CUSTOMER STRATIFICATION

The key to profitable and sustainable customer relationships

WHITE PAPER
By

F. Barry Lawrence ■ Pradin Krishnadevarajan ■ Senthil Gunasekaran

July 2012

Sponsored by

SAP
**TABLE OF CONTENTS**

Not All Customers Are Created Equal........................................................................................................03

Introduction..................................................................................................................................................03

Importance of Customer Stratification ........................................................................................................04

Benefits of Customer Stratification ............................................................................................................06

Customer Stratification Process ................................................................................................................08

What to Look For in a Solution? ..................................................................................................................08

Next Steps and Road Map............................................................................................................................10

Conclusion ..............................................................................................................................................11

Resources ................................................................................................................................................11

About the Global Supply Chain Laboratory (GSCL) .................................................................................12

About the Industrial Distribution Program at Texas A&M University ......................................................12

NOT ALL CUSTOMERS ARE CREATED EQUAL

Best-in-class companies categorize customers based on various factors (discussed later under "customer stratification process. section) but customer stratification is still an unexplored area for most wholesale distribution companies. This is not the case in other industries, such as airlines, hotels, retail stores, and other service businesses.

When you walk to the ticketing counter at the airport, for example, you will notice two lanes—priority access and general access. Whatever the airlines may call it; this is a clear form of customer segmentation or customer stratification. The message is that the premier customer is very important and that they intend to motivate or inspire the people in the general lane to move to elite status. The value to the premier customer is convenience, some pricing advantages (tightly controlled), more service, less wait time, immediate assistance, and so on.

To understand customers better, the airlines look at information such as frequency of travel, price paid, total spend, how long in advance tickets are booked, cancellations, ticket changes, and so forth. The airlines have all the information they need to segment their customer base. The same philosophy applies to hotel management chains and rental car agencies. These industries practice customer stratification religiously and make customers aware of the segmentation category they belong to—platinum, gold, or silver, for example. Their motive is to understand the difference between profitable and not-so profitable customers and then array resources and map strategies (pricing, marketing, and promotions) geared toward growth and market share.

In 2004, Best Buy, a leading electronics retailer, began identifying big spenders in its stores as "angels" based on sales records. Best Buy further classified the angels as Barrys (high income men), Jills (suburban moms), and Buzzes (people interested in the latest gadgets) based on demographics and buying patterns. This classification helped Best Buy customize its local stores and train its sales force to assist the right customers. Best Buy also identified unprofitable customers and formulated strategies to avoid them.

The underlying message is that “not all customers are created equal.” Should wholesaler-distributors also seek to understand customers better? If so, do they have relevant, reliable, and quantifiable information routinely recorded in their IT system on a periodic basis? How should they stratify their customer base? These become vital questions for wholesaler-distributors.

INTRODUCTION

Customer stratification may sound like an odd idea in a climate where any paying customer is a good customer. Still, the sales force has two issues to deal with: First, who do I call on that has a chance of giving me an order and paying for it? Second, who should I be calling on, and how do I secure relationships that will still be worthwhile when the economy takes off? The stratification process answers these questions and many other, perhaps more important, ones. Questions like;
CUSTOMER STRATIFICATION

how much business a customer does with us (sales), how profitable they are in gross margins, how loyal they are, and how costly they are to serve (to protect net margins). Each of these dimensions has a bearing on the sales force’s questions. Customer stratification is the process of classifying customers into groups based on various factors, such as profitability, revenue, loyalty, and cost-to-serve. The stratification process helps companies determine which customers they could grow with and remain profitable. It examines the customer relationship in terms of the value customers provide their distributors. That value is achieved through increased revenue (which means the value to the customer must be addressed), decreased expenses (which means complex service offerings and how the customer accesses them are key factors), and optimal allocation of assets (which are driven by customer and supplier expectations). This is a complicated combination to be sure, but one issue is clear: All of these factors are determined by whom you choose to serve and how you communicate your value proposition to them.

Researchers at Texas A&M University’s Global Supply Chain Laboratory (GSCL) felt it was critical to determine best practices for customer stratification. The researchers wanted to develop a holistic, practical, and easy-to-implement customer stratification model. The lab created a series of consortia to accomplish this undertaking. A Pricing Optimization research consortium was formed (consisting of nine companies--distributors, manufacturers, and technology providers) to fund a massive study to create pricing solutions primarily driven by a customer stratification model.

Customer stratification was one of the key results of the Pricing Optimization consortium. The next consortium, Optimizing Distributor Profitability (ODP), was comprised of 10 distribution firms and one distributor association across six lines of trade. The ODP consortium addressed quantifying and prioritizing large-scale improvement projects. This consortium also explored stratification and linked our framework to shareholder value. The recently concluded Sales and Marketing Optimization (SMO) consortium, with 20 distribution firms from 10 lines of trade, further applied our customer stratification model to prioritize sales activities. Each of these three consortia used customer stratification, demonstrating its importance in:

• Prioritizing customers from the seller’s perspective
• Creating a practical, scientific, simple, and holistic customer stratification framework
• Determining the “true cost to serve”
• Leveraging readily available information technology (IT) system information to aid in sales and marketing efforts
• Providing meaningful and actionable customer information to the sales force
• Managing less-than-profitable customers
• Improving pricing decisions
• Establishing best practices in customer relationship management

THE CUSTOMER STRATIFICATION FRAMEWORK NOT ONLY DISTINGUISHES CUSTOMERS FROM EACH OTHER, BUT ALSO PROVIDES A BLUEPRINT FOR CONDUCTING FUTURE BUSINESS IN A PROFITABLE AND SUSTAINABLE FASHION.
CUSTOMER STRATIFICATION

IMPORTANCE OF CUSTOMER STRATIFICATION
The next question to companies is “what is the importance or motivation to perform customer stratification. There are various reasons as to why companies should pursue this best practice; however, a critical few are discussed in this section.

- **The "Key" Profit Driver:** As a result of the Global Supply Chain Laboratory's (GSCL) research over the last decade, five primary pricing variables were identified as critical to pricing optimization. Customer type (result of customer stratification), item rank, customer item visibility, unit cost, and historical gross margins are the five variables. Customer stratification is most vital of the five accounting for more that 50% importance to any pricing improvement initiative and is key to driving profitability.

- **What the Recent Recession Revealed?** The recent recession was quite challenging for top-line (sales) driven firms, revenue decline forced them to reduce prices or increase services to hang on to existing customers. The problem with this strategy was that distributors extended it across the board rather than target specific customer types who valued price reductions and services more than others. A more selective approach would have been to support customers who have demonstrated a higher degree of loyalty, are likely to become highly profitable in the long run, and can eventually be groomed to become core customers. Cost-driven (cost-to-serve and net profit) firms turned smarter and started to track customer-level profitability—creating profit and loss statements at a customer level, but only for select customers. Survival came down to the strategies distributors put in place based on customer stratification.

- **Cost of Doing Business:** The key to profitability is gaining real visibility into the cost-to-serve each customer. To be profitable, you have to understand your total costs. Cost-to-serve can be effectively captured only by implementing a holistic customer stratification model. This factor is the one that helps companies understand the difference in service requirements/needs for each customer. Cost-to-serve can be grouped under three major categories based on resources utilized by the customer:
  A) Sales: This sales force is often the most expensive resource at any distribution firm. The various factors that can be used to capture the cost under this resource category are – number of sales calls to customers, time spent with each customer, sales expenses by customer, etc.
  B) Operations: The factors that can be tracked in this category are – order size, number of items on an order, order returns, order cancellations/changes, slow moving inventory accessed by customers, quote conversion ratio, online ordering, special packaging requirements, will-call orders, etc.
  c) Finance: The factors in this category are – days to pay, accounts receivable, customer specific inventory requirements, transportation/freight expenses by customer, etc.

- **Double your EBITDA (Earnings Before Interests Taxes Depreciation and Amortization):** Customer stratification emerged as the top best practice based on Texas A&M’s research consortium – Optimizing Distributor Profitability ([http://www.naw.org/optimizdistprof](http://www.naw.org/optimizdistprof)). The objective of the consortium was to understand how profitable a distributor could be? The key finding of the consortium was that distributors can double EBITDA and triple their RONA (Return on Net Assets). Customer stratification is a key tool to help accomplish the same.
Distributors working with the researchers at the Global Supply Chain Laboratory have reported gross margin improvements in the range of 150-700 basis points.

**Vilfredo Pareto was an Optimist:** The Pareto rule states that 20% of customers will generate 80% of sales. Pareto of Net Margin becomes Whalebone Curve in distributors enabling company to see the Margin 90:10 rule but also the profit destroying Customers. Focus on high revenue and high C2S customer drainers by transforming behaviors in such customers can reduce C2s and improve profitability radically. This should give one pause to think, since it demonstrates that the average wholesaler-distributor’s success lies in the hands of only a few customers. If you do not identify those key customers you are putting your business at risk.

**Do Companies have Unlimited Resources?** Companies cannot be everything to all customers as they do not have unlimited resources. Customer stratification not only helps sales managers tactically allocate resources, it equally helps salespeople better allocate their time with customers. The stratification provides a common platform for the team to build a sales plan.

**Blue Print for an Effective Compensation Plan:** Customer stratification gives you insights that can be used to build an effective compensation plan. When we look at sales reps’ performance (revenue and profitability contributions) through the lens of customer types (result of customer stratification analysis), we can better see the degree of alignment between salesperson performance and company objectives.

**The New Normal:** There are many definitions for the new “normal” (the world after the 2007-2010 recession), depending on one’s role in the economy or position in the value chain. There are some factors most people agree on, however. Tighter credit access will lead to a higher cost of capital and increase the importance of cash flow. Customer stratification is a critical tool that can help distributors manage and adapt to the new normal conditions.

In addition to the above, today’s pressure on distributors, leads to some interesting questions:
- Is there a practical and simple, yet scientific, customer stratification framework distributors can adopt/implement?
- Are all customers equal? Should we treat all customers the same?
- How do we determine the true cost to serve customers?
- With all of the data constantly collected by an information technology (IT) system, how should one leverage existing and readily available system information?
- Should you fire customers or adjust how you work with them?
- What lesser-known customer stratification best practices have been tested and implemented?
- How do we implement best practices in customer stratification with minimal resources to achieve a higher ROI?

**BENEFITS OF CUSTOMER STRATIFICATION**
Distributor resources are limited and expensive, so they should be deployed optimally for a better return on investment. Distributors cannot be everything to all customers, and must prioritize value-added resources such as inventory and the sales force. Customer stratification allows distributors to achieve these goals by providing a measurable scale of customer...
importance that is connected to optimizing shareholder value. Distributors’ gross margins are often sub-optimized by a generic cost-plus pricing approach. Customer stratification results can greatly aid distributors with pricing decisions because they reflect the cost to serve customers in comparison to their buying power. Distributors can manage margin erosion effectively by developing customized pricing strategies based on customer category (core, opportunistic, marginal, and service drain). Since every business decision involves customers directly or indirectly, there are numerous ways to apply customer stratification results; some examples include pricing optimization, sales force deployment, and inventory management. In this chapter, we will discuss how to apply stratification results to optimize distributor resources. The benefits of customer stratification are multifold, but the key gains from implementing such a process are listed below.

<table>
<thead>
<tr>
<th><strong>AREA OF APPLICATION</strong></th>
<th><strong>BENEFITS AND STRATEGIES</strong></th>
</tr>
</thead>
<tbody>
<tr>
<td>Inventory Management</td>
<td>Maintain or increase service levels for key customers while reducing / redeploying inventory. Protect slow moving items for core customers.</td>
</tr>
<tr>
<td>Pricing Optimization</td>
<td>Rather than applying an across the board cost plus margin pricing, structure your pricing matrices based on business opportunities and the cost-to-serve associated with each customer.</td>
</tr>
<tr>
<td>Negotiation</td>
<td>If a salesperson has information about the characteristics of the customer with respect to other customers, he or she will be better positioned to make judicious decisions. Stratification reveals this kind of information.</td>
</tr>
<tr>
<td>Sales Force Deployment</td>
<td>The sales force’s time becomes scarce, given the number of customers they must handle. Customer stratification reveals who the key customers are, allowing sales reps to better focus their time.</td>
</tr>
<tr>
<td>Sales Force Compensation</td>
<td>Align sales force objectives with company objectives. Since not all gross margins are the same, customer stratification helps distributors design sales force incentives that reflect the business they want-to-do against don’t-want-to-do.</td>
</tr>
<tr>
<td>Marketing Communications</td>
<td>Allocate marketing budgets judiciously across customer types by media (that is, direct channels such as field sales and customer service reps, as well as indirect channels, such as catalogs, line cards, and Web sites) while achieving a higher return-on-investment (ROI).</td>
</tr>
<tr>
<td>Growth and Market Share</td>
<td>Develop strategies to identify and capture new product and end-market opportunities. The strategies, in turn, provide a roadmap for the marketing department to focus on the new prospects.</td>
</tr>
<tr>
<td>Reduce Operating Expenses</td>
<td>One major benefit is reducing cost-to-serve with the less profitable (service drain customers - High cost-to-serve and high revenue). Transforming behaviors and buying pattern in such customers can reduce cost-to-serve and improve profitability significantly. These service drain customers can often be destroyers of net margin.</td>
</tr>
</tbody>
</table>
CUSTOMER STRATIFICATION

CUSTOMER STRATIFICATION PROCESS
Best-in-class companies categorize customers based on various factors, but customer stratification is still an unexplored area for most companies in wholesale distribution. This is not the case in other industries, such as airlines, hotels, retail stores, and other service businesses. The practice levels for customer stratification are as follows:

**COMMON practice:**
1) No defined customer stratification
2) Customer groups based on market type or product line
3) Top customers based on revenue

**GOOD practice:**
Based on a single factor
1) Volume [sales $] based
2) Gross margin
3) Business potential
Volume (sales) is critical to achieve economies of scale. The fact that gross margin customers are willing to pay in down times says a great deal about what they’ll do in up markets. Beggars can’t be choosers, but given the choice of calling on high-margin versus low-margin customers is a no-brainer.

**BEST practice:**
Based on multiple factors
1) Cost to serve, customer loyalty, business potential, profitability, and relationship
2) Combination method. Texas A&M’s customer stratification best practice model (www.naw.org/customerstrat) which is a combination method is shown in Exhibit 1.

---

**Exhibit 1** – Customer Stratification Model (Lawrence, Krishnadevarajan, Gunasekaran, 2011)

Best practice techniques (Exhibit 1) stratify customers into different groups such as core, opportunistic, marginal, and service drain. Core customers are profitable customers that transact in high volume on a regular basis. Opportunistic customers are also profitable customers who buy infrequently when their regular supplier stocks out. Marginal customers buy infrequently in low sales volumes and require either low prices or high service levels. Service drain customers are high-volume customers who consistently require higher levels of service while demanding low prices.
The customer stratification model is constructed using four dimensions. Buying power is represented using a combination of sales volume in dollars, product line penetration, and number of items accessed. Profitability is a combination of gross margin percentage, gross margin dollars, and profitability trend (profit dollars over 2-3 years). Customer loyalty is represented using number of orders, order pattern, growth trend, and business potential (if data is available and reliable). Cost-to-serve (CTS) is one of the critical components of the stratification model. CTS can be represented effectively using an activity based costing method. However, a surrogate approach using factors such as average order size (dollars), number of line items, days to pay, product returns, freight cost, pick-up vs. delivery, number of C and D (inventory rank) items accessed, etc. can also be used as a proxy for activity based costing methods. Based on various research projects and data analysis, researchers at Texas A&M have observed that results based on a surrogate approach were quite similar to ones obtained using as an activity based costing approach.

**WHAT TO LOOK FOR IN A SOLUTION**

The needs will vary from company to company depending on what they would like to accomplish with the customer stratification solution. Few basic elements to look for in a solution are – setup, data, analysis, results, and what-if capabilities.

![Exhibit 2 – Basic Elements to look for in a Solution](image)

1) **SETUP:** The solution should be able to aggregate the data at different levels as shown in exhibit 2.

2) **DATA:** Data fields for customer stratification are typically available in all ERP systems. If there are any company specific attributes, data from different tables can be grouped to accomplish the same.

3) **ANALYSIS:**
CUSTOMER STRATIFICATION

Filters: The analysis capability of the solution should be able to account for exceptions such as flexibility to include/exclude new customers, active customers, national accounts, etc.

Tools: The solution should also provide ability for the user to modify ranking criteria and also weight various factors as needed.

Frequency: The solution should be able to run the analysis at various periodicity levels (monthly, quarterly, yearly).

4) VIEWS/DASHBOARD: The results display is the most important item. Depending on the application for customer stratification the way the results are presented to the user is vital. There should be dashboards for management, regional managers, sales, etc. The views should be based on the job function of the users.

5) WHAT-IF ANALYSIS: The user should be able to apply different strategies for various customer groups to understand the impact. A simple need could be the ability to increase/decrease for a select set of customers and see the overall impact on revenue and/or profitability.

This list is in no way comprehensive and could vary based on company needs across multiple lines of trade. However, the solution should address the basic needs shown in exhibit 2.

NEXT STEPS AND ROAD MAP
It’s time to move away from the “gut-feel” and “art” approach to ranking customers to a scientific data driven comprehensive and holistic approach. Here are the 10 things you need to do right away to implement customer stratification.

For details and complete roadmap refer – http://www.naw.org/customerstrat

| 01. Discuss the role and relevance of customer stratification to your firm. |
| 02. Develop a cross-functional tactical team consisting of middle managers and potential leaders. |
| 03. Assess current status of customer stratification – common, good, and best. Hold team meetings to discuss the impact of process gaps on shareholder value |
| 04. Quantify profitability to determine the projected improvements of implementing best practices. |
| 05. Identify a set of pilot locations for implementation and develop a specific project plan. |
| 06. Communicate the plan to the focus group and understand the best practices methodology for customer stratification. |
| 07. Discuss and decide upon the mechanism (bolt-on vs. integration) you will use to implement the best practice in your IT system |
| 08. Identify metrics you can use to sustain best practices in the future |
| 09. Educate your workforce about best practices. |
| 10. Review your goals quarterly and adjust to business conditions. |
CONCLUSION

The following conclusions on customer stratification are drawn from multiple research findings and our experience with hundreds of best practice implementations and educational sessions—which provided the opportunity to observe, interact, and learn from thousands of distribution professionals—over the last 10 years:

- Customer stratification processes can be measured to assess potential.
- The potential for improving profitability exists with customer stratification.
- You can always establish a one-to-one connection between customer stratification and shareholder value.
- This connection can be quantified.
- Customer stratification best practices can be achieved.
- Consistent education will enable distributors to realize potential profitability.

RESOURCES

http://www.naw.org/customerstrat
http://www.naw.org/customerstrat
http://www.naw.org/salesmarketingoptimi
ABOUT THE GLOBAL SUPPLY CHAIN LABORATORY

Texas A&M’s Global Supply Chain Laboratory (GSCL) is the nation’s premier distribution-focused research lab. The lab brings cutting-edge distribution and supply chain research solutions to the industry. GSCL transforms companies by creating competitive advantage and by facilitating change management. The lab offers total solutions for companies by providing research expertise, education, and implementation support. The research team at GSCL has many years of experience partnering with the wholesale distribution industry to help companies solve difficult challenges. These partnerships have resulted in millions of dollars of cost savings, inventory reductions, and margin improvements. GSCL has expertise in several areas, including inventory stratification, forecasting and replenishment, sales and marketing, supply chain network design, pricing optimization, customer stratification, growth and market share, transportation and logistics, and lean distribution. For more information, please visit: www.http://supplychain.tamu.edu/.

ABOUT INDUSTRIAL DISTRIBUTION PROGRAM AT TEXAS A&M UNIVERSITY

The Industrial Distribution program at Texas A&M was founded in 1956. With more than 500 undergraduate students and 25 graduate students, it is the largest and best Industrial Distribution program in the country. The executive Masters in Industrial Distribution program is the only advanced degree in industrial distribution in the country. The Thomas and Joan Read Center for Distribution Research & Education is the nation’s premier and only distribution-focused research center. The center also trains more than 500 professional development executives in its Certificate in Distribution Management program every year. The center has conducted applied research projects for wholesaler-distributors ranging from small/midsize regional to multibillion dollar global companies. For more information, please visit: www.http://id.tamu.edu/.