Measuring the Payoff From Improved Customer Service

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In recent years, we have often been approached by senior executives with questions along the following lines: „I hear all this hype about providing better customer service as part of my Total Quality Management program, and it sounds intriguing, but the thing is, how do I justify investing in it? I know that improved service is supposed to generate higher revenues, but can anyone prove that it does – and by how much? What's the payoff?"

That was a challenge we couldn't ignore. So we set to work to establish – in hard dollars-and-cents terms – the relationship between levels of customer service and levels of revenue. And we did establish it – and then went on to develop our discovery into a uniquely effective methodology. What follows is a brief account of how we went about linking levels of customer service to real customer-defined value.

Defining Our Terms

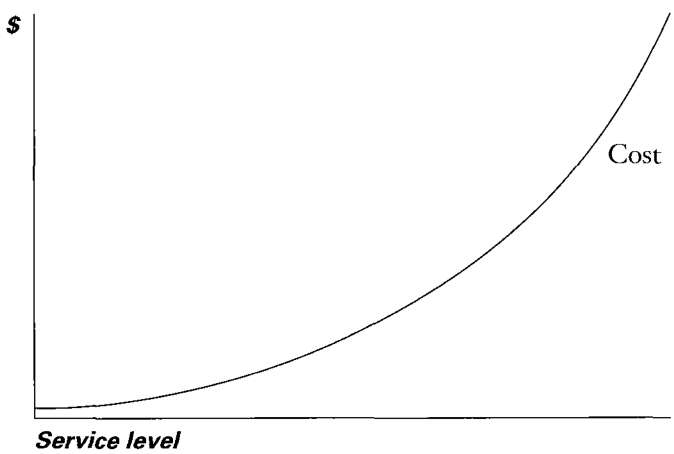
The first step in determining the payoff for improved customer service quality was to define the full scope of service as the customer sees it. Our studies indicated that the customer sees service as part of a total package comprising three elements: the product itself, the service that comes with it, and – inextricably linked to these two things – value.

We defined „payoff" as the incremental profit received – both from increased market share, sales, and revenues and from reduced overall cost – as a result of better service. In other words, we were looking for the impact of improved customer service on the bottom line.

We observed that, over the past two decades, highly accurate tools and techniques had been developed for measuring the cost of providing increased levels of service. Generally, the relationship between service levels and cost takes the form shown in Exhibit 1. That is, as the level of service delivered with the product is improved, costs usually go up. But, of course, this relationship is only one side of the equation. The other side – the level of sales achieved for the different service levels delivered – has always been based on intuitive judgments. Because managers have been able to quantify only the cost side of the picture, decisions about the level of quality to build into a given package – including product, service, and value – have been based on cost figures and „hunches."

Exhibit 1

Service Level and Cost



Of course, responsible managers have always known that better service increases sales and market share – up to a point. The critical thing for us to determine was „How much added sales – and profit contribution – do you get for how much added service?" We knew that the curve we were seeking would look pretty much like the one in Exhibit 2.

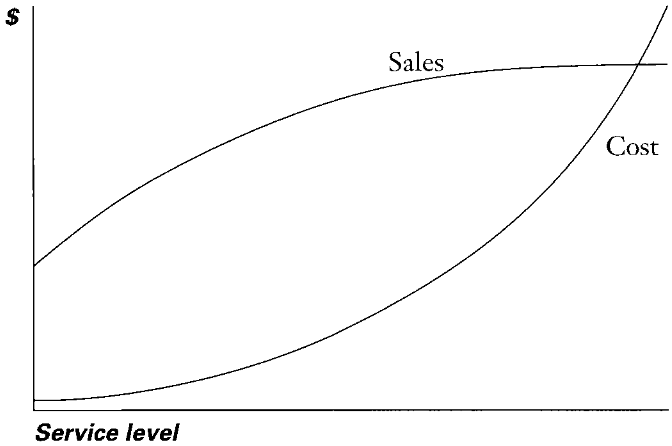
The Breakthrough

We developed our methodology for linking service levels with value in the course of a study we were asked to conduct for a large national food products firm. This company was one of two major producers in the food category being studied. The sponsoring firm enjoyed a 38 percent market share nationally, whereas its principal competitor had 3 5 percent. Clearly, competition was keen.

We found that with one of its major customers, a large regional chain, our client enjoyed a 41 percent share, while the competitor had only 32 percent. Upon investigation, we discovered that for this chain, our client had a special four-times-weekly delivery schedule, in contrast to the twice-weekly schedule it provided to most of its other customers. This had the effect of reducing the inventory the customer needed to carry, increasing turnover, improving freshness, and eliminating the need for store personnel to restock the shelves. Clearly, the more frequent schedule meant reduced cost and higher value for the retailer.

Exhibit 2

Service Level, Cost, and Sales



For the manufacturer, although the more frequent delivery schedule required somewhat lower volumes of „safety“ stock, it nonetheless meant a somewhat higher cost of service. On the plus side, however, delivery of fresher product to the consumer – combined with more frequent contact with store management – had the effect of increasing sales. The manufacturer could also charge a slightly higher price. The resulting increase of three share points for the manufacturer also meant an 8 percent increase in sales volume and an almost 15 percent improvement in profit.

But this clear connection between service and profits was demonstrated for only one regional customer. The critical questions for the manufacturer were whether this pattern would hold true across a range of customers and markets and whether other improvements in service would yield similar benefits.

To answer these questions, we needed to determine the value to the customer of specific service elements provided by the manufacturer to the customer. By comparing those service elements with the service packages provided by major competitors (each including product quality, service levels, and price) and determining how the customer split its purchases among several suppliers, we could determine how the customer valued the total service package in all its aspects and what level of service the customer was willing to pay for.

In this case, it was clear that the retailer valued the more frequent delivery of fresher product enough to pay a slightly higher price for the total service package and to place more business with the preferred supplier. However, it was not at all clear precisely how much value was provided by each element in the service package. To answer a question of this kind, composed of many complex and interrelated variables, requires extensive data, computer modeling, and the application of sophisticated statistical analysis techniques. But once the relationships between service levels and value have been identified and implemented, the payoff can be enormous.

The final chapter in this case study provided a landmark indication of the power of quantifying the value of customer service. After the data from our study had been fully evaluated on a national basis, we helped the client design and implement a Total Quality Management program in all markets. The results: two additional share points nationwide, for an additional $15.8 million in annual sales revenues and an additional $4.75 million in profit – a very substantial return on the service investment.

Quantifying the Payoff for Improved Service

Our approach to linking service levels to value, in brief, is as follows. First, we identify those service elements that are critical to the customer, causing him or her to prefer to do business with the supplier that provides these in superior fashion. We then identify to what degree the customer responds negatively when these elements are not offered or are executed poorly. We also determine how the client in question – and the client's major competitors – perform on the service attributes shown to be important. Next, we identify the respective shares of the customer's purchases, by product category, from the competing suppliers. The relationship between service received and purchases made provides the critical information. Finally, we construct an individual service package, emphasizing the service attributes proven to influence customers for increased business with the firm in question.

Our program begins conventionally enough, with an extensive survey of customers. We often interview several hundred customers or more, depending on the product/service and the market segments being evaluated as well as the variability of service requirements among customer groups. This survey elicits information about product and service needs, value, and the relative performance of the several suppliers in these markets. In particular, it is vitally important to determine how customers split their business among the several suppliers for each product category.

Once the data are collected, we are able to subject them to the unique analysis that permits us to identify and quantify the value of customer service. In brief, we statistically cross-section responses to a variety of questions relative to service received from each supplier, and we relate these responses to the share of customer purchases (market share) among the various suppliers.

At this stage we identify, through statistical analysis, customer purchase behaviors that differ from the norm and relate these to the differences in service levels provided by various suppliers. Ultimately, this evaluation identifies the cause-and-effect relationships among various values for specific elements of service and customers' decisions to purchase greater or lesser volumes from each supplier. Once these relationships have been expressed numerically, we can mathematically express patterns of buying behavior in response to levels of service provided by suppliers. Modeling these relationships in this manner enables us to identify the optimal set of service attributes – and the optimal standards of service for each attribute – to yield maximum return on the service investment. In other words, we can develop a service strategy for which we can predict not only the costs that will be incurred, but the added sales and profits that will result – and the overall return on investment.

A Case Study: Service Impact on Price

In the mid-1980s, we were retained by a manufacturer of plastic laminates for the furniture and cabinet industries. At the time, this industry was producing to capacity to satisfy the demands of an expanding market for both new and refurbished housing. Our client was selling all he could make. He had two questions for us: „What are the customer service issues in the current sold-out market, in which there is no room for improved market share (because we're out of capacity), if we attempt to realize added price for added service?“ And, second, „What are the customer service issues when the market returns to normal and traditional competitive forces mean fighting for market share?“

Our initial market research revealed 2 5 factors that are important to this company's clients. Of these, our analysis identified nine as critical in enhancing value sufficiently that the customer is willing to pay a higher price. These factors are shown in Exhibit 3, along with the price increase each can command. We assisted the client in determining the market's assessment of his company's performance on each of these nine critical attributes. While our client was quite strong in the product-related attributes, there was substantial room for improvement in certain important service-related and value-related attributes, including order accuracy and payment terms.

With this information, the client undertook a program to ensure continued good performance in its areas of strength, to improve performance in key service attributes, and to identify money-saving opportunities on attributes not considered critical by customers. The results: In the short term, the client achieved significantly improved profit margins. In the longer term, when capacity ceased to be a problem, the client won significantly improved market share.

A Case Study: Service Impact on Market Share

We were asked by a West Coast pharmaceutical manufacturer to evaluate one of its promising products. The client believed, and clinical evidence indicated, that the product was as effective as its major competitors. Thus, the client was eager to develop a customer service package that would achieve competitive advantage. At the time, the product's market share varied from 30 percent in California – its home turf – to 18 percent in the Midwest and 5 percent in the Northeast.

Exhibit 3

Total Service Attributes That Command Increases in Price (Plastic Laminates Example)

Product attributes	***% Price increase***
Product line scope	1.4
Consistent quality	0.4
Finishing capabilities	0.2
Service attributes	
Accuracy of shipment to order	2.4
Carrier reliability	0.8
Handling of rush orders	0.6
Problem-solving helpfulness	0.4
Notification when shipment is delayed	0.2
Value attributes	
Reasonable payment terms	0.6
Total price impact	7.0

Our customer service analysis, performed as described above, revealed that customers for this product valued the following attributes, in order of priority:

• Product attributes: a specific taste and „mouth feel"

• Service attributes: emergency response capability, reliability of delivery date and time, and product availability (i.e., order fill) when needed

• Value: appropriate quantity discounts (i.e., „price points")

We recommended a customer service package incorporating all these attributes in a cost-related (value-based) mix. We also recommended concentration in the East and Midwest, including establishing a manufacturing plant in the East to support service and reliability to meet customer needs.

The results: Three years after the firm implemented our quality package, the product's market share had risen to 3 5 percent in California, 2 5 percent in the Midwest, and 16 percent in the Northeast – and was still growing.

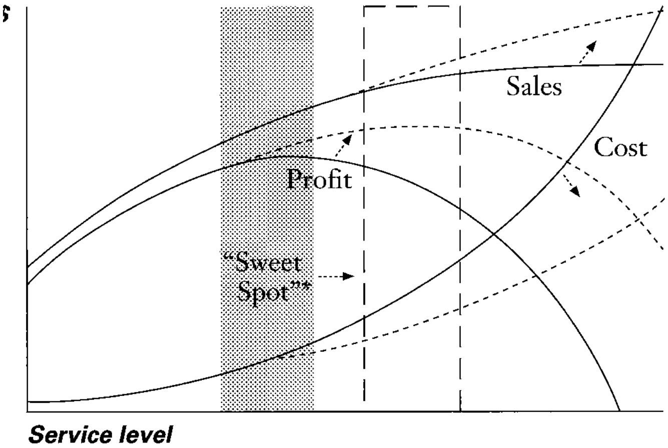
The Payoff

The ability to quantify both the costs and the revenues associated with different levels of service provided to customers makes it possible to design a total quality package – product, service, and value – to optimize return on investment (Exhibit 4). As the exhibit indicates, this new methodology can pinpoint the „sweet spot“ at which the level of service provided will yield the highest possible profit. It can also identify the point at which additional investments in service will yield diminishing returns – or no returns at all.

Over time, as Total Quality Management techniques are applied, the entire cost curve should move down and the region of maximum profit should move to the right – reflecting the ability of a continuously improving organization to provide higher levels of customer satisfaction per dollar of profit margin than their competitors. Clearly, the implications of this new capability are tremendous – not only for pricing flexibility and short-term profit margins, but for long-term customer retention and market share growth.

Exhibit 4

Service Level, Cost, Sales, and Profit



** Zone of most profitable service level*

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