$119.95

MDM Special Report:

Making Money with Small Customers

Copyright © 2014 by Gale Media, Inc. All rights reserved. Modern Distribution Management® and mdm® are registered trademarks of Gale Media, Inc. Material may not be reproduced in whole or in part in any form whatsoever without permission from the publisher. To request permission to copy, republish, or quote material, please call 303-443-5060.

Table of Contents

Making Money with Small Customers.......... 3

Cost-Effective Channel Alignment.......... 6

Balancing Margin & Cost.......... 9

Defeating the Profit Drage.......... 11

MODERN DISTRIBUTION MANAGEMENT

Founded in 1967
by J. Van Ness Philip

Publisher
Thomas P. Gale
tom@mdm.com

Editor
Jenel Stelton-Holtmeier
jenel@mdm.com

Associate Publisher
Craig Riley
craig@mdm.com

Associate Editor
Eric Smith
eric@mdm.com

Editorial Advisory Board

John Allenbach, SVP, Professional Sales, Apex Tool Group

Chester Collier, SVP, Global Distribution, Walter Surface Technologies

Ted Cowie, Vice President Sales, Safety & Industrial Products, Motion Industries

Larry Davis, Chief Commerical Officer & EVP, Stellar Industrial Supply

Charley Hale, President, FCX Performance

Mary Johnston, Sales & Channel Marketing Director, 3M Industrial Markets Center

Julia Klein, Chairwoman & CEO, C.H. Briggs Company

Doug Savage, President & CEO, Bearing Service Inc.

Burt Schraga, CEO, Bell Electrical Supply

Ted Stark, President, Dalco Enterprises

Contact Information
Questions, comments, article proposals, address changes or subscription service to:

Gale Media, Inc.
2569 Park Lane, Suite 200, Lafayette, CO 80026
Tel: 303-443-5060 Fax: 303-443-5059
Website: http://www.mdm.com

Subscription Rates
To subscribe to Modern Distribution Management, please call 303-443-5060, email dillon@mdm.com or **http://www.mdm.com/subscribe.**

Subscriptions are available by online delivery and/or first-class mail. Nine years of archives of MDM are available online to subscribers.

Published twice monthly; $395/yr., $415 U.S. funds other countries). Six-month and two-year terms are now available. For group subscription rates and site licenses, please contact Dillon Calkins at 303-443-5060.

Copyright © 2014 by Gale Media, Inc. All rights reserved. Modern Distribution Management® and mdm® are registered trademarks of Gale Media, Inc. Material may not be reproduced in whole or in part in any form whatsoever without permission from the publisher. To request permission to copy, republish or quote material, please call 303-443-5060.

ISSN 0544-6538

mdm.com

Making Money with Small Customers

Smaller customers provide big opportunity for the bottom line

There is often a perception in sales that the smallest accounts are not worth the time and effort to obtain the small amount of sales they provide. But a shift in how these customers are served can result in a significant improvement to the bottom line. In this article, Jonathan Bein of Real Results Marketing provides an overview of how distributors can serve smaller customers and still make money doing so.

By Jonathan Bein

If you give a salesperson 100 accounts to call on, odds are he or she will actively work the top 20 to 30, receive calls from the next 20 to 30 and ignore the remaining accounts. While this salesperson is busy maximizing his or her commission by focusing on the larger accounts, the company is missing significant opportunity in the smaller accounts. When these accounts are acquired and serviced through the proper channels, priced appropriately and managed well, they can increase the bottom line by several margin points. In turn, those margin points often lift net profit more than 50 percent.

At the same time, these smaller accounts cannot be serviced in the same way the largest accounts are if distributors wish to turn this kind of profit. But there are cost-effective ways to serve these small to mid-size customers:

- Sales and marketing channel alignment
- Price improvement
- Cost-to-serve reduction

The net effect of these approaches is to increase revenue and margin while reducing cost to serve such that small and midsize customer segments become attractive. This article provides an overview of these approaches.

Marketing and Sales Channel Alignment

For most distributors, the top 10 percent of customers represent 60 percent to 90 percent of that distributor's revenue. This top decile is almost always managed by field sales representatives who rely on large accounts to make quota.

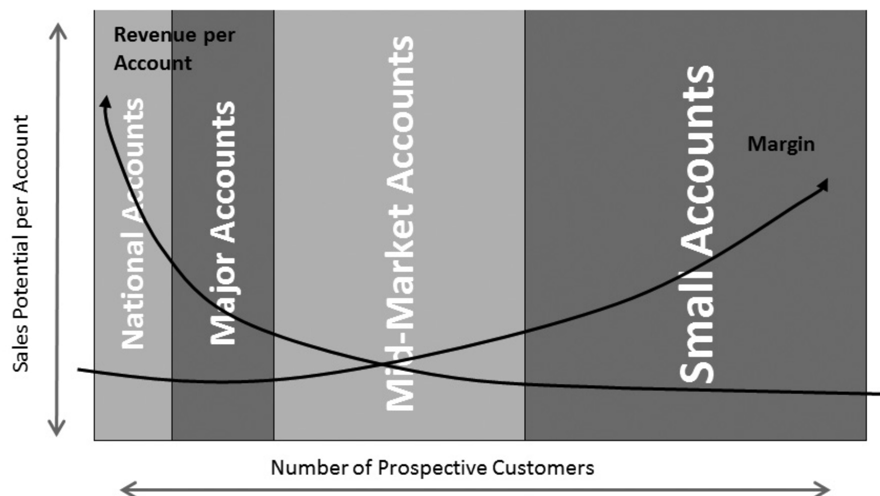
While there is substantial revenue in large accounts that form the top decile, mid-market and small accounts that make up the other 90 percent of accounts provide an opportunity to get higher gross margin percentage, as shown in **Figure 1**.

There are three main channels that are cost-effective for selling to mid-market and small accounts:

- E-commerce sites that provide easy navigation, good search and great product content.
- Proactive/outbound inside sales which involve account managers interacting almost exclusively by telephone rather than face-to-face.
- Direct response marketing programs including traditional print catalogs and flyers, as well as email marketing and marketing automation.

The proper development of any one of these

Figure 1: Account Potential



channels can usually deliver 10 percent or more compounded revenue growth among small and mid-market customers over a two- to four-year period. The combination of these channels can achieve a compounded growth rate of 15 percent to 20 percent over a two- to four-year period. The financial impact to the entire company is 2 percent to 8 percent overall growth.

The expansion of sales channels provides for a proactive account management process for every single customer. Without proactive account management, small to mid-size customers are highly susceptible to defection – especially when competitors are prepared to give your customers the attention that you failed to provide. Our research shows that defection rates among customers who are managed by a sales rep are much lower than those with no account management process in place.

The development of small accounts can smooth lumpiness in revenue streams that results from a customer base that is too concentrated. It can also provide diversification and options for when the market shifts. Furthermore, the cultivation of these accounts will always reveal underserved accounts with huge potential that should be transferred to field sales.

Here are some symptoms that marketing and channel alignment could be right for you:

- Top revenue decile represents more than 75 percent of total revenue. This is evidence that your business is too concentrated in a small set of customers.
- High churn rate among lower decile customers suggests that those customers are getting better served by your competitors and moving on.
- Lumpy revenue can occur when your business is too dependent on large accounts or on accounts that have project revenue.
- Low wallet share in your small accounts indicates that the accounts are underserved by you.
- When field sales is the only or primary channel, then it is virtually guaranteed that small accounts are underserved by you.

Price Improvement

Many distributors subscribe to the myth that a principled price improvement initiative will result in losing key customers who are driven away by higher prices. In reality, small and mid-size customers are much less price sensitive than customers in the top revenue decile, particularly for non-core items they purchase infrequently.

Figure 2 plots the size of the customer on the X-axis versus the price they pay relative to list price on the Y-axis. The area highlighted below 1.0 on the Y-axis shows small customers who are purchasing at a significant discount. These discounts are invariably offered for no apparent reason other than force of habit and belief that it is necessary to win or maintain the business.

Some pricing solutions help customers achieve a margin improvement of 1 to 2 points. However, work by Strategic Pricing Associates has repeatedly shown that margin improvement of 2 to 4 points can be achieved by getting small customers to pay another 5 percent to 10 percent on non-core items. This additional margin drops right to the bottom line and often enhances profit by 25 percent to 50 percent.

Here are symptoms that price improvement could be right for you:

- A small spread between the average gross margin percentage of your top revenue decile customers and the rest of your customer base is strong evidence that you need price improvement. The spread should be at least 5 to 10 points and possibly more depending on your business.
- If your business culture tries to please the customer at any cost, then it is nearly certain that you are offering unwarranted discounts. It is essential to be able walk away from customers or transactions that are not good for your business.
- When your business is reacting to pricing moves in the market without any discipline, then price improvement is a great

Figure 2: Pricing and Customer Size

opportunity for you.

- If your value proposition looks like 80 percent of other distributors who tout selection, availability, delivery, and expertise then it means you need to better understand value and value selling, and how to create a differentiated value proposition.
- Frequently there is a vague objective to get more gross margin without a concrete plan to do so. This is yet another indication that price improvement will yield very good results.

Reduce Cost-to-Serve

Waypoint Analytics has detailed cost-to-serve information about the customers and transactions for several hundred distributors. A random sample of 87,000 customers from Waypoint revealed that unless a distributor has undertaken the process to reduce cost-to-serve its customers, it is likely that more than 70 percent of the customers are unprofitable. The business is sustained only by the 30 percent of customers who are profitable. The rest of the customers are breakeven or a drain.

Measuring net profit, including cost-to-serve, at the customer level is a powerful starting point for assessing where customers fall on this spectrum. Plot the peak internal profit (PIP) by starting with the most profitable transaction and proceeding to the least profitable transaction as shown in **Figure 3**.

This curve, called a whale curve because of its shape, reaches a point of peak internal profit near the middle. Remaining unprofitable transactions will reduce the peak internal profit. For a typical wholesale distribution company, only 20 percent to 25 percent of their PIP goes to the bottom line

The different parts of the curve include:

- **Core customers** – transactions at the left of the curve that contribute significantly to net profit.
- **Opportunistic customers** – transactions slightly to the left of center that contribute somewhat to net profit.
- **Marginal customers** – transactions slightly to the right of center that subtracting somewhat from net profit.
- **Service drain customers** – transactions at the far right that are a significant drain on profit.

When processes are put in place to reduce the cost-to-serve for the small customers in the middle – the opportunistic and marginal customers – the PIP curve is transformed to what is shown in **Figure 4** on the next page. The key objective to reduce cost-to-serve is to increase the size of transactions and/or reduce the total number of transactions while keeping revenue constant. In this new curve, the marginal customers are now at breakeven. The result is a company that previously had $1.9 million net profit and now has $2.5 million net profit, a 30 percent gain. This is the conservative view, because increasing the profitability of the opportunistic customers or getting the marginal customers above breakeven will contribute even more to the bottom line.

While it is possible to create an in-house solution to reduce cost-to-serve, for most distributors, getting a third-party solution such as Waypoint Analytics or add-ons to an ERP system is more efficient and effective.

Here are symptoms that indicate that reduc-

Figure 3: Small Orders on the Peak Internal Profit Line

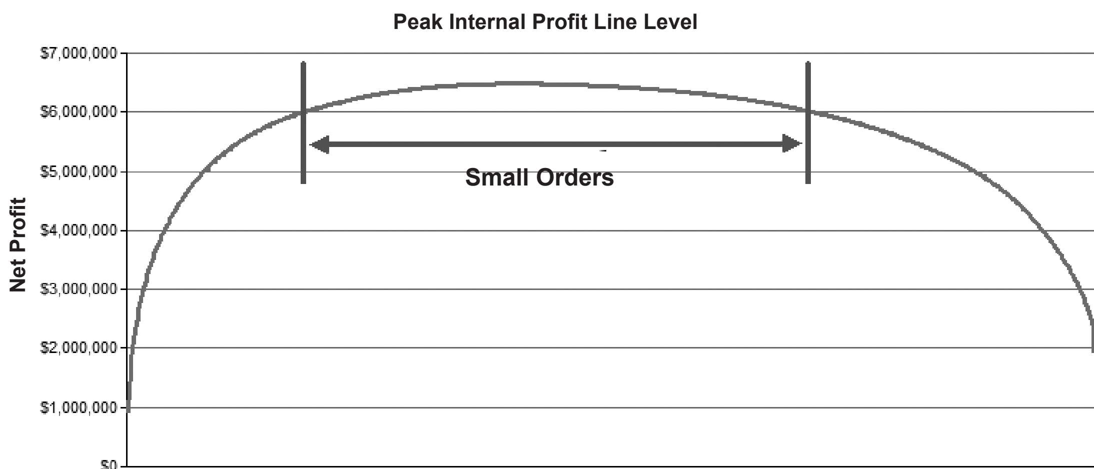
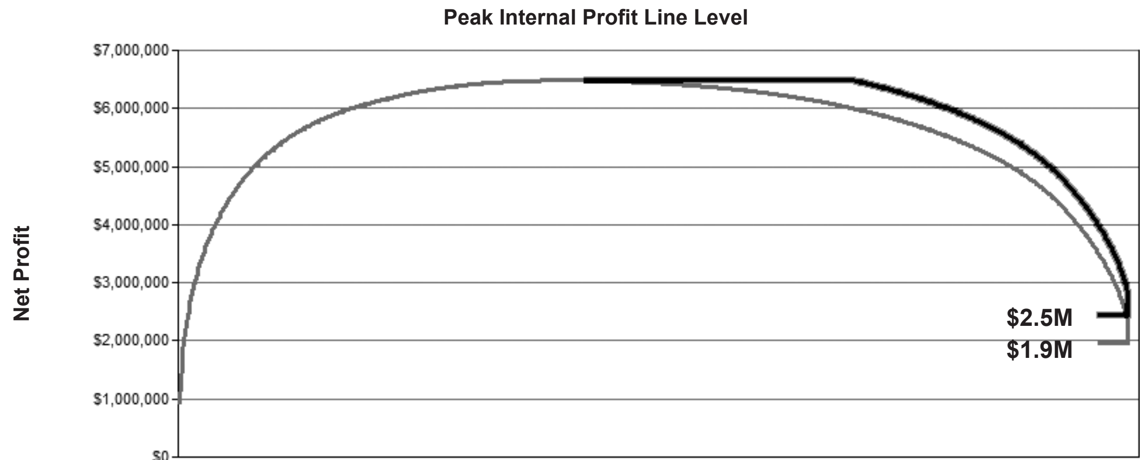


Figure 4: Peak Internal Profit After Cost-to-Serve Reductions



ing cost-to-serve could be right for you:

- There are too many sales where expenses exceed gross profit.
- Nobody knows where profits are made or lost because it cannot be measured at the transaction or line item level.
- Growth and gains are weak because few companies manage deltas (profit improvements over time).
- Sales people and others are rewarded only on gross profit rather than net profit.
- There is nothing in the current systems or processes to detect, prevent or manage these problems.

Each of these approaches will help distributors make money with small customers; some of the most profitable distributors recognize the potential to make money with small customers by combining these approaches. When used alone, sales and marketing channel alignment can deliver 3 percent to 5 percent compound revenue growth over a several year period; price improvement can provide 2 points to 4 points of margin improvement, which flows through to the bottom line; and cost-to-serve reduction can improve the bottom line by 30 percent or more.

Cost-Effective Channel Alignment

Use the right resources to serve small customers for big impact

There is often a perception in sales that the smallest accounts are not worth the time and effort to obtain the small amount of sales they provide. In this article, Jonathan Bein of Real Results Marketing provides an overview of how realigning sales channels can help distributors benefit from these small customers.

By Jonathan Bein

For most distributors, the top 10 percent of their customers represent 60 percent to 90 percent of that distributor's revenue. Those customers are well-served by field sales reps. The remaining 90 percent of the customers, often called house accounts, have 10 percent to 40 percent of the total revenue. They are usually passively served through phone calls to customer service reps, branch visits and e-commerce sites. However, there are two attributes of house accounts that make it worthwhile to actively cultivate them through the right sales and marketing channels:

Because house accounts are mostly managed passively, even minimally active efforts to grow wallet-share in these accounts yields 5 percent annual growth. Managed properly, these house accounts can grow 10 percent or more annually with a significant contribution to overall company growth.

In work we have done for distributors, house accounts often have three to six percentage points higher margin than assigned accounts. For distributors who have implemented a price improvement program, the difference in margin percentage between assigned and house

Table 1: Overall Company Growth Based on Growth in House Accounts

Growth rate of house accounts	House account percent of total revenue: 10%	20%	30%	40%
12.5%	1.25%	2.5%	3.75%	5%
10%	1%	2%	3%	4%
7.5%	0.75%	1.5%	2.25%	3%
5%	0.5%	1%	1.5%	2%

accounts can be as high as 10 points.

The opportunity for growth of house accounts depends heavily on how concentrated the revenue is among assigned accounts. When it is more concentrated, even large growth in the house accounts will have minimal effect on the total company revenue. **Table 1** shows two dimensions:

- Annual growth rate in revenue of the house accounts on the vertical axis.
- The percent of all revenue that comes from house accounts on the horizontal axis.

Each cell shows the revenue growth for the entire company based on revenue growth in house accounts. At the lower left, a company with 10 percent of all revenue in house accounts that grows those accounts at 5 percent will only see a net half-percent increase in company revenue. In the upper right, a company that grows house accounts at 12.5 percent and has house accounts that total 40 percent of the revenue will see a net increase of 5 percent in company revenue.

Also, since the gross margin percentage for house accounts is higher than assigned accounts, the company gross profit grows slightly more than the company revenue, as shown in Table 1.

Integrated Marketing

To cost-effectively grow house accounts from 5 percent to 12.5 percent per year requires proper channel alignment. This means that the most cost-effective channels are different for acquiring and serving large, mid-size and small customers. **Figure 1** shows a sales and marketing map that works well for house accounts including mid-market accounts and small accounts. For the mid-market accounts, the primary channel is in-

Figure 1: Sales and Marketing Channel Map

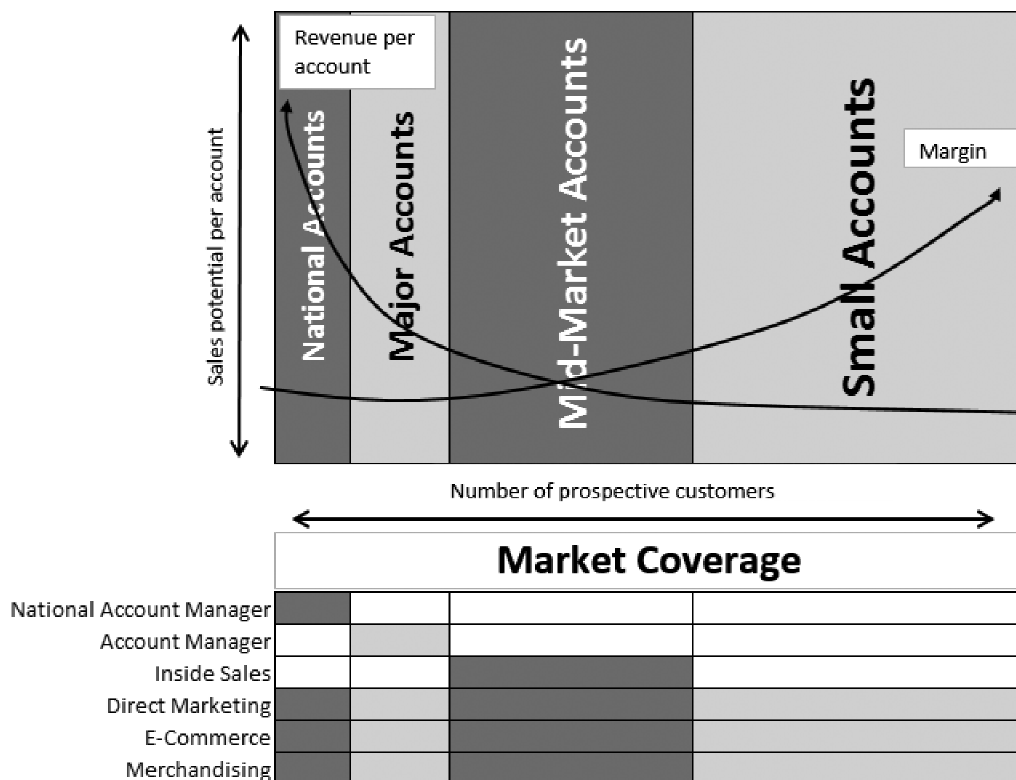


Table 2: Cost per Contact by Channel

	Contacts/day	Contacts/year	Average annual salary	Average cost/ contact
Field sales	3-4	750-1,000	$100K	$100-$133
Inside sales	20-25	5,000-6,250	$45K	$7-$9

side sales, supported by direct marketing and e-commerce. Small accounts are primarily handled through direct marketing and e-commerce.

The multichannel approach works for house accounts by keeping the distributor on top of its customers. The net result is increased order frequency and increased average order value that provides 5 percent to 15 percent annual growth. The channels work together to drive branch traffic, calls, e-commerce and email orders.

Inside Sales

True inside salespeople are skilled hunters. They are motivated by capturing new accounts and rewarded accordingly. This is in contrast to customer service people who are better at gathering.

When the proper structures are set up for proactive inside sales, distributors can cost effectively serve mid-market and smaller accounts in a manner that was previously infeasible. The economics of inside sales are shown in **Table 2**. They can reach 20 to 25 customers per day at a much smaller cost per contact than field sales. Typical inside sales accounts spend $2,500 to $15,000 or even $25,000 per year.

Our research finds that there is increasing preference for inside sales because it takes three to five minutes instead of an hour-long field sales visit. This is part of the larger trend toward more transactional channels and vehicles.

Inside sales programs can be initiated with only a couple of salespeople. Once the program is working well, it is easy to add new salespeople to the team. But keep in mind that a new inside salesperson will take several months to reach top efficiency.

E-Commerce

As noted in the 2014 MDM e-commerce survey, distributor e-commerce channels are maturing. The percentage of companies with at least 5 percent of total revenue going through the e-commerce channel is expected to grow by more than 25 percent in 2014. Distributors with at least 10 percent of total revenue from e-commerce are expected to see that number double in 2014.

Distributors who have successful e-commerce channels view it as a strategic opportunity rather than a tactical requirement dictated by their largest customers. They combine push and pull marketing techniques to get customers and prospects of all sizes to purchase from their e-commerce platforms.

E-commerce is a great venue for customers of all sizes, but is particularly well-suited to customers who purchase small amounts infrequently, totaling less than a few thousand dollars per year. The low cost of creating and fulfilling an order reduces the cost-to-serve of the customer to a level where it is profitable for a distributor.

Many distributors with more than $500 million in sales have achieved good levels of integration across the channel and have developed more sophisticated marketing effectiveness measurements. The imperative for distributors of all sizes is to create and continually refine multi-channel offerings.

Direct Marketing

Direct marketing includes both traditional print media such as catalogs, brochures and flyers, as well digital marketing through email and marketing automation tools. Direct response marketing will not only increase sales of items featured in offers, but it also increases sales of other products. The rising tide lifts all boats.

The cost of direct marketing is usually less than $1 per contact, perhaps even a few cents per contact. Key with direct marketing is the regularity of touching the customer. It is well understood that multiple touches per customer are usually required before they are compelled to action.

Like the inside sales, there is no need to begin a direct marketing program with the entire customer base. The program should be large enough that it can have a test group and a control group to see what is working. For example, a print and digital flyer program would be tested with a control group that gets no correspondence, one that get just digital, one that gets just print and one that receives both. This type of testing is powerful because many customer segments touch a variety of age groups who each have different communication preferences.

Getting the right mix of digital and print will improve both effectiveness and efficiency of the campaign.

Aligning sales and marketing channels is one of the keys to making money with small customers. A company can grow 3 percent to 5 percent every year just by actively cultivating small and mid-market accounts. Over time, customers should be able to purchase from you how and when they want.

The sequencing of these programs is important. E-commerce will take about a year to launch and another year to have a smooth operation. Inside sales or direct marketing can be implemented more quickly, and as a result, may be a better place to begin.

Balancing Margin & Cost

The key to success is keeping services costs in line with gross profit

Predicting profitability of an order by measuring average margin is ineffective. Averages are susceptible to outliers and rarely represent the true value of any individual measure within the set. In this article, the authors examine flaws in conventional thinking about margin and provide practical ways to better manage small orders.

By Randy MacLean and Jonathan Bein

Distributors and wholesalers have been dealing with the "small order problem" for decades. Now, more than ever, mastering the policies and procedures that are a near-complete solution to this issue is a necessary and fundamental skill for every distribution organization.

Examination of distribution company transaction data provides deep insight into distribution profit production, and clear guidance on how every company can quickly and directly address this very real challenge.

Nearly a decade of this work shows that every company has a small account component to its business, and the profit dynamics are pretty much universal. It reveals significant adverse impact on profitability where this component hasn't been managed, and significant profit contribution where it has.

Addressing this effectively can be one of the most important things a company can do because it can lead directly to immediate and sustained profit gains of 25 percent or more. There's no delay because there's no requirement to develop new business; it's already there.

How'd We Get Here?

Every distribution company, at its genesis, is a very small player and for the most part, can attract and retain only very small accounts. In this phase, the company will have a naturally low operating cost as it has not yet invested in the personnel and infrastructure that will later be needed to service larger accounts and larger deals.

As the years pass and the company grows, it is able to attract and service larger accounts, which produce larger gross profit numbers that cover the service costs of larger deals. The company invests in capabilities and infrastructure to support a service model geared to a more sophisticated relationship with its larger accounts. This "improved" service model is a mismatch for small accounts, with increased infrastructure costs they don't need, don't want and won't pay for. The gross profit production is just too small to support the additional cost-to-serve.

The issue occurs at the order level: larger accounts will have more orders that produce gross profit to cover the service costs; small accounts will have a larger proportion of orders that do not.

To enhance the profit viability of small orders, companies don't have to invent a new infrastructure or skill set, they can just reconstitute an old one.

How Profit is Actually Made

In our profit analytics work, a core discovery provides guidance to reliable strategies for profit production. It also refutes much of the conventional wisdom that thwarts companies' attempts to drive profit gains.

Paradoxically, it's the pursuit of analytics that has led to the biggest roadblock to distribution profitability.

At one point or another, every manager has gone through an exercise of determining the average profit on an order or the average size of a profitable order to establish a "rule of thumb" guideline to assist with identifying good

or poor performance. It also led to the conclusion that every order above this average would make some small contribution to the bottom line. In practice, the average is most commonly expressed as a gross margin rate.

The data shows this methodology – and the resulting decision-making – is just flat wrong.

The profitability of an order cannot be predicted by its margin. That would be like trying to predict the height of the next person to walk by a building using the U.S. national average male height of 5′ 10½″, which will result in an incorrect prediction in all but the rarest of cases. Correspondingly, the next order likely will generate a profit that will be lower than (or, potentially, much higher than) expected regardless of the gross margin rate.

Every order generates a specific number of gross profit dollars and carries with it a specific cost structure directly related to the consumption of infrastructure. Direct orders, for example, don't involve the warehouse, and therefore are less expensive and can support lower pricing. The profitability of any particular order is driven by the spread between the gross profit dollars and the specific cost structure associated with the order.

Mathematically, margin rates stay within a very narrow band, roughly 15 to 30 percent. The cost structure rates cover the whole range, from near-zero to more than 100 percent of the order's revenue. The important discovery is that, because of its much broader range, the cost rate is a much bigger factor in determining order profitability than gross margin ever can be.

This leads to another epiphany in profit generation: a company's bottom line is the net of all money-making orders, less all money-losing orders. For most distributors, between 60 percent and 80 percent of all orders lose money. This means that the money-making orders produce extraordinary profit rates, enough to cover the losses on the majority of orders and leave some small amount that is the company's bottom line.

It's not only a strong indictment of the industry's rule-of-thumb gross-margin management, it also suggests a pathway to extraordinary profits. This knowledge can be used to directly exploit the opportunity in small accounts.

Addressing the Small Account Challenge

Since every order generates a specific number of gross profit dollars – the operating budget for servicing the order – and has a specific cost structure determined by the associated logistical elements, the real trick is to keep the service costs within the gross profit operating budget of each and every order.

To make sure this happens, increase gross profit amount on the order and/or reduce the service costs for the order.

The company can decide to either give up the small accounts or reestablish the kind of infrastructure that is an ideal match for accounts of this size. This is what Bruce Merrifield refers to as the "wholetail" model:

Increasing gross profit can be achieved by establishing differentiated (higher) pricing for the small account group and for wholetail sales. Add-ons, such as delivery charges, small order charges and other service fees, also contribute to higher gross profit production, helping make small orders viable.

Decreasing associated infrastructure costs also contributes to the viability of small orders. There are commonly five logistical elements that make up the cost structure of any order: order entry, warehousing, delivery, A/R & administration and sales compensation. In the wholetail model, the goal is to reduce or eliminate as many of these as possible.

Attack order entry costs by selling only vendor-bundled and barcoded items at the counter. Stop selling singles of 50-cent parts that need manual processing at the register.

Reduce warehousing costs by moving the most popular products in front of the counter and let the customers do the picking.

Make sure delivery is a gross profit generator by charging more for it than it costs to buy or produce.

Eliminate account receivable and administrative expenses by making all small accounts, and all small counter sales, credit card only. Fully half of A/R tracking and collection structure is driven by tiny orders from tiny accounts.

Helping customers combine orders contributes positively to all of these areas.

Finally, eliminate sales commissions on counter sales, small orders and small accounts. Reps need a narrower focus to service and obtain significant accounts. Paying them on accounts they never call on – accounts they don't influence – is both a distraction to the reps and an unnecessary drain on your bottom line.

Making It Work

Moves like these usually trigger a little noise and smoke, but rarely an actual fire. Meanwhile, they get the company on a path to increased profitability and remind everyone the relationship between gross profit and logistics costs.

There can be amazing results when company leaders realize how the math works and how to use these techniques to get control and mastery over their small account/small order business. Some companies have realized permanent triple-digit profit gains.

Defeating the Profit Drag

When managed properly, small customers can be served profitably

While small customers present significant challenges for many distributors, implementing changes to how they are served can eliminate the profit drag created by them. This article examines the challenges and provides practical steps for mitigating the profit challenge of small customers.

By David S. Bauders

Companies typically start with small customers, grow some of them into large customers, continue to add new small customers and learn a lot from serving all of them.

Small customers are an important source for learning how to serve myriad market needs. They diversify the customer base (and associated risks of customer concentration) and, in aggregate, improve pricing leverage with more powerful customers and vendors. They also can represent a leading indicator of a company's sales and marketing vitality, its operational capabilities and, more fundamentally, the validity of a company's value proposition and competitive positioning. A healthy business will likely have a continuous flow of small customers. It's exciting, at a gut level, to attract new small customers.

So, why do so many executives feel ambivalent about small customers? If you ask them to describe their customer base, they almost always start off by using the 80/20 rule and tell you about everyone in the top 80 percent and nothing about those in the bottom 20 percent. They treat the bottom tier as if it were nonexistent, not worth understanding, not worth managing.

This perspective has consequences.

First, there are plenty of reasons to be cautious about small customers and their profitability. Small customers are a challenge to serve profitably. There is a lot of churn with small customers, many of whom buy one time and then disappear. Their up-front costs to serve, as a share of available gross profit, are high. They can consume valuable organizational bandwidth, reducing service levels, implied future growth rates and pricing leverage for larger accounts.

Small customers may distract the sales team from targeting the bigger customer opportunities that drive profitability. Additionally, typical sales commission structures pay a higher share of potential profit than they would if small customers' relatively greater costs were properly understood.

Small customers may be more prone to haggle on price, and they frequently receive discounts that many executives would consider unacceptable for larger accounts. It's no surprise that many management teams are cautious of the value small customers provide. Every business should understand these factors carefully and be thoughtful about how and when to pursue small customers.

Small Customer Turnover

Many small customers are one-time customers. They often buy a product once, often as a convenience purchase, and never buy from you again – presumably reverting to their usual supplier. They churn at a very high rate.

"Churn" is the percentage of accounts that have sales in a given 12-month period but do not have sales in the following 12-month period. Strategic Pricing Associates data show the discouraging difference in small-customer churn: There is a 30 percent to 40 percent churn rate in small customers (defined as the bottom quintile, or 20 percent, of revenue), compared to 3 percent to 6 percent churn in the higher quintiles.

Setting up accounts for a one-time event is expensive and time-consuming. It requires entering new customer information in the CRM, finding product from bottom-tier vendors (also more costly to serve), understanding new specification and application requirements, and processing credit and payment activities.

For the typical distributor, these setup costs are broadly estimated at $50 to $75, lowering the profitability for virtually all small one-time customers. Furthermore, small customers' order volumes are also small, frequently less than break-even revenue. Any order below $250 from such a customer is likely to be unprofitable if

properly measured. SPA estimates the impact of these money-losing orders at about 50 basis points on overall revenue.

Inside and outside sales reps waste time, effort and focus on accounts that provide the superficial gratification of new business but that are actually reducing profits. The commission structure likely rewards them on either sales dollars or (overstated) gross margin dollars.

The Myth of "Growth Potential"

Sales reps often misunderstand the true potential of small accounts, labeling them "high potential." SPA's research shows that in any given year, 93 percent of accounts stay in the same size class the following year. Furthermore, 97.5 percent of small accounts in any given year remain small the next year; 4 percent move up one quintile; 1 percent move up two quintiles; 0 percent move up three or four quintiles.

The upward mobility statistics are modest but better for other customer size quintiles. The biggest opportunities seem to be concentrated in retaining and/or expanding the loyalty of the next two quintiles up in size; in these groups, there is a 30 to 40 percent probability that they will shrink by one or two quintiles from one year to the next. Sales efforts should be prioritized accordingly.

The real growth opportunities are concentrated in **Table 1** below.

Under-Pricing of Small Customers

The tendency of small customers to receive lower prices cannot be overstated and shouldn't be ignored. SPA's research shows that 30 percent of small customers in any given year are paying below-market price for their basket of products, reducing overall margins by 3.5 percent to 5.5 percent. To measure the margin impact, we compare actual margin to what it would have been if customers had paid true market price and/or size-adjusted market pricing.

Small customers often get lower prices for several reasons. First, the small dollar impact of large pricing concessions to small customers doesn't trigger the financial alarm bells that would result if the same percentage concessions were given to larger customers. This is called financial death by a thousand small price cuts. This disparity in demonstrated in **Figure 1** on the next page.

Many small accounts, because they are new to the ERP system, get priced on-the-fly, sidestepping pricing structures and safeguards. They aren't tracked carefully due to their size and churn rates. Most importantly, their cumulative drag on financial performance is rarely fully understood.

The cumulative effect of small customers' churn characteristics, disproportionate fixed costs and tendency to be underpriced conservatively total 4.2 percent of sales for the typical distributor, 0.4 percent for disproportionate churn characteristics, 0.4 percent for disproportionate up-front costs and 3.4 percent for underpriced small customers. Since the average distributor makes only 4 percent EBITDA, the incremental costs of serving small customers represents an ongoing drain of more than 100 percent of average EBITDA. For a $50 million distributor, that reduction in EBITDA is $2.1 million annually, with an implied reduction of $14.7 million (at multiplier of 7x) in enterprise value. Managing small-customer profitability is indeed a million-dollar challenge.

Are most distributors better off firing small customers and avoiding acquiring new ones?

Table 1: Customer Mobility

The table shows the percentage of customers who shift size quintiles from one year to the next. For example a huge customer in Quintile 5 that changes by -4 quintiles would move into Quintile 1 (Small).

% of Accounts	Quintile Moves from One Year to the Next								
Customer Size	**-4**	**-3**	**-2**	**-1**	**0**	**1**	**2**	**3**	**4**
Quintile 5 (huge)	4.0%	4.0%		16.0%	76.0%				
Quintile 4		6.0%	3.4%	20.7%	65.5%	4.3%			
Quintile 3			9.0%	27.2%	56.7%	6.9%	0.3%		
Quintile 2				41.5%	49.9%	7.8%	0.7%	0.1%	
Quintile 1 (small)					97.5%	2.2%	0.2%	0.0%	
TOTAL	0.0%	0.1%	0.3%	3.8%	92.8%	2.7%	0.3%	0.0%	0.0%

Shareholders will want to know the strategy to address these pivotal facts. These facts can be mitigated, setting the stage for true profitability (or, perhaps, just smaller losses) from the small customer base.

Manage What You Measure

First, establish a quantitative assessment of the issue in your business. Expert reporting and pricing tools can help quantify your small customer challenge:

- Document the percentage of revenue coming from small accounts.
- Identify churn rates by customer type and size.
- Profile vendor cost-to-serve and vendor mix per customer type/size tier.
- Identify and measure underpriced volume by customer type and size.
- Set up pricing tools and processes to remediate and prevent under-pricing of small customers.
- Understand transactional cost-to-serve by customer type and size.
- Identify and quantify unprofitable customers.
- Properly adjust commission structures to reflect profitability characteristics.
- Quantify the financial drag on EBITDA and enterprise value.

These metrics and tools can help identify how to turn the profit situation around for both small customers and others,

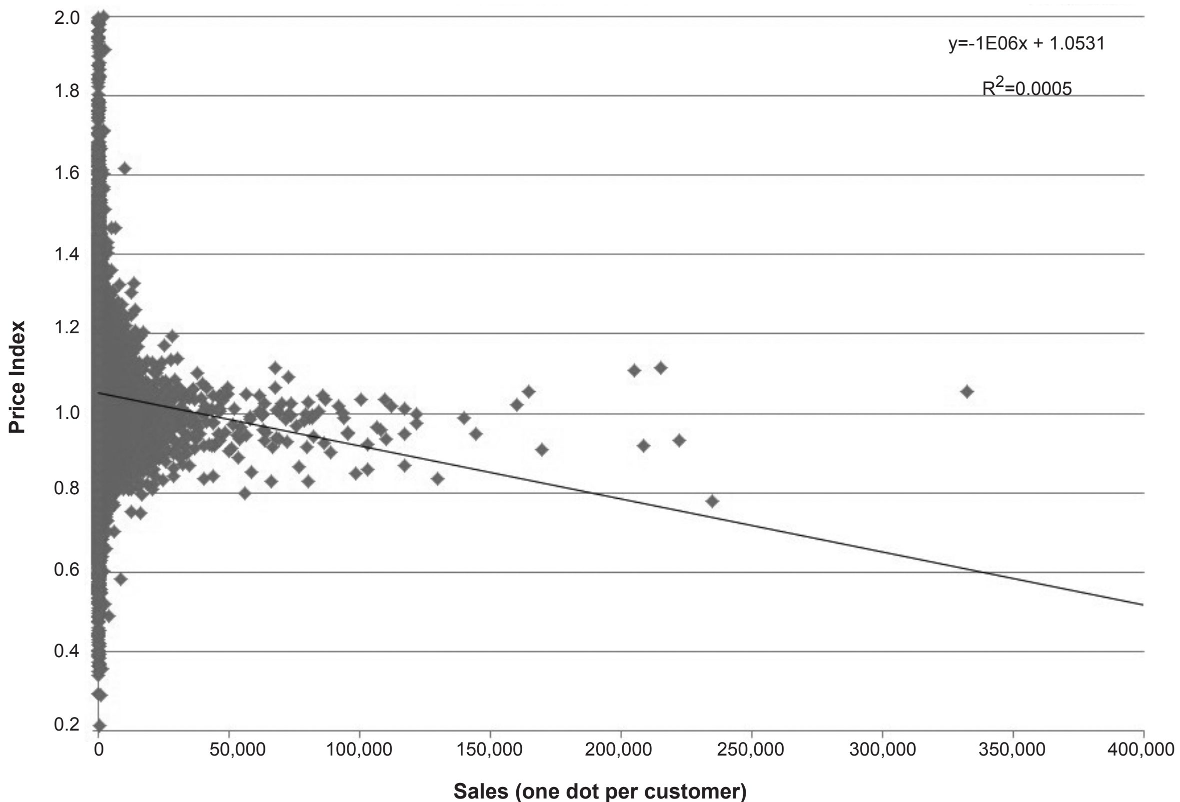
A Path Forward

The key to happiness with small customers is complex yet simple. Refrain from exerting scarce organizational resources on small accounts that have little or no potential growth rates. Point them to methods of service (inside sales, e-commerce, etc.) and vendors that are appropriate to the size of the opportunity. Incent the sales team to reduce churn rates for mid-size accounts and to identify and deliver profitable small accounts.

Most importantly, make sure small accounts are priced at reasonable premiums to offset their higher costs to serve. Make sure the pricing pro-

Figure 1: Customer Size vs. Price Index (1.0=Market Average Price)

Pricing for small customers often fails to follow market prices for a number of reasons. The smaller the customer, the wider the pricing disparity.



cess and tools reliably produce this outcome.

Commit to making meaningful progress to boost the profitability of small accounts:

- Identify which customers are underpriced, by how much and on which products.
- Assign those customers to new, optimized pricing structures that mitigate or reverse the profit drag.
- Identify which customers must do business online or through other low-cost transaction methods or suppliers.
- Set terms and conditions (minimum order size, payment terms, price tiers, vendor limitations) that improve profit drivers.
- Identify predictive factors to avoid churn-prone small customers.
- Prioritize sales assignments to those small accounts with clear predictors of growth.
- Add important safeguards to commission structures to align incentives.

Distributors need to apply classic Six Sigma principles to define, measure, analyze, implement and control a small-customer strategy.

With a proper understanding of small-customer profit and vitality characteristics, realistic expectations about their costs and benefits, and a strategy for managing both, a company can improve its vitality and profitability. The key is understanding, strategy, processes and execution. Instead of always thinking about the 80/20 principle, make a point of systematically inverting this perspective to the 20/80 principle.

Make small customers a profitable source of growing vitality. Shareholders will appreciate it.

About the Authors

Jonathan Bein, Ph.D., is managing partner at Real Results Marketing Inc. He can be reached at jonathan@realresultsmarketing.com or www.realresultsmarketing.com.

David Bauders is the president of Strategic Pricing Associates Inc. Learn more about SPA at strategicpricing.com.

Randy MacLean is president of WayPoint Analytics, a profitability service provider for distribution companies. He can be reached at rmaclean@waypointanalytics.com, or visit www.randymaclean.com.

Thank you for your purchase. Interested in more special reports?

MDM Premium subscriptions include full access to all MDM Special Reports at no additional cost.

Learn more about subscribing to MDM Premium at www.mdm.com/subscribe. Use SR10 to save 10%.

mdm.com