Innovative companies today recognize that not all customers contribute equally to profitability.

For example the authors analyzed the customer base of a leading bank and found:

- The top tier of customers (20%) accounted for 82% of the bank’s retail profits
- Top tier balances were 5 times as big as the lowest tier’s (bottom 20%)
- The average profit of a top tier customer was about 18 times as much as bottom tier customer
- The top 20% were almost 10 times more responsive to beneficial changes in programs and service quality.

So, companies can supercharge profits by acknowledging that groups of customers vary widely in their behavior, desires, and responsiveness to marketing, and that these variances result in differing levels of profitability.

For example FedEx revolutionized its marketing philosophy by categorizing business customers as the “good”, the “bad”, and the “ugly” -- based on their profitability. Rather than marketing to all customers in a similar manner, the company now puts its efforts into the good, tries to move the bad to the good category, and discourages the ugly.

Similarly, First Union Bank uses a database technology known as “Einstein” to color code its customers. Green customers are profitable and receive extra customer service support. Red customers lose money for the bank and are not granted any special privileges or fee waivers.

These and other firms have discovered that they need not serve all customers equally well. In fact, many customers are too costly to do business with and have little potential to become profitable, even in the long term.

So, while companies may want to give all customers superior service, it is neither practical nor profitable to meet (and certainly not to exceed) all customers’ expectations.

Further -- and probably more objectionable to quality zealots -- in many cases it is desirable for a firm to alienate or even “fire” at least some of its customers.

The “Customer Pyramid” (Exhibit 1) is a framework that enables a firm to leverage differences in customers’ behavior and profitability.

Firms can utilize this framework to develop customized products and services that are more closely aligned with individual customer’s underlying utility functions, thereby creating more value for high potential customers, some of which can be retained (captured) by the firm as higher profits.

The service quality - profitability relationship

In the early 1990s, research findings established the general link between service quality and profitability.

More recently, research has linked service quality improvements and customer satisfaction to stock price shifts, the market value of firms, and overall corporate performance (i.e. profitability).

More specifically, studies have shown:

- Higher overall service quality and customer satisfaction lead to increased behavioral intentions such as greater repurchase intentions.
- Increased behavioral intentions lead to behavioral impact, including repurchase or customer retention, positive word-of-mouth, and increased usage
- Behavioral impact leads to improved profitability and other beneficial financial outcomes (e.g. higher share prices).

Most importantly, it has been found that indiscriminate marketing and service investments across all customer groups will not yield similar returns and are not equally advantageous to the firm. Different profitability segments are likely to receive differential levels of attention, and to respond differently to marketing and service initiatives.
The bottom line is that companies can become more profitable by acknowledging the varying profit potential of different customer segments, and then developing tailored approaches to serving them.

**Profitability tiers**

To build and improve upon traditional segmentation, businesses have been trying to identify segments -- or, more appropriately, profitability tiers of customers -- that differ in current and/or future profitability to the firm.

This approach goes beyond traditional usage segmentation because it tracks costs and revenues for groups of customers, thereby capturing their financial worth to companies.

After identifying profitability tiers, firms can offer products, services, and service levels in line with the identified tiers’ interests and profitability.

To date, this approach has been predominantly used by financial services, retail, and business-to-business firms because of both the amounts of customer data existing in those firms, and the in place ability to associate data with individual customers.

**Conditions necessary for customer tiers**

Four conditions are necessary for customer tiers to be advantageous:

- **Tiers have different and identifiable profiles.**

  Profitability differences in customer tiers are most useful when other variables are common among individuals in the tiers. As with traditional customer segmentation, differing demographic characteristics can be the basis for addressing customers with tailored marketing offerings.

- **Customers in different tiers view service quality differently.**

  Customers in different tiers can also have different needs, wants, perceptions, and experiences. Understanding the factors that affect the customer's decision to purchase a new product or service from an existing provider, and the factors that affect their decision to increase the volume of purchases from existing provider are crucial for managing customers for profitability.

- **Different factors drive incidence and volume of new business across tiers.**

  Differences in customers’ characteristics, needs, wants, and definition of service quality are likely to result in different drivers for the incidence and volume of new business.

- **The profitability impact of changing or improving service quality varies greatly in different customer tiers.**

  Just as direct marketers routinely qualify lists to test for potential profitability, companies need to qualify their customer tiers for potential profitability.

  Higher tiers should produce a much higher response to improvements in service quality that will be evident in increases in new business, volume of business, and average profit per customer.

**The Customer Pyramid**

Large databases and sophisticated analytical tools make it possible to separate customers into multiple tiers that can be identified, motivated, served, and expected to deliver different levels of profitability.

For example, a typical Customer Pyramid may have four tiers (see Exhibit 1):

- **Platinum.** A company’s most profitable customers are often those who are heavy users of the product, not overly price-sensitive, willing to invest in and try new offerings, and committed to the firm (i.e. “loyal”).

- **Gold.** Gold customers are not as profitable as Platinum customers, perhaps because they want price discounts that cut into margins, or because they demand higher levels of service (i.e. high maintenance).

  They might be heavy users in the product category, but might not be as loyal to a single firm (as Platinum customers). That is they seeking to minimize their risk (of overpaying, or of stockouts) by working with multiple vendors rather than just one company (i.e. “polygamous loyalty”).

- **Iron.** The Iron tier contains customers that may provide the volume needed to utilize the firm’s capacity, but whose spending levels, loyalty, and profitability are not substantial enough for special treatment.
• **Lead.** The lead tier consists of unprofitable, high maintenance customers that tie up the company’s resources. They often demand more attention than they are due given their spending levels and resultant profitability. Sometimes, they’re problem customers who complain about the firm to others.

**Pyramid example: real estate**

For example, a real estate franchise company may define its Platinum customers as those who pay full commissions on a house costing $500,000 or more; are motivated to purchase within the next six months; have purchased more than two homes in the past; and are members of social or professional networks that make them likely to refer other high-end buyers.

Gold customers purchase homes in the $250,000-$500,000 range and are more price-sensitive than Platinum customers. For example, some Gold customers may want to negotiate on the commission or have the realtor pay points at closing. Gold customers are likely refer others, but the types of customers referred will not be as valuable to the firm as those referred by the Platinum customers.

The Lead customers at the bottom of the pyramid are sometimes shoppers rather than buyers. They may spend as long as two years looking at homes, frequently calling upon realtors to show them homes. Sometimes, they are merely looking to be entertained. While they might be looking at homes in all price ranges, the homes they buy are likely to be under $100,000. These clients are often dissatisfied with what they see and buy, making them less likely than other tiers to send qualified referrals to the company.

**Pyramid example: market research**

Similarly, a market research firm might classify customers as Platinum if they pre-commit to a certain level of research spending spread across the year, so that the timing and nature of the research can be anticipated, making it easy for the firm to smooth supply and demand.

The Platinum customers might buy a full range of research services, tend to stay with the company for years, be willing to try new services and test innovative research approaches, and serve as references for the firm. They are likely to be loyal to the firm and use other marketing research companies only when they need something specialized that the firm doesn’t provide.

Lead customers, on the other hand, spend little in research, conduct one-time projects, and seek cheap, “quick and dirty” solutions. Often, they require multiple sales calls and, if landed, are high maintenance clients who need a lot of “hand holding” since they don’t understand the research process or outputs. They often change project requirements in midstream and expect the firm to absorb the added costs.

**Pyramid example: pharmaceuticals**

Pharmaceutical companies depend on doctors to prescribe their branded drugs over competitive or generic drugs.

A major pharmaceutical firm strove to reduce its costs and improve the efficiency of its marketing by sorting doctors into profitability tiers.

The first step it took was to recognize that all doctors were not equally profitable customers. The company departed from industry practice and began to view physicians as long-term strategic assets and thereafter targeted them based on potential profitability based on:

- The volume of prescriptions written across the company’s portfolio of products.
- The doctors’ influence on other MDs in their local area or in their specialty (i.e. “opinion leaders”).
- “Sales receptivity”: the willingness of a doctor to actually see a salesperson (rather than brushing them off or keeping them waiting for long, costly periods of time).

**When to use the customer pyramid**

The customer pyramid is an appropriate remedy whenever a company is delivering the same levels of service to customers that differ in profitability. In these situations the firm is stretching its limited resources across a wide group of customers, possibly (probably) under-serving its best customers.

More specifically, it makes practical sense to implement the customer pyramid principles when:

- **Service resources, including employee time, are limited.**
• Customers want different services, service levels, or functionality.

For example some customers may want extensive on-site service, others may want “bare bones” products that they will maintain themselves.

• Customers are willing to pay for different (higher) levels of service or functionality.

• Customers can be separated from each other, enabling differentiated service levels.

For example, many companies now have state-of-the-art phone systems that can immediately identify specific callers, map them to their profitability tier, route their calls to specific agents, and vary the parameters for handling the call (e.g. negotiating limits, time spent).

• Service differentials can motivate customers to another level.

Sometimes it is beneficial for differences in the quality of services being delivered to be apparent to all customers. For example main cabin airline customers know that service in the first-class cabin is better than they receive in the back of the plane. And, they know that 1st class flyers either pay more for their seats or reap the upgrade benefits of frequent flyer programs. So, the coach travelers may be induced to change their buying behavior to get 1st class benefits.

• Customers can be accessed either as a group or individually.

That is, once identified, there are means to communicate with and differentially serve the customers in each of the tiers.

Customer Alchemy

Customer alchemy is the art of turning less profitable customers into more profitable customers.

Turning Gold into Platinum

Only when a company fully understands its Gold customers can it design strategies to turn them into Platinum customers.

Industrial or B2B firms with dedicated sales forces often meet this need because the salesperson knows the business, stays in constant touch with the customer, and anticipates the customer’s needs.

This “customer intimacy”, when effective, allows the company to move the customer to a higher tier because the firm can develop offerings that satisfy the client’s unique needs, identify ways to serve the client better, and communicate in the right way at the right times to clients.

The following strategies are recommended for turning Gold customers into Platinum customers:

• Become a full-service provider

• Provide outsourcing services

For example, a computer hardware company may offer maintenance services that free customers of that set of tasks.

• Increase brand impact via line extensions

Sometimes companies can leverage their established brand positions by introducing products in adjacent categories that broaden the scope of a customer's purchases.

• Create structural bonds

For example, some hospital supply companies provide logistical services to hospitals that simplifies inventory management, ordering, receiving, and invoicing (billing).

• Offer service guarantees

Often companies will offer their very best customers a complete, hassle-free satisfaction guarantee. That way, Gold customers have no reason to leave and may become Platinum customers.

Turning Iron into Gold

Customer alchemy can also change something ordinary (a less profitable Iron customer) into something more valuable (a Gold customer).

Among the strategies for transforming Iron customers into Gold customers are:

• Reduce the customers non-monetary cost of doing business

For example, many cable and telecom companies bundle multiple services,
positioning the bundles as simpler for customers..

- **Add meaningful brand names**

  A strategy used by some discount retailers to turn Iron customers into more profitable Gold customers is to create a “brand within a brand” image in their stores.

  For example, when K-mart was working to improve its image and profitability, it affiliated with Martha Stewart to manufacture and market an entire line of household soft goods (e.g. sheets and towels). Customers were interested in buying these products not because they were associated with K-mart, but because they were affiliated with a very fashionable and well-known person.

- **Become a customer expert through technology**

  One of the best examples of turning Iron customers into Gold customers are the strategies used by Amazon.com.

  Initially, the company focused on being able to get virtually any book that a customer wanted.

  Starting with the first purchase, Amazon builds an information database about the customer's preferences. So, whenever the customer subsequently orders a book, his/her profile is retrieved and a list of books from the same author and on similar topics are presented.

  After multiple purchases, the database makes suggestions as soon as the customer signs on, attempting to stimulate increased purchasing.

- **Develop frequency programs**

  Most retail firms can benefit from frequency programs that encourage customers to spend more with the company in order to receive special benefits. In theory, companies can motivate customers to turn to them for all their category needs.

- **Create strong service recovery programs**

  A strong service recovery system -- one that catches all possible service errors and corrects them promptly and appropriately -- is critical to turning Iron into Gold.

  The best recovery systems proactively identify when customers are disappointed with the company's products or their interactions with company personnel, and initiate appropriate remedial actions.

**Getting the Lead out**

Allocating more effort to customers that are more valuable implies allocating less effort to customers that are less valuable.

In particular, Lead customers weigh the company down. They are the customers who don't pay their bills. They're the careless people who bounce checks. They are the telephone company's deadbeats who run up large unpaid bills. They are the industrial firms who make purchases and then, in questionable disputes over deliveries or quality, let their invoices go 60 or 90 days or longer.

Lead customers are also those who buy so little that dealing with them costs more than they're worth. Marketing and personal selling expenses may exceed the revenue generated – making the customers unprofitable. And sometimes, these expect the most in terms of service, making the cost of servicing them prohibitive.

Attempting to move customers from Lead to higher categories is not an easy task, and is not always appropriate. Only if the future potential of a Lead customer is known to be high (for example the MBA student who is currently an unprofitable banking customer) is an enduring a period of customer unprofitability justified.

A first step is to try to make unprofitable customers profitable by raising prices or cutting the costs to serve them. The last resort is to “fire” them.

- **Become an expert by leveraging intermediaries**

  Caterpillar, the world's largest manufacturer of mining, construction and agricultural heavy equipment, owes part its superiority and success to its strong dealer network and the product support services dealers offer throughout the world. The dealers knowledge of local markets and close relationships with customers, make them invaluable to Caterpillar.
• **Raise prices**

One effective approach to improving customer profitability is to increase prices to Lead customers by charging for services that they've been receiving but not paying for.

For example a software company that has been giving free technical help to low profit customers can begin to charge for the service. Its unprofitable customers will either leave rather than pay, or will pay and have the additional revenue cover the costs of serving them.

• **Reduce costs**

The alternative to raising prices among unprofitable customers is to reduce costs and find ways to serve the segment more efficiently.

Banks accomplish this by redirecting low profit customers from live tellers to ATMs or the Internet. Some banks even charge a fee if low profit customers use tellers more than two or three times a month.

Similarly, many business-to-business firms that previously served all customers with personal salespeople now only call on Platinum for Gold customers that way. Lower tier customers are served by via telemarketing or the Internet.

• **Get the lead out**

Often, it is very difficult to move Lead customers to higher tiers because they have characteristics that make them less desirable customers. They either don't pay their bills, don't have much money to spend, don't need what the company offers, or don't have the qualities that make them loyal to companies.

If either or the both of the two approaches discussed above -- raise prices or cut costs -- are not effective, then the wisest solution is often for the company to try to free itself of these low profit customers. That is, to “fire” the customers and “get the Lead out”.

**Profit implications of moving customers up the pyramid**

The use of the Customer Pyramid can supercharge a company's profits as it eliminates unprofitable customers and converts lower-tiered customers to higher-tiered customers using targeted and efficient strategies.

For example, a major automotive manufacturer has used a 4-tiered customer pyramid approach to identify its dealers’ best customers based on their average number of service visits and their spending per visit.

In one of its major dealerships, the annual service revenue differences across these groups are striking: $3,743 for Platinum customers; $2,713 for Gold customers; $620 for Iron customers; and $263 for Lead customers. For this dealership, the implication of moving 20% of the Lead customers to the Iron category is an annual revenue increase of over $700,000; moving only 10% of the Iron customers to Gold would increase revenues almost as much.

The same manufacturer also examined the gross profit from distinct tiers of customers -- those customers who have no service performed at the dealership, those who have some service done there, and those who have all of their service performed at the dealership.

The “all service” customers generate $2,259 in annual gross profit; the “some service” group generates $1,674 – a difference of $585 in annual gross profit. If the dealership were able to motivate 10 to 20% of its “some service” customers to become “all service” customers, it would increase annual gross profits by almost $1 million.

**Summary**

Customer profitability can be increased and managed. By sorting customers into profitability tiers (i.e. the Customer Pyramid), service can be tailored to achieve even higher profitability levels.

Highly profitable customers can be pampered appropriately, customers of average profitability can be cultivated to yield higher profitability, and unprofitable customers can be either made more profitable or weeded out. Tailoring service to customers profitability level can make a company more profitable – much more profitable!
Exhibit 1

Most Profitable Customers

Platinum

Gold

Iron

Lead

Least Profitable Customers

What segment spends more with us over time, costs less to maintain, spreads positive word of mouth?

What segment costs us in time, effort and money yet does not provide the return we want? What segment is difficult to do business with?