Maximising the Value of the Customer Base for Enduring Profitability

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For any business, customers are a critical intangible asset, they tend to be hard to come by and need to be valued and managed with care. In building a base of profitable committed customers, businesses should make the maximisation of the value of their customer base a clearly stated and measured business goal. Key to this is focus on the attraction, retention and enhancement of customer relationships in a way that not only minimises customer defections but also importantly customer migration. These smaller migratory changes in customer spending have been shown to offer substantial potential. A sales funnel is a metaphor to describe a process of how new sales leads (i.e. prospects) are attracted into a system, initially placing them in the top of the funnel and then worked down through the system by informing, persuading, overcoming objections, providing information, demonstrating, etc., until at the narrow part of the funnel, an order is placed and a sale is closed when payment from the customer is received. A viAt thew of a sale top e of ts funnelh presente funnels snapshot" of a sales function or an individual sales territory at any given p

Strategically managing the longer-term sales cycle from beginning to end is practiced by the most successful sales professionals.

oint in time as shown in Fig 1. "unqualified" prospects" or potential customers and at the bottom, are the several stages later, are those customers who have received the product or service and have paid for it. Once in the funnel, the task is to progress prospects through it as fast as possible with as little effort as makes sense. Along the way there may be points where they are progressed further or qualified out of the funnel. Sometimes roadblocks appear or progress is slow, making qualifying-out an important task. Sales professionals try to avoid focusing overly on any one stage. Instead they identify each individual stage of the process and allocate time and the resources appropriate to each stage, so that they can maximize their sales output.

Fig 1: The Sales Funnel/Pipeline

This "pipeline management" process, involves identifying the sales stages appropriate to a business, the activities necessary to generate sales opportunities, and following each opportunity from the top of the funnel through to completion. This provides the following benefits:

- Balanced activities: The pressure to produce immediate revenue today (closing the sale) can minimize attention given to the top of the funnel (developing sales leads). Using the correct techniques at each step in the funnel, focus is not lost on prospecting and finding opportunities.
- Minimisation of peaks and valleys. A well-managed pipeline improves sales forecasting and helps the attainment of sales goals on a more consistent basis.
- Resources will be allocated to strategic more profitable opportunities
- Better follow-through on sales opportunities. Not following through in a timely manner can cause a pipeline leak — and a waste of precious resources.

Marketing has traditionally focused on getting new customers and building the customer base through adding more first-time customers. However studies carried out by McKinsey's, the management consultancy firm, identified that improving the management of migrating customers as a whole by focusing not only on defecting customers but also on smaller changes in customer spending can have as much as ten times more value than preventing defections alone. While getting new customers is still important, the cost of customer churn (defection) and the maturity of many industries suggest that this can no longer be the primary or sole source of growth for most organisations as demonstrated. Much research suggests that it is more cost-effective to keep a current customer than to attract a new one. According to studies carried out by McKinseys, “many more customers change their spending behavior than defect, so the former typically account for larger changes in value (Fig 2&3). At one retail bank, for example, 5 percent of checking-account customers defected annually, taking with them 10 percent of the bank's checking accounts and 3 percent of its total balances. But every year, the 35 percent of customers who reduced their balances significantly cost the bank 24 percent of its total balances, while the 35 percent who increased their balances raised its total balances by 25 percent. This effect showed up in all 16 industries they studied and was dominant in two-thirds of them”.

Fig 2: Effects of Customer Defection & Migration.

Defection bad, migration worse

Retail Banking Example	%Value of Deposits	% Share of Customers
Year 1 value of Deposits	100	100
Loss due to defection	-3	5
Loss due to reduced balances	-24	35
Gain from increased balances	+25	35
Year 2 value of deposits	98	

Source: Adapted from The McKinsey Quarterly, 2002 Number 2

Fig 3: Effects of Customer Defection & Migration.

Defection bad, migration worse

Airline Example	% Sales Revenue	% Share of Customers
Year 1 revenues	100	100
Loss due to defection	-3	3
Loss due to reduced travel	-19	35
Gain from increased travel	+24	24
Year 2 revenues	102	

Source: Adapted from The McKinsey Quarterly, 2002 Number 2

Relationship marketing thus focuses on attracting, satisfying, keeping, and even enhancing customers over their ‘lifetimes’ with chosen companies. The overall goal is to build and maintain a base of committed customers who are profitable for the organization. Its focus is the retention and enhancement of customer relationships

In essence for an organisation to grow successfully it must: a) create a profitable system to attract, on a continuous basis, prospective customers; b) create a system to convert maximum prospects into customers; c) establish a profitable system for keeping customers and d) establish a profitable system for growing existing customers.

An article reporting Wharton marketing Professor David Reibstein’s presentation to their Marketing Conference 2004 entitled “Linking Marketing Metrics to Financial Consequences.” talks about the problem of marketing and financial people not sharing the same language and the importance of drawing a line between concepts of the two languages. In essence a translation problem exists between marketing terminologies such as “customer satisfaction”, “awareness” and the language of profitability and share price, which is the language of most CEO’s. The difficulty for marketing people arises in being able to demonstrate the value of such concepts to sceptical CEO’s and CFO’s. “CEO’s on the other hand want to know for example what a 5 per cent increase in customer satisfaction will do for the bottom line”.

Determining the value of a business’s key intangible assets would be a considerable step forward, such as valuing the company’s customer base. However this is something a straightforward financial statement does not do. To illustrate this, Reibstein outlined the financial history of two companies, Company A and Company B, both of which had the same stable profit over the past five years. However Company A had spent much more on marketing than Company B, sales revenues had grown faster, but not as fast as its marketing expenditures. The return-on-sales of Company A fell as a consequence compared to Company B.

At that point Reibstein asked the delegates which company was doing the better job. By and large Company B was favoured most, as did the majority of Chief Financial Officers to whom Reibstein had recently posed the same question. Company B was also their favoured choice on the basis it seems of "doing more with less", or putting it another way, by "providing stable profitability with less marketing expenditures than Company A".

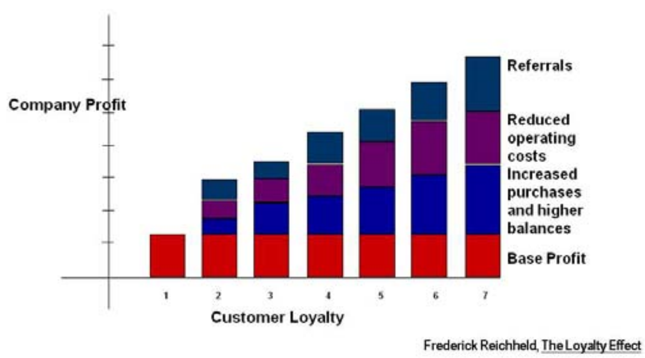
Getting in behind the numbers, Reibstein then showed data on the customer relationships developed by the two companies. Company A it turns out had three times as many customers as Company B. "So it becomes really important how to value that asset," Reibstein suggested. And, in fact, there is an equation for just that purpose. It calculates the cost to acquire the customer, the amount of the company's product that the customer purchases, the profit margin of those purchases, the cost of retaining the customer, the actual retention rate, how that customer influences others and the cost of capital.

Falling out of this exercise the delegates learned that Company A not only had a tremendous increase in the number of new customers, but its "churn rate" (the rate at which it lost customers annually) was much lower. So when the formula to value customers was applied to firms A and B, the value of Company A's customer base was four times that of Company B. Denigrated Company A was actually doing the right thing all along by spending heavily on marketing. "Valuing a customer base is something a straightforward financial statement doesn't do," said Reibstein "And that's why financial statements can lead us astray. They require us to expense all marketing expenditures the year they occur, when actually customer relationships have a life for a corporation."

The Lifetime Value of a Customer

The lifetime value of a customer is a useful concept and is based on a calculation that looks at customers in terms of their lifetime revenue and profit contributions to a business. In essence it is the current value of the likely future income stream generated by an individual customer. "It is influenced by the length of an average "lifetime", the average revenues generated per relevant time period over the lifetime, sales of additional products and services over time, and referrals generated by the customer over time".

Fig 4: Lifetime Value of Customers



One way of tracking the money value of loyal customers is to estimate the increased value or profits that accrue for each additional customer who remain loyal to the company rather than defecting to the competition. Bain & Co. have done this for a number of industries, showing dramatic increases in profits ranging from 35 to 95 percent when the retention or loyalty rate rises by 5 percent. The increases were calculated by comparing the net present values of the profit streams for the average customer life at 5 percent higher retention rates.

"Served correctly, customers generate increasingly more profits each year they stay with a company. Across a wide range of businesses, the pattern is the same: the longer a company keeps a customer, the more profit it stands to make" [Reichheld et Al 1990].

The following example is a lifetime value chart for George's Restaurant. Three thousand customers are being tracked on George's database. The formula for the discount rate is $D = (1 + i)^n$ where i = the interest rate and n = the number of years. Typically, the lifetime value numbers in and of themselves have no particular significance. What makes them important is when they are used in comparison with other numbers to evaluate the effect of proposed strategies.

Example: George's Restaurant Lifetime Value (LTV).

Fig 5:
George's Base Level LTV.

REVENUE	**Year 1**	**Year 2**	**Year 3**
Total customers	3,000	1,650	990
Retention rate %	55%	60%	65%
Visits per year	2	3	4
Average spend €'s	110	120	130
Spending rate €'s	220	360	520
Total revenue	660,000	584,000	514,800
COSTS			
Direct %	46%	48%	50%
Direct Costs €'s	303,600	285,120	257,400
Acquisition cost €20	60,000	0	0
Total Costs €'s	363,600	285,120	257,400
PROFITS			
Gross profit €'s	296,400	308,880	257,400
Discount rate €'s	1	1.2	1.44
NPV profit €'s	296,400	257,400	178,750
Cumulative NPV €'s	296,400	553,800	732,550
LTV €'s	98.80	184.60	244.18

Fig 6
George's LTV with retention building strategies

REVENUE	**Year 1**	**Year 2**	**Year 3**
Referral rate	6%	8%	10%
Referred customers	0	180	158
Retention rate	60%	65%	70%
Retained customers	0	1,800	1,170
Number of customers	3,000	1,980	1,328
Visits per year	2.5	3	3.5
Average spend €'s	120	130	140
Spending rate €'s	300	390	490
Total revenue	900,000	772,000	650,916
COSTS			
Direct %	46%	48%	50%
Direct Costs €'s	414,000	370'656	325,458
Acquisition cost €20	60,000	0	0
PR €4	12,000	7,920	5,314
Referral rewards €4	0	3,600	3,168
Staff training €10	30,000	19,800	13,284
Total Costs €'s	516,000	401,976	347,224
PROFITS			
Gross profit €'s	384,000	370,224	303,692
Discount rate €'s	1	1.2	1.44
NPV profit €'s	384,000	308,520	210,898
Cumulative NPV €'s	384,000	692,520	903,418
LTV €'s	128.00	230.84	301.14

In Fig 5you can see a base level lifetime value chart which demonstrates clearly the impact of defecting customers from George's. In Fig 6 you can see how George's have invested in a customer retention building and referral programme that involves the following range of activities; public relations; staff training, and a referral reward incentives. You can also see the effect of these efforts. The retention rate has risen from 55% to 65%, the number of visits to the restaurant has increased from 2 to 2.5 times per year, and diners have increased their average spend by €10 each time they dine in George's, minimizing customer migration also. The net impact is substantial as summarized in Fig 7.

Fig 7: Net Impact of Adoption of the Strategy

	Year 1	**Year 2**	**Year 3**
Without strategy - €'s	98.80	184.60	244.18
With strategy - €'s	128.00	230.84	301.14
Difference - €'s	29.2	46.24	56.96
With 3000 customers €'s	87,600	138,720	170,867

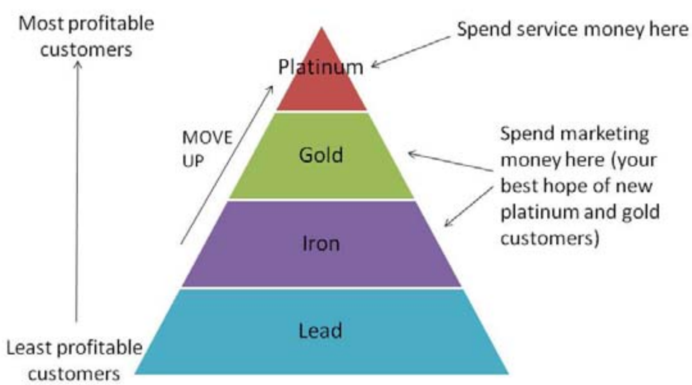
Analysis of lifetime value is a useful tool. It tests the validity of loyalty building tools before serious money is expended. More and more companies are using this tool today to test out and improve retention strategies and migration minimisation strategies.

Selecting profitable customers

As relationships and service become increasingly central in business, the profitability of customers is becoming more important than the profitability of products. In such conditions, marketing success will be very much the same as generating maximum profits from a firm's total set of customers. Many companies realise that not all customers are worth attracting and keeping and that many customers are too costly to do business with and have little potential to become profitable, even in the longer term and it is neither practical nor profitable to meet all customers' expectations. Most companies realise that their customers differ in profitability but do not have the data or the analytic capability, by and large, to be able to distinguish between them and as a result many often overcharge their best customers, in effect, subsidizing the worst customers. So in many cases, it is advisable for a company to become indifferent to or even "fire" perhaps some of its customers. When you know the lifetime value of a customer, you have a benchmark for how much you would or should be willing to invest to acquire a customer.

As customers step up their commitment to a supplier or provider, they expect more and want more if they are to be satisfied. For customer satisfaction to be high on a consistent basis a company should subdivide its customers into categories or what Zeitaml et Al refer to as customer tiers(Fig 8).

Fig 8:The Customer Pyramid



Adapted from Zeithaml et Al 1996

1) The platinum tier represents the most profitable customers. e.g. heavy users, not too price sensitive, willing to try new offerings from the company, loyal and committed to the firm.
2) The gold tier represents less profitability probably because of demand for more discounts that squeeze margins or are not as loyal. They are likely to be heavy users of the product but may buy from a variety of suppliers.
3) The iron tier represents important volume to the company but their expenditure levels; profitability and loyalty don't justify any special treatment.
4) The lead tier is those who cost the business money, they insist on more attention than can be justified, and can be problem customers, bad-mouthing the company and using up expensive resources of the firm.

Each of the tiers represents different levels of profitability and each respond differently to marketing activity. Ideally then companies need to offer bespoke products and services that meet individual needs. This will require the business to either change the customers' behaviour so as to make them profitable, through increases in revenue, or changes in or reduction of the firm's cost structure.

Companies can improve their profit situation by getting a bigger share of customer purchases from those who have the largest need for the service, or from those who demonstrate the most loyalty to a single provider. Customer potential can therefore be increased by lengthening relationships with loyal customers, increasing sales with the existing customer base, and by increasing profitability on each sales opportunity.

Clearly customer relationship management is potentially a source of enduring profitability. Maximising the value of the customer base must surely be a priority and key to all of this is a focus on the attraction, retention and enhancement of customer relationships.

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