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How to Identify the Best Customers for Your Business



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Many companies pursue growth opportunities without adequately defining who their ideal customers are. That lack of clarity can hamper profitable growth.

BY FRANK V. CESPEDES, JAMES P. DOUGHERTY AND BEN S. SKINNER III

IT'S DIFFICULT TO start a venture that gains traction with paying customers. In the first decade of the 21st century, fewer than half of all U.S. startups were able to survive beyond three years.¹ But it's even harder to grow a company beyond certain levels of sales. Of the nearly 44,000 companies founded in 2000 and listed in the Capital IQ database — which includes public and privately held companies — fewer than 6% achieved more than \$10 million in revenues by 2010, and fewer than 2% grew to more than \$50 million.² Why?

Once a venture reaches a critical size, its complexity greatly increases. Not only are there more “moving parts,” but interdependencies are more difficult to manage. The original business model must deal



THE LEADING QUESTION

How can businesses achieve profitable growth so that their costs don't grow faster than sales?

FINDINGS

- ▶ Clarify who the ideal customer is; don't rely on “heroic” sales efforts.
- ▶ Understand the differences between transaction buyers and relationship buyers and know the cost implications.
- ▶ Be prepared to revisit and adjust the ideal customer profile on an ongoing basis.

ABOUT THE RESEARCH

We have been studying sales processes for years through a combination of consulting and board work with numerous entrepreneurial ventures; case studies concerning sales practices in startups and established companies; managerial experience at companies; data from venture capital and other databases; insights from workshops and executive-education programs at Harvard and MIT; and implementation of sales effectiveness processes at many businesses, including Allscripts Healthcare, Avaya, Boston Beer, Elsevier, Gartner Group, GE, Innosight, Lotus, Siebel and United Technologies.

Individually, we began with the common observation that most profitable sales are attributable to relatively few customers. In investigating why, we examined the data concerning entrepreneurial ventures and the inability of many of them to grow beyond certain levels of revenue. One of the authors had conducted interviews on this topic for case studies and previous publications concerning how businesses are using “big data” (large data sets and new analytical software) as a tool for understanding and managing customer selection. This research was complemented by our own experiences in entrepreneurial ventures and as board members for portfolio companies of private equity and venture capital firms. The ideal customer process methodology discussed in the article and illustrated with “BusinessProcessingCo.” (a real company whose name has been disguised) has been used at more than 30 businesses.

with new products or markets, and the early leadership behaviors that worked in establishing the business are often inadequate to manage and grow it. Most visibly, SG&A (selling, general and administrative) costs often accelerate faster than revenues, and because resource-constrained ventures cannot afford to burn through working capital, promising ventures are forced either to go out of business or to operate in small niches because they are unable to scale their sales activities. Even large, established corporations can face a problem with SG&A expenses: Between 2000 and 2010, production efficiencies reduced the cost of goods sold at the average S&P 500 company by about 250 basis points, while SG&A as a percentage of revenue didn’t change.³

Consider the case of an entrepreneurial company we’ll call BusinessProcessingCo. BusinessProcessingCo. (a real company whose name we disguised for this article) was founded in 2000 to provide Web-based outsourced payroll services to small and medium-sized businesses. By 2004, it had about \$40 million in sales and 75 sales representatives with annual quotas of \$600,000 each and target compensation of about \$60,000 per rep. In 2004, the founder raised nearly \$30 million from investors to develop new products and expand the business. But two years later, even though product development plans were on schedule, BusinessProcessingCo.’s revenues were stagnant and investors were restless. Management tried a number of tactics, including offering bundled products at a steep discount, six months of “free” services if customers made annual commitments and other incentives to close deals.

The result? Over the next two years, the company’s prices declined faster than revenues increased. By the time the recession hit in 2008, the company’s directors were asking fundamental questions about the venture and its business model.

The experience of BusinessProcessingCo. is, unfortunately, all too common. Among other things, the company’s early growth led to a seductive but costly ad hoc process for evaluating opportunities, for forecasting and for business development initiatives. Probably the biggest problem over time was the leadership team’s inability to define its core customers. Without clarity around that, the sales process becomes a function of individual salespeople’s “heroic” efforts in the field, not a scalable platform for profitable growth.

The Importance of Customer Selection

In this article, we discuss the importance of customer selection and how intelligent opportunity management helps companies scale their selling initiatives. While the example used in this article is a young entrepreneurial company, many large, established companies can also benefit from taking a more systematic approach to opportunity management. (See “About the Research.”)

Every company, large or small, does things that make it easier for some customers to do business with it, and harder for others. Selecting the right customers is critical, especially if resources are constrained and the brand is little known.

A customer ultimately represents a stream of orders for the seller. That order stream, in turn, has a domino effect on the company’s business. Different customers come with different transaction costs for the seller — for example, in a manufacturing business, stock vs. custom items, or in a service business, customers that do or don’t require proposals. These customer requirements affect “upstream” capacity utilization at the selling company in two ways, influencing both the kind of capacity utilized (the product mix) and how capacity is utilized (for example, production lines needed in manufacturing or the types of people and skills needed in a service business). The orders also affect “downstream” after-sale economics and organizational requirements. Together, these factors help to determine the cumulative net cash flow associated with the customer exchange, the price the seller needs to charge to earn a profit and the margins available for other business needs.

Surprisingly few companies — especially entrepreneurial ones — clarify their core customer selection criteria. Many executives in entrepreneurial companies in effect tell their salespeople to “go forth and multiply!” By selling to anyone willing to pay a certain price, though, companies fragment their resources and make further growth difficult. As customers use the product, the company modifies the offering and processes associated with making and selling it, typically in contradictory directions uncovered by this selling activity.

This haphazard process inhibits learning and can blind a company’s leadership team to what is actually going on in its business development efforts. Effective

customer selection focuses on the buyer — addressing the problems or opportunities he or she confronts. However, most entrepreneurial ventures simply partition their served markets based on what is accessible to salespeople, whether via purchased customer lists, SIC codes or cold calls. Although sales may be made and customer value intermittently identified with this approach, it is far from optimal. Practically speaking, the successes can blind management to the limits of its sales process and prevent scaling of the business. To avoid this trap, executives need to practice core principles of opportunity management.

The Principles of Opportunity Management

Customer selection impacts not only operating costs and margins; in an entrepreneurial company, initial sales also influence the venture’s trajectory of organizational skills, because businesses develop capabilities and routines in the process of interactions with customers. The choice to do business with a customer also represents an opportunity cost: The money, time and people allocated to customer A are resources not available for customers B, C and D. The fact is that no matter how large or fast-growing a market may seem to the entrepreneur, the venture can add and extract more or less value from different opportunities in its portfolio of market possibilities. In a competitive market, moreover, ineffective opportunity management eventually leads to loss of money, time and positioning with customers who are (or should be) core customers. The company runs the risk of becoming better and better at activities that core customers value less and less.

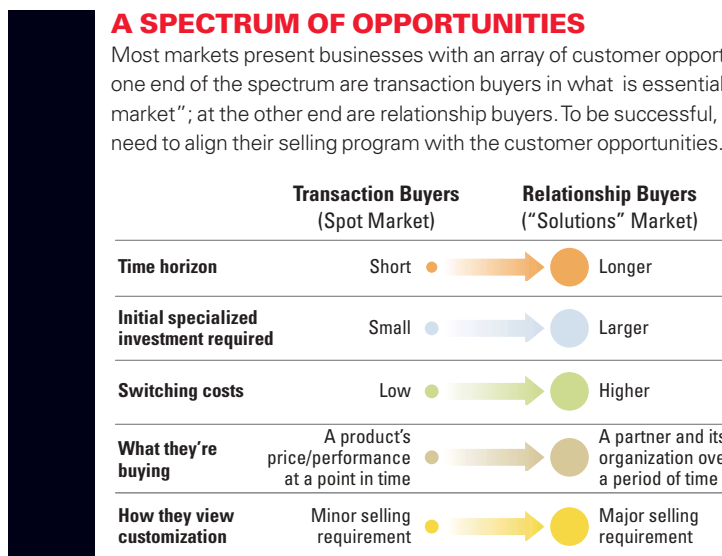
Most markets present businesses with an array of customer opportunities. At one end of the spectrum are transaction buyers in what is essentially a “spot market”; at the other end are relationship buyers. (See “A Spectrum of Opportunities.”) Transaction buyers have short time horizons when purchasing in the venture’s product category. In such markets, the lack of switching costs means that buy/sell adjustments are easy to make. Because transaction buyers invest little in specialized procedures or assets when purchasing in that category, they are less interested in the wider system benefits (or total life cycle costs) that the venture may offer. These buyers purchase a product for its price and performance at a point in

time. This does not mean that these buyers are uninterested in quality or value. Rather, they define value as meeting specifications and do not want to pay for a product or service whose quality, applications or scope exceed what they want at that point.

In contrast, relationship buyers have a longer time horizon. There is something about the product, seller or buyer that motivates them to make larger investments in specialized procedures or assets. Once made, the investments are not easily fungible. Enterprise software offers a good example. Historically, the choice of an enterprise software vendor has

A SPECTRUM OF OPPORTUNITIES

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been a multiyear choice of support, upgrade and other processes — a choice not easily altered after the fact. Because of these investments and switching costs, buyers are interested in the wider system benefits and in choosing a longer-term business partner. Hence, they are legitimately interested in knowing more about the seller’s organization, commitment to the category, future plans, etc.

Many executives prefer relationship buyers in the belief that these customers will pay higher prices and be more loyal. But the selling cycle with the relationship buyer is also likely to be longer and more complicated (a big issue if a company is cash-constrained), depressing margins. In general, transaction buyers want products and services that are consistent, standardized and easy to purchase at a given point in time. This means sellers need to provide appropriate selection and threshold levels of quality at an accept-

able price. Relationship buyers, on the other hand, want to understand the quality and applicability of the particular solution and its feasibility over time.

To be successful, businesses need to align their selling program with the customer opportunities. If they're selling solutions to relationship customers, they need to be sure that the longer selling cycles, multiple requests for proposals, custom product requirements and after-sale support services are necessary and "worth it." In contrast, if they're focusing on transaction buyers, companies need to find ways to take costs out of the selling process, product offering and after-sale support services. Such decisions have implications not only for sales management (for example, who is hired, the coverage model and relevant sales tools) but also for product development, finance and other aspects of the business.

There are two types of failure in opportunity management. One type involves going after transaction buyers with a solutions sales approach. In such cases, transaction buyers would do the company a favor by chasing its salespeople away. Instead, such buyers tend to seek out more information about product possibilities and available services and then use the information in setting specifications with transaction sellers. New ventures, in particular, commonly overestimate their ability to acquire relationship buyers in their market. The result is that they often fail to make the numbers in the business plan and are forced to raise a dilutive round of additional capital to remain in business.

The second type of error in opportunity management occurs when businesses go after relationship opportunities with a transaction selling approach. Since the buyers in such situations are looking for a solutions-oriented relationship, they reject the offering, and the company misses a chance to compete in a market it wants or needs.

Responding to a sales opportunity, therefore, is a choice but not a binary — yes/no — decision. In new ventures, entrepreneurs almost always find that until they are out there selling, they really don't know the crucial differences between early adopters and other customers along the relevant spectrum of opportunities. To grow, the venture needs processes for learning about these differences and the responses available. An understanding of the venture's core customer profile should drive the crafting of the relevant processes.

A Step-by-Step Process

Let's return to BusinessProcessingCo., the payroll services company. As BusinessProcessingCo. struggled, a member of the company's board asked about the profile of the company's ideal client. The CEO had assumed that the offering was aimed at small, independently owned restaurants and food stores; in fact, by 2008, such customers represented almost 40% of BusinessProcessingCo.'s customer base and the focus of its selling efforts. But a careful analysis led management to other important insights.

Assemble and analyze customer data. BusinessProcessingCo. gathered a small team of senior leaders (the CEO, CFO, VP of sales and an outside director) to analyze extant customer data. Given the competing priorities in any entrepreneurial venture, an ideal customer profile must come from the top team in order to be credible and organizationally effective.

BusinessProcessingCo.'s team created a list of the potentially relevant client attributes, based on data available from public sources (annual reports, websites, press releases, etc.) and internal financial systems. Variables considered included customers' revenues, profits, number of employees, industry and location. Any could be relevant criteria for an ideal customer profile, but at this stage the important thing was generating the information, not screening the list. The CFO imported the data into a software tool that allowed the team to analyze the information.

At smaller companies like BusinessProcessingCo., the availability of data to develop an ideal customer profile is often a challenge, and, as at BusinessProcessingCo., a tool may need to be developed to analyze the data. However, at large companies that have grown over decades through acquisitions, reorganizations and divisions, the issue may be too much data — in particular, too much incompatible data from different sources. Diverse data can allow managers to justify almost any strategy they prefer because there simply is no agreed-upon version of customer reality. As a result, the process of developing an ideal customer profile typically has additional value at a big company: It helps to reestablish a shared vision across functions and divisions about what the company is good at.

At BusinessProcessingCo., the team working on

creating an ideal customer profile identified three primary differences among customers: location/geography, vertical market and company size in employees. It correlated this information with sales metrics including win rate, selling cycle length, average sale price, churn rate and up-sell rate. (Although every company has some customer differences that are unique to its business, most companies will want to know how the attributes link to core selling metrics.) The team held a one-day team meeting to examine the findings and reached the following interim conclusions:

Profitability Profit margins generally were proportional to the number of employees at the client company. BusinessProcessingCo. had relatively high fixed costs, with low marginal costs required to support more employees at a client. This underscored the importance of pricing and customer selection.

Selling Cycles BusinessProcessingCo.'s cost of sales was directly correlated with the length of the selling cycle: Longer sales cycles typically meant multiple proposals, demos and more calls. This affected sales productivity and required the involvement of other functions, which added costs and affected profits.

Lifetime Value of Customer Although BusinessProcessingCo. was not growing, overall satisfaction with its services was high, particularly among growing companies. Clients that were growing companies churned less than small, independent restaurants and food stores.

Develop preliminary hypotheses. Reviewing these factors in the context of BusinessProcessingCo.'s spectrum of opportunities, the team defined "good customers" as:

Professional Service Firms With 15 to 30 Employees These businesses were large enough to require repeatable payroll processes but not so large as to require significant internal IT staff. Hence, they continued to rely on outsourced services of the kind BusinessProcessingCo. offered. The team also speculated that these businesses chose BusinessProcessingCo. because they were dissatisfied with the treatment they had received from larger, more established competitors.

Companies in Urban Locations BusinessProcessingCo.'s customers in cities allowed the company to achieve selling economies, tended to be earlier

adopters of technology solutions and, at the time of the analysis, were more likely than nonurban customers to have high-speed Internet connectivity.

Companies With a Significant Operating History Customer churn was highly correlated with how long a customer had been in business. Companies that had been operating for at least five years had much lower churn rates and higher lifetime value for BusinessProcessingCo.

Analysis of an ideal customer profile can lead to faster decision making and adaptation in any company where leaders have strong entrenched opinions about why things have or have not worked. At BusinessProcessingCo., the hypotheses were based on criteria and data that management could document and use to test both internally with its people and in the marketplace.

Refine and modify the hypotheses. Once they had their preliminary hypotheses, the team members solicited feedback from other people in the company. They began with a two-day offsite with the ideal customer profile team and function leaders. Participants received a briefing package in advance, and during the offsite each good-customer attribute was examined in detail: What are the trends? What are the impacts on other functions in terms of costs or efficiencies? How long does it take to close with customers in different vertical markets? How does service mix affect order fulfillment? The ideal customer profile team asked: "If we could only invest our sales, marketing or R&D money and time in pursuing one customer segment, which would we choose? What are the specific attributes of customers in that segment?" As one participant in the offsite noted, the discussions were sometimes tedious, but they resulted in decisions to change the preliminary hypotheses. Equally important, participants bought into the importance of customer selection as critical to BusinessProcessingCo.'s growth and business model.

In any company, the people with the best understanding of the behavior that distinguishes transaction and relationship customers are the people in sales, marketing and service; however, the cost implications of customer behavior are often managed by frontline employees in operations, product groups and finance. To reach a better understanding of the cross-functional implications of Business-

ProcessingCo.'s selling efforts and results, the ideal customer profile team obtained input from such frontline employees. This input was compiled and discussed at a follow-up leadership team session. The discussions centered on questions such as: What did we miss in our hypotheses about the effects of different sales orders on our business processes? Are there other explanations for the impact? Does the logic of our ideal customer profile hold up? If not, what are the implications?

Communicate the “ideal client profile” and the implications. As a result of its ideal client profile development process, BusinessProcessingCo. shifted its focus from small, independent restaurants and food stores to professional services firms with more than 15 employees. The number of employees became an indicator of potential revenue and also correlated to the age of the prospect company and the stability of the potential revenue stream from that company.

This shift had implications both externally and internally. Externally, independent restaurants and food stores were no longer a priority on sales call lists; they were replaced by small accounting firms. Once viewed as competitors, CPA firms were now seen as a valuable source of referrals to other professional services. With the revised ideal customer profile, BusinessProcessingCo. sales reps could more easily identify ways to reach and work with these channel partners.

Internally, BusinessProcessingCo. altered its sales performance metrics. Previously, the sales force had been measured only on bookings results, with no consideration given to order quality or customer renewal rates. Now, the company established metrics that encouraged the most profitable activities. For example, BusinessProcessingCo. found that there was a clear cause-and-effect relationship between the number of meetings a sales rep had with local CPA firms and the number of referrals it received; referrals, in turn, led to demos and sales. To drive the process, salespeople were expected to contact a certain number of CPAs in their territory every week. What's more, BusinessProcessingCo. paid commissions only for deals matching the ideal client profile.

The new strategy paid off. By focusing on professional service firms (with CPAs as the main vehicle

for accessing them), call patterns improved. Recruiting efforts also improved as BusinessProcessingCo. sought out salespeople with contacts or experience at CPA firms. The new approach allowed the company to reduce its sales force from 75 to 35.

The new focus led to changes beyond sales and marketing. In terms of product offerings, BusinessProcessingCo. introduced a new payroll/human resource bundle to allow its customers to track employee-related information such as date of hire and salary history. The additional features leveraged referrals and increased renewal rates with ideal customers. In the meantime, BusinessProcessingCo. also changed its business model for nonideal customers. When accounting firms introduced the company to prospects that didn't fit the company's ideal customer profile, these prospects were treated as *transaction* customers; with them, the mandate was to take costs out of the selling approach. BusinessProcessingCo. contacted these prospects via email, directed them to an online demo and offered self-service setup. Although close rates were lower than for customers who received personalized attention, the sales were much less expensive to achieve and more profitable.

Given the scope of the changes, communication was critical. BusinessProcessingCo.'s leadership invested time and effort explaining to employees the rationale for the new ideal customer profile and the implications across the business. Management developed a detailed presentation and used various channels (email, “town hall” meetings, operating meetings and webinars) to deliver the information and answer questions.

It took three months from the time the board asked the question about the company's ideal client to fully implement the changes. Within six months of the rollout, nearly one-third of the salespeople either were let go for not meeting quota or left on their own. But over the next year, BusinessProcessingCo.'s bookings increased nearly 25% with fewer sales reps. What's more, the new clients churned at half the previous rate, driving longer-term increases in profitability as well as top-line revenue. BusinessProcessingCo. also worked to upgrade its recruitment, orientation and training processes, enabling new sales reps to become productive faster. Overall, the company has created a scalable

sales model and a process for adapting its model as the market changes. To monitor the relevance of the current ideal customer profile, the company's leadership has made the "ideal customer" analysis part of its ongoing strategic planning review and revisits it regularly.

Improving Sales Productivity

Understanding your ideal customer has wide-ranging implications for selling and managing. The productivity of a sales model is a function of three things: *capacity* (how much the sales force can do in terms of call capacity and the capacity of salespeople to reach various customer groups); the *close rate* (how much they sell); and *profit per sale* (what they sell and at what prices). (See "Analyzing Sales Productivity.") To improve sales capacity, managers need to get people to work harder and more effectively — for example, to make more calls or do a better job at generating leads in the sales pipeline. But to increase close rates and accelerate selling cycles, managers need to get better at identifying and selecting potential deals along the opportunity spectrum and then managing target opportunities more efficiently. This is a key output of an ideal customer profile analysis and process. For example, as BusinessProcessingCo. gained more insight about its core customers and shared that insight across the business, it was able to improve training, deployment, channel selection, call lists and close rates.

Finally, to improve profit on sales without raising prices, companies must lower selling costs *without* harming effective selling. Knowing your core customers also means knowing where to cut and where not to. The ideal customer profile process gave BusinessProcessingCo. a deeper understanding of the relevant cause-and-effect relationships between internal activities and customer acquisition and retention. Armed with this knowledge, the company was able to devote more resources to truly important activities.

Of course, even the best process for identifying ideal customers cannot compensate for a flawed business model or a management team unwilling or unable to make required changes. In such cases, gaining a better understanding of core customers can do two important things: identify key links in business development activities and help management under-

ANALYZING SALES PRODUCTIVITY

A company's sales productivity is a function of its sales capacity, close rate and profit per sale. To improve sales productivity, managers can use any or all of the three levers:

INCREASE SALES CAPACITY BY:	INCREASE CLOSE RATE BY:	INCREASE PROFIT PER SALE BY:
<ul style="list-style-type: none"> • Longer hours, more calls, better lead generation 	<ul style="list-style-type: none"> • Better opportunity/ deal selection criteria 	<ul style="list-style-type: none"> • Better pricing, better product mix and/or higher sales per customer
<ul style="list-style-type: none"> • More focus on high-impact selling tasks and activities 	<ul style="list-style-type: none"> • Better account and/or channel partner management 	<ul style="list-style-type: none"> • Lower selling costs and/or improved internal process efficiencies

stand the implications of change. Improving sales productivity is closely tied to opportunity management. Both sales productivity and opportunity management will improve when executives and their sales teams understand and communicate understanding about their core customers.

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