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- ▶ *New Techniques for Maximizing the Lifetime Profitability of your Customer Base.*

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Audience: This paper is intended for enterprise managers who need to understand customer value management, the next step beyond traditional customer relationship management.

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Customers Are Your Critical Asset

In an economy where products, marketing campaigns and even sales channels are transitory, business managers increasingly recognize customer relationships as the key to enduring profit. Bain and Company's Frederick Reichheld has demonstrated that a 5% increase in customer retention leads to a 25-95% increase in company profits.

There are numerous reasons for this spectacular uplift. For example, if customers who make ongoing purchases have longer to offset the cost of acquisition. Experienced customers also naturally become more efficient at dealing with the business, and therefore more cost-effective to service.

Loyal customers are both a scarce resource and a source of value. How can business managers nurture this crucial asset? For a start, companies must make maximizing customer value an explicit and measured business goal. As companies evolve from product-or campaign-centric to customer-centric marketing, a set of best practices is emerging that focus on measuring and increasing the lifetime value of the customer base, one customer at a time. We call these practices customer value management.

Customer Value Management Defined

Customer value management is managing each customer relationship with the goal of achieving maximum lifetime profit from the entire customer base. Customer value management enables companies to take full advantage of the economics of loyalty by increasing retention, reducing risk, and amortizing acquisition costs over a longer and more profitable period of engagement.

Although customer value management seeks to increase the aggregate value of the customer base, this is accomplished customer by customer. Not every individual customer will be profitable, but each must be managed to maximize overall profit, even when the management consists of identifying which customers have little value to the business, and focusing development and retention efforts elsewhere.

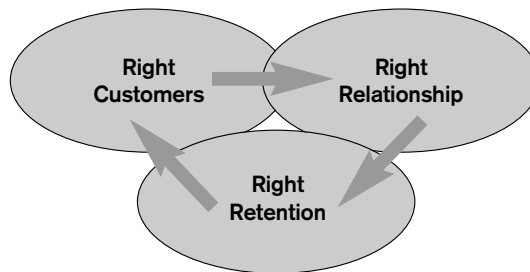
CVM shifts the focus of the enterprise from managing products or marketing campaigns to managing the profitability of each individual customer over the entire life of the relationship. While CVM can and does lead to better product offerings and more targeted campaigns, a customer value manager will ask different questions than a traditional marketing manager. Instead of asking, "Who will respond to a 10% off promotion?", a customer value manager is driven to understand, "Who is this customer, and what can I offer to increase their lifetime value?".

Making this shift requires companies to move from giving lip service to one-to-one marketing to actually developing the analytical and operational capabilities to do it. But those that do so can expect increased profits, not only in the short term, but for years to come.

Three “Rs” of the CVM Cycle

The customer value management cycle can be broken down into three stages:

- Right customers (acquisition)
- Right relationship (development)
- Right retention (keeping valuable customers)



■ *Figure 1*
Each of the three CVM stages naturally feeds the next to maximize customer value.

► Right Customers

The customer value management cycle starts with acquiring the customers who will be most valuable to your business. Who are these customers? Most often those who will do repeat business with your company for a long time. In *The Loyalty Effect*, Reichheld cites examples of how long a customer must stay in order to pay for the cost of acquisition. In many industries the break-even period is a year or more, and rising. Companies can no longer afford to indiscriminately recruit customers without examining their long-term value.

All customers are not equal. Even a customer that is high-value to a competitor might well be unprofitable for you. For example, there are profitable insurance companies that specialize in safe drivers, as well as those who focus on drivers with higher risk. A “good driver” company would be acquiring the wrong customers by placing ads in racing car magazines. Because customer acquisition is so costly, effective customer value management requires your company to develop the analytical capabilities to identify customers who will be loyal and profitable, not just for your industry, but for your specific company.

Your best source of intelligence about the customers you want is deep analysis of your current customers – the people on whom you already have extensive data. Fine-grained segmentation and analysis of your customer base reveals hidden characteristics and trends that affect value. Perhaps certain customers have been regarded as low-value because they make only small purchases. Finer segmentation that includes frequency of purchase might reveal that a subset of these customers have a very high lifetime value, because they have regularly made these small purchases every week for the past ten years. Such deep understanding of who are your best customers, and why, enables you to go after the new customers your company can most profitably serve.

Customer vintage analysis – examining the loyalty and profitability of customers who joined at different times through different channels – adds insight into where your best customers come from. Perhaps customers who joined during a price promotion left quickly, while those who joined after attending an educational seminar stayed. This time-based analysis is key to knowing which acquisition strategies are worth repeating, and which are long-term money losers hiding behind a mask of high recruitment rates.

► **Right Relationship**

Even with the most well chosen customers, managers must develop the relationship. Customers who do not receive the right touch or get too many conflicting offers lose rather than gain value. Just because Jack and Frank live in the same zip code does not mean they are both in the market for home office furniture at the same time. Ideally marketers would be able to spot these differences, targeting Jack with the right offer at the right time, without annoying Frank with another promotion for something he does not want.

For any business, the right relationship is one that maximizes that customer's lifetime value. A simplified view of customer lifetime value is:

$$\text{LTV} = \text{purchase size} \times \text{frequency} \times \text{duration}$$

So the business's goal of customer relationship management is to increase the size and frequency of purchases and extend how long the customer continues to buy. Since marketers can't know the duration of a relationship until it is over, they use loyalty measures to estimate how long customers will stay.

Customers do repeat business with vendors that understand and respond to their individual needs, and respond when those needs change. To improve customer value, marketers must understand differences between their customers, and track how each individual evolves over time. The specific actions managers should take depend on the value of the customer.

For high-value customers, managers should work to cement loyalty, extending the length of an already profitable relationship. The LTV of a customer that makes large purchases regularly for ten years is significantly more than that of a customer who makes the same purchases for only five years.

Customers that are not currently high-value may still have high potential for growth in any of the three parts of the value equation. Telling these customers apart from those who will never grow in value represents a significant analytical challenge. Unless marketers can distinguish high-potential customers from ones who will always be low-value, companies will waste resources trying to develop customers who will never grow.

One often-ignored group of high potential is former high-value customers who have migrated downward. These customers are often still high value, but most of that value has simply been transferred to a competitor. Most companies cannot easily identify these individuals because they value customers based on a point in time, with no reference to previous value and history. If Jill and Jim each were gold-segment customers until last month, but have transferred some of their business to a competitor, the company may well not notice if enough customers have entered the gold segment to replace them and kept the total number of gold customers steady.

The company needs deeper analysis to spot Jill and Jim's downward migration and to work on restoring their value. Companies that develop the capability to track changes in the value of individual customers can guard against competitive attacks and respond quickly to changing customer behavior to maintain and grow customer value.

► **Right Retention**

Effective retention means retaining the right customers, not every customer. Managers need to focus their retention actions on customers with the highest lifetime value. Spending precious resources to retain marginally profitable or unprofitable customers actually hurts the overall value of the customer base, especially if these retention efforts succeed.

Right retention is therefore rooted in knowing which individuals are most valuable, and why. Accurately analyzing lifetime value helps managers take the long view, giving equal weight to customers who are already doing a high volume of business and those who purchases are modest, but whose actions indicate loyalty and profitability over time.

Having identified the customers worth keeping, managers must ensure that their retention strategies maintain value, not erode it. According to Reichheld, one reason loyal customers are more profitable is that they are less price-sensitive. Therefore managers should retain these loyal customers through incentives other than price, such as special recognition and premium levels of service. Even if heavy discounting does retain high-value customers, they train customers to become more price sensitive and therefore less valuable.

Conclusion

Customer value management offers a roadmap to acquiring, developing and retaining your most valuable customers. Taking the journey shown on the map is not free. Managers who wish to reap increased customer value must pay more than lip service to the idea of being customer-driven. They must develop the analytical capability to understand their customers as individuals, and integrate this customer intelligence into their operational systems to enable immediate response to each customer's changing behavior and value.

The reward for making this investment is sustained and increasingly profitable relationships, potentially the most enduring asset in today's ever-changing business climate. By deepening and lengthening customer relationships, your business can drive increased revenue from its customer base, even as products and sales channels continue to evolve.

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