Unprofitable Customer Relationships: The Suppliers' Perspective

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Abstract

In relationship marketing, customers are viewed as the main source of value to a supplying firm. But customers are not equally contributing value for the supplier; some even create financial losses. Suppliers therefore need to handle unprofitable customer relationships which might even need to be dissolved. This issue is also neglected in relationship marketing that has focused on customer orientation, satisfaction, and bonding as its main tasks. Based on an exploratory study in a business-to-business-setting, the supplier's challenging task of integrating relationship marketing and unprofitable customer relationships is investigated.

1. Introduction

For nearly twenty years, Berry's (1983) definition of relationship marketing as the task of "attracting, maintaining and [...] enhancing customer relationships" has dominated research and practical management. It has led to major interest in building and retaining strong and long-term relationships with customers. More than a decade later, Grönroos (1994) mentions a new aspect of relationship marketing. He states that "relationship marketing is to identify and establish, maintain and enhance and when necessary also to terminate relationships with customers and other stakeholders, at a profit, so that the objectives of all parties are met, and that this is done by mutual exchange and fulfillment of promises". Profitability measures can be used by the customer and the supplier to evaluate the state of a relationship. The broad discussion of

'customer value' (e.g. Anderson and Narus 1998; Eggert and Ulaga 2002) has focused one interaction partner; the supplier's viewpoint has been rather neglected. But obviously, there might be cases when the supplier's aims are not fulfilled and the loss of a customer is more efficient than keeping him (Alajoutsijärvi, Möller and Tähtinen 2000).

Practitioners' interest in profitability measures for customer relationships shows the need for handling systems which enable suppliers to invest in the 'right' customers which is vital during economic downturns (Blattberg and Deighton 1996). Taking this view of relationship marketing, dissolving customer relationships is added to the tasks of relationship marketers. Until now, analyses of supplier-initiated dissolutions have remained rare, though.

A theory-based reason for this neglect might be seen in the general acceptance of the powerful and widely recognized exchange theory calculus (Emerson 1962; Thibaut and Kelley 1959). The concept does offer relationship break-up as a rational solution but leaves unexplained the underlying processes (Dwyer, Schurr and Oh 1987). Recently, relationship dissolution has become a topic of interest though – also within the IMP group (for an overview see Havila et al. 2001). But deficits in customer profitability are not handled explicitly as a dissolution determinant as the customer is focused as the disengaging or switching party in most publications (e.g., Perrien, Paradis and Banting 1995). Within a relationship marketing context, both parties need to be considered (Grönroos 1994).

Taking this gap in relationship marketing literature as a starting point, the further investigation is motivated by the following research questions:

(1) What do suppliers know about the profitability of their customer relationships?

(2) How many unprofitable customer relationships do suppliers have in their customer portfolios? Is lacking profitability a common phenomenon among business-to-business suppliers?

(3) What is the suppliers' view of relationship marketing and dissolving unprofitable relationships?

2. Customer Profitability and Relationship Dissolution

Customer profitability is the individual customer relationship's value for the supplier. It combines sales or revenues and the costs associated with individual customers as value drivers of a relationship (Shapiro et al. 1987). Usually, acquisition costs are higher than the returns during the first phases of a relationship, and profitability may improve or deteriorate during subsequent phases (Reichheld 1993). Lifetime calculation takes into account these dynamics of a relationship (e.g. Dwyer 1989). Customer lifetime value (CLV) is the present value of the expected benefits minus the expected burdens from customer relationships analogous to a Discounted Cash Flow Valuation (DCF) (Dwyer 1989). It is modeled as a function of a customer's lifetime duration, revenue flows and firm costs associated with serving the customer (Reinartz and Kumar 2000). From an economic point of view, relationship dissolution becomes an issue in those cases where the real or anticipated costs outweigh the benefits of relational exchange (Dwyer, Schurr and Oh 1987).

Suppliers do not always correspond to this economic rationale and commonly engage in unprofitable customer relationships, too. This could be due to differing marketing goals and selling objectives at the company level (above all, profitability), and goals for managing individual customer relationships (customer satisfaction). During preliminary interviews in the context of this

study, sales managers claimed that their primary focus in individual customer relationships is on qualitative goals. As one respondent stated: "We cannot preach customer orientation and meanwhile eliminate customers only because of low contribution margins". From a relationship marketing perspective, this possible conflict merits further investigation.

Relationship dissolution has taken place if "at least one partner no longer views the relationship as continuing [...] or the interdependency has otherwise critically decreased" (Tähtinen 2001, p. 46). It is a process where links, ties and bonds (e.g. exchange of objects, personal relationships, interfirm knowledge, social norms, contracts, bonds of trust, attraction, and commitment) are disconnected (Halinen and Tähtinen 2002). Either of the exchange parties can decide to terminate the relationship; dissolution management therefore is a topic for supplier and customer alike.

A blanket approach to foster or drop customers solely on the basis of current-period profitability or an evaluation determined by subtracting costs from sales would ignore the investment character of relationships (Jackson 1985). Often, the ending decision represents the last step to take after other strategies aiming to improve the benefit-cost-ratio of the relationship have led to unsatisfactory results – bearing in mind that these strategies also induce cost. For instance, unprofitable customers will first receive standardized instead of individualized treatment or face price increases to make the relationship profitable (Niraj, Gupta and Narasimhan 2001). There is no evidence in the literature if unprofitable customer relationships are a common phenomenon or how they are handled. Therefore, the suppliers' perspective needs to be observed more closely.

3. Outlines of the Study and Main Findings

Questionnaire design, data collection and sample characteristics

To answer the research questions, the results of an exploratory study shall be presented. Empirical data were gathered among sales managers of firms in the German mechanical engineering industry. The study was conducted in cooperation with the German professional association of engineers (VDI), sales engineers section, as sales and customer service in the industry is typically handled by employees with a technical educational background. Based on the association's membership directory, a sample of 3,000 sales managers was identified in the relevant industry; they received a standardized questionnaire by mail. Two weeks after mailing the questionnaires, a follow-up was conducted, again by mail. 184 participants returned a questionnaire which corresponds to a response rate of 6.1 percent.

As the response rate has to be classified as low, a comparison of early and late respondents was conducted for all questions included in the questionnaire (Armstrong and Overton 1977); these tests did not show any significant differences between the two groups. The low response rate may be explained by quite a number of reasons: 1. the dissolution of relationships is a topic with negative connotations (Havila et al. 2001) that company representatives do not like to talk about. 2. Furthermore, customer valuation and dissolution matters are often treated confidentially by firms, so representatives are not publicly communicating their views on the matter. 3. Generally, we have noticed that respondents in business-to-business markets are more and more refraining from participation in empirical studies. In any case, the low participation rate means, that the results of the empirical research have to be interpreted tentatively.

Participants were asked about the use of different customer valuation techniques. Also, they were to estimate the percentage of profitable customers of their firm. Respondents' views of relationship marketing and dissolution of relationships were dealt with in another part of the question-

naire. Finally, participants were invited to respond to a set of questions describing their own firm. Respondents were mostly CEOs/general managers (44.3 percent), 23.4 percent stated to be vice president/divisional managers, about 20 percent were central department managers (7.2 percent) or heads of department (13.2 percent). In about half of the sample (52.8 percent), the sales volume amounted to less than 25 Mio. Euro. The sample therefore contained rather small and medium-sized firms which is a typical feature of the German mechanical engineering sector.

Main results

The percentages of respondents claiming to use certain valuation methods in their companies for all or selected customer relationships are shown in the second column of Table 1. Traditional ABC-analysis based on sales ranks highest, as could well be expected. Customer contribution margins, which also take into account customer-specific costs, rank second, followed by ABC-analysis based on sales and costs. Customer portfolios and the more complicated method of customer-focused activity-based costing follow on ranks three and four. Astoundingly, scoring models are hardly used. CLV is applied by only 11 percent of respondents. Also stated is the percentage of respondents who were not familiar with the methods. Especially noteworthy is the low awareness concerning customer lifetime valuation. Although there is an intense discussion on lifetime measurement in academia, business-to-business firms - at least in Germany - seem not to use it (yet); managers in charge of handling customer relationships in the industry investigated are, to a large extent, not even aware of it. Information on customer profitability is scarce in the industry as the methods to measure it are not used commonly.

Table 1

According to Jackson (1985), extremely few marketing practitioners are able to provide meaningful estimates of the profitability of their individual customers. Being in charge of handling

customer relationships, our respondents should at least intuitively know which relationships are profitable, regardless of the measurement techniques they apply. On average, respondents believe 75.0 percent of their customer relationships to be profitable. As shown in Figure 1, unprofitable relationships are a common phenomenon for most of the responding firms. 17.5 percent of respondents claim that *more than half of their customer portfolio is not profitable*. A business that calls for high capital investments, high costs to serve individual customers and needs to establish long-term relationships such as mechanical engineering might often be faced with relatively low profitability (Turnbull and Zolkiewski 1997). Still, in order to allocate resources efficiently, the revenue-cost structure of customer relationships should be made transparent (Reinartz and Kumar 2002).

Figure 1

In order to learn more about the suppliers' view of relationship marketing and dissolving unprofitable relationships the respondents were asked to rate several statements on an agreement / disagreement scale ranging from 1 to 7. Figure 3 shows a line chart of the means of their answers, providing percentages and standard deviation for each statement.

Figure 2

The vast majority of respondents regard possible future potentials as a reason not to terminate unprofitable relationships (statement 1). The fact that the majority of respondents agree with the statement that "it is always more expensive to attract a new customer than to keep an old customer" (statement 10) suggests that the majority of respondents hold a rather cautious or passive view of the termination of unprofitable business relationships. On the other hand, the distribution of responses to the statements "One should try to keep all customers, regardless of their profit con-

tribution" (statement 7) and "A given customer should be parted with once they become too expensive to satisfy" (statement 9) suggest that there is basic agreement on the economic rationale behind the termination of a customer relationship if the actual or expected costs outweigh the benefits of the relationship (Dwyer, Schurr und Oh 1987).

The means of the remaining statements fall in the middle of the 1 ("completely agree") to 7 ("completely disagree") range. Given the high standard deviation and distribution of the relative frequencies, no generally valid statement can be made with regard to respondents' attitude towards termination of unprofitable business relationships by suppliers. Consequently, as companies seem to differ in their view of relationship marketing and dissolving unprofitable relationships, Ward's method was used to build a number of clusters. This is a hierarchical procedure to join groups of the 178 respondents (6 respondents were excluded because of missing values) according to their similarity in answers to the 11 statements (calculated as the sum of squares between the two clusters summed over all variables). The Euclidian distance is applied to measure the similarity between the objects (Hair et al. 1998). This procedure results in three clusters or opinion groups, which differ significantly with respect to their opinions on all statements (see Figure 3).

Figure 3

(1) 'Hardliners' seem to support an active approach to terminating unprofitable relationships, including the regular cleaning of their customer portfolio. Strategic implications (e.g. a potential loss of trust also in relationships with other customers or negative 'word of mouth') don't seem to be important.

(2) 'Softies' take a more considerate approach to terminating unprofitable relationships, above all due to strategic considerations (e.g. so as not to play customers into competitors' hands).

(3) ‘Couch Potatoes’ are reluctant to terminate unprofitable relationships because they fear the costs involved in attracting new customers.

The notable differences in opinions of the three groups might be due to the number of customers companies have in their portfolios. Companies in Group 3 (‘Couch Potatoes’) have a significantly lower number of customers than companies that were described as being ‘Hardliners’.

4. Discussion and Implications for Relationship Marketing

The general purpose of the study was to examine the status quo of customer valuation and supplier-initiated dissolution of relationships in practice. Most respondents confirm that unprofitable relationships are a common feature of the market. 17.5 percent of respondent firms have to deal with more than half a customer base that is not profitable (yet). This means that the other half has to cover for the losses to make the supplier profitable which might not be possible during an economic downturn. A thorough review of the customer portfolio could provide a solid basis for practical customer management. But as was shown, most methods for customer valuation that could deliver such information (CLV, scoring models, portfolios) are not widely applied by the respondent firms.

From a theoretical point of view, relationship marketing needs to focus the mutual gains and losses in relationships considering both parties. The supplier’s perspective needs to be investigated more closely leading to a more thorough understanding to relationship dissolution as a strategic task of the relationship marketer.

5. Limitations and Directions for Future Research

As in any empirical research, the results of the present study cannot be interpreted without taking into account the study's limitations. Firstly, only sales managers with a technical background and belonging to one – although major – German industry have partaken in the study. The study is not representative of the German population of manufacturing companies. A randomized sample using other sources and an investigation into other industries such as consumer goods would probably provide different insights. Knowledge on customer valuation is certainly more advanced in industries such as insurance and banking. It might be interesting to relate the findings to a study undertaken in those settings. Secondly, the study has been labeled exploratory, as the low response rate poses problems. Still, considering the reluctance in responding to the topic, some interesting results have been achieved. They might provide input for other research projects, which should aim at increasing response rates and use a broadened sampling frame including other industries and markets.

Future research could include:

- broadening the field of analogous studies in different industry settings,
- a functional or role differentiated approach of customer valuation knowledge of different managers and their understanding of customer 'profitability',
- studying other quantitative and qualitative criteria of customer valuation with respect to planned dissolution of relationships,
- studies on the antecedents and consequences of relationship dissolution and
- studies on the means of ending customer relationships.

Customer valuation method	percentage of respondent firms using method	percentage of respondents not familiar with method
ABC-analysis based on sales	70.2	5.6
Customer contribution margins	47.7	5.7
ABC-analysis based on contribution margins	44.3	6.3
Customer portfolios	38.5	12.1
Customer focused activity-based-costing	24.0	19.3
Customer focused scoring models	14.0	39.5
Customer lifetime value	11.0	43.6

Table 1: Awareness and application of customer valuation methods

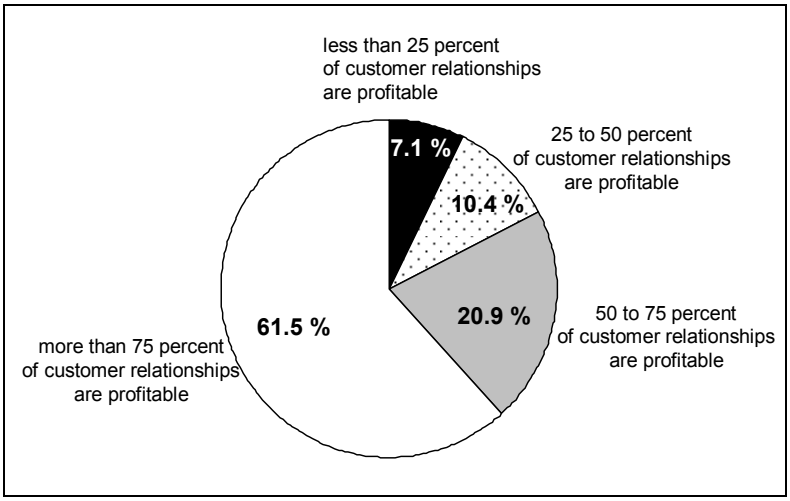

Figure 1: Percentages of responses to 4 segments of estimated unprofitable customer relationships

		SD
"Even unprofitable relationships should not be terminated as the customer could become profitable in the future."	absolutely agree 16.1 27.2 28.3 13.3 6.1 6.7 2.2 absolutely disagree	1.50
"Unprofitable relationships should not be terminated so as not to play customers into competitors' hands."	absolutely agree 7.3 16.8 24.6 17.3 7.3 15.1 11.7 absolutely disagree	1.81
"Unprofitable relationships should not be terminated as this could lead to a loss of trust also in relationships with other customers."	absolutely agree 6.7 17.2 20.0 15.0 8.3 22.8 10.0 absolutely disagree	1.83
"Unprofitable relationships should not be terminated as the customer could practice negative 'word of mouth'."	absolutely agree 9.5 13.4 17.9 12.3 16.2 20.1 10.6 absolutely disagree	1.87
"Customer satisfaction cannot be preached yet at the same time customer relationships terminated because of insufficient profitability."	absolutely agree 9.9 12.7 22.1 10.5 10.5 12.7 21.5 absolutely disagree	2.04
"The customer portfolio should be cleaned on a regular basis and relationships with unprofitable customers terminated."	absolutely agree 10.0 12.8 21.1 20.1 15.0 16.1 5.0 absolutely disagree	1.70
"One should try to keep all customers, regardless of their profit contribution."	absolutely agree 3.3 8.3 13.9 10.0 9.4 27.2 27.8 absolutely disagree	1.83
"Due to rationalisation, one's sights of customer satisfaction should be lowered."	absolutely agree 5.6 18.4 22.9 14.0 10.6 15.6 12.8 absolutely disagree	1.84
"A given customer should be parted with once they become too expensive to satisfy."	absolutely agree 16.7 18.9 21.7 15.0 12.2 12.2 3.3 absolutely disagree	1.72
"It is always more expensive to attract a new customer than to keep an old customer."	absolutely agree 45.9 24.9 9.4 9.4 2.2 5.5 2.8 absolutely disagree	1.63
"It is better if a customer terminates the relationship of his own accord rather than the supplier."	absolutely agree 12.2 19.4 10.6 16.7 7.8 13.9 19.4 absolutely disagree	2.08

Figure 2: Comparison of means concerning the opinion on dissolution of unprofitable customer relationships

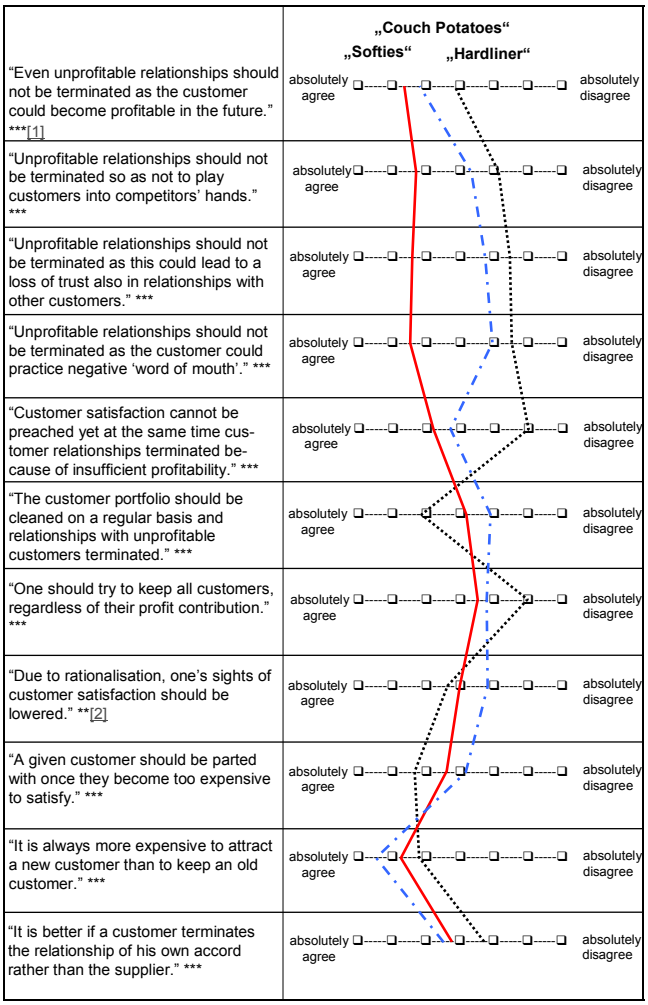

Figure 3: Comparison of groups with different opinions on dissolution of unprofitable customer relationships[2]

[1] Groups differ significantly at the 0.001 level (Kruskal-Wallis H)

[2] Groups differ significantly at the 0.01 level (Kruskal-Wallis H)

[2] F-values for each cluster were computed to assess their homogeneity. “Softies” and “Couch potatoes” form homogenous groups with f-values ranging from .23 to .99. The cluster labelled “Hardliners” is not homogenous with respect to statements 1, 8 and 10.

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