

Maximising Profit from Customers, Products and Channels Through “Cost to Serve” Analysis

Read on to find out how targeted Cost to Serve analysis can help you rapidly improve your top-line and bottom-line results.

- Cost to Serve analysis involves building a detailed understanding of a business's costs and profitability by allocating variable and fixed costs to customers, products and channels based on identified cost drivers and activities
- Cost drivers and activities are identified by reviewing the underlying operational activities which are not typically allocated in management or financial accounts
- Cost to Serve is used as a tool to improve profitability by identifying efficiency initiatives to improve margins of key customers, products and channels. Examples of such initiatives can include changing service levels, increasing delivery charges, exiting products and even terminating customers where the analysis shows a destruction of value by those customers (i.e. high cost to serve with no potential remediation actions)
- Through Cost to Serve analysis the direction of the sales effort can also be given much sharper focus once the characteristics of higher profit customers are known, increasing the ability of the business to retain these critical customers

Many businesses are unable to quantify who their value creating and destroying customers, products and channels are. In fact, in a recent survey (conducted by Portland Group in association with the Australian School of Business and the Australasian Production and Inventory Control Society), over half the organisations surveyed did not use Cost to Serve models, implying a significant opportunity exists in these organisations to apply this approach to the management of their cost base.

Answering the following key questions will be a first step in enabling businesses to better understand and rapidly transform their financial performance.

1. Customers & Sales:

- Are we making sales that are destroying profit – negative or low gross margin sales which could be avoided?
- Which customers create and destroy economic value? What measures can we take to rectify this situation?

2. Products:

- Which products are responsible for 80% of our profits? Which products are destroying value?
- What actions can we take to improve profitability or stem losses resulting from value destroying products?

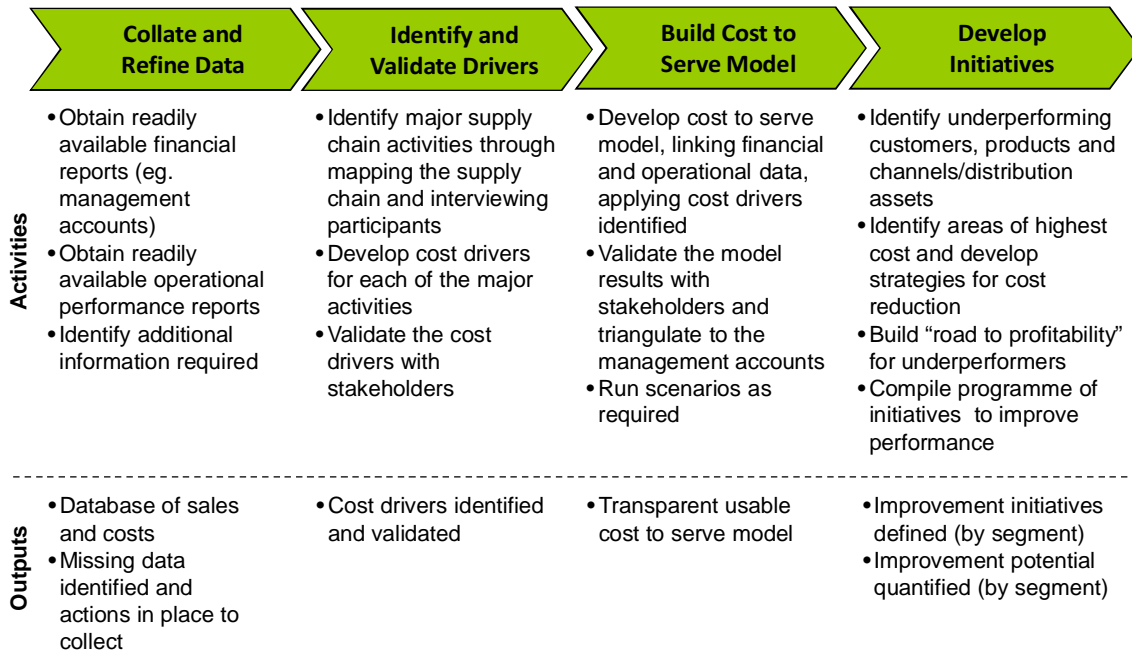
3. Manufacturing & Supply Chain:

- Are all manufacturing plants generating positive profits and return on capital?
- What are the optimal distribution channels and are all distribution assets being adequately utilised? What are the key drivers of cost in the distribution network?



Cost to Serve Major Steps

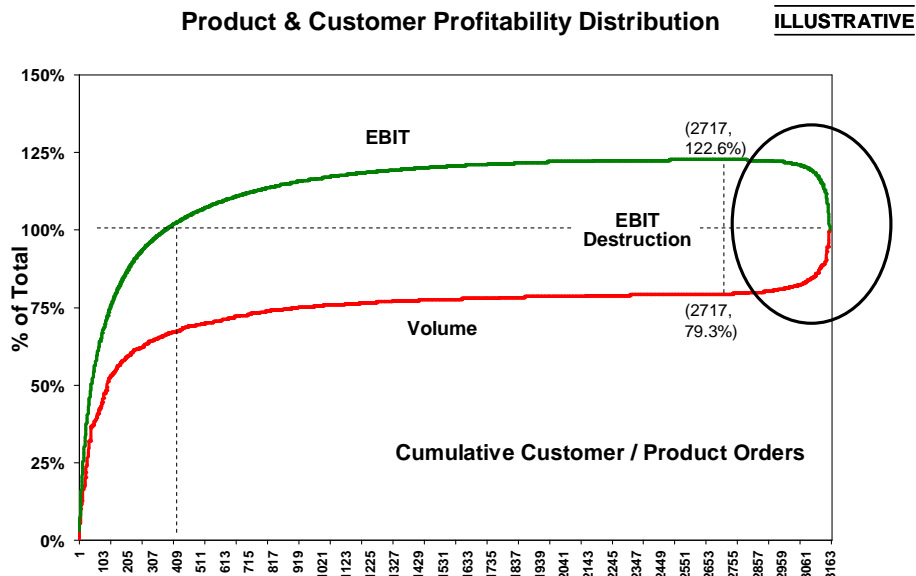
There are 4 major steps in conducting a Cost to Serve analysis, these are outlined below.



The output of Cost to Serve analysis always presents opportunities for effective and fact-based profit improvement and cost reduction. The following are a few examples of how some of the output from the analysis can be put to use in your business.

1. Ensure that all of your sales and customers are profitable

Once you have a true picture of fully allocated customer and / or order profitability, it is a relatively straightforward proposition to create a view of cumulative profitability by customer. Most organisations have a 'whale' shaped customer profitability distribution, similar to the illustrative diagram below.

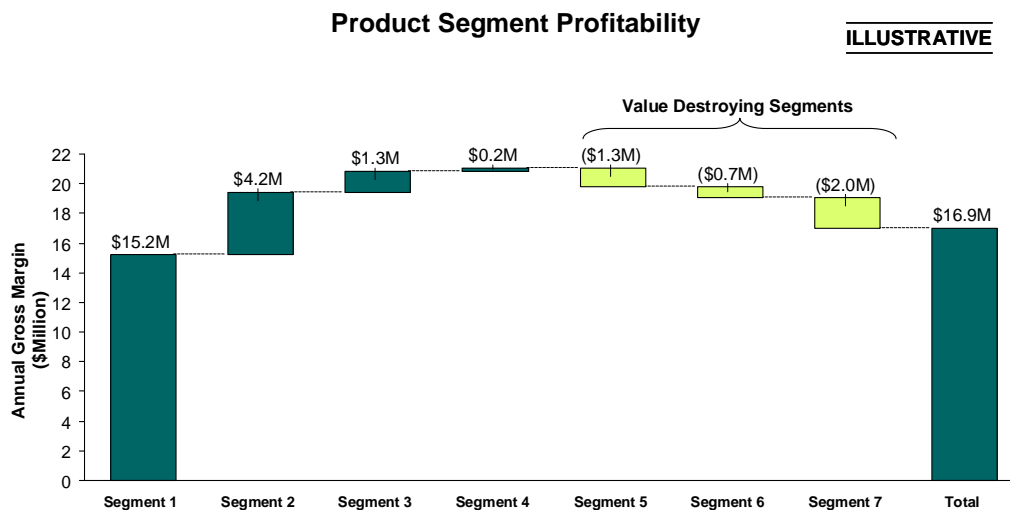


Value destroying customer analysis allows you to highlight those sales that destroy overall profitability (as shown in the circled area on the above diagram). Once identified, initiatives can then be taken to bring these customers back to at least value-neutrality, including pricing, operational and service-level initiatives. Service levels can be adjusted in line with what customers are willing to pay for, increased or specific charges can be applied for differentiated service levels and delivery charges can be increased in line with your current costs. In some cases, ending the customer relationship may be warranted where there are no means to remediate the value destruction.

At the very least, the analysis provides the facts and an objective basis for the necessary internal and customer-facing discussions to begin the process to address the issues.

2. Strengthen your product and service offerings

As in the case of customer profitability analysis, similar profitability analysis applied to your organisation's products, segments or channels will often provide equally important opportunities. Product profitability analysis provides an objective view of the true high-margin as well as value destroying products for immediate attention. Applied more broadly, the analysis can provide a view as to whether entire segments are unprofitable, as shown in this example.

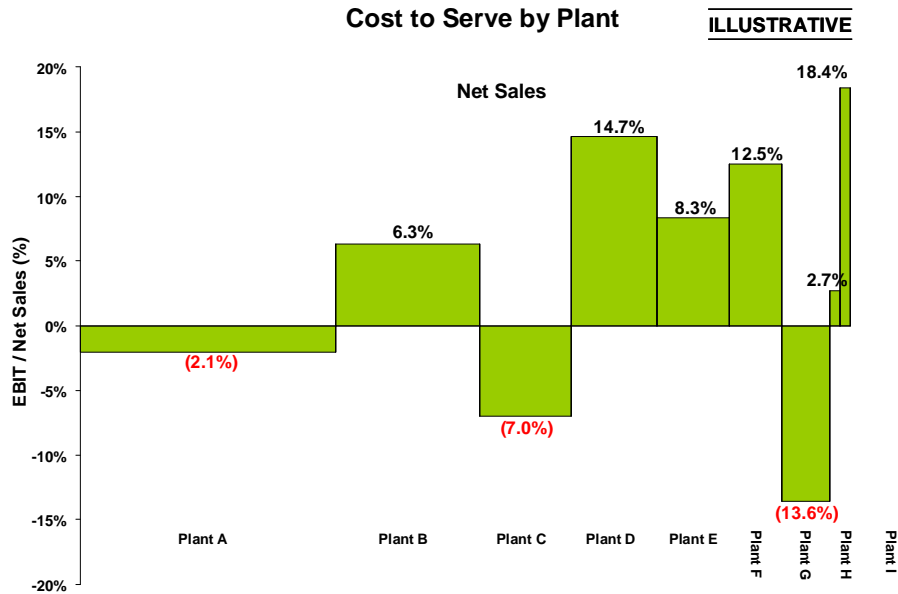


For unprofitable products, a variety of levers are available, including more appropriate pricing, alignment of product investment and R&D with higher margin products, product portfolio or lifecycle analysis as well as specific initiatives for manufacturing or sourcing cost reduction.

In the case of unprofitable segments, closer examination of the factors driving the unprofitability is usually warranted, leading to segment-wide opportunities for action, such as SKU rationalisation, price increases or creation of alternate or lower-cost delivery methods. While questions of retaining or exiting a segment should not be avoided, in our experience there are usually a number of available operational levers available that have not been used that can have a dramatic impact on overall segment or channel profitability.

3. Optimise your supply chain

Given the relatively high cost proportion for sourcing, manufacturing and supply chain for most organisations (and certainly for all product-focused companies), this is often an area for high leverage in addressing Cost to Serve imbalances. The situation with respect to manufacturing and plant profitability is often no different than that found in analysis of customer, product or channel profitability, along the lines of the following example.



A number of levers exist to improve manufacturing and supply chain profitability, here are two of the options to consider:

- 1. Assess manufacturing plant and production network efficiencies.** Significant opportunities for further improvement typically exist in two areas, which will become an increasingly important area of scrutiny in times of softening demand. First, in improving the efficiency and operating effectiveness of standalone plants and assets. Second, through improving manufacturing network-wide production efficiencies; the increased cost visibility provided by Cost to Serve analysis facilitates decisions on product-to-plant allocation towards those assets with true lower-cost production capability.
- 2. Optimise distribution and transportation network.** Taking a holistic and rigorous view of your distribution and transportation network (including size and location of distribution centres, product flowpaths and the nature, means and modes of transportation used) typically leads to significant improvement opportunities. Cost to Serve analysis will provide detailed perspectives on actual freight costs (by region, channel, customer and supplier) enabling actions to be taken in the procurement and management of your freight spend and customer recovery; for example the analysis will allow for more accurate freight cost recovery or improved cost to service level alignment. Expect savings opportunities to range from 10 to 20% (and more) of your transportation and distribution cost base depending on extent, scope and approach of a review.

What should you do now?

Use your existing profitability metrics to identify negative gross margin sales and extreme value destroying customers and products and review the case for profit improvement through rationalisation or pricing adjustment. If you have performed a Cost to Serve analysis in the past, changes to your business and the broader environment over time may necessitate a review and updating of the past analysis to make it more pertinent to today's business environment.

Also consider conducting a more thorough Cost to Serve review, particularly if your current financial reporting and systems do not provide the level of granularity or accurately allocated full cost views of your business (taking into account key cost drivers to activity level) to provide you with the necessary facts, data and objective basis to further improve the profitability of your business in the current economic environment.



This article is the first in a series providing topical insights from Portland Group on reducing costs through a focus on supply chain and procurement improvement.

Further information on Cost to Serve or any of our service offerings can be found at www.portlandgroup.com or by contacting one of the follow individuals:

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The Portland Group / Australian School of Business / Australasian Production and Inventory Control Society Supply Chain Survey White Paper referenced above can be found at www.PortlandGroup.com/Supply Chain Survey