PROFIT BY DESIGN

How to build a customer portfolio full of profitable promoters

Includes 17 Bonus Templates

MARK HOCKNELL

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ENDORSEMENTS

"In *Profit by Design*, Mark Hocknell makes a compelling case for putting the customer at the forefront of your strategies, and lays out a practical method for understanding, nurturing, and enhancing the two-way exchange of value with your customers."

Evan Douglas, Professor of Entrepreneurship, Griffith University

"Mark provides a powerful framework to truly understand your customers, allowing you to design an experience which delivers immense value to them while returning a well-deserved profit to your business."

Adam Franklin, CEO Bluewire Media, Best-selling author of *Web Marketing That Works*

"Mark is great leader in customer centricity designing win-win scenarios where customers have wonderful experiences and business owners grow profitable businesses"

Jon Hollenberg, Founder 5x5Marketing, and author of *Love at First Site*

"This book made me fall in love with customers all over again! Mark helps us see the focus of business where it should be all along: the customer. Designing business from there ensures not only enduring profit, but enduring value for both the business owner and the people they serve. It's the people stuff that makes the business stuff work best!"

Zoë Routh, Leadership and People Stuff Expert, author of *Composure*, *Moments*, and *Loyalty*

"*Profit by Design* will prove to be a great addition to your sales and marketing toolkit. Mark shares his lessons learned over the past 20 years, explaining why you need a customer strategy in your business as well as how to design, implement and measure it for success. B2B, B2C or even non-profit organisations will all benefit from Mark's wisdom."

Mark Brand, Director Turing Point Partners;
Director APAC RavenHouse Asia Pacific

"*Profit by Design* outlines Mark's wealth of experience in helping businesses achieve their customer-centric agenda, taking you on that journey using his practical and pragmatic approach to growing customer value that lasts. It's worth the read!"

Michael Berndt, Chief Customer Experience Officer, eHealth Queensland

"Many organisations have expressed their intent to be customer centric, but have struggled to bring this to life within traditional organisational approaches. Other than the few exceptions, consumers generally remain underwhelmed with the value they are provided and as a result are disloyal to brands. In response to this mismatch of intent and impact, Profit by Design maps a pragmatic, step by step approach to providing value to customers that in turn drives profit for the organisation. Easier said than done in today's complex operating environments."

Steve Waters, Executive General Manager - Sales & Marketing,
Endeavour Foundation

“Mark is one of the original ‘customer-focussed’ professionals who has worked across many brands, organisations and teams to orient their focus, work and delivery around value creation for customers which in turn ALWAYS delivers value for organisations! Mark has shared some great ideas and approaches in this new book to update and adapt the tried and tested principles of customer value and centricity into a new era for business performance.”

Tracey McFarland, Chief Experience Officer, Goodstart Early Learning

“If customers are not at the centre of how we design our business – the products and services, the structures and processes, and the culture - then sooner or later we’ll find it on a downward spiral. But Mark’s approach for how to put customers at the centre of our businesses creates a virtuous cycle fed by the goodness of our relationships with our customers. First, we make things better for our customers. Then, they make things better for our business through their loyalty and advocacy. And then we can continue to make more things better for more customers. Profit by Design should be the canvas on which any new or evolving business strategy is designed.”

Stacey Barr, Performance Measure & KPI Specialist, Author of “Prove It!”, and “Practical Performance Measurement”

ACKNOWLEDGEMENTS AND THANKS

The journey that has produced Profit by Design is the one that has accompanied me during my professional career. For that reason, there are so many people that have contributed, challenged and listened to these ideas. From the hundreds of students at the Brisbane Graduate School of Business (QUT) to scores of people in dozens of organisations that engaged me to help them find their own way to greater value in their customer portfolios. Not to mention the authors of so many books over the years that that have helped assemble these pieces together. Below is a (possibly incomplete) list of people that have accompanied me on this Profit by Design journey. Thank you.

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Mark Lourigan
Rob Mansfield
Sonya Edbrooke
Stacey Barr
Steve Baxter
Steve Goldsworthy
Steve Travis
Steve Waters
Teifi Whatley
Wendy Boyd
Wendy Joy

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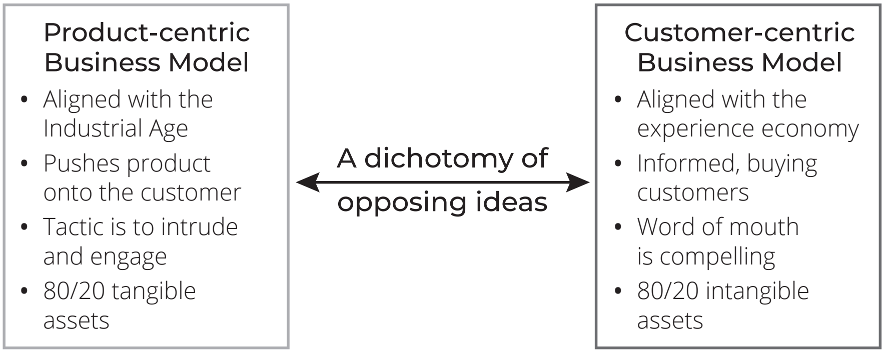
INTRODUCTION

Welcome to *Profit by Design*. This book is the result of 20 years of working with organisations of all types and sizes, combined with many years of research and postgraduate teaching. I've watched so many businesses struggle to engage their target markets, and identified one common factor that always seems to be missing – meaningful exchange of value with the right customers. It was from this realisation that *Profit by Design* began to take shape and develop. The program in this book will take you all the way from selling products and services to engaging with the customers that are most likely to become profitable promoters of what you do. It will show you how to leverage two-way value exchange and build a portfolio of customers that will ensure you thrive. Want to succeed in this overstimulated marketing world? It's time to stop closing sales and start opening relationships with the right customers. It's time to stop chasing cash flow and start building sustainable profitability.

Let's have a quick look at what you'll find in each chapter. If you're already partway along your *Profit by Design* journey, you can skip ahead.

In Chapter 1 we will delve into the dichotomy between the old-world, product-centric approach and the customer-centric approach relevant for this age.

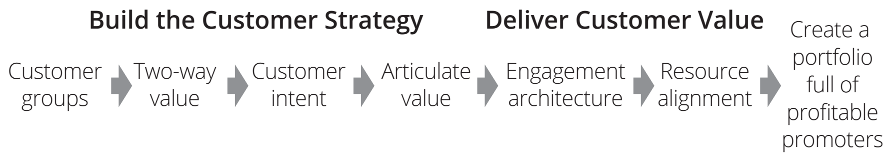


So many leaders today fail to see this dichotomy for what it is. They look to the past to see how today's large organisations successfully leveraged their products, then try to use the same strategies. When they do this, they ignore how times have changed. But more importantly, they ignore how customers have changed. Customers no longer want to be sold to. They want to buy, but they are influenced by the opinions of their social networks rather than by advertising.

Chapter 2 follows a case study that shows how the key principles of *Profit by Design* were uncovered. The case study follows a personal journey of discovery. Many people were quite shocked by the benefits of the *Profit by Design* approach, particularly since they directly challenged traditional approaches to growing value and profit. We will then see how these principles can be applied in a variety of business contexts.

Chapter 3 delves into the type of thinking that prevents so many leaders and managers from seeing what you will see. Your perception of your current constraints will become acute. Only by understanding those constraints will you be able to overcome them as you design and implement a new business model and novel strategies that will create long-term value.

From there we will go into detail on the process of using and applying the *Profit by Design* approach in your organisation. The subsequent chapters will traverse the following route, which will lead you to unlock the value in your customer portfolio – to foster a portfolio full of profitable promoters.



In Chapters 4 to 6, we will learn in detail how to build a Customer Strategy.

Our ultimate aim is to create a profitable portfolio of customers, so we will start there. Not all customers are equal, so we will need to examine the various customer groups. This goes beyond segmentation to really understanding how our customers behave and interact with our products and services. This will deepen our understanding of the two-way value exchange: what value the customer group gets from you, and what value you get from them. Primarily, the value businesses seek from customers is financial and advocacy, which are both measurable.

Once we know the customer groups and understand the two-way value exchange, we can then determine our intent for each group. Do we want this customer group to grow? Do we want to change how this customer group interacts with us to bring the two-way value exchange back into balance? This analysis and decision making will form our Customer Strategy – how we plan to build a profitable portfolio.

In Chapters 7 to 9, we will hone in on ways to identify and deliver customer value.

Once we know the customer portfolio we want to build and the value those customers seek, we then have to design a strategy for delivering that value. This starts with considering how we communicate value to specific groups of customers. We will see that, for customers, value propositions exist at various levels. Therefore, we will design a customer communication strategy that aims to clearly articulate value at all the various levels required.

When it comes to how we engage with the various customer groups, we will need to look at service design and an Architecture for Customer Engagement. These design elements will be the foundation of the

Customer Strategy, the basis for realising the intent of creating a portfolio of profitable promoters. Of course, this will be an iterative process. We must be sure to use action learning cycles to continually finetune the customer portfolio.

Finally, Chapter 10 will wrap the program up with some helpful approaches to implementation and change. We will use a maturity model to help you assess where you are now as a starting point for your own mission to get out of the dark, product-centric age and into the light of a business model that delivers value both for customers and for your organisation.

Next, you'll find a super-handy appendix that walks you through real-world case studies of the implementation of *Profit by Design*. In an effort to help you see more clearly how the *Profit by Design* approach can be applied to any customer context, the appendix contains three cases: a B2B case, a B2C case, and a non-profit, government agency case. As an added bonus, at the end of the book you'll find a collection of all the templates you'll need to build your own Customer Strategy.

Thanks again for joining me on this expedition of discovery. We will begin on territory that pioneers have forged, but you will soon discover this is an iterative journey where you create your own territory and map. All you need is an adventurous spirit and a positive attitude to learning and improvement.

Let's start!

CHAPTER ONE
CUSTOMER PORTFOLIOS

The central theme of *Profit By Design* is that the overwhelming value for any organisation comes from the configuration of its customer portfolio. Your customer portfolio is your unique collective of customers. How these various customers behave drives the value and cost elements that produce your financial outcomes. Some customers will get more value from you than you can recover from them. Other customers will get the value you deliver and return value. Your customer portfolio is the total sum of those customers – the pluses and the minuses.

In this book, we will discuss how to unlock the value within your customer portfolio. That means creating or building a customer portfolio full of customers that are profitable and promote what you do. Once you learn to see businesses and organisations in this way, the strategic choices involved in creating more value will become much clearer, and the outcomes will be measurable.

But first, we need to discuss what prevents leaders and managers from seeing value creation this way. For many leaders, the well-trodden paths to 'success' have resulted in rigid mindsets that, in this age, are becoming less and less meaningful. So to understand how we got to where we are today, and how things have changed, let's start with a story from the Industrial Age.

The Wedgwood empire

Let me introduce you to Josiah Wedgwood, an English potter and entrepreneur born 'poor into the squalor and dirt of a peasant industry' in 1730.[1] In his early days, products were made and bought locally in market towns and sometimes carried further afield by various merchants and traders. But by the time of his death in 1795, his name (brand) was known around the world for running one of the 'finest industrial concerns in England'.[2] He was worth £500,000.

Wedgwood was the first to produce product catalogues and put them in the hands of travelling salesmen. These salesmen travelled first throughout the British Isles, then into Europe, and ultimately right around the world. Wedgwood also had elegant showrooms with offerings like, 'Buy one get one free' and 'Free delivery for orders over £50!' Wedgwood was able to sell his products at a premium price, in large part thanks to what we would now call celebrity endorsements. Wedgwood went to great lengths to become the British Queen's potter, and later gained endorsement from the Queen of Russia.

Wedgwood was able to leverage all the technological and organisational advances that the Industrial Revolution provided, such as division of labour and industrialisation itself. These efforts not only improved the quality of the products he produced, but also the volume. And this was a hallmark of the Industrial Age. Pre-industrialisation entrepreneurs made and produced goods at a much smaller scale and really only exchanged or sold these goods locally. Industrialisation brought about a new problem for entrepreneurs: *How do we move the volume of product we can now make*? While Wedgwood was no doubt a talented potter and industrialist, what sealed his ultimate success was that he applied himself to solving this very problem: how to move large volumes of product. He was a pioneer of what we now call sales and marketing.

The Wedgwood business continued to outperform its rivals by developing and applying sales and marketing practices that are still popular today. The business was purchased in 1986 by the Waterford Glass Group for

US$360 million and now trades under the name Waterford Wedgwood, continuing to thrive even today.

No doubt about it, the sales and marketing approach Wedgwood developed to move product worked – and it worked for over 200 years. It *still* works to some extent, particularly for organisations like Apple or Coke that have high brand recognition and serious volumes of product. However, the product-centric approach that Wedgwood built his empire on no longer works for the majority. The world has changed – but businesses are yet to catch up. Yes, the technology has changed. Yes, many organisations are now digitised. But more importantly, people have changed – in how they feel about businesses and, importantly for this discussion, in how they behave as customers. It is the changes in customer behaviour that have triggered the need for new insights into how businesses can gain better value through better design of the customer portfolio.

Customers have changed

These last 10 to 15 years have seen a complete change in the way customers behave. This isn't just about the Digital Revolution or the proliferation of apps, though that has of course contributed. This is about a change in *how* customers buy. A huge portion of customer buying journeys are completed without any interaction with the people in the business. And even in those journeys that do require interaction with a salesperson, about 60–70% of the journey is completed before the interaction even occurs. It appears that we don't need travelling salespeople with catalogues anymore!

What customers need and want from businesses has changed. *When* they need it has changed. And *how* they need it (the experience) has also changed. Yet most leaders and managers haven't really adapted their customer engagement practices to align with the way new customers engage and buy today. We may have added some self-service tools or catalogues to websites, but many of the old product-centric sales and marketing tactics are still being used.

There are probably many ways you've seen customer behaviour change, in yourself and others. Here are the top five ways I've noticed that customers have changed.

Customers are sales resistant

No one wants to be sold to. Anything that looks like, sounds like, or feels like *selling* will make the customer's resistance rise. Back in Wedgwood's day, products were new and information was shared by word of mouth, so salespeople were indispensable. But these days, after decades of dodgy sales practice and stereotypically pushy sales behaviours, people don't want to talk to anyone, let alone someone they think is pushing them to buy purely out of self-interest. In short, customers have had enough of being sold to.

Customers want to do it themselves

The widespread resistance to selling has triggered a self-service revolution. It seems the optimal experience for a customer today is not when they can access the experience and advice of someone from the business to help them make a decision, but when they can make the decision themselves. If they want advice, typically they will check in with their large and connected social networks. A customer today can ask their online social network about the best local Indian restaurant or what car they should buy, and within moments have the information they sought direct from a trusted source… which leads us on to the next point.

Customers have more information available to them than ever before

Scattered across the internet are endless expert reviews from 'independent' sources that have done the comparisons for you and, even more importantly, reviews and comments from other customers – real people, just like you, with no bias (well, not much). Customers will do their research, read other people's reviews, ask around, and then decide for themselves. As bestselling author Dan Pink puts it, sales people are needed when there is "information asymmetry, where the seller always has more information than the buyer." The sales person knows more than the buyer and the buyer needs to ask someone about the product, service or solution provided.[3] In many contexts today however, the buying customer knows more than the person selling, particularly when it comes to what other customers are saying about their products.

Customer expectations are rising

No matter what type of organisation or business you are in, the expectations your customer has of you are now much higher than ever, and increasing. Customers expect that things should be easy. They expect you to get it right. They expect you to know them. Some businesses have really nailed the customer experience, which has made our expectations as customers rise even further – often to the point where the service and experience many other organisations provide seems, by comparison, 'clunky' and 'unprofessional' or, on the other end of the scale, overly professional and not human enough. Either way, it's not what the customer expected, and as far as they're concerned, it's not good enough. At this point the customer is likely to disengage, or at worst spread negative word of mouth to their networks about your organisation.

Customers are joining the experience economy

As we have become less and less satisfied with product-based consumerism and raised our expectations of service providers, the economy has shifted to one where customers are making their purchasing and advocacy decisions on their overall experience. We all could probably identify half a dozen examples where we have spent money based on the experience – our favourite coffee shop or restaurant, or perhaps a Wedgwood tea set for Mum. And whether or not we advocate a product is definitely based on our overall experience. But the experience economy is also manifesting on a more macro level.[4]

Consider the music business. Not that long ago music artists and bands made records/CDs and then went on tour to promote sales of their albums. Today, artists produce digital music and songs that are easily accessible and cheap or free. They produce music so that when they go on tour their legion of fans come to the show. This is where the majority of the money now is for these artists: concert tickets. What does the customer buy...? An experience. They buy expensive tickets to hear the same songs they have on their phones because it's an *experience*. Clearly, this industry has transitioned to the experience economy.

Since the turn of the century, our customers have completely changed how they behave. This has brought about – or at least stimulated the beginning of – a different economy that's much less about consuming products and much more about having experiences. Customers will make their decision to spend/invest with your organisation, or to provide positive word of mouth for your organisation, based on how you make them *feel* – not what information you provide. And yet so many organisations and businesses today continue to rely on the 'tried-and-true' sales and marketing methods from a hundred years ago to create their customer portfolio.

Profit by Design provides a pathway and a set of techniques that will help you deliberately build a customer portfolio that provides value for your customers and, in turn, increased long-term value for your organisation.

Let's first look into this dichotomy between an approach focused on products and an approach focused on the customer portfolio.

The product-centric approach

Many businesses focus on what they *do* – the services they provide, the products they make – in the belief that sales and revenue lead to profitability for the business. Again, this thinking comes out of the Industrial Age, when the 'problem' was about selling products to people who, for the most part, had never seen products like these before and were learning new things about them as they were being sold. During the last century, armies of door-to-door salespeople took to the streets to sell their products, from brushes and cleaning products to 24-volume encyclopaedias (that also came with a free bookcase!). These salespeople had a lot more information about these new products than the customer, especially in terms of their features and benefits. Obviously, this is far from true in today's retail landscape.

Product-centric thinking leads businesses to focus on developing the product, as well as keeping an eye on competitors and product alternatives. But selling lots of product does not directly increase profitability for the business. It can, but it often doesn't. A focus on the product misleads business leaders into driving sales and marketing teams to sell more, generate revenue, and worry about profit later. This effectively compartmentalises the business functions, creating silos and factions rather than interdependent, collaborative teams. The marketing team succeeds when it produces an agreed quota of leads for the selling teams, or produces enough mass brand awareness to push enquiry levels up to a certain level. Likewise, the sales team succeeds when it meets pre-agreed and negotiated quotas. The causal relationship between individual team performance and overall organisation success is tenuous at best. Often teams become self-serving and live in survival mode – where one team can win while another loses – rather than working towards a common business outcome.

A product-centric mindset can also lead us to thinking that products sell themselves. We give the customer all the information we can think of – features, benefits, and random testimonials are listed ad nauseam. The reality is: products do not sell themselves. Products are 'sold' when a customer decides to buy. More products are sold when a customer was so pleased with the product or service and experience that they tell others, who also buy. Additional products are purchased based on the first customer's initial experiences with those products and services.

Using a product-centric mindset and approach today in your business or organisation will limit the value you can create.[5] Selling more product does not lead to greater value creation for the business, especially if you are selling to the wrong customers. What *will* lead to great value creation for the business itself in the long term is focusing on value creation for your customers.

Let's now define the customer portfolio and look into how it generates value. In the next chapter, we'll look into the story of where these principles first came to life for me.

The value of the customer portfolio

Profitability for a business is a direct outcome of the customer portfolio. Whether we are talking about for-profit businesses (large, medium or small), government-owned corporations, or not-for-profit organisations, the value they create is the sum of the customer portfolio. Put simply, the customer portfolio (or customer base) is the cumulative sum of your customers – the number and the value of those customers. This will, of course, change over time as you gain and lose customers. The value of a given customer is their individual margin – revenue earned through the customer, less the cost to serve.

Each year, you (hopefully!) retain a certain portion of your customers. This means that the financial value of each customer depends not only on what they are spending now, but also on what they will spend in future. (On this basis, we can calculate an *estimated Customer Lifetime Value*, or eCLV – more about this later). For example, if you gain 100 new customers in year one and retain customers at 80%, then in year two you will still have 80 of these customers; in year three you will still have 64, and so on. Are these customers paying subscription fees, renewing products, or repurchasing from you? And what are the ongoing costs to serve these customers? Your customer portfolio is made up of the customers you acquire and the customers you retain. It is the net sum of your customers, today and into the future.

The ongoing value of the customers in your customer portfolio is the value of the business. Each customer has a lifetime value, calculated based on their individual margin and the overall retention rate. Adding the lifetime values of all your customers gives an overall financial value of your customer portfolio. But it's vitally important not to only consider the numbers. Today, the financial measure is only part of the value from your customer portfolio.

Advocacy within your customer portfolio is a key driver of business profitability. Word of mouth has always been critically important for business, but today it is paramount. What percentage of your customer portfolio actively promote your products and services to their friends, colleagues, and family? What percentage of customers actively provide negative word of mouth? The level of advocacy within your customer portfolio has a critical impact on the number of customers you retain, as well as the number and cost of newly acquired customers. High levels of negative word of mouth can increase service costs, acquisition costs, and losses. But it's worth noting that this is always relative to the alternatives available to your customers. For example, some 'telcos' have a high percentage of customers giving negative word of mouth (detractors), but they may not be that concerned as long as the alternative telcos have just as many or more detractors. We'll discuss customer advocacy in more detail later.

Most businesses have an ongoing relationship with their customers, and this is where most of the ongoing revenue comes from. Customer behaviour motivated by the ongoing relationship – that is, repurchasing and word of mouth – is a significant driver of the profitability of the customer portfolio. If your business standard is to produce a one-off sale with no further relationship then you might feel like you are in a slightly different position, and you are – but your success is still reliant on customer behaviour.

Since its introduction to online businesses in the late 1990s, customer feedback has become ever more important. Now, almost every business has an online presence, and customer reviews drive search results and significantly influence customer decision making. Most of us wouldn't dream of booking accommodation for a holiday or interstate business trip without first checking the reviews of other customers (or getting a recommendation from a friend). The level of advocacy within your customer portfolio is a key contributor to the value of your customer portfolio.

In short, the value of the business is derived from the customer portfolio – it is the cumulative value of every customer. That value, a combination of the dollar value and the word-of-mouth value, is a predictor of the future value of the business. Business leaders should see groups of customers as revenue streams and recognise that different customer groups offer different kinds of value to the business. We will examine these concepts in far more detail in subsequent chapters.

Summary

We started by looking into the Industrial Age origins of sales and marketing. Why? Because many businesses build their customer portfolios mainly through their sales and marketing efforts. This is a product-centric approach to thinking about business growth, and it is fast approaching its use-by date. Relying on this approach nowadays will lead to a whole range of shortcomings in business model design and implementation. Customers have changed how they behave. We are entering into an experience economy, in which the long-term value of a business or organisation comes from the configuration of its customer portfolio. This value is derived from both the financial value of customers and the advocacy they provide.

CHAPTER TWO

THE GENESIS OF *PROFIT BY DESIGN*

As my *Profit by Design* journey began, there were not only lessons I had to learn about the value of the customer portfolio, but also paradigms I had to unlearn and let go. I was guided by one overriding fact: the value of the customer portfolio is persistent and profound. Above all, I discovered just how important it is for the organisation as a whole to focus on how the customer portfolio is created, rather than allowing all the various teams and individuals, each with their own unique perspective, to do what they feel is best. Focusing the whole organisation on *how* the customer portfolio is created – rather than letting it happen by chance – is the key driver of long-term value. We will finish this chapter with the three key insights I learned about how businesses create their customer portfolio almost unwittingly.

Lessons from financial services

I feel that I intuitively first learned these principles many years ago as a young lad working for my parents' businesses, but the definitive lessons came while working for a financial services group a few years ago.

The financial services group I worked with was divided into three product 'houses': a bank, a general insurance company, and a wealth management business. From a regulatory and business perspective, each product house was assessed on its financial results. The bank's profits came from the deposits it collected and the loans it disbursed, such as property loans, personal loans, and credit cards. The insurance company produced an underwriting result: net profits from insurance premiums collected less claims paid out on, for example, home and car insurances. Finally, the wealth management business made money based on sales of financial planning services, investment products, and life and income protection insurances. Yes, this is a little oversimplified, but I think you get the point: each product house made money from the products it sold, less the costs outlaid.

In the early 2000s, this financial services group decided to implement a Customer Relationship Management (CRM) system.[6] I had a background of working across many distribution channels and was appointed as the business lead on this initiative. We began by looking at the technology systems that would support our goal of having a CRM system. The project soon grew into a program as we started to piece together all the components required to make CRM successful. We would need an operational CRM system, supported by a single customer database, a way to do activity-based costing, and marketing systems and analytics. The first step was to create a single customer database, which would form the foundation for a clear Customer Strategy that could be brought to life by people across the group. With around two million customers across multiple product systems (with no consistent naming conventions and duplicate customers everywhere), creating this database was a project in itself.

The program ran continuously for more than three years, deploying a suite of six core pieces of technology in a sequenced delivery. The change affected 5,000 employees. The story of the program is a story within itself, but for our purposes, the point is that the seeds of success were sown with a deep understanding of the customer. As we looked deeper into the customer portfolio, the unexpected insights we uncovered eventually led to a group-wide cross-selling approach that would result in the highest cross-selling rate of any financial services organisation in Australia.[7]

So what were these customer insights that we stumbled across? To start with, we recognised that our customers generally purchased as a household. Decisions about financial products and services were typically made together, either as a couple or as a family unit. A child's first banking products normally followed along with the household banking. Likewise, when a child got their first car, it would likely be insured by the same insurer that the household used. It therefore made sense to analyse households, not individuals, as the basic customer 'unit'.

It's important to recognise the flaw in averages. We knew that the average value of a household to the group was about $680 per annum, but this doesn't provide any actionable insight whatsoever! To work out where customer value was coming from, we needed to break the portfolio down into segments.

We divided the customer portfolio into five segments based on the annual value contribution of the household. Ideally we would have used an estimated customer lifetime value, but back then we weren't that sophisticated! We analysed profit contribution per annum, but also recognised that customer retention was a key driver of long-term value.

This is what the five segments looked like:

Segment	**Average Profit Contribution per Annum**	**Percentage of Total Customer Portfolio (Approx.)**
A	> $2,600	14%
B	$1,000–2,600	
C	$100–999	57%
D	$0–99	29%
E	< $0	

Pareto's 80/20 principle was alive and well here in this customer portfolio – 80 percent of value was coming from around 20 percent of customers (households).[8] This reflects one of the key principles of the customer-centric approach to business: not all customers are equal. When I talk with businesspeople today, they readily accept this principle and do recognise that potentially 80% of their customers aren't adding much value at all.

In the late 1990s, a couple of Australian banks realised this principle as well, and determined to 'sack' a lot of customers they no longer wanted.

They closed the accounts of these low-value customers, and even closed some of the branches that were serving them. The backlash from the public was huge (actually, I believe this is where the term 'bank-bashing' stems from). The problem, though, was that the banks weren't reducing their costs in line with the amount of customers they were sacking. Although the profit per customer increased, so did the cost per customer – thereby reducing the overall profitability of the customer portfolio.

When we recognise that a significant portion of customers may not be adding much value to the business, the reaction shouldn't be to get rid of those customers, but to ask different questions. What is it that makes our more valuable customers more profitable? Why are we acquiring new customers that are not profitable? How do we turn our less valuable customers into more valuable, or at least cost-neutral ones?

Diamonds in the portfolio

As we delved into the customer portfolio, we expected to find that the valuable customers were also the high-net-worth clients. But this was not the case. High-net-worth clients are great to win over, but they can be more costly to serve and often seek discounts. When we looked into customer engagement and spending in more detail, we found that a particular type of customer/household was associated with a higher value to the organisation. Around 40% of these customers were in Segment A, another 35% in Segment B, and 25% in Segment C. The average profit contribution of these segmented households was $2,767 per annum. We called these 'Diamond Customers'.

A Diamond Customer had at least five products and was engaged across at least two lines of business (banking, insurance, and/or wealth management). They had utilised service channels that cost less to serve, and leveraged value from linkages between their products, like transfers for loan payments or insurance payments. These customers had not only engaged in a way that delivered value for the organisation, they had also extracted more value from the business for themselves. It was this symbiotic, two-way exchange of value that made these customers absolute diamonds.

While the financial services group itself managed and assessed each line of business – insurance, banking, and wealth management – separately, the customers saw it completely differently. They saw an organisation that offered a range of services and products that they could use to manage their finances, protect their assets, plan for the future, and improve their quality of life. This was something of a surprise to us at the time. But there were two other surprises that topped it off.

First, we looked at the retention rate of customers. We found that the average retention rate for a customer of a single line of business, let's say insurance, was about 80%. The Diamond Customers, on the other hand, were retained at a rate of about 98–99%. These customers were invested in the relationship they had developed with the company. They had connected with the brand and with its array of services. In other words, we would have to do something really bad to lose one of these customers!

Retention of customers adds significant monetary value to an organisation. The estimated lifetime value of a customer contributing $2,000 per annum and retained at 80% is $5,714 (using a discount rate of 8%; more on this later.) For a customer with the same annual contribution, but a retention rate of 98%, the estimated lifetime value is $19,600.

Second, we conducted further research into the Diamond Customers. What we found was that these customers were highly likely to give positive word of mouth to their family and friends. It turned out that not only were they making decisions to engage with the products and leverage the services to extract value for themselves, they were also advocating to others to do the same. When your customers are advocates of what you do, attracting the optimal customer is that much easier.

For me this was the first profound example of a two-way exchange of value. A subset of customers, invisible to the business until now, was extracting optimal value from the organisation, while also delivering value for the business. As the Diamond Customers leveraged the products and services to gain value, the business was rewarded with higher levels of profitability through margins, retention, and promoter behaviour.

Insights into action

Once we understood *how* value was created for the Diamond Customers, we could then develop tactics to create more customers with the same characteristics. The overall strategy was to grow the number of Diamond Customers. Therefore, we needed to retain our existing Diamond Customers, convert as many other existing customers into Diamond Customers as possible, and encourage all new customers to be Diamond Customers. By growing the number of Diamond Customers, we would increase the profitability of the customer portfolio.

First, we considered how to retain our existing Diamond Customers. We found that one of their key frustrations was that the organisation did not really treat them as a group customer – interactions were always based on a single line of business (banking, insurance, or wealth management). Every time the customer moved house and wanted to change their mailing address, they had to contact each part of the organisation individually to update their details. Therefore, we decided to deliver the capability to update customer details across all the product systems with a single action. This was implemented in the final phase of the program.

Converting existing customers into Diamond Customers came down to a cross-selling strategy. First, we needed buy-in from frontline employees. This was achieved through educating everyone about what Diamond Customers were and how much value *they* were getting from the organisation. Frontline people care about the people they interact with and need to feel they are adding value. So to engage frontline people, we had to demonstrate value for the customer, not just the business.

Next, we educated frontline employees as to what each customer needed in order to become a Diamond Customer, which was as much about leveraging the value of existing services as it was about adding products. Real-time marketing systems also helped with producing these 'next-best-offers' that were focused on adding value for customers (either service suggestions or products) with the ultimate goal of creating more Diamond Customers. Additionally, the executives in charge of the bank, insurance, and wealth management product houses not only accepted financial targets, but also committed to grow the portion of their customer portfolio that had other products with the group, which drove higher levels of cross-product collaboration.

When it came to customer acquisition, a few things had to change in order to onboard new customers as Diamond Customers. For example, the bank's lenders were predominantly assessed and rewarded based on loan disbursement – the dollar value of loans drawn down from the bank. From a customer perspective, applying for and getting a loan from a bank to purchase a new car, home, or investment property is a fairly big life event. Lots of information is exchanged, including future goals and plans. Yet the business was really only interested in dollar drawdowns and conducting the transaction efficiently. The insights we gained about Diamond Customers indicated that this needed to change. Much more could be done to offer customers better value not just from the loan, but also from related financial services. Processes, systems, and incentives were changed to align with the goal of onboarding all new customers as Diamond Customers.

After all these initiatives were implemented, the organisation had the highest cross-selling rate of any financial institution in Australia. We grew the number of Diamond Customers, significantly improving the profitability of the customer portfolio, and built the organisational capability to continue achieving this for years to come. Incredibly, the CRM program achieved a return on investment of more than 100% within a mere 12 months.

Lessons learned

As we explored the customer portfolio for the first time, we found that the way customers behaved significantly affected the profitability of the customer portfolio in ways the business never expected. We also discovered that the thinking of the people who ran or managed the organisation was very much framed by what they saw, failing to take into account what they couldn't see.

This whole experience provided a significant and profound set of lessons for me. Throughout my work both at the time and with a broad range of organisations, I have found that a few specific principles are consistent across all industries and sectors, in business-to-consumer and also business-to-business contexts. The common theme? People.

The three key lessons were:

1. Customer portfolios are *created* by the business – through implicit and explicit actions and decisions.
2. Not all customers are equal. Customers differ in how they gain value from the business, and in how they reciprocate value (typically margins, retention, and advocacy).
3. Most organisations cannot see their *awesome customers* – those that represent the optimal value to them and that are getting the best value from their offerings.

Now that we have seen how these 'lessons' applied to a large financial services customer portfolio, let's take a quick look at each one and see how it might apply across other contexts.

Customer portfolios are created by the business

Since working with the financial services group, I have collaborated with more than 50 other organisations. Every time I've looked into an organisation's customer portfolio, I've found similar mixes of customer groups, each representing different levels of value to the business. And every time, as these differences in customer groups become obvious, someone asks, 'How did we get here?' In the following section we will discuss in more detail the systematic process by which we can identify meaningful customer groups. But for now, let's look at a couple of real-world examples and see how something that seems like a good idea at the time can actually leave a business with a customer portfolio that's less profitable than before.

A subscription software business provides a software package for building contractors that allows them to quote jobs and then manage costs and variations as the job progresses. The software also incorporates a financial system that meets the regulatory obligations for managing subcontractors and tax compliance. This product solves a key problem for contractors, who typically quote in Microsoft Excel, manage delivery of the job through a project application, and take care of financials through yet another system.

To gain more sales, the company decided at the outset to set their price quite low. Before long, they ended up with a customer portfolio full of people who weren't really committed to setting the software up, and weren't reaping the full benefits. Frustrated staff would often comment, 'We know our customers are not using the functionality, but we can't get them to use it!' These customers did not provide positive word of mouth, they were reluctant to renew their subscriptions, and they required much effort (and cost) to try to retain. The business had created their customer portfolio through poor decision making, which led to actions that reduced profitability.

The solution was to raise the price commensurate with the value of the software, develop the ability to communicate this value, then ensure that each new customer set up the system in a way that ensured they got the maximum value from their subscription. Over time customer retention and advocacy increased, and cost to serve reduced.

This is how the two-way value exchange works in practice. We must ensure that if we claim a set of benefits for customers, they receive those benefits – in bucketloads. By ensuring customers get absolute value, we increase the value of the customer portfolio.

Let's consider another example of a business inadvertently reducing the profitability of their customer portfolio. I worked with a building supplies company that wanted to grow their sales. They had a large national network of salespeople visiting existing customers, as well as an internal (inbound) sales team taking orders from existing customers.

It was decided that the outside sales team needed an incentive to get more customers. So, a target – to add one new customer each month – was linked to their bonus/commission structure. Seems reasonable, right? Not too onerous on the salespeople. However, this was a very mature market. All the potentially valuable customers knew them or had dealt with them in the past and had, for one reason or another, chosen not to be a customer (maybe they chose another supply partner or had poor credit). The salespeople met the target of getting one new customer per month quite easily… by going to smaller, less valuable customers. They added them into the system and took an order, thereby meeting their target and growing the customer portfolio. However, many of these smaller customers had actually already been getting product from the business, just indirectly through their larger customers. The customer portfolio grew, as did the cost of acquisition – but overall profitability did not, and nor did advocacy.

Not all customers are equal

Each customer is different in how they gain value from the business, and in how they reciprocate value (typically through margin, retention, and advocacy). The secret is in grouping these customers in meaningful ways that help us understand and leverage this value exchange.

First, let's note that the Diamond Customers within the financial services group found a way to gain value from the products and services that was almost beyond the imagination of the business, particularly from a product-centric mindset. In turn, they reciprocated much more value than other customers.

Likewise, in the case of the subscription software business, a handful of customers figured out how to use the full functionality of the product. They had invested their time and effort into setting everything up and learning how it works, and had the discipline to apply the processes to their own businesses. The value they gained from the software was huge. They were confident on the margins they would make from their contracts, and regulatory compliance was achieved with the click of a mouse. They were advocates for the software, and had a retention rate of 100%.

Yet when the business wanted to grow the customer portfolio, they offered their product to new customers at a low price point. These customers did not have the commitment to learn how to set up the system and expected everything to be much easier that it actually was. Most did not resubscribe. Nor were they advocates for the system – why would they be, when they had tried to use it and could not get the promised benefits?

The software business could see their awesome customers, but they failed to recognise them. They took the approach that it was up to the customer to get the value from the product, and it was this thinking that prevented them from growing the profitability of their customer portfolio. Not all customers are equal, and to grow the profitability of the customer portfolio we need to ensure the customer gains value.

Most organisations cannot see their *awesome customers*

We saw in the case of the financial services group that the Diamond Customers – the most profitable customers – were initially hidden from view. The building supplies company was in a similar situation. They were having high levels of interaction with a group of customers that were really ‘wheelers and dealers’ – price-sensitive customers who just wanted a cheap deal. We found that these customers, who accounted for about 15% of the customer base, were taking up a lot more time and effort than other customers, and had a lower margin. Their idea of advocacy was bragging to others about the deal they got, rather than giving actual positive word of mouth for the business.

We looked within the customer portfolio to discover customers that were interested in a partnership style of relationship. These customers valued service and consistency of supply, potentially outsourcing some inventory management to their supplier. These customers offered higher margins and an ongoing partnership – which in this context related to retention and a high share of wallet. By focusing more effort on these customers, and leaving the 'wheelers and dealers' to their competitors, this business improved the profitability of their customer portfolio.

Another example of this principle arose when I worked with an operator of passenger rail services along the coastline of the state, and between the coast and regional centres. They were keen to grow sales and get more people using their passenger services, and to them the obvious target was backpackers. They were planning a huge international campaign to attract more backpackers. This did seem like a good idea. But first we did a review of the customer portfolio. We found that backpackers did provide some value, and that word of mouth on social media influenced other backpackers to use the passenger train services. However, many were purchasing a cheap travel-pass ticket rather than individual train tickets. In the process, though, we did find another interesting customer group.

People that lived within regional areas and were looking to take a short break or visit family and friends were repeat travellers, mostly on full-price tickets. We revised our goal to instead grow this customer group. These customers were the gems within the portfolio. This didn't mean that the rail operator wouldn't also market to backpackers, it just meant taking a more balanced approach to growing the profitability of the portfolio. Through an analysis of the lifetime values of its customer groups, the company was able to determine the optimal investment in marketing to ensure a return. Finding and knowing your awesome customers allows you to finetune your customer engagement approach to improve the profitability of your customer portfolio.

Summary

The composition of a business's customer portfolio provides the best indicator of long-term profitability. The number and value of customers gives us the base value, but the retention rate allows us to also calculate value into the future. Ongoing customer relationships add value over time, particularly in an age where the value of advocacy is of utmost importance. The value of a business is derived directly from the customer portfolio – the cumulative financial value of every customer, combined with word-of-mouth value.

Always, the development of strategy and tactics should be based on improving the value of the customer portfolio – increasing the proportion of Diamond Customers.

The three key lessons I learned from my experience with the financial services group bear repeating:

1. Customer portfolios are *created* by the business – through implicit and explicit actions and decisions.
2. Not all customers are equal in how they gain value from the business, or in how they reciprocate value.
3. Most organisations cannot see the *awesome customers* that represent optimal value to them and to their customers.

These three insights are key to designing your business for profit.