CHAPTER 10

Relating Revenue Management to Customer Value

One theme in cost analysis has direct linkage to revenue management, namely the effort to classify costs as value-added or non-value-added costs. Value-added costs are those that provide something for which a customer is willing to pay. This concept has a direct role in revenue management; customers are willing to pay for the *value* they receive from a purchase.

Early research by McNair and Vangermeersch analyzed profitability as four concentric circles.[1] The inner circle represents a core of activities that adds value to the company's products or services. These activities may contribute to the functional characteristics of the product or service, their quality, customer support services, company reputation, timely delivery, and price. Surrounding these value-added costs are non-value-added but necessary costs. These costs do not contribute to the customer's benefit but are required to run the business. The next circle is that of non-value-added and unnecessary costs, termed *waste.* The outer ring is the company's profit, which is bounded by limitations on its ability to charge higher prices.

In subsequent research, the terms *non-value-added* costs and *waste* did not sit well with managers of those functions. The previous three cost categories were revised to the following five.[2]

1. Value-added costs, which directly benefit a customer.
2. Business value-added costs—current, which do not directly affect customer satisfaction (unless done poorly, such as billing).

3. Business value-added costs—future, which create the company's future products or services, growth, and competitive position.
4. Business value-added costs—administrative, which are needed to support the firm and its management.
5. Non-value-added costs, which have no stakeholder benefits and thus should be minimized or eliminated (formerly termed *waste*).

Value-added costs may be further subdivided, according to McNair, Polutnik, and Silvi (2000), into *table stakes* and *revenue enhancers*.[3] *Table stakes* involves the costs of providing the basic features a customer would expect in a product or services; these are required to be a player in the industry.[4] *Revenue enhancers* are the costs of the extra product or service features that differentiate a company's offerings from those of its competitors.

The Discount Phenomenon

Providing customer value is central to revenue management; however, much of the development in recent years has been at the low end of the value scale. Shell traces the history, expansion, and widespread implications of a discounting culture in her book, *Cheap: The High Cost of Discount Culture*.[5] The concept of discount stores is not new. One of the earliest, John Wanamaker & Co., dates to the 1860s. Their large stores enabled purchasing in bulk, hence giving a pricing advantage over the small retailers of the day. Wanamaker is also credited with inventing the price tag, changing retailing from negotiated prices to pre-established prices.[6] In 1878, Frank W. Woolworth opened the first 5 and 10 store, featuring inexpensive merchandise. He pioneered the change from clerk service (goods behind the counter) to self-service (goods on open display), gaining a price advantage by requiring fewer—and less-skilled—workers. Eventually, Woolworth expanded into manufacturing as well, achieving further price reductions by emulating European mass production techniques.[7] Other similar stores, such as W. T. Grant and S. S. Kresge, soon followed. In 1895, Richard Sears took another step toward lower prices by beginning a catalog mail-order retailer, thus reducing the need for, and cost of, retail outlets and giving the company an instant national presence.

The post–World War II period saw the growth of the large suburban discount store, which followed the mass migration of the population from cities to suburbs. Kmart, Target, Woolco, and others emerged, and then, later, Walmart. Again, various cost savings drove prices down.

Besides bulk purchasing and labor savings, the stores were located in lower-cost areas, forcing customers to drive some distance to shop there. Shoppers had to accumulate their purchases and bring them to cashiers at the front of the store, and little service was available in the merchandise aisles. Moreover, the variety of merchandise was more limited than that in a full-service department store. More tasks were transferred to the customer, often including the assembly of merchandise.[8]

The outlet mall developed initially as a way for manufacturers to dispose of imperfect or excess products, initially in *factory stores*. Later, these were grouped together as outlet malls. Located in remote areas, sometimes between major cities, these locations required considerable travel. Unlike many discount stores, outlet malls offered top brand names at reduced prices, despite the risks of degrading the brand name by discounting. More recently, *dollar stores* have become increasingly prevalent, not limited to poorer neighborhoods. It is evident that there is considerable demand for low cost, and sometimes lower quality, merchandise.

Much of the success in discount operations depends on tight cost management: using buying power, keeping labor costs low, maintaining low-cost and efficient distribution and retail operations, and making maximum use of information. Yet, the revenue management side is important as well, identifying merchandise that will sell in volume, and pricing that merchandise at a profitable level. Discount stores are not necessarily low profit; Walmart is one of the country's most successful businesses. As Shell states, "It seems that the poor benefit the discounting industry far more than the discounting industry benefits the poor."[9]

The notion of providing customer value, however, extends beyond selling at low prices. Indeed, a focus on customer value is often considered as a way of maintaining prices in a culture that emphasizes discounting. The companies just mentioned found ways to add customer value, often by reducing non-value-added costs, which in turn reduced consumer prices. Those who managed revenues and costs successfully have thrived.

Types of Buyers

In considering customer value as a revenue management strategy, one must understand actual and potential customers, their preferences, and their motivations. This section addresses different types of buyers and revenue management strategies appropriate to each. It is said that there are four types of buyers:[10]

1. *Price buyers* make decisions strictly on price. They maintain a variety of suppliers and have little to no supplier loyalty.
2. *Value buyers* make decisions on broader criteria, including the impact of purchases on their operations and customers. They tend to maintain longer supplier relationships, and interact with suppliers on enhancing the cost-effectiveness of both parties.
3. *Relationship buyers* value long-term connections with their suppliers, which they feel will lead to superior service and support.
4. *Perennial negotiators* are motivated to see how low a price they can achieve, even on nonstandard products and services. They often see negotiating the lowest possible price as a challenge.

Original applications of revenue management focused on customers who were price buyers. The earliest users offered price reductions to entice price-sensitive buyers to situations where excess supply—especially perishable supply—existed. Price buyers can be profitable customers, if properly managed. Managing the price buyer was the theme of early revenue management, establishing restrictions on the availability of price reductions and trying to minimize the migration of regular customers to the reduced price offerings.

A greater variety of revenue management options is available for dealing with customers who are value buyers or relationship buyers, as factors other than price enter into the purchase decision. These types of customers can be the most profitable. The following sections discuss the notion of providing customer value.

Perennial negotiators, called *poker-playing buyers* by one writer, are probably best avoided, as they are the least likely to generate profitable business, either for individual sales transactions or as long-run customers.[11]

What Is Customer Value?

This section discusses determining what is valued by customers and then managing product decisions to optimize revenue and overall profitability.

Customer value is generally the savings and satisfaction that a customer receives from the purchase of a product or service. Zeithaml defined customer value as consisting of low price, receiving what was expected, and product or service quality commensurate with price.[12] Dube and Shoemaker identified six dimensions of value:[13]

- Financial (current price, future savings, money back if not satisfied);
- Temporal (time savings);
- Functional (availability of desired services);
- Experiential (quality of the experience, especially in establishments such as restaurants);
- Emotional (recognition and more pleasurable experiences); and
- Social (a personal linkage with the provider).

Different customers will attach different weights and values to these dimensions.

In business-to-business selling, customer value is whatever supports the financial and operating priorities and needs of the customer. Although low price certainly falls in this category, customers may also find value in the following services and support:

- Ready availability of products and services;
- Reliable delivery dates;
- Responsive service, availability of parts, or both;
- Reliability of operations or technology; minimal downtime;
- Geographical convenience for service and support;
- Available options for customization; and
- Favorable credit terms.

Determining customer value means understanding the customer, the customer's business, and what the customer needs to do to be successful. Interaction with customers is helpful in determining what they value. Ask them what they need, offer it, and provide it.

In consumer selling, customer value may be broader, fulfilling a variety of customer needs or desires. Customers may find value in the following nonprice areas:

- Availability of variety (colors, sizes, etc.);
- Ease of use;
- Preassembly, or ease of assembly;
- Technical support;
- Availability of, and ease of, a return privilege;
- Availability of service;
- Availability of the latest style, technology, and so on.

Determining what consumers value is more difficult than determining what business customers value. Consumers' tastes and needs change, and are driven by a variety of motivations. Keeping in touch with customer markets, such as seniors, college students, high earners, or other relevant groups, is essential to anticipate what tomorrow's customer will value. Detailed transaction analysis may also be helpful in early identification of trends.

Revenue Management of Customer Value

Using customer value in revenue management usually requires having a range of product and service offerings, to be able to match to the price willingness and business needs of the customer. One can then add or subtract value features—services and product enhancements—to allow for price flexibility.

One author suggests that there be a minimum of three levels of the product or service offering:[14]

1. A core offering, with a minimum set of features to make the product or service usable by a large number of customers. This offering will appeal to the most price-sensitive customers.
2. One or more *expected offerings*, adding product features, support services, or other elements of the transaction (such as credit terms or delivery promises) desired by many customers.
3. Value-added options that meet the needs of specific customers.

For example, TurboTax®, Intuit's popular income tax preparation software, offers six versions:[15]

1. Free, capable of completing the most basic income tax return (1040EZ or 1040A). This base product is offered free, presumably as an inducement to consider higher-level programs in the future. The free product is available for online use only, and free access to an online state program is also provided.
2. Basic ($19.99 download or CD), for individual taxpayers with a range of fairly common income items.
3. Deluxe ($34.99 online/$59.99 download or CD), for individual taxpayers who seek to maximize their deductions and require assistance to ensure that all deductions are claimed.
4. Premier ($54.99/$89.99), for individual taxpayers with investments and rental property.
5. Home and Business ($79.99/$99.99), for individual taxpayers with an unincorporated business or single-owner limited liability company (LLC).
6. Business ($149.99), for corporations, partnerships, and LLCs.

Although bundles and options change frequently, online options for the Deluxe, Premier, Home and Business, and Business versions do not include software for state taxes, which is available for an additional fee, according to the customer's needs. The download or CD price, except for the basic version, includes state software. These extensive options are an attempt by Intuit, the provider of TurboTax, to tailor purchase options to different customer needs. These six versions serve a range of customer situations.

As an example of providing a much greater degree of customization, consider the wide range of options offered by Disney World for tickets to its attractions:[16]

- One-day to 10-day passes good for admission to a single theme park each day, at per-day prices ranging from $99 to $35.40 ($354 total), with the pass expiring 14 days from the first use.

- A *park-hopper* option, providing admission to as many as four theme parks on the same day, at a flat price of $60 in addition to the basic ticket price, whether attached to a 1-day or 10-day ticket.
- A *water park fun & more* option, providing one additional admission per day to any of seven added attractions, at the same price as the park-hopper option.
- Both the *park-hopper* and the *water park fun & more* options at a flat price of $86 in addition to the basic ticket price, whether attached to a 1-day or 10-day ticket.
- A *no expiration* option (unused days never expire, thus can be used beyond the 14-day limit of the base pass). The price for this option is no longer shown on the website, and is available only by phone call.
- An annual pass priced at $634, featuring a year of unlimited admission to the four theme parks, free parking, and other amenities.
- A premium annual pass priced at $754, which adds a year's unlimited access to water parks, a golf course, and other attractions to the basic annual pass.

The various combinations of number of days and the add-on options create a large number of customizable choices for the buyer.

Conclusion

Providing customer value is an important basis for differential pricing. Note that differential pricing does not mean charging what the customer is willing to pay, as different prices for identical product or service packages will engender customer ill will in the long run. Rather, it means being able to configure a combination of product features, services, and transaction terms that meets the needs of a particular customer. Providing such value also engenders confidence on the seller's part, an important defense against the constant pressure for discounting.

CHAPTER 11

Are Your Customers Profitable?

Not all customers are good customers. Eliminating unprofitable or marginally profitable customers is a component of effective revenue management. Many sellers are not particularly discriminating; one author reports that 79 percent of business-to-business companies respond to all customers.[1] There may be a cost to responding to all customers because optimal revenue management seeks customers who will result in *profitable* sales. This chapter discusses how to assess which customers are valuable and which are not.

The 80/20 rule is well known: In general, 80 percent of one's business will come from 20 percent of customers. This rule does not imply that one should pay attention only to big customers, many of whom may be *price buyers*, adept at obtaining price concessions. Smaller customers may be more likely to be *value buyers* or *relationship buyers* who may need, and be willing to pay for, value enhancements and support services.

The key question is not only how much revenue does a customer generate but how much does it cost to service that customer? Harvard professors Robin Cooper and Robert Kaplan have proposed the 20/225 rule. They studied one company where 20 percent of the customers provided 225 percent of profits, 70 percent of customers were more or less break-even, and the remaining 10 percent of customers *lost* 125 percent of profits.[2] Whether these percentages apply in other situations or not, every business has some customers who cost more to serve than they generate in revenues. These customers may successfully negotiate lower prices, buy low-value products and services, require excessive support, change orders on short notice, be slow paying, or evidence any number of other characteristics that are costly to the seller. The first goal is to convert unprofitable customers to profitable ones, which may require interaction with the

customer to get them to change their costly behaviors. The ultimate option, if customers cannot be moved to the profitable category, is to terminate them. Faced with such an ultimatum, some customers may revise their behaviors, and those who will not are best left to one's competitors.

One Company's Experience

Kanthal is currently a brand of heating and technology service products for the Swedish company, the Sandvik Group. It provides furnace products and heating systems, materials in wire and strip form, resistors and capacitors, along with various technical services.[3] In 1988, it served as a subject for a Harvard Business School case study on its experiences with customer profitability analysis.[4] The company was then a part of the Kanthal–Hoganas group. At that time, it had about 15,000 items in its product line, and it served about 10,000 customers.

To assess customer profitability, the company used activity-based costing techniques to analyze its selling and administrative expenses. These costs, which represented about 34 percent of total company costs, had previously been largely ignored. To the extent they were considered at all in pricing, they were applied as a flat percentage of sales revenue. The company felt, however, that individual customers made varying demands on their sales and administrative resources. They described high-profit and low-profit customers as follows:

- Low-profit customers place high demands on technical and commercial service. They buy low margin products in small orders. Frequently, they order nonstandard products that have to be specially produced for them. And we have to supply special selling discounts in order to get the business.
- High-profit customers buy high-margin, standard products in large orders. They make no demands for technical or commercial service, and accurately forecast for us their annual demands.[5]

The company analyzed its production, selling, and administrative costs in two categories: those related to a customer order and those related to

manufacturing volume. Various product lines, customers, and customer groups were studied. All analyses found a wide range of outcomes, with some orders or customers showing high profitability and others a large loss. Its analysis of in-country (Swedish) customers showed that only 40 percent were profitable, and that these, in fact, generated 250 percent of profits, whereas the least profitable 10 percent of customers lost 120 percent of profits.[6] The original expectation that low-volume customers were likely to be unprofitable was not always borne out. Two of the company's largest-volume customers were shown to be unprofitable. These customers had adopted just-in-time systems, which required frequent shipments and placed huge demands on Kanthal's production and order-filling operations.

How to Respond?

Kanthal's findings then raised the question of what to do. The actions taken by this company are illustrative of possible actions to change unprofitable orders into profitable ones:[7]

- Simplify product lines. For one line, Kanthal reduced the number of available sizes from 10 to 3.
- Set minimum order sizes for custom products. Kanthal decided to accept small orders only for stocked products.
- Service smaller accounts through distributors, rather than directly.
- Work with large customers having special needs to find more effective ways of meeting their requirements. Kanthal installed online order systems for the just-in-time customers to facilitate smooth information flow.
- Work with customers to reduce their high-cost behaviors. Kanthal gave one customer a five percent price reduction when that customer reduced the number of order lines by half. This action more than doubled the customer's profitability.
- If all else fails, consider dropping the customer.

Actions such as these may not fully solve the problem; orders and customers generating losses may remain, but their numbers should be reduced and overall performance should improve.

The Difficulty of Customer Analysis

Calculating customer profitability is no easy task. The starting point is straightforward: How much does the customer buy (gross revenue), and what is the cost of the goods or services sold to that customer? Price adjustments such as discounts or extended terms are fairly easy to analyze, along with the costs of certain specialized services such as particular packing and shipping requirements. Other elements of customer profitability are harder to analyze. How much extra cost is incurred for a customer who places frequent small orders or who orders a great variety of items in small quantities? What does it cost to field technical information or assistance requests from a customer? How much extra do orders for nonstandard products cost? How much time does the sales staff spend with a given customer and at what cost? Incorporating elements such as these into customer profitability analysis requires specialized cost studies, which may be both costly and imprecise. But even if one is unable to quantify all the costs of servicing each customer, a partial attempt is still informative.

The Importance of Customer Analysis

As the Harvard case study demonstrated, a company can manage revenues and optimize profits if it gathers and analyzes customer data. Many companies (a) lack the capability to analyze customer profitability; (b) do not take the time to carry out this analysis; or (c) do not believe that the assessment will result in higher profits after considering the cost to collect and analyze the data.

If the 20/225 rule proposed by Cooper and Kaplan, or something close to it, indeed applies to many companies, managers should try to identify which customers are the major profit drivers, and which customers constitute a drain on profits. A good company information system can be an excellent way to collect such data.

There are many examples of companies that do not seem to effectively manage their revenues by assessing valuable versus unprofitable customers. For example, one could consider the last time the customer ordered. A common example is a gift order for a child from a mail order company's

catalog. That customer is likely to continue to receive costly mailings from that company for many years, even though the recipient may no longer be a viable customer because the child has advanced beyond the age of the company's products. Further, the common practice of sharing mailing lists will result in that customer receiving mailings from many other suppliers, who may never receive an order. A customer information system might report (a) if this customer ever placed an order; (b) if so, how many orders; (c) how long ago the last order occurred; and (d) whether the order was sufficiently profitable. Customers who may have placed a single order long ago and have not ordered since then should probably be dropped from the mailing list.

Some years ago, a national public accounting firm analyzed its customer base in a smaller city. They had two large, profitable customers there and many smaller, much less profitable customers. The firm decided to drop many of these smaller customers. While the firm addressed the profitability of individual customers, it needed to take into account the overall picture as well. Many of the smaller clients were not-for-profit organizations, which had June 30 fiscal years compared to the December 31 fiscal years for the large clients. Although they were less profitable, these clients did generate revenue during a time when the staff was underutilized. The absence of opportunity costs of the staff working on these clients reduced the cost of serving them, perhaps making them more profitable than the firm's analysis showed. Other negative outcomes occurred as well. There was ill will in the community from the firm dropping clients, especially those in the nonprofit sector. The firm also signaled that it was not particularly interested in small- and medium-sized clients, even though such entities dominated the local community. When the firm later lost one of its large clients, it was unable to replace that revenue, and the size of that office declined significantly. This example demonstrates that an assessment of customer value must go beyond current profitability, and give consideration to capacity, seasonality of work, customer behavioral implications, public image, and other factors. As mentioned earlier, the first action after finding that certain customers are unprofitable or provide minimal profit is an attempt to make the customer more profitable. Only as a last resort should termination of the customer be considered.

Upgrading Unprofitable Customers

Cokins observes that there are two elements of customer profitability: the mix of products and services that each customer purchases and the costs of providing various services to that customer.[8] A customer buying low-margin goods and services, and requiring a lot of individual customer service, is likely to be an unprofitable customer.

The goal of revenue management is to attempt to move such customers into profitable territory. The first element of customer unprofitability—buying low-margin products and services—may be addressed by:

- Raising prices;
- Adding new products and services, and possibly abandoning the least profitable ones; and
- Promoting higher-margin items to these customers.

The second element of customer unprofitability—requiring excessive special services—may be addressed by:

- Streamlining these services to reduce their cost;
- Adding extra charges for services above a certain threshold; and
- Offering a mix of services at varying prices.

Customer profitability is dynamic. An unprofitable customer today could become a very profitable customer in the future. Similarly, a customer's current profitable status could deteriorate. Monitoring customer profitability is an ongoing task, and continuing efforts are needed to enhance profitability of each customer.

Conclusion

Successful revenue management is not about serving as many customers as possible, at any cost. Revenues *and* profits are the goal, both short term and especially long term. Having a customer information system

that identifies many features of each customer's history and behavior is essential. Analysis of customer value then leads to determining which customers regularly contribute to profits and which do not. Finding ways to convert the customer's unprofitable status to profitable status then becomes the revenue management challenge.