Understanding Profitability through Cost-to-Serve…

Cost to Serve is fundamental to being truly profitable, says Jeremy Howcroft* – and in today's business climate, it may also determine whether you sink or swim

Let's start with a couple of examples – and see if they sound familiar… Your company has a range of valued customers, but interacts with them all quite differently. Some customers fax you orders once a day; others require outbound calls to capture their orders every second week. Some place large orders; others place small orders more regularly. All of your customers behave differently and all of them are thought of as "valuable". Some, though, may be more valuable than others – and some may not be valuable at all…

Which customers and products make you money?

Suppliers commonly report sales and gross margin by key customers accounts, few accurately report channel or customer group profitability after the cost of servicing customers has been taken into account. Attempts to report profitability at this level are often misguided and involve spreading servicing costs such as fields sales, warehousing and distribution on a fairly arbitrary basis such as sales value or as an average cost. The result is an inaccurate and distorted picture with low cost to serve customers subsidising high cost to serve customers (consider the order assembled in Figure 1). Product category variation can further distort the profitability of customer groups, for example, some product categories may be physically heavier than others attracting higher freight charges, some may need specific in-store attention from territory managers whereas others are relatively 'hands-free'. The different tasks or effort required for various customers and products affects their overall profitability.

Figure 1: The customer order illustrated has cost to serve implications for order picking and freight, not to mention pallet hire.

Unsure of the cost of serving customers?

How well does your company understand cost to serve? The following are some indicators that cost to serve knowledge is limited within your company:

- Low volume products with equivalent margins to high volume products are thought of as equally profitable.
- Operation managers frequently complain to sales about small unit based orders.
- Sales staff celebrate large orders of heavily discounted low margin product.
- A significant proportions of deliveries incur minimum freight charges from your transport provider.
- Sales are increasing but profitability is static or declining.
- Management KPIs do not include, Customer product mix or Customer average order size.

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- Trading terms do not provide incentives for customers to behave in an efficient manner (eg, discount for full truck loads).
- Ullage agreements are not based on the actual cost savings of having to issue credits in the field and process them at head office.
- Compared with competitors, you are the only supplier in a category delivering direct-to-store.
- When outsourcing warehouse operations comparison of internal costs versus suppliers activity based rates is difficult.
- Profitability of a customer group is only reported at a gross margin level.
- Profitability of a product group is only reported at a gross margin level.
- Uncertainty of which products are most profitable to which customers.

Collaboration results in win-win-win

By understanding the cost of servicing customers action can be taken to reduce costs (where inefficiencies are found) and to improve profitability. Corrective action requires working with, not against, retailers. Often inefficient servicing behaviour will drive costs for both supplier and retailer alike. Consider the handling of very small top up orders, the supplier incurs minimum freight charges while the retailer's distribution centre incurs receiving and putaway diseconomies and more than likely increased congestion. Cost-based or volumetric trading terms offer financial incentive to retailers to behave efficiently - they make visible the steps in the supply chain which enables effective decision making by the retailer enabling lower cost to shelf, a 'win' that can be shared with the consumer.

One company demonstrated through the activity based costing of their customer services processes an example of the 80:20 rule – 20% of their customer orders were faxes and these were responsible for nearly 80% of their transaction processing costs. Furthermore these 20% were generating less than 10% of their total sales. This insight allowed the account manager to actively discuss the situation with the retailer and with an almost zero cost fix, reduced the effort (and therefore cost) of handling future small orders from those customers.

Collaboration is good but some solutions lie in-house

Engaging retailers is not always necessary to achieve improvements, change is almost certainly quicker if an in-house initiative can be undertaken. Re-aligning service infrastructure to match customer behaviour can be an important first step. Can couriers be used for small orders of dry goods? Can outbound telesales be used to capture orders instead of visits by territory managers to some customers?

A common insight revealed by completing a cost to serve study is an assessment of how well suited your freight rates are with your customers order profiles. Ultimately the only way to know that your freight rates are working for you, not against you, is to do the hard detailed analysis. It is not unusual to see companies with greater than 30% of their consignments shipped at the minimum freight charge. Often the separate placement of different category orders along with trading terms that do little to incentivise large orders are the cause of this sort of inefficiency.

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Cost to Serve is about understanding the drivers of customer and product profitability

Cost to Serve is often seen as a narrow exercise focusing only on the supply chain. It is actually a wider view of the drivers of profitability across the whole organisation. Figure 2 illustrates the 'interconnectedness' of discount structure, product and customer mix and customer ordering behaviour. No one element alone explains profitability, but depending on the mix of products and customers and the service strategy a company chooses to adopt, the cogent drivers of profitability can be identified.

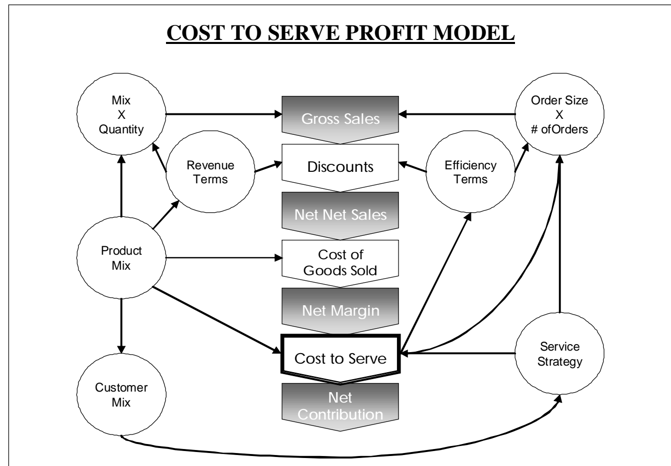

Figure 2 The Cost to Serve Profit Model.

Determining Cost to Serve

Reporting the cost of servicing customers requires a detailed analysis that traverses the supply chain from the point that finished goods are available for supply, through the capture of orders from retailers, to the delivery of the product. The breadth of the analysis required can be quite daunting for some suppliers but insights gained and resulting savings identified almost always outweigh the required effort.

The outputs from understanding cost to serve are far reaching and necessary for the ongoing reporting of true customer profitability as well as crucial for more strategic orientated initiatives or one-off decisions. Cost to serve knowledge is essential when tendering a freight contract (ensuring pricing structure is aligned with you and your customers' behaviour profiles), establishing cost-based trading terms (what volume discounts reflect your transport savings? What does it cost you to process ullage credits in the field? etc).

Why is cost to serve a key issue?

Cost to Serve is a fundamental for running a better, more profitable and more efficient business - and in a business climate like today's, where manufacturers, suppliers and retailers are all faced with fast-changing markets and huge technological change, it is acquiring crucial importance. Not convinced? Think for instance about Woolworths' pursuit of best of best trading arrangements with trans-Tasman suppliers and its website statement that suppliers should "assess the benefits and costs of doing business with Woolworths before entering into any trading arrangement."
Or consider Foodstuffs' recent announcements requesting cost-based and volumetric trading terms that will allow it to pass on supply chain efficiency savings directly to the shelf price. That's why Cost to Serve is a key issue for everybody in FMCG - and one that you ignore at your peril.

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