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# *Commercial excellence programs*

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**A way for B2B  
companies to  
pursue growth  
in hard times**



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# Executive summary



**Having cut their expenses** as deeply as possible in recent years, and with no signs of rebounding growth in their markets, many B2B companies are looking for new ways to grow their top and bottom lines. Commercial excellence may be the answer. As an approach that imposes discipline on a company's pricing decisions and aligns its service offerings with its customers' needs, commercial excellence can quickly improve margins in designated regions, on select products, and on key accounts, and support an overall rise in corporate profitability.

A company embarking on a commercial excellence initiative must develop expertise in more than a half-dozen disciplines that touch customers and its operating model. The most important disciplines are margin diagnostics, customer segmentation, and pricing. Margin diagnostics creates detailed, graphic insights into a company's economics, and gives managers at every level a crucial tool for decision making. Customer segmentation, when done correctly, sets the stage for B2B companies to win more business and package their service offerings in efficient ways. A well-conceived pricing approach matches the value a company captures to the value it creates — and lets B2B companies base pricing more on science and less on guesswork. When reinforced by other disciplines in a commercial excellence initiative, these three areas can materially improve results in as little as six months to a year.

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# ***Introduction: Increasing profitability in a new way***

Business-to-business (B2B) firms' financial results have rebounded since the crisis of 2008, but not because of a return of top-line growth. Instead, what has helped those in B2B report better earnings is a renewed focus on costs, along with a concerted effort to manage their supply chains to better align with uncertain demand. The difference between bottom- and top-line performance in recent years has been unmistakable: Companies in the S&P 500 had a cumulative 17 percent jump in EBITDA from 2009 to 2011, but only an 8 percent increase in revenue.

Most companies turn to inorganic growth when they can't grow organically, but that has not been the case in recent years. In the chemicals industry, for example, acquisitions in 2012 amounted to only US\$67 billion, less than half of the value for 2007. An extensive study of M&A transactions between 1995 and 2010 showed that acquisitions don't necessarily add value — the EBITDA multiples of the 767 acquirers during that period barely budged from two years before they completed their deals to two years afterward. Chief executives may not have these statistics at their fingertips, but a lot of them sense the limits of M&A as a solution.

What to do? Some corporations are turning to commercial excellence as a new means of creating value. Commercial excellence is a state in which companies have such a clear understanding of different customers' needs and profitability that they are able to achieve top- and bottom-line improvements without necessarily changing products or adding customers. One hallmark of a commercial excellence initiative is optimized pricing, which can pay off disproportionately. A 1 percent increase in price can deliver six times more margin growth than a 1 percent reduction in fixed costs. This report focuses on the three business disciplines most important to commercial excellence.

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# ***A system of interconnected capabilities***

Let's begin with a wide view. Commercial excellence typically involves eight disciplines that gain power to the extent that they draw on, and reinforce, one another. For instance, product/service development uses insights generated by customer segmentation to fine-tune activities in the supply chain and in manufacturing. Likewise, sales force effectiveness draws on other parts of the commercial excellence system to improve the quality of customer interactions — a frontline activity critical to every company's success (*see Exhibit 1, next page*).

Not all of the disciplines required for commercial excellence are equally important, of course. For every B2B company, however, three stand out as clear priorities: margin diagnostics, customer segmentation, and pricing. Without developing excellence in these three areas, it will be impossible for most companies to realize the potential of a commercial excellence initiative. These three areas generate the largest returns in the shortest amount of time.

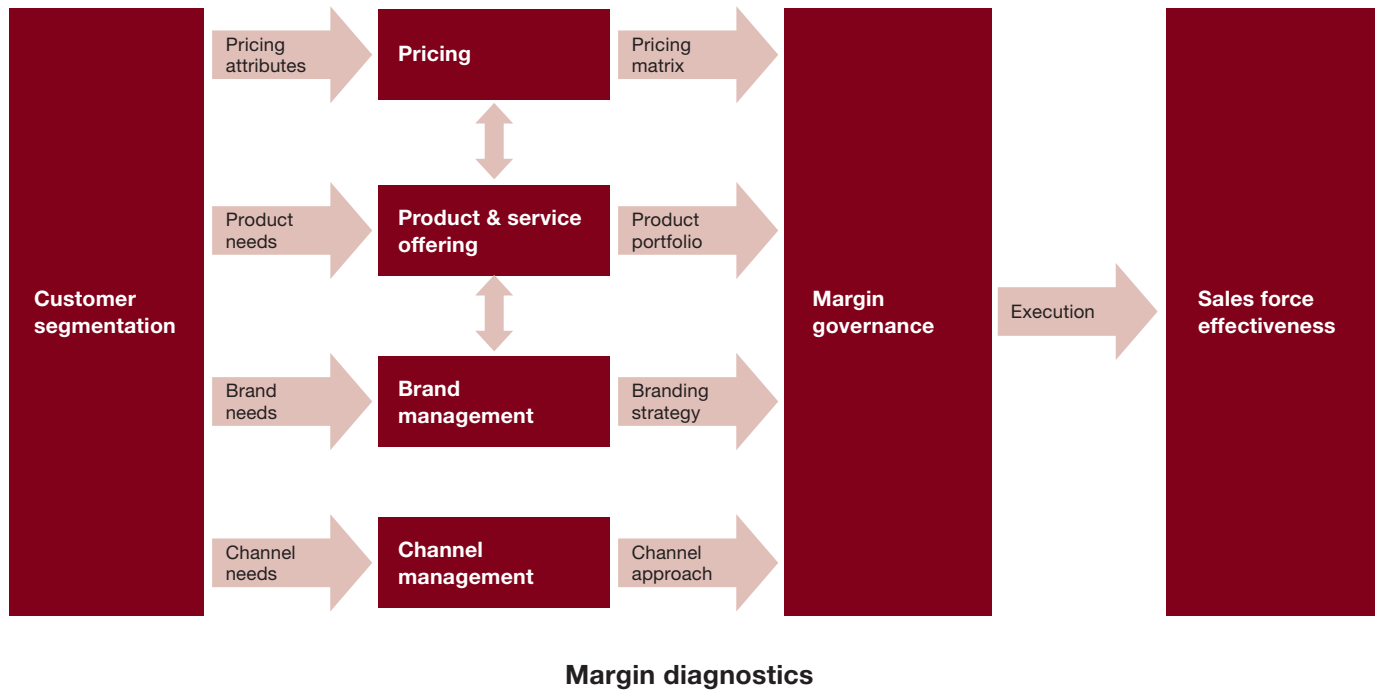
## ***Margin diagnostics***

By providing transparency into multiple measures of profitability, this discipline provides the underpinning for any commercial excellence program. But what is margin diagnostics exactly? To better understand this concept, it helps to contrast margin diagnostics with the more conventional way of tracking performance: financial reporting. Financial reporting provides a view of the profitability of discrete business organizations — such as strategic business units or divisions. Margin diagnostics, by contrast, uses much more granular measures of profitability — by region, by site, by product, and especially by customer.

The differences extend to presentation. A good margin diagnostics system uses visual data in place of tabular data, such as earnings or balance sheet statements. With margin diagnostics, financial managers create Pareto, bar, and scatter charts — to take three common examples — to illuminate what really matters, and to make it easier for commercial staff to determine a course of action. The visual element is

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*Exhibit 1*  
**Components of a B2B commercial excellence system**



Source: Strategy& analysis

important because unlike with traditional financial reports, the output of a margin diagnostics analysis is intended for commercial managers who aren't expert in finance: sales managers, marketing managers, product managers, and regional/segment leaders.

To this end, a margin diagnostics system should be interactive and allow for nearly limitless drilldown. It is not enough, for instance, to know that a given customer lags its peers in profitability. What's needed is detail about the product, and the price charged by a particular salesperson. Indeed, the reason for a customer's subpar profitability may not be fully understood until all the transactions with the customer are analyzed. Perhaps the customer has multiple manufacturing sites and is getting the same price for deliveries at all of them — but the locations of certain sites make deliveries there far costlier from a logistics perspective. A good margin diagnostics system will help pinpoint these issues, and allow the supplier to take corrective action. With margin diagnostics, pricing becomes a precision tool and sales managers get information that allows them to make better decisions.

To use margin diagnostics effectively, a company needs to understand earnings at the level of EBIT rather than at the less instructive level of gross margin or contribution margin. This is important because a primary goal of commercial excellence is to make sure that customers are correctly served — with neither too much nor too little invested in them in the way of fixed costs. Sometimes the right way to get a view of fixed costs, for the purposes of margin diagnostics, is to do a simple percentage-of-volume calculation. At other times it makes sense to employ more sophisticated methods, such as activity-based costing. Which way to go depends on the amount of precision the company requires, and how much variability there is in the cost of serving customers.

### **Customer segmentation**

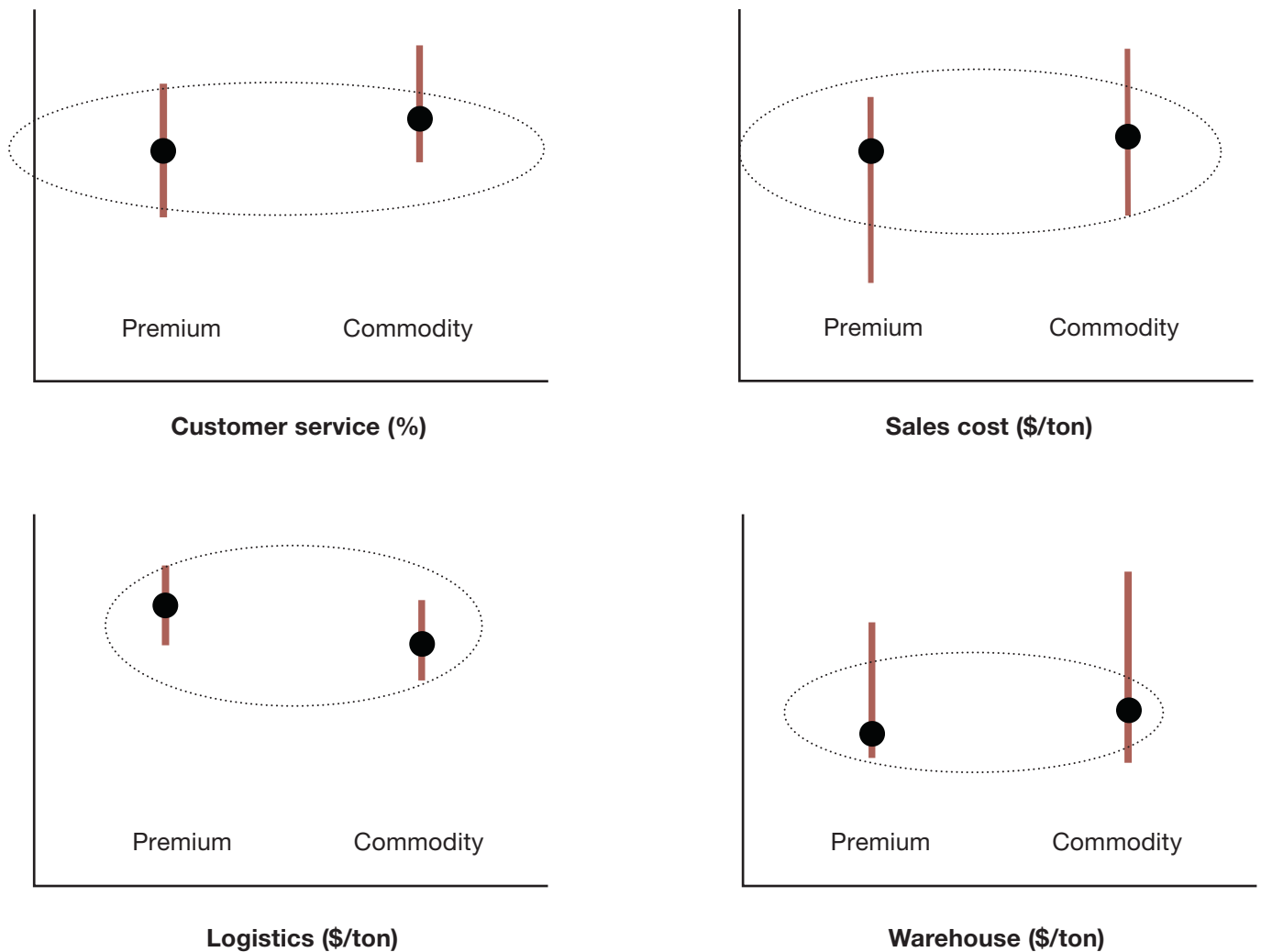
Customer segmentation can be important in both B2B and business-to-consumer (B2C) settings and is absolutely essential in a commercial excellence initiative — it gives form to all of a company's customer-facing activities. For this reason, companies must avoid the many bad practices that undermine the effectiveness of segmentation and weaken the resulting insights.

The most common pitfall is segmenting at too high a level — for instance, at the level of the manufactured end product or end markets. Suppose an agricultural seed company groups all of its customers that grow corn for food into one segment (“premium”), and all of its customers that grow corn for ethanol into another segment (“commodity”). There is some value in grouping customers like this —

*Customer segmentation can be important in both B2B and B2C settings and is absolutely essential in a commercial excellence initiative.*

the external opportunities and obstacles of customers in the same end markets tend to be similar — but it is not the type of segmentation that provides the best intelligence on how to serve the customer. And it can lead to waste and inefficiency if a segmentation that is too loose means superficially alike customers get the same level of service (see Exhibit 2). In that case, B2B companies may set up delivery and support mechanisms that overcharge customers that simply want the basics, while underserving their most demanding customers.

*Exhibit 2*  
**Non-differentiated cost-to-serve**



Source: Strategy& analysis



The best kind of segmentation to start with is usually one based on *service needs*. A segmentation of this sort, for instance, allows companies to define distinct and standard service packages for groups of customers with similar needs. In practice it may not make sense to create too many service clusters. But most B2B companies do offer multiple levels of service — from basic service for customers seeking the most cost-effective transactions, all the way up to premium service for customers that need a high level of responsiveness (rush deliveries and flexibility on volumes, for instance) and are willing to pay for it. There's a spectrum of possibilities that grows out of a segmentation based on service needs, and companies need to figure out how to address those needs.

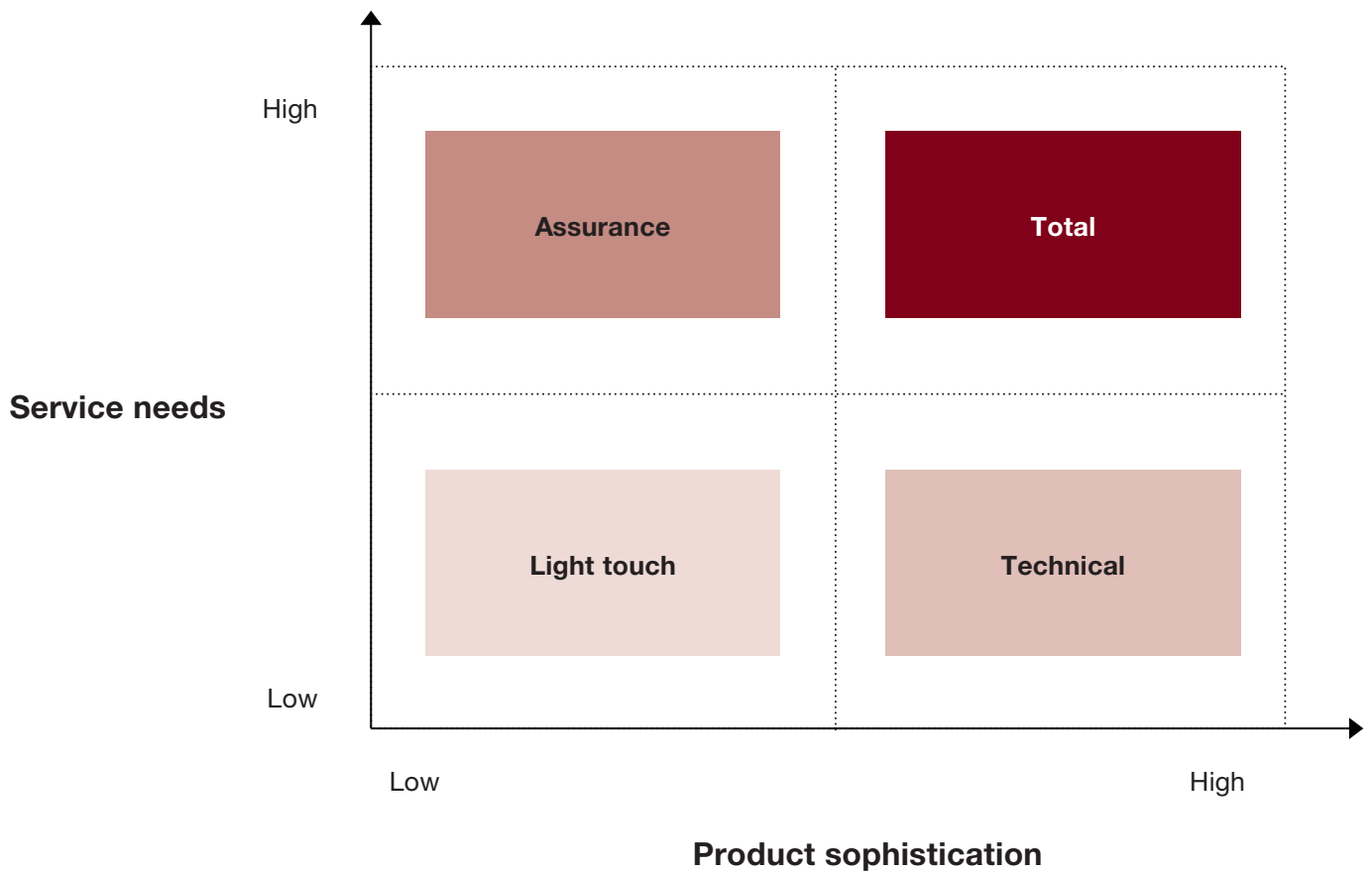
Determining the right questions to ask, in order to segment customers according to their service needs, can be tricky. While customer questionnaires typically focus on top-of-mind requirements including price, safety, and on-time delivery, these are qualifiers (things that allow companies to *compete* for business) rather than differentiators (things that position companies to *win* the business). Indeed, there are usually second-order needs — for example, customer intimacy, technical support, and a flexible supply chain — that determine who gets the order. Grouping companies by their needs along two axes provides a useful segmentation; Exhibit 3, next page, with sample descriptions for each customer segment, shows how such a framework might look.

In our experience, four is usually the right number of customer segments for B2B companies. Fewer, and the company drifts closer to one-size-fits-all simplification. More, and the company risks becoming entangled in unhelpful complexity. It is not unthinkable that a B2B company would have more than four customer segments, but any company that does should make sure it can justify the added complexity.

Although service needs are the most important input in doing segmentation, two other inputs should be used to supplement the analysis. One is size, meaning the amount of revenue or net gross margin the customer produces. A size-based segmentation might cluster customers into quartiles. A segmentation based on size alone would be dangerous, because it measures only how the company sees the customer — not the other way around. It's also by definition backward-looking, meaning it can leave a company unsure of what to do next. On the other hand, paired with a service-based segmentation, one based on size can be valuable in determining what premium to charge over and above the baseline price (*see Exhibit 4, page 11*).

A third segmentation component is *supply* of product. It might seem that a product segmentation should be done independently of a customer segmentation — and it should, except insofar as it influences what the

*Exhibit 3*  
**Needs-based segmentation**



Source: Strategy& analysis

supply chain must do to deliver on the overall service package. In fact, companies should separate their products or SKUs into three groups: the ever-present “runners,” the less frequent but still common “repeaters,” and the truly unusual, low-volume “strangers.”

These product categorizations become critical in determining forecasting and inventory strategy. Put simply, runners do not require manual estimation; an extrapolation based on historical trends is enough. Strangers must be forecast using all the resources that an extended supply chain can provide. The two product categories also demand dramatically different inventory policies, with runners made to stock and strangers made only to order. A company creating an offer for

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*Exhibit 4*

**Price premiums for customers, segmented by account size and service requirements**

	<b>Total</b>	<b>Technical</b>	<b>Assurance</b>	<b>Light touch</b>
1st quartile (customers in the Top 25% by revenue)	<b>3%</b>	<b>2%</b>	<b>1%</b>	<b>0%</b>
2nd quartile	<b>4%</b>	<b>3%</b>	<b>2%</b>	<b>1%</b>
3rd quartile	<b>5%</b>	<b>4%</b>	<b>3%</b>	<b>2%</b>
4th quartile (customers in the bottom 25% by revenue)	<b>6%</b>	<b>5%</b>	<b>4%</b>	<b>3%</b>

Source: Strategy& analysis

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stranger products must be careful to specify a minimum batch size and an optimal lead time.

With these three inputs, this approach to segmentation (with customer needs leading) releases the supplier from the one-size-fits-all straitjacket. Suitable behaviors follow, beginning with sales but driving deep into scheduling, logistics, and manufacturing. This alignment with a customer's needs positions the supplier to achieve — and be rewarded for — commercial excellence.

**Pricing**

The third foundational discipline in commercial excellence is pricing. There are really three main approaches to B2B pricing, and suppliers should strive to be fluent in all of them. This fluency allows suppliers to vary pricing approaches depending on the product, and to adopt different approaches to the same product depending on where it is in its life cycle.

*Cost-plus*, often used in “low-need” commodity segments, is a common pricing approach in B2B settings. It involves figuring out one’s total cost, overhead included, and adding a markup to achieve a target rate of return.

Cost-plus sounds simple in theory, but B2B companies are often deficient in how they execute it. In particular, although companies generally do a good job of analyzing their current cost structures, they often fail to anticipate how those costs might change, particularly with respect to raw materials. Or if they think about raw materials, they don’t convert the raw material costs into variable costs for the finished product. And only a small percentage of organizations take cost-plus to its logical conclusion, which is indexing.

Indexing is the practice of automatically making price adjustments when the costs of raw materials (which often trade on public markets) go up or down. Indexing has obvious benefits to both seller and buyer but faces an organizational obstacle: Most salespeople dislike it. They dislike it because the automatic nature of indexing detracts from their own contribution and deprives them of the opportunity, if commodity prices fall, to make supernormal profits for their companies (and bigger bonuses for themselves). On the other hand, in the absence of indexing, many organizations end up with the worst of both worlds: prompt price reductions as the costs of raw materials fall (and as customers clamor for a break), and lagging increases as those costs rise. One way to think about the contradictions inherent in indexing is to remember that it’s the rare salesperson who likes it, and the rare senior manager or shareholder who *doesn’t* like it. At the executive and owner level, the stable cash flow enabled by indexing is valued enormously.

Companies don’t like to reveal their cost-plus calculations, so even if they are mostly using this approach, they sometimes say they practice *value-based pricing*. Value-based pricing certainly has its place — and can deliver strong profitability in “high-need” sophisticated segments for a supplier with a differentiated product — but it is much more difficult to do. As a first step, a supplier needs to establish both a reference product and a market price. The supplier must then establish how the benefits of the new product — lower application cost, ease of storage, lower cycle times, and so on — create value for the customer. Such value is often much easier to discuss conceptually than to quantify, leading to a situation where sellers leave money on the table. One chemicals company, in rolling out a new product that cost 10 percent more to produce, proposed a 25 percent price hike to a customer — and then crossed its fingers. The customer accepted within days. Only later did the chemicals maker realize that its product allowed the customer to eliminate an entire manufacturing shift — a savings that would have justified a sixfold increase in price. With all the things that are invisible

in B2B pricing, it's no wonder that value-based pricing is relatively rare. A sales force has to be extraordinarily capable to apply it well and consistently.

The lack of visibility in many areas of B2B also factors into the third pricing approach: *competitor-focused*. Unlike at consumer companies, salespeople at mining or steel or agricultural companies can't simply go to a store to learn what their competitors charge. They have to make an educated guess about it. Yet in some niches of B2B, competitor-focused pricing — imperfect as it is — is the main model used.

In competitor-focused pricing, business ethics emerge as a concern. Certain ethical and legal boundaries exist — companies cannot do price-signaling, for instance. Within those boundaries, however, companies are free to try to predict a competitor's strategy. To do this, they make educated guesses about the supply and demand balances of third parties, and about the competitor's manufacturing and logistics costs. When all these factors are incorporated into an industry cost-curve model, a company can predict minimum price levels across different regions. Still, there is no guarantee that the company will get it right. Might suppliers optimize their costs and serve the nearest customers first? Might the cost laggard set the price ceiling for the rest of the market? Markets do not always operate rationally, and the lack of perfect information creates risk for those deciding what price to put on a product. But even a rough level of insight is better than none, and there are ways to do competitor-focused pricing that are more methodical than others.

*The lack of perfect information creates risk for those deciding what price to put on a product. But even a rough level of insight is better than none.*

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# ***Conclusion: The potential for a fast payback***

The last few years have been tough for many B2B businesses. Their end markets have been flat and their cash flows weak, and after several years of aggressive cost containment, their options for continued profit gains through cost reduction are limited. But they can still derive significant value through commercial excellence.

Companies beginning commercial excellence initiatives should take a holistic approach, rather than pursue piecemeal change. That said, they would be well advised to focus first on the three interlocking commercial disciplines that form the basis of future improvements. Margin diagnostics gives management confidence that commercial processes are under control. Customer segmentation ensures that the company is aligning its various activities with customer needs to achieve a pricing premium. The premium, in turn, depends on strong capabilities in the area of pricing.

Building these three disciplines requires commitment from an organization, and can benefit from a high-level champion. But such a commitment can pay off handsomely. We have seen commercial excellence programs add 3 to 5 percentage points to profit margins within six months. It's easy to create the business case for that.

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