

**SEGMENTATION** ● *Seek high-yield returns*

# Weigh customer segments based on profitability model

By NITI AGRAWAL

**G**ood marketing principles are based upon market segmentation; understanding the needs and wants of a unique grouping of companies and consumers in global markets and then attracting them with compelling products, messaging and branding to create a personal connection between the customer and the company. However, within this traditional view of market segmentation, ascertaining which customers yield the highest profitability—and are therefore better for the company—is critical.

Profitability is at the core of all business drivers. Companies must report profitability to boards and stockholders on a monthly, quarterly and yearly basis. Companies also understand profits by company divisions, regions and product families. Yet few companies have insight into understanding their profitability by customer, customer type or customer segment. This understanding is absolutely critical for making strategic marketing and overall business decisions: defining the right customers to target, which customers to keep and how to price across different types of customers.

CMOs can provide the cross-functional guidance within their company to analyze customer segments and grow the bottom line.

## **Customer profitability: Why does it matter?**

All companies must understand how profitability is created—who their best customers are. “Best customers” typically translates into “customers who buy the most—highest sales.” For many product-only companies that have consistent product margins across product families, this is a feasible way of looking at their business. However, with service companies and companies with differing product margins, a view only on revenue generated by customers is far too limiting. Understanding what products and services customers buy, and the associated product and services costs, are strategic components to designing the most profitable business strategies.

Companies can typically calculate total sales revenue across product divisions and service offerings by customer. However, determining the cost of those sales—especially for service offerings—is exceedingly difficult for most organizations. If customer profitability and customer segment profitability are understood, then CMOs could manage their businesses far more effectively, and develop strategies to:

- ◆ Target the most profitable customer segments;
- ◆ Price services to maximize gross

margins across customers;

- ◆ Discount sales to specific customers; and

- ◆ Design promotional bundles and service bundles.

## **Service business complexity**

Service costs are particularly difficult to quantify and tie to specific services delivered because there are more shared costs among services and customers. Additionally, services tend to be labor-intensive, and employee costs are typically not tracked against specific services delivered and customers served.

Service companies frequently don't understand which customers cost more to serve than others, and which customers use fewer resources—and so, in fact, are more profitable. The type of financial information necessary to determine the cost to serve a customer is typically not available through financial accounting systems or management tools, and can be a significant challenge to assemble. However, this detailed and involved process may possibly be the most critical determination to business success. Without this knowledge, service businesses run as if blindfolded.

## **Building the customer profitability model**

Developing a customer profitability analysis is a complex process. Companies

can approach a customer profitability analysis by first doing the planning and strategic mapping of data and then building the model to leverage enterprise system data and potentially create an automatic system that can be updated on a periodic basis. For lasting value, such solutions must be adopted so that customer profitability becomes an integral part of an organization's decision-making and strategic planning processes.

A fixed time period must be established for the initial analysis. Selecting a time frame over which revenue and cost data is accessible is key. After the time frame is selected, you need to decide which customers for whom this analysis will be performed. Some companies can select to do this analysis for all customers or a subset of the entire customer base. The more customers, the more gradual the analysis; however, it is also more time-consuming to perform.

The key components of a customer profitability model are:

- ◆ *Revenue by customer*—All product and service sales revenue for each customer in the analysis needs to be identified. Any sales discounts or rebates should be accounted for.

- ◆ *Services delivered*—A list of all serv-

ices that are provided to customers needs to be created. All services that are delivered to customers must be categorized as discrete activities, so a bundled service offering may need to be categorized into individual service types. A back-office outsourcing service may need to categorize a bundled service into accounts payable service, payroll service and general ledger service.

- ◆ *Services cost drivers*—For each identified service, a cost driver must be associated. A cost driver is a transaction that can be used to count the number of service transactions provided. For instance, for a basic technical support service, the cost driver would be number of phone calls received.

- ◆ *Total cost by service*—All salary and nonsalary costs need to be divided into the individual service types identified. This step may require time surveys of service employees or estimates of people expense against each service type. Nonsalary direct service costs also need to be categorized by services.

- ◆ *Product costs*—Costs associated with each product sold must be identified and assigned to customers who have purchased those products.

- ◆ *Overhead costs*—Overhead costs may or may not be allocated back to each

customer. We recommend that overhead costs not be allocated to customers and instead, have the analysis be done at customer contribution margin level (customer revenue less the costs to deliver services and products).

Defining and analyzing each of these facets requires a great deal of thought and cross-functional buy-in to develop a meaningful analysis. While the creation of this analysis is complex, the benefits far exceed the input requirements. Armed with a detailed understanding of customer profitability, the CMO and marketing vice president will become leaders within the organization for targeting the right customers within traditional market segments and increasing bottom-line results. ■

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