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Introduction

"Customer is king" is a centuries-old corporate saying. Not much has changed in the current century other than the fact that your company's customer can also be the *most sought after.* Because of advances in technology and globalization, you never know in what form competition will emerge to attract your customers. For example, the incumbent books-retailer leader Barnes & Noble was overshadowed by a then-innocuous Internet-based company, Amazon; IBM was challenged by the new entrant Dell; and American car companies are currently running huge losses at the expense of Japanese and Korean car manufacturers.

A common factor governing the success or failure of any firm is almost always the ability of the firm to service its customers better or offer superior value propositions. So, what's new? It is common wisdom that customer relationship initiatives are *expected* to deliver superior financial performance. However, *reality* often belies *expectation.*

Consider Continental Airlines, for example.[1] In late 1994, Continental had lost an average $960 million per year for the previous four years. Customers were annoyed by the way the airline was being operated—unreliable, dirty, and frequently losing passenger baggage. The Department of Transportation ranked Continental last on the list based on its on-time airline rankings. By March 1995, Continental had moved from last to first in the on-time rankings. In 2000, Continental Airlines was ranked number one in customer satisfaction by J. D. Power and

Associates. An unprecedented recovery! The biggest underlying success factor was Continental's ability to win back customer satisfaction. There was no doubt that Continental had a winning customer management formula. But, was the formula profitable? What about the cost of satisfying the customers? Between 2001 and 2005, Continental Airlines reported an average net loss of about $200 million per year.

In the mid 1990s, Dell Corporation introduced a novel e-commerce business model.[2] The company's strategy of selling directly over the Internet with no intermediaries (such as retail outlets) was the most talked about success story of the early twenty-first century. Dell's revenues and earnings grew by more than 30% year after year, and the company reported a return on invested capital of 243% for 2000. *Fortune* magazine listed Dell as America's third-most admired company. Television audiences in the United States were treated to an extensive advertising campaign by Dell that showed Dell employees putting in long hours in their customer contact centers to service customers. Was Dell's success profitable in the long run? Dell's stock has tumbled more than 40% over the past two years on decreased sales and slimmer profit margins. In March 2007, Dell reported a 33% drop in fourth-quarter profits and warned that growth and profit margins will remain "under pressure" for the next few quarters.

A common underlying theme of these two examples is the importance of sustaining successful customer management initiatives in the long run. In other words, although it might be possible to keep customers happy and loyal in the short run, the greater challenge often lies in achieving that objective with both *growth* and *profits* in the long run.

It may be argued that operational efficiencies are also important. We don't deny that fact. However, operational efficiency cannot hold precedence over customer focus. Consider the case of First USA & Capital One, for example.[3] Both companies are prominent players in the credit card industry. However, what sets them apart is their customer management approach. First USA is "laser focused on operating efficiency and to pass those savings on to customers," according to former Chairman Richard Vague. In contrast, Capital One's primary goal is to "deliver the right product, at the right price, to the right customer, at the right time." This is an interesting paradox between two players of the same industry selling exactly the same product.

First USA transacted its business with little differentiation across its customers. This approach was consistent with its corporate structure, which was organized around products or functions. The company's customer acquisition strategy was based on luring customers from other credit card companies and using affinity partners. The company did not make an investment in archiving customer data. Therefore, it lacked the ability to compute individual customer profitability. Employees were mandated to try to retain all customers irrespective of whether they appeared as good or bad prospects in the long run. In 1999, the bank discontinued the policy of allowing a grace period for late payments and raised late-fee penalties. This policy was applied uniformly across the board, across all customers. Not surprisingly, a mass exodus of customers (both profitable and unprofitable) resulted. The company was later forced to revoke its policy. However, the damage was done.

In contrast, Capital One's primary focus is customers. The company conducts business by microsegmenting its customer base so that each customer can be individually serviced in consonance with the customer's value potential. Furthermore, Capital One set up a customer data warehouse that has an unmatched ability to mine any customer's information in a matter of seconds. For instance, when a customer calls, computers instantly access the full history of the customer and cross-reference it with millions of other customers. If a valuable customer calls to cancel a credit card, the call-routing system automatically rattles out three attractive counteroffers that the customer service representative can use to negotiate. In a nutshell, each customer is treated differently. Capital One's deep commitment to knowing its customer is evident from the fact that in 2000, Capital One ran 45,000 tests on product variants, procedural changes, and customer interactions.

So, what was the financial consequence of these two approaches? As the credit environment worsened, First USA's customer attrition rate grew by 50%, contributing to a 23% decline in revenue in 2000, and the company's first ever loss. On the other hand, Capital One earned 40% more interest income from each customer as compared to First USA, with double the profit margin, despite being half the size.

The bottom line is that the bottom line matters. To manage and sustain profitability, we need to come up with the right marketing strategies,

backed by the right marketing metrics. Although there are 50+ important metrics that every executive should know,[4] this book focuses on one particular metric: the *Customer Lifetime Value* (CLV) metric. This book takes an in-depth look at how marketing strategies based on this powerful metric can help manage customer relationship and profitability simultaneously.

Customer Lifetime Value

Customer Lifetime Value refers to the net present value of future profit from a customer. The beauty of the metric lies in the fact that it is *forward*-looking, unlike traditional measures based on past contributions to profit. Hence, it enables marketers to adopt the right marketing activities *today* to increase *future* profitability. Moreover, CLV is the only metric that incorporates all the elements that drive profitability: revenue, expense, and customer behavior. Thus, the metric keeps the focus on the customer (rather than the product) as the driver of profitability. In fact, in recent times, the importance of CLV has evolved from merely being an important metric to a way of thinking and of doing business.

Figure 1.1 shows a typical life cycle curve of a customer. If a manager at time (t) were to make a managerial decision regarding this customer, would it make sense to decide based on the customer's past customer value, or would it make sense to decide based on the customer's future value. If the customer's future revenue is expected to drop as compared to past revenue (as seen in Figure 1.1), it may make sense moving forward to reduce the marketing expenditure for this customer.

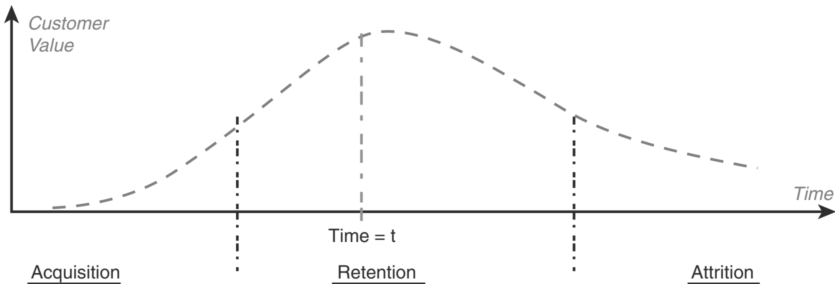

Figure 1.1 Typical life cycle of a customer

Because the metric is forward-looking, the value associated with the CLV is an estimate or a prediction. Therefore, it is imperative that proper methods be employed to measure CLV.

CLV can be measured in two fundamental ways: top down and bottom up.

Top-Down Approach

As shown in Figure 1.2, the top-down approach involves estimating the average customer equity (or lifetime value) of the customer. This can be accomplished by identifying and measuring the drivers of customer equity at the firm or customer segment level. For example, Lemon, Rust & Zeithaml define the drivers of customer equity as comprising the value equity, brand equity, and relationship equity.[5] These drivers are measured based on the customer's objective and subjective assessments of these three drivers of customer equity. The drivers are typically measured using a survey-based methodology because the drivers include subjective assessments of the customer that are not directly observed (such as the customer's attitude toward the firm's brand and the customer's brand awareness). It is practically infeasible to measure these drivers from each customer through a questionnaire. This is particularly true for large firms having millions of geographically dispersed customers. Hence, the drivers are typically measured on a small sample of customers and then extrapolated across the population to arrive at the customer equity at the firm level or the customer segment level.

The customer equity at the firm or the customer segment level can then be divided by the total number of customers of the firm/segment to arrive at the average lifetime value of a customer.

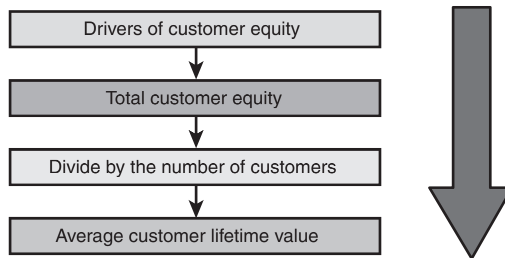

Figure 1.2 Top-down approach to measuring CLV

Another way to compute customer equity using the top-down approach is by applying observed aggregate measures pertaining to customers at the firm level. These measures include the total number of customers of the firm, their growth, the average margin per customer, the average customer retention rate, the average customer acquisition cost, and the discount rate for the firm.[6] Using these measures, firms can easily calculate customer equity at the firm level.

The main benefit of top-down approaches is the ability to measure customer equity without the need for customer-level information for *all* customers of the firm. Such an approach offers a simple way to compute the overall customer equity of a firm. However, a potential drawback is that all customers of the firm (or customer segment level) have the same CLV. Therefore, they are all treated as equal. In reality, customer values can differ significantly within the customer base (or segment). In fact, most firms swear by the Pareto principle (the 80/20 rule). That is, 20% of customers usually provide 80% of the total value to the firm. In such a scenario, it is advisable to adopt a computation method that recognizes the individual-level differences in customer value.

Bottom-Up Approach

As shown in Figure 1.3, the bottom-up approach involves first estimating the lifetime value of each customer of the firm. Thereafter, the individual CLV measures are summed up across the customer base/segments to arrive at the total customer equity at the firm/customer segment level.

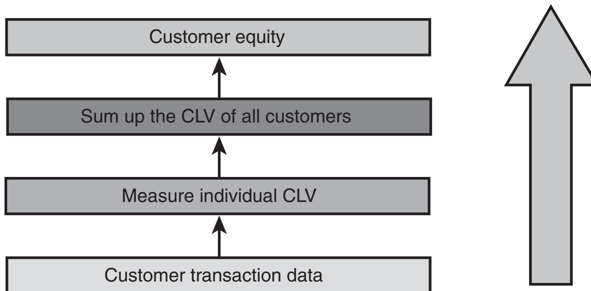

Figure 1.3 Bottom-up approach to measuring CLV

A key requirement of this approach is that it needs data at the customer level. Not all firms may meet this criterion. Further, estimation of CLV for each customer could be time-consuming, especially for large firms with millions of customers. However, the bottom-up approach offers rich customer-level insights (such as individual customer behavior, response to promotion, and individual customer value) that might have otherwise been lost due to aggregation under the top-down approach. Our contention is reinforced by new challenges infused by the changing business landscape of the twenty-first century, as shown in Figure 1.4.

	Traditional Business	Twenty-First Century Business
Philosophy	Sell products	Serve customers
Orientation	Market orientation	Interaction orientation
Management Criteria	Portfolio of products	Portfolio of customers
Strategy Motivation	Increase customer satisfaction	Increase customer profitability
Selling Approach	How many customers can we sell this product to?	How many products can we sell to this customer?
Strategy Outcome	Sales maximization	Customer Lifetime Value maximization

Figure 1.4 Changing business landscape of the twenty-first century

The shift in focus from products to customers has been a significant development of the twenty-first century. State-of-the-art marketing is now concerned with servicing each customer differently. These developments have been accelerated by technological advances. Increase in computation power and reduction in data-storage costs have prompted several companies to set up huge IT infrastructures to archive customer-level data. The proof lies in the ubiquity of grocery cards, retailer credit cards, and point-based loyalty schemes (such as airline frequent-flyer programs). All these measures are a means to a common end: collection of customer-level data in an effort to know the customer better. So, if you don't know your customers, your competition will! Further proof comes from companies that have succeeded in

knowing and managing their customers at the individual level. Such organizations have been richly rewarded because of an improvement in both cost and profit efficiencies. For example, Harrah's Entertainment, a prominent casino and gaming resort chain, has consistently outplayed its competition and recorded impressive financial performance despite a weak economy. The critical success factor: superior ability to cater to its customers based on a forward-looking metric.

The concepts covered in this book apply to disparate relationships, regardless of whether the customer is contractual or noncontractual, whether the firm sells a product or a service, or whether transactions with specific customers occur repeatedly or are just one-off (and perhaps with follow-up services). CLV can be measured across all these situations, but how it is measured will vary. Chapter 3, "Customer Selection Metrics," covers CLV measurement issues across various scenarios.

Therefore, the adoption of the CLV metric seems to be not only sufficient but a necessary condition of business in the twenty-first century. Given the increasing focus on customers, this book strongly advocates the bottom-up approach to CLV estimation. The bottom-up approach enforces customer-centricity within an organization, as you will discover in the subsequent chapters of this book. The full potential of the CLV metric is realized when all customer-level marketing strategies of the firm are aligned and integrated with the CLV metric.

Aligning Customer Management Strategies with the CLV Metric

Figure 1.5 illustrates a typical customer life cycle scenario. Based on the location of the customer on the life cycle plot, the firm can extend acquisition, retention, or customer win-back strategies in an effort to speed acquisition, increase revenue during retention, and delay attrition. The net result is a lift in customer value. This is denoted as strategic impact in Figure 1.5.

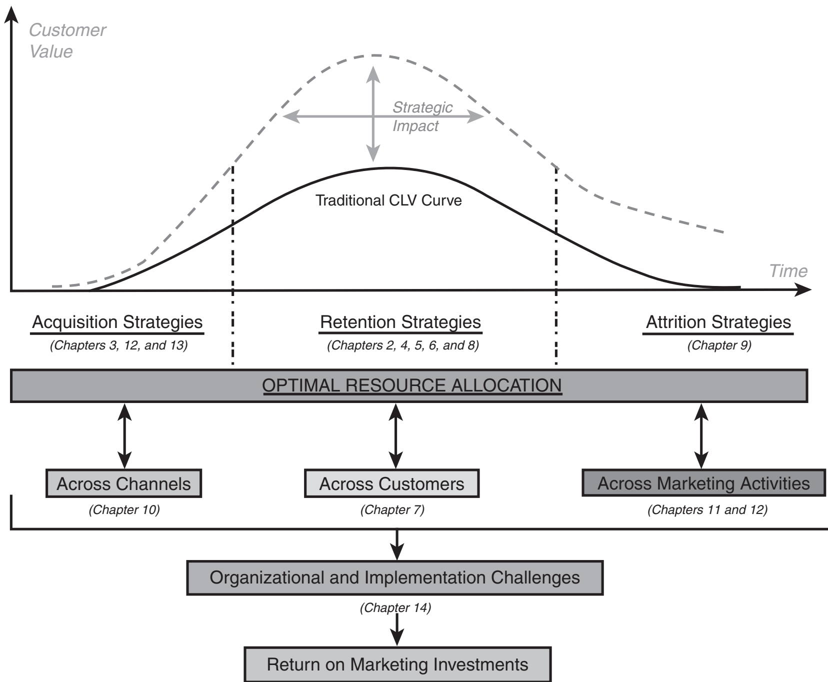

Figure 1.5 Typical customer life cycle scenario

The rest of this book takes an in-depth look at powerful customer-level strategies relevant to virtually any business in the business-to-consumer (B2C) or business-to-business (B2B) domain. With regard to the customer acquisition stage, this book covers how firms can go about acquiring profitable customers, the best metric to use while acquiring customers, and how to use customer referral as a strategic tool to acquire new customers. With regard to the retention stage, this book examines how firms can manage customer value, loyalty, and profitability simultaneously; that is, how can they pitch the right product to the right customer at the right time. With regard to the customer attrition stage, this book discusses dynamic proactive strategies to prevent losing customers. Deployment of these customer-level strategies has resource allocation consequences that lead to greater cost and profit efficiencies. This book talks about reallocation of resources *across different channels* to increase the level of interaction and hence spending per customer. Resource allocation *across customers* helps in the prudent reallocation of

limited marketing budgets from low-profit customers to customers who are expected to provide higher profits in the future. Resource allocation *across marketing activities* seeks to balance marketing budgets across acquisition and retention strategies. The net result of all customer-level initiatives is a higher return on marketing activities. However, this is often an impediment in the wake of strategy-implementation challenges at the organizational level. These challenges have been addressed in a separate chapter of the book. The book chapters relevant to each strategy/topic are indicated in parentheses in Figure 1.5. All strategies are state-of-the-art, with a proven track record of unprecedented success when implemented at select Fortune 500 corporations.

Endnotes

[1] The Continental Airlines example is based on the following sources: (a) B. O'Reilly, "The Mechanic Who Fixed Continental," *Fortune,* April 23, 1999: 176–186; (b) Continental Airlines annual reports.

[2] The Dell example is based on the following sources: (a) Rangan V. Kasturi and Marie Bell, "Dell-New Horizons," *Harvard Business Review* Case Study 9-502-022, October 10, 2002; (b) Dell Corporation annual reports; (c) Kelley Rob, "Dell reports steep decline in profits," CNNMoney.com, March 1, 2007.

[3] George Day, "Creating a Superior Customer-Relating Capability," MSI Working Paper Series, Issue One, No. 03-001 (2003): 21–36.

[4] Paul W. Farris, Neil T. Bendle, Philip E. Pfeifer, and David J. Reibstein. *Marketing Metrics: 50+ Metrics Every Executive Should Master* (Wharton School Publishing, 2006).

[5] Katherine N. Lemon, Roland T. Rust, and Valarie A. Zeithaml, "What Drives Customer Equity," *Marketing Management,* Spring 2003: 21–25.

[6] Sunil Gupta and Donald R. Lehmann, *Managing Customers as Investments* (Wharton School Publishing, 2006).