What Are Your Customers Really Worth?

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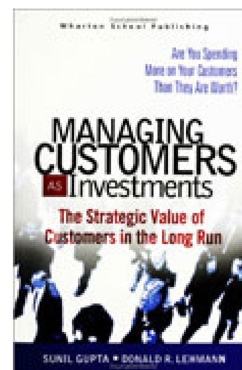

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In their book titled, Managing Customers as Investments: The Strategic Value of Customers in the Long Run *(Wharton School Publishing), authors Sunil Gupta and Donald R. Lehmann offer practical examples and case studies to help companies estimate the lifetime value of their customers. That information, the authors suggest, can then be used to make better strategic decisions about customer acquisition, service, retention and segmentation. Knowledge@Wharton has excerpted a section of the book below.*

If you walk into Stew Leonard's, a unique grocery store on the East Coast of the United States, you will probably notice a sign engraved in stone. This sign, which represents the company's philosophy and is meant as much for its employees as its customers, highlights two rules. It reads, "Rule #1: The Customer Is Always Right. Rule #2: If the Customer Is Ever Wrong, Re-Read Rule #1."

A focus on customers is not unique to this company. For years, managers all over the world have reiterated the need to focus on customers, provide them good value, and improve customer satisfaction. In fact, metrics such as customer satisfaction and market share have become so predominant that many companies not only track them regularly but also reward their employees based on these measures.

However, this kind of customer focus misses one important component -- the value of a customer to a company. Effective customer-based strategies take into consideration the two sides of customer value -- the value that a firm provides ***to*** a customer *and* the value ***of*** a customer to the firm. This approach recognizes that providing value to a customer requires marketing investment and that the firm must recover this investment. In other words, this approach combines the traditional marketing view, where the customer is king, with the finance view, where cash is king.

This chapter describes how a strategy that focuses on the two sides of customer value differs from traditional marketing strategy. We argue that traditional marketing's focus on customer satisfaction and market share may be counterproductive at times. We demonstrate that the two approaches use different metrics for measuring success and frequently lead to quite different insights and strategic decisions. Finally, we discuss in detail the three strategic pillars of this new approach -- customer acquisition, customer margin, and customer retention.

Traditional Marketing Strategy

A longstanding approach to marketing strategy discussed in almost every marketing management textbook and taught in most business schools can be summed up as consisting of 3 Cs, STP, and 4 Ps.

The first component of this framework is the analysis of custom-ers, company, and competition (the 3 Cs) to understand cus-tomer needs, company capabilities, and competitive strength and weaknesses. If a company can fulfill customer needs better than its competitors, it has a market opportunity. The second compo-nent is to formulate the strategy for STP -- segmentation, target-ing, and positioning. This part recognizes that customers are different in terms of their needs for product and services, so a firm has to decide which of these customer segments it should target. After selecting a target segment, the firm needs to decide on the value proposition or positioning of its products with respect to competitive offerings. The final component of this framework designs the 4 Ps -- product, price, place (i.e., distribu-tion channels), and promotion or communication programs.

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This framework is logical and useful. However, implicit in this structure is an emphasis on providing value to customers by sat-isfying their needs with little focus on cost. Metrics used to mea-sure success in this framework, such as sales, share, or customer satisfaction, drive decisions. What is missing is the explicit recog-nition or measurement of return on marketing investment. For example, it is not uncommon for firms to spend billions of dollars on advertising. For example, in 2002, GM spent $3.65 billion in advertising in the United States alone. It also offered billions of dollars in discounts to attract customers. What is the return on these investments? Do they build customer value in the long run? Do they eventually help the financial health of the com-pany? It is difficult, if not impossible, to answer these questions within the traditional marketing framework.

Customer-based strategy does not completely ignore the key principles of the traditional marketing approach. Providing value to customers is still critical. However, this approach recognizes that marketing investment in customers must be recovered over the long run. Specifically, this approach highlights the two sides of customer value -- the value a firm provides *to* a customer and the value *of* a customer to a firm. The first part is the investment, and the second part is the return on this investment.

The Two Sides of Customer Value

[There are] four scenarios with different values to and of customers. *Star Customers* get high value from the products and services of the firm. These customers also provide high value to the company by way of high margins, strong loyalty, and longer retention time. The relationship is balanced, largely equitable, and mutually beneficial. This is clearly a win-win situation where customers get superior value, which earns the firm loyalty and higher profitability. A firm would be well-advised to build this type of customer.

In contrast, *Lost Cause* customers do not get much value from the products and services of the firm. Generally these customers are marginal for the firm; their main value, if there are enough of them, is to provide the economies that come with greater sales -- e.g., reduced production costs and promotion efficiencies. Absent economies of scale, if the company cannot migrate them to higher levels of profitability, it should consider either reducing its investment on these customers or even "firing" (dropping, shift-ing to other suppliers) them.

One cross-sectional study of U.S. banks found that in the early 1990s only 30% of a typical bank's customers were profitable over the long run. In other words, 70% of customers destroyed value! Some insurance companies found themselves in a similar situa-tion a few years ago when they realized that after several natural disasters in Florida, their zeal to grow and add more customers had led them to acquire a large number of customers in disaster- prone areas. For long-run profitability, it is imperative for these companies to either convert unprofitable customers to a profit-able status or "fire" them. This notion of dropping customers runs counter to the intuition of managers who have been trained to think that adding customers, increasing sales, and gaining mar-ket share are good *per se*. In many cases, market share and reve-nue growth may be the wrong metrics to gauge success.

The other two cases show unbalanced, and hence unstable, relations. *Vulnerable Customers* provide high value to the firm but do not get a lot of value out of company's services. These may include newly acquired large customers whose experi-ence is less than stellar and who may be wondering why they chose your product in the first place. These may also be long-standing customers who, largely through inertia, remain loyal. In a sense, they are exploited, much like overworked cows or farmed-out fields. These customers are vulnerable and prone to defect to competitors unless corrective action is taken.

A company can invest in these customers through better product offerings, additional services, and related activities. These cus-tomers may deserve better service than others. The concept of service discrimination is similar to the idea of price discrimina-tion, where not all customers pay the same price for a product (e.g., an airline ticket). Airlines and casinos have provided prefer-ential treatment for their best customers for many years, and more and more companies are beginning to implement a similar strategy. For example, the call centers of Charles Schwab were configured so that the best customers never waited longer than 15 seconds to get a call answered, while other customers could wait for as long as 10 minutes. Even airlines that pioneered loy-alty programs are now adjusting their frequent flier programs on the basis of ticket price (and hence profitability to the firm) rather than simply the number of miles flown. Although such ser-vice discrimination can generate a backlash from customers, it is also

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possible that customers will accept the old adage that "you get what you pay for," especially if the policy is clear and trans-parent.

Free Riders are the mirror image of the *Vulnerable Customers*. These customers get a superior value from using the company's products and services but are not very valuable to the firm. For whatever reason (e.g., large size, strong competition), these cus-tomers are "exploiting" the relationship with the company, appropriating the lion's share of value.

Consider the case of supermarkets. Every week, supermarkets promote certain products at a low price in order to attract cus-tomers to their store. Several items are treated as "loss leaders." A supermarket does not expect to make money on these items but hopes that their low prices will attract more customers to the store. Once these customers are in the store, the hope is that they will buy other items that are profitable. However, many cus-tomers are cherry-pickers -- i.e., they only buy those few items that are on sale. It is somewhat ironic that supermarkets have a special line for customers who buy a few items while heavy spenders wait in long lines. Doesn't it make more sense to treat your more profitable customers better by opening a special line for them? Clearly, care is needed in implementation. In general, however, a firm should either reduce its service level or raise prices for the*Free Riders.* Although this will reduce the value to customers and risk losing them, it will, if successful, enhance their value to the firm. As someone once said, "The difference between a sales and marketing person is that a good marketing person knows when to walk away from a sale."

In sum, successful customer-based strategies require that a com-pany consider both the value the firm supplies to the customer and the value the customer offers to the firm.

Key Marketing Metrics

How do we "keep score" in marketing? Each of the strategic approaches has its own key metrics. Unsurprisingly, these met-rics drive decisions. They become goals and are stated every-where from annual reports to marketing plans as objectives and measures of success.

The key metrics in the traditional marketing approach are sales and share. Ancillary metrics may include customer satisfaction and brand image. Profit is typically measured at a product or brand level. As already illustrated, market share or sales may be the wrong metric in many cases. A credit card company may acquire a lot of low-value customers, which will increase its share but not its long-term profitability. Improving customer satisfac-tion is good in principle but the benefit of this improvement has to be weighed against the cost to achieve it. Measuring profit at a product or brand level is useful but incomplete for at least two reasons. First, most firms focus on the short-term or quarter-by- quarter profits of a brand and treat marketing as an expense. This short-term focus is counter to the very concept of marketing as investment. Second, measuring profit at the product level ignores the vast differences in the profitability of customers. A bank may be losing money on its mortgage business. This aggregate profit measure hides the fact that the problem may lie with the bank having too many customers who are *Free Riders*. Adjusting the price and service to customers based on their value to the firm can significantly enhance the profitability of this product.

In sum, capturing share, increasing satisfaction, and enhancing the brand experience are all useful. They also serve as motivators toward measurable goals. However, they are neither consistent with each other nor necessarily good business. For example, increasing share typically requires bringing in more marginal cus-tomers, who inherently are less likely to be satisfied. A study of 77 firms across a wide range of industries confirmed that increas-ing share may lower satisfaction. Similarly, increas-ing average satisfaction ratings doesn't guarantee increased profits, as Cadillac discovered in the 1980s, when it increasingly appealed to a smaller, aging customer base.

Customer Metrics

The customer approach focuses on customer value or customer profitability in contrast to share, satisfaction, or product profit-ability. A focus on customer profitability has several advantages. First, it inherently takes a long-term view, emphasizing that customers are assets who provide long-term returns and that marketing is an investment in these customers. This also shows how to assess the return on this marketing investment. Second, it recognizes that the value of customers may vary substantially. For

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example, in many business-to-business situations, it is not uncommon to find that while large customers are generally the largest revenue generators for a firm, they are not necessarily the most profitable because of the high cost required to serve them. Note, if a firm keeps track of profit at only the product level, it will never be able to uncover this. As we will discuss in Chapter 6, a focus on customer profitability may require a major change from product-based accounting to customer-based accounting to keep track of revenues and cost for each individ-ual customer. In other words, this new metric is more than a mere difference in semantics. It will not only drive decisions in a different direction but it may also entail significant changes in organization structure.

As discussed in Chapter 2, customer profitability and the value of customers are primarily driven by three major components -- customer acquisition (acquisition rate and cost), customer margin (dollar margin and growth), and cus-tomer retention (retention rate and cost). These three factors are the key metrics of the new approach. They not only provide tan-gible and measurable metrics but also make clear the inherent tension between growth and efficiency. For example, it is hard to simultaneously increase customer acquisition and cut total or average acquisition cost. Similarly, increasing the acquisition rate is likely to draw marginal customers and may negatively impact customer retention rates and margin per customer. Such trade- offs are the essence of astute business decisions and the hallmark of *profitable* growth.

A Case Study

To highlight some of the differences in the strategic insights gleaned from using the traditional versus the new approach, we present a case study for the U.S. automobile industry. The auto-mobile industry is one of the most competitive in the United States, with very heavy marketing expenditure. In 2002, the automobile industry was the world leader in advertising expendi-ture, with over $16 billion in the United States alone. In addition, several billion dollars were spent on discounts in the form of cash rebates and the like. Some reports suggest that in 2003, U.S. automakers spent as much as $3,310 on each vehicle in the form of cash rebates and below-market loans.

A recent study examined the U.S. luxury passenger car market to determine how marketing efforts influence sales (the traditional metric) versus customer profitability (the customer metric).7 The study examined nine brands (Acura, Audi, BMW, Cadillac, Infiniti, Lexus, Lincoln, Mercedes-Benz, and Volvo) from January 1999 to June 2002. The data covered 26 regional submarkets, representing over 70% of the U.S. market.

Using rigorous time series models, this study arrived at some star-tling conclusions. It found that all brands' discounting efforts either increased or maintained sales volume. Therefore, dis-counting may be considered an effective marketing tool by the traditional metric of sales. However, on average, across these nine brands, discounting rarely increased a brand's customer equity (i.e., profitability of current and future customers) in the long run. The results were even more dramatic in some cases. For example, discounting had a positive effect on Lincoln's short- term sales, but the brand's discounting activities hurt its cus-tomer equity in the long run due to the negative long-term impact on its acquisition rate. This is consistent with other studies that find that discounting does not help in the long run, with either customer purchases or the firm's shareholder value.

Results for advertising were also different when viewed from the traditional versus the new lens. For example, while the advertis-ing for BMW had a positive short-term effect on its sales, it did not have any significant impact on its customer equity. Advertis-ing for Acura increased its sales in the long run but not its cus-tomer equity. Only the advertising for Mercedes-Benz had a positive influence on its customer equity. If $16 billion of adver-tising expenditure does not affect the long-term profitability of customers (which, as we will show in Chapter 4, is closely linked to shareholder value), then the industry needs to re-examine its marketing strategy.

This study also emphasized the differential impact of marketing instruments on customer acquisition and retention rates. For example, when high-quality brands offer discounts, it affects their customer acquisition rate more than their retention rates. Evi-dently, if customers are satisfied with a high-quality product, their repeat purchase decisions are less likely to be affected by their favorite brand's price discounting. This suggests that differ-ent brands may need to monitor different metrics (e.g., acquisi-tion or retention) to assess the impact of their marketing investments on customer profitability.

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This study illustrates the value of understanding how marketing dollars affect customer profitability and why this focus may lead to very different conclusions than those obtained from traditional approaches.

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