



Increasing Profitability With the Whale Curve

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A journey is completed in thousands of small steps. Similarly, your business's annual profit is generated from the profitability of each of your individual customers. To increase your overall profits, you need to increase the profitability of your customers.

In some of his recent work, the Harvard Business School professor Robert Kaplan discovered an interesting dynamic that exists when you analyze profitability at the customer level. Understanding what Kaplan has termed "the whale curve of profitability" can help you develop strategies for maximizing customer profitability, which in turn will increase the overall profitability of your business.

Understanding the Whale Curve

To determine customer profitability, you need three data points: (1) the revenue generated by each customer, (2) the cost of goods sold to each customer, and (3) your service cost.

Service cost is an interesting metric that is worth tracking for other reasons. You can develop complicated formulas to determine it, but for our purposes here a simple approach will serve. Divide your annual overhead cost by the number of customers who walk through your door each year. If you have \$100,000 in overhead and 8,000 customer visits each year, your service cost is \$12.50 per customer visit.

To calculate the profitability of any one customer, total the customer's sales and then subtract the cost of goods sold and the service cost. Let's say one of your steady customers comes into the store once a

month and purchases \$150 of goods on each visit. During the year that customer generates \$750 in profit (\$1,800 in sales, less \$900 in cost of goods, less \$150 in service cost for those 12 visits).

Knowing your shop's total annual profit, you can calculate the percentage of your profit generated by this customer. If you showed a profit of \$25,000, this hypothetical customer accounted for 3 percent of your annual profit.

Kaplan demonstrated that if you calculate profitability for all of your customers, determine the percentage of your profit that each customer is responsible for, sort the customers from most to least profitable, and then graph the results, the resulting graph will always be curved in a specific shape. He called it a "whale curve" because it looks like a breaching whale's head. The curve rises sharply from the left, levels off in a plateau in the middle, and then falls at the right to end at 100 percent—your profit for that year.

Segmenting Customers

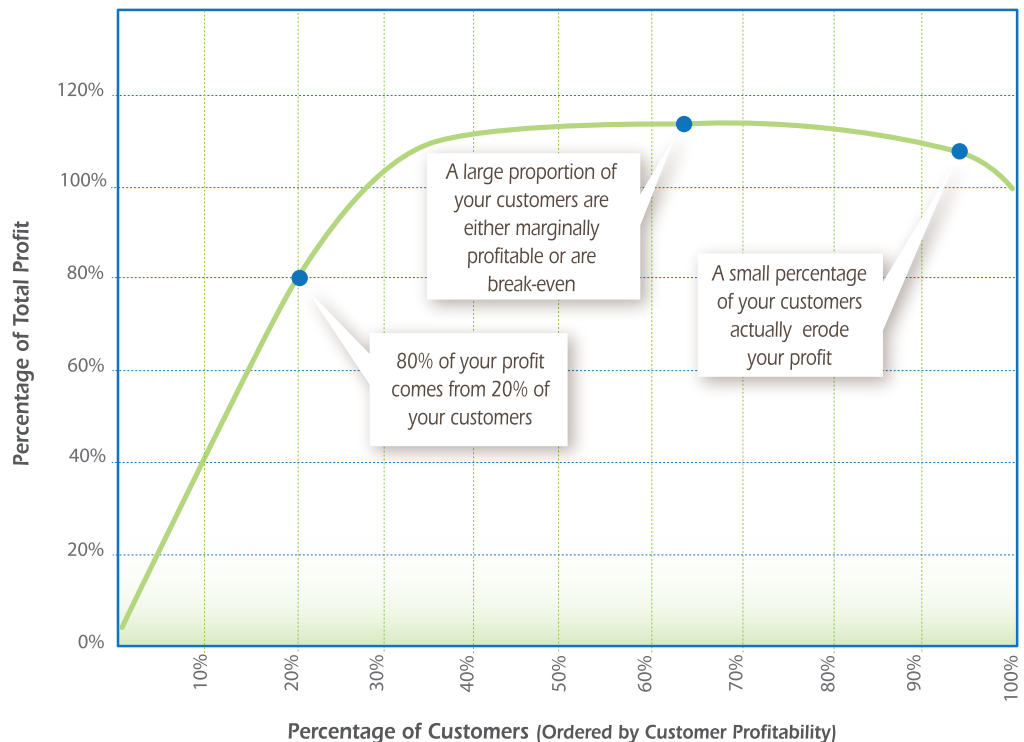
When you see this chart drawn, you'll notice that it's possible to segment your customers into three groups based on their profitability to your business, as follows:

- 1. **Profitable customers.** This subset of your customer base accounts for more than 100 percent of your annual profit. When you look at whale curves generated by different businesses in different industries, there's an interesting

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The Whale Curve of Profitability

Increase Your Profits by Determining Which Segment Your Customers Fall Into



$$\text{Customer Profitability} = [\text{Customer Revenue}] - [(\text{Customer Cost of Goods Sold}) + ((\text{Total Overhead}) \div [\text{Number of Customers}])]$$

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similarity that occurs. Although the curves are all different, almost universally 80 percent of a business's profit is generated by the most profitable 20 percent of its customers. You know these people. They are your biggest and best customers.

- 2. Break-even customers.** These customers fall into the long plateau in the middle of the chart. Some of these customers are marginally profitable, some are truly break-even, and others are marginally unprofitable. Taken together, these customers do not generate profit for your business. Their purchases cover their service costs, but that's it.
- 3. Unprofitable customers.** The right side of the curve tails down to end at 100 percent. These are the customers that cost you money to serve. Their presence in your shop erodes your overall profitability. Chances are you know these people. They are the needy customers who enter the store frequently, taking inordinate amounts of your staff's time but never purchasing at a level that compensates you for what you invest in serving them.

Profitability Strategies for Each Segment

When you see the profitability of your customer base charted this way, you can see that there are three ways to change the shape of the curve to bring your total profitability up.

1. Steepen the slope on the left by focusing on your most profitable customers.
2. Shorten the width of the plateau in the middle by turning your break-even customers into profitable ones.
3. Lop off the tail at the right by pruning away the unprofitable customers.

Changing the shape of the curve requires the use of different strategies for the customers in each segment. Let's look at each strategy.

Profitable customers. Increasing profitability with customers in this part of the curve will push the left side of the curve higher, bringing up the rest of the curve along with it.

To do so, think about ways of increasing "wallet share." A little improvement here can make a large difference. I once worked with a client whose top customer provided 18 percent of his annual profit. We determined that if the client was able to gain just 10 percent more business from this customer, overall profitability would increase by about 2 percent.

To increase wallet share, find out if you are your top customers' sole supplier or if they are spreading their business around. If they are, consider developing a customer loyalty program that provides your top customers with rewards for doing more business with you. Also determine what these customers are buying most often and expand your selection of goods in those categories. This provides them with more opportunity to purchase the products they like from you.

Break-even customers. These customers are likely to be price-sensitive. They'll purchase *fabric* from you—because they like to see the colors and feel the hand, and they value

the support you provide—but if they see an interesting book in your shop, they won't buy it from you. Instead, they'll head home to purchase it at a discount online.

To increase your profitability with these customers, you'll need to work around their price sensitivity to find new ways of getting them to open their wallet.

Loss leaders work well with this group. Give these customers a one-time 50 percent discount on a book or pattern that you know will interest them. If they take the offer, they'll probably purchase the fabric from you to make the project. You can also offer a deeply discounted item to introduce them to a new product category or brand that they don't currently buy from you. And then be sure you have adequate stock in that category for when they come back to make their next purchase at full price.

With these customers, you can also use bundled pricing. A kit is a good example of bundling. This hides the price of individual items and focuses the customer's attention on the finished project rather than the price of the components.

Another idea is to do something that only your shop can do: Sell experiences instead of products. Develop new or innovative classes or sewing excursions to offer, and then bundle products into the price of the experience you're offering. Often customers who would not pay full price for a product will pay a premium for an experience if they get a product along with it.

Unprofitable customers. These customers are damaging to your business. They are, after all, costing you money every time they enter your store. You have two options with customers in this group: Either you can turn them profitable, or you can "fire" them.

Deploying the strategies for break-even customers may help turn some of these customers profitable. But you'll still have a few laggards who are a drag on your business.

There are no two ways around how to deal with these customers. You need to have the difficult discussion with them. When you do, it's best to be frank. Let them know that you are operating a business, not a sewing support center or a social club. While your business does provide support, service, and community for sewers in your area, it needs to generate revenue by selling products and services.

To continue taking advantage of the services your shop provides, the customer will need to begin supporting the business. If the customer isn't able or willing to do so, be clear that there are other places the person can go. Recommend a sewing forum on the Internet, a sewing guild that meets somewhere other than your shop, or another store. Make it clear you'll be happy to have them back when they're ready to make purchases from you. But in the meantime they'll need to find their camaraderie and support elsewhere. It may not be pleasurable to hold these discussions, but once you have done so, you'll be glad you did.

As you can see, a one-size-fits-all strategy doesn't work for increasing profitability customer by customer. By identifying where on the whale curve your customers sit and taking the right steps to increase their profitability, your business will see results.

