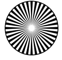
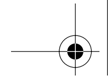
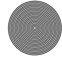
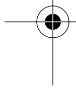
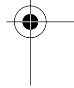


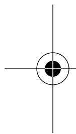
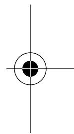





CHAPTER

3

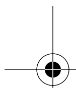
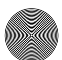
CUSTOMER-BASED STRATEGY

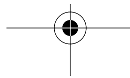
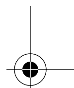
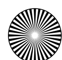
If you walk into Stew Leonard's, a unique grocery store on the East Coast of the United States, you will probably notice a sign engraved in stone. This sign, which represents the company's philosophy and is meant as much for its employees as its customers, highlights two rules. It reads, "Rule # 1: The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

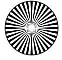



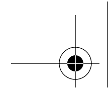
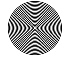
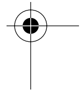
A focus on customers is not unique to this company. For years, managers all over the world have reiterated the need to focus on customers, provide them good value, and improve customer satisfaction. In fact, metrics such as customer satisfaction and market share have become so predominant that many companies 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.

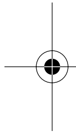
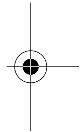


Chapter 3.fm Page 42 Tuesday, December 14, 2004 3:14 PM




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 is depicted in Figure 3.1. This approach can be summed up as consisting of 3 Cs, STP, and 4 Ps.

The first component of this framework is the analysis of customers, company, and competition (the 3 Cs) to understand customer 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 component is to formulate the strategy for STP—segmentation, target-

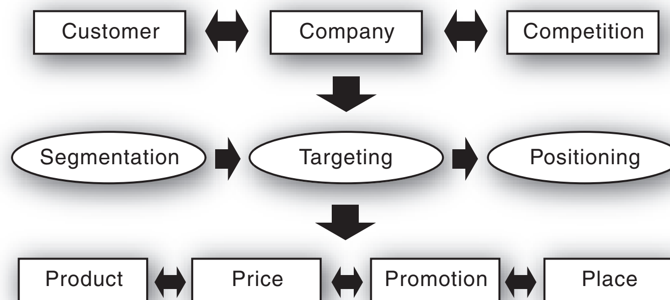
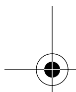
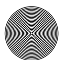
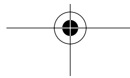
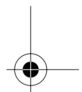
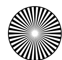
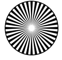
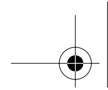
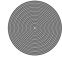
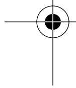
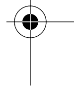


Figure 3.1 The framework of a traditional marketing strategy.

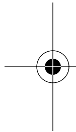
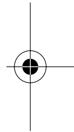






Chapter 3.fm Page 43 Tuesday, December 14, 2004 3:14 PM





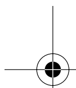
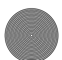
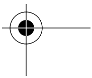
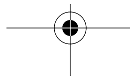
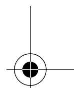
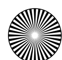
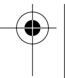
ing, and positioning. This part recognizes that customers are different in terms of their needs for product and services, so a firm has to decide which of these customer segments it should target. After selecting a target segment, the firm needs to decide on the value proposition or positioning of its products with respect to competitive offerings. The final component of this framework designs the 4 Ps—product, price, place (i.e., distribution channels), and promotion or communication programs.

This framework is logical and useful. However, implicit in this structure is an emphasis on providing value to customers by satisfying their needs with little focus on cost. Metrics used to measure success in this framework, such as sales, share, or customer satisfaction, drive decisions. What is missing is the explicit recognition 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.[1] 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 company? It is difficult, if not impossible, to answer these questions within the traditional marketing framework.

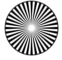



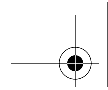
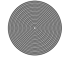
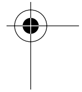
VALUE TO THE FIRM VS. VALUE TO THE CUSTOMER

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.

Chapter 3.fm Page 44 Tuesday, December 14, 2004 3:14 PM

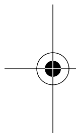
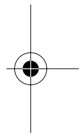


The Two Sides of Customer Value

A firm provides value to a customer in terms of products and services, and a customer provides value to a firm in terms of a stream of profits over time. Investment in a customer today may provide benefits to the firm in the future. In that sense, customers are assets that a firm needs to invest in. At the same time, as with any investment, the firm needs to assess the potential return. Since not all customers are equally profitable, investment in customers should vary by their profit potential, as illustrated in Figure 3.2.

This figure illustrates 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

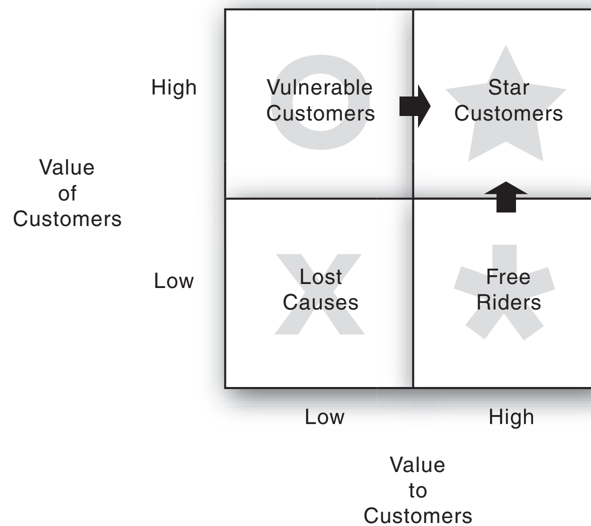
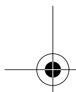
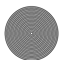
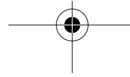
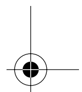
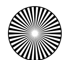
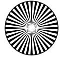
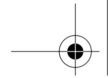
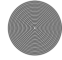
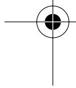
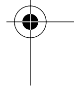


Figure 3.2 The two sides of customer value.

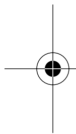
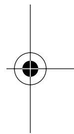






Chapter 3.fm Page 45 Tuesday, December 14, 2004 3:14 PM





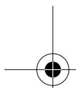
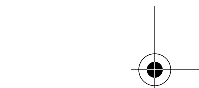
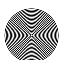
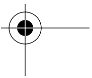
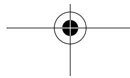
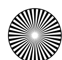
higher profitability. A firm would be well-advised to build this type of customer.

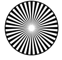
In contrast, *Lost Cause* customers do not get much value from the products and services of the firm. Generally these customers are marginal for the firm; their main value, if there are enough of them, is to provide the economies that come with greater sales—e.g., reduced production costs and promotion 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, shifting to other suppliers) them.

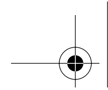
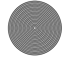
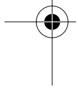
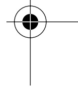



One cross-sectional study of U.S. banks found that in the early 1990s only 30% of a typical bank's customers were profitable over the long run.[2] In other words, 70% of customers destroyed value! Some insurance companies found themselves in a similar situation a few years ago when they realized that 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 profitable 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 market share are good *per se*. In many cases, market share and revenue growth may be the wrong metrics to gauge success.

The other two cases in Figure 3.2 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 experience is less than stellar and who may be wondering why they chose your product in the first place. These may also be longstanding 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.

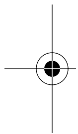
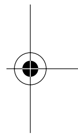









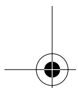
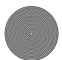
Chapter 3.fm Page 46 Tuesday, December 14, 2004 3:14 PM

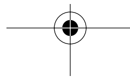
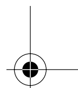
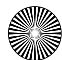
A company can invest in these customers through better product offerings, additional services, and related activities. These customers may deserve better service than others. The concept of service discrimination is similar to the idea of price discrimination, where not all customers pay the same price for a product (e.g., an airline ticket). Airlines and casinos have provided preferential 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.[3] Even airlines that pioneered loyalty 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 service discrimination can generate a backlash from customers, it is also possible that customers will accept the old adage that "you get what you pay for," especially if the policy is clear and transparent.

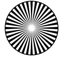



Free Riders are the mirror image of the *Vulnerable Customers*. These customers get a superior value from using the company's products and services but are not very valuable to the firm. For whatever reason (e.g., large size, strong competition), these customers are "exploiting" the relationship with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

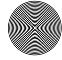
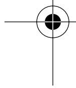
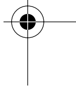
Consider the case of supermarkets. Every week, supermarkets promote certain products at a low price in order to attract customers to their store. Several items are treated as "loss leaders." A supermarket does not expect to make money on these items but hopes that their low prices will attract more customers to the store. Once these customers are in the store, the hope is that they will buy other items that are profitable. However, many customers 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



Chapter 3.fm Page 47 Tuesday, December 14, 2004 3:14 PM

for them?[4] 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."

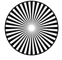
In sum, successful customer-based strategies require that a company consider both the value the firm supplies to the customer and the value the customer offers to the firm.

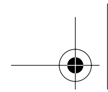
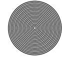
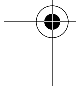
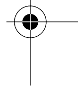
KEY MARKETING METRICS

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

Traditional Metrics

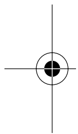
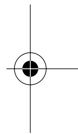
The key metrics in the traditional marketing approach are sales and share. Ancillary metrics may include customer satisfaction and brand image. Profit is typically measured at a product or brand level. As already illustrated, market share or sales may be the wrong metric in many cases. A credit card company may acquire a lot of low-value customers, which will increase its share but not its long-term profitability. Improving customer satisfaction 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



Chapter 3.fm Page 48 Tuesday, December 14, 2004 3:14 PM





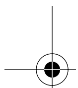
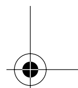
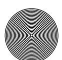
be losing money on its mortgage business. This aggregate profit measure hides the fact that the problem may lie with the bank having too many customers who are *Free Riders*. Adjusting the price and service to customers based on their value to the firm can significantly enhance the profitability of this product.

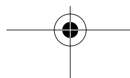
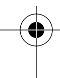
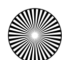
In sum, capturing share, increasing satisfaction, and enhancing the brand experience are all useful. They also serve as motivators toward measurable goals. However, they are neither consistent with each other nor necessarily good business. For example, increasing share typically requires bringing in more marginal customers, who inherently are less likely to be satisfied. A study of 77 firms across a wide range of industries confirmed that increasing share may lower satisfaction (Figure 3.3).[5] Similarly, increasing average satisfaction ratings doesn't guarantee increased profits, as Cadillac discovered in the 1980s, when it increasingly appealed to a smaller, aging customer base.

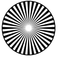



Customer Metrics

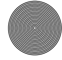
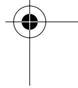
The customer approach focuses on customer value or customer profitability in contrast to share, satisfaction, or product profitability. A focus on customer profitability has several advantages. First, it inherently takes a long-term view, emphasizing that customers are assets who provide long-term returns 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 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 individual customer. In other words, this new metric is more than a



Chapter 3.fm Page 49 Tuesday, December 14, 2004 3:14 PM

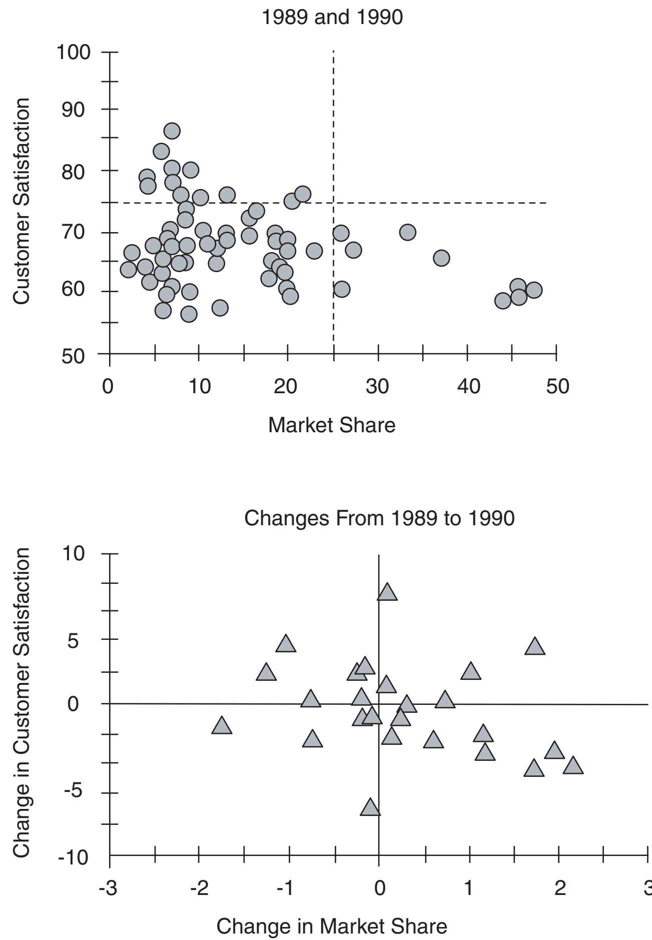
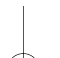
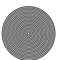
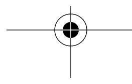
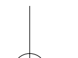
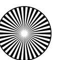
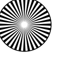
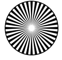


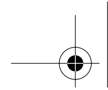
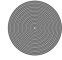
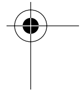
Figure 3.3 Market share and customer satisfaction. Source: Eugene W. Anderson, Claes Fornell, and Donald R. Lehmann, "Customer Satisfaction, Market Share and Profitability: Findings from Sweden," *Journal of Marketing,* 58 (July 1994), pp. 53–66. Reprinted by permission from the American Marketing Association.

mere difference in semantics. It will not only drive decisions in a different direction but it may also entail significant changes in organization structure.



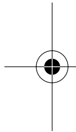
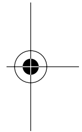








As discussed in Chapter 2 and illustrated in Figure 3.4, customer profitability and the value of customers are primarily driven by three major components—customer acquisition (acquisition rate and cost), customer margin (dollar margin and growth), and customer retention (retention rate and cost). These three factors are the key metrics of the new approach. They not only provide tangible 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.

Table 3.1 summarizes and contrasts the metrics used by the traditional and the new customer-based approach.

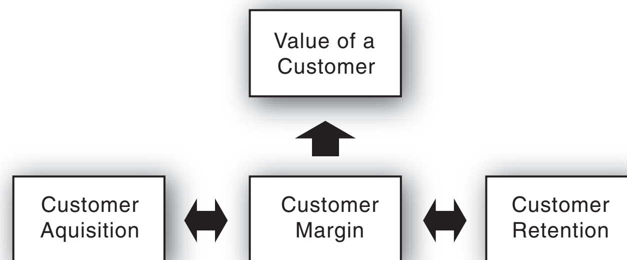
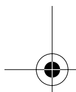
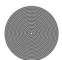
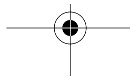
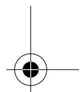
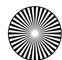
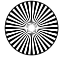


Figure 3.4 The drivers of customer profitability. Source: Eugene W. Anderson, Claes Fornell, and Donald R. Lehmann, "Customer Satisfaction, Market Share and Profitability: Findings from Sweden," *Journal of Marketing,* 58 (July 1994), pp. 53–66. Reprinted by permission from the American Marketing Association.



Chapter 3.fm Page 51 Tuesday, December 14, 2004 3:14 PM

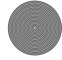
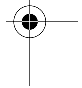
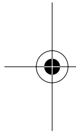
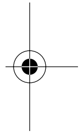



TABLE 3.1 Traditional and Customer Metrics

Traditional Marketing Metrics	Customer Metrics
Sales/Share, Product profitability	Customer profitability
	Customer acquisition (rate, cost)
	Customer margin (dollar, growth)
Satisfaction	Customer retention (rate, cost)

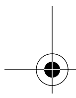
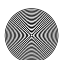
TRADITIONAL VS. CUSTOMER-BASED STRATEGY: A CASE STUDY

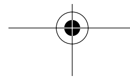
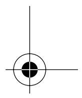
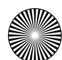
To highlight some of the differences in the strategic insights gleaned from using the traditional versus the new approach, we present a case study for the U.S. automobile industry. The automobile industry is one of the most competitive in the United States, with very heavy marketing expenditure. In 2002, the automobile industry was the world leader in advertising expenditure, 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.[6]

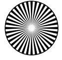



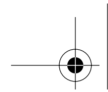
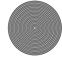
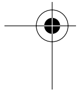
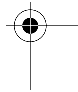
A recent study examined the U.S. luxury passenger car market to determine how marketing efforts influence sales (the traditional metric) versus customer profitability (the customer metric).[7] The study examined nine brands (Acura, Audi, BMW, Cadillac, Infiniti, Lexus, Lincoln, Mercedes-Benz, and Volvo) 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 startling conclusions. It found that all brands' discounting efforts either increased or maintained sales volume. Therefore, discounting may be considered an effective marketing tool by the traditional metric of sales. However, on average, across these nine

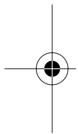
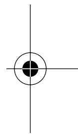






Chapter 3.fm Page 52 Tuesday, December 14, 2004 3:14 PM





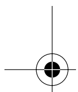
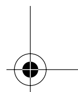
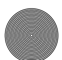
brands, discounting rarely increased a brand's customer equity (i.e., profitability of current and future customers) in the long run. The results were even more dramatic in some cases. For example, discounting had a positive effect on Lincoln's short-term sales, but the brand's discounting activities hurt its customer 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.[8]

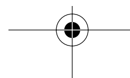
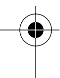
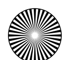
Results for advertising were also different when viewed from the traditional versus the new lens. For example, while the advertising for BMW had a positive short-term effect on its sales, it did not have any significant impact on its customer equity. Advertising for Acura increased its sales in the long run but not its customer equity. Only the advertising for Mercedes-Benz had a positive influence on its customer equity. If $16 billion of advertising 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.

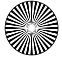



This study also emphasized the differential impact of marketing instruments on customer acquisition and retention rates. For example, when high-quality brands offer discounts, it affects their customer acquisition rate more than their retention rates. Evidently, if customers are satisfied with a high-quality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

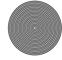
This study illustrates the value of understanding how marketing dollars affect customer profitability and why this focus may lead to very different conclusions than those obtained from traditional approaches.



Chapter 3.fm Page 53 Tuesday, December 14, 2004 3:14 PM



DRIVERS OF CUSTOMER PROFITABILITY

As Figure 3.4 shows, customer profitability is influenced by three factors—customer acquisition, customer margin, and customer retention. These three factors are the critical drivers of a firm's growth and overall profitability. We now discuss these three key drivers in detail.

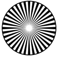
Customer Acquisition

Growth is critical for all firms. Growing revenues, market share, and customers are typically considered infallible yardsticks of success. In recent years, many companies, especially the dot-coms, went on a binge to acquire customers in the belief that customer acquisition and rapid growth are critical to success. This belief was so strong that several companies had a mandate to acquire customers regardless of the acquisition cost.[9]

As Table 3.2 shows, acquisition costs can be substantial. It makes economic sense to spend, say, $500 to acquire a customer only if the value of a customer to the company over his/her entire life with a company will be more than $500. While many companies adhered to this simple and intuitive principle, a surprisingly large number did not.

Gerald Stevens. Flower company Gerald Stevens was founded in 1998. In order to build a powerful presence on the Net, it made deals with CNN.com, Lycos, and Yahoo!, in addition to starting its own Web site. In 1999, AOL offered Stevens a prime position on its Web site that would provide it access to several millions of AOL customers. In return, AOL wanted $75 for each of its customers. While the prospect of rapidly increasing its customer base was appealing to Stevens, it declined AOL's offer. Stevens reportedly estimated that, on average, Internet customers would make three purchases over two years, with a lifetime value of $60—less than the $75 acquisition cost through AOL.

In contrast, Stevens estimated that the average brick-and-mortar customer buys flowers four times per year. The company esti-



Chapter 3.fm Page 54 Tuesday, December 14, 2004 3:14 PM

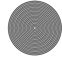
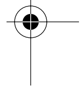
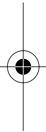
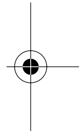
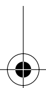
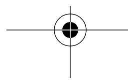
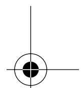
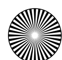
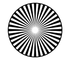



TABLE 3.2 Reported Customer Acquisition Costs

Industry	Company	Acquisition Cost per Customer	Time Period	Source
Telecom	Sprint	$315	Q4, 2001	Company report
	Nextel	$430	Q2, 2001	*LA Times*, 07/25/01
	Voicestream	$335	Q1, 2001	*Seattle Times*, 05/08/01
	Alltel	$305	2001	*RCR Wireless News*, 01/28/02
Retail	Index of 74 online-only retailers and brick-and-mortar retailers that also sell over the Web	$14	Q2, 2001	Shop.org and Boston Consulting Group, 09/10/01
	Barnesand-noble.com	$9.8	Q2, 2002	Company announcement, 04/25/02
	Direct-to-consumer catalogs	$15		
	Bluefly.com	$9.4		
Magazines	Most consumer magazines	$48		*Business Week Online*, 08/30/01
Satellite/Cable	XM Satellite Radio	$123	Q1, 2002	*Reuters*, 04/23/02
	Cable companies	$150		*Miami Herald*, 11/19/01
	Direct satellite broadcasting companies	$400		*Miami Herald*, 11/19/01
	DirectTV	$550		Company reports, 2001



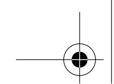
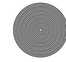
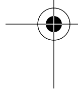
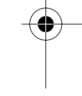
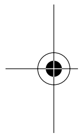
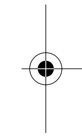
Chapter 3.fm Page 55 Tuesday, December 14, 2004 3:14 PM





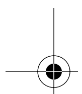
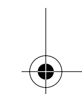
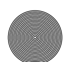
TABLE 3.2 Reported Customer Acquisition Costs (Continued)

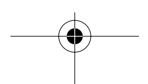
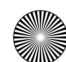
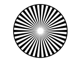
Industry	Company	Acquisition Cost per Customer	Time Period	Source
Financial	TD Waterhouse	$175		*Comtex*, 02/14/01
	Ameritrade	$202	Q2, 2002	
	NetBank	$108	Q4, 2000	Sales and marketing management, 05/01
	Etrade	$475	Q2, 2002	*American Banker*, 07/19/02
	Credit Card	$75–150 (Platinum)		Consultant reports
	Credit Card	$25–35 (Sub Prime)		Consultant reports
	Mortgage	$300–700		Consultant reports
	Lending Tree	$28	2001	Company reports
Travel	Priceline.com	$8.66	Q4, 2001	Goldman Sachs Equity Research

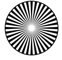



mated the acquisition cost of that type of customer to be about $50, with a lifetime value in the hundreds. In other words, by estimating lifetime value, Stevens made the right choice. It favored a brick strategy over a click deal at the height of the dot-com mania, a prescient decision indeed.[10]

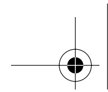
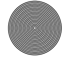
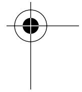
Ameritrade. With almost 3 million customers, Ameritrade is a leading online brokerage company. In its attempt to acquire new customers, Ameritrade has offered many incentives to potential customers, including free trades. Advertising and other marketing expenses added significantly to the total acquisition cost. In



Chapter 3.fm Page 56 Tuesday, December 14, 2004 3:14 PM

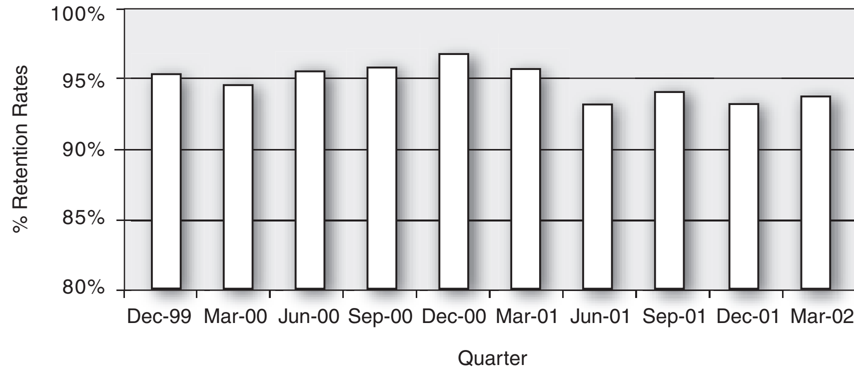
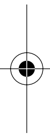
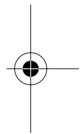


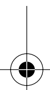
Figure 3.5 The retention rate for Ameritrade. Source: Salomon Smith Barney.

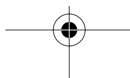
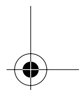
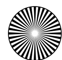



March 2002, its acquisition cost per customer was almost $203. However, its average annual gross margin per customer was $201.56.[11] In other words, Ameritrade recovered almost all its customer acquisition cost within a year.

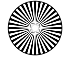
Figure 3.5 shows that the customer retention rate for Ameritrade remained constant at around 95%. Using the lifetime value formula from Chapter 2 and a discount rate of 12%, we estimate Ameritrade's margin multiple as 5.59. Therefore, the lifetime value of an Ameritrade customer is $1,126, significantly above its acquisition cost of $203. Apparently Ameritrade has been making wise choices in its customer acquisition strategy, as confirmed by its stock market performance, which stands in stark contrast to many other online companies.

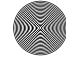
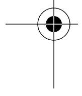
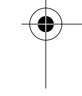
Figure 3.6 provides estimates of customer lifetime value for several firms. We again used companies' financial reports and related data to estimate customer acquisition costs, annual margins, and retention rates. (We recognize that these are rough estimates since estimating acquisition costs, margin, and retention rates involves complex and sometime subjective decisions—see Chapter 2.) This figure suggests that although there are significant variations in acquisition costs and lifetime value across compa-



Chapter 3.fm Page 57 Tuesday, December 14, 2004 3:14 PM



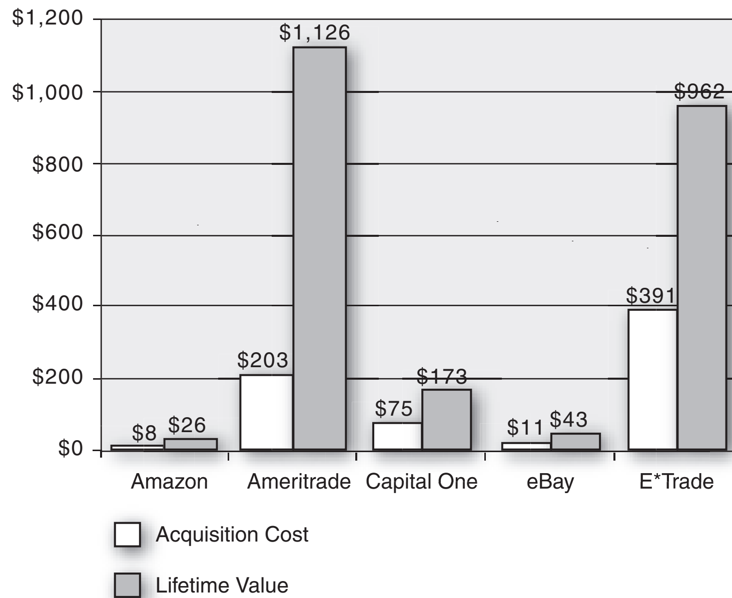
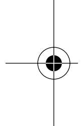
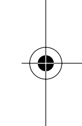
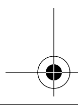
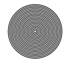


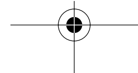
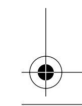
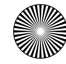
Figure 3.6 Acquisition costs and customer lifetime value (as of March 2002). Source: Company reports and our analysis.

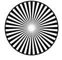



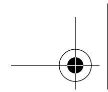
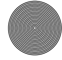
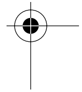
nies, all companies in the figure made sensible economic decisions for customer acquisition. Unfortunately, this is not always the case as illustrated by the now defunct CDNow.

CDNow. Jason and Matthew Olim launched CDNow in 1994 in the basement of their parents' house in Ambler, Pennsylvania. Within a year, revenues reached $2 million. Like most Web-based startup companies, CDNow focused heavily on acquiring new customers. Its customer acquisition strategy used traditional methods such as television, radio, and print advertising, as well as some innovative programs. For example, in 1997 CDNow introduced Cosmic Credit, the Internet's first affiliate program, where thousands of customers effectively became part of a commissioned sales force for the company. The same year, CDNow agreed to pay $4.5 million to a large portal to become its exclusive online music retailer.



Chapter 3.fm Page 58 Tuesday, December 14, 2004 3:14 PM




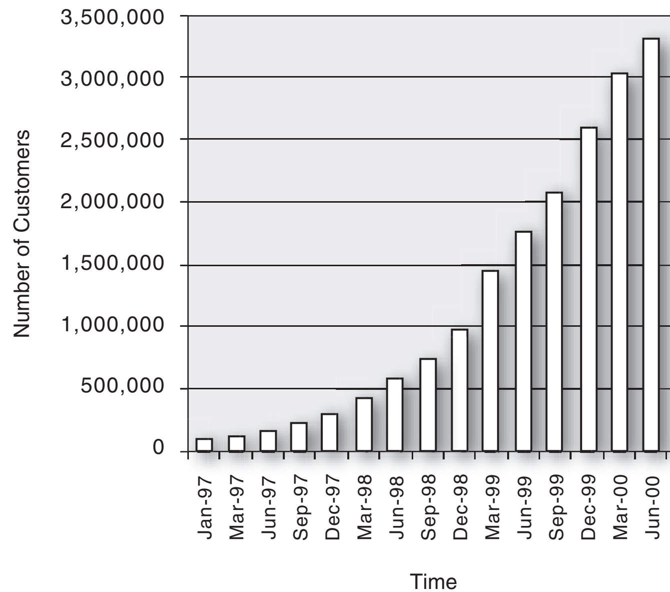
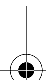
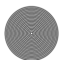
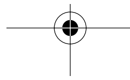
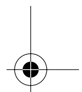
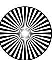


Figure 3.7 The growth of the number of customers at CDNow. Source: Company annual reports and 10Q statements.

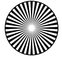
In 1998, CDNow merged with rival N2K, nearly doubling its customer base from 980,000 customers to more than 1.7 million. Overall, CDNow's customer base grew to more than 3 million customers within five years (Figure 3.7). The company was so successful in generating traffic on its Web site that in its advertisements, as well as its reports to financial analysts, it regularly highlighted the number of new customers, page views, and unique visitors.

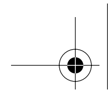
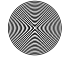
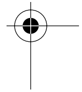
Clearly CDNow needed to emphasize customer acquisition—a startup has to acquire new customers to become a viable business. Heavy emphasis on customer acquisition was also driven by Wall Street. Several research studies show that without the benefit of traditional financial measures such as P/E ratios (which were meaningless for many Internet companies, which had negative earnings), during 1998–1999 financial markets started



Chapter 3.fm Page 59 Tuesday, December 14, 2004 3:14 PM



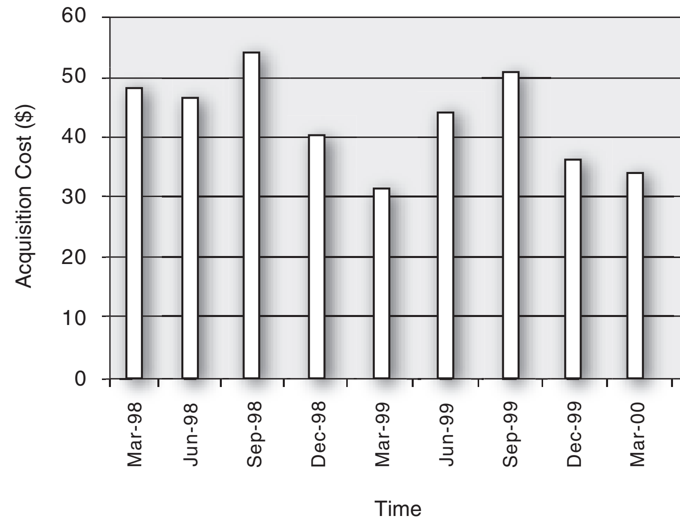
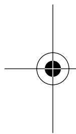
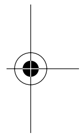


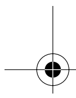
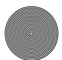
Figure 3.8 The customer acquisition cost at CDNow. Source: Company annual reports and 10Q statements.

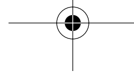
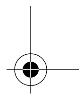
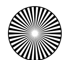



rewarding companies with strong nonfinancial measures such as number of customers.

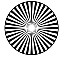
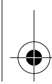
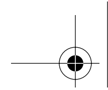
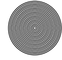
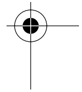
Was the emphasis on customer acquisition by both CDNow and Wall Street misplaced? For CDNow's customer acquisition strategies to make economic sense, the lifetime value of its customers had to be significantly more than their acquisition cost. Based on company reports, we estimate that during 1998–2000, the average customer acquisition cost for CDNow ranged from $30 to $55 (Figure 3.8).

During the same time, annual gross margin per customer was consistently in the range of $10–20 (Figure 3.9). CDNow reported an average customer retention rate of 51% to 68%. Increased competition and the nature of the Internet (where shopping at a competitor is a mouse click away) made it very hard to maintain high customer retention. Some research studies show that while an increasing number of new visitors were coming to Web sites over

Chapter 3.fm Page 60 Tuesday, December 14, 2004 3:14 PM

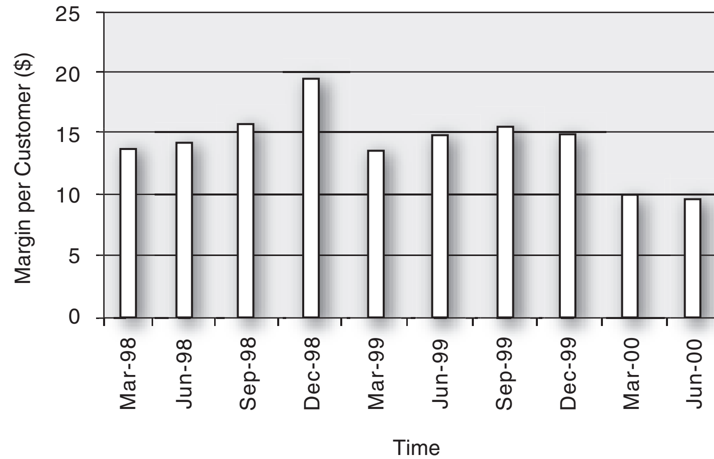
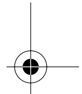
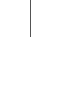
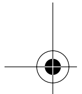
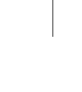


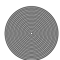
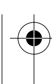
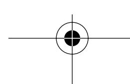
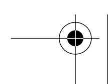
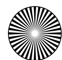
Figure 3.9 The margin per customer at CDNow. Source: Company annual reports and 10Q statements.

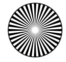
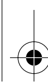
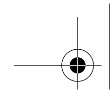
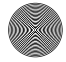
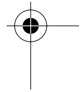
time, there was a significant slowdown in the visit behavior of past users.

Our estimates of acquisition cost ($30–55), annual margin ($10–20), and retention rate (51–68%) enable us to evaluate the economics of CDNow's customer acquisition programs. Even assuming a favorable discount rate of 12% (for a risky young firm, the rate is likely to be higher) and a higher than reported retention rate of 70%, the lifetime value of a CDNow customer, based on Table 2.1, is 1.67 times its annual margin, or $16.70–33.40. Only for the most favorable margin and retention rate and the lowest estimate of acquisition costs are the economics profitable, and then just barely. In other words, unless some unknown growth strategy was involved, the business model of CDNow was fatally flawed. Partly due to its expensive customer acquisition strategy, CDNow reported a loss of over $100 million at the end of 1999. In July 2000, CDNow was bought by Bertelsmann.

The European Cable Industry. Cable companies in Europe served over 60 million customers and generated more than €10 billion in

Chapter 3.fm Page 61 Tuesday, December 14, 2004 3:14 PM

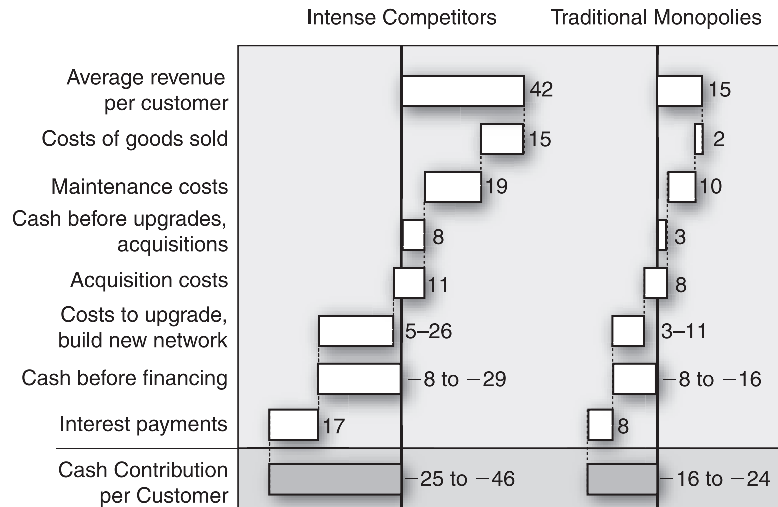
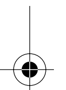
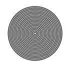
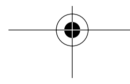
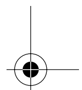
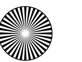


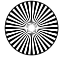
Figure 3.10 The cash contribution per customer for two cable segments. Source: Wendy M. Becker, Luis Enriquez, and Lila J. Synder, "Reprogramming European Cable," *The McKinsey Quarterly,* no.4 (2002).

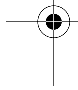
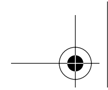
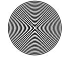
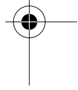
annual revenues by 2002. These companies borrowed heavily to spend enormous sums of money building networks and acquiring customers in the hope that customers would be quick to adopt digital services. However, analysis for a typical customer shows that the cable operation in Europe had so far been a losing proposition (Figure 3.10).

The negative value of a typical customer led many of these debt-laden operators to bankruptcy. In May 2002, NTL, a U.S. company and the fourth-largest operator in Europe, declared bankruptcy. Europe's third-largest operator, United Pan-Europe Communications, defaulted on its bond payments and was



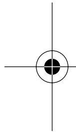
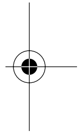


Chapter 3.fm Page 62 Tuesday, December 14, 2004 3:14 PM

delisted from one of the stock exchanges. A German cable operator, Ish, also filed for bankruptcy.

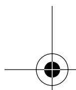
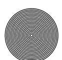
A careful customer value analysis would have shown these operators that in order to be profitable, they would need average monthly revenues of €30 to €100 per customer compared to the €9 to €15 they were generating, a large discrepancy. Many of these companies apparently did not recognize that the cost of acquiring and serving (retaining) these digital customers was also too high. For example, setting up a customer with digital services cost almost twice as much as an analog installation. Similarly, call-center costs for these customers are significantly higher due to complex queries. It is possible that over time some of these costs may decrease and revenue per customer increase as customers become more comfortable with the new technology. However, some experts believe that cable companies need to change their strategy significantly rather than simply hope that consumers spend more.[12]

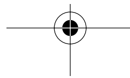
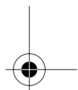
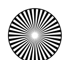
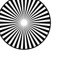



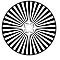
Acquiring Customers in Emerging Markets. India has a population of over 1 billion with a per capita GDP of less than $2,000. For many years, multinational companies avoided significant investment in India because of its low per capita income. However, with a population of over a billion people, if even a small fraction of the population is wealthy, the raw numbers make India a very large and attractive market. Some companies are looking at the even larger market of low-income consumers.

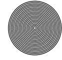
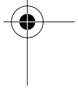
One leading financial institution in India is experimenting with a mobile-banking product for low-income people. Accredited bank agents will own a mobile handset that consumers can use with a mobile card they obtain with their bank application. This will allow consumers to perform basic bank transactions. Does it make sense to consider mobile-banking for *low-income* consumers in a developing country or to try to acquire these low-income customers?

On the surface, this strategy sounds crazy. However, the customer economics show that the idea has a large profit potential. Figure 3.11 indicates that the bank expects a value of $6.20 per



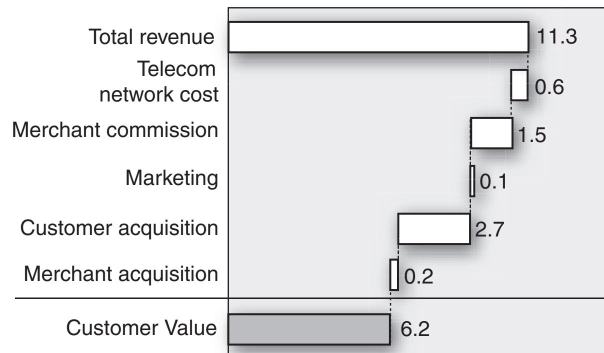
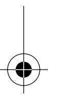


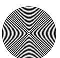
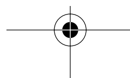
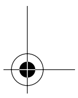
Figure 3.11 The customer value for mobile banking in an emerging market. Source: Rajat Dhawan, Chris Dorian, Rajat Gupta, and Sasi K. Sunkara, "Connecting the Unconnected," *The McKinsey Quarterly,* no. 4 (2001).

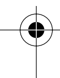
customer from this operation. With millions of low-income customers in India, this could translate into significant profit. Clearly, the bank needed to do careful experimentation to ensure that its assumptions of revenues and costs per customer would hold in the field. And that is precisely what it did.[13]

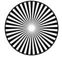
Choosing the Right Customer. In his famous book, *Animal Farm*, George Orwell said, "All animals are equal but some are more equal than others." The same is true for customers. All customers are important but some are more important than others, because of their greater profitability. A customer acquisition strategy that ignores differences in customers' lifetime value is naïve and inferior.

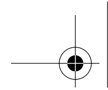
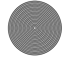
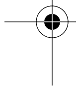
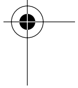
Who are the best customers for a casino? Conventional wisdom in the industry suggested that they are gold-cuff-linked, limousine-riding high rollers. After all, they are wealthy and spend a significant amount of money in their typical visit to a casino. Not



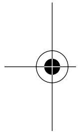
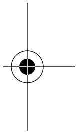








Chapter 3.fm Page 64 Tuesday, December 14, 2004 3:14 PM





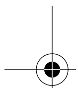
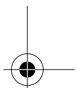
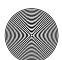
surprisingly, casinos for a long time courted high rollers by providing them red carpet treatment and lavish incentives. However, Harrah's Entertainment, Inc., one of the most successful casinos in recent years, discovered that customers with high lifetime value included middle-aged and senior adults with discretionary income who enjoyed playing slot machines. A senior who lives within 50 miles of a Harrah's casino and loves playing slot machines is likely to come to the casino more frequently than a busy wealthy individual who flies in his private jet across the country. This realization changed the focus of Harrah's marketing and has paid rich dividends for the company.[14] The moral of this story: Customers' value not only depends on how much they spend on a single occasion but also their purchase frequency and longevity. Banks and credit card companies have realized this for many years, offering credit cards to students who have limited current but significant future value.

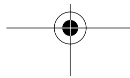
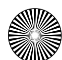



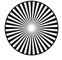
Should you acquire customers in the order of their expected lifetime value, assuming equal acquisition costs? It makes sense to acquire customer A, with a lifetime value of $1,000, before spending resources on customer B, whose potential value is only $800. However, there is considerable volatility associated with customer cash flow. For example, customer B may have a more stable and predictable purchase pattern, such that there is very little variation in his cash flow. In contrast, customer A may have large fluctuations in his purchase pattern. This raises the same issues as two stocks where one stock has a higher return but is also accompanied by higher risk. Financial theory suggests that we should diversify and have a mix of high-risk, high-return and low-risk, low-return assets. Customers, like stocks, are risky assets whose future cash flow is not guaranteed. Based on that logic, it makes sense to have a portfolio of customers that takes into consideration not only their expected lifetime value but also the risk or uncertainty associated with it.[15]

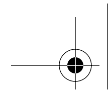
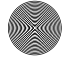
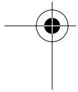
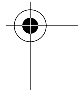
Customer Margin

While customer acquisition focuses on growing the number of customers, increasing customer margin focuses on growing the

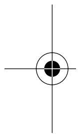
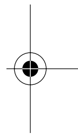





Chapter 3.fm Page 65 Tuesday, December 14, 2004 3:14 PM





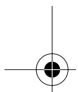
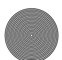
profit from each existing customer. In the retailing context, this means increasing same-store sales rather than opening new stores. Growth can be achieved through a variety of methods such as up-selling (e.g., migrating customers to a higher price/profit product) and cross-selling related products (e.g., providing a credit card to a bank customer). We discuss three specific strategies to create growth from current customers.

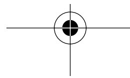
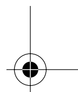
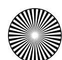
Share of Wallet. When you open your mailbox, you are likely to find a letter from one of the many credit card companies inviting you to become its customer. If you sign up, a smart company may subsequently track your credit card expenditure pattern, probably on a monthly basis, and use it to make special offers to you. However, this data is missing one important component: Most customers carry multiple cards in their wallet. Two customers who spend the same amount of money on a credit card may have vastly different potential for a company depending on how much they spend on other cards. In other words, it is important to know not just the amount of money customers spend with your company but also the "share of wallet" your company has.

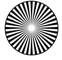



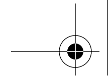
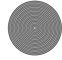
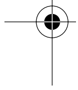
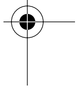
One company that understands the importance of wallet share is Harrah's Entertainment, Inc. A few years ago, Harrah's was getting 36 cents of every dollar that its customers spent in casinos. Today, that share is over 42 cents. Since 1998, each percentage point increase in Harrah's share of its customers' overall casino spending has resulted in an additional $125 million in shareholder value. Harrah's achieved this by better understanding their customers through a variety of programs. One such initiative involved merging the company's database of more than 24 million customers across 25 properties and tracking their behavior through a Total Gold loyalty program. In 2001, existing customers increased their year-over-year play by more than $160 million. [16]

Disney is another company that successfully increased its customers' share of wallet. During the mid-1980s, Disney found that a typical family of four people (two adults and two children) who visited its theme park in Orlando, Florida, spent several thousand

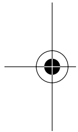
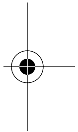






Chapter 3.fm Page 66 Tuesday, December 14, 2004 3:14 PM





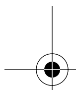
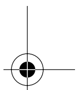
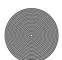
dollars for their trip. Trip cost included the cost of airfare, the hotel stay, restaurants, and the entrance fee to Disney's theme park. To many senior managers at Disney, it was both shocking and enlightening to realize that while the Disney brand attracted many of these families to Orlando, it captured only a relatively small fraction of the total money spent by a family. In its effort to increase its share of the consumers' wallet, Disney literally followed the money. As a result, they decided to build hotels on Disney property, offer a choice of multiple Disney restaurants, and even have a Disney cruise ship. This investment has led to a substantial increase in Disney's share of wallet of a typical Disney visitor.[17]

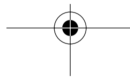
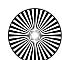
Yet in spite of its importance, it is disconcerting how many companies don't even know their customers' share of wallet, let alone design programs to improve it. Ironically, as companies build large customer databases, they focus more and more on what their customers spend with them and not what they spend with competitors. This focus is essentially company-centric. Unfortunately, that is not necessarily desirable.

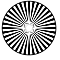



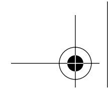
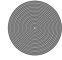
Careful examination of share of wallet requires strategic thinking about how to define your market (or wallet) and your competition. For example, should Visa define its competitors as Master Card and American Express? Or should it broaden its competitive definition to include cash and checks? While defining competition narrowly leads to larger share values and a sense of pride, it also can lead to missing key trends, new competitors, and emerging opportunities. Defining share of "what" is an art and requires applying the "Goldilocks" principle: not too broad (i.e., total spending), not too narrow (i.e., just your revenues), but "just right."

Cross-selling. It often takes considerable effort to acquire a customer. Telecommunication firms spend anywhere from \$300 to \$400 to acquire a customer. Once you establish a relationship with a customer, it makes sense to try to maximize the value of the relationship by selling customers multiple products. In many cases, there is a natural sequence or progression of the products.



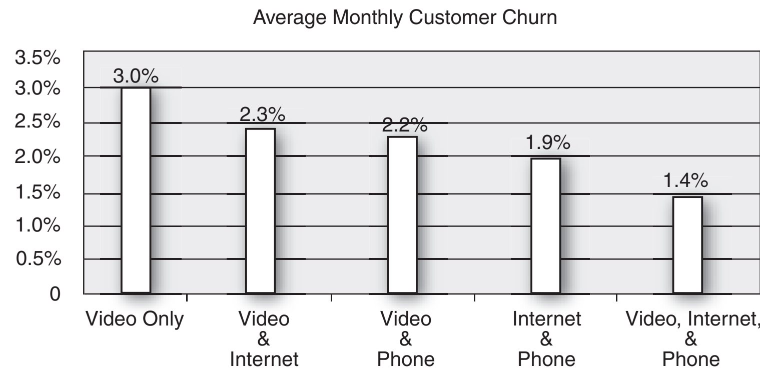
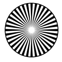
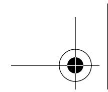
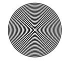
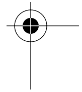


Figure 3.12 The impact of cross-selling on churn at Cox Communications. Source: www.cox.com.

For example, bank customers typically start with a checking and savings account and then gradually move to mortgages and investment advice. Detailed customer databases and sophisticated predictive modeling can help companies pinpoint the next product to target to a specific customer. In addition to the obvious benefit of a higher margin per customer from selling multiple products, cross-selling also has the potential to improve customer satisfaction and retention. Hence, cross-selling can have a two-part impact on the lifetime value of a customer.

Cox Communications, Inc., the fifth largest cable television company in the U.S. in 2003, served over 6 million customers nationwide. A full-service provider of advanced communications products, Cox offered an array of residential services, including cable, local and long-distance telephone services, Internet access, advanced digital video programming services, and commercial voice and data services. By examining its customer data, Cox found that turnover, or churn, was lower for customers who subscribed to multiple products (Figure 3.12).[18] Consequently, Cox increased its emphasis on getting subscribers to buy two or more products from the company (Figure 3.13)[19]—in a sense locking them in, since it is harder to switch multiple services.



Chapter 3.fm Page 68 Tuesday, December 14, 2004 3:14 PM




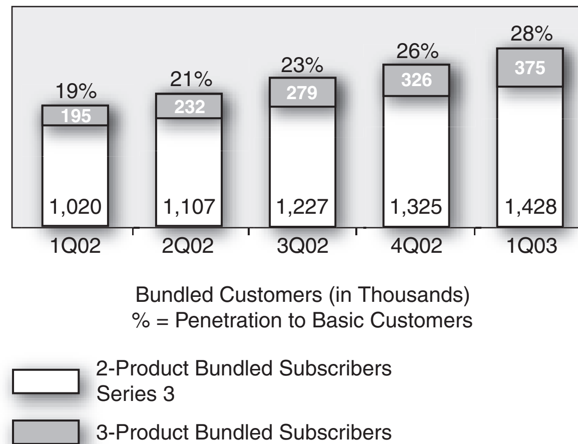
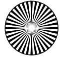
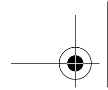
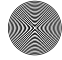
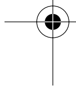
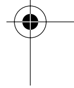


Figure 3.13 The results of Cox's emphasis on cross-selling. Source: www.cox.com.

Redefining Your Business and Product Line. For years, managers have been advised to ask themselves, "What business are you in?" This simple but profound question can often lead to remarkable changes in a company's strategy and product line. Cosmetic companies follow their customers over their life stages and create products that cover the spectrum from acne to anti-aging cream. Banks do the same by offering products that meet customers' changing needs over their life stages. Having invested in a customer, it seems logical to prolong this relationship by providing products and services that meet the changing needs of that customer over time.

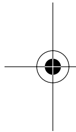
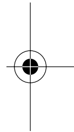
Redefining your business and product line is not limited to changing customer preference over time or life stages. U-Haul provides one such example. Several years ago, U-Haul noted that the rental truck market was becoming very competitive with thin margins. It also observed that consumers who rent trucks also need packing supplies. By offering such supplies to its rental truck customers, it not only added value to its customers, but also increased its sale of a high-margin product. A second exam-



Chapter 3.fm Page 69 Tuesday, December 14, 2004 3:14 PM





ple of extending the business is offered by automobile manufacturers, who for many years have offered financing to their customers. Given the intense global competition in this industry, which has eroded margins on new car sales, financing has become, along with service, one of the most profitable parts of the U.S. auto industry.

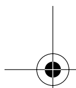
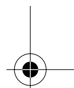
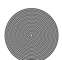
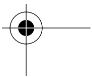
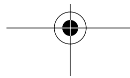
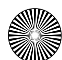
7-Eleven provides a recent example of entering a new business to satisfy its customers' needs. In June 2000, 7-Eleven, a convenience store chain (now owned by a Japanese company), applied for permission to operate a banking business from its 3,500 convenience stores in Japan. What is a convenience store doing in the banking industry? Viewed from the product or operations perspective, these two businesses are incongruent. However, 7-Eleven made this decision by taking its customers' perspective. Since most of its customers conduct small transactions with cash, adding ATM machines provided a value-added service for its customers. Needless to say, this service also enhances the profitability of each customer to 7-Eleven.

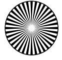



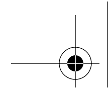
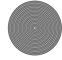
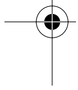
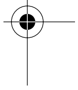
Easier Said Than Done. While cross-selling, increasing share of wallet, and enhancing product lines are attractive from a firm's perspective; it is not always useful for a customer. A few years ago, Citibank and Travelers merged, with the idea that they would cross-sell insurance products to bank customers and vice versa. Many insurance companies, such as State Farm, followed a similar path by extending into banking. However, most of these cross-selling attempts have not been very successful.

For several years, AOL has attempted to cross-sell multiple services to its subscribers. Like most firms, AOL believes that customers prefer one-stop shopping. However, it is not clear if for consumers the convenience of one-stop shopping outweighs the benefits of quality, variety, and value of competitive offers.

Amazon started by selling books online. To get more revenue from its customers, it extended its product offerings to music and DVDs. Now it offers a vast range of products, from apparel to toys and hardware. While some may consider the ability of a consumer to buy a lawnmower and a book about mowing lawns from

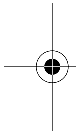
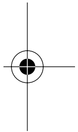









Chapter 3.fm Page 70 Tuesday, December 14, 2004 3:14 PM





the same Web site a significant synergy, over time Amazon's margin per customer improved only slightly, from about $12 in early 1997 to about $15 in early 2002.[20]

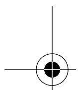
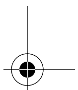
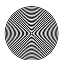
Why does it make sense for 7-Eleven to get into banking, while insurance companies' attempts seem to draw skepticism? Two factors conspire against successfully expanding business offerings to the same customer. The first factor is customer resistance. When the products or services seem to have little synergy in production (e.g., making cars and greeting cards share few skills) or image match (e.g., Timex watches and engagement rings), customers are skeptical of such joint offerings (a.k.a. brand extensions). The second factor is company competence, or lack thereof. Even seemingly related products may require different skills to produce and deliver (e.g., fast food restaurants and processed food sold through supermarkets). Moreover, a varied product line can divide a company's attention so that one or several products may suffer accordingly. Basic moral: Growth is easy to envision but hard to pull off operationally, especially if you ignore customers' inherent skepticism or companies' limited competence.

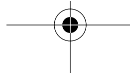
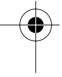
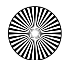



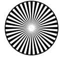
Customer Retention

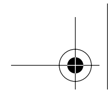
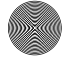
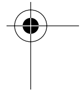
In their zeal to grow, many companies focus almost exclusively on entering new markets, introducing new products, and acquiring new customers. However, these companies often have a "leaky bucket"—as they add new customers, old ones defect from the firm. Some studies report the average retention rate for U.S. companies is about 80%.[21] Put differently, on average, 20% of a company's customers defect every year. This means that, roughly speaking, the average company loses the equivalent of its entire customer base in about five years.

Studies also show that the cost of acquisition is generally much higher than the cost of retaining existing customers. Therefore, it seems obvious that a firm should focus on retaining its existing customers. Unfortunately, many companies don't even know their customer retention or defection rates. Part of this problem



Chapter 3.fm Page 71 Tuesday, December 14, 2004 3:14 PM




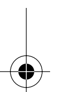
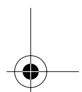
lies in the lack of appreciation for the importance of customer retention. We now show that customer retention has a dramatic impact on both long-run market share and profits.

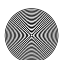
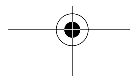
Impact of Retention on Share. In spite of its many limitations as a goal, market share continues to be a dominant metric that managers monitor and manage constantly. Customer retention can have a dramatic impact on the long-run share of a company. Consider customers' retention–defection or switching pattern under the three hypothetical scenarios given in Table 3.3. These scenarios represent customers' switching behavior over time between two competitors in an industry (e.g., Amazon and Barnes and Noble, or GM and Ford).[22] In scenario 1, both company A and B have 80% customer retention. For example, 80% of GM customers trade their old GM car or truck to buy another GM vehicle, while 20% switch or defect to Ford. In scenario 2, company A (e.g., GM) improves its customer retention through better products and improved customer service from 80% to 90%. The retention rate for company B (Ford) remains the same. In scenario 3, company A does an even better job of satisfying its customers, improving its retention to 95%, while company B continues to have 80% retention. If both companies start with equal market share, what will be their long-run market share under the three different scenarios?

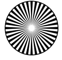
TABLE 3.3 Retention–Defection Tables

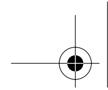
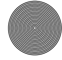
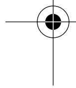
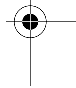
		Scenario 1			Scenario 2			Scenario 2	
		Purchase at Time T+1							
		A	B		A	B		A	B
Purchase at Time T	A	80%	20%	A	90%	10%	A	95%	5%
	B	20%	80%	B	20%	80%	B	20%	80%

Scenario 1 is relatively obvious. Since both companies have the same retention and defection rate, they both end up with a long-run share of 50%. Notice this happens even if their initial shares

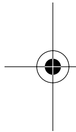
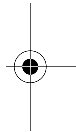





Chapter 3.fm Page 72 Tuesday, December 14, 2004 3:14 PM





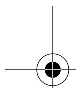
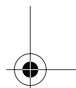
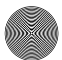
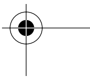
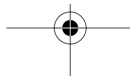
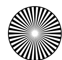
are quite different (e.g., 90% and 10%), albeit not quite as quickly. The result in scenarios 2 and 3 is less obvious. In both of these, company A should have a share greater than 50% due to its stronger retention rate. However, it cannot have a 100% share because each period it also loses some customers to company B. The exact formula, for long-run share is given in Appendix B. Applying that formula in the present case, we find that the long-run share of company A is 66.67% in scenario 2 and 80% in scenario 3.

This example illustrates three important points. First, it shows how changes in customer retention affect market share. In our example, improving customer retention from 80% to 90% improved the long-run share of company A from 50% to 66.67%. It is generally fairly easy for a company to assess how much an extra point of market share is worth to them. For example, some studies estimate the new vehicle sales in the United States in 2003 to exceed $400 billion.[23] Therefore, one share point is worth $4 billion in revenues. This type of analysis helps a manager determine the maximum amount of money worth spending to improve customer retention by a given amount.

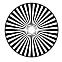



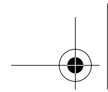
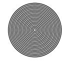
The general wisdom, which in this case is correct, is that by increasing customer satisfaction, you will increase retention. After making an investment in a customer satisfaction program, a manager should not only monitor satisfaction scores but also link those scores to the purchase behavior to determine how the program impacted customer retention. This analysis then helps determine whether or not the investment in a customer satisfaction program provided an appropriate return.

The second key point illustrated by our example is that share increases at a faster rate as retention increases. For example, improving retention by 10 percentage points, from 80% to 90%, helped company A increase its market share from 50% to 66.67%. In contrast, improving its retention rate by only 5 percentage points, from 90% to 95%, increased its share by almost the same amount, from 66.67% to 80%. Figure 3.14 shows the relationship between retention and long-run market share for company A.

Chapter 3.fm Page 73 Tuesday, December 14, 2004 3:14 PM



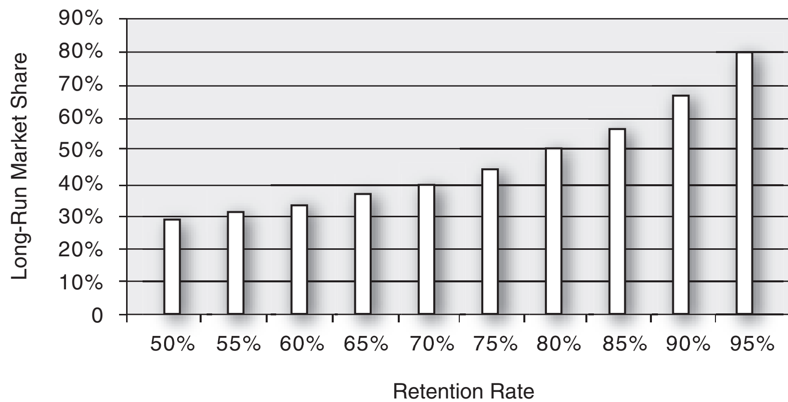
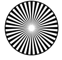


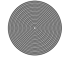
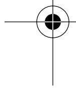
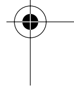
Figure 3.14 The impact of retention on long-run market share. (Assumes competitor's retention rate remains constant at 80%.)

Unfortunately, in general, the cost of retention also increases dramatically as the company reaches high retention levels. In other words, it is generally more expensive to increase retention rates from 90% to 95% than to improve them from 70% to 75%. Therefore, if we consider both the greater benefits and higher costs of improved retention, there is an optimal level of retention that a company should strive for. Notice this implies that, in contrast to the suggestion of some experts,[24] 100% retention, or zero defection, is not the optimal strategic goal. In fact, if a firm has 100% retention, or perfect customer satisfaction, it is very likely that it is either overinvesting in its customers and not charging them enough, or has a small base of customers who are either intensely loyal or have no choice but to remain loyal (e.g., when confronted by a monopolist).

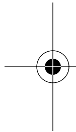
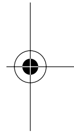
This point is even more evident when you recognize that not all customers have the same inherent attraction to the company. Some may receive tremendously high value from the firm, while others may find the benefits marginal. While the first group can be retained relatively easily, the second group is clearly at risk. To get marginal customers to be loyal is typically an expensive undertaking. While one can increase their retention rate by giv-



Chapter 3.fm Page 74 Tuesday, December 14, 2004 3:14 PM

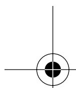
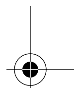
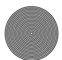




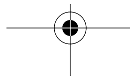
ing them special deals, the cost of these deals may outweigh the benefits of retaining marginal customers *and* be irritating to more loyal customers (unless they get the deal also, which simply reduces their profitability without affecting their retention). Put differently, total customer loyalty may be a good slogan for an ad and a good motivational goal for employees, but it is a lousy business objective. If you have 100% loyalty, you are either leaving money on the table with your customers or focusing on an overly narrow segment and ignoring potential customers.

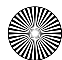



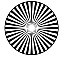
The third main message from our example can be understood by noting that so far we have shown the long-run market share of two companies that start with equal market shares. What happens if the starting shares are not equal? For example, if company A has 90% share to begin with, what will be its long run share in scenario 2 or 3? A careful examination of Appendix B shows that regardless of the starting share of company A, its long run share will still be 66.67% in scenario 2 and 80% in scenario 3. This makes a dramatic point about the relevance of retention versus a company's current share. Even if company A has a current share of 90% and 90% retention, while its competitor has only 10% share and a relatively lower retention rate of 80%, in the long run company A will lose share and stabilize at 66.67%! Put differently, company A's dominant share position and superior retention rate are not high enough to prevent share erosion over time. This is perhaps painfully obvious to many firms, such as General Motors, who lost significant market share over multiple decades in spite of an initially dominant market share and high customer loyalty.

If this is *fait accompli*, what can a manager do? Given a retention–defection matrix, it is relatively easy to see how the market share of a firm is likely to evolve over time. If a manager does not like the long-run outcome, then programs must be designed to change the acquisition and/or retention rates. How much retention affects the long-run share also provides a guideline to the manager on how much to invest in retention-enhancing programs.

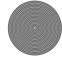
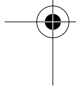
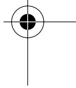








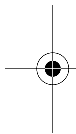
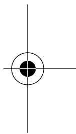


Chapter 3.fm Page 75 Tuesday, December 14, 2004 3:14 PM

Impact of Retention on Profits—the U.S. Wireless Industry. Although market share is the metric most commonly monitored by marketing managers, retention is at least as critical for long-run profits. This is especially evident in the telecommunication industry.

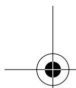
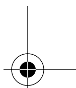
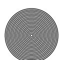
By December 2002, the U.S. wireless industry had more than 140 million subscribers, with over $76.5 billion in annual revenue. New customer annual growth was still 9.7%. Even in the face of falling prices, revenue per customer had remained fairly constant over the last four to five years, as customers increased their usage of cellular phones. In 2002 alone, U.S. consumers used more than 600 billion wireless minutes.[25] Yet in spite of impressive growth in the number of subscribers and usage, the wireless industry has been under severe financial pressure. While part of the problem lies in the heavy capital expenditure needed to upgrade systems, another major problem is high customer churn—i.e., defection.

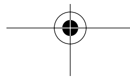
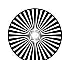



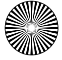
Several studies report that the average customer churn in the U.S. wireless industry is 2.5% per month, or approximately 30% per year.[26] This means that 42 million customers, nearly one-third of the total, defect from a wireless carrier each year. With an average customer acquisition cost of $300–400 (see Table 3.2), this translates into $12.6 billion to $16.8 billion in cost, or 16–22% of revenue, just to keep the number of customers constant. Since the average operating margin was 20–30%, this acquisition (or in many cases re-acquisition) cost is almost as large as the entire operating profit of the industry.

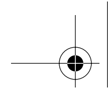
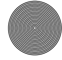
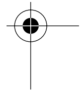
Some companies actively work to reduce customer churn by providing better customer service, using data-based predictive modeling to anticipate which customers are at greatest risk of defection and appointing special representatives to handle potential defectors. Bell Canada has done this quite successfully and managed to keep its monthly churn at 1.5%, the best in North America. If the entire U.S. wireless industry could achieve this, it would add $1.5 billion to $2 billion in operating profit excluding the additional cost of improving retention.

Retention Elasticity. To understand the impact of customer retention on profits, it is helpful to assess the percentage change in profits



Chapter 3.fm Page 76 Tuesday, December 14, 2004 3:14 PM




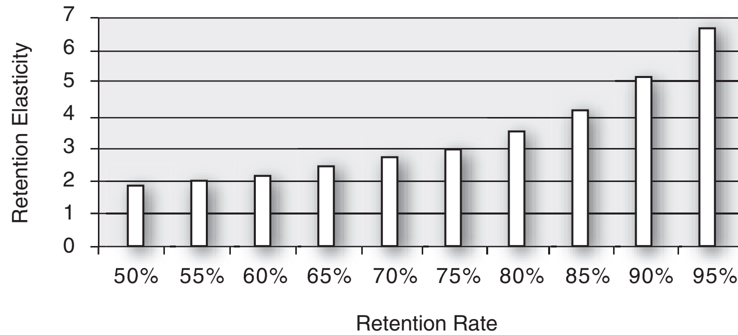


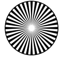
Figure 3.15 Retention elasticity at various levels of customer retention.

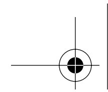
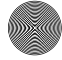
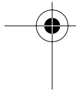
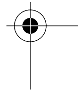
for a 1% change in customer retention (economists call this type of measure elasticity). Appendix B shows that retention elasticity turns out to be a very simple formula. Specifically,

Retention Elasticity = 1 + Margin Multiple

Chapter 2 showed how the margin multiple varies with a firm's discount rate (or cost of capital) and its customer retention rate. Using a 12% discount rate, Figure 3.15 shows retention elasticity at different levels of customer retention. This figure shows that if a firm has 80% customer retention, improving its retention by 1% will improve its profit (or customer lifetime value) by 1 + 2.5, or 3.5%. Similarly, improving the retention rate from 90% to 90.9% should improve its profit by 1 + 4.09, or 5.09%.[27]

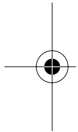
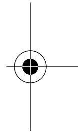
These profit improvements do not take into account the cost of improving retention. Even so, they provide a useful standard of comparison for evaluating retention programs. Put simply, for a typical company with 80% retention rate, if a retention program costs more than 3.5% of profits for a 1% improvement in retention, it is too expensive. It also shows that there are increasing returns to retention—each percent is worth more than the previous one. However, retention cost is likely to increase dramatically at higher levels of retention. Therefore, the message is that it is generally not optimal for a firm to have 100% retention.



Chapter 3.fm Page 77 Tuesday, December 14, 2004 3:14 PM





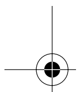
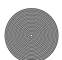
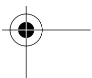
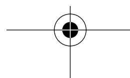
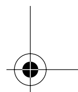
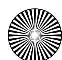
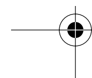
How does this compare with the benefit from increasing margins? Interestingly, improvement in customer margin (from cross-selling, increasing the share of wallet, etc.) generally has a much smaller impact on profitability than improving customer retention. As shown in Appendix B, while retention elasticity is (1 + margin multiple), margin elasticity is usually 1.[28] Since the margin multiple is always greater than zero, the retention elasticity is always greater than the margin elasticity. In other words, assuming comparable costs, a 1% improvement in retention is usually better for a company than a comparable improvement in margin per customer.

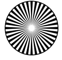
What about savings on acquisition costs? Reducing customer acquisition cost, a one-time effect, has less impact on profitability than improving either retention rate or margin, whose impacts occur over multiple periods. Therefore, while short-term financial results may favor cost-cutting (e.g., reducing acquisition cost), real financial value comes from intelligent allocation of resources for improving service to profitable customers.

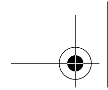
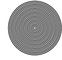
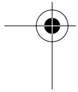
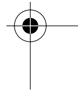



SUMMARY

This chapter has demonstrated that effective customer-based strategies should take into consideration the two sides of customer value—the value a firm provides to a customer and the value of a customer to the firm. This view considers the investment in customers as well as its return. Therefore, it integrates the marketing world, where the customer is king, with the finance world, where cash is king. We also showed that traditional marketing's focus on customer satisfaction or market share may be misleading at times. We discussed the three key drivers of customer profitability (acquisition, retention, and margin) and how they affect marketing decision-making. We outlined various strategies for customer acquisition, customer retention, and margin growth, and demonstrated how their financial consequences can be considered.



Chapter 3.fm Page 78 Tuesday, December 14, 2004 3:14 PM





While this chapter has focused on marketing decisions, a main theme of the book is the relevance of the customer lifetime value concept to finance. In the next chapter, we explicitly address this link by showing how it can be used to value companies and inform merger and acquisition decisions.