Context…

Spice Distributors is focused on the delivery of flavoring products for use in kitchens. The company competes mostly with broadline distributors. Their value proposition is "quality, depth, and consistency".

They sell through a single channel, directly to restaurants, diners, and delis. They have over 10,000 customers, only the largest of whom are under contract. All other sales are typically made by the drivers.

The company is quite profitable. As the scope of products is limited to flavorings, most customers are small. The gross margin is good, but EBITDA could be improved as the pick, pack, load, and deliver costs are high due to the relatively small size of the average customer.

AVANT
ADVISORY GROUP
SECURING VALUE

Quality of Customer Diagnostic Report

SPICE DISTRIBUTORS
• BRINGING FLAVOR TO LIFE •

Prepared for Value Ventures, LLC

February xx, 202x

February xx, 202x

Ms. Jane Doe
Chief Executive Officer
Value Ventures, LLC
Penny Lane
Anywhere, USA

Dear Ms. Doe:

We performed certain analytical procedures on customer transactional data at your request and direction in connection with your contemplated acquisition of Spice Distributors, LLC (“Spice” or the “Company”).

The procedures that we performed do not constitute an audit of Spice’s financial information in accordance with generally accepted auditing standards, nor do they constitute an examination of prospective financial information in accordance with standards established by the American Institute of Certified Public Accountants. Accordingly, we express no opinion or any other form of assurance on the financial information, management representations, or other data of the Company included in or underlying the accompanying information. While we believe the information substantially addresses your request, we are not in a position to assess its sufficiency for your purposes. In addition, we have no responsibility to update this report for events or circumstances occurring after the date of this report.

In performing the analytical procedures, we have accumulated customer transactional data and performed various levels of analysis for your use and the use of other members of your due diligence team. The related findings are presented in the attached report and supporting analyses.

This report and supporting analyses are intended for use solely by the management team of Value Ventures, LLC. Copies should not be made, nor should the report be distributed to others without our express permission. If you have any questions related to this report or its contents, please contact NAME, TITLE, EMAIL ADDRESS.

Very truly yours,

Avant Advisory Group

DEFINITION OF TERMS

Term	Definition
SU	Strongly unfavorable average trend slope of customer purchasing behavior.
U	Unfavorable average trend slope of customer purchasing behavior.
N	Neutral average trend slope of customer purchasing behavior.
F	Favorable average trend slope of customer purchasing behavior.
SF	Strongly favorable average trend slope of customer purchasing behavior.
GP	Gross profit.
GM	Gross margin.
Core Product Penetration	The number of unique products purchased by a customer that comprise 75 percent of that customer's sales.
MCPP	The average of the 20 largest Core Product Penetration numbers.
Customer Penetration	The number of customers that have a product included as a Core Product Penetration.
MCP	The average of the 20 largest Customer Penetration numbers.

DEFINITION OF TERMS

Term	Definition
Champion Customer	The top 5 percent of customers by sales and that have a Core Product Penetration equal to or greater than 40 percent of the MCPP.
Flight Risk Customer	Customers that are in the top 75 percent of sales and that have a Core Product Penetration equal to or less than 5 percent of the MCPP.
Promising Customer	Customers that are in the 40^{th} to 75^{th} percent of sales and that purchase more than 40 percent of the MCPP.
Core Customer	The top 75 percent of customers by sales, excluding customers that are categorized as Champion, Flight Risk, or Promising.
Non-Core Customer	The customers that are in the bottom 25 percent of sales.

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Summary of Analyses

We were provided with the sales and related cost of sales transactional details of Spice for the period January 1 to December 31, 2022. Total transactions for the period were 573,726 across 10,510 customers, producing approximately $41.9 million and $23.6m in sales and gross profit, respectively.

We restricted our analyses to the top 75 percent of sales ($31.4m), which represented 74.8 percent of gross profit ($17.6m), and 24.2 percent of total customers (2,547) (see Figures 1 and 2).

Statistics

Financial period covered	January to December 2022
Transactions evaluated	573,726
Customers evaluated	2,587 (24.2 percent)
Sales evaluated	$31.4m (75.0 percent)
Gross margin evaluated	$17.6m (74.5 percent)

Figure 1

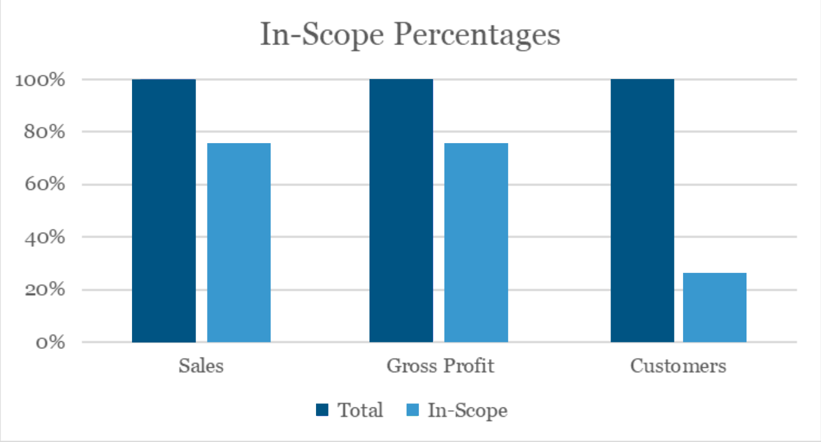
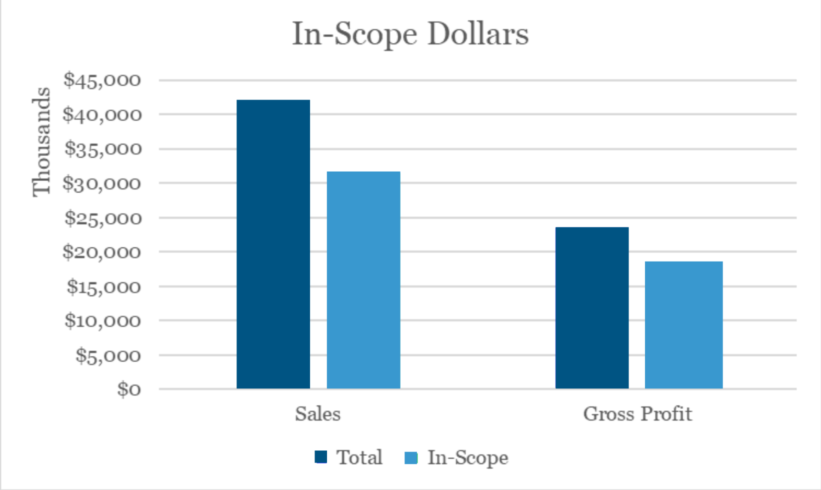


Figure 2



Summary of Analyses (cont'd)

We use the following scale, based on advanced algorithms, statistics and proprietary models, to rate customers for each of the quality and risk analyses performed:

Strongly Favorable – the analysis uncovers significantly compelling signals or evidence indicating a highly desirable customer population.

Favorable – the analyses uncovers compelling signals or evidence indicating a desirable customer population.

Neutral – the analyses does not uncover signals or evidence indicating a desirable or undesirable customer population.

Unfavorable – the analyses uncovers compelling signals or evidence indicating an undesirable customer population.

Strongly Unfavorable – the analyses uncovers significantly compelling signals or evidence indicating a highly undesirable customer population.

Figure 3 shows the individual ratings and overall rating of the quality analyses we performed, and Figure 4 shows the overall rating of the risk analyses we performed.

Figure 3

Quality Analysis	Top 1 Percent of Customers	All Others In-Scope
Core Product Penetration Rating	Unfavorable	Unfavorable
Stratification Rating	Favorable	Unfavorable
Purchasing Trends Rating	Neutral	Neutral
Categorization Rating	Neutral	Neutral
Unearned Discounts Rating	Neutral	
Overall Quality Rating	**Unfavorable**	**Unfavorable**

Figure 4

Risk Analysis	All Customers In-Scope
Churn Simulation Rating	**Neutral**

Core Product Penetration Analyses

A customer's Core Product Penetration (CPP), which is defined as the number of unique products purchased by the customer that comprise 75 percent of the customer's sales, is a key factor in evaluating the quality of a customer. A higher CPP is an indication of greater "wallet share" and stickiness of the customer. All things being equal, a customer that purchases many products from a company has higher switching costs to an alternative supplier and is more inclined to remain a customer in the long term.

An overall determinant of customer quality is the Maximum Core Product Penetration (MCPP) number, which is the average of the 20 largest customers' CPP's. Companies with higher quality customer have MCPP's above 15 percent of the total available, indicating that the largest 20 customers are making significant purchases across a broad number of products.

Spice offers a total of 242 unique products for sale. The minimum targeted MCPP is 36 (i.e., 15 percent of the total products for sale) and Spices' actual MCPP is 13. At a macro level, this is an indicator of a strongly unfavorable customer base. Spice's MCPP is approximately 5 percent of the total products for sale (see Figure 5). And there is virtually no distinction between the CPP's of the top 1 percent of clients and all other customers in-scope. In general, a company's larger customers will purchase a broader basket of products (reflected in a higher CPP) compared to smaller customers.

As Figure 6 shows, 79 percent of the in-scope sales are to customers with CPP's of 5 or fewer. This presents a potentially material risk to Spice. Unless there is a strong and defensible unique selling proposition (which is not included as part of our analyses) for either the products or from Spice, sales generated from customers with low CPP's are indicators of low customer wallet-share and stickiness.

Figure 5

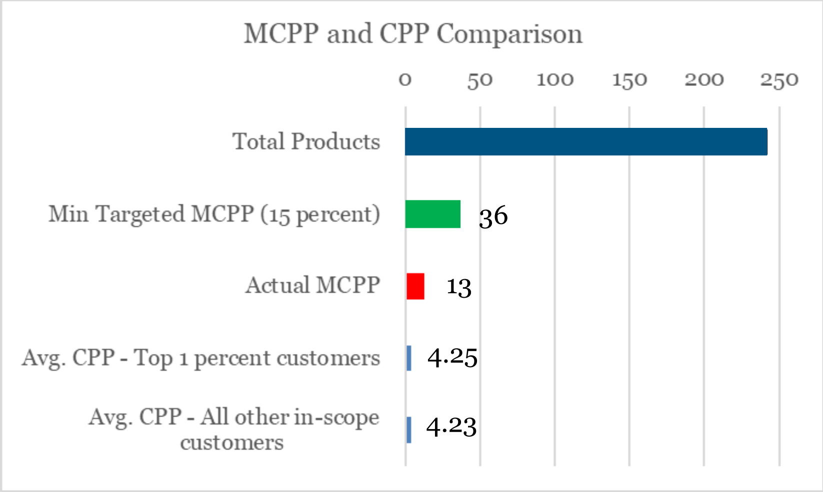
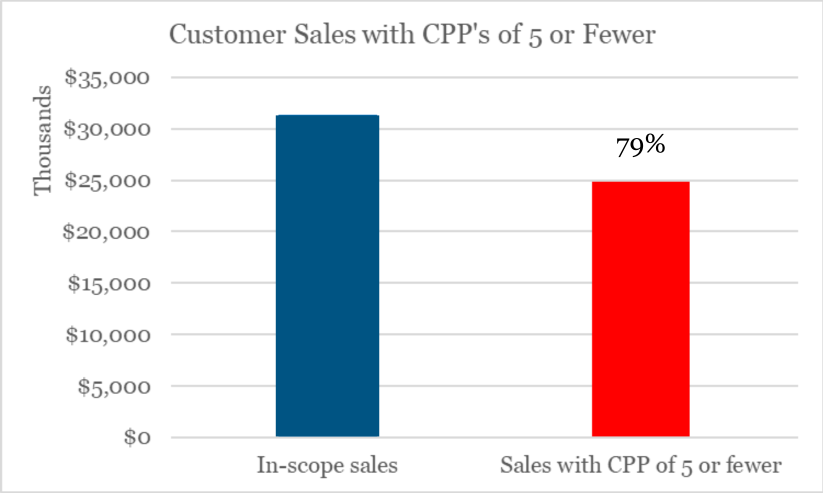


Figure 6



Core Product Penetration Analyses (cont'd)

Quality Analysis	Top 1 Percent of Customers	All Others In-Scope
Core Product Penetration Rating	Strongly Unfavorable	Strongly Unfavorable

What impacted the overall rating?

The actual MCPP is only one-third of the minimum targeted MCPP. The average CPP's of the top 1 percent of customers is virtually the same as the other in-scope customers, and 79 percent of in-scope sales are to customers with CPP's of 5 or fewer.

Why is core product penetration important?

Company's want to sell products that their targeted customer segments want to buy. Core product penetration is a strong indicator of a whether a company's product portfolio is meeting the needs of its customer base. Higher CPP's indicate that the company has a defensible and unique selling proposition that resonates with their target customers. Conversely, customers with lower CPP's indicate that they are generally "cherry picking" the products they purchase from the company and are utilizing other suppliers to meet their needs and/or wants.

Marketing and sales can use CPP to gain insights into which products are generally more valued by the different customer segments. Customers with low CPP's may not be aware of the unique selling proposition of the company's other products and additional engagement with and education of the customer may be warranted. These insights provides sales management and salespeople with specific actions and discussions to have with customers and target customers.

Finance can use CPP to develop a more nuanced pricing and discount strategies to improve sales, profitability, and wallet-share with existing customers. Expanding sales to existing customers is a highly effective tactic to grow sales and improve profits.

Customer Stratification Analyses

The top 1 percent of customers by sales had materially larger average sales (6.2x) and average gross profits (5.7x) than the other in-scope customers (see Figure 7). Accordingly, we analyzed the two stratified customer segments separately, when appropriate, to avoid the distorting effects that would result from analyzing the in-scope customers as a whole.

The top 1 percent of customers (105) comprised $6.6m of sales (15.8 percent), $3.4m of gross profit (14.6 percent) and all other in-scope customers (2,442) comprised $24.8m of sales (59.2 percent) and $14.1m of gross profit (59.9 percent) (see Figure 8).

No single customer accounts for more than 1 percent of total sales.

Figure 7

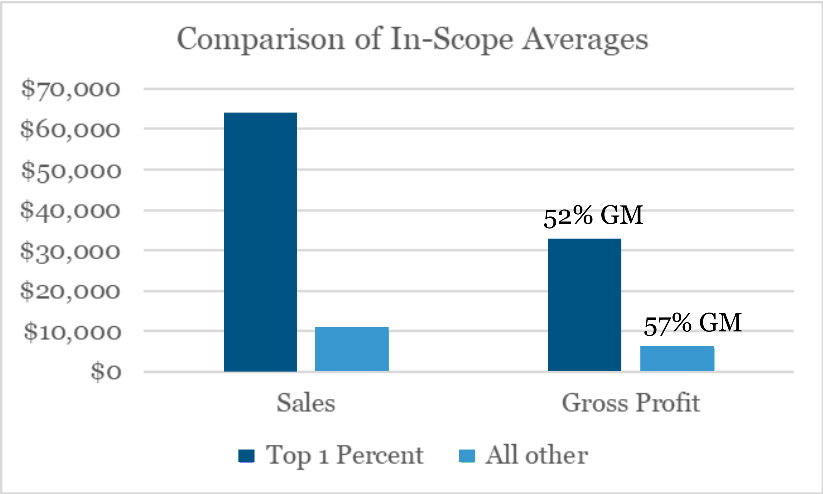
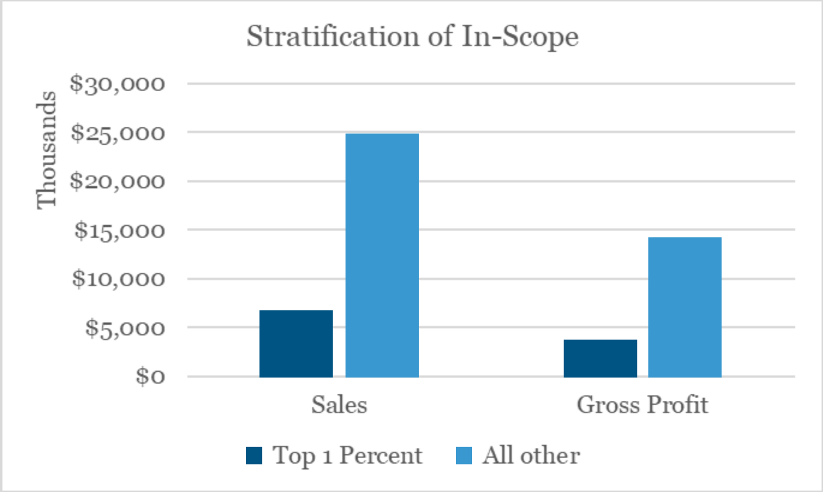


Figure 8



Customer Stratification Analyses (cont'd)

A histogram of the top 1 percent of customers is summarized in Figure 9. There are 15 customers with sales greater than $100,000 for the period under review. As expected, the larger customers have smaller gross margins, and the gross margins generally increase as the size of the customer decreases. The customers in the $30,000 - $40,000 sales range are an exception, which may be due to differences in product mix.

Figure 10 shows the histogram of the other in-scope customers. There is a significant skewing of customers towards the two lowest ranges of sales that, while not unusual, indicates that the typical customer size in this population is relatively small.

The customers in the $1,500 - $5,000 sales range have an average gross profit of $2,807. The cost to acquire and serve these customers should be compared to their estimated lifetime value to ensure this customer population can be profitably served.

Figure 9

Top 1 Percent of Customers by Sales					
Sales Range	**Customers**	**Sales**	**GP**	**GM**	**Avg. GP**
$30,000 - $40,000	39	$1,386,518	$746,972	53.87%	$19,153
$40,000 - $60,000	35	$1,673,814	$962,708	57.52%	$27,506
$60,000 - $80,000	9	$616,819	$344,637	55.87%	$38,293
$80,000 - $100,000	7	$623,293	$309,083	49.59%	$44,155
$100,000+	15	$2,286,630	$1,082,293	47.33%	$72,153

Figure 10

All Other In-Scope Customers by Sales					
Sales Range	**Customers**	**Sales**	**GP**	**GM**	**Avg. GP**
$4,600 - $5,000	182	$871,457	$510,917	58.63%	$2,807
$5,000 - $10,000	1,352	$9,845,481	$5,536,594	56.23%	$4,095
$10,000 - $15,000	536	$6,579,796	$3,724,676	56.61%	$6,949
$15,000 - $20,000	216	$3,709,340	$2,157,947	58.18%	$9,990
$20,000 - $30,000	156	$3,794,641	$2,175,059	57.32%	$13,943

Customer Stratification Analyses (cont'd)

In analyzing the number of customers per sales quintile (see Figure 10), 60 percent of total revenue is generated from 14.5 percent of the customers. Furthermore, the bottom 20 percent of sales is generated by 70.6 percent of the customers, with an average gross profit per customer of $647.

The gross margin generally increases with each incremental quintile, which is expected, however, the last two quintile gross margins are materially unchanged from the second and third quintile, which indicates a potential opportunity to increase prices for the smaller customers.

Figure 12 shows the total sales per customer quintile. Approximately 96 percent of the sales is generated from the top 60 percent of customers. The last quintile of customers generates an average sale and gross profit of $154 and $87, respectively, and only contributes $324k of sales and $182k of gross profit to the Company.

The gross margin is almost unchanged in each of the quintiles. This too indicates a potential opportunity for a more nuanced pricing strategy that appropriately reflects a customer's purchasing power and the Company's cost to acquire and profitably serve them.

Figure 11

Customers per Sales Quintile							
Quintile	Sales	Gross Profit	Gross Margin	Customers	Cumm. Percentage of Customers	Avg. Sales per Customer	Average per Customer
1	8,356,774	4,466,700	53.45%	169	1.61%	49,448	26,430
2	8,390,986	4,819,670	57.44%	500	6.37%	16,782	9,639
3	8,373,769	4,711,675	56.27%	858	14.53%	9,760	5,491
4	8,376,576	4,761,209	56.84%	1,564	29.41%	5,356	3,044
5	8,377,819	4,801,689	57.31%	7,419	100.00%	1,129	647
Total	**41,875,924**	**23,560,943**	**56.26%**	**10,510**		**3,984**	**2,242**

Figure 12

Sales per Customer Quintile							
Quintile	Sales	Gross Profit	Gross Margin	Customers	Cumm. Percentage of Sales	Avg. Sales per Customer	Average Gross Profit per Customer
1	28,910,196	16,120,852	55.76%	2,102	69.04%	13,754	7,669
2	7,915,711	4,546,029	57.43%	2,102	87.94%	3,766	2,163
3	3,385,112	1,946,146	57.49%	2,102	96.02%	1,610	926
4	1,340,601	765,418	57.10%	2,102	99.23%	638	364
5	324,304	182,498	56.27%	2,102	100.00%	154	87
Total	**41,875,924**	**23,560,943**	**56.26%**	**10,510**		**3,984**	**2,242**

Customer Stratification Analyses (cont'd)

Quality Analysis	Top 1 Percent of Customers	All Others In-Scope
Stratification Rating	Favorable	Unfavorable

What impacted the overall rating?

The top 1 percent of customers does not include a single customer that makes up 1 percent or more of total sales. Customers are favorably distributed amongst the sales ranges of the histogram and there is only a moderate skewing of customer counts towards the lower range of sales. The gross profit at the top sales range is 3.8x the amount as the lowest sales range of the histogram. The gross margins generally increase as the size of the customer decreases.

The other customers in-scope have a material skewing of customer counts towards the lower ranges of sales. The gross profit at the top sales range is 5x the gross profit in the lowest sales range of the histogram. The gross margins are materially unchanged between the customer histogram sales ranges or the quintiles by sales or customers.

Why is customer stratification important?

Customer stratification is the least complex analysis, but it is useful to identify customer concentration risks and provides insights into the alignment of a company's strategic operating model with the customer base. The targeted customer segments must produce sufficient gross profit to adequately cover the marginal and fixed costs required to serve them and to produce a sufficient net profit margin to compensate the company for the risk taken.

Finance can use customer stratification to isolate differences in costs incurred by the company, if any, to support each tranche of customers. Finance can also evaluate the efficacy of the company's pricing strategy and ensure that the company's unique selling proposition to the various customer is appropriately captured and reflected in the realized profits.

Marketing can use customer stratification to evaluate the most cost-effective channels to acquire customers. Marketing can determine which customer segments (by sales and by assigned segment) have the highest and lowest customer acquisition costs and lifetime value and evaluate the overall attractiveness of a customer segment.

Customer Purchasing Trends Analyses

We analyzed the following purchasing trends for each in-scope customer over the financial period:

1. Sales
2. Quantity of items
3. Number of unique items
4. Frequency of purchases
5. Time between purchases

Each purchasing trend was equally weighted, and the average of the trends analyzed was calculated to determine the overall customer score. Customers with fewer than 15 observations ($2.9m in sales and 729 customers) were excluded from the analysis.

Figure 13 shows the purchasing trends for the top 1 percent of customers. The overall balance trends towards the favorable side. However, Figure 14 shows the average sales and gross profit of the customers in each category which is more evenly balanced on either side of "Neutral".

The gross margins for each of the customer purchasing trends are within a relatively small margin of each other (3 percentage points) except for the customers with a Strongly Unfavorable purchasing trend, which have a GM of 58 percent.

Figure 13

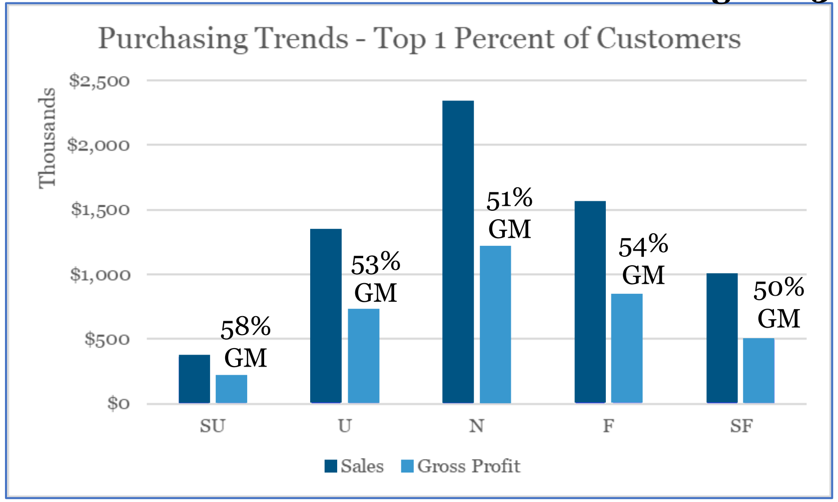
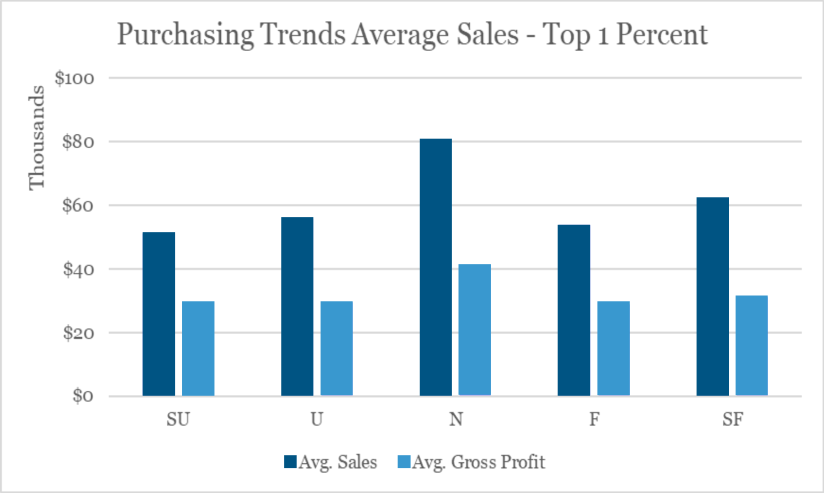


Figure 14



Customer Purchasing Trends Analyses (cont'd)

Figure 14 shows the purchasing trends for all other customers in-scope. The overall balance trends strongly towards the favorable side of the chart, with Strongly Unfavorable comprising the smallest of total sales. However, as Figure 16 shows, the average sales are the largest with customers having unfavorable purchasing trends, with the overall balance leaning slightly toward the unfavorable side of the chart.

The seeming paradox between the overall purchasing trends and the average sales of the purchasing trend classifications is due primarily to the larger customers in-scope generally exhibiting more unfavorable purchasing trends than the other customers. Additional analyses is warranted to determine whether commonalities amongst companies in the two extreme classifications can be identified. Customers in the Unfavorable classification will have the most adverse impact on the future sales, profitability, and growth of Spice should they churn.

Further analyses may also uncover operational and/or customer service issues that need to be addressed and resolved.

Figure 15

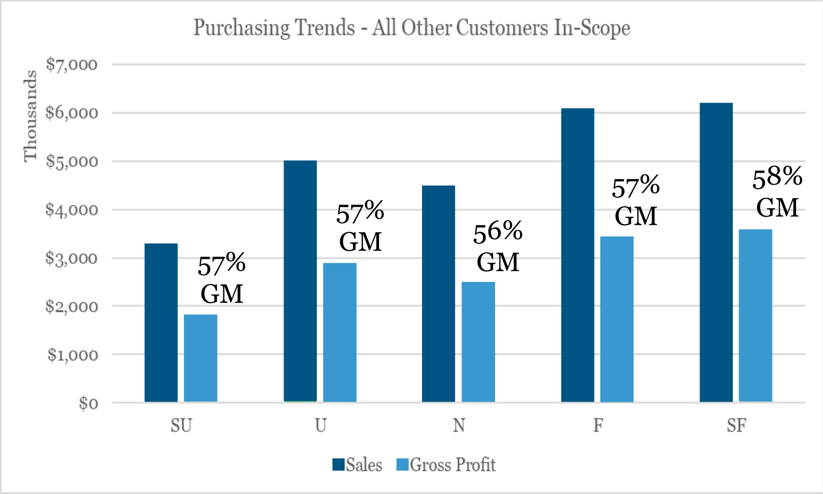
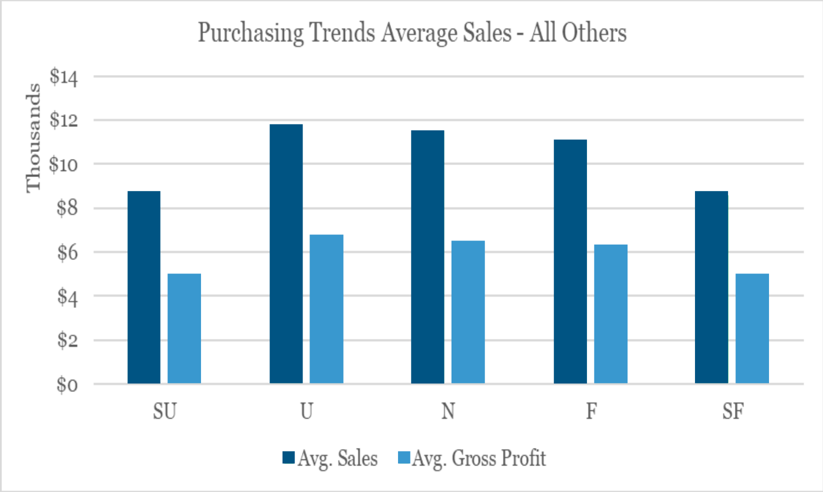


Figure 16



Customer Purchasing Trends Analyses (cont'd)

Quality Analysis	Top 1 Percent of Customers	All Others In-Scope
Purchasing Trends Rating	Neutral	Neutral

What impacted the overall rating?

The top 1 percent of customers have an overall slightly favorable purchasing trend which is somewhat offset by the more evenly balanced and neutral distribution of the average sales. There are no compelling or significant indicators that would lead to a rating other than neutral.

The other customers in-scope have a noticeable skewing towards the favorable side of the purchasing trend chart. However, when looking at the purchasing trends of average sales, a less favorable picture emerges. Taken together, the purchasing trends of the other customers in-scope appear to be balanced and neutral.

Why are customer purchasing trends important?

Customers are what drive a company's revenue and growth. Customer purchasing trends serve as an early warning indicator that a customer may soon churn, particularly customers that are classified as U and SU. Research indicates that reducing the customer churn rate by 5 percent can increase overall profit between 25 percent and 85 percent and has the same impact on profits as reducing costs by 15 percent. Companies that monitor customer purchasing trends can be more proactive in their customer retention efforts and uncover and remedy the underlying root causes of churn.

Analyzing purchasing trends by customer segment can provide insights into macroeconomic changes and trends that may impact the revenue and performance of the company in the future. These insights may also have a material impact on inventory planning and purchasing.

An investor in a company may use the customer purchasing trends to adjust their valuation. Higher multiples may be paid on customers with favorable purchasing trends and a discounted multiple on customers with unfavorable purchasing trends. Likewise, the customer purchasing trends may be used to validate or bring into question growth assumptions which the forward-looking financials are based upon.

Customer Categorization Analyses

We analyzed the sales volume and product penetration of the in-scope customers for the period under review. Customers were categorized based on sales and their Core Product Penetration as follows:

> **Champion** – the top 5 percent of customers by sales AND that have a CPP that is at least 40 percent of the MCPP.
>
> **Flight Risk** – customers in the top 75 percent by sales AND that have a CPP that is less than 10 percent of the MCPP.
>
> **Promising** – customers in the 40 to 75 percentile by sales AND that have a CPP that is more than 40 percent of the MCPP.
>
> **Core** - customers in the top 75 percent of sales AND that have a CPP that is at least 10 percent of the MCPP, excluding customers categorized as Champion, Flight Risk, or Promising.

Figure 17 shows the categorization of the top 1 percent of customers. The distribution of the customers amongst the categories is materially consistent with the expectation that the Core category would comprise the majority customers. However, Figure 18 shows that the average sales and gross profit of Flight Risk customers are materially larger than the other categories. This indicates that the customers categorized as Flight Risks are the larger customers on average and purchase a small percentage of the products offered by Spice. Unless Spice offers a defendable unique selling proposition, the barriers for customers to switch vendors are lower which translates into more price sensitivity and dampers Spice's ability to increase prices for these customers.

Figure 17

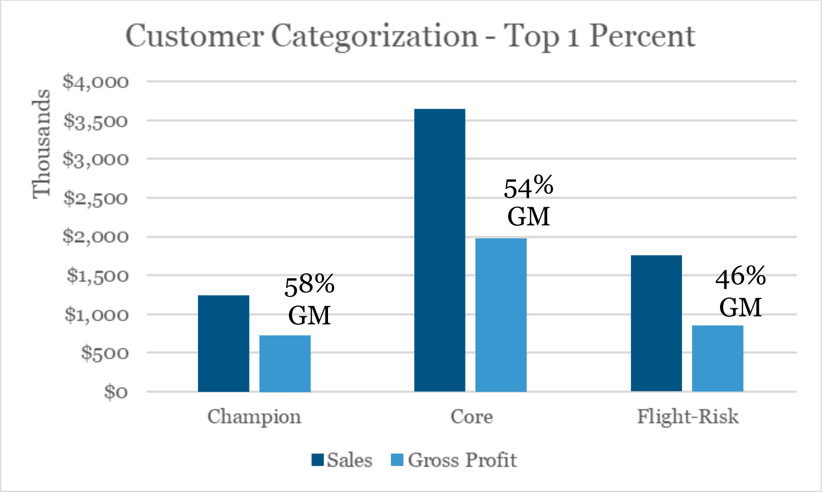
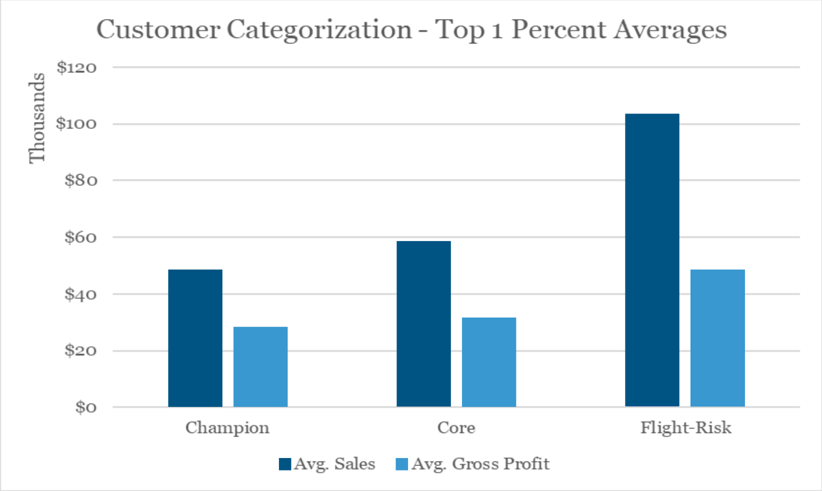


Figure 18



Customer Categorization Analyses (cont'd)

Figure 19 depicts the categorization of all other in-scope customers. Approximately 84 percent of sales and gross profit are concentrated in the Core category. This is a higher concentration than usual, which is overall favorable as it means the riskier Flight Risk customers comprise a smaller percentage of sales.

The average sales and gross profits for all other in-scope customers are reflected in Figure 20. It is not surprising that the average sales and gross profit of the Champion customers are materially higher than the other categories, since by definition, a Champion customer is in the top 5 percent of customers by sales. The Flight Risk customers have higher sales and gross profit than the Core and Promising customers, but their relatively small overall sales mitigates this potential risk.

Figure 19

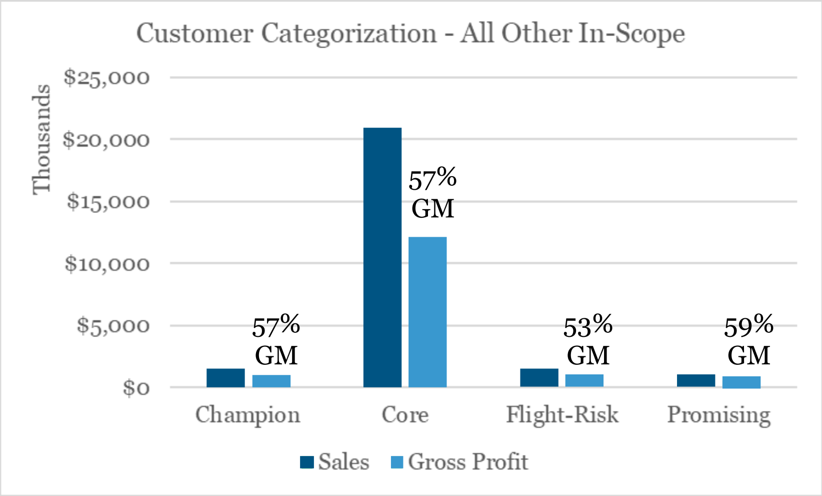
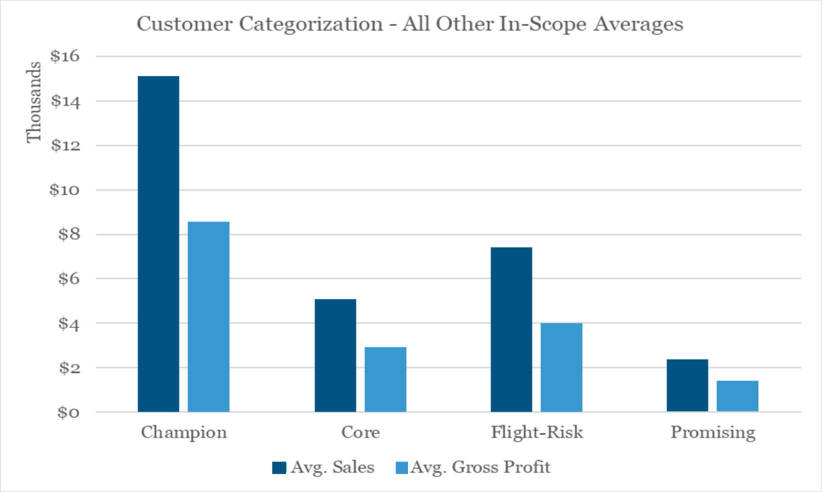


Figure 20



Customer Categorization Analyses (cont'd)

Quality Analysis	Top 1 Percent of Customers	All Others In-Scope
Categorization Rating	Neutral	Neutral

What impacted the overall rating?

The categorization of the top 1 percent of customers was materially consistent with expectations. Although the Flight Risk customers had a significantly higher average sales and gross profit, which is unfavorable, the overall sales and profit categorized as a Flight Risk weren't sufficient to warrant an overall rating below Neutral.

With the majority of sales and gross profits categorized as Core, and no other factors indicating either a favorable or unfavorable tilt, all other in-scope customers are squarely in the Neutral rating.

Why is customer categorization important?

Customers that exhibit different purchasing habits and patterns present different opportunities and risks and should be managed accordingly. Customers that purchase only a few of the available products present an opportunity to expand the portfolio of products sold through targeted sales initiatives and incentives. Conversely, those same customers are likely to be more sensitive to prices since the barrier to switch to alternative providers is much lower than if they were purchasing a larger basket of products.

Marketing and sales can use customer categorization to develop more customized and tailored sales plans to grow wallet share with a customer. Including customer segment information may also lead to insights in which channels and unique selling propositions are most effective in reaching the targeted customers. For certain customer categories, awareness of competitor pricing and unique selling propositions is required to mitigate the risk of losing customers due to changes in the competitive landscape.

Finance can use customer categorization to develop more nuanced pricing strategies and tactics for each category of customer. Pricing decisions are among the most impactful business decisions a company can make. They are arguably one of the few decisions that affect a company's revenue directly and can do more for a company's bottom line than any other lever.

Unearned Discounts Analyses

Unearned discounts are determined by calculating the average price paid by the top 1 percent of customers, for a specific product, during a specific week, and comparing that average price to the price paid by another non-top 1 percent customer for that same product during the same week. Instances where a non-top 1 percent customer received a more favorable price are then identified and totaled.

Total unearned discounts for the in-scope customers were $568,908, representing 2.64 percent of in-scope sales. This "foregone profit" does not take into consideration the incremental profit that should have been captured had a discount not been granted.

These discounts were widely disbursed amongst the customers and products, and no customer or product accounted for more than 1 percent of the total unearned discount.

Figure 21 shows the 10 customer with the largest unearned discounts. A total of 668 customers received at least one unearned discount on a product, which represents 13 percent of in-scope customers. These unearned discounts were granted across a multitude of products.

Figure 22 shows the 10 products with the largest unearned discounts and the number of customers that benefited.

Figure 21

Customer	Foregone Profit
TROYERS FOOD	2,718
CARNICERIA DEL VALLE 3	2,658
MANUELS TORTILLA FACTORY	2,576
ELLIS ISLAND CASINO & BREWERY	2,527
PAPACITAS RESTAURANT LONGVIEW	2,481
GLORIA'S RESTAURANT	2,365
ROUTE 66 STOP-IN	2,242
MARKET VALUE FOODS LLC	2,182
GRISTMILL	2,133
BROTHERS SEAFOOD	2,117
EL PATIO	2,028
ALL OTHER CUSTOMERS	542,881
Total	**568,908**

Figure 22

Product	Foregone Profit	Customers
SEASONALL 30LB	4,793	14
FAJITA SEASONING 9LB/4CS	4,687	26
NUTMEG GROUND 25LB	4,544	21
CHILI POWDER 25LB	4,456	12
TACO VILLA HOT SAUCE 25-LB	4,377	32
CINNAMON GRD POPPIN FRSH 25LB	4,172	16
WOODYS BBQ 50LB (s,w)	3,954	8
SPICE MIX ENCHILDA SAUCE 100LB	3,850	12
ALL OTHER PRODUCTS	534,074	668
Total	**568,908**	**668**

Unearned Discounts Analyses (cont'd)

Quality Analysis	Top 1 Percent of Customers	All Others In-Scope
Unearned Discounts Rating	Neutral	

What impacted the overall rating?

The in-scope customers are rated as neutral with respect to unearned discounts.

The percentage of customers receiving an unearned discount is relatively large (13 percent of in-scope customers). Although the amounts of the unearned discounts are not individually significant to overall profitability, foregone profit was 2.64 percent of in-scope sales. This factor is more of an opportunity than an indicator of the quality of the customer base.

The dispersion of the total unearned discounts across customers and products indicates that the pricing policies are not sufficiently rigid enough, or the overall pricing strategy does not adequately differentiate between customers, resulting in forgone profits and lower profitability than what would be expected.

Why is preventing unearned discounts important?

As a rule, smaller customers are not entitled to the same discounts and preferential pricing (referred to as "unearned") that larger customers are typically able to negotiate, with the possible exception of new customers on an introductory sales plan from which they should be moved away from in a reasonably quick time. Companies that do not have sufficiently rigid pricing policies and procedures are at a greater risk of granting unearned discounts to a customer and thereby foregoing potential profits. Granting unearned discounts is one of the most pervasive profit thieves of a company. Companies can typically improve their gross margin by 1 to 3 points solely by finding and reducing/eliminating the root causes of unearned discounts.

Granting unearned discounts to customers without changing the company's offering communicates to them (and the market) that there was "extra profit" in the transaction which has several adverse consequences. Firstly, the unearned discount erodes trust in the customer relationship. Reducing the price without a corresponding change in the offer (e.g., quantity purchased, delivery availability, warranty period) destroys the price integrity, meaning the exchange of value is based solely on price. Secondly, unearned discounts devalue the company's unique selling proposition and moves the focus away from value and onto price. Lastly, unearned discounts train the customer that price reductions are possible with enough negotiation and persistence.

Customer Churn Simulated Analyses

We analyzed the sensitivity of in-scope sales and gross profit to customer churn using the customer purchasing trends as a proxy for the probability that a customer would churn.

The following rating scale, constructed on a ratio-based algorithm, was used to assess the sensitivity of the in-scope customers sales and gross profit to churn (see Figure 23):

1 – Customers have a 62 percent probability of being retained in the future (Strongly Unfavorable).

2 – Customers have a 72 percent probability of being retained in the future (Unfavorable).

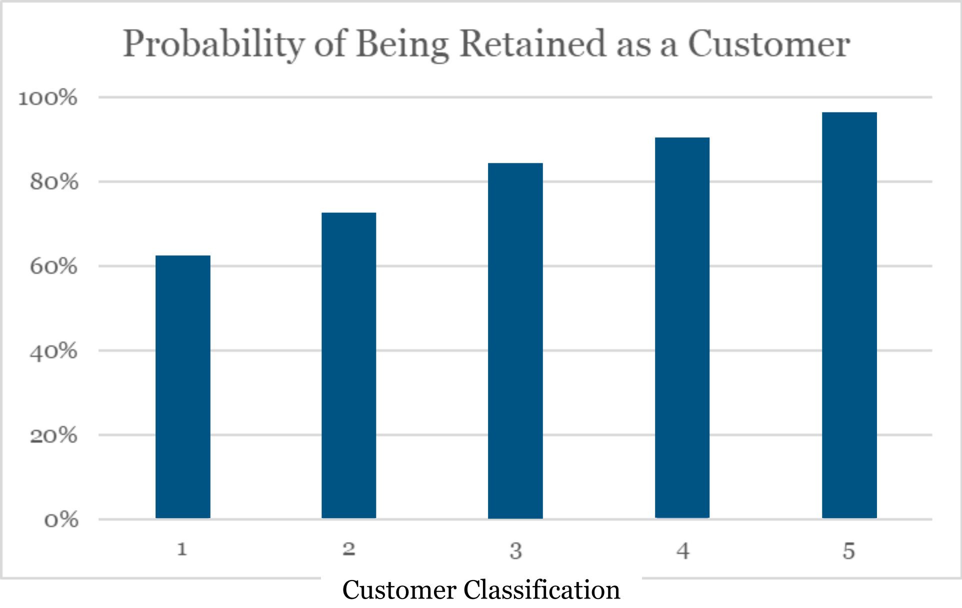
3 – Customers have an 81 percent probability of being retained in the future (Neutral).

4 – Customers have 90 percent probability of being retained in the future (Favorable).

5 – Customers have a 96 percent probability of being retained in the future (Strongly Favorable).

We performed 10,000 simulations of random customer churn to measure the sensitivity to and risk of Spice's sales and gross profit to changes in customer retention based on the customer classifications of SU, U, N, F, and SF.

Figure 23



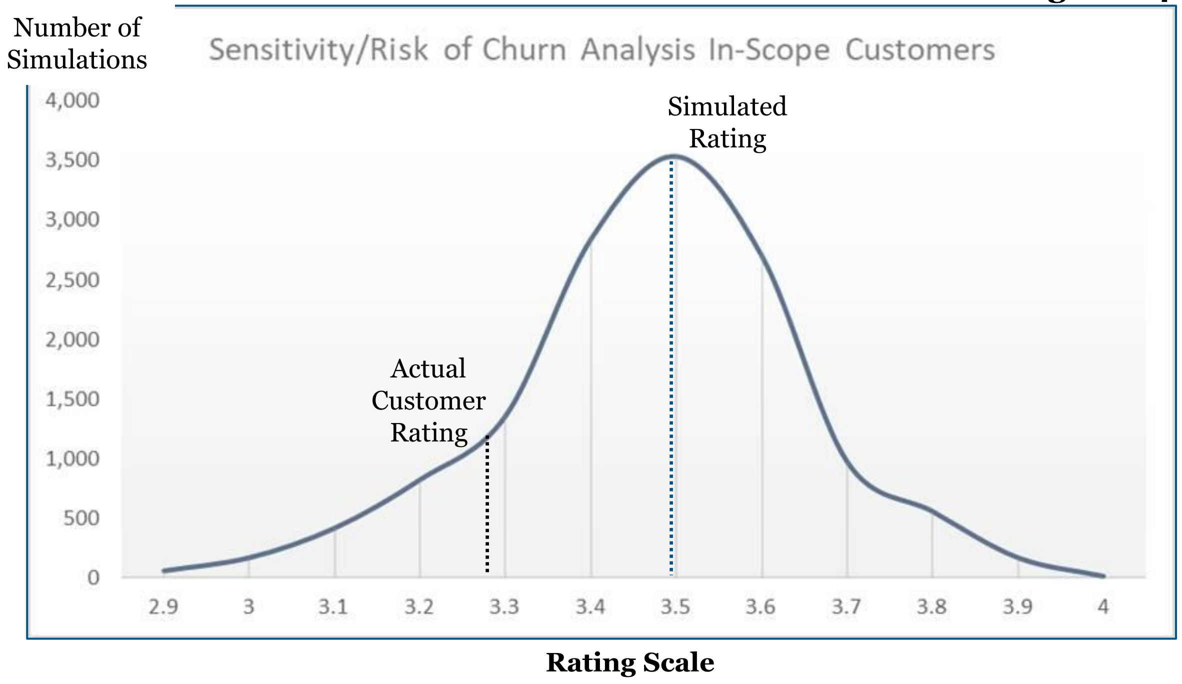
Customer Churn Simulated Analyses (cont'd)

Each simulation was a data set of 2,587 randomly selected customers (the same number of in-scope customers), with each customer having an equal chance of being selected. In addition, our algorithms allowed for a customer to be randomly selected multiple times (sampling with replacement).

The output of each simulation was an overall rating based on the classification of the customers in the simulated data set (SU, U, N, F, SF) and the relative size of their respective sales. Accordingly, customers with larger sales had a proportionately larger impact on the overall rating.

Figure 24 shows the distribution of the 10,000 simulations. The distribution is centered on 3.5, with a near equal distribution on either side. The actual customer rating for the in-scope customers is 3.28. This indicates that the in-scope customer base, overall, has a more favorable chance of remaining as customers into the future. The simulated rating, while more favorable than the actual rating, is not statistically different from the actual rating.

Figure 24



Customer Churn Simulated Analyses (cont'd)

Risk Analysis	All Customers In-Scope
Churn Simulation Rating	**Neutral**

What impacted the overall rating?

The simulated analysis is analogous to a weather forecast. When considering the volume of sales, quantity, unique products, frequency, and time between purchases, the typical Spice customer has approximately an 86% chance of being retained. In weather forecast terms, there is an 86% chance of no rain tomorrow. This analysis is based on objective variables. The chance of being retained would be positively impacted by subjective actions such as additional customer touches, improved understanding of what customers value and how that message is communicated to customers.

Why is predicting customer churn important?

Customers are what drive a company's revenue and growth. Research indicates that reducing the customer churn rate by 5 percent can increase overall profit between 25 percent and 85 percent and has the same impact on profits as reducing costs by 15 percent.

Historical churn rates are a lagging indicator of a company's performance and do not always take into consideration the size and profitability of the customers that churned. Incorporating a customer's purchasing trend into a forward-looking analysis allows a glimpse into how the future may unfold and could impact capital expenditure planning and the confidence in financial projections.