Throughout my consulting career, I've had a personal vision (many colleagues said it was an unreasonable dream) that someday companies would manage marketing and operations functions like an orchestra, rather than like an all-star competition. By that I mean that there should be times when...

- powerful functions would know when to subordinate themselves for the greater good,
- separate functions would trust each others’ information,
- all functions would focus on delighting customers, not on purely optimizing self-serving metrics.

There are very few companies who have done well in balancing their strategic and operating priorities this way. They are the ones that always top the lists of "best managed" or “most successful”. Unfortunately, the overwhelming majority of companies have not been able to achieve this orchestrated balance.

In the May/June 2003 issue of Supply Chain Management Review, I published “A New Way to Maximize Contribution” article, which illustrates a practical way to look simultaneously at the profitability of both marketing and operations. The methodology opens the door for both sides to share information in a non-threatening way and act in concert. The process works well, however, it still needs the day-to-day linkage between marketing tactics and results.

Well, sometimes it pays to be lucky. In a conversation with a long-term colleague, Linda Sharp, she shared her framework, which captures market insights directly from marketing activities and customer interactions, then evaluates the patterns, compares them to plan, and shares them with management so that marketing efforts can be readjusted. Consequently, new promises can be made, economic benefits of revised actions can be understood, and appropriate responses can be taken -- by both the customer-facing and operations-focused teams.

Our combined process in the Religence Framework gets both sides playing on the same team. It builds the missing link between promises to customers and fulfillment of those promises.

In the following pages you'll find a copy of “A New Way to Maximize Contribution” for your review. To learn more about the Religence Framework and how it creates the everyday link between strategy and execution, please take a look at the wealth of material on the Religence website www.Religence.com. If you’d like to get started learning who your most profitable customers are and why, what's important to them, what to promise, and what to deliver, we invite you to contact us.

Bob Sabath CMC, FIMC
A New Way to MAXIMIZE Contribution

By adopting a “contribution focus strategy” companies can approach new levels of profitability. The key is to begin viewing customers and products not by volume but rather by profitability—and then integrating the customer-facing and operations-focused parts of the organization accordingly. The customer/product matrix presented here is a tool that can help make it all happen.

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By Robert E. Sabath

It is a well-accepted truth that a huge divergence exists in most companies between the functions, people, measures, activities, and outcomes of the customer-facing organization and the operations-focused organization. Rarely are companies structured in a way that effectively combines the two. Leading corporations are recognized for their capabilities in one, but rarely both, sides of the equation.

Still, in this article, we argue that companies can gain exceptional advantage by balancing both sides—that is, by integrating according to customer and product contribution, and by acting strategically and operationally in concert with the economic implications of that integration. The success of this process, called contribution focus strategy, depends heavily on supply chain managers. Although these individuals typically reside in the operations-focused camp, they have more direct customer interface than any of their colleagues there. They are uniquely positioned to make the needed collaboration happen.

The key to a contribution focus strategy is pretty straightforward: Instead of viewing customers and products by volume, you need to view them by contribution. By carefully analyzing and cross-referencing customer and SKU profitability, companies can gain the insight needed to drive customer-facing and operations-focused activities toward identical results. This article lays out the rationale for adopting a contribution focus strategy and presents a customer/product matrix to help companies implement this strategy.

Two Points of View

Historically, businesses have been managed around two focus areas: customers and operations. In recent years, many silos have come down within each of these areas. But in most companies, the dichotomy between the customer-facing and opera-
Contribution

Most past attempts to link the customer-facing and operations-focused parts of the organization have fallen short of expectations.

In short, the customer-facing organization wants flexibility, avoids negative exceptions to customer satisfaction, responds anecdotally to problem situations, and loves volume—even when it results in incentive-induced spikes at the end of each measurement period. The biggest frustration to the customer-facing organization is getting the operations people to understand and respond to the right priorities—that is, their priorities.

Now consider the operations people. They are driven by demand. Efficiency measurements rule: number of items shipped, low operating costs, minimal down time of equipment, high line-fill rates (even if they result in low order-fill rates). A successful operations-focused organization wants cost-effective service, expects minimal levels of inventory, and hates SKU proliferation. The operations-focused people emphasize consistency and predictability. They are recognized for attaining budgets and minimizing costs while maintaining high quality.

Attempts to Link the Two Sides

Many initiatives of the past decade have attempted to link the customer-facing and the operations-focused parts of the organization. For the most part, however, these initiatives have fallen short of the high expectations.

In the early 1990s, efficient consumer response (ECR) was introduced as an initiative that would save billions of dollars in inventory, transportation, and other costs through an intimate and immediate sharing of customer demand throughout the grocery products distribution chain. The industry invested several billion dollars in ECR; trade publications wrote glowingly of its potential; and a national committee of industry leaders promised to carry the ECR banner forward. Unfortunately, only small changes resulted from the ECR initiative. It seems that this first attempt at collaboration was undermined by competition—competition to get the lowest price even if it meant market inefficiency and competition between the customer-facing and operations-focused camps within corporations.

Today, collaborative planning, forecasting, and replenishment (CPFR) has picked up where ECR left off. However, this newer initiative is experiencing the same kinds of problems as its predecessor. There are still two or even more sides—some internal and now some external—that do not speak the same language or respond to the same measures espoused by CPFR. The pilots have worked well, but results typically falter as soon as the regular, traditional customer-facing and operations-focused business units get involved in an ongoing program.

Enterprise resource planning (ERP) was originally heralded as the bridge that would connect all the internal functions of a corporation. Although it gained market leverage as an antidote to Y2K problems, ERP rarely has been able to bridge the chasm separating customer-facing and operations-focused activities. Each of the primary ERP providers has been recognized for a particular focus: their customer-facing skills, their operations-focused capabilities, or their financial systems. None has been recognized for balance among these capabilities.

A primary objective of lean manufacturing was to link production incrementally to demand. The objective: reduce in-process inventories to minimal levels while supporting immediate production response to customer demand. In theory, the process makes sense—especially if setup costs are low and customers are willing to share information on anticipated needs with their suppliers. In reality, however, these conditions are rarely met. Customers concerned about not living up to their expectations seldom provide an accurate picture of expected demand.

Manufacturers that do try to live up to the commitments of lean manufacturing often become disenchanted as customer demands trend toward smaller orders made more frequently. Consider a fastener supplier to the automotive industry whose largest customer ordered more than 15 million units across several different cold-headed products each year. Over a period of years, the customer’s order pattern moved from an annual target with quarterly releases down to no target and daily orders. Because the cold-heading process wastes hundreds and sometimes even thousands of pieces during start-up, the lean, manufacturing-to-order approach led to a huge buildup of waste and drove profitability to a loss. The customer-facing managers at this supplier company were thrilled at the continuing growth of product demand as well as the heightened customer satisfaction. The operations-focused managers, on the other hand, begged for relief from the waste and production inefficiency. But the customer-facing leadership feared that its relationship would be ruined if...
the supplier requested a longer-term forecast from the customer.

Remember mass customization, another highly publicized initiative of the recent past? For many years, forecasters assured us that, thanks to the new Internet-based technology, lot sizes of one would be a certainty in the very short-term future. But a continued emphasis on traditional manufacturing efficiencies keeps driving mass customization into the long-term future and away from short-term feasibility.

The Practical Reality

Many of those well-intentioned initiatives discussed above failed to live up to expectations because of the difficult handoff between long-term, unconstrained plans and short-term, constrained production and assembly capabilities. As long as the agreements are handled in the abstract (unconstrained), both sides are happy with the commitments—whether those commitments relate to sales volumes or manufacturing responsiveness. When the limitations of facilities and capabilities play against the limitations of forecast and commitment, the customer and operations sides return to their opposing corners.

Perhaps this is why in Deloitte’s research on digital loyalty networks, only 13 percent of leading companies reported having any consistent linkage between the customer-facing and operations-focused parts of their organizations. Fewer still reported having a high degree of linkage. In fact, most just clear the minimal hurdle defining customer-facing/operations-focused collaboration. Nonetheless, the few companies that are in this segment produce better results across every important success measurement than the other 87 percent.¹

There are many reasons cited for this inability of the two sides to get together. Most of the problems center on technology, process, or existing barriers to collaboration. The reality is that working together doesn’t come naturally to the customer-facing and operations-focused organizations. They are used to taking parochial positions. After all, they have a lifetime history of separate, unrelated measures and information. Both sides have a list of “absolutes” that translates to incompatible directions, unrelated measures, differentiated organizations, different personalities, and unaligned objectives. And because operations and marketing only link at the highest organizational levels, there is rarely a shared budget keyed on producing a shared result, even on a minor project.

The solution to this problem, however, is right in front of us. Think of your largest customer. What happens when they ask for a special favor? They’re given special consideration. Although the request may be awkward or problematic, it’s not good to let the relationship down. Somehow the customer-facing people pick up the problem on their radar screen. Somehow, everyone finds a way to straighten things out. Somehow, because of the importance of the relationship, the operations-focused activities are refocused to make the problem go away. Could a company afford to do this all the time, for every customer? Most assuredly not. But under the right circumstances, the two sides do come together to solve the tough problems. They know that with limited resources, their strategy must be focused where it can most affect bottom-line contribution.

Why do Procter & Gamble and Wal-Mart work so well together? Because they can’t afford not to; they are just too important to each other. Why does Dell consistently outperform the competition? Because its operations people treat customers with special, appropriate focus. That doesn’t mean that all customers are treated equally, but every customer is treated according to its economic importance to Dell. Notably, these companies are among the very few that have successfully balanced the customer-facing and operations-focused organizations.

A Structure for Understanding

Virtually every company measures sales and at least informally ranks them from largest to smallest, according to customer or SKU. This analysis may or may not be structured. But even at an intuitive level, the most important customers are broadly known throughout the organization. Exhibits 1 and 2 show the typical cumulative sales charts of a consumer products manufacturer. It is immediately clear that a very small proportion of products or customers contribute a very large proportion of revenues. The typical: “Twenty percent of the customers give us 80 percent of our sales” or “20 percent of our SKUs give us

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¹ The source of the quote is not provided in the text.
80 percent of our sales” applies to virtually every company.

Formally ranking demand by sales and SKUs helps management determine where to focus its efforts. Rarely will any executive, salesperson, or production supervisor do anything to disrupt the relationship with a large customer or do anything to jeopardize the availability of a primary product. Supply chain people respond in a similar attentive manner when it comes to frequently purchased raw materials, high volume assemblies, and the highest volume production parts.

What’s needed is a structure for integrating the two perspectives. To stockholders, senior management, and the investment community, it is direct contribution—that is, profitability—that defines a company’s success. And only by looking at the combination of operating costs and sales volume can you come up with the true contribution measure. The problem is that most organizations can’t do this; they are set up to view operating costs and sales separately.

By simply understanding costs and revenues and assigning them properly, any organization can use currently available information to bring together the divergent focuses of revenue and cost. Companies can develop effective measures by first building and then executing a simple, accurate cost model (perhaps based on activity-based costing); then ranking customers and SKUs by their contribution; and finally building a cumulative distribution chart for each. In this way, companies can focus their strategy where it most affects total contribution—in other words, build a contribution focus strategy.

When viewed from this perspective, the insights can be quite astounding, as shown in Exhibits 3 and 4. In most cases, an extremely small group of customers, often as few as two or three, account for an exceptionally high proportion of profitability—generally 30 percent to 50 percent. These high-contribution customers (shown as group A in Exhibit 3) are your franchise players. Adding one more will probably make your numbers for the next two years, whereas losing one is tantamount to disaster. These customers are so important that they each should be considered a market segment in and of themselves, receiving the focus and attention such segments should warrant. Service to them must be perfect (not 99 percent most of the time but 100 percent every time).

The next group of customers (signified as B in the exhibit) is very significant, though as a group they generally contribute relatively less to profitability than the A players. There are too many B customers to manage each one individually. The Bs do, however, warrant significant attention, and they should be clustered according to their service needs. Special care should be taken to identify which of the B customers could potentially become A customers, and special actions should be taken to assure their satisfaction. Service levels to all B customers should be virtually perfect, as defined by the customers’ own criteria for that term.

The next category, C customers, can be characterized as “nice to have.” Typically, this represents a large group of customers, each of which contributes slightly to profitability. Although they should be serviced, the Cs should never be allowed to borrow resources that can be used for the A or B customers.

The final group, the D customers, produce losses. At many companies, Ds account for a combined loss of 20 to 50 percent. The obvious question is, “Why should we serve them at all?” And the most common responses are, “Some day they will be a big customer” or “They once were one of our major customers, and we are trying to rebuild the relationship.” In fact, there may be reasonable explanations for keeping loss-generating customers, but none of these reasons is valid for the long term. Customers in this category should be managed
on a transaction basis, with only profitable transactions allowed. In cases where losses are being accepted intentionally to establish a relationship, those losses should be measured and controlled against a budget. When those budget limits are hit, the customer should be moved to a transaction-based status.

When SKUs are analyzed, the results prove similar to the customer analysis. Products typically fall into the four categories shown in Exhibit 4 (identified in the exhibit as 1, 2, 3, and 4 to differentiate them from the categories used for customers). As with the customer categories, management needs to focus its attention on the higher-profit products in categories 1 and 2, while taking appropriate actions to minimize the profit-draining items in the other categories.

Living with the Process

It’s clear from the contribution analysis that not every customer or every SKU should receive the same level of service. The A customers, regardless of their SKU mix, require impeccable service. Similarly, there can be no justification for making any product in the 4 (loss) category available to a D (loss-producing) customer. (Although when that D customer wants to buy a 1 item, that sale is certainly worth considering.)

This process of cross-referencing customer and SKU profitability provides the most important insight, and finally drives customer-facing and operations-focused activities toward identical results. Consider the matrix in Exhibit 5, which provides 16 categories of response and activity, based on the cross-reference between customer and SKU profitability. Note that appropriate actions vary from “perfection” in the upper left cell to “cull” in the lower right. Certain categories are likely to be painful to the operations side, such as having to “tough it out” for unprofitable items being sold to A customers. The fact is that dealing with the D-customer line or the 4-SKU column will offer challenges. But keep in mind that they both represent a surprisingly small proportion of sales and contribution.

Of primary interest is the sweet spot of categories in the top left-hand quadrant (A-1, A-2, B-1, and B-2). Low-cost, perfect response capabilities can deliver astonishing results in these high-criticality, high-profit-contribution cells. In many companies, these four key cells account for the lion’s share of sales (50 to 75 percent) and generally close to 100 percent of total profits.

Historically, the customer-facing people focused on the top left of this matrix, and the operations-focused staff were concerned with the bottom row and far right column. This naturally led to the dichotomy of sales worrying about volume and operations worrying about cost.

In the new paradigm, both sides base their decisions on the full customer and product array displayed within this matrix, which is based on a realistic and rigorous costing analysis. In each cell, it is easy to identify the specific products and customers being addressed, their revenues, and their profit contribution (or loss). In a direct and unbiased way, this matrix supports shared, relational actions, and provides exact measurement of their effect on profitability and revenue. The sidebar on page 68 describes the appropriate actions for each cell of the matrix.

Both the customer-facing and operations-focused organizations need to understand the importance to the company of continually moving from the bottom right toward the top left in Exhibit 5. Many separate activities—in both customer-facing and operations-focused communities—can help move companies in the right direction. Some proven techniques include:

- Improved linkage to customers as a way of better understanding their needs, challenges, values, and leverage points.
- Better integration of market intelligence to know where to focus service efforts and to sense demand changes much earlier.
- Improved scheduling to provide greater availability and better promises.
- Lean manufacturing to reduce cycle time and develop greater flexibility.
- Outsourcing selected activities to partners with lower cost models.
- Reducing overhead costs so that all SKUs and customers become more profitable.
- Staggered sales incentive cycles to maintain more even demand and, consequently, to support more level production.

Making it Work

The customer/product mix matrix has worked well in every client application we have undertaken. One specific example will demonstrate the effectiveness. A food products manufacturer conducted a four-week activity-based-costing analysis of its customer and product mix as part of an initiative to enhance its contribution strategy. Exhibits 6 and 7 show the company’s cumulative customer and SKU patterns, respectively. Note that 20 percent of the company’s customers (the As and Bs) accounted for 100 percent of its profits. The next 40 percent increased that profit number to approximately 115
percent of final profitability. The remaining 40 percent—the D customers—lost that 15 percent.

The SKU analysis revealed a similar pattern. Specifically, 24 percent of SKUs (the Category 1 and 2 products in Exhibit 7) accounted for 100 percent of the profit. Adding in the Category 3 products took that profit figure up to 115 percent.

When the customer and product information was cross-referenced, a fascinating relationship emerged, as shown in Exhibit 8. The top four categories (A-1, A-2, B-1, and B-2) accounted for 67 percent of revenues and 98 percent of profits.

Analysis of the cross-referenced relationships revealed some additional important findings, including:

- The highest volume customers all were profitable.
- A high-volume customer that dropped the company as a supplier because it would not lower its prices would have produced a loss had the relationship continued.
- Certain “marginal” distributors, previously thought to be unprofitable, were in fact profitable.
- Certain categories of customers, especially those more geographically distant and highly specialized, produced losses.
- A few loss customers (such as the R&D facility of a major, high-profit customer) were warranted and

### Understanding the Customer/Product Matrix

Each of the 16 cells in the matrix is identified by a letter and a number, which represent the relative profitability of the customers being served (A-D) and of the products being purchased (1-4). The highest-profit customers buying the highest-volume products are categorized into cell A-1. At the other end, the lowest-profit customers buying the lowest-volume products fall into D-4. Here are suggested approaches for each of the cells in the customer/product matrix.

#### “A” Customers: Never miss

- **A-1.** Perfection should rule in this highest profit and highest volume category. Never delay a shipment, never fail to respond to a request, never generate a back order, nor give even a second thought to the immediate availability and support of the customer order. Products in this category should be made continuously.

- **A-2.** These products should be considered a priority and must be regularly scheduled so that they are always available to this customer group.

- **A-3.** These marginally profitable products should always be available to important customers in this category but filled through reserved capacity or inventory.

- **A-4.** For these loss-producing products, it’s best to “tough it out” for the best customers. An alternative to carrying the inventory yourself would be to use an outside source to guarantee product availability.

#### “B” Customers: Deliver as promised

- **B-1.** For the important customers in this category, always deliver the high-profit products as promised. Production of these products must be high enough to avoid any chance of shortages. Availability is a top priority.

- **B-2.** Products for customers in this category should be produced on a regular schedule so that availability is predictable and delivery reliability is high.

- **B-3.** These more marginal products still turn a profit for this group of profitable customers. Thus, it’s important to schedule capacity or maintain sufficient inventory to satisfy customers, almost always within the timeframes they require.

- **B-4.** To the extent possible, these customers should be directed toward alternative sources for these profit-draining products. If that’s not feasible, consider outsourcing these products to satisfy customer needs.

- **C-1.** To the extent possible, these items should be made available to customers in this category if they are scheduled and available.

- **C-2.** If available, orders in this category should be regularly filled and made available to these customers. If excess capacity is idle, these orders should be scheduled or filled—if they are priced profitably.

- **C-3.** In cases where inventory is promised and available or if excess capacity exists, these orders should be scheduled or filled. But again, they must be priced profitably.

- **C-4.** For the most part, these orders should be refused. The only exception would be instances where sufficient inventory happens to be available and uncommitted, and the transaction is profitable.

- **D-1.** If a particular order in this category can be filled from available, uncommitted inventory, then it should be done—provided that the individual transaction is profitable.

- **D-2.** On a transaction basis, if the customer contributes profit and if no conflict exists with any other inventory requirement, then the order should be accepted.

- **D-3.** Rarely should an order in this category be processed. Only in those few exceptions where inventory happens to be available and there is absolutely no other use for that inventory, should the order be filled.

- **D-4.** Products in this category for these customers should be culled. There is no reason whatsoever to offer money-losing products to money-losing customers.
should be retained.

Operational improvements, focused in one or two small and easy-to-improve areas, could yield huge benefits for key service-sensitive relationships.

Because of his involvement in both customer-facing and operations-focused activities, the supply chain manager was well positioned to positively affect contribution strategy—and the matrix gave him the tools to do so successfully.

Initially, by simply dropping unprofitable offerings to loss customers, the company was able to increase its profits significantly—at no cost. Further, by identifying the cells that adversely affect profitability, management was better able to focus its attention on those customers and products that had the highest profit potential. With such unbiased focus and an exceptionally small investment, profits increased dramatically—in terms of both control and sales growth. This balance is the essence of the contribution focus strategy.

Dealing with Exceptions

Although the customer/product matrix methodology has broad application, some important exceptions need to be considered. First, when a new product or new customer is introduced, adequate history may not be available or volumes may be insufficient to truly represent reality in a costing model. In such cases, volume and cost estimates should be applied and the resulting matrix can be used as a planning tool. As actual results begin to be measured, great discipline is needed to assure that assumptions were correct and that events are consistent with assumptions. If incorrect, actions should be taken immediately to respond according to the action recommended in the matrix.

Second, where there is significant fixed-cost coverage, which may be adjusted through the re-allocation of SKUs or customers, it’s important to understand how rapidly capacity can be removed or added. This is especially critical with seasonal or fashion items or in high-capital manufacturing.

Third, where customers or products have linkages to others, they should be analyzed individually and then clustered to determine the effects on profitability under both scenarios.

Even with these few exceptions, though, the contribution focus strategy process is surprisingly simple to use. Applying appropriate costing techniques can capture the right costs and enhance customer and SKU profitability in a short period of time—even with less-than-thorough and well-developed information. In fact, even a simplified, rough profitability analysis can provide immense one-time directional value. Most importantly, the process is unemotional. It is separate from the traditional power silos of a company and focuses everyone on joint results. In short, it’s a perfect vehicle for finally integrating the customer-facing and operations-focused sides of the company.

Footnotes