Identify Best Customer Niches For Profit Maximization

CURRENT CUSTOMER SEGMENTATION?

1. **Typical channel segments (x)**
   a. **Outside sales assignment; or,**
   b. **“House”**
2. **Biggest gross margin accounts & target accounts**
3. **Slow-pay, deadbeat A/R accounts**
4. **Plus?**

Further Refine Our Process?

Customer Niches Slide # 2

Every distribution channel has its own ways of segmenting distribution customers; you will see these segments in channel publications and reports. In addition, each distributor further divides these segments in a few common ways. Some examples are:

- Those assigned to outside sales reps (typically too many) and the rest which belong to the “house”.
- Most locations and reps sub-divide accounts into A,B,C size piles based on sales and/or margin dollar volume and/or potential for time-and-territory and target focus purposes
- And, there are the slow-pay A/R department’s target accounts for trade credit collection.

These measures help to focus the right total service formula and energy towards the right accounts. But most distributors could get breakthrough results if they just went a few steps further, especially by rethinking customer niche strategies around the accounts “profit before interest and tax” (PBIT) contribution and splitting each segment into A,B,C,D strata to be sold, served, priced and termed in a significantly different manner. Too many customers are treated the same. This includes many that are over-served and unprofitable and a very few that are under-served and could be the company’s future.

ASSUMPTIONS/QUESTIONS?

- Historic strategy = Biggest PBIT customers
- Common cluster within top 10+ PBIT accounts
  - Same segment
  - Buy same one-stop-shop basket
  - 2 - 5 best to co-create better service value forward

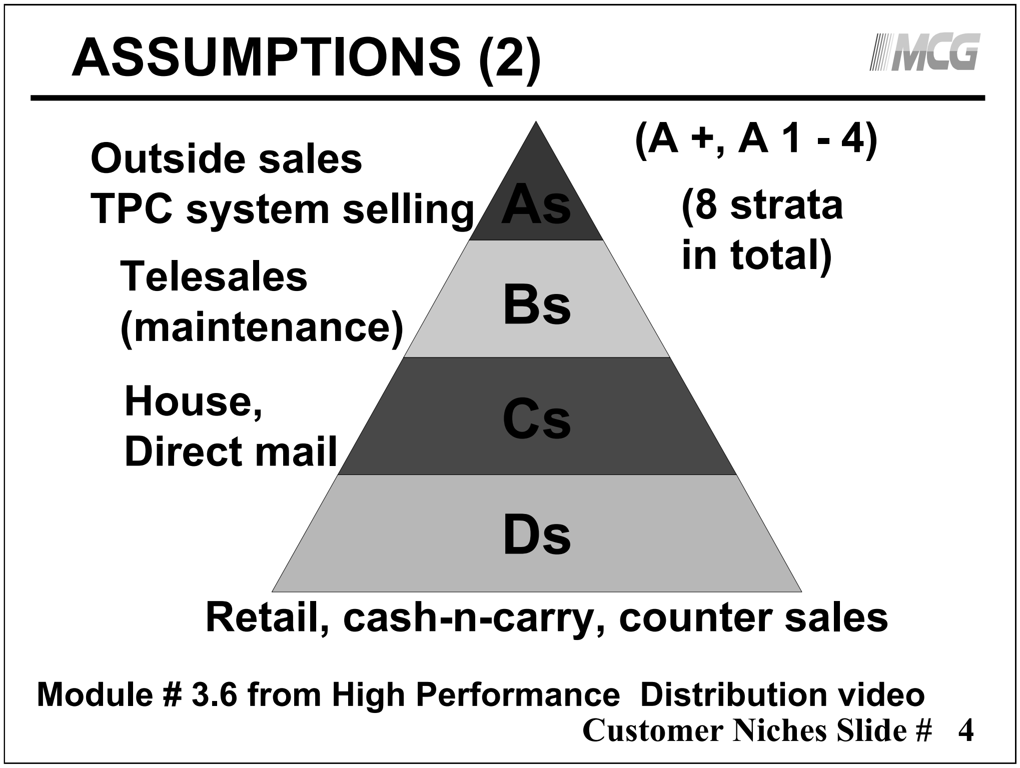
In spite of what we might say our corporate strategy is, I believe it is defined by where our company makes its money. In today's world of commodity products, profit power comes from customers and more specifically the top 20% that will generate roughly 150% of the company's PBIT to offset the 50% losses generated by the bottom 20%. (This is not Pareto's 20/80 guideline which only applies to sales volume.)

Within the top 10 to 20 customers on a PBIT ranking report, a distributor can usually identify one or more clusters of customers that are:

- in the same traditional industry segment
- buyers of the same common basket of warehouse items
- best able to tell us why they buy from us, and what we and other competitive suppliers do that bothers them the most. These service blind spots can lead to new service formula improvement changes.

If you (re) read the case study on "ABC Distribution Company" at the end of "Chapter One" in my "forthcoming book" (posted on our homepage below the red star), you will understand how you might:

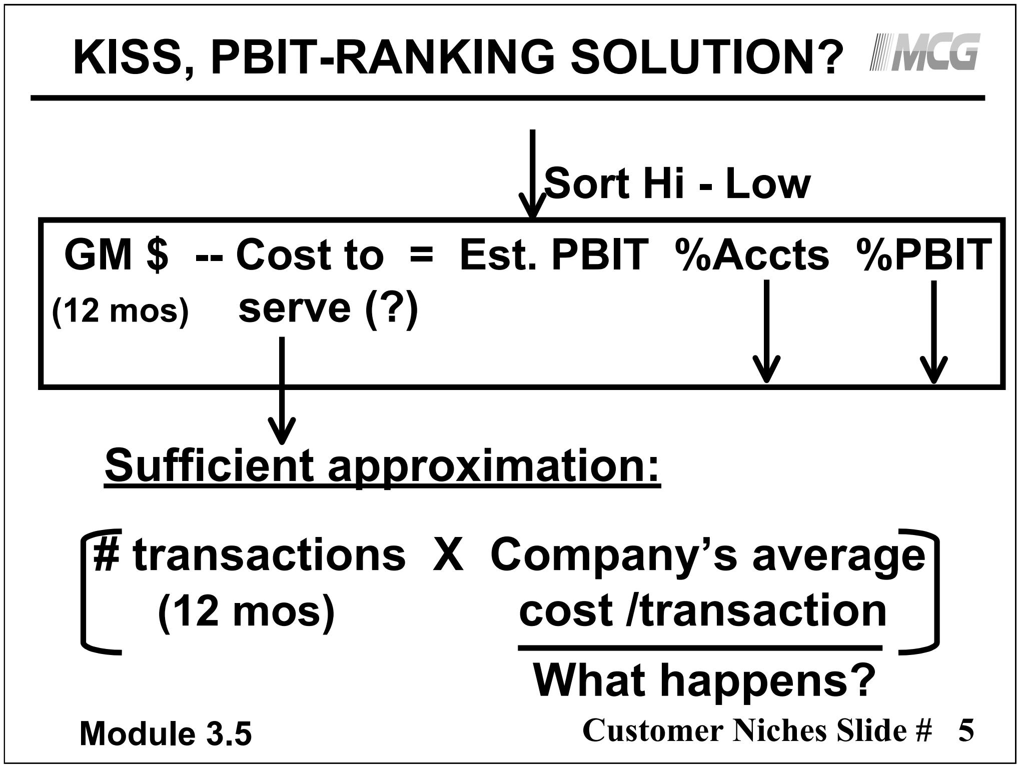
- do a common item analysis for the core customers within each customer niche
- beef up the inventory and fill rates of the most popular items for surprising improvements in service, order size and personnel productivity.



This slide, and its story, are in module 3.6 of our videotape product “High Performance Distribution Ideas for All”. It suggests that we should be more specific about how to segment and to serve the different size groupings of customers within a given segment. Slide 11 in this show will explain why I think outside sales people should be limited to calling on only those accounts that have the potential to do at least $400 in gross margin per month.

Because the typical distributor has too many B and C accounts assigned to outside sales reps, this opens up a reassignment opportunity to a (new?) telesales rep who can better maintain and grow existing accounts at a lower cost per contact. Most D accounts would like wholesale prices and services, but they only buy retail-sized orders. They should be switched to retail-list-less pricing based on order size discounts. They should: pay with cash or credit card, do as much of the work/service as they would at a predominantly retail-format competitor’s store. This leaves a much smaller C category of “house” accounts that might receive a few mailings per year and be offered wholesale list pricing with minimum order sizes, service charges and very tight, limited trade credit privileges at best, so that they are profitable.

Most distributors can be profitably effective with about 2 of the four segments at any given location. Because each strata requires different, operational capabilities and cost structures, the different structures and attention needs start to conflict. To use a track and field analogy, there aren’t any shot-putters and distance runners that get into each other's niche. Unlike the decathalon event, there are no gold medals given by customers to distributors that are “good” at serving a lot of different niches. We have to be the best and largest share-owner of one niche at a time to achieve golden profits.



This equation's whole story is told in module 3.5 of our "High Performance…" video. You can also read about the equation in article 2.3 at our web site, and its application in case study stories in articles #ed – 2.15 and 2.19. Many distributors want to use more comprehensive, "activity based costing" equations, but for strategic directional and quick action purposes, this Keep It Simple Stupid (KISS) equation will suffice.

WHY KISS EQUATION WORKS

1. **Ranking extremes are same with all equations**
2. **All you need to get going on plays; avoid analysis paralysis**
3. **Take extremes (x) exceptional extra cost list**
   - **huge special stock investment**
   - **huge slow A/R cost/risk**
   - **deliveries far (!) away**
   - **abusive service costs(cr/trx)**

Customer Niches Slide # 6

The reason the KISS equation works when put into high-to-low ranking format is that both the most profitable and the most unprofitable customers will always be big winners and losers no matter what refinements are applied to the profitability equation. The size of the profits and losses, moreover, are so large that they compel action. Seven specific plays are listed in the next two slides. Do reports for the entire company, each branch and each sales territory. For a case study that shows results by sales territory – more than half of them were unprofitable – check the case study at the end of article 2.19.

If people want to drag in the extraordinary costs that one account might incur, it is easy enough to compile short ranking lists for those customers that have the biggest costs associated with: special stock; extraordinary account schmoozing; slow pay; exceptional delivery costs; etc. These short lists can then be cross-referenced to the most profitable and unprofitable accounts.

PROFITABILITY REPORT PLAYS (1)

1. Find/define #1 niche amongst top 10 (M 3.3)

2. Sign top 5 up to: (M 3.2)
   - re-define, re-tune, re-allocate services
   - upgrade fill-rates (> turn x earn > price)
     - be #1 best fill-rate supplier (M 4.2-3)
     - best critical-mass, niche inventory turn-earn

3. Team sell (+) heroic actions for:
   - core
   - targets
   - case study results

   (M 3.4)
   (M 3.6-7)

This slide and the next one summarize 7 initiatives that can be refined or initiated anew with guidance by customer profitability ranking reports. I have put the video modules that cover the how-to details for each play in parentheses.

The #2 opportunity in this slide is detailed further in slide #9 of this show and also in article 5.8.

For lots more on #3 (team sell target accounts) see the #8 slideshow posted on our site entitled "Cracking Target Accounts”. (http://min.isisit.com/merrifield/articles/Cracking_Target_Accounts.pdf)

PROFITABILITY REPORT PLAYS (2)

4. Bottom 5 - 15 lead accounts → gold

5. Other sub-categories of small orders

M 3.8 - 3.11

6. Segment customers (A, B, C D) & serve (M3.6)
- **downsize, upgrade, re-orient outside sales**
- **add dedicated tele-sales (B)**

7. Transaction/day/ops people downsizing (?)

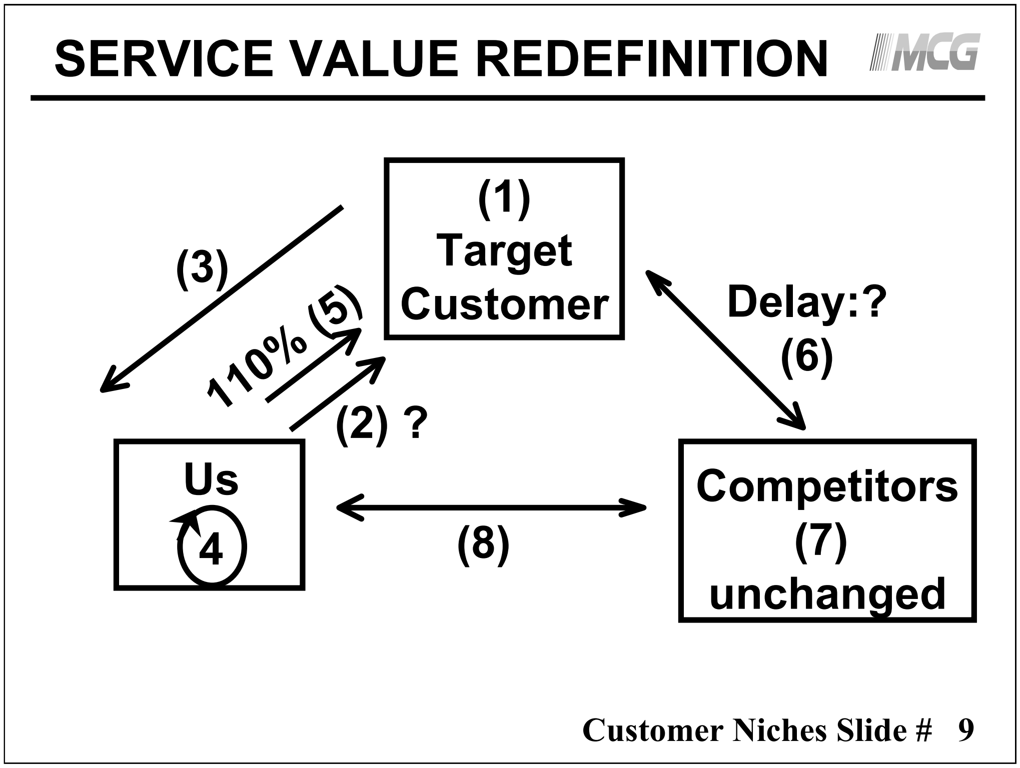
#4 in this slide refers to turning biggest loser accounts into winners. You can do this about 70 to 80% of the time. The 20 to 30% of these accounts that will not change or accept new pricing and terms will walk, but then come back for fill ins on “C” account terms to become very profitable house accounts (because they have been reassigned away from sales rep coverage). Helping loser accounts to rethink their replenishment processes to create a win-win flow of optimally sized orders will require management-to-management negotiations. Sales reps can not typically make these changes happen through their normal contacts.

For more on the lead into gold account opportunity see the following distribution channel commentary topics: Commentary #'s and then item number: 18.4, 21.4, 23.4, 39.3, 40.2, and 50.1.

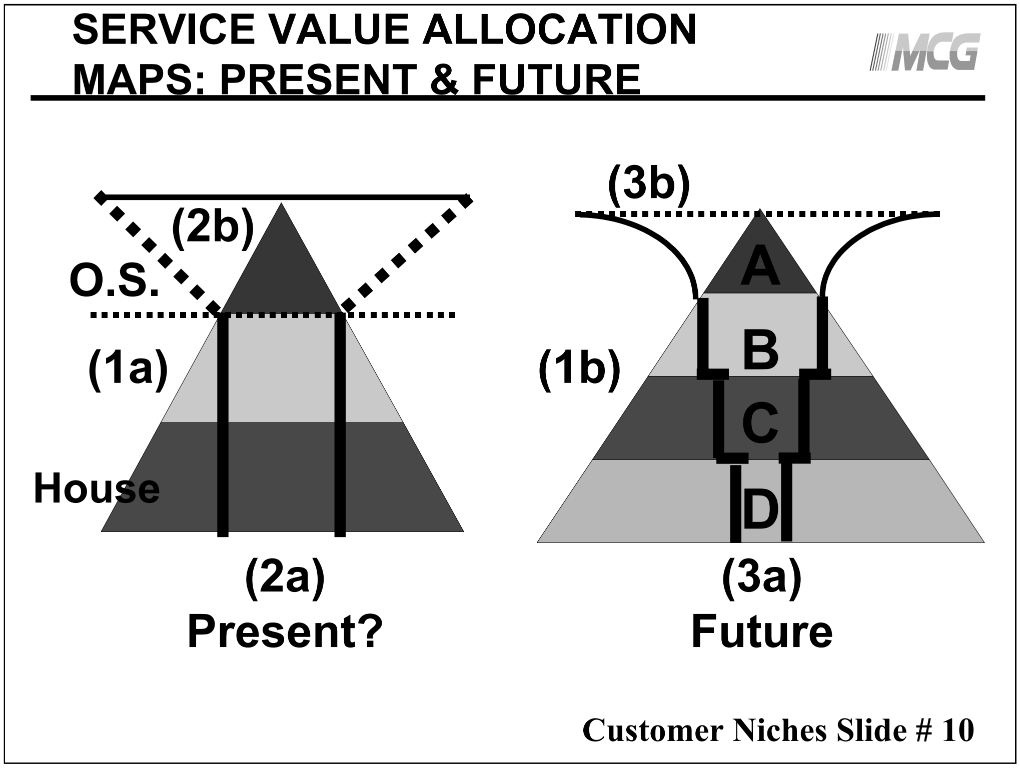
#6 in this slide is explained in more detail in slide #10 of this show.

Play #7 is referring to a metric used while implementing the “small order program” (video modules #ed 3.8 to 3.11) that has a number of different sub-categories and tactics. The opportunity area is the bottom 40% of all transactions at a typical distribution location that contains less than 5% of the gross margin dollars. A comprehensive small order program can consolidate away 30 percentage points of transactions, which includes some driven away that will cost about 2 percentage points of margin dollars.

If a firm tracks the number of transactions per day per order fulfillment employee, then they will know when they can lay off or re-deploy employees. A firm actually has a range of options from no layoffs to maximum ones to keep the transactions per day ratio at the level that existed before a “small order program” is implemented. The most aggressive layoff option will reduce operating expenses much faster and permanently greater than the small amount of lost margin dollars. Operating profits at small order branches can increase 2 to 3 fold within 3 months time!



This slide is explained in great detail in video module 3.2 and partially in article 5.8. Briefly, in Step 1 above, we identify the 2-5 most profitable (and progressive) customers in one customer niche. Then, (Step 2) good-listening management visits them to find out how to better re-define and re-tune the total service offering for this niche. (Step 3) new insights are brought back to the firm that will typically require comprehensive changes (Step 4) in: strategy redefinition, service processes, personnel training, service scoring and ultimately incentives. Then, the new, best, service formula can be sold obnoxiously (step 5) to better retain, grow and steal niche share from the competition. The competitors most hurt by our better value proposition will (Step 6) eventually understand superficially what we are delivering. But, (Step 7) most competitors can not change and (Step 8) will retreat from our targeted niche, if not go out of business, because our costs are lower and our service values are higher due to a perfect match between what we are doing and what the customer niche wants.



This slide is fully explained in video module #3.6, and it is meant to illustrate how distributors need to better:

- Define economic boundaries based on margin dollars generated per month for customers (A-D)
- And, service, price and term the segments more radically than what has been done.

If we are guilty of over-serving B-D accounts to breakeven and lose money on them, then we can't super, team-focus on the few core and target A accounts that are our profitable past and profit growth future. Less than 5% of the customers in any mature customer niche will account for 80% of the future profit growth for some distribution supplier; shouldn't that supplier be us?

OUTSIDE SALES LIMIT?

1. To sell to & through a customer on a "TPC" basis, 1 call/month min.
2. Cost/call = $100
3. Cost = 25% or less of GM$; $400 GM +/mo.
4. Downsize, upgrade, re-orient salesreps?*
5. Case study: (ABC Bakery Supply - Ex. 2)

*Article 4.9 and support notes

Customer Niches Slide # 11

To expand on this slide's points:

#1: We don't just want an order from an account, we want to ultimately have a stream of optimally sized (for both of us), profitable orders that are the by-product of inter-company sell-buy replenishment work. See article 4.9 for more on this objective. For now, let it suffice to say that a rep can not sell, install and maintain a lowest total procurement cost supply system for an account without making a minimum of one call per month on an account.

#2: Take the full loaded cost of an outside sales rep and divide it by the actual account calls that are actually made, and you are apt to get an average cost of about $100/call

#3: Let's assume that we would like our total sales cost to be 25% of the gross margin that an account produces. At one, $100 call per month minimum, then the account will have to generate a minimum of $400 per month in margin. I would guess that 50 to 80% of all accounts assigned to outside sales reps at various distributors across the country do less than $400 in margin.

#4: If we were to reassign the true B and C accounts from outside reps to either telesales rep(s) or the house, how many outside reps would really be needed to call on true A accounts? Perhaps the A accounts from 2 or 3 territories can be pooled into one excellent territory assigned to a best sales rep who can retrained to sell win-win replenishment systems.

#5: See ABC Bakery Supply case study in article 2.19 for an illustration of the opportunity alluded to in point #4.

FURTHER NICHE SEGMENT BY “SERVICE VALUE” PERCEPTIONS

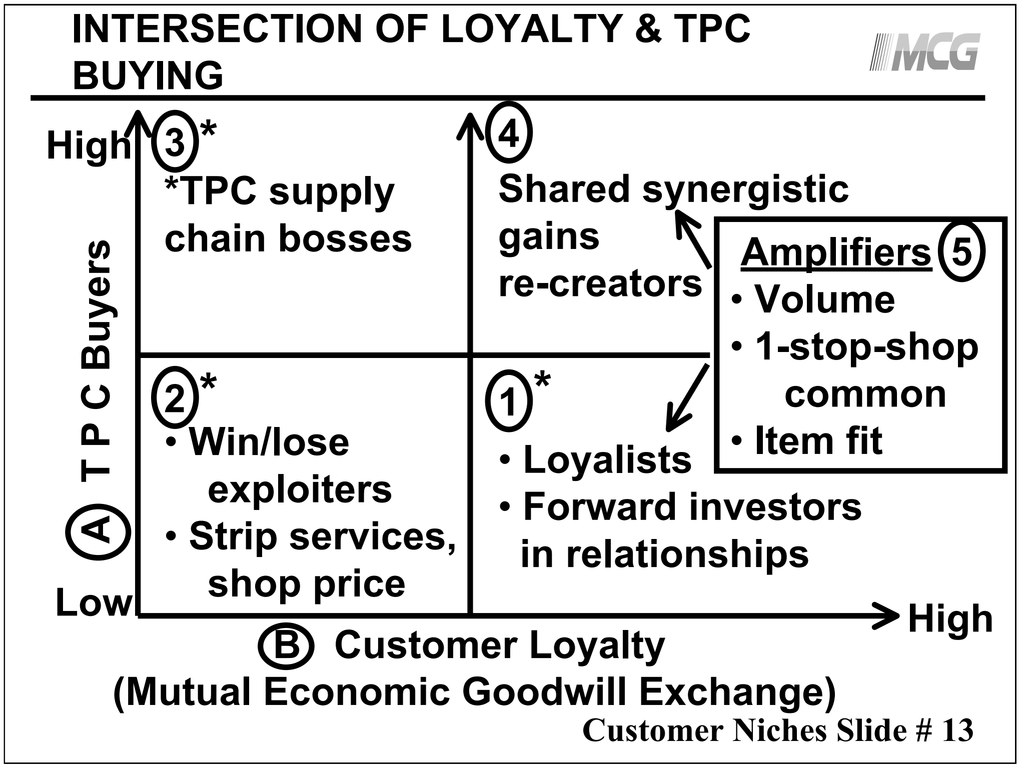
1) Emotional, Loyalty	“Buy from those who I trust, like over time”
2) Best Total Value Passive Aggressive	TPC IQ; partner capable; disc. Systems/execution
3) Pure Price	• Wholesale club, I-Buy • High grow up rate

Customer Niches Slide # 12

One last dimension for furthering sub-dividing and defining customer niches is “why a customer buys”. Perhaps 5 to 15% of customers buy from the service people (outside sales rep and/or inside sales rep) who have most thoroughly cared for and served them over the years (“Emotional Loyalty”).

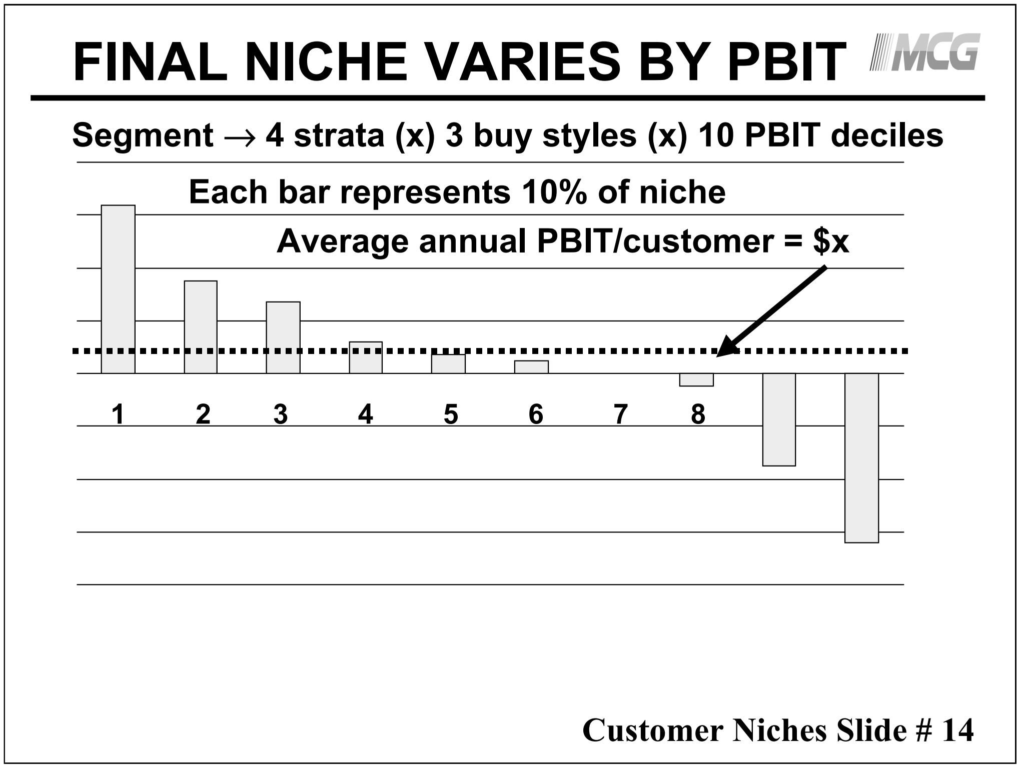
The largest group of customers are “value buyers”. Some are quite scientific and strategic about how they measure, choose and manage suppliers to deliver the lowest “total procurement cost” (TPC) while others are quite vague on the idea, but willing to be educated if a supplier does have the best TPC proposition for the niche and the buyer. Some value buyers are quite aggressive in trying to get both the best, guaranteed service value and the lowest price. At the other extreme, there are those (passive) to whom you can ask and get last-look plus a bit more, because your total value package is still the lowest TPC.

The “pure price” buyer segment is actually very small. The wholesale clubs offer this proposition for the items they stock, and they have captured only 2 to 3% of both the consumer and the small business market segments. A number of public institutions are required by law to bid out their needs and take the lowest price, even though they know that it will assure “bargain service”, the costs of which will exceed the price savings.

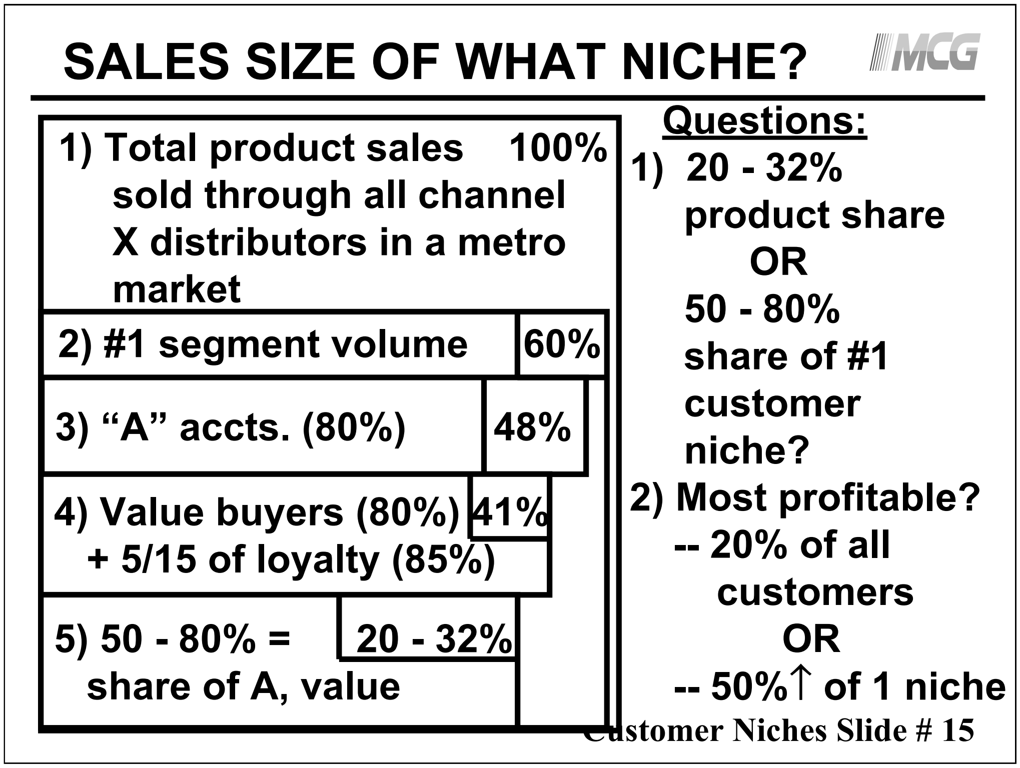


This slides plots customer loyalty against "total procurement cost" disciplined purchasing. The best of all worlds is to target and win buyers in the upper right square who believe in mutual goodwill exchanges for win-win, synergistic value AND who understand and will work towards creating win-win lowest TPC/lowest cost to serve replenishment systems. The potential profits of such relationships then scale or are "amplified" by both volume and the customers' buying the same common item basket of goods. Then, the collective demand of these customers gives the distributor an inventory investment that delivers:

- high fill-rates for a one-stop-shop array of items for the customer niche;
- high turn x earn productivity for the inventory investment for the distributor;
- and, good purchasing power and continuous, frequent re-ordering opportunities with suppliers.



If we were to take a strata of a customer segment and measure the PBIT contributions of all customers in that strata, we would get a range of profitability. The most profitable decile on the left of the graph would be buying a common, one-stop-shop basket of items on a good-sized average order basis due to predictable supply needs and a discipline replenishment system. The ones on the far right would be killing us with small orders, perhaps because they were cherry-picking us for all of the odd items that we might have that their primary suppliers didn't have on a ready-enough basis.



This slide is a hypothetical case study to illustrate why it is more profitable to own a big share of one customer niche instead of an equal amount of sales sold to all types of customers in a distribution market. How do we calculate a distributor's share of a customer niche? We zero in on it by starting with:

Box 1 – the total estimated volume of product volume sold through all of the distributors within a given channel in a given market. Call this "100%".

Box 2 – we identify the number one segment of customers that we sell and estimate that this segment buys 60% of all of the product volume.

Box 3 – within this given segment of customers, we further sub-divide them by primary mode of selling ("A"- outside sales; B – telesales; C – catalog; D – cash-carry/retail). We estimate that the "A" strata buys 80% of the segment's volume for a total product volume share of .60 x .80 = 48%.

Box 4 – we then only go proactively after the 85% of the A strata customers that buy "value" (or TPC) as best they can understand and measure it. We are assuming here that: 5% are pure price buyers and 15% are relationship loyalty buyers even if total service value is less the service value leading distributor's. But, we may get 5 of the 15 points of relationship buyers. So, 48% x 85% = about 40% of the total product volume sold in the market.

Box 5 – because we are so focused on the accounts that matter in our #1 customer niche, we have tuned our service metrics to offer the best total service value starring the highest effective fill rates on a robust one-stop-shop array of SKUs that this #1 niche buys. We win the retention war and achieve somewhere between 50 to 80% of this niche's total purchases. This allows us to get better turn x earn economics on our inventory, higher and better average order size economics and last look plus a bit more for our still best total value proposition. (More on all of this in our other annotated slide shows and our "strategy paper" free via e-mail request from karen@merrifield.com)

Our final share of the total product sales for the channel is 40% x 50 to 80 = 20 to 32%. This does not preclude that we can't then do the same process for a second niche that we choose to dominate; perhaps the value-buyers in the B strata of the same customer segment.

Big questions concerning fees-for services.

1) What extra services would the top 3% of the biggest profit producing accounts like to have? Considering how profitable these accounts are: do we do the extra services as part of our bundled offering or do we un-bundled them for a fee?

2) If we have been serving all customers within a segment, A – D, how many customers are we losing on by providing standard wholesale services for retail sized orders? By segmenting customers, we can also un-bundle standard services and charge for them – delivery, special orders, minimum order requirements, tighter credit terms and treatment. Lost margin dollars? See articles #ed: 2.19, 2.15, 2.3 and video modules 3.3 to 3.11 for the good news answers.

CONCLUSIONS

1. PBIT-centric, customer-niche thinking = breakthrough
2. See KISS PBIT-ranking as first-cut "directional"
3. Downsize, upgrade, re-evaluate & re-incent sales force to profitable stream-of-order, system selling
4. Team-sell lead-2-gold accounts first

Customer Niches Slide # 16

The bullets above are hopefully self-explanatory. I would just encourage every distributor that has not already done so to do customer profitability ranking reports on a simple basis by: company, branch and sales territory. Then these slides and the articles and video modules that are provided should help some breakthrough thinking and PBIT-growing action to happen.