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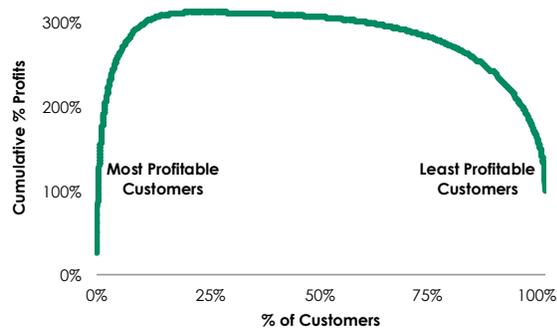
Our perspective at Strategic Resources, Inc.

Why now is (finally) the time to embrace customer profitability management

A brief history

Customer profitability was first popularized in 2001 when Robert Kaplan of Harvard Business School published his research paper entitled *Customer Profitability Measurement and Management*.¹ Amid buzz around the day's hot topic, Customer Relationship Management (CRM), Kaplan argued that understanding which customers are truly profitable or unprofitable is arguably the most fundamental issue facing most businesses. "Our experience indicates that only a minority of typical company's customers is truly profitable," wrote Kaplan at the time. He went on to demonstrate this fact with a case study and summarized his "big idea" in the chart shown below (see **Figure 1**).

Figure 1: Whale Curve of Cumulative Profitability



The "Whale Curve," as it is called, is a visual representation of customer profitability. It shows that a company's most profitable customers can generate as much as 300% of total profits, while the least profitable ones can reduce profitability by 200%. A key takeaway from Kaplan's paper is that decisions about CRM – or any other business initiative, especially those related to sales and marketing – should be grounded in the reality that not all customers are created equally. Companies should perform a customer profitability analysis before considering improvement initiatives, because only then are they armed with the right information about how changes will impact profitability, thus ensuring smart decision-making.

Challenges to adoption

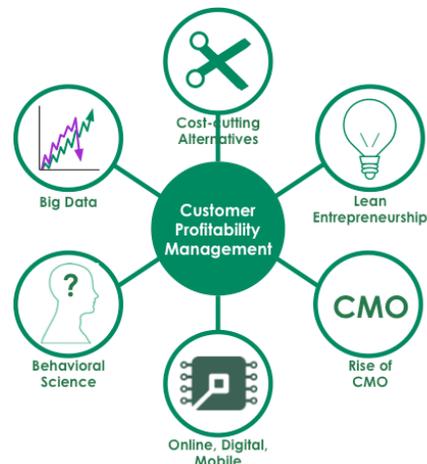
Since Kaplan's paper was first published, additional research has been conducted and numerous examples have sprung up around the topic of customer profitability. Yet, widespread adoption of customer profitability as a guiding principle in management practices has been slow to catch on. Many companies and managers are still unaware that the secret to growth and improved profitability often lies in understanding and effectively managing customer profitability. The reason for this lies in part in several difficulties related to implementing customer profitability initiatives.²

First, effective application requires companies to adopt a customer-centric view of their business. Many businesses today though are still organized according to product lines or siloed by function making it difficult for them to be demand driven. Second, creating something as seemingly simple as the whale curve can be time-consuming and costly, complicated by a lack of available data. Finally, many managers still struggle with the implications of customer profitability. Even once identified, they simply do not know what to do with profitable versus unprofitable customers. For small and medium-size businesses these challenges are often exacerbated by a limit on resources and capabilities to tackle them. Yet lack of understanding aside, which can be addressed through training or third-party support, customer profitability is more important now than ever as a source of competitive advantage for businesses of all sizes. Viewed through the lens of customer profitability management, companies can make sense of today's most fundamental business trends, which suggests companies will need to overcome challenges to adopting a customer profitability mindset if they want to capitalize on these key ideas.

The case for customer profitability management

Below is an illustration of six of today's most important business trends, which are shaping a world in which customer profitability will become a central theme in how companies are run (see **Figure 2**). These trends come from a variety of sources. Some are buzzwords everyone in business is familiar with (e.g. Big Data). Some have been the topic of best-selling business books (e.g. Lean Entrepreneurship, Behavioral Science). And some are just plain truths in the marketplace (e.g. Cost-cutting Alternatives). The common link across these trends is that each points to the importance of customer profitability to the success of businesses now and into the future. A brief explanation of these linkages follows.

Figure 2: Trends Pointing to Customer Profitability



Big Data Few if any hot topics can trump big data as today's top business buzzword. The book *Big Data: A Revolution That Will Transform How We Live, Work, and Think* was in many ways just the beginning of the literature related to how the ability to capture and transform data into insight will transform business. Among the key findings from a recent survey by Deloitte entitled *The Analytics Advantage* is that not only have big data and analytics arrived, but they are here to stay, with 96% of respondents feeling that analytics will become more important in the next three years.³ Every day it gets easier for companies to store and analyze large amounts of data. Using data to make smarter, more informed decisions is no longer an option for companies to stay competitive, it is an expectation. Overcoming the challenges to data availability as part of adopting customer profitability practices will help lay a foundation for businesses to do this successfully.

CMO Rise Related to big data is the increasing importance of the chief marketing office (CMO) in most businesses today. The survey by Deloitte mentioned above also reported that big data's impact on marketing is rising, with a majority of respondents indicating that marketing and sales are second only to finance in analytics investments.³ A separate report from Deloitte chronicled *The Rise of the Chief Marketing Officer*, highlighting the new centrality of the CMO's role in the C-suite amidst pressure on organizations to "meet customer demands – and profitably."⁴ This last fact reflects the role customer profitability plays as a bridge between big data and sales and marketing organizations. With its requirement to make data tracking and measurement available, adopting customer profitability management encourages companies to invest the time and resources necessary to build big data capabilities that sales and marketing can leverage.

Lean Entrepreneurship Another new idea to have gained traction over the past several years is lean entrepreneurship, described in several books including *The Lean Startup*. Lean entrepreneurship is a methodology whereby businesses create a minimum viable product that is tested and iteratively modified based on customer feedback.⁵ Central to the methodology is input from the customer, which drives the iterative process. According to a recent report from IBM, 88% of business leaders say getting closer to their customers is a top priority, and this is reflected in lean entrepreneurship methodology.⁶ In addition to implying the need for customer-centricity, the relevance of this statistic is that customer needs and wants typically come at a cost. And companies make poor decisions when they cannot distinguish between needs versus wants, or more importantly, when they fail to understand the financial impact of providing one or the other. Translating the type of customer insight garnered through lean methodology into financial impact is at the heart of using customer profitability to manage a business.

Behavioral Science From *Contagious* to *SmartTribes* to *Thinking, Fast and Slow*, the last several years have seen a proliferation in books related to social and behavioral sciences, driven in large part by advances in science and technology that have produced a better understanding of the human brain and social networks. The connection between better understanding customer behavior and its relevance to customer profitability is easy to make. Behavioral data is arguably the most untapped marketing resource, and a recent report from Forrester found that the two areas with the biggest potential benefits from applying behavioral marketing are revenue (return on marketing investment) and customer experience.⁷ The emphasis here is on the connection between customer behavior and (again) financial impact. Businesses that understand this relationship can provide better, more profitable incentives to encourage the right type of customer behavior.

Online, Digital, Mobile The truism that today's business environment is characterized by the "Age of the Customer" is perhaps best captured in trends related to online, digital, mobile – and the relationship between the three. The Boston Consulting Group has described the development of a digital ecosystem including not only voice and messaging but also content, ecommerce, cloud services, mobile payments – you name it.⁸ Books like *The New Digital Age* and *The Mobile Wave* discuss these developments and how online, digital, and mobile are changing the world. Increasingly personalized, tailored customer experiences create a need for businesses to adopt a customer-centric view. Customer-centricity as reflected in individualized digital and mobile experiences has both revenue and cost implications related pricing, supply chain management, channel mix, and customer service.⁹ In an "Age of the Customer" it just makes sense that customer profitability would be paramount to managing a business.

Cost-cutting Alternatives Finally, companies who successfully "survived" the Great Recession have in recent years taken out a lot of costs. They are now looking for new and different ways to grow and improve their bottom line. Many are still sitting on the sidelines afraid to invest not knowing what will happen with broader economic conditions. Customer profitability grounds a business in understanding the true value of its customers, allowing for confident decision-making that can help drive both growth and simultaneously improved profitability.

The six trends just described all point directly to the importance of customer profitability management as a guiding principle for businesses and managers going forward. The future success of companies of all sizes depends on their willingness and ability to overcome challenges related to adopting a customer profitability mindset if they are to capture the opportunities and financial return associated with these trends.

Looking ahead

The case for adopting customer profitability management as a core philosophy for running a business is clear. Big data is here to stay, and its application in sales and marketing settings to meet customer demands – and do so profitably – is becoming more central to every CEO's agenda, especially in partnership with increasingly powerful CMO's. Lean entrepreneurship emphasizes customer-centricity, being close to the customer and using those insights to make profitable decisions about customer relationships particularly as it relates to costs. On the revenue side, behavioral science similarly presents opportunity for businesses to relate customer behavior to improved financial performance. In the "Age of the Customer", more personalized online, mobile, and digital experiences have a host of both revenue and cost implications, highlighting the reality of today's customer-centric business environment. And taking all that into consideration, understanding which customers are truly profitable can help companies make confident investment decision to grow and improve the bottom line in an era where better performance is not achieved just through cost-cutting. Companies today that tackle the challenges to adopting customer profitability management – by becoming customer-centric, and investing time and resources to make data available and useful – can capitalize on these key business trends and gain a competitive advantage for the future.

So turn the page to learn more. And if you'd like to discuss anything you've read here, give us a call. Let us help you – Profit From The Know-HowSM.

Footnotes

- ¹ Kaplan, Robert. *Customer Profitability Measurement and Management*. Harvard Business School. May 2001.
- ² *Customer Profitability Management*. Institute of Management Accountants. Statements on Management Accounting. 2010.
- ³ *The Analytics Advantage: We're just getting started*. Deloitte Analytics Advantage Survey. 2013.
- ⁴ *From Mad Men to Superhero – The Rise of Chief Marketing Officer*. Deloitte Debriefs. September 2012.
- ⁵ Rise, Eric. *The Lean Startup*. 2011.
- ⁶ *From Stretched to Strengthened: Insights From the Global Chief Marketing Officer Study*. IBM Institute for Business Value. October 2012.
- ⁷ *Use Behavioral Marketing To Up the Ante in the Age of the Customer: A Winning Strategy and a Path to Higher Gains*. Forrester Research. May 2013.
- ⁸ *Through the Mobile Looking Glass: The Transformative Potential of Mobile Technologies*. Boston Consulting Group. April 2013.
- ⁹ *Minding your digital business: McKinsey Global Survey results*. McKinsey and Company. May 2012.



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