Harpooning the Whale

By Dr. Albert D. Bates
President, Profit Planning Group

One of the most widely discussed topics in distribution today is the fact that a lot of customers and a lot of items lose money for the company. That is, the cost of servicing a large component of the customer set or handling many of the items is larger than the gross margin dollars generated by those customers or items.

While the economics of the situation are fairly straight forward, the implications for action are not. One widely-suggested option is to eliminate items and customers that don't cover their costs. It is a quick and easy solution.

Another option is to work on enhancing margins or lowering costs to overcome the profit deficit. This approach is both time consuming and difficult.

Because the observations regarding customer profitability are largely mirrored by item profitability, this report will focus exclusively on the profit realities of customers for distributors. The report will examine customer profitability from two perspectives:

- **The Economics of Customers**—An analysis of how customers break out into widely varying profitability groupings.
- **Changing the Profit Relationship**—A discussion of how profitability can be enhanced by working with customers.

The Economics of Customers

Within every line of trade in distribution there are wide variations in customer purchasing patterns. Some customers buy a lot of merchandise, others buy very little. Some customers are aggressive price negotiators while others are more service oriented. Finally, some customers are the proverbial "squeaky wheel" while others are easier to work with.

These factors come together to produce widely varying levels of profitability across the distributor's customer set. At one extreme, customers who purchase a lot of products, are service oriented (rather than price oriented) and don't "have issues" tend to be highly profitable for the distributor. At the other extreme, some customers who are high maintenance actually result in a loss for the distributor.

Unfortunately, there are only a few of the highly-profitable customers and a fairly large number of the unprofitable ones. This relationship between customers and the profitability they produce for the distributor is often referred to as the "whale curve." It is shown graphically in Exhibit 1.

Customers are ranked from most profitable to least profitable along the horizontal axis. The percent of total profit generated is presented on the vertical axis. The graph looks something like a whale, albeit a rather anemic one.

As can be seen, the most profitable customers cause total firm profit to rise quickly. Somewhere along the way the slope changes as additional customers generate profit at a lower rate. Finally, the curve starts back down as some customers cause the firm to lose money. Eventually the curve ends up at the 100% of total profit level.

Consider, for example a firm that generates $500,000 in profit. For that firm, the customers fall into four categories based upon the profit they generate for the distributor. The A customers are the most profitable and the D customers are the least profitable—the money losers.

The relationship for customers and profit tends to be a little more dramatic when put into tabular form:

Customer Category	Percent of Customers	Percent of Profit	Dollar Profit
A	15	100	500,000
B	15	35	175,000
C	35	10	50,000
D	35	-45	-225,000
Total	100	100	500,000

The fact that the typical firm loses $225,000 on slightly more than one-third of their customers is not an inconsequential issue. Potentially, dollar profit could be increased by 45% through concerted effort.

Changing the Profit Relationship

The immediate, knee-jerk, reaction is to just fire the D customers. In point of fact, this is an approach that some analysts support. It is an approach that should be avoided. Instead, it is essential to break the customer base into three target groups and work with them systematically.

Group One—A Customers: In the rush to focus on the money losers, there is a tendency to overlook the most profitable customers in the mix. It is actually more important to support the A accounts than it is to worry about the D ones.

No customer set buys all of their needs from one supplier. Anything that can be done to encourage A customers to purchase more has a direct and immediate impact on profitability. It is also a positive set of actions that everybody supports.

Group Two—The Down and Dirty Two Percent: Anecdotal evidence suggests that somewhere around two percent of all customers are not just unprofitable for the distributor, they are highly unprofitable. Even worse, they probably enjoy being unprofitable. These customers really should be fired.

Care must be exercised in the firing. Today's fired customer may become tomorrow's acquirer of one of the best A customers. The simplest approach is to simply let them fire themselves. This involves systematically moving them to a different, higher, category on the pricing schedule.

Group Three—The Mass of D Accounts: After the members of Group Two have been eliminated, there remains a massive number of accounts that still produce a gross margin that does not cover the cost to serve them. It is a lot of customers and requires a lot of work to correct the situation.

There may be some opportunity on the pricing side with these accounts. However, most of the effort must be devoted to the issue of the cost to serve. This inevitably gets back to the reality of too many small orders, too many emergency orders and too many returns.

The key is to get customers to plan ahead and ultimately place fewer orders. Alas, customers place the number of orders they want to place. Time and effort must be spent to educate customers about the cost savings on their side of the profitability equation if they were to order less frequently. It requires both an analytical effort and a sales effort. The profit impact, though, justifies the effort.

Moving Forward

A lot of firms are aware that some customers are unprofitable to them. What is needed is a more precise analysis of the nature of the challenge. Once the analysis is conducted that analysis must lead to action.

About the Author:
Dr. Albert D. Bates is founder and president of Profit Planning Group. His recent book, ***Breaking Down the Profit Barriers in Distribution*** is the basis for this report. It is a book every manager and key operating employee should read. It is available in trade-paper format from Amazon and Barnes & Noble.

Exhibit 1
The Whale Curve