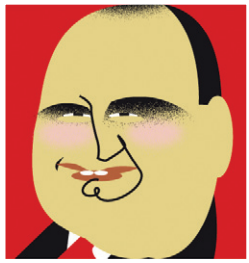
Case Study

A supplier contemplates cutting off one of its biggest accounts. *by Robert S. Kaplan*

When to Drop an Unprofitable Customer

The Experts



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HBR's fictionalized case studies present dilemmas faced by leaders in real companies and offer solutions from experts. This one is based on the HBS Case Study "Elkay Plumbing Products Division" (case no. 9-110-007), by Robert S. Kaplan.

ILLUSTRATION: JORGE ARÉVALO

As Tommy Bamford and Jane Oldenburg drove into the visitor section of Westmid Builders' car park, Jane pointed out the man they had come to see: Steve Houghton, Westmid's purchasing executive. He was in front of the headquarters building, waving a greeting. Jane waved back to her friend, whom she had known for decades, but Tommy scowled. He wasn't looking forward to this visit. "Oh, come on," Jane said, nudging him. "Look how friendly he is."

Tommy was a director and Jane was the Midlands regional sales manager for Egan & Sons, a supplier of doors and staircases to Westmid for 63 years. The two executives had to pause before crossing the gravel road that ran through Westmid's grounds, because of the steady stream of trucks traveling to and from construction sites around Birmingham and all the way to London. Tommy knew that despite the heavy traffic that April morning, Westmid was hurting from the economic downturn in the UK. The company was building only half as many housing units this year as it had during recent boom times. With the steep falloff, Westmid was no longer Egan's biggest customer, but it still retained considerable clout. Too much clout.

"I'm flattered by such an august delegation," Steve said. "Shall we start with a tour?" Jane, a tiny and exuberant blonde with a boy's haircut, happily agreed. She had been here many times, of course, but Tommy was not a regular. Steve chatted away as he shuttled them in a little electric vehicle past warehouses and outbuildings.

Jane had promised Tommy that a visit to Westmid would change his view of the company. But he could not shake his newfound awareness of how much money Egan was losing with Westmid—the account's ratio of operating income to sales was a negative 28%. The two companies had enjoyed a smooth relationship for decades, but Tommy strongly believed the time had come to terminate it.

Steve kept glancing at Tommy during the tour. "You look pale," Steve said at one point. "I hope my driving isn't making you queasy."

"That's quite all right," Tommy said. "I've got a strong stomach."

The Power of Customer Costing

Egan & Sons, founded in Birmingham in 1908, was hardly a sleepy company. With three efficient plants staffed by 3,000 employees, it had reinvented itself to become an innovative manufacturer of modular steel staircases and fiberglass doors. Its accounting system, however, remained simple and traditional. The weaknesses became apparent only in the mid-2000s, when Chinese companies began to encroach on Egan's low end, severely undermining profitability.

With careful study, Tommy had figured out that the company's costing system had made it blind to its own operations: It allocated factory overhead to products as a percentage markup over direct labor costs, and corporate overhead as a percentage of sales. Thus, the company could not accurately identify its costs for serving individual customers or for designing and producing all the new goods it had recently brought to the marketplace. The lack of traceability and transparency extended to the costs for specialized equipment that was used only for particular products or customers.

Tommy, an avid reader of the business literature, wanted Egan to adopt an activity-based costing, or ABC, approach. Enlisting several younger financial managers, he made the case to the executive director, Wilfred Hammond, who approved the hiring of a consultant with extensive experience in ABC. Tommy and the consultant assembled a team that began by identifying the costs associated with each customer order, through all stages: bidding, raw-materials purchasing, production and delivery, and invoicing and collection.

With 6,000 SKUs and 2,500 customers, the team had to crunch reams of data, but the basic ABC process was straightforward: Calculate the hourly (capacity) cost of the resources that performed each sales, production, administrative, storage, and distribution process and the time that each order required at each stage. Before long, the team could pinpoint the cost of every process performed for every customer and could trace revenue deductions—discounts, allowances, promotions, and returns—back to individual customers. Those deductions, which totaled 12% of sales, had previously been collapsed into a single line item in the P&L for each customer.

At one point, Hammond had grilled Tommy about why the project was taking so long and costing so much. Tommy responded that the time and care were critical to producing valid, defensible numbers from which he could initiate candid discussions with the least-profitable customers. Tommy also hoped to identify Egan's most profitable customers so that sales managers might extend and deepen relationships with them.

> "They've stuck with us when lots of other customers have turned to China. We can't just cut them off."

The Art and Science of Rationalizing

It took four months for the ABC project's initial findings to emerge. And they were shocking: Just 1% of Egan's SKUs accounted for 100% of its operating profits. The most profitable 20% generated more than double that amount, but the extra gains were canceled out by the company's unprofitable products, which generated losses equivalent to 120% of profits. The customer story was similar: The most profitable 1% of accounts generated 100% of profits, and the top 10% accounted for nearly double that amount. The remaining 90% of customers were either break-even or a drag on the bottom line.

So Hammond formed a management team to take action on the large number of unprofitable products and customers. At a "SKU rationalization meeting," the team classified its money-losing SKUs into four action categories: drop, reprice, redesign, or take no action (for products that had been ordered by important customers or were unprofitable only because of internal process inefficiencies). The company soon had a plan to eliminate or modify nearly half of its 6,000 SKUs.

Tommy chaired a subsequent "customer rationalization meeting," which he hoped would yield a similar consensus: that Egan should sever ties with its loss-making customers—especially the least-profitable 1%, among them Westmid, whose accumulated losses had cost Egan 40% of the company's profits.

Hammond was traveling and unable to attend the meeting, so Jane had monopolized it. "Customers aren't SKUs—they're relationships," she'd declared. "Some of these accounts are new ones with a huge upside. Do we really want to cut them off? And Westmid—sure, it's been tough going with them for the past few years, but things are starting to improve. And look at our history together: 63 years! They've been hugely profitable for us in good times, and they've stuck with us when lots of other customers have turned to China. We can't just cut them off based on a cost-accounting report."

Tommy had tried to make his case, but in the face of Jane's impassioned stand, the committee couldn't agree on what to do about the unprofitable customers.

Later that day, Jane knocked on Tommy's office door. "I'm serious about Westmid," she said. "They're right here in Birmingham. I drive past their yard on my way to work. They've been great partners. Dropping them is unthinkable."

Hardly an objective observer, Jane had been instrumental in creating that "great" partnership, by encouraging Egan to meet Westmid's requests for customized products and services, special allowances, and discounts. The larger Egan's sales to West-

mid, the bigger Jane's monthly commission, to say nothing of the annual bonuses and award trips for the salespeople with the largest accounts.

Tommy had to restrain himself from congratulating Jane for transforming one of Egan's oldest customers into one of its most unprofitable. Instead, he said, "Our aim should not be to sell as many products as humanly possible to anyone who wants to buy. It should be to win in every one of our chosen markets. I, too, have a warm spot in my heart for Westmid—but the account is a laggard."

He told Jane that he had e-mailed Hammond about the committee's failure to reach consensus and that the CEO had pointedly asked for his recommendation regarding the worst-performing customers, such as Westmid. "I need to have an answer when he returns next week," Tommy said.

"Then come to my meeting at Westmid tomorrow," Jane offered. "You can't analyze everything from behind a desk. Due diligence happens in the field, too."

Tommy reluctantly agreed.

The Intangibles

"We don't need tea," Tommy said, waving away the tray. He didn't like Steve's overly chummy demeanor. Customers weren't supposed to know about the rationalization initiative yet, but he suspected that Jane had let the cat out of the bag.

Steve switched to a look of sincerity as he sat down. "We *truly* value our relationship with Egan," he began.

"I know you do," Tommy said. In truth, he felt a bit sorry for Steve. It wasn't his fault that Egan had developed a bad habit of providing Westmid with one-offs and custom work at a fraction of the real cost and of rush-delivering products in half-empty trucks just to hit Westmid's deadlines.

Jane chimed in: "And *we* value our relationship with Westmid." Tommy shot her a glance, but she continued.

"Steve, tell Tommy about the Sunderland project."

"Yes, right," Steve said, as if remembering lines from a script. "We're in negotiations to build a development of attached homes near the A19."

"And what about that industry conference last month?" Jane prompted.

"Yes, the conference. In London. Well, lots of talk about Chinese suppliers there. Impressive group, actually. Lots of buzz about them. But our CEO gave the keynote, focusing on the benefits of our relationships with local suppliers. He's passionate about supporting UK businesses, you know, and the press ate it up."

"We so often overlook the intangibles that we get from our loyal customers," Jane said. "The showrooms, too." She picked up a glossy booklet from Steve's desk and handed it to Tommy. He flipped through it, glancing at the photos of Westmid's new chain of decorator showrooms at high-end sites around London. She pointed to a picture. "*Our* doors," she said.

"This is a small part of Westmid's business now," she went on, "but it's bound to grow once the economy picks up. Our products *have* to be in these showrooms. Am I right?" This time Steve refrained from speaking, because the question was clearly aimed at Tommy.

The only sound in Steve's office was that of Tommy turning the heavy pages. The booklet showed many images of Egan's doors—beautiful, top-of-the-line, thermally insulating products with fan lights and other expensive features. He looked at Jane. Her point was well taken: Westmid's showrooms were indeed an asset to Egan, one that Tommy hadn't considered.

Jane's smug expression said clearly, "Add this to your P&L, Tommy."

Robert S. Kaplan, the Baker Foundation Professor at Harvard Business School, has written many HBR articles, including "Time-Driven Activity-Based Costing," coauthored with Steven R. Anderson (November 2004).

Q Should Tommy recommend that Egan drop the Westmid account?

See commentaries on the next page.

"I'll shoot you an e-mail."

CARTOON: BOB ECKSTEIN

The Experts Respond

Timothy J. Jahnke is the president and CEO of Elkay Manufacturing Company. He was formerly the president of Home & Family Products at Newell Rubbermaid.

IT'S NOT SURPRISING that the new activity-based costing system has thrown Egan & Sons into turmoil. Learning the true cost of each customer and each SKU can transform a company. But businesses rarely do it.

Standard costing systems, which arbitrarily paintbrush costs across products and customers, are almost guaranteed to be wrong. Executives might say they have a good handle on what's being spent where, but that's only because if they admit to themselves that they really don't know, they'll go insane. As a consequence, most are stuck making bad decisions about everything from pricing to product launches to discontinuations.

Once you start using activity-based costing, you can do a P&L on anything in your business, including your best and worst customers. But even with those results in hand, the solution is not as simple as buttering up the best customers and firing the worst. Tommy must recognize that there's a lot of room to maneuver between keeping the relationship with Westmid and cutting it off entirely—that's the zone where he should concentrate.

I would advise Tommy, first, to have a direct conversation with Steve, Westmid's purchasing executive. Ask him point-blank: "Would you do business with a customer that has a dismal P&L?" Steve will undoubtedly get Tommy's message. Most customers prefer to avoid the upheaval of a supplier switch, so Steve will probably ask, "How can we change our P&L profile to prevent Egan from terminating the relationship?"

> Start by making Westmid pay higher prices on a few items—but don't stop there.

What's the solution for Egan? Start by making Westmid pay higher prices on a few items—but don't stop there. When my company, Elkay, confronted a customer in these circumstances, we noticed that it had been ordering products that we manufacture in a location far from its headquarters. So we helped the customer make a transition to similar products made in one of our factories nearby. We also persuaded that company to shift its product mix—from an emphasis on low-end items to one on more attractive, higher-margin, higher-priced ones, thereby generating greater income both for us and for them. The dramatic result: The customer is no longer unprofitable for us.

In that regard, Egan's sales manager, Jane, is right: It can make good sense to continue working with a customer, even if it's currently unprofitable. At Elkay we'll sometimes do that if we're trying to break into a certain region of the country, if we think we'll benefit from having the customer carry our products or our brand, or if we foresee an improvement in the customer's situation down the road. When you patiently show a customer how to improve its relationship with you, payback comes in the form of future loyalty. Does that sometimes prove to be a naive point of view? Maybe, but that's how we choose to do business.

We have the luxury of making such choices only because they are educated ones: We fully understand the P&Ls for each of our customers and each of our SKUs. It sounds so basic, but truly understanding costs is a real breakthrough for most businesses.

WHAT WOULD YOU DO?

SOME ADVICE FROM THE HBR.ORG COMMUNITY

IT'S NOT in Egan & Sons' best interest to continue working with Westmid. In these fiercely competitive conditions, profitability is more important than retaining the customer or increasing Egan's already large market share.
Zeeshan Ansari, *business studies teacher, Southshore School for A-Level Studies, Karachi, Pakistan*

DROPPING A customer can increase a supplier's cost per remaining customer and harm the supplier's reputation, so Egan should seek creative solutions before ending its relationship with Westmid. Perhaps Egan can reduce costs by subcontracting the least-profitable products in its portfolio.
Hari Nayak, *associate partner, Expicient*

ANALYSES OF customer profitability should depend less on the most recent accounting period than on customer lifetime value. Also, focusing on just the negative accumulated customer profitability isn't sufficient. Even very profitable customers typically purchase many loss-making SKUs.
Hans-Gerlach Woudboer, *owner, RapidBusinessModeling*

RIGHT NOW Jane is making her numbers, gets paid bonuses, and is recognized by management and her peers. If Egan wants to use ABC data to drive profitability, it has to compensate salespeople in line with its business objectives.
Patrick Giry-Deloison, *vice president, Go-to-Market, EMEA Customer Solutions, Alcatel-Lucent*

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A BUSINESS relationship must benefit all parties involved. Not only is an unprofitable customer bad for a supplier's bottom line, but ripple effects can ensue: Other buyers may start demanding their own special prices, preferential distribution policies, and extra services.

I remember the first time I told a group of executives that they shouldn't necessarily keep every customer. They protested: "We need them all, no matter how profitable, because we want to spread our fixed costs among them." It has gradually become more acceptable to drop loss-making accounts, but many companies still resist.

Don't get me wrong: You should never drop a customer without considering the potential loss of strategic benefits such as brand equity, share building, and referral value. As Jane notes, Egan's brand could get a significant boost, especially among high-end designers, once its products start appearing in Westmid's new showrooms. Moreover, by retaining Westmid, Egan can protect its market share and fend off Chinese and other competitors. Referrals from Westmid might also help Egan in new markets and with new types of customers. Suppliers often overlook these strategic factors and get stuck on the financial ones.

Egan should also explore which perks Westmid really cares about. Maybe, for example, timely delivery is essential, and the discounts are just gravy. If so, Egan could enhance delivery and limit the discounts. It might also try to discontinue unprofitable SKUs that Westmid is buying and sell alternative SKUs on more-profitable terms.

Exclusivity arrangements can also improve profitability. For example, might Westmid agree to use Egan as the supplier for a specified percentage of any new business in an especially strong segment, such as luxury homes?

Sometimes, though, a customer just cannot be made profitable. If Westmid keeps demanding the loss-making perks, Tommy needs to speak frankly with Steve Houghton, without actually saying "You're fired." (It almost never comes to that.) Instead, a supplier might announce a drastic change in terms, such as a steep price increase. I was on the receiving end of that tactic once: When my landscapers realized they were not making money on me, they said they would continue only if I paid a much higher price—so *I* broke up with *them*. That said, raising prices can simply create antagonism with no end in sight.

> Egan & Sons should do what it can to facilitate Westmid's transition to a new supplier.

And, of course, dissatisfied customers tend to be vocal, online and elsewhere. Given that risk, Egan should help Westmid understand exactly where the relationship went wrong and should do what it can to facilitate Westmid's transition to a new supplier. For highly technical products, this could mean creating a transition team to minimize the ex-customer's loss of production or efficiency.

After the breakup, Jane will grumble, and revenue will take a hit. Eventually, however, Tommy will feel relieved that Egan moved on. The company's efficiency will rise, and the salespeople will have more time and money to devote to bringing in profitable new business.

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