Don't forget the customer!

Darwinism in effect - Customer retention and margin management during the downturn

By Ralf Möbus & Joachim Klein

Evolution and natural selection

If Charles Darwin had been an economist, he might have been interested to study the survival of the fittest (company) in the current economic downturn. When environmental pressure forces organizations to adapt, only those which have developed the required capabilities for survival will be able to endure.

Currently companies within the pulp and paper sector are mainly responding to the crisis through capacity consolidation, cost reduction and focus on liquidity. While all of these activities are necessary and important they are mostly forced upon the company by external circumstances and can be considered reactive. On the other side companies still need to focus on their most important asset which is the customer relationship. Focusing too heavily internally may lead to negligence of the markets and loss of revenue and profit.

StepChange Consulting conducted a survey among 60 participants of the 2009 RISI conference in Berlin and the 2009 PRIMA conference in Turin, asking "which are your company's priority areas for dealing with the current crisis?" While areas such as cost reduction, cash flow, pricing and margin management were mentioned most often, external focus areas such as marketing, customer service & retention and mergers & acquisitions were mentioned to be of less importance.

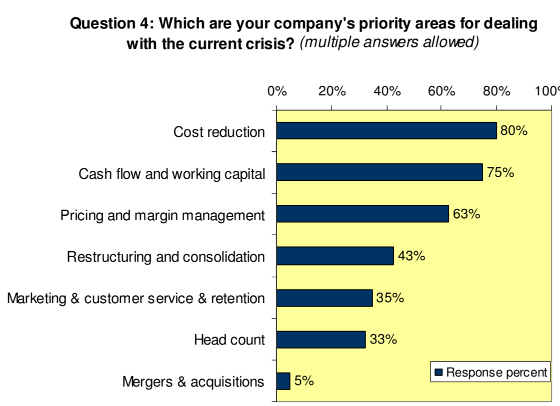

Figure 1: Results of question: "Which are your company's priority areas for dealing with the current crisis?"

There can be no objection against capacity consolidation in order to balance supply and demand and to reduce costs. The industry has been slow to adjust in the past. However, companies which forget to include the markets and their customers in their improvement initiatives will realize that earning their way to profitability through cost reductions alone can be dangerous. Those companies, that manage to get closer to the customer, will most likely be the ones, which will be rewarded by evolution and leave the recession strengthened for future growth. These companies will then have created a competitive cost position and at the same time secured future demand and growth potential with their customers.

The following article highlights potential measures that managers and sales executives can apply to manage through the downturn successfully with respect to customer management.

Segment the customers – anticipate who will survive

In today's environment where demand is declining an active management of the customer relationship becomes even more essential to retain revenues.

Segmentation of customers takes a whole new meaning within the current economic environment. In times of crisis it is required to segment against different criteria than during "normal" times. Volume and profitability need to be assessed against the risk of loss and against the likelihood of survival in the mid term / long term. The following table illustrates segmentation requirements of customers in a downturn with respect to risk. The cumulated volumes and margins in each quadrant will then help determine the required measures.

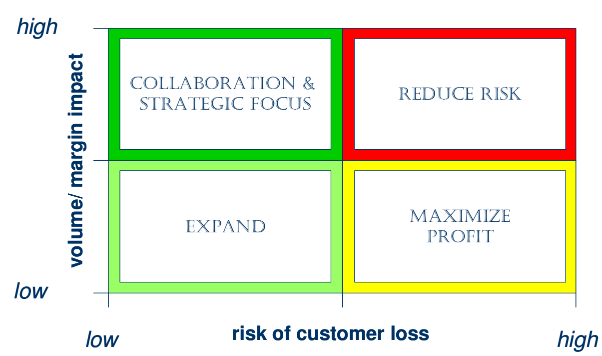

Figure 2: Customer classification matrix in a downturn according to customer risk

A reassessment of customer relationships is required under the assumption that the current downturn means threat to survival for many customers. A differentiation of a customer's financial strength according to expected short and long term impacts will help filter out the desired customers for the long term.

Customers expected to survive in the long term are the ones a company should target in the current environment to build long term relationships with a focus on long term profitability. A short term profitability focus should rather be applied to customers expected not to survive the downturn.

The differentiation of customers based on anticipated long term survival and profits will then help tailor customized service offerings.

Get in the driver seat – identify and interpret early warning signals!

Availability of indicative information becomes key to anticipate changes in customer behavior and to proactively identify mitigating actions.

The sales organization needs to be set up to gather, consolidate and interpret market signals faster than during regular market environments.

Similar to the "situation room" in the US white house where all intelligence matters are discussed concerning national security and which is used to monitor and deal with crises, companies should gather key customer information centrally and keep executive sales managers and company management informed in case of critical developments. This will enforce company wide sensitivity to important customer developments and enable faster decision making if required.

Figure 3:Situation Room: Walt Rostow shows President Lyndon B. Johnson a model of the Khe Sanh area , 02/15/1968, **US Archiv ARCWEB**

Besides maintaining a close proximity to the customer, a sales force needs to receive support in reading the signs. Pragmatic sales tools need to be implemented that will help to identify alarming trends and support interpretation of customer activities.

Installing a continuous customer and market forecasting process will assist in minimizing instances where customers default without having any prior indication about it.

Tracking different indicators can help to anticipate customer defaults or signal supplier changes. Examples for signals to be tracked and interpreted are

- Declining volume forecasts
- Declining order book compared to forecasts or budgets
- Postponed orders
- Increased price sensitivity
- Additional service requests
- Late payments
- Increasing number of claims
- Change in relationship and hierarchical contact level on customer side

A European CEO of a paper producer recently stated at a conference that he was spending more time than ever with his clients and that he advised all top executives to do the same. This shows how important the customer relationship is perceived in some companies. Of course the downside is that it may appear that top management only cares about the customer when times are tough. On the other side some customers feel that their suppliers only focus internally and forget the customer in the current environment. At the same European conference, a printer asked, after listening to various presentations from companies in the paper industry that mostly dealt with cost reduction and consolidation: "Where is the customer in all of this?"

As discussed above the first step to avoid volume or customer losses is to identify signals of increased volatility and risk. Thereafter sales executives need to identify measures to retain customers according to the defined segmentation criteria and to try to influence long term loyalty.

The following illustration highlights sample opportunities to increase loyalty and needs to be applied according to the service portfolio defined for each customer.

-Loyalty grid for customer management-

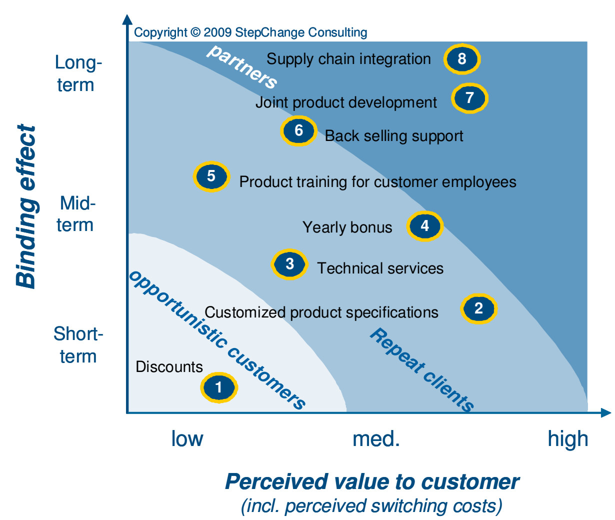

Figure 4: Sample opportunities to increase customer loyalty on the loyalty grid

Becoming part of a winning supply chain – invest in long term partnerships

The economic downturn offers opportunities to win additional market share as customers are looking aggressively for additional cost saving potentials. The statement from a paper producer "We've always been told during the last years to look for margin and now they are telling us to go for market share" does not point to a complete shift in paradigm, it is rather a different accentuation: While it still needs to be evaluated carefully if a customer's profitability complies with the return requirements of the company, the question is when the customer needs to reach these returns. The recommendation is to focus long term profitability and not to overstress the short term in order to capture future profitable market share. However as discussed above, this approach should only be applied to those customers a company deems fit for long term survival.

Companies need to define measures how to secure existing customers and determine what it is, that customers really need and what they may not need. This approach is not new but should be done more rigorously and proactively in times of a downturn to anticipate customer behavior. It is essential to take the customer perspective and support key customers to manage through the downturn. As shown in figure 3 the downturn provides a great opportunity to strengthen customer relationships and build long term partnerships through definition of collaboration and integration opportunities. Drastic changes in the economic environment provide an opportunity for structurally healthy supply chain participants to redefine existing relationships and build collaborative supply chains for future competitive advantage.

In terms of customer relationship this means that a threat of losing margin through lower service level requirements by a customer may actually force a company to reconsider their overall service approach. Especially in the current environment sales managers need to understand the burning issues of their customers and proactively help their customers to reduce costs and become more competitive.

As an example a customer may be forced to reduce the internal cost of order handling or time and efforts spent to manage the inbound supply chain. Through customer collaboration and communication the supplier may identify opportunities together with his customer to reduce total supply chain costs. Targeting future partnerships the supplier can then proactively help the customer to capture these potentials. The collaborative solution design may even lead to a shift of process ownership from the customer to the supplier creating a win-win scenario – cost reduction on the customer side and long term customer commitment on the supplier side. A standard example for this evolution can be found in many other industries, most notably the transformation of the auto industry during the 80's and 90's when whole parts of the automakers' supply chain was transferred to the suppliers.

In the industry survey conducted by StepChange in March and April 2009, almost a third of all participants indicated that customer service level requirements were actually up, while sales prices were reported down by a clear majority.

	up	down	no change
Sales prices	10%	63%	27%
Customer demand	2%	90%	8%
Required customer service level	21%	2%	77%
Customer complaints	21%	0%	79%
Late payments & bad debts	73%	7%	20%
Availability of financing	0	68%	32%

Figure 5: Question: "How is the current crisis impacting your company?" (percentage of respondents), March/April 2009

None of the participants indicated a decline in service level. It can be expected that in times of an economical downturn service costs will be questioned. This may indicate that companies are forced to take a new look at how to serve their customers – maintaining or even increasing service levels while managing the supply chain at lower costs to maintain profitability.

Expanding the skill set beyond price and volume negotiations

Traditionally sales and purchasing managers have focused mostly on price and volume during negotiations. In recent years this has slowly changed as both suppliers and customers have been forced to consider further topics such as supply chain collaboration, joint marketing efforts and working capital. This has also resulted in the requirement for the sales force to expand their skill set beyond price and volume discussions. However, this skill set still needs to be developed further with respect to training on topics like supply chain or financial management.

In the current downturn existing customer-supplier relationships may be impacted by intentional or "desperate" pricing moves from competitors. In this situation the before-mentioned "intelligence system" will support early detection of threats. A skilled sales representative will gather all arguments and secondary costs to evaluate the total benefit of the existing supply collaboration vs. a price-induced competitive offer. The target is to lead discussions based on the total benefit of the customer-supplier relationship (total cost of ownership from a procurement point of view). In many cases a discussion based on solid facts will help prevent the risk of volume or customer loss as it highlights the total picture.

In case this open book negotiation will unveil medium term improvement opportunities it is necessary for the supplier to collaboratively improve on these areas together with the customer.

This customer collaboration approach will demand a broad set of skills from the sales force in addition to the need to have a comprehensive set of information readily available.

However with eroding price levels the core skills of sales people will be highly tested – negotiation skills. It may take years to develop new products, months to implement new cost saving ideas but only seconds to give away margin in a price negotiation. 1% difference in sales price, typically leads to an impact of more than 20% on operating income, considering the P&L of merchants in the sector, even up to 50%.

As discussed above a sales force needs to prepare for price negotiations through consideration of all information available taking all cost parameters into consideration. The first step to do so is to profile a clients' behavior for costly elements: Examples of elements impacting customer profitability are long payment terms or bad payment behavior, special delivery slots, packaging, inventory or delivery requirements, short term order postponement, customized specifications and a long list of other elements. In these times concessions will most likely have to be made. However from a sales perspective this is also the time to negotiate on some of the elements mentioned above to reduce cost-to-serve and retain margins.

It's a sale when the money is in your pocket

Companies which have neglected to implement a tightly managed collection and working capital process may suffer even more, as customer payments are increasingly postponed, credit limits are lowered by insurances and bad debts are increasing. In the StepChange industry survey, 73% of participants indicated that bad debt and late payments were up.

If not implemented already, these processes will have to be installed quickly in order to improve liquidity and avoid bad debt. Potential measures are:

- Early personal contact with continuously overdue customers
- Revised frequency of dunning runs
- Task force approach and shared responsibility ("good-cop" / "bad cop" approach) in close collaboration with finance
- Definition of maximum payment terms for each customer segment
- Clear and uncompromising credit management processes and guidelines
- Inclusion of working capital targets in sales force bonus agreements
- Set-up early warning system for potential bad debt customers
- Top management reporting and early involvement in case of critical events

Suppliers may be inclined to support their customers (if they can afford it) in case they are in liquidity troubles. As discussed above a decision on potential "support" should be based on the segmentation of a customer's likelihood of long-term survival. If a customer is deemed a survivor in the long run it can certainly be expected that any assistance given will be rewarded at a later stage.

Summary survival recommendations

The previous paragraphs have highlighted the following measures managers or sales executive can introduce to deal with the current economic situation:

- Implement information gathering and evaluation procedures and mechanisms to identify the risk of customer and volume loss
- Segment customers according to risk criteria and determine the options for each group
- Target long term customer collaboration and integration - use the downturn to get closer to the key customers
- Survey customer needs and adjust the service offering collaboratively with the customer
- Identify costly client behavior and allocate cost to elements of leakage for use in negotiations
- Equip sales force with information of margin leakage to gain transparency, arguments and confidence
- Expand the skill set of the sales force through training on topics beyond volume and price
- Focus working capital and receivables management and enforce credit control mechanisms
- Align sales force incentive systems with company targets including volume and profit but also liquidity, working capital and supply chain costs

Actions to retain customers and assess their behavior should not be once-off exercises but embedded into a holistic approach of customer collaboration, profitability and pricing. Services should be questioned on a regular basis and aligned to customer needs and segments in order to be appealing on the one hand and profitable on the other.

The current turbulences and high level of volatility in the market may lead to short term opportunistic behavior on both supplier and customer side. However, the environment provides an excellent basis to develop long term partnerships.

It may be expected that the excessive short term profit focus that caused the global downturn will nurture a shift in management approaches. Therefore one can assume that a long-term focus may become more important again. Within this context a company's survival may be best ensured if it becomes part of a highly competitive supply chain cluster of companies.

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