Hidden losses

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Most business leaders are familiar with the ironic business aphorism, "Sell at a loss and make it up in volume!" Its dark humor comes in the recognition that when you sell at a loss, big volume only drives bigger losses. It turns into a death spiral.

The ironic wisdom of the joke also points at another important business insight. That is, it is easy to lose a little money on a small volume customer, but to lose big dollars you need the kind of high volume that typically comes from your biggest customers. That's just how the math works.

But in that truth lays a challenge. Namely, we love customers that deliver high volume and rapid growth. They are considered to be important for a reason. However, high volume customers and rapid growth, while looking good on the surface may not actually be good if achieved at a loss. Most companies would never intentionally pursue loss producing products or services, but what about unintentional, hidden losses?

We previously have talked in these papers about the "quality of growth"[1] with respect to its source and strategic impact. Here we want to focus on growth that may drive hidden losses. Those situations where, in the name of customer service, the company makes big investments that on their face look like good business, but in actuality hurt profitability. This can be particularly challenging for growing middle market companies that have hit the inflection point where it becomes increasingly difficult to maintain line of sight supervision of individual products and customers.

When middle market companies are experiencing this type of growth, new staff and new process may be added in order to support key customers. Furthermore, key customers understand that they are important (and often much larger than the seller) and may therefore demand accommodations that are unavailable to smaller purchasers. Employees often are happy to oblige these requests for what they see as superior service. A view often prevails that all revenue is good revenue as long as gross margin demands are met. Sometimes, however, this is not true.

[1] Gorman, Trish. "All growth is not created equal." Deloitte, October 2013. http://app.response.deloitte.com/e/er?s=958345745&lid=1832&elq=b2de8f3797f14f02aa5d48aa59cf416d

Drivers of hidden losses exist where costs are generated, but not directly linked to the customer being served. If a business has high SGA and other expenses "below the gross margin line," then it is a good bet that such losses exist, but are unrecognized. In an effort to grow the customer — to attain that next big contract or order — the company may acquiesce to providing services that if left untended can turn into drivers of hidden loss. These might include:

1. Small, high frequency orders or frequent low volume deliveries
2. Frequent order changes or returns
3. High levels of customization
4. Late payment or demands for extended payment terms
5. Significant demands for pre- and post-sales support
6. Expedited requests

The challenge growing mid-market companies face is that drivers of hidden loss often look a lot like drivers of superior service. In fact, they can be both at once. Here we argue not against providing service, but rather in favor of understanding how these costs accumulate against and mitigate the profitability of the business — so the investment can be wisely made. A few critical steps ought to help:

1. Consider developing (at least high level) profitability statements for each customer, especially the biggest, most important ones.
2. When staff and other resources are added to support the business, document their intended link to customers within the profitability statement — even if the expense is considered "fixed" or "general." Try to avoid falling into the trap of believing all customers consume company resources evenly. Except for a subset of truly central services, this likely is untrue.
3. Be honest with yourself. Companies often find that those they think are their "best" customers turn out to be drags on profitability. If this ends up being the case, don't overreact. There are plenty of ways to make an unprofitable customer profitable. Knowing, as they say, is half the battle.

You might quickly find that you see reason to pursue a more accurate Activity Based Costing project to understand not just customer, but product and service line profitability as well. The keys to success in such an endeavor are to focus on the big picture (as opposed to bogging down in the minutia), link cost and customers (or products, etc.) in ways that are relatively easy to understand and communicate, and develop a system that is practical, and easy to execute and maintain. By tending to these simple practices, executives can continue on their thoughtful path to quality growth.

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