ANNUAL CONFERENCE TOPIC

CRM

USING

Customer Relationship Management

TO INCREASE PROFITS

BY MICHAEL E. KENNEDY

In today's challenging economic environment, both customers and company profitability are more elusive than ever. Many companies are having difficulty stabilizing their business model and have been forced to downsize, more than once. Companies such as Wells Fargo, Harrah's Entertainment, IBM, Boise Cascade, and Lowe's Home Improvement, however, have stabilized or grown their companies by putting a priority on investing in customer relationship management (CRM). CRM helps companies unlock the full value of their relationship assets, accelerating revenue and profit growth. Industry experts indicate that nearly 90% of all companies have yet to adopt the new tools and methods of CRM and continue to fall behind by adhering to the old method for managing their relationship assets. Let's look at the benefits realized by adopting the tools and methods of this new paradigm, the key value drivers of customer relationship assets, how a company can independently determine whether or not they need to adopt this new paradigm, and how financial executives can act as catalysts for change.

RELATIONSHIP ASSETS

Not a part of traditional balance sheets, relationship assets are defined as customer relationships, channel relationships, and partner relationships. Also included are the investments that companies utilize to build these assets, specifically, the investments in sales and marketing.

Industry experts indicate that most organizations don't effectively manage their customer relationship assets, but those that do enjoy a competitive advantage. According to Wendy Close, research director at Gartner, Inc., "Less than 10% of enterprises have a single, integrated view of their customers, and those that do are just beginning to leverage their investments to improve customer loyalty and profitability." The same holds true among mid-sized companies as "less than 10% of mid-sized companies have developed comprehensive systems and processes to actively manage and maximize the value of their market-based assets," says Kevin Myers, vice president of Regional Sales for SalesLogix, a leading CRM software provider.

Managing relationship assets has evolved from old traditional methods to a new paradigm that provides new methods and tools to protect and manage the growth of

TABLE 1	OLD METHOD	NEW PARADIGM
LEAD-GENERATION AND TRACKING PROCESS	Lead-generation marketing investments driven by "gut feel" rather than with empirical results grounded by ROI metrics. Manual distribution of leads to sales team and channel partners. Channel conflict over deal ownership inherent without centralized database. Leads managed independently by salesperson or partner. Productivity and performance metrics limited.	Lead-generation efforts are guided by marketing ROI metrics calculated from the lead-tracking system. As a result, marketing programs are optimized, and customer acquisition, development, and retention costs are reduced. Leads automatically distributed to sales team and channel partners from a system based upon predefined criteria (zip code), shortening sales cycle and reducing channel conflict over lead ownership. Leads actively co-managed by salesperson and management, improving conversion ratios of leads to revenue-generating customers. Deal details utilized to improve close ratios and shorten sales cycle.
RELATIONSHIP INTELLIGENCE GATHERING	Acquired, developed, and retained by salesperson in black book, Rolodex, or elementary computer-based tracking system. Efforts to obtain customer information are duplicated by other departments. Information assets are easily lost, rarely enhanced over time, and not accessible by enterprise to cultivate and leverage. These assets tend to leave when the salesperson leaves.	Acquired and developed by salesperson and retained by enterprise in database as knowledge asset. All information obtained during sales cycle, from lead to close, is retained and leveraged later to activate customer or cross-sell for additional revenues, extending duration and value of relationship. Customer service leverages information to service customer needs, optimizing limited customer-service resources. Customer product feature and solution requests retained and leveraged by R&D to prioritize product road map investments, optimizing limited R&D resources.
SALES-FORECAST PROCESS—THE LEVER FOR TUNING YOUR BUSINESS	Salesperson submits estimate with limited details. There's manual consolidation of estimates by management. Accuracy is usually suspect and difficult to improve over time due to infrastructure limitations. Faulty sales forecasts can increase inventory exposure risk and lead to misallocation of resources.	Salesperson enters detailed estimate into enterprise database with customer, product, and timeline details, which is automatically consolidated by system. Forecast accuracy is easily reviewed and improved over time. Improved revenue forecast accuracy limits inventory exposure risk. Limited resources are more efficiently allocated across the enterprise with more accurate short- and long-term revenue forecasts.

FIGURE 1: QUANTIFYING THE VALUE OF RELATIONSHIP ASSETS*

CASH INFLOW COMPONENTS

Q = Volume of Period Purchases

M = Margin per Purchase

CASH OUTFLOW COMPONENTS

A = Relationship Acquisition Costs—Expenditures made to attract, qualify, and obtain new relationships.

D = Relationship Development Costs—Expenditures made in order to maintain and/or increase the value of existing relationships. This includes expenditures for improving knowledge of customer needs, responding to customer requests, and servicing their accounts.

R = Relationship Retention Costs—Expenditures made to increase duration of relationships, reduce defections, or reactivate customers.

t = Duration—Duration of the relationship or number of periods over which purchases are made

d = Discount Rate

$$\text{Value of Relationship Assets} = \text{Relationship Lifetime Value} = \sum_{t=1}^{n} Q_t M_t d^t - \sum_{t=1}^{n} (D_t + R_t)\, d^t - A_1$$

Cash Inflows—Volume of Period Purchases and Margin per Purchase: Historical contact information for each customer, captured in a lead-tracking system, is essential for spotting trends and understanding the motivation behind each purchase. With this, sales representatives can be more proactive and anticipate the needs of their customer. Additionally, enterprise-wide CRMs make it easy to categorize thousands of different customers based on their needs. This makes it easy to utilize targeted programs, which migrate customers from a low-margin product to a higher-margin product or to additional services. Managing all customers from a single platform, from campaign to close, drives volume and margin improvements, increasing relationship asset values.

Cash Outflows—Relationship Costs: An effective lead-generation system can create higher-quality leads, which translate into improved close ratios for the sales team. This drives customer acquisition costs down, and companies spend less on marketing programs targeted to activate and retain existing customers. A CRM process can be actively retuned to minimize relationship costs allocated to customer development and retention programs, increasing relationship asset values.

**Derived from Robert Wayland and Paul Cole,* Customer Connections, *Harvard Business School Press, 1997.*

these assets. The benefits of using these tools are substantial. There's greater visibility into the sales pipeline, lower inventory exposure risk, shorter sales cycle, lower costs to manage these assets, improved customer profitability, and better intelligence on financial returns for specific marketing initiatives (ROI). With these techniques, Lowe's improved store performance and sales, Wells Fargo Home Mortgage decreased loan defaults and risk, and Harrah's raised customer sales and cross-property visits.

MIGRATING FROM THE OLD METHOD TO THE NEW PARADIGM

The core processes of a customer relationship management system merge the so-called islands of relationship information into one comprehensive database. In the old method, islands of information prevailed as customer leads and existing relationship information were retained by the salesperson in their own paper-based system or elementary computer-based tracking system. As a result, all vital relationship information was owned by the salesperson rather than existing as an enterprise asset that could be viewed, leveraged, and retained by the organization. As a result, many of these relationship assets had a short lifespan, and they weren't always passed on to management when the salesperson moved on. Corporations were forced to duplicate their investments as the new salesperson rebuilt the relationship intelligence. See Table 1.

VALUE DRIVERS FOR RELATIONSHIP ASSETS

The value generated by these relationship assets can be quantified from a cash flow perspective, which measures the cash inflows generated by a group of customers, the duration and frequency of those cash inflows, and the cash outflows required to establish and retain customers. Essentially, this translates into the Relationship Lifetime Value. Figure 1 illustrates how the value of relationship assets is quantified.

DO YOU NEED TO ADOPT THE NEW PARADIGM?

To identify a need, conduct a brief analysis of the five components of the value drivers. The metrics, key indicators for a company's current competence in managing their relationship assets, depend on two key elements: (1) the existence and relative maturity of an organization's lead-tracking system and (2) an accurate sales-forecasting process. If metrics vary significantly from any of the industry averages or internal benchmarks, then the relationship assets probably aren't being managed effectively.

1. Inventory Performance Metrics. Many inventory problems experienced today result from a company's inability to leverage their relationship assets. Using industry benchmarks for inventory turns is a good way to determine efficiencies. Mushrooming inventory is a good indicator that the company is having difficulty matching the sales team's demand information with manufacturing's production activities. This increase in inventory exposure risk leads to unwanted write-offs and higher carrying costs. A CRM process improves visibility into the sales pipeline and increases sales forecasting accuracy, which enables the company to better correlate production with demand.

2. Marketing Investment Performance Metrics. Marketing efforts like direct mail, online seminars, trade shows, and advertising are the engines for generating leads. But many companies fail to establish a lead-tracking system that enables them to determine which marketing programs generate the most leads. This information is valuable in assessing the relative return on past marketing programs in order to steer future marketing investments.

For example, let's say that Company A attends a large industry trade show that generates thousands of leads, which are lumped together with thousands of other leads generated from other marketing programs. When new customers are qualified from this large pool, it will be very difficult to determine which new customers came from which marketing programs without a good lead-tracking system.

A good lead-tracking system optimizes marketing investment performance and improves lead quality, which, in turn, facilitates two key elements: (1) Sales-cycle performance is improved because marketing investments are tuned to those programs that generate higher rates of qualified leads, thus improving close ratios, and (2) customer profitability is improved because the cost to acquire a customer is significantly reduced when marketing activities yield a higher ratio of qualified leads. Without a comprehensive lead-tracking system, marketing investment decisions are based on anecdotal information or gut feel.

3. Sales-Cycle Performance Metrics. Close ratios and sales-cycle time are indicators of relative sales productivity and should be compared to industry averages or what management deems acceptable. Within the sales cycle, bottlenecks often develop from lead to close. Bottlenecks are the result of limited sales resources available to pursue multiple opportunities or leads. With a lead-tracking system in place, management is able to improve lead-generation quality, sales-contact management, and, ultimately, close ratios. Without a comprehensive lead-tracking system, visibility into the sales cycle is limited, which allows bottlenecks to develop and exist unchecked. In these cases, the organization's financial risk exposure is unnecessarily increased due to mismanagement of these assets.

4. Customer-Profitability Metrics. Customer profitability defines an organization's relative ability to generate a profit from their customers after taking into account the costs invested to acquire, develop, and retain customers. Their ability to efficiently allocate their sales and marketing resources enables the organization to more effectively leverage and cultivate their relationship assets. These metrics consist of two critical components: (1) revenues—historical customer revenues from the accounting system plus forecasted revenues from the sales-forecasting system, and (2) customer costs—costs to acquire, develop, and retain customers. Without the sales-forecasting and lead-tracking processes, customer profitability is diluted, and these assets risk impairment.

For example, Boise Cascade, winner of the Gartner CRM Excellence Award, uses their CRM's customer profitability to direct their sales and marketing efforts to compete in a commodity-driven environment. According to Boise Cascade's David Goudge, senior vice president of marketing, they categorize each customer, using their own nomenclature, as Most Valuable Customer, Most Growable Customer, Migrators, or Opportunity, also known as Below Zeroes. With this detailed breakdown, the company is able to use this information to more effectively allocate their sales and marketing resources to maximize their efforts. Using this and other CRM efficiencies, Boise Cascade can effectively compete with larger rivals such as Staples and Office Depot.

5. Sales-Revenue Forecasting-Accuracy Metrics. Accurate sales-revenue forecasting provides a critical element necessary for optimizing relationship assets. Expectations of revenue streams help determine how a

An Exception and Several Observations

Even though relationship assets aren't usually a part of traditional balance sheets, there is one area where they *are* shown on the balance sheet. That's after a company has bought another firm and has applied Statement of Financial Accounting Standards (SFAS) No. 141, "Business Combinations," to allocate the purchase price to the assets acquired.

While the Financial Accounting Standards Board (FASB) hasn't yet allowed companies to show the value of self-developed relationships on their own statements, they do require that, when purchased, these assets be recognized. So there's a dichotomy—some customer relationships do appear in the financial statements and others do not. It's beyond our scope here to argue the merits of the FASB's inconsistency. What's important is to recognize that Michael Kennedy's points about the benefits of customer relationships and how they can be improved relate to every company that is a potential M&A candidate.

Let's see how some of the benefits the author identified increase the value of the customer relationships directly and how they indirectly increase the total value of the target company.

◆ **Inventory exposure risk lowered.** Certainly to the extent that inventory turnover increases and write-offs are reduced, profitability will be enhanced. It's relatively easy to measure inventory turnover ratios, both on a historical basis for the subject company and in comparison with comparable competitors. Favorable trends and favorable comparisons with other firms would lead an analyst to value the company higher and attribute part of the increase to the improved inventory management.

◆ **Sales cycle reduced.** It's hard for an outsider to measure the average sales cycle from lead to shipment. But, as the author recommends, to the extent the sales cycle can be shortened, profits will invariably be increased. Companies can, and probably should, try to set up internal systems to measure this metric. In case of a potential merger transaction, the seller can focus the buyer's attention on this improvement, thus providing a negotiating advantage.

◆ **Customer profitability increased.** This can be accomplished in two ways: getting rid of unprofitable customers and increasing volume with profitable customers. Few companies perform continuing detailed customer profitability studies. Adoption of the author's recommended approaches should show an immediate increase in margins, return on assets, and return on equity. All three metrics are used by analysts in evaluating a company vis-à-vis its competitors.

◆ **Increase ROI on marketing initiatives.** As one famous quip goes, "I know that half of my advertising is wasted; I just don't know which half." Even a small improvement in this area—lowering expenditures on unproductive marketing programs—will have an immediate bottom-line impact. It will be hard for outsiders to evaluate whether a margin improvement is caused by increased customer profitability, reduction in sales cycle, or better inventory management. The measurement of marketing investments is strictly an internal management function and one that may be hard to track quarter to quarter or even year to year. Nonetheless, this may well be one of the greatest benefits of improving customer-management processes.

A final recommendation. Companies that undertake these initiatives should trumpet the news in annual reports, press releases, and shareholder communications. As the author reports, probably fewer than 10% have so far gone down this road. If the benefits are as promised, companies shouldn't wait for the results to show up in the P&L, where they may be swamped by external events. In fact, the Securities & Exchange Commission's (SEC) new MD&A recommendations specifically suggest that companies focus on this type of analysis. The information in this article should be taken to heart by every financial manager if he or she truly wants to be a part of the management team.

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company allocates its resources across the enterprise, and, in some cases, are used in a larger model to communicate expectations to external investors. If certain expected revenue streams never materialize, metrics can be negatively impacted and frustrate both internal and external stakeholders. For example, faulty sales-revenue forecasts can increase an organization's inventory exposure risk. According to Steve Ward, general manager for IBM's Global Industrial Sector, "Our sales forecasting processes are relatively advanced and are critical in managing supply-chain efficiencies," which has positioned IBM to weather the economic downturn and helped extend their lead over the competition. The context of sales forecasting extends beyond the obvious bookings and backlog and includes deals in process as well as other market intelligence, which provide a long-range detailed view into the sales pipeline by customer and product. These forecasts incorporate the knowledge-based assets, which are retained in a central database. Over time, as intelligence is gathered on deal wins and losses, sales-forecasting accuracy improves.

HOW FINANCE CAN BE A CATALYST FOR CHANGE

First and foremost, propose that a CRM system and process be implemented. Finance is a credible champion for this type of initiative because CRM ensures that the assets of the corporation are maximized and well-managed while generating a healthy return on investment. But the real champion for this initiative should eventually be sales as their business processes will be impacted the most by it. Therefore, the role of finance should be to influence sales to lead this initiative.

This is a great opportunity for the finance organization for two reasons. It provides finance with an opportunity to build a positive partnership with sales since this relationship traditionally has been disjointed because of their opposing views on revenue targets and customer-credit policies. And initiatives like this provide finance the opportunity to contribute more strategically to asset management by proposing new methods for managing relationship assets rather than continuing to narrowly focus on only the tangible assets governed by GAAP.

To ensure the success of this initiative, it's important for finance to recognize that this is truly an enterprise-wide initiative involving every functional organization within the company. Therefore, it's imperative to build a cross-functional team with key sponsorship from the CEO so all functional groups are on board. Too often, organizations place the software solution before the people and the business processes, causing many failed CRM implementations.

WHICH CRM?

There are several different software options to consider when planning a CRM implementation. Some of the well-known packages to consider, depending on your company size, include:

Large *Fortune* 500 Companies. Siebel is considered the market leader. Oracle and SAP deliver good solutions that integrate well with their back-office financial and supply-chain modules.

Mid-Range Companies. SalesLogix, owned by Best, provides full integration with some of Best's accounting packages, notably the MAS 90 family of products. Goldmine is another popular choice.

Small Companies. Salesforce.com offers a formidable ASP solution while Best's ACT! offers a refined desktop solution.

Mismanagement of relationship assets is widespread in Corporate America because many organizations have yet to migrate from the old traditional method to the new paradigm. Those companies that no longer view relationship assets as objects owned by the salespeople but rather as assets of the enterprise are employing the advanced tools and methods of the new paradigm to actively manage these assets. By supporting this initiative along with other key stakeholders, companies avoid the financial exposure risk inherent with the old traditional method. All stakeholders benefit from increased visibility into the sales pipeline, a reduction in inventory exposure risk, and a shorter sales cycle. Costs to manage these relationship assets decrease, thus maximizing customer profitability, return on investment performance on marketing initiatives, and overall competitiveness. ■

Michael Kennedy has more than 15 years' experience leading financial teams/projects at Sun Microsystems and Kraft Foods that were responsible for managing corporate assets, advising on investments, and supporting marketing, development, operations, and sales organizations. Michael was also the CFO for Pacific Gourmet, Inc. Now he is managing director of Kennedy Associates, where he advises CEOs and CFOs on business process restructuring, corporate financial strategy, and business growth initiatives. You can reach him at michael_e_kennedy@yahoo.com.

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