When less is more

The urgent need to prioritize customers and products

Applied Value Knowledge
Revenue Efficiency

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Introduction

In recent years, consistent economic prosperity has driven companies to focus on top-line growth. Abundant access to liquidity has motivated companies to introduce new products and customer segments with limited consideration for cost-drivers or complexity. While these additions may appear attractive in a highly competitive economy, the seismic economic shift caused by COVID-19 has revealed the latent danger in these approaches.

Companies facing supply chain disruptions and plummeting demand are left with no choice but to turn their attention away from top-line growth and shift to cash flow focus. While some will inevitably fare better than others, all companies looking to adapt will need a thorough understanding of profitability, complexity, and the relationship between the two.

This paper breaks down Applied Value's proven approach to **Optimize the Value Proposition**, a component of the **Commercial Excellence** strategy. **By understanding true profitability**, **strengthening core business**, **and optimizing product portfolios**, businesses can stop chasing complexity-riddled strategies and build real, sustainable value that can endure through economic shifts.

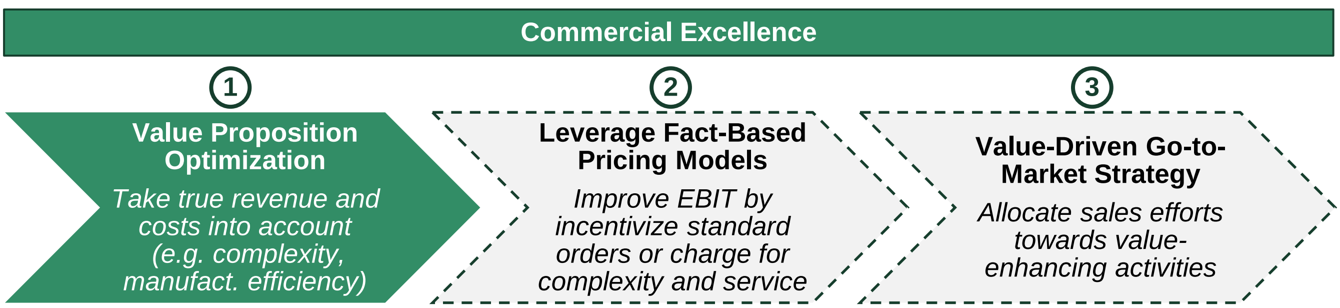


Figure 1: The three steps to achieve commercial excellence

Applied Value's three-pronged framework for improving profitability enables businesses to make data-driven decisions about their products and customer segments by focusing on genuine profit assessments and differentiated strategies for growth.

Figure 2: Key improvement areas to maximize customer and product profitability.

Understanding True Profitability

The Cost of Unnecessary Complexity

For many companies, making small configuration changes to introduce new products, services, and customer segments may seem like an effortless way to drive growth. However, introducing even small, incremental costs associated with new additions can create significant profitability pitfalls over time.

Unthoughtful additions often result in excessive complexity in the value chain. This complexity can obscure costs, drive supply chain delays, and decrease overall business profitability while making it harder for companies to adapt to changing market dynamics.

Both in trying to reach new customers and add new products, complexity traps exist throughout the value chain. Examples of common mistakes that add complexity include:

- *Opening regional sales offices without comparing incremental sales to the cost of servicing new segments*
- *Under-analyzing increased purchasing complexity or decreased overall equipment effectiveness (OEE) resulting from product introductions*
- *Adding segments that require increased sales and marketing or customer services*

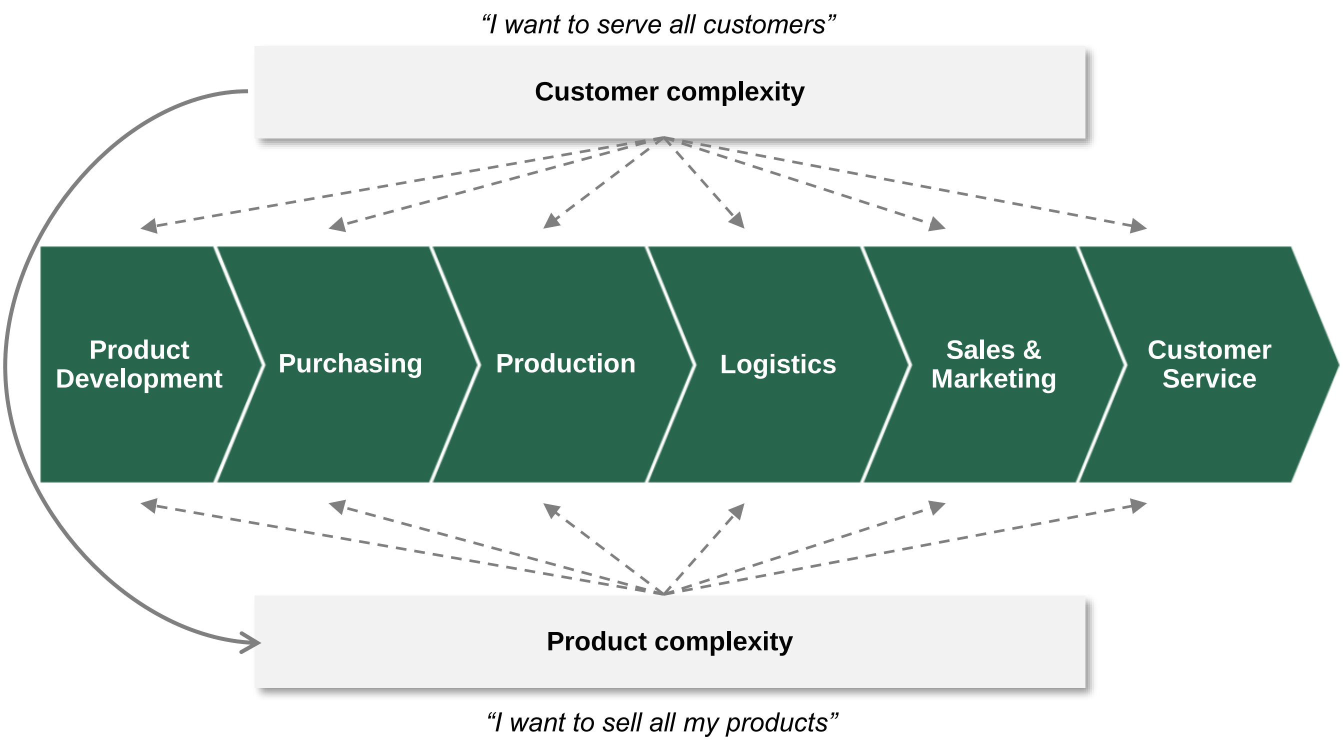


Figure 3: How customers and products drive complexity throughout the value chain.

It is important to acknowledge that **complexity related to product variety, customization, seasonality, geographical markets, and customer segments can also be central to value creation**. However, effectively differentiating between complexity that creates more customer value than increased costs and complexity that only helps the top-line is critical in establishing a meaningful, competitive advantage.

Modeling Profitability Effectively

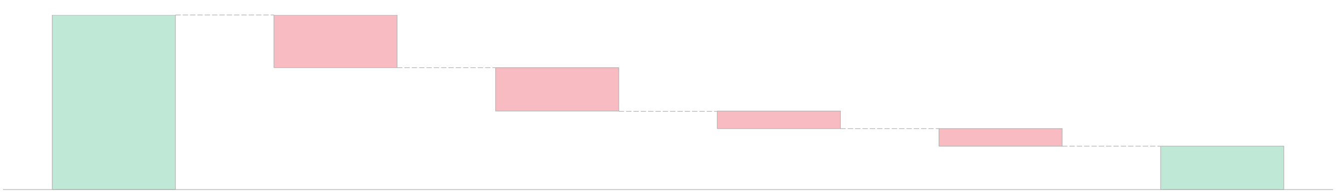
In order to understand True Profitability and avoid complexity traps, companies must account for **all costs associated with a product or customer on a granular level**. These assessments should be comprehensive and linked directly to the P&L, factoring in costs by order, product, customer, and market.

Many companies have surprisingly shallow understandings of their portfolio profitability, operating with insufficient or inaccurate product cost calculations. There is no singular driver for these incorrect calculations, but common causes include:

- Inputting costs based on legacy production processes
- Relying on budgeted as opposed to actual consumption inputs
- Omitting Overall Equipment Effectiveness (OEE) assessments
- Applying high-complexity models that are poorly aligned for different functions in disparate ways OR ignoring models entirely because of poor alignment
- Failing to account for fixed costs and cost drivers
- Neglecting profitability when addressing markets with strategic importance

To avoid these mistakes, companies must be diligent and comprehensive when building profitability models. While relevant inputs and factors will vary by industry, companies should account for **revenue, material costs, planning and product costs, logistics, selling, general and administrative expenses (SG&A), and profit by product, customer, and order.** By accounting for complexities and cost drivers throughout the value chain, businesses can create accurate models for predicting and measuring value.

Important Factors for Modeling True Profitability



Revenue	Material Costs	Planning & Prod.	Logistics	SG&A	Profit
Discounts & Bonuses	Purchasing and landing costs	Setup costs	Inventory and storage costs	Sales efforts	Profit by product
Claims	Storage and handling	Equipment downtime	Shipping costs	Cust. Service Support	Profit by customer
Payment terms	Scrap / Waste	Maint. and equip. costs	Internal log. / handling	Overhead time consumption	Profit by order

Figure 4: Important components to include in True profitability model.

Strengthening Core Business

Beyond cost modeling, understanding True Profitability also requires **differentiating customer segments**. Most companies can and must maintain some level of unprofitable orders and products in order to drive sales for highly profitable products. However, unprofitable customers present a unique challenge.

A **granular analysis of a company's customer base** can provide insight into which customer segments drive profit for the business. Often, small segments of customers (<20%) contribute to the majority of profit (>80%). Unfortunately, the inverse is also true: ~20% of the customer base is often wholly unprofitable. There are numerous reasons a customer segment might become unprofitable, but understanding and addressing these customers is important for building True Profitability. Examples of behaviors that create unprofitable customers include the following:

- *The customer buys low-margin or unprofitable products*
- *The customer gets additional service or customizations free of charge*
- *The customer is given company time disproportionate to their purchase size*
- *Low-potential customers are treated as strategic accounts with growth opportunity*

In times of economic uncertainty, managing this unprofitable tail of the customer base distribution is essential. In order to maximize earnings across customers, companies must first **categorize customers** in order to **differentiate service levels by customer category**.

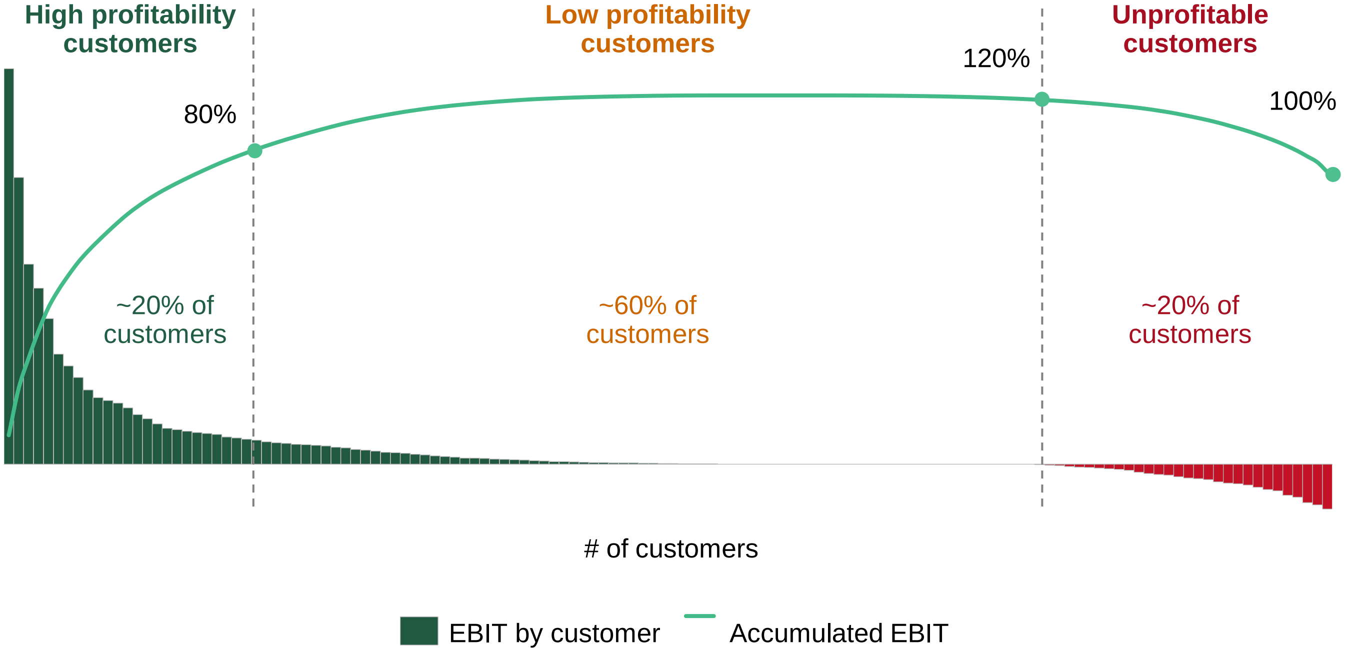


Figure 5: EBIT by customer for a leading company in the process industry.

1. Customer Categorization

Categorizing customers is a proven method for decreasing complexity and increasing productivity. By grouping customers into clear segments **based on profit contribution**, companies can create efficient strategies for prioritizing sales and delivery efforts.

Fig. 6 outlines a categorization strategy that places customers into three categories based on **% of earnings before interest, taxes, depreciation and amortization (EBITDA)**. Once sorted, these categories are prescribed a customer strategy based on a "what we can afford" mentality.

Customer Categorization — *Categorization based on profit*

	A	B	C
Customer Profile	***Large and profitable, high share of pocket***	***Large & medium size, medium profitability***	***Small size with low profitability or unprofitable large & medium customers***
% of customers	< 5%	~15%	~80%
% of EBITDA	*60%*	*35%*	*5%*
Customer strategy	Grow	Fix	Exit

Figure 6: Customer categorization strategy

2. Service Level Differentiation

Once customers are effectively categorized, organizations should tailor service models to account for profitability. Understanding the value drivers for each segment – what features they're willing to pay for – is important for extracting extra profit from segments across the customer base.

Basing service differentiation on customer perspectives is one way to create additional earnings. While some customers might value tailored solutions and services, that interest must be assessed alongside an assessment of their willingness to incur the additional costs personalization drives. In differentiating service levels, companies must ensure service improvements account for and align with customers' willingness to pay for them. Improvements in **R&D, customer service, sales attention, flexibility, and additional value drivers** may all create opportunities for bringing customers additional value. Making these improvements based on a thorough understanding of **what customers will pay for** enables companies to take actions because they will help a company's bottom line – not just because they're possible.

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Especially in periods of economic uncertainty, it is important to prioritize customer segments with intention. Depressed demand, reduced service capabilities, and changed operating models can require service level adjustments. In these settings, **companies must understand what each customer category values and the tradeoffs between value drivers**.

When switching focus from growth to cash flow, knowing which factors can be adjusted in the short term with relatively low effort and minimal impact on customer value is essential to maintaining profitability.

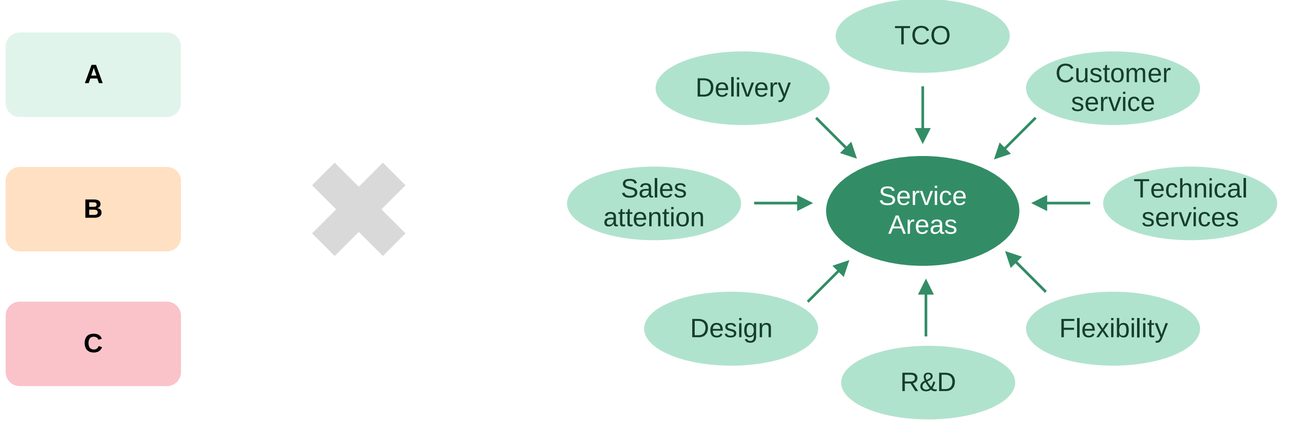

Figure 7: Examples of value drives that could be differentiated between customer categories.

Optimizing the Portfolio

Although customer preference and behavior lies at the heart of True Profitability, it is also important to assess companies' product portfolios.

Quick fixes and product cuts are tempting solutions to unprofitable portfolios. However, companies must ask additional questions before determining which products to keep or improve. When dealing with unprofitable products, businesses should consider the following:

- Are they offered to key customers as a courtesy?
- Do they complement a profitable product?
- Are they priced correctly?
- Are they over-engineered or allocated too many internal resources?
- Can we remove any fixed costs associated with the unprofitable product?

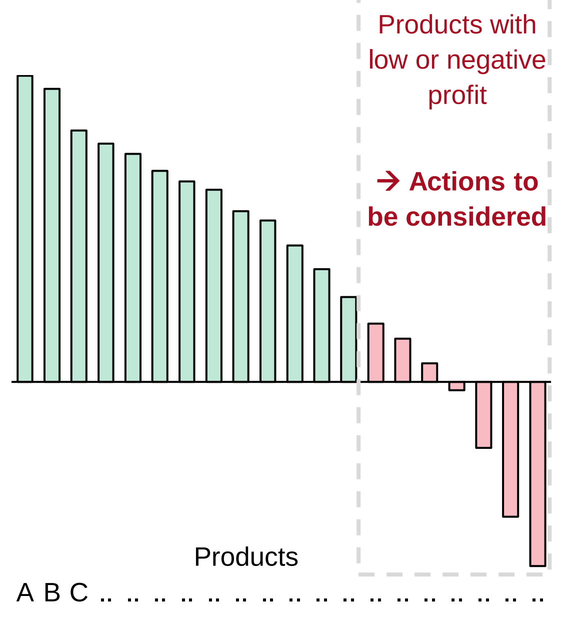

Figure 8: EBIT by product for a leading company in the process industry.

Answering these questions can help companies to choose effective strategies for dealing with unprofitable products including **Fact-Based Pricing, Minimizing Costs,** and **Rationalizing Portfolios**.

1. Develop Fact-Based Pricing

Fact-Based Pricing is an effective solution for restoring profitability to a complex customer or product portfolio**.** Standard offerings are priced based on a flexible pricing, incorporating service level and complexity concerns into the strategy. When utilized effectively, Fact-Based Pricing maximizes profit through several channels:

- **Efficiency Improvements:** Reduced complexity, increased OEE, streamlined processes
- **OR Up-charged Inefficiencies:** Customers pay for unavoidable inefficiencies included in the pricing

For more information about **Pricing Excellence**, see our Value Paper **"**How to Maintain a Healthy Pricing Strategy."

Figure 9: Product portfolio improvements.

2. Offer Products as-a-service

When customers' purchasing power and cash flow are limited, offering products *as-a-service* can be a useful strategy for removing investment hurdles. Some benefits include:

- Enables new customers by lowering initial cost for customers
- More flexible pricing models by adjusting services levels / features
- More predictable cash-flow by establishing recurring fees
- Deeper customer relation by creating a closer contact through support and maintenance

3. Minimize Costs

In situations where customers will not pay more for unprofitable products, cost minimization becomes a necessary way to rebuild profitability. Some options for cost minimization include:

- Increased batch sizes and lead times to increase OEE
- Reduced customization options for streamlined and simplified processes
- Remove features to lower the cost of over-engineered products

4. Rationalize Your Portfolio

When all options have been exhausted, eliminating unprofitable products that don't drive value can sometimes be the best solution. When making choices about what to keep and cut, companies should be mindful to focus on profitability models, not internal politics.

Implementing True Profitability

In order to reap the benefits of a True Profitability strategy, companies must go beyond comprehension and match intention with effective implementation. Reducing costs and altering sentiments can be challenging and contentious. From starting small to remaining goal-oriented, companies should consider the following factors for implementation success.

Important Factors for Implementation

› **Start with a pilot project:** Begin creating True Profitability with a single business unit. A successful pilot to establish proof-of-concept builds trust and ease for a company-wide roll-out. Starting narrow prevents internal resistance and delays in implementation..

› **Secure organizational buy-in:** Key stakeholder buy-in is crucial to building profitability. Ensuring that parties agree on project objectives and assumptions makes results more sustainable.

› **Stick to critical components:** Companies must remember to not miss the forest for the trees. Focus on the 20% of actions yielding 80% of the results instead of aiming for 100% accuracy. Avoid unnecessary sub-optimization by identifying and prioritizing holistic solutions and keeping True Profitability projects short. It is important to build company-wide solutions without getting sucked into unnecessary details.

› **Kill your darlings:** In order to ensure earnest profitability, companies must be willing to “kill their darlings.” Remain open to change and the potential necessity of removing legacy products. Removing products or renegotiating pricing with long-term customers requires a tolerance for change.

› **Make exceptions purposefully:** Every rule has exceptions, and sometimes there’s good reason to hang onto unprofitable customers or products. Whether it’s a product that drives sales for a profitable one or a potential customer with strategic long-term value, unprofitable choices should be made with intention and explicit business reasoning.

› **Prioritize quick wins:** While all decisions should prioritize bottom-line impact, time-to-money, and support for core business, quick wins can build credibility and demonstrate project purpose. Getting quick wins fosters buy-in and helps build cascading success.

› **Set goals for implementation:** All projects need goals and targets. Whether it’s a new profitability target or threshold for complexity trade-offs, set and stick to specific goals for achieving profitability gains.

› **Communication and transparency:** Deep-diving on unprofitable products and practices can lead to major shifts in companies’ directions and priorities. In order to maintain support and company alignment, communicate goals and processes clearly at every step.

Conclusion

No matter the state of the general economy, achieving True Profitability allows companies to build sustainable profits and channel resources towards their bottom line. From understanding profit and complexity tradeoffs to developing effective implementation processes, approaching busines decisions with True Profitability in mind builds lasting and resilient growth.

During business uncertainty, these strategies are more essential than ever. Applied Value can help companies respond to economic shifts by outlining and driving Commercial Excellence initiatives to improve the performance and profitability of the customer and product portfolio.

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