The three myths of profitability

I like working with business owners as you are doing what you are doing because you want to work for yourselves. So it worries me that most people are working really hard for someone else. Because we all have customers that aren't worth having. Yet few of us realise who they are. Because of the three big myths of profitability. So I think that we need to discuss them.

So when we have discussed the three myths of profitability, you will have a clearer picture of what your customers mean to you.

Let's put in a check point here that we can refer back to. Think who are your three best customers and write them down.

Now the myths:

Number 1. ***The more you sell, the more you make***

Lots of people try to tell you how to get more revenue... and they say increase your profit. But will it?

Even if it does, it takes the average British company £26 of revenue to earn £1 in profit. Which means it takes a £100 m company a snap of the fingers, but a £100 thousand company over half an hour.

So it's pretty hard work.

The simple fact is that more revenue doesn't automatically lead to more profit. After all what are some quick ways to sell more?

1. Run a marketing campaign - cost money and we are never sure of who we will get.

2. Or offer discounts, incentives or whatever. Fine, you sell more but are you making more? Ultimately everything gets cheaper and more competitive . In Asia 51% of manufacturers dropped prices last year and 23% raised them. It's not a sustainable advantage.

3. Or find big customers. They expect superior treatment, better prices and many other treats, Big often means less profitable.

At the end you might be worse off. I had one project where the client thought that the product was bouncing around breaking even: marketing told them that if they doubled sales there would be lots of profit. I studied the situation, found that they were losing £40 million right now and that all selling twice as much would achieve was losing £80 million. They didn't understand the real cost of what they were doing.

Anyway, if you are selling yourself, you are already working all the hours God sends, so is selling more an option?

We need to find a way to make more profit without working any harder. Why work for someone else?

Number 2. ***Satisfaction and loyalty means profit***

The claim is that satisfied customers mean loyal customers which means customer retention and so lower costs.

Yet there is no proven rule between satisfaction and loyalty, let alone anything to do with profit.

What evidence have I got?

- Manchester Business School has found that satisfied customers are 65% loyal but the very satisfied are 95% loyal. Sounds good.

- Against this American automobile manufacturers typically have satisfaction survey results of close to 90%, but repurchase rates of 30% to 40%.

- And then some customers of big software companies are very dissatisfied but very loyal as they can't get off.

So how can we say that there is a relationship between satisfaction and loyalty? Even if we could, what makes a satisfied customer? Customers who are taking lots more value from you than they are giving you. This is not a recipe for success.

I'm not saying that having satisfied customers is bad. What I am saying is that pursuing satisfaction as your core objective is a doomed strategy.

Number 3. *All revenue is equally profitable*

I think we all know that this isn't true, but I wanted to share the scale of it with you.

We all know the old 80:20 rule. Most of the marketers and business strategists that I listen to talk about 20% of your customers giving you 80% of your profit. Well it's just not true - it's much, much worse than that.

The last one to hold forth about this rule to me used an example of a restaurant that he used to run. He had 'yummy mummies' who would come in and drink quite a few bottles of wine.

He also had a permanent group of 'hey-mans' saying "Hard night man can we have a pot of tea and seven cups man?"

Is that the 80:20 rule? No, more like a 200:10 rule. Not only were the 'hey-mans' not making any money in themselves, they were stopping profit being made - all those wallets that kept walking past the door.

I can give you no end of other examples:

- The big four UK banks make £60m a day, which sounds a lot. Well, they actually make up to £102 million a day from their top ten per cent of customers and then lose £42 million again on the other 90 per cent.

- At the other end of the size scale, Bob Olsen, president of Peregrine Outfitters, a Vermont-based sporting-goods wholesaler, discovered he was losing money on two-thirds of the 6,000 products he sells. He's not alone: a recent American study showed that half of products and customers lose money.

- And Walmart found that they spent 75% of all the procurement costs on products that generated less than 5 per cent of profit.

I mentioned earlier about the £26 it takes to make £1 profit. It's starting to look like you make £2 profit and lose half of it. So you have to earn another £26 just to put the £1 back. That means that companies like this are spending a third of their time just getting back to where they started.

More importantly, you're wasting a third of your life.

How is this possible?

The problem is that we don't really know what's going on. We don't because of traditional accounting systems that arose from the industrial age. I'm told that accounting is great. It minimises your tax, keeps you out of prison and useful stuff like that, but does it help you make money?

Well it was fairly simple then as life was simple: we took something in, used labour to bash it about and then sell it. Now we have so many things that happen. Think about Henry and his Model T's against the modern Ford with so many models, servicing, finance….

Yet understanding that we need a better grip on things isn't new: in fact it was what used to happen with postage stamps, where the cost was related to distance. But Charles Babbage, who for once actually managed to finish something, proved that it cost more to work out the cost of postage than the actual postage itself, and that's why we have universal pricing.

But now we have the power to understand what we actually do to create our revenue:

1. *The cost of making it*: activity based costing - pretty well understood

2. *The cost of selling it*: you have to wrap it up in transaction costs - customer specific. A lot of people pay little attention to this.

Imagine you are a bank with two customers. Both give you a million pounds a year: one in one cheque, the other in bits of £100. They look equally valuable on the books, but which would you rather have?

Transaction costs are driven by events not volume

It's Babbage again: the cost of selling outweighs profit from doing. It's all about the amount of activity.

4. *The cost of keeping customers*: marketing, customer service, etc.

It's not about accurate bookkeeping, but about appreciating what you actually do. This was too costly before as it had to be worked out by hand, but now we have computers. So e don't have to have wrong information.

Let me give you three examples of the cost of wrong information:

5. The CEO of a computer printer manufacturer was going to stop one of his lines. His finance people told him that each of those printers that he sold lost £5 in every box. However, some of his management team did a study and found that it was actually making a contribution of 25% - the best model that he had.
6. I went to project for a distribution company where customer complaints were rife, yet internal measures showed a very low error rate. I found that the problem was that there was so much going wrong that the depot staff had set up ways to fix most of them: they were only reporting the errors that they weren't expecting! Yet all the effort was costing £100 million a year and the main source of the errors were the customers who were complaining.
7. A service garage owner is the UK expert on a certain model. He was spending lots of his time giving free advice to callers, but wasn't selling anything to them. We rebalanced the customer contact systems to make sure that he was spending time with the people who spent money with him.

The solution
Build a plan to get more reward from your time. By managing those customers and products that lose you money. Trust me, you do have them.

The answers

The first thing is to create a product- customer matrix and find which intersections give you the most profit.

1. Treat different customers differently

If you are spending a lot of money with a customer for little return, then reduce the cost of transaction and the cost of customer. Build a strategy that reflects their real profitability to you. Consider differential pricing. Or offer web contact for some and priority phone numbers for profitable customers.

2. Find different customers

When you know who your most profitable customers really are, then find more like them. If you can move lower margin customers into cheaper channels to increase your profits, then pursue more like them as well.

3. If you can't make them profitable, then let them go. Maybe sell the leads to a competitor for a fee!

We need to appreciate that understanding what is happening is a mathematical exercise, but taking these decisions isn't. Look at your customers in the round. Banks don't like scout groups, but scoutmasters tend to be senior people in big companies. So they smile and run scout accounts.

Conclusion

Focus on where you make your money, not where you spend it. Know what drives your costs rather than how you divide them up.

Investing in customers is like investing in capital - make sure you get a return.

So now we've finished our journey I'd like to ask you the question that I asked when we started this journey.

who are your best customers?

But the really important question is:

how do you know?

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