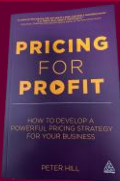

Why firing the bottom 10% of your clients will actually increase your profits

It is perhaps reasonable to see every single customer as a contributor to profit. As long as they are buying at a price higher than the raw cost of the product or service it is fair to suggest that they are making some small contribution to the general overheads of the business and adding, however marginally, to profits.

At a pure numbers level this may well be true. Even the lowest value customer generating a gross profit of say £5 does add to the bottom line. But this doesn't tell the full story.

The starting point to assess the legitimacy of this approach is to test the accuracy of the maths. Many businesses just don't accurately calculate the amount of gross profit that they actually make on each product or service. The result is that those very small customers they think are making some contribution may very well be costing them money to look after. In one case study the business analysed the gross profit on every one of its thousands of products ranging from items costing just a few pence to some costing more than a thousand pounds. The fast pass calculation showed that all of the products were profitable with some achieving 60% gross profit, although the margins on some others were very low. The business then quantified the average discounts that customers were given on all the items. The owners were amazed to see for example, that they were giving an average of say 30% discount on products where they only made a 10% profit margin. In effect they were selling at a gross loss, and they were doing this on more than a quarter of their products!

The cause of the problem was that they were negotiating across the board discounts with major customers of say 30%, but failing to consider that this also applied on products where they didn't make that much. What made this even worse was that further analysis showed that many customers were buying high quantities of the items where discounts exceed the margin, and shopping elsewhere for products where the margins were higher. By simply limiting discounts on the low margin items the business almost doubled profits.

The other flaw in assuming low profit items make some contribution to profits is the failure to identify what it actually costs to serve customers. Even at the most basic level, invoices cost money to print, and almost every transaction requires a human interaction that costs time and hence money. These marginal profits are often wiped out when these costs are included in the equation.

A survey of professional firms asked them to list clients by their contribution to bottom line profit. The results showed a variation of the classic Parreto's Principle, or the 80:20 rule. On average the firms made 125% of their profits from the top 80% of their clients, losing 25% on the bottom 20% of their clients to end up at the 100% overall result.

Consider for a moment a business making an overall 30% profit margin. I.e. it buys stuff for £70 and sells for £100. It increases prices by 4%. Some customers vote with their feet and shop elsewhere. The question is, does it matter? The business now sells the items at £104, making £34 of profit, so if the extra £4 it makes on all those customers that stay is greater than the £30 it loses on the ones that leave, then it will still be better off. In fact it can afford to lose almost 12% of its customers to achieve the same overall gross profit. Of course losing 12% of its customers will see some reduction in costs from not serving these customers, and bottom line results should therefore still increase. If the business had the courage to add 10% to the price, it could lose a quarter of its customers and still achieve the same gross profit, and significantly increased bottom line.

Perhaps the hardest cost to quantify is the impact on the business' confidence to charge a fair price to reflect the value they deliver to customers. Almost by definition, the bottom 10% of customers is of the lowest spending, low margin, high maintenance type. By selling to this section of the market the business gets beaten up on price, and ends up giving a discount to the 90% of customers that didn't ask for it by setting prices or discount structures that satisfy this bottom 10%.

In the vast majority of businesses this assumption that all customers bring something to the party is flawed based on inaccurate calculations, but most significantly as it undermines the value of the offer to the majority of customers.

If a business can identify the bottom 10% of customers clearly, and to have the courage to send them packing, profits will increase. The better course of action is to gently price them out, on the basis that some may not vote with their feet and become profitable!

Peter Hill
Author Pricing for profit