfer of balances by customers from higher APR credit cards to a lower one provides the card issuer with an important signal," Clemons and Thatcher write. "Customers who do not carry balances find no value in a lower APR and will not take the time and effort to switch cards. More importantly, the customers that the balance transfer product will attract are those customers who have a balance they cannot presently pay off but which they will eventually pay off slowly. Therefore, they care about the lower APR."

Customer-segmentation techniques such as these have paid off handsomely for Capital One and eroded the market share of once-dominant players in the credit-card business. Since 1992 the dollar value of loans managed by Capital One has risen from $1.7 billion to $56.9 billion, and Capital One is now one of the top 10 credit-card companies in the U.S., according to The Nilson Report's 2002 ranking of the top U.S. issuers of general purpose credit cards.

"It's a scarier notion to turn clients away than it is to hope against hope that you can make profitable the 500 clients you should get rid of," says Booz Allen's Chris Dallas Feeney

The lessons of Capital One's success can be extended to many other industries, says Clemons. He adds: "If companies in an incumbent industry can't fire the kill yous, and a new entrant can go after the love 'ems, incumbent industries can fall apart."

A Multi-industry Perspective

Here are examples of how other industries are managing customer profitability:

Wireless telephony. Dominic Endicott, a vice president in Booz Allen's Boston office, says wireless companies have wonderful opportunities to segment customers by profitability. He cites several reasons. First, each wireless player has between 10 million and 30 million customers, which means they have many chances to increase the value of each customer. Companies can target certain segments and offer a new value proposition, while improving the value of calling packages for existing customers.

According to Endicott, any business with lots of customers with a subscription history is ripe for this sort of segmentation, including cable TV operators and Internet service providers. Wireless companies even have the ability to reach customers any time by sending messages to their phones. If a customer has experienced a lot of dropped calls, a company not only knows this but can compensate her for the trouble, say, with an additional hour of peak-time calls. By contrast, Endicott says, "With a product in a supermarket, you're lucky if you get scanner data telling you that a person buys soap once a month."

Despite these ready advantages, wireless companies have yet to take full advantage of customer profitability management. Since their inception, wireless firms have pulled out all the stops to acquire customers but have placed little emphasis on managing the value of the customer base.

Endicott says that, in his experience, most wireless operators are "woefully" ill prepared to do this well. "We found it requires comprehensive changes, beginning with the kind of information you gather, the kind of analytics you do and how you organize policies and process across the organization. It is difficult to change the acquisition culture of most wireless companies, which drives them to acquire more and more customers without regard to the qualities of their customer base. This is the first year they've seen a slowdown in growth. It takes a lot of time to change that. But I'm not sure other industries are doing it much better."

"Companies have difficulty analyzing the profitability of customer bases at the level of the individual person... However, it is a long-accepted practice to make predictions about groups of people."

Consumer products. Major consumer-products manufacturers have any number of ways to use business streams that are tailored to the needs of customers, explains Les Moeller, vice president in Booz Allen's Cleveland office. For instance, a consumer-products company can use different models to serve three customer segments: a mega-retailer such as Wal-Mart; a national supermarket chain that is a major player but smaller than Wal-Mart; and a small regional or local retailer.

It turns out that larger customers, like Wal-mart and some regional grocery chains, are better able to order in more efficient quantities, because of their size and distribution capabilities. The real trick is to get those orders from larger customers and to get the inefficient smaller accounts to order and take delivery through a more efficient delivery system, or pay for their increased service requirements.

Moeller, says achieving higher efficiency requires both the retailer and the manufacturer to make complex choices. Should, for instance, the buyer order a full truckload of a product? Or, if the buyer orders a pallet, does it order a full pallet of one stock keeping unit (SKU, or barcode), or does it order layers of one SKU? Or does it order layers that consist of mixed SKUs?

Moeller describes the process

this way: "When a product comes off the production line, it's one SKU and it all ends up on one pallet. If you order a full pallet of one product, all the same size — laundry detergent with bleach or lemon-scented dish detergent — the forklift operator picks that pallet up and puts it on the delivery truck. It's simple. But if that buyer doesn't move enough products in his stores to warrant buying a full pallet of a single item, he may have to mix, on one pallet, regular dish detergent with the lemon-scented kind. That means the warehouse worker has to break pallets apart and reconfigure pallets to fill an order. That can become very expensive." Once the product is delivered to the buyer, other costs come into play: Who, for example, unloads the truck and how much time is allotted to unload it?

There are ways, however, for consumer-products companies to ensure that the buyers are getting the right kind of service and are still a profitable segment to serve. If the retailer is large enough, the consumer-products company can provide incentives to entice them to buy full pallets. If the retailer is not large enough to buy full pallets, they should be pushed to buy from a distributor instead of directly from the factory. This way, the supplier can keep its costs down, while at the same time getting its products on shelves.

Or, a buyer could strike a deal with the supplier regarding delivery. If the truck arrives on time, the buyer agrees to unload the truck within 30 minutes. That way, the driver can quickly get back on the road and make more deliveries. In return, the supplier gives the buyer, say, $50 for every truck that is unloaded in the allotted half-hour. Another option would be for the consumer-products company to offer a deal whereby the buyer orders in full pallets, or even full truckloads, unloads the truck in 30 minutes, and always pays its bill on time. In return, the supplier gives the buyer a rebate of $300 per delivery. "These are the kinds of incentive programs that consumer products companies can put into place to make their customers more profitable and their supply chain more efficient," Moeller says.

> **"Every unprofitable customer should get a chance to become a better customer. But some customers will remain unprofitable no matter what steps a company takes to change its cost structure."**

Health insurance. Health insurers face a somewhat different set of circumstances in trying to develop tailored business streams to deal with good and bad customers. Typically, people obtain health insurance in one of three ways: through their employers, which is most common; as individuals dealing directly with an insurer, which is the least common way; or through a government program like Medicare or Medicaid. To a health insurer, a good customer is someone for whom their employer pays a premium and never files a claim. Bad customers are people who are genetically-predisposed to a particular illness, or who are sick or injured as a result of an event beyond their control, such as an accident.

"In the past, insurers have dealt with unprofitable customers through retroactive analysis," explains Booz Allen's Ahlquist. "They analyze claims information and see where they've had bad risks with employers in the past. They aggregate that data to the employer level, and then determine how much to charge the employer in the future. Or, they may decide not to offer coverage to that employer if the employer was involved in a hazardous business like coal mining."

Even today, the retrospective model prevails. But some insurers are trying to use prospective models. For example, if a company is bidding for the health-insurance business of a law firm, it might analyze data from another law firm and engage in predictive modeling on what it believes its exposure will be, and price coverage based on this analysis.

Once it has the new law firm as an account, the insurance company will try to get more information on individuals so that it can begin to put them into cost-control programs, such as conducting ongoing health assessments or special programs for diabetics. So an insurer, knowing that of the 100 people in the law firm some will contract Type 2 diabetes, can price its premiums accordingly. It can also require that such patients be monitored by their doctors on a regular basis and encouraged to take steps (perhaps a combination of medication, a healthy diet, exercise and weight loss) to mitigate or eliminate the long-term effects of the disease. "Type 2 diabetes can be managed so that the person does not incur huge costs later in life due to loss of vision or some other problem," Ahlquist says.

"Monitoring programs such as these are a way to provide incentives for the individuals who are prone to be ill to try to become healthier, and, therefore, more profitable for the insurer. Of course, if there are many unprofitable customers in the account, the insurer can either drop coverage or re-price it." However, most people covered by employer insurance plans cannot be "fired" by insurance companies because dropping coverage is usually prohibited under terms of the contract with the employer.

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Hope Springs Eternal

Convincing businesses that it is sometimes necessary to get rid of customers is not easy. Booz Allen's Dallas-Feeney, who is co-author with Rosenbleeth of "Capturing Value Through Customer Strategy," describes how companies strenuously resist any suggestion that some customers have to go.

"It's a scary notion for companies to think they have to make more money on fewer clients because it means you really have to win their commitment and loyalty to you. It's a scarier notion to turn clients away than it is to hope against hope that you can make profitable the 500 clients you should get rid of. I call this the 'hope springs eternal' way of thinking. The reason salespeople are successful is because they are generally optimistic and don't want to get rid of customers. And that's a good thing. But a company can't afford to let optimism stand in the way of making a tough decision about customers when it's necessary."

Wharton's Fader is skeptical about much of the thinking behind the notion of managing individual customers' profitability. I think it's insane to do," Fader says of the idea of customer management at the individual level. "For one thing, it is hard to diagnose past behavior to understand why people did what they did. Historical behavioral data is rich and interesting, but it has its limits as a guide to the future." He is especially adamant in doubting the wisdom of firing unprofitable accounts in the business-to-consumer sector, although he does say that managing business-to-business customers is often feasible and worthwhile.

He also says that customers who tend to be unprofitable may not be as bad as they may look, and the ones that appear profitable may not be as good as they appear.

"Any time you rank customers, you'll find that the extremes tend to regress toward the mean and become more average over time. If you have an incentive or rewards program for good customers, you'll find that, eventually, they may not be as good as they used to be. This is especially true when you're talking about very sporadic behavior, as we are here. If a person applies for a bank loan only once in a while, how can the bank know if the customer is abandoning the bank or just has no need for the bank's services at the moment?"

Fader acknowledges that companies have difficulty analyzing their customer bases at the level of the individual person because each customer behaves randomly. However, it is a long-accepted practice to make predictions about groups of people. Actuaries do it all the time. They can forecast accurately what percentage of a group of people will perish in auto accidents, but cannot name the individuals who will die.

"No matter how much data you have on a customer, it's hard to capture everything that's going on," Fader says. "But when you aggregate a bunch of people together it is possible to make very accurate statements about the cohort as a whole. You can, for example, study a group and say with confidence that 25% of these customers will buy products twice from us this year. That's the way a customer base should be analyzed. I worry about clients or vendors who sell or use CRM services that claim to be able to pinpoint customers and their behavior. It's voodoo."

Fader argues that data mining "is wonderful for the original reasons it was developed, like credit card scoring to determine who should get cards. Data mining can help you figure out what makes group A different from B. There are lots of applications for that framework. But it doesn't work well where behavior is evolving. Data mining is pretty darn limited when you move outside of a static snapshot."

It is more difficult in B2B relationships than in B2C to lump customers together, and analyze them on that basis, Fader says. However, the benefits of one-to-one marketing can be greater in B2B relationships where the monetary value of each customer is much larger than in B2C.

Don't Shoot from the Hip

Fader's opinions represent the minority view. Dallas-Feeney, the Booz Allen consultant in New York, says managing customers can be done and done well, as long as it is not misunderstood. It involves, he says, more than just firing customers.

"None of our clients would say, 'OK, your analysis tells me I should exit this many customers, so let's get rid of them immediately.' Every one of those customers -- with the obvious exceptions of bad credit — will be presented with a set of incentives so that a company can say, 'Hey, if we can make this relationship better, we'll keep you. But we can't be successful unless you do the following.'"

The overarching philosophy is that every unprofitable customer should get a chance to become a better customer, with the sales force being given the responsibility of turning those customers around. But some customers will remain unprofitable no matter what steps a company takes to change its cost structure.

Says Dallas-Feeney: "Everything we've been talking about amounts to a reality check that companies should do with every customer on a regular basis. They should look at their relationships and see whether those relationships are working for both parties."

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