# Disposing of your unprofitable customers

BY JOSEPH SULLIVAN

Would it surprise you to learn that electrical distributors all over the country are investing time and money into serving markets that do not now—and never will—make decent money for them? Would it surprise you even more to learn that you might be in danger of being one of those distributors? Just as surely as the old-fashioned general store passed into memory, general distributors will find it harder and harder to make a go of it. Yet there are plenty of opportunities to make money in this industry. It takes focus. However profitable you may be today, one of the best business investments you can make is the time and effort to identify the markets you can serve most profitably, and clarify your approach, or value proposition, to those markets.

As we discussed in an article in the market planning issue of *TED* (July 2001), stripped to the basics, there are only three fundamental value propositions:

- Convenience;
- Lowest delivered cost;
- High service/knowledge.

**The convenience value proposition** in electrical distribution offers customers rapid and easy access to the items they

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use the most, just as 7-11 does for customers who need milk, coffee or toothpaste. Inventories are not deep and location is important. The convenience model may involve job-site trailers or mobile sales units, and possibly kitting.

**Lowest delivered cost** is a value proposition that requires buying power and considerable logistical skill. It is the most difficult of the value propositions, especially for smaller distributors who lack economies of scale. Lowest delivered cost includes features that reduce the customer's cost of purchasing or receiving including the as-yet-to-be-realized promise of both EDI and the Internet. Efficient warehousing, very low error rate shipping, and reduced paper ordering and receiving can play a big role in lowest delivered cost.

**The high service/knowledge** value proposition, on the other hand, relies on value-added services to attract customers and develop bonds between them and the distributor. The key to success in the high service/knowledge value proposition is to provide expertise not easily developed, on which customers will depend, and which is not sold primarily on price.

### Show me the money

So fine—but how do you decide which is the most profitable for you, not just now, but for the foreseeable future? Begin by clearing your mind of pre-set notions of what it means to be a full-line distributor. The objective is to take a cool-eyed, analytical look at your present and potential customer base, and see where the money is.

If you already have the ability to determine profitability by customer, you are way ahead of the game, if the approach is valid. Every brand of business system is different. Some, with the best of intentions, offer customer profitability computations based on algorithms that really do not do the job. They can be quite misleading. Be sure that you know, in detail, exactly what computations are being done to generate the report.

If you do not have the built-in capability, try creating a custom report. Begin with gross profit, and add in such specific variable costs as you can identify. At worst, you may be able to download various bits of the data you need and create your reports using a spreadsheet and a database program, such as Microsoft Excel and Microsoft Access. In either case, beware of averaging of costs, and be especially worried about allocation of fixed overhead. ***Tip:*** Contribution analysis based on variable costs and reasonable assignment of certain fixed personnel costs (like inside sales), is almost always more meaningful than profitability analysis based on full allocation.

**If sales go down and profits go up you are simply seeing incontrovertible evidence that some of your customers were not good for you.**

Once you have developed or verified a profitability/contribution report, try running what we call a Pareto ranking—that is, most to least—of your accounts by profitability. If you already have accounts identified in the computer by type, such as industrial, commercial MRO, residential contractor and the like, so much the better. If not, look into creating such categories. Run your Pareto ranking within each category, and ask the computer to also give you a summary profitability figure for each.

### Watch for patterns

When you eyeball the finished report, look for patterns among all categories, and within each of them. Those most profitable categories/customers at the top of the report—why are they there? What makes them more profitable for you than the others? How about the ones at the bottom? What is different about them? Look also at the spread—how much more profitable are the most than the least? If the spread is big, it might simplify decision-making. On the other hand, if all your customers are within a couple of points of one another, the patterns are harder to see. You also—but to a much lesser extent—care about volume. If you are getting 30% margins in hospitality lighting, but only have one small customer, what does that tell you?

### Take notes

Make notes of your observations, and develop an overall idea of the who's and why's of customer profitability. For example, you might decide something like this: "We tend to have good sales volume, and make good money with medium-sized residential and commercial maintenance contractors, and in our commercial and hospitality lighting business. We get good sales volume in the commercial construction business, but the profits are low. Our industrial MRO business is nicely profitable, but the volume is low. Our big commercial and small residential contractor businesses do not make much money at all."

Show the reports and your findings to other people in your organization. Ask them for their observations. Ask if you are missing anything. You might learn that some apparently profitable customers use a lot of unallocated management and purchasing department time, are slow paying, or are always asking for return authorizations. You might learn that customers with certain profiles are much higher credit risks than others, or that you have two or three extra people in the credit department just to handle all the job filings and related issues. All of these kinds of information must be taken into account. Try to fit the resulting concept into the framework of the three fundamental value propositions.

### Good business profile

With everything in the mix, your "good business" profile might change a bit. Continuing the example above, you might now find that: "We tend to have good sales volume, and make good money with medium-sized residential and commercial maintenance contractors, and in our commercial and hospitality lighting business, because we know and stock the items most frequently used by our customers, and have locations that are close to their operations. We sell to them on a day-to-day basis, and will special order parts as needed. This particular customer profile tends to have and keep good credit ratings and be reasonable in its demands for service. Our small number of industrial MRO customers fit a similar pattern, in that they buy their day-to-day needs from our nearby counter. We do not get their project business, however, because we lack the technical support staff, expertise and lines. We get good sales volume in the commercial construction business, but the margins are low, because of the intense competitively bid nature of the business. Furthermore, we do not process volumes of big-job correspondence very well. This leads to expensive errors and issues. Despite decent margins, our small residential contractor business does not make much money at all, due to the cost of handling. It also involves higher credit risk."

A profile like this one fits pretty squarely into the convenience value proposition. Customers come in because you are reliably providing most of the stuff they need at convenient locations. You do not have high-tech lines or experts, and you do not handle the low-margin/high-volume commodity business especially well.

Now it is time to work up a business plan that plays to your strengths. Convenience has a value, and your target market is credit-worthy contractors and MRO buyers who are willing to pay a reasonable price for it. Some actions you might consider if you had a profile like the one in the example are:

- **Using DUNS data or some other source, develop a marketing database** of prospects in your coverage area who fit the profile of your better customers, and focus sales efforts on those prospects;
- **Re-profile your inventory** to more specifically meet the needs of profitable customers, and don't worry about keeping stock for those who do not make you money;
- **Through customer feedback,** explore the use of mobile sales vehicles, jobsite trailers, kitting, and other low-rent ways to make it easy for them to buy from you—at good margins;
- **Raise your floor gross margin** percentage on bid business;
- **Using an artfully managed pricing** matrix, raise the prices for risky or high-handling-cost customers;
- **Tighten up your credit standards;**
- **Pull out of the big-project business.**

**Now it is time to work up a business plan that plays to your strengths.**

With a different profile, you would build a different business plan. For example, if you made good money in the commercial/hospitality lighting business, but always got beaten up by contractors, you might develop deep expertise in lamps and fixtures, and specialize in that while cutting back severely on your contractor business. If you were an Allen-Bradley house with other complementary lines and a staff of specialists, you might do best to focus on the industrial markets and sell training and expertise as well as parts. One distributor on the East Coast has a remarkably profitable niche in parts for municipal overhead trolley cars. It is not his whole business, by far, but it is a good example of niche identification.

You only stand to gain by market analysis and focus. What you will gain is profit, the ultimate business scorecard. You might actually (but certainly not necessarily) lose sales, but who cares. If sales go down and profits go up you are simply seeing incontrovertible evidence that some of your customers were not good for you. They needed to go. Cry all the way to the bank.

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*Joe Sullivan is president of Joseph Sullivan LLC & Associates, which helps electrical distributors build top performance, plan for the future, and buy and sell companies and branches. He can be reached at 972-463-1125 or at josephsullivan1@earthlink.net.*