COLLABORATIVE FOR
CUBES™
Customer-Based Execution & Strategy

THE EBITDA CONUNDRUM

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Earnings before interest, taxes, depreciation, and amortization (EBITDA) is a powerful metric used to evaluate the profitability of a business. Because of its nuanced approach to earnings, it is a different metric from cash flow.

At the 100,000-foot level, many boards and CEOs of business-to-business (B2B) companies rely on EBITDA as the key to evaluating the current and near-term health of their companies. Efforts to manage EBITDA typically focus on production factors that fall within the realm of finance and operations. Indeed, managing a firm's operational expenditures is seen as key to managing EBITDA.

While managing EBITDA via operating expenses can be effective, the focus of such an approach is strictly inward-looking. Over time, the focus becomes cost cutting, efficiency, and lean production. Research shows companies focusing on efficiency succeed at delivering higher long-term value to shareholders, but surprisingly, a 2005 study showed companies that combine an efficiency focus with a customer focus deliver even higher long-term value to shareholders — up to 1.5 times higher.

Managing EBITDA With Customer Focus

Why is a simultaneous focus on efficiency and customers beneficial for shareholders? It serves two purposes — an efficiency focus reduces a firm's costs, while a customer focus increases a firm's revenues. Though difficult, companies that can simultaneously become efficient and increase revenues create more shareholder value in the long run.

Executives intuitively understand this. However, how relevant is such an approach for B2B companies? B2B firms are different than their business-to-customer counterparts. B2B companies frequently deal in industrial products sold through large buying centers and purchasing departments. This puts the focus on improving product performance while lowering price. This condition, known as the "value trap," may erode a company's ability to maintain and increase EBITDA. Increasing product performance entails investments in research and development, modifications in plants and processes, and investments in supporting new features. These increased costs, when coupled with pricing pressures to stay competitive, crimp EBITDA.

Resolving this conundrum requires B2B companies to amend their focus to include customers as well as efficiency. In any firm, overall customer satisfaction provides a clear and concise metric of its customer focus. Customer satisfaction reflects the extent to which a company meets the totality of its clients' needs. As a metric, customer satisfaction goes beyond product and pricing to capture the whole customer experience, including initial sales/bidding, communication, pricing and billing, project management, safety, sustainability, and product and service quality.

So what is the association between EBITDA and customer satisfaction in a B2B setting? If higher overall customer satisfaction is associated with lower EBITDA, a customer-focus would be considered incompatible with efficiency. If higher overall customer satisfaction is associated with higher EBITDA, it would imply a customer focus is compatible with an efficiency focus. Which is true? The Collaborative for Customer-Based Execution & Strategy (Collaborative for CUBES™) offers the answer.

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 scholars 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 financial metrics made the results far more robust than subjective or self-reported measures of performance.

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 EBITDA

Figure 1 shows the association between overall customer satisfaction and EBITDA. Collaborative for CUBES™ researchers draw several key conclusions from the relationship:

- “Extremely dissatisfied” customers yield 77% lower EBITDA than clients who are “somewhat satisfied.”
- Going from an “extremely dissatisfied” customer to an “extremely satisfied” customer more than doubles EBITDA from \$6.79 billion to \$13.89 billion.
- For the average firm in the Collaborative for CUBES™ sample, EBITDA increases from \$10.93 billion to \$13.89 billion when customers shift from being “neither satisfied nor dissatisfied” to being “extremely satisfied.” This represents a 27% increase.

Figure 1. EBITDA and Overall Customer Satisfaction

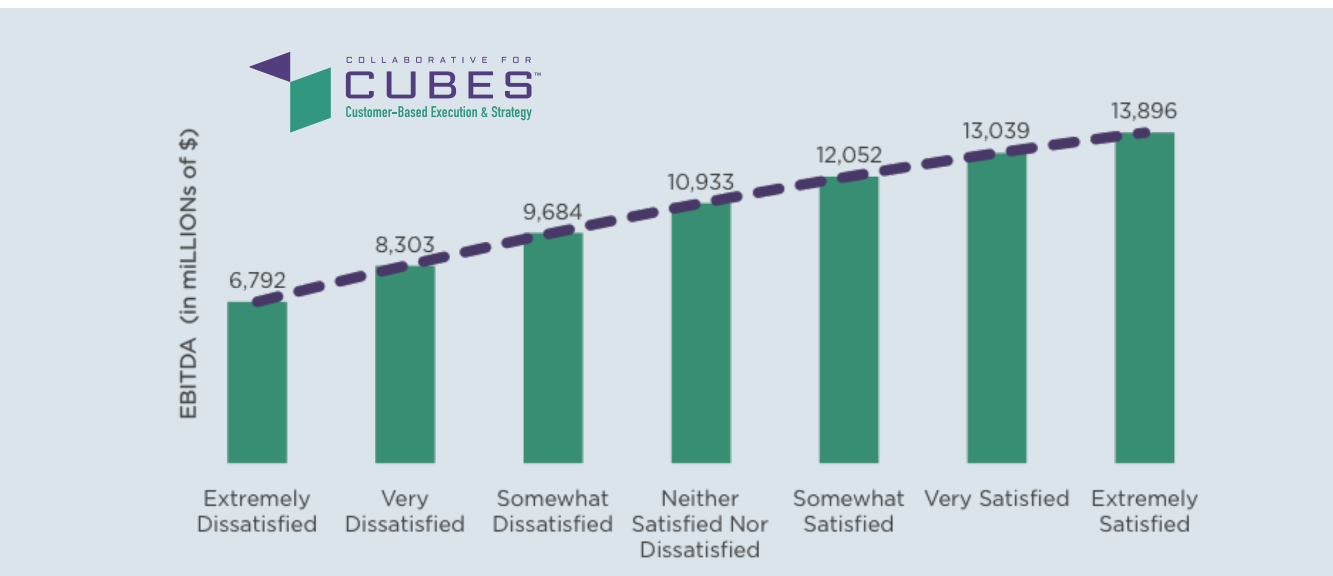
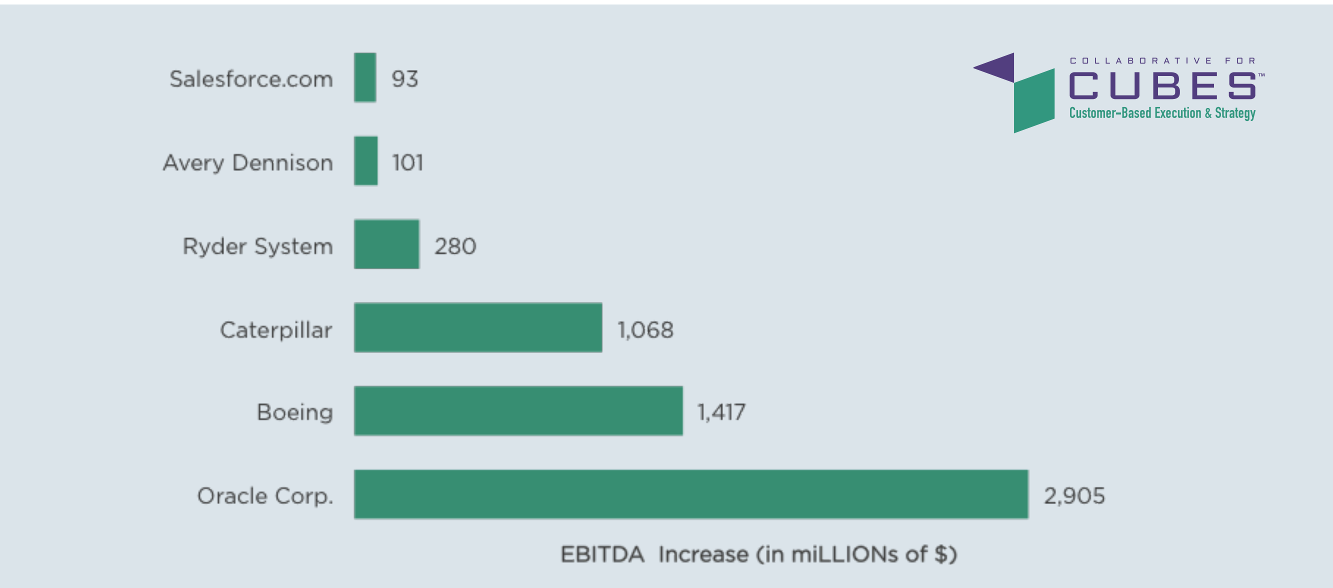


Figure 2 shows the EBITDA expansion for several B2B firms if they increased customer satisfaction from being "very satisfied" to extremely satisfied. For Oracle Corp., the increase in EBITDA is $2.9 billion, while for Caterpillar the increase is $1.1 billion.

Figure 2. EBITDA When Customers Go From "Very" to "Extremely" Satisfied



What's Next?

Customer satisfaction and increasing EBITDA are compatible goals, and B2B companies can be customer focused and efficiency focused simultaneously. At the 100,000-foot level, B2B CEOs can increase EBITDA by improving overall customer satisfaction.

In addition to EBITDA, the Collaborative for CUBES™ has shown overall customer satisfaction is associated with increased sales, margins, customer quality, and pricing power. The metric has proven to be a powerful indicator of success and one B2B companies should focus on to ensure continued profitability.

FURTHER READINGS

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