Customer Elimination:
Brilliant Strategy or a Fool's Game?

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DISTRIBUTORS HAVE BEEN CONCERNED ABOUT UNPROFITABLE accounts for nearly 50 years (the first rigorous analysis of the topic, *Marketing Productivity Analysis*, by Charles Sevin, was published in 1965). The inescapable conclusion then, as now, is that distributors lose money on about one-third of their customers.

Until fairly recently, the unprofitable customer concept was simply that—a concept. With the advent of more sophisticated technology and computer programs (especially Excel), there is now the ability to precisely measure which customers are and are not profitable and why. Alas, such sophisticated analysis has frequently led to automatic, ham-handed efforts to deal with the unprofitable customer problem by simply eliminating large numbers of customers.

This article suggests that customer elimination programs have the potential to do far more harm than good. It does so by exploring two aspects of the customer profitability relationship:

- Customer Elimination Economics – an examination of the sales, margin and expense impacts associated with eliminating customers
- Customer Strategies – some specific suggestions for ensuring that the firm drives maximum profit from its customer set

Customer Elimination Economics

Calculating customer profitability is a relatively simple process. Improving profits based on that customer analysis is much more complicated. Measurement is a lot different than improvement.

In determining customer profitability, it is necessary to tie costs to customers in a meaningful way. For example, if the firm's total delivery costs are divided by the number of deliveries, it is possible to approximate the cost of making a delivery. This basic calculation can be modified for distance, size of the delivery and the like, but the underlying process remains the same.

After that, the cost per delivery is applied to the number of deliveries made to a specific customer, and the total delivery expense for that account can be estimated. Similar approaches can be taken for other cost categories, such as sales commissions, order picking and returns processing.

In almost every instance, about 40.0% of total costs can be assigned to specific customers. These are what are referred to as direct costs. The remaining 60.0% are indirect costs. They are incurred for the overall benefit of the firm and cannot be traced to individual customers. These include the salaries of the administrative staff, rent and utilities associated with the warehouse, and a wide range of other overhead expenses not associated with a specific customer.

When customers are eliminated, the direct versus indirect cost analysis is no longer applicable. It must be replaced with a different managerial accounting concept with cumbersome titles—escapable versus inescapable costs. Simply put, escapable costs are those that will go away when the customer is eliminated. Inescapable costs will not. To make matters more complex, some costs are partially escapable and will merely be reduced.

From an expense perspective, 20.0% of the expenses associated with customers are fully escapable when customers are eliminated. Another 20.0% are partially escapable. The remaining 60.0% are entirely inescapable.

This issue is highlighted in Exhibit 1. The Current Results column represents the performance of the typical DHI member. In the Customer Elimination column, the firm has chosen to rid itself of a set of customers that represent 10.0% of its sales volume. Since unprofitable customers are also typically low-gross-margin ones, the firm has only sacrificed 5.0% of its margin dollars.

In addition, unprofitable customers are almost always high-expense customers. It is assumed that when 10.0% of sales go away, a full 15.0% of the fully escapable expenses, such as sales commissions, can be eliminated. The partially escapable expenses are another matter entirely. The reduction in delivery costs, order picking, sales force travel and the like are modest in relationship to the sales eliminated. In the example, these costs decline by only 7.5%—about half the decline for the fully escapable expenses.

As can be seen in the After Elimination column, when customers representing 10.0% of sales are eliminated, both dollar profit and profit as a percent of revenue decline. The company is doing less work and may have fewer accounts, but it also has less profit. Large customer cuts simply don't drive higher profits.

Exhibit 1
The Impact of Eliminating Customers for the Typical DHI Member

Income Statement--$	Current Results	Customer Elimination	After Elimination	Percent Change
Net Sales	$11,500,000	1,150,000	$10,350,000	-10.0
Cost of Goods Sold	8,165,000	983,250	$7,181,750	-12.0
Gross Margin	3,335,000	166,750	$3,168,250	-5.0
Expenses				
Fully Escapable Expenses	635,000	95,250	$539,750	-15.0
Partially Escapable Expenses	635,000	47,625	$587,375	-7.5
Inescapable Expenses	1,905,000	0	$1,905,000	0.0
Total Expenses	3,175,000		$3,032,125	-4.5
Profit Before Taxes	$160,000		$136,125	-14.9
Income Statement--%				
Net Sales	100.0		100.0	
Cost of Goods Sold	71.0		69.4	
Gross Margin	29.0		30.6	
Expenses				
Fully Escapable Expenses	5.5		5.2	
Partially Escapable Expenses	5.5		5.7	
Inescapable Expenses	16.6		18.4	
Total Expenses	27.6		29.3	
Profit Before Taxes	1.4		1.3	

Customer Strategies

Customer profitability analysis can be helpful if used properly. Two specific actions prove to be most beneficial in working with customers: (1) focusing on the least profitable 2.0% of customers, and (2) and developing a meaningful customer profitability plan.

The Bottom 2%: Most analyses suggest that about 2.0% of customers can never be made profitable. These are the ones that do not generate enough gross margin to even cover the direct costs of servicing them. They also don't really care if their suppliers make a profit or not.

The easiest approach is to simply let such customers fire themselves. This can best be accomplished by systematically increasing prices until they cover the direct costs of servicing the account. "Systematic" can be interpreted either as "slow but steady" or "fast but steady." In either case, driving more margin is almost the only way to overcome large-loss customers.

Eventually, problem accounts either become profitable or choose to become problems for some other supplier. Since these customers are dramatically unprofitable, their self-elimination actually does increase profit. Unfortunately, that is not true for the remaining customers that are not covering their full costs.

A Meaningful Customer Plan: The real challenge in customer profitability is that with one-third of the customers unprofitable and yet only 2.0% worthy of firing themselves, the firm is left with a substantial challenge

Getting the remaining group to profitability will require some price increases coupled with a large dose of service modification. This group almost always places too many small orders too frequently. This practice not only increases the costs of servicing an account, it increases the customer's own costs as well.

Over time it is possible to explain to customers how placing fewer well-planned orders and deliveries improves profitability for everybody in the channel. It is a slow process, but one that inevitably leads to much higher profit. It is also a process that needs to be led by the sales force—the group on the front line in dealing with customers.

The More You Cut, the Worse It Gets

Unless some reductions can be made in overhead expenses, the more customers (and their sales) that are eliminated, the lower the profit level earned by the firm.

The following table indicates the profit generated by the typical DHI member when up to 30.0% of the sales from problem customers are eliminated. It rests on the same assumptions as in Exhibit 1—namely: (1) there is a positive impact, in that gross margin dollars disappear half as fast as sales, (2) there is another positive impact in that some expenses disappear 50.0% faster than sales, (3) the positive impacts are offset by the inevitability that some expenses disappear more slowly than sales, and (4) some expenses cannot be eliminated at all. It is a cautionary tale that suggests that the scalpel is always better than the meat axe.

The Impact of Customer Elimination on the Typical DHI Member

Percent of Sales Eliminated	Total Firm Profit
0.0 %	$160,000
5.0	148,063
10.0	136,125
15.0	124,188
20.0	112,250
25.0	100,313
30.0	88,375

Moving Forward

Distributors have a wonderful array of new analytical techniques at their disposal, of which customer profitability analysis is only one. Unfortunately, the analytical techniques available often outpace the capability to use those techniques fully. Obtaining maximum impact requires understanding that they must be used as aids to management judgement, not replacements. dh

About the Author: *Dr. Albert D. Bates is founder and president of Profit Planning Group. His latest book,* Triple Your Profit!, *is available at www.tripleyourprofitbook.com, as well as Amazon and Barnes & Noble.*