COLLABORATIVE FOR CUBES™ Customer-Based Execution & Strategy

EXPANDING MARGINS

COLLABORATIVE FOR CUBES™ FINDINGS SHOW RIGHT WAY TO GROW

STRATEGY OUTCOMES
CUBES 100,000

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Increasing sales in a way that also increases margins is not easy for business-to-business (B2B) companies. Often business suppliers find their margins are far lower than their customer-facing counterparts. And at the 100,000-foot level, where CEOs are looking to examine the financial outcomes of their actions, B2B companies struggle to expand margins even as their sales increase.

B2B clients, unlike retail consumers, often have leverage on pricing. Many B2B clients are larger in size than their suppliers, and purchasing departments can exert substantial pressure when negotiating contracts. The ability of a B2B client to lock prices can also limit a company's opportunities to expand margins. Inflationary pressures can compound this effect.

A disadvantage on pricing is one of the reasons many B2B suppliers find themselves stuck in the "value trap." Feeling pressure to improve product performance by adding more and new features, B2B companies see their costs increase. But because of their clients' leverage on pricing, they are unable to pass on the rising costs, and their margins erode.

A Customer-Based Margin Expansion Solution

What if you could increase margins without having to load your products and services with costly new features? You can, and the solution is overall customer satisfaction.

Overall customer satisfaction lends itself to many benefits that help a firm increase margins. As overall customer satisfaction increases, customers are:

- Less likely to shop for competitive offers.
- Less price sensitive.
- More likely to continue using existing products/services.
- More likely to recommend products/services to others.
- Less likely to file complaints or request customer service.

All these outcomes reduce a business' operating costs, lower the pressure to compete on price, and expand a company's base of high quality customers. As a result, a B2B firm with higher customer satisfaction is likely to experience higher margins.

While this hypothesis may seem apparent, the Collaborative for Customer-Based Execution & Strategy (Collaborative for CUBES™) has tested it using data specific to B2B firms and shown precisely what companies can expect to happen to margins as customer satisfaction increases.

The Customer Satisfaction Effect

Satisfied customers benefit firms in a variety of ways. Customers who are more satisfied are more likely to:

- Recommend and refer a company to their peers.
- Repurchase a company's product or service.
- Increase quantities purchased.
- Engage in positive word of mouth activity.
- Be committed to a brand.

Customers who are more satisfied are less likely to:

- Complain to outside entities, such as regulators.
- Switch to lower-priced competitors.

By increasing revenues and decreasing operating costs, satisfied customers and the activities in which they engage aid margin expansion.

Collaborative for CUBES™: Collaborative for Customer-Based Execution & Strategy

The Collaborative for CUBES™ is intended to develop a B2B customer-based perspective that enables executives to design and execute strategy. The goals of the project are to:

- Understand the extent to which overall customer-satisfaction a key customer metric—is associated with executive-relevant outcomes like pricing-power, customer loyalty, willingness to recommend, and financial performance.
- Identify key strategic areas (e.g., bidding, safety, pricing) that can be leveraged to improve overall satisfaction.
- Determine specific execution levers to improve performance in key strategic areas.
- Provide a framework for executives to use a customer-based approach to crafting and executing strategy.

Collaborative for CUBES™ uses a multi-step approach to answer the key question: How, if at all, is overall customer satisfaction associated with non-financial and financial outcomes in a B2B context?

Step 1: Literature Review

A rich body of academic papers shows customer satisfaction can affect many company outcomes. However, the vast majority of papers address only B2C interactions. When academics have examined B2B interactions, they have examined single companies. And while it is easier to work with such case studies, it does not provide the level of descriptive confidence needed to understand the dynamics of the larger B2B marketplace.

Existing studies are also narrow in scope. Most examine a limited set of outcomes, focusing only on customer loyalty metrics and not aligning them with financial results.

The Collaborative for CUBES™ project examines a broad set of outcomes, including:

- **Customer loyalty metrics:** Whether a company will use a supplier for the next job, invite a bid, recommend the supplier, and pass along positive or negative word-of-mouth.
- **Top-line financial performance:** Sales and revenue.
- **Bottom-line financial performance:** Gross margins and earnings before interest, taxes, depreciation, and amortization (EBITDA).
- **Stock-market metrics:** Return on assets and Tobin’s Q (q ratio, asset market value divided by asset replacement cost).

Step 2: Data Collection

In November 2016, a national panel of more than 4,900 B2B managers participated in the baseline Collaborative for CUBES™ survey. The researchers measured overall customer satisfaction using a seven-point Likert scale. The scale is balanced with three categories indicating dissatisfaction, one showing indifference between satisfaction and dissatisfaction, and three categories indicating satisfaction. Each category has a numeric value and verbal descriptor.

If the supplier rated by the respondent represented a publicly traded company, researchers matched the supplier name to financial information. This is the source of all sales, revenue, and margin data used in the study, and such objective sales metrics made the results far more robust than subjective or self-reported sales measures.

Step 3: Econometric Estimation

The Collaborative for CUBES™ team merged the overall customer satisfaction survey with the financial data. The results are based on an econometric model that statistically isolates the unique association of overall customer satisfaction with each metric. The econometric model controls for the confounding effect of non-focal factors associated with the B2B firm (e.g., liquidity), industry (e.g., industry concentration), and respondent. This procedure provides a representative picture of the association of overall customer satisfaction with the different outcomes.

Overall Customer Satisfaction and Margins

Using the described methodology, Collaborative for CUBES™ was able to answer several critical questions about the relationship between customer satisfaction and margins. In Figure 1, margins are represented in millions of dollars on the Y-axis. The X-axis shows the overall customer satisfaction scale. Key conclusions from the relationship include:

- For a company, margins are 17% lower among dissatisfied clients than clients who are somewhat satisfied.
- When clients go from "extremely dissatisfied" to "extremely satisfied," margins nearly double from 7.4 billion to $14.8 billion.
- When clients go from "neither satisfied nor dissatisfied" to "extremely satisfied," sales jump from $10.4 billion to $14.8 billion for the average firm in our sample, a nearly 39% margin increase.

Figure 1. Margin Expansion with Customer Satisfaction

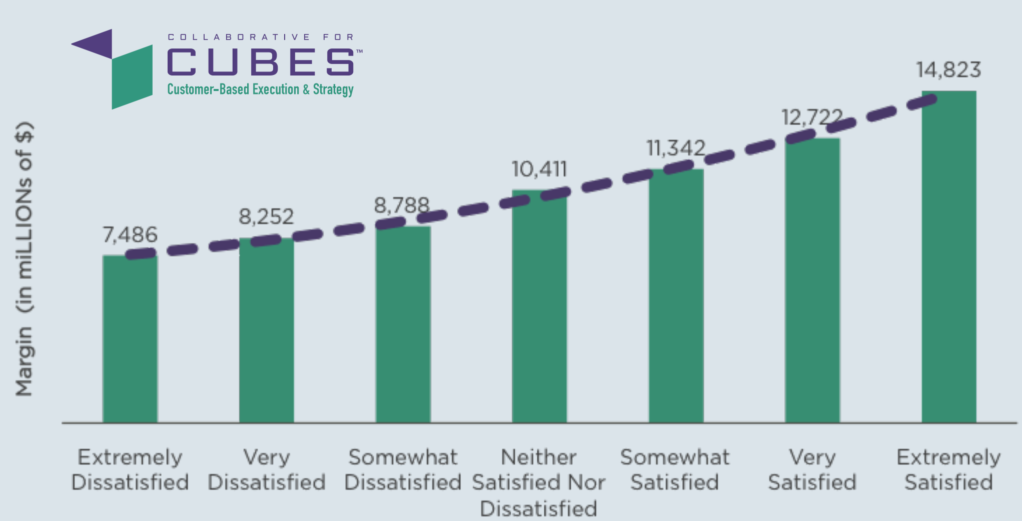
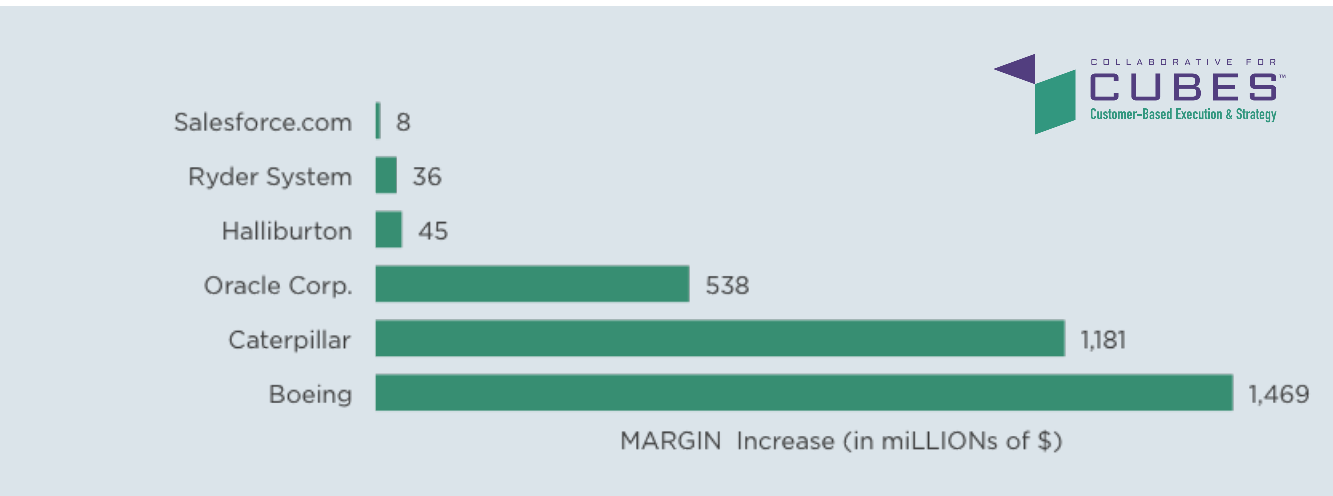


Figure 2 shows margin expansion for a select group of firms in different B2B sectors. For Oracle Corp., the increase in margins amounts to $538 million. Margins for Boeing would increase by $1.47 billion if its customer satisfaction moved from "very satisfied" to "extremely satisfied."

Figure 2. Margin Increase When Customers Move From "Very" to "Extremely" Satisfied



What's Next?

At the 100,000-foot level, B2B CEOs are responsible for delivering healthy margins and expanding them. Shareholders demand it, and company board members expect it.

One of the best ways to expand margins is to focus on increasing overall customer satisfaction. As documented in Volume 1 of the CUBES Insights Series, overall customer satisfaction also increases sales. In addition to sales and margins, can increased customer satisfaction have other beneficial consequences relevant to a CEO? The Collaborative for CUBES™ intends to address this question in a future Insights Series brief.

FURTHER READING

Anderson, Eugene W., Claes Fornell, and Roland T. Rust. "Customer satisfaction, productivity, and profitability: Differences between goods and services." *Marketing Science* 16, no. 2 (1997): 129-145.

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Mittal, Vikas, Eugene W. Anderson, Akin Sayrak, and Pandu Tadikamalla. "Dual emphasis and the long-term financial impact of customer satisfaction." *Marketing Science* 24, no. 4 (2005): 544-555.