

# Uncover Sweet Spots Using Net Profit

*Examine profitability to segment markets, target new customers*

*This article examines ways distributors can use net profit or net before compensation to segment their markets and target new customer acquisition efforts. The authors argue that this approach will be more lucrative and ultimately easier to implement and less resource-intensive than other methods, including Activity Based Costing.*

**By Jonathan Bein, Ph.D. and Randy MacLean**

Good segmentation of your markets is one of the keys to successful new customer acquisition, making sales and marketing efforts more efficient and effective. Focusing on sweet spots lowers your acquisition cost and increases customer profitability.

The following approach uses net profit or net before compensation to help determine effective segmentation. It assumes that past success in the market is the best predictor for future success. If you can identify successful segments, that success can be replicated in the market by acquiring similar customers. Replicating success is the fastest way to grow your business.

## Measuring Success

Before analyzing segments, it is important to understand how to measure success at the account

or customer level. Most distributors measure account success based on gross profit or gross margin percentage. While using gross profit is clearly better than using revenue as the key metric, it completely excludes any indication of cost-to-serve, the most significant element in predicting profitability. Cost-to-serve includes all of your operating expenses and sales compensation, which vary significantly by customer and by segment.

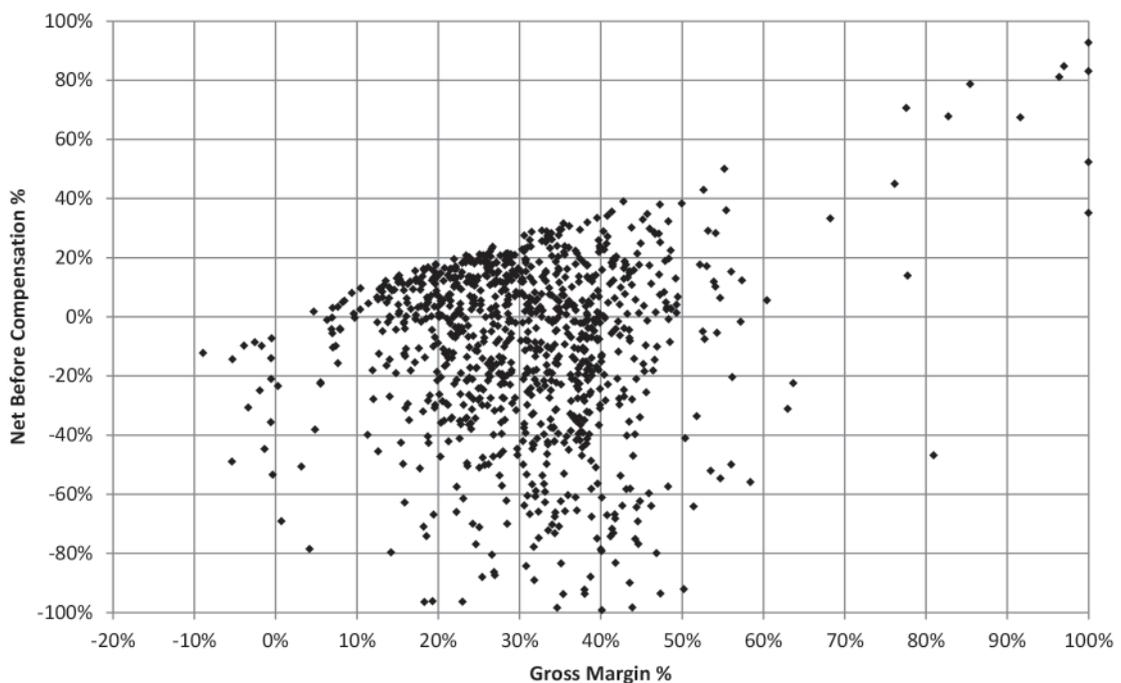
At the account level, there are two better measures of success:

- Net profit: gross profit minus cost-to-serve
- Net before compensation (NBC): net profit plus sales compensation.

NBC is likely the best-available indicator of profitability, as it accounts for volume, margin and operating expenses.

Gross profit and either net profit or NBC are often very poorly correlated. **Figure 1** shows NBC and gross margin for about 1,000 accounts of Acme Distributors. Acme is a real distributor focused on the building materials market; its name and business segments were changed for this article. The horizontal axis shows gross

**Figure 1: Account Gross Margin Percentage vs. Net Before Compensation Percentage**



margin percentage, and the vertical axis show NBC percentage. Most of Acme’s accounts have 20 percent to 40 percent gross margin. Yet, there is very little correlation between gross margin and NBC as the NBC ranges from 40 percent to -100 percent.

It is tempting to think that Acme Distributors is an anomaly, yet this lack of correlation between gross profit and profitability (represented by either profit or NBC) is the norm for most distributors. Working with detailed WayPoint profit analysis in more than 60 channels, we’ve seen almost no correlation between profitability and margin and only a very slight correlation between profitability and volume.

Gross margin is an unreliable approach to measuring success at the account level. NBC and net profit are much more relevant and reliable. NBC also avoids the analytical distortions introduced by the vagaries of sales pay.

But how can NBC be used to segment your market for customer acquisition?

### Choosing Segments

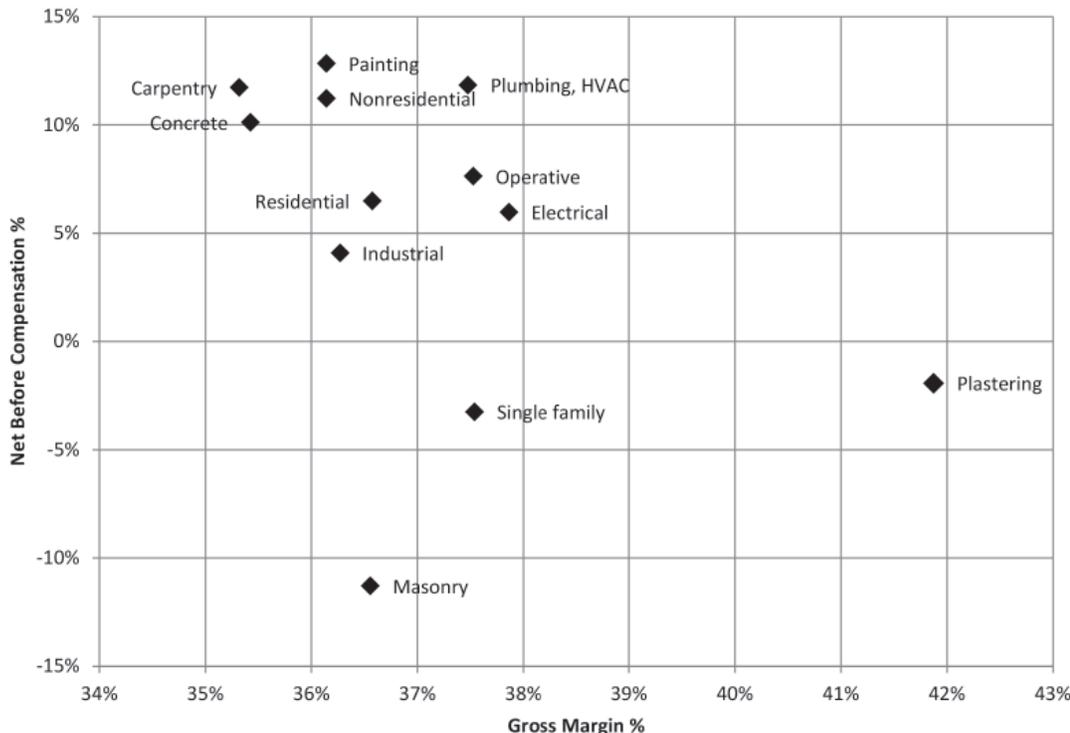
There are many ways to segment markets. We use firmographic variables such as line of business, customer revenue, number of employees, proximity to distributor locations, etc. The measurement of success at the account level, NBC, can also be applied to identify sweet spot market segments with firmographic variables.

**Figure 2** shows 12 different market segments by line of business for Acme Distributors. The horizontal axis shows gross margin percentage and the vertical axis show NBC percentage. While most of these segments vary between 36 and 38 percent gross margin, the NBC varies between 13 percent down to -12 percent. The plastering segment has 42 percent gross margin (the highest among the segments), but a -2 percent net profit.

But there are clear differences between the segments that should be noted when acquiring new customers. The table on page 6 provides a description of each of the segments. Based on NBC percentage and total NBC, the painting, plumbing/HVAC, carpentry, nonresidential, concrete, operative and residential segments are attractive. On the other end, the electrical, industrial, plastering, single family and masonry segments are either too small or the NBC percentage is too negative.

Based on this data, Acme Distributors should focus its customer acquisition efforts on the attractive segments as defined by the data, not by simple gross profit or gross margin percentage. In addition, it should also seek to understand why the five segments are unattractive, especially single family since it is such a large segment. Is the unattractiveness of those segments something structural about the segments themselves, or is the issue in how Acme

**Figure 2: Segment Gross Margin Percentage vs. Net Before Compensation Percentage**



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serves them? This type of analysis provides a good starting point for assessing the success and potential success of these segments.

NBC and net profit are the most relevant means for measuring success at the account level. When used with firmographic data, it forms a powerful basis for market segmentation. Targeting the right segments for new customer acquisition will have a dramatic effect on profitability because the profitability of individual segments varies so widely.

While there may be some additional effort required to capture and gather these costs, it is nominal compared to prohibitively expensive

techniques, such as those involved in Activity Based Costing. And the increased profitability of this approach significantly offsets any additional cost.

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Line of Business	Total Revenue	Gross Margin Percent	NBC Percent	Net Profit Percent
Painting and Paper Hanging	\$645,393	36%	13%	10%
Plumbing, Heating, Air-conditioning	\$1,453,928	37%	12%	9%
Carpentry Work	\$251,657	35%	12%	9%
Nonresidential Construction, nec	\$1,570,798	36%	11%	9%
Concrete Work	\$1,717,511	35%	10%	7%
Operative Builders	\$1,544,532	38%	8%	5%
Residential Construction, nec	\$5,485,862	37%	6%	3%
Electrical Work	\$1,007,092	38%	6%	3%
Industrial Buildings and Warehouses	\$2,106,601	36%	4%	3%
Plastering, Drywall, and Insulation	\$624,179	42%	-2%	-5%
Single-family Housing Construction	\$3,344,731	38%	-3%	-6%
Masonry and Other Stonework	\$1,683,206	37%	-11%	-14%

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