Managing the Customer Portfolio to Improve Service and Financial Performance

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The State of Business Practice:
Few companies consider "whether all of their individually desirable customers are, from the standpoint of risk, desirable collectively."
(Dhar and Glazer, 2003, p. 88)

Cash Flow Patterns of Market Segments
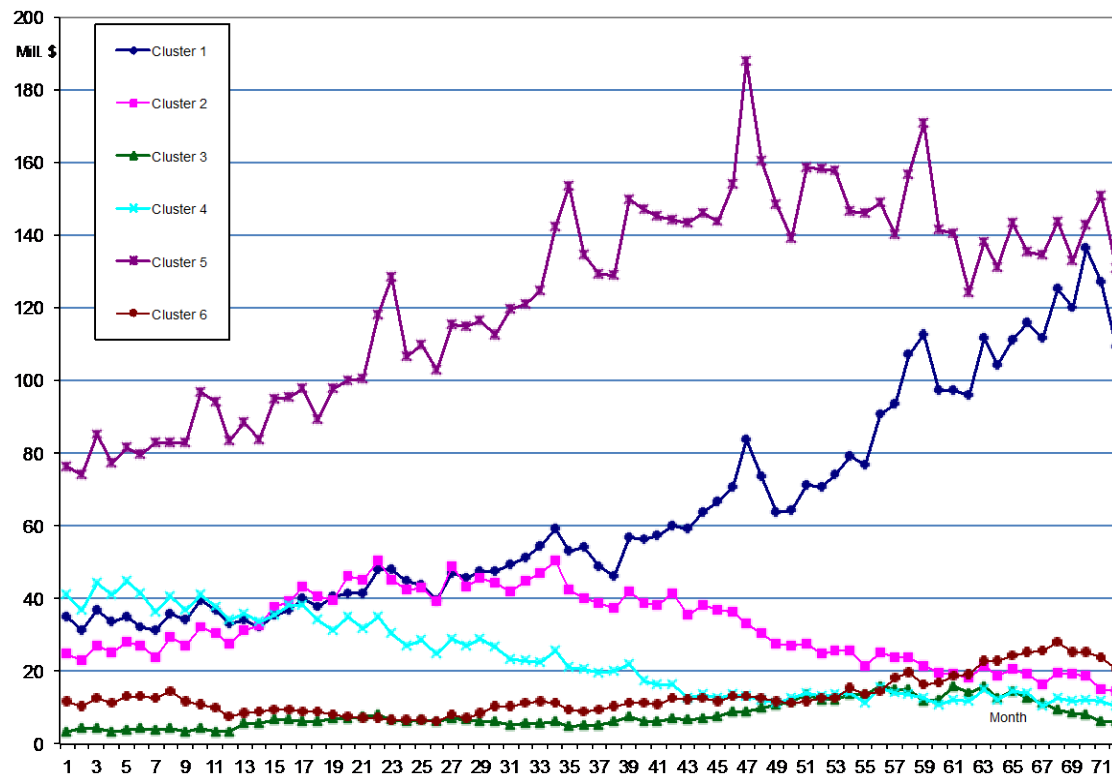
VS.

A Wall Street analyst aptly observes: "Revenue is not the goal at IBM. Its model is about pursuing higher-margin recurring revenue and reducing volatility" (Lohr, 2010).

Research Purpose:

To demonstrate how the fundamental tools of analysis that professional investors use in managing the risk and variability of a stock portfolio can be effectively applied to manage a firm's customer portfolio.

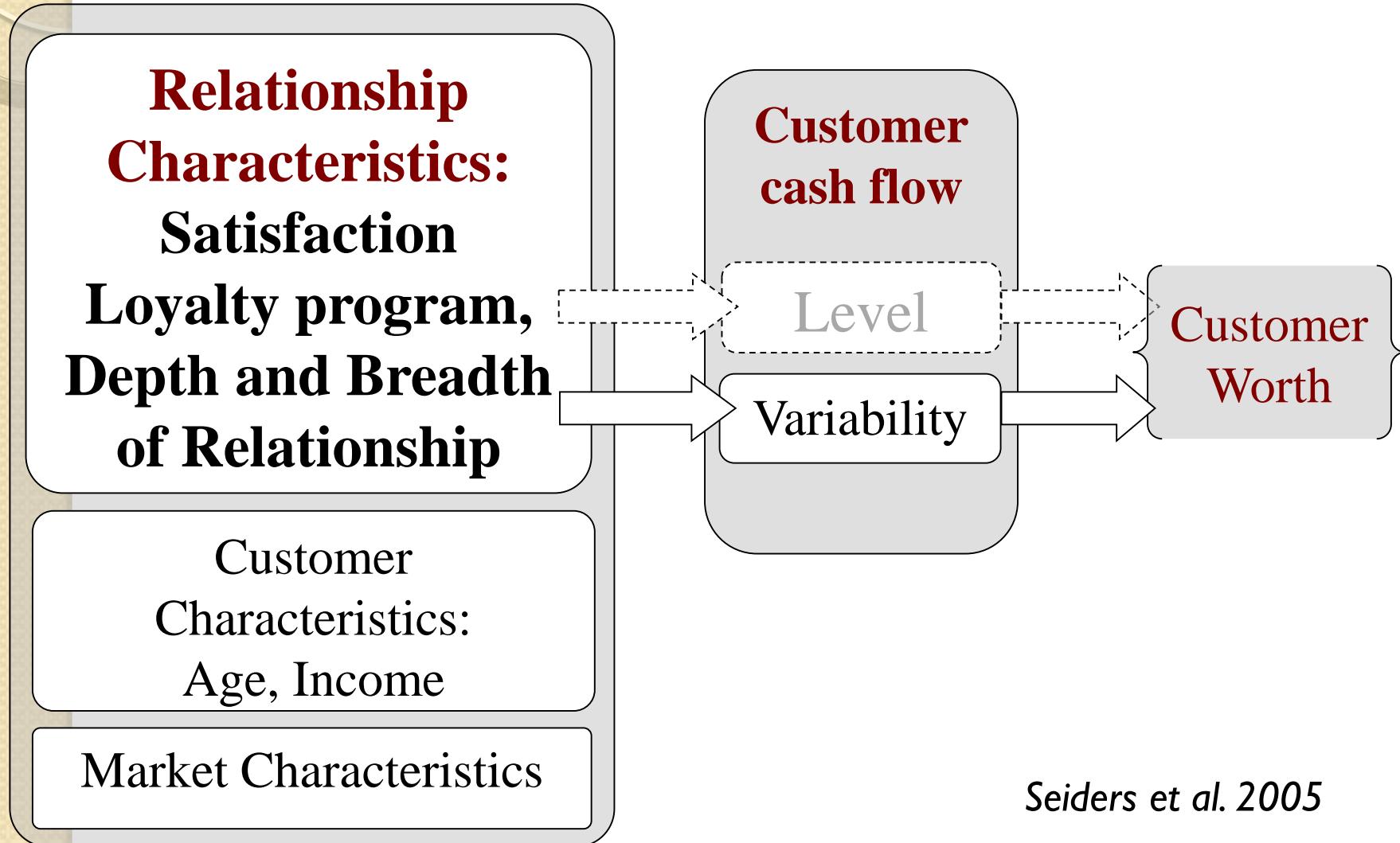# Two Ways to Manage Risk

1. Manage the drivers of variability
   - What are some ways to lower individual customers' cash flows variability without adversely affecting revenues and profits?
2. Combine customers to create a customer mix that reduces overall variability
   - What are some ways to combine customers so that (in aggregate) their cash flow patterns offset each other?

Three Field Studies – Three Industries – Three Countries

- B2C Telecommunications service provider in Sweden
- B2C Financial service provider in Netherlands
- B2B Logistics service provider in USA

- Highly competitive markets
- Rich data: revenues and/or profits over time for individual customers, plus survey data

# Approach 1: Manage individual customer cash flow patterns

Relationship Characteristics:
Satisfaction Loyalty program, Depth and Breadth of Relationship

Customer Characteristics: Age, Income

Market Characteristics

Customer cash flow

Level

Variability

Customer Worth

Seiders et al. 2005

Key Findings:
Telecom & Financial Services

- Satisfaction improvement programs have a "Double whammy"
  - They increase revenue and profit levels AND decrease in variability in cash flows
- Loyalty programs create a "Sour taste"
  - They increase variability in cash flows without increasing revenue and profit levels
- Programs that increase the number of products held (breadth or depth) are "Sweet and sour"
  - They increase BOTH the level and variability of customer cash flows
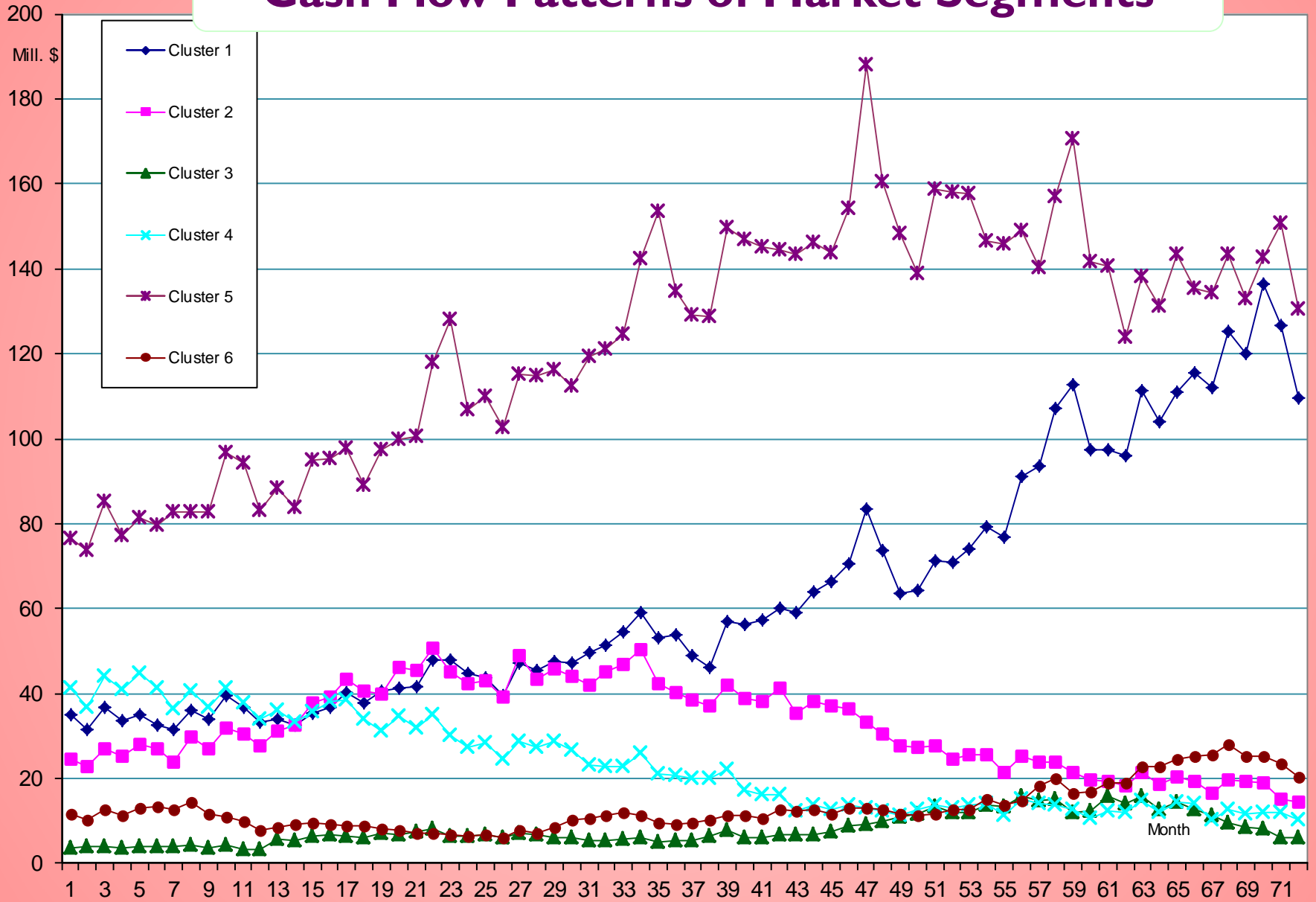
Key Results
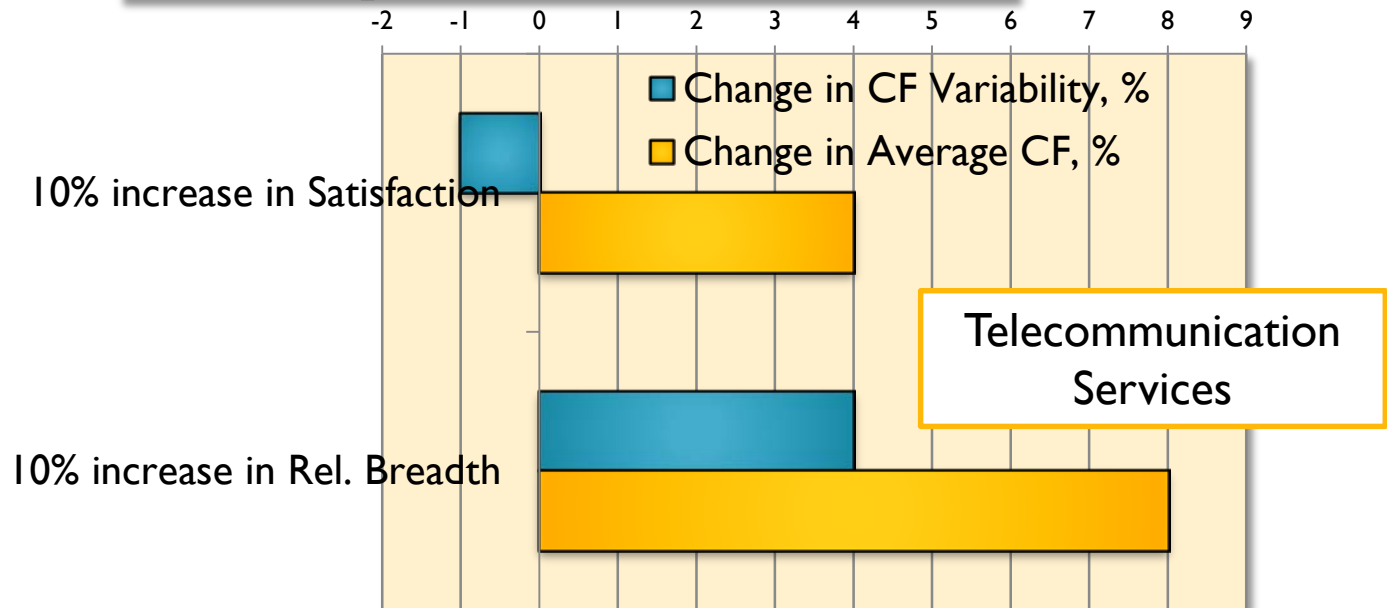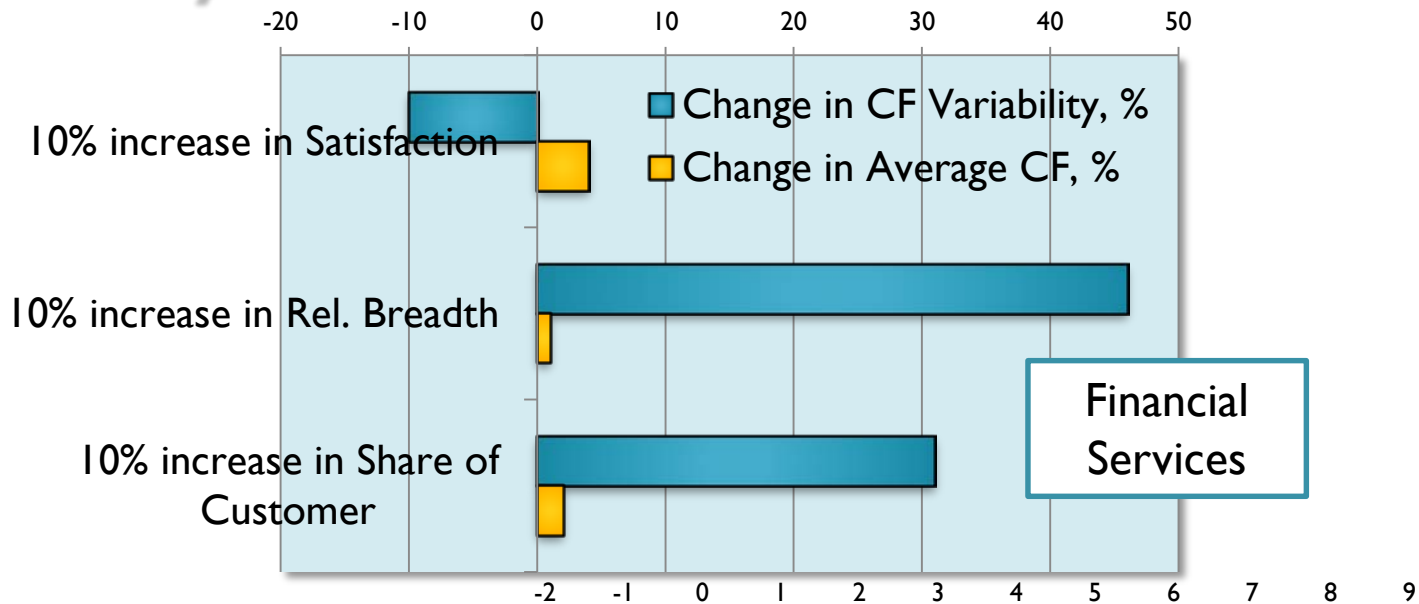
Approach 2: Managing the Customer Portfolio

Study Context

- B2B firm with diverse customer base
- Monthly sales and profit data provided for all customers over a seven-year period
- Examined the 516 unique customers that accounted for 98% of sales

Cash Flow Patterns of Market Segments
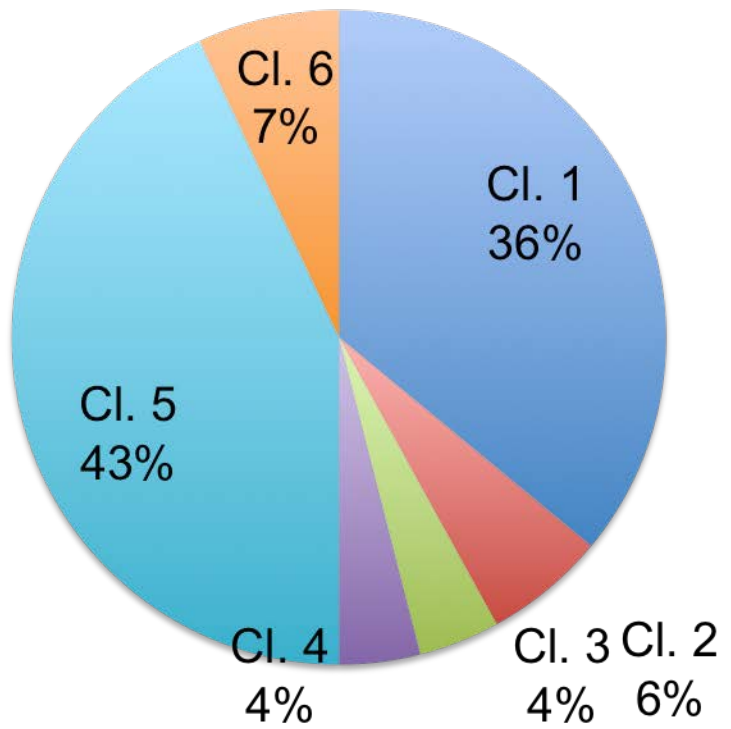
New Customer Metrics

- <u>Customer beta</u>: the degree to which an individual customer contributes to the risk of the entire portfolio

- <u>Customer reward ratio</u>: the rate of return on risk of a customer (i.e., the reward for assuming variability)

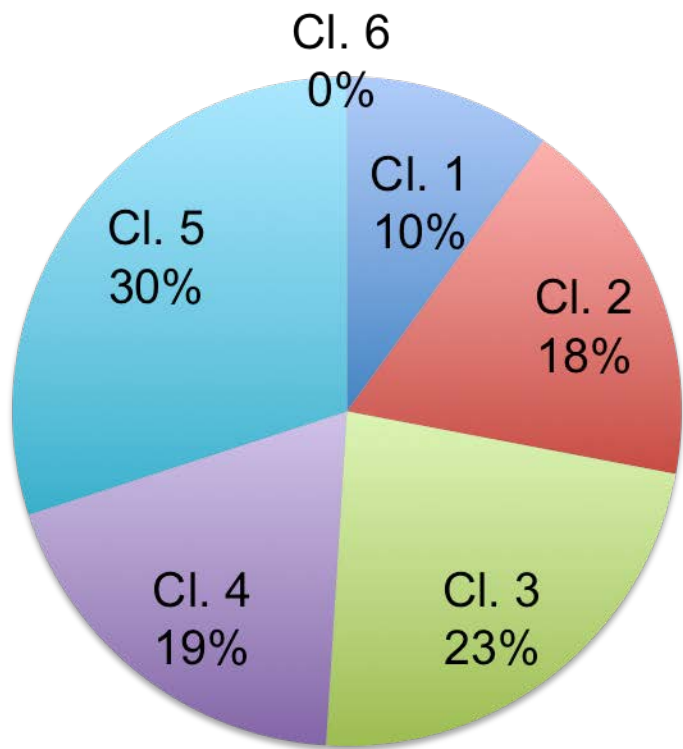# Example of Variability Metrics for Different Business Customer Segments
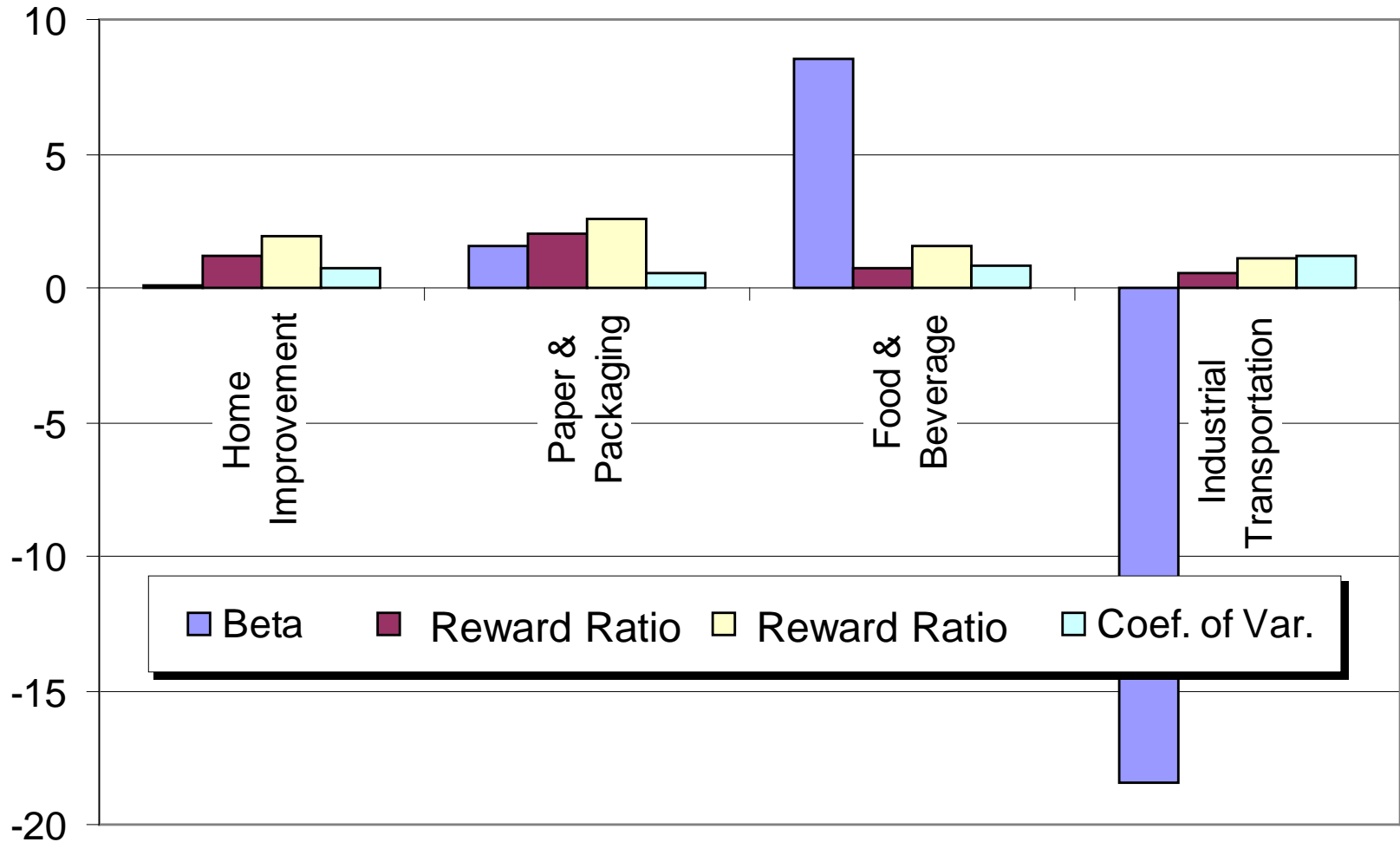
The Current Portfolio Compared to the Efficient Portfolio with Identical Return
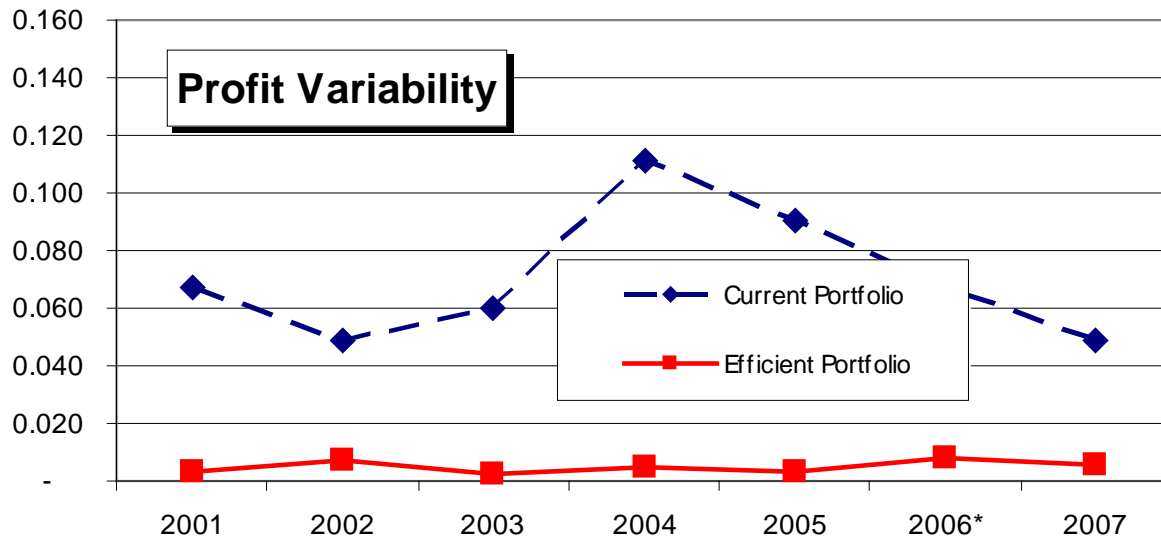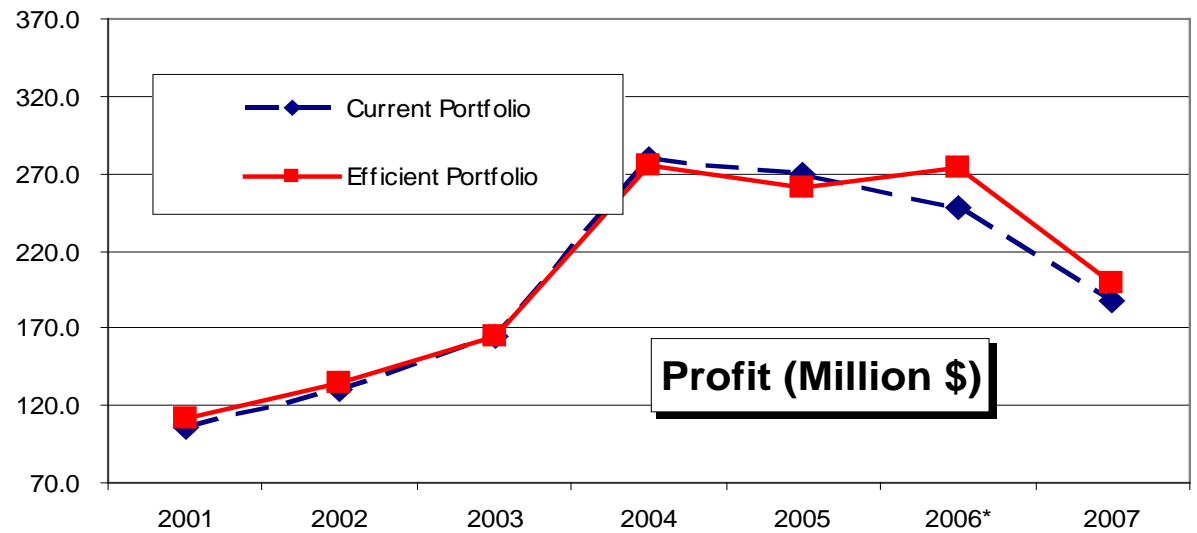

Current Portfolio

Cl. 6 7%
Cl. 1 36%
Cl. 5 43%
Cl. 4 4%
Cl. 3 4%
Cl. 2 6%

Efficient Portfolio

Cl. 6 0%
Cl. 1 10%
Cl. 2 18%
Cl. 5 30%
Cl. 4 19%
Cl. 3 23%

Forward & Back Testing

Current vs. Efficient Portfolio

Profit (Million $)

Profit Variability

Key Insights for Practice

1. The customer beta and customer reward ratio provide a fresh approach for identifying desirable customers and revising the customer portfolio.

2. Firms can layer this information over their existing market segmentation descriptors.

3. The data and methods used for this research are available to most companies:

    - purchase transactions (revenues or profitability) of customers over time
    - firmographics