CREATING MAXIMUM VALUE FROM YOUR SCARCEST RESOURCE

RETURN ON CUSTOMER

Special Excerpt

A REVOLUTIONARY WAY TO MEASURE AND STRENGTHEN YOUR BUSINESS

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Don Peppers and Martha Rogers, Ph.D.

FOUNDING PARTNERS

Recognized for the past decade as world-renowned experts on customer-based business strategy, and individually named to Accenture's global list of "Top 100 business intellectuals," Don Peppers and Martha Rogers, Ph.D. continue to set the standard in customer relationships.

The United Kingdom's premier marketing organization, the Chartered Institute for Marketing, recently cited Peppers and Rogers among their listing of the "50 most influential thinkers in marketing and business today." *Business 2.0* named them as two of the 19 most important business gurus of all time. In addition to being acclaimed authors and influential speakers, the two thought leaders are also the founding partners of Peppers & Rogers Group, the world's leading customer-focused management consulting firm. Founded in 1993, the firm has grown into a network of 11 offices on six continents, serving Fortune 500 clients across vertical segments.

Peppers and Rogers have co-authored six best-selling books to date, focused on customer strategy, building the value of the customer, and related subjects. These include *The One to One Future*, which *Inc.* magazine called "one of the two or three most important business books ever written," and *Enterprise One to One* which received a five-star rating from the *Wall Street Journal*. The global demand for Peppers and Rogers' books and presentations has resulted in translation to 14 languages, with over a million copies in print. The authors have recently published a CRM textbook for university use in graduate level courses and applicable as a desk reference for the business executive, *Managing Customer Relationships*.

In June 2005, Peppers and Rogers will publish their latest business book, *Return on Customer*SM. The publication is the next great breakthrough publication to revolutionize business practice. It advances the concepts and tenets of business valuation to the next evolutionary stage, demonstrating how maximizing the value of the customer base means maximizing the value of the enterprise.

AN OVERVIEW:

Return on CustomerSM

Creating Maximum Value from Your Scarcest Resource

In their upcoming breakthrough book, noted authors Don Peppers and Martha Rogers, Ph.D., answer today's foremost business question: What's the right balance between current profit and long-term value? Excessive focus on the short term has led not only to a rash of business scandals, but also to a culture of bad management and poor corporate governance. Nevertheless, current profit is still important, and investing now to achieve long-term value is hard to reconcile with the need for immediate results. Without doubt, answering this single question is each and every CEO's primary responsibility.

However, both short-term and long-term value come from the only business asset that ultimately matters: Customers. Customers are the scarcest resource for a business today, scarcer even than capital. If you have a customer, you can get the capital you need. Now Peppers and Rogers, who defined and launched the global CRM movement with their previous books, are proposing a tool certain to become the must-have business metric of our time. Return on CustomerSM (ROC) is a deceptively simple formula for measuring the rate at which overall enterprise value is created by customers.

According to Peppers and Rogers, a customer can create value for a business in two ways: by increasing the company's current-period cash flows, and by increasing its future cash flows. For instance, if a customer has a bad experience with a company and becomes less inclined to do business with it in the future, the firm loses value at that very instant, with the customer's change of mind. It doesn't matter that the customer might continue doing business normally for a few weeks or even for a few years – the customer's intent changed, and so the customer's lifetime value declined. This company lost real value – current value – in the same way a share price loses current value when future profits are threatened.

Return on Customer is a speedometer for organic growth. Maximizing ROC optimizes the mix of both current-period and future profits, to create the most enterprise value possible, as quickly as possible. ROC is equivalent to total shareholder return, except that ROC can be divided and sub-divided into smaller and smaller groups of customers, right down to the molecular level of the individual customer. As a result, managers can see how to create value faster, by employing different strategies for different groups of customers. ROC makes a direct connection between a company's total shareholder return and the day-to-day tactical decisions of its mid-level managers.

> "Finally! A business metric that can drive better management and a higher stock price. I predict soon you'll be hard pressed to find a company that isn't tracking ROC."
>
> Larry Kudlow
> *Co-host,* **Kudlow & Cramer**

Maximizing the value created from a given customer, over time, most likely occurs when the company's value to that customer is maximized, and the customers who get the most value are those who have come to trust the firm. So to maximize ROC a firm must earn the trust of its customers, encouraging employees at all levels simply to treat customers the way they would want to be treated if they were customers. The ROC-maximizing company will have "trust" in its corporate DNA, and not only will that create shareholder value more quickly, but it will also create antibodies to help the firm resist other types of trust violation, from shoddy service to accounting fraud.

Return on Customer is that rare book with an influence that will be truly ubiquitous. Its message impacts not just sales and marketing, but accounting and investor relations, production, service delivery, competitive strategy, and even mergers and acquisitions.

CHAPTER 1

An Open Letter to Wall Street

Businesses succeed by getting, keeping, and growing customers. Customers are the only reason you build factories, hire employees, schedule meetings, lay fiber-optic lines, dispatch service trucks, stock inventory, file for patents, operate call centers, negotiate contracts, write software, or engage in any other kind of business activity whatsoever.

Without customers, you don't have a business. You have a hobby.

The problem is that business success is extremely difficult today – probably more difficult than it ever has been. All the easy growth has now occurred. Every household in the industrialized world already has one or two or more cars, a washing machine, television sets in different rooms, and a cell phone (or several). Once an economy matures, customers are no longer so hungry to buy, but businesses are even hungrier to make sales.

Yes, we've all benefited from the unprecedented improvements in productivity over the last couple of decades, but higher productivity has also put renewed pressure on margins. No matter how much streamlining you do today, you're just keeping up. Everyone in your firm is already doing a job and a half. The cost cutting you thought was a temporary inconvenience has now become a permanent hardship.

And then there's the impact of globalization. Off-shoring and business process outsourcing may help you control your costs but globalization, too, comes with a price tag. Your products are being reduced to commodities, as more competitors find their own opportunities in your section of the globe, and at least part of the reason you can't get any pricing traction is because someone in the Far East is already undercutting you.

Even though price increases may be nearly impossible to sustain, the cost of selling and marketing is still going up. The more you spend on marketing, the less you have to show for it. Response rates decline, sales effectiveness erodes, and customers continue to become more demanding. New and improved products may temporarily solve your problem, but knock-offs and competitive innovations now appear in days. And we've seen a lot of new and improved products introduced, as companies all try to innovate their own way out of the same problem.

In category after category, in market after market, companies are

excerpt

wrestling with the fact that their products and services are simply in oversupply. Too many personal computers chasing too little demand. Too many airline seats chasing too little traffic. Too many varieties of fresh fruit in the produce section, too many kinds of bottled water, flavored popcorn, and coffee beans. Too many accounting services, consultants, systems integrators, and executive-recruiting firms. Too much advertising space chasing too few advertisers. Too many frozen foods, breakfast cereals, skin creams, razor blades, cold remedies, and hair rinses. Too many trucking services, wireless minutes, and drums of chemicals.

The only thing in short supply these days? Customers. Customers are difficult to find and hard to keep.

The scarcest resource

In today's business world, customers are even scarcer than capital. If you have a customer for your business, you can almost certainly get the capital you need to serve him. But the market – any market – contains only a finite number of customers, who will each do only so much business in a lifetime, with anybody. Even if there are lots of customers, it's still a finite number.

To remain competitive, you must figure out how to keep your customers longer, grow them into bigger customers, make them more profitable, and serve them more efficiently. And you want more of them.

Unfortunately, none of the financial metrics you learned in business school can properly account for the value companies generate from this scarce resource, with the right balance between current-period sales and customer lifetime value. Traditional financial metrics just won't tell you whether you're better off investing in customer acquisition or in customer retention, or in product development, or opening new stores, or plant efficiency, or better qualified personnel, or more service, or cost reduction. While you may believe in your heart that a particular decision creates shareholder value, there's no financial metric currently available to tell you how much shareholder value you actually created, or even whether you created any at all.

But Return on Customer can help you. Return on Customer is a breakthrough financial metric that can quantify the actual shareholder value you are creating (or, possibly, destroying) with your various business actions and initiatives.

Thinking long-term

Let's face it: Businesses gauge their success today almost entirely in terms of current-period revenue and earnings. Wall Street demands that a firm "make its numbers," or the stock price will likely founder. Certainly, public-company CEOs think this is the case, and they'll go to great lengths to meet Wall Street's expectations.

A 2004 survey revealed that meeting short-term Wall Street expectations is such an urgent need at publicly held firms that three out of four senior executives say their company would actually give up economic value in exchange for doing so! More than half of the executives said they would "delay starting a project to avoid missing an earnings target." Four out of five executives said they "would defer maintenance and research spending to meet earnings targets."

Quarterly reporting of financial results has certainly created a highly competitive business landscape. But it also drives executives to pursue contradictory business goals. Company managers are expected to strive for long-term value and growth, in order to increase true shareholder value, even while they are also pressured to deliver against more and more aggressive short-term goals. Moreover, as financial systems become more sophisticated, we measure performance with continually shortening yardsticks. Some companies now boast about their ability to close a quarter in one day. Stock-market analysts focus on short-term results as a proxy for long-term potential.

The problem is that the more short-term a company's focus becomes, the more likely the firm will be to engage in behavior that actually destroys long-term value.

The problem is that the more short-term a company's focus becomes, the more likely the firm will be to engage in behavior that actually destroys long-term value. The obsession with current revenue and earnings at many firms has generated a pervasive culture of bad management.

Don't get us wrong. It's a good thing for publicly traded firms to respond to investor demands, and it's good that a free market for a company's stock can discipline an errant management. The real problem has to do with the way a firm's future earnings and cash flow are evaluated by investors, and by the stock analysts who interpret the firm's numbers for them.

Investors are in fact very interested in understanding a company's long-term value, but at present there is no better or more reliable indicator of

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long-term value creation than, well, short-term financial performance. The discounted-cash-flow (DCF) method for valuing a business is based on forecasting the firm's future cash flows, but in the end even the most sophisticated predictions rely mostly on aggregate business trends, projections of market growth, and competitor activity, and in any case all such projections begin with today's numbers. So, like the butterfly whose wings cause a tornado a continent away, small fluctuations in current earnings or revenues wreak massive changes in projected company valuations and share prices, as their effects are extrapolated and magnified years into a company's financial future.

Tightrope: Balancing short-term reporting with long-term success

This creates a difficult problem for managers, because any firm's current earnings are likely to go up and down frequently, due to unexpected and unpredictable events. The natural noise of commerce is hard to dampen out of a firm's "earnings trajectory" from quarter to quarter, but investors' preoccupation with current numbers requires a firm to try, simply in order to preserve its public-market value.

One symptom of this malaise is the rash of executive scandals and questionable accounting practices that have plagued the investment community in the last few years. Senior managers know they can "game" the price of their own company's shares by pumping up their current sales, or by smoothing out their short-term results, and then all they have to do is sell their own stock or cash out their personal options some time before reality catches up with the market.

As bad as the most recent round of corporate scandals has been, however, this obsession with current numbers has had a far more corrosive effect on overall management decision-making. Focusing on the short term to the exclusion of other concerns allows managers to shirk their primary responsibility altogether – which is to preserve and increase the value of the enterprise.

Think about it: Almost every senior manager at any public company has had the experience of attending a meeting called for the express purpose of hitting the year-end numbers, or even quarter-end numbers. Perhaps at this meeting they decided to put off some valuable R&D work, or maybe they trimmed a costly but important service improvement. Chances are, the attendees knew full well that taking these actions would do more actual harm to the company than good, but they went ahead anyway – because they weren't being held accountable for creating enterprise value. They were being held accountable for short-term results. Wall Street results. Bonuses depended on it. Jobs depended on it. Many of these managers probably also figured they'd be long gone before the company tabulated the actual bill.

And why is it that in business magazines and surveys, lists of the most admired and successful companies seem to include a disproportionate number of privately held firms? Obviously, the market for private companies' equity is less liquid, so private companies have some disadvantages relative to publicly-traded firms when it comes to raising capital. But their equity values are also considerably less volatile, with the result that private firms do not have to dance the Wall Street Quickstep. At private firms, cynicism does not trump economics.

Surely there is a message here. Surely this has some significance. Is there anything Wall Street analysts could do to address the difficulty public companies have in paying serious attention to the long term? Well – yes, actually. And that's why we're addressing this open letter to the investment community.

The desperate push for organic growth

Investors today want executives to demonstrate that their companies can actually make money and grow, the old-fashioned way – by earning it from the value proposition they offer customers. They want a firm's customers to buy more, to buy more often, and to stay loyal longer. They want a firm to show it can go out and get more customers. They want organic growth.

Managers read this message loud and clear. As one CEO put it, "I believe that you don't get better by being bigger, you get bigger by being better. And so [we want] organic growth." According to another, "We don't create shareholder value by getting larger through acquisitions, but rather through organic growth." Of course, sometimes an acquisition does create shareholder wealth, but it has to be the right kind of acquisition – a business combination that increases the power of the customer value proposition, allowing the combined entity to achieve genuine, organic growth.

Managers push for growth because it is essential to protecting and improving shareholder value. All management's thoughts and actions, from strategizing with respect to competitive positioning, to cutting costs and streamlining operations, to creating an attractive and productive environment for employees – everything, in the end, is designed to preserve and increase the value of the firm they are managing, and organic growth is the key.

Growth fuels innovation and creativity, generating new ideas and initiatives, and stimulating managers in all areas to "think outside the box." Growth keeps a company vibrant and alive, making it a good place to work – a place that provides employees with economic benefits and opportunities for advancement. Organic growth is, in the words of one HR executive, "the Fountain of Youth" for a company.

Most business executives would agree, intellectually, that customers represent the surest route to business growth – getting more customers, keeping them longer, and making them more profitable. Most understand that the customer base itself is a revenue-producing asset for their company – and that the value it throws off ultimately drives the company's economic worth. Nevertheless, when companies measure their financial results, they rarely if ever take into account any changes in the value of this underlying asset, with the result that they are blind – and financial analysts are blind – to one of the most significant factors driving business success.

Think about your personal investments. Imagine you asked your broker to calculate your return on investment for your portfolio of stocks and bonds. She would tally the dividend and interest payments you received during the year, and then note the increases or decreases in the value of the various stocks and bonds in the portfolio. Current income plus underlying value changes. The result, when compared to the amount you began the year with, would give you this year's ROI. But suppose she chose to ignore any changes in the underlying value of your securities, limiting her analysis solely to dividends and interest. Would you accept this as a legitimate picture of your financial results? No?

Well, this is exactly the way nearly all of today's investors assess the financial performance of the companies they invest in, because this is the only way companies report their results. They count the "dividends" from their customers, and ignore any increase (or decrease) in the value of the underlying assets. But just as a portfolio of securities is made up of individual stocks and bonds that not only produce dividends and interest but also go up and down in value during the course of the year, a company is, at its roots, a portfolio of customers, who not only buy things from the firm in the current period, but also go up and down in value.

Return on Customer: Measuring the value created by customers

Return on investment quantifies how well a firm creates value from a given investment. But what quantifies how well a company creates value from its customers? For this you need the metric of Return on Customer℠ (ROC℠). The ROC equation has the same form as an ROI equation. ROC equals a firm's current-period cash flow from its customers plus any changes in the underlying customer equity, divided by the total customer equity at the beginning of the period.

Before going further, let's define customer equity more precisely. The most useful definition of an individual customer's value is lifetime value, or "LTV" – the net present value of the future stream of cash flows a company expects to generate from the customer. If we add together all the lifetime values of a firm's current and future customers, the result is "customer equity," representing the net value, discounted back to the present, of all the future cash flows a firm expects its customers to generate.

Most business executives would agree, intellectually, that customers represent the surest route to business growth – getting more customers, keeping them longer, and making them more profitable.

The Return on Customer metric explicitly takes into account the two different ways customers create value for a business – by increasing the company's current-period cash flows, and by increasing its future cash flows. When a customer has a good (or bad) experience with a company, and decides on the basis of that experience to give more future business to it (or less), the firm has gained (or lost) value at that very instant, with the customer's change of mind. It doesn't matter that the extra business a customer might give a company won't happen for a few months or a few years – the customer's intent has changed already, and so the customer's lifetime value (LTV) went up immediately, in the same way a share price would go up immediately if the company were suddenly expecting better profits sometime in the future.

The actions a company takes to achieve either of these outcomes – increases in the customer's current or future cash flows – can have costs

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and tradeoffs, requiring a balanced approach. For instance, a higher promotion budget might improve customer acquisition. But each new acquisition will be more expensive. It's possible to wind up spending more than an incremental new customer will ever be worth. Or a bigger variety of products might appeal to a wider group of customers, but represent a disproportionately high per piece production or distribution cost. Or an extra service might boost customer satisfaction, but at a cost that will be a drag on current earnings.

Clearly, creating value from customers is an optimization problem, which is something every business manager already knows. Often, however, the tradeoffs occur in terms of increased future cash flows at the expense of reduced current cash flows, or vice versa. This creates a serious problem when a firm is focused exclusively on current-period sales. A short-term focus prevents a firm from making optimum decisions. If a company fires off a truckload of direct mail or email to generate more current sales from its customers, for instance, it might also erode their willingness to buy in the future, or even to pay attention to future solicitations. Similarly, although a cost-cutting effort might not damage current customer cash flows, it could undermine future cash flows. One frustrated manager at a magazine publisher actually confessed to an investor that whenever his company faced a bad quarter, they cut costs by halting their subscriber reactivation campaigns!

Reconciling the conflict between current profit and long-term value is one of the most serious difficulties facing business today. Failing to take a properly balanced approach not only penalizes good management practices but also undermines corporate ethics, by encouraging managers to "steal" from the future to fund the present. Often companies end up destroying value unintentionally – or worse, they know they are destroying value, but feel they have no real choice about it. At the extreme, a firm might even resort to over-promising or tricking customers out of their money, in order to maximize short-term profit. Of course, this almost certainly hampers future sales and destroys customer equity, by eroding the trust that customers have in the firm.

But there are other extremes to be avoided, as well. For example, a company could invest time and expense lavishing service on its customers to ensure their long-term loyalty, without paying enough attention to current profit or cash flow. While this action might generate higher customer loyalty, if LTV doesn't improve enough to offset increased costs, then value will be destroyed, even as loyalty improves. Or a firm might want to install new call-center or sales-force software that is supposed to pay itself off with higher revenue from customers in the future, but not know how much is too much to pay for it.

Balancing between such extremes in order to maximize overall value creation is not a new or revolutionary idea. In an innovative and forward-thinking Harvard Business Review article as early as 1996, Bob Blattberg and John Deighton suggested that a firm should apply "the customer equity test" to balance marketing expenditures between customer acquisition and customer retention efforts. They even proposed a mathematical model for fitting exponential curves to find the optimum levels of acquisition and retention spending, based on executives' answers to some level-setting questions.

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A 2003 white paper from Mathias and Capon of Columbia Business School considers the implications of managing customers for three "quite different outcomes: maximizing revenue in the near term, maximizing profitability in the short to intermediate term, and optimizing the asset value of customer relationships – customer relationship capital – over the long term." The paper suggests that salespeople have traditionally been held accountable for short-term revenues, but as more organizations have come to emphasize key account management over the last decade, the metric of success has shifted perceptibly from customer revenue to customer profitability. To be successful in the future, say the authors, a firm will have to "take the long view," and "maximize the net present value (NPV) of future profit streams from these customers…"

Clearly, at some point in between the extremes of maximum current-period profit and maximum customer equity growth, there is an optimum level of overall value creation. This optimum point occurs when Return on Customer is at its highest value.

It might be easier to visualize the problem by thinking about the kind of balancing act that farmers must manage, when they try to maximize the overall value of their farming operations. A farmer could plant the richest, most productive cash crop on all his acreage every year and make a great deal of money in the short term, but his land would soon burn out. The more prudent farmer would ensure the long-term productivity of his land by practicing conservation – rotating his crops, fertilizing, aerating the soil, and leaving some land fallow each year. This is a more costly way to farm, and in the first few years the prudent farmer is unlikely to harvest as much profit as he could have. But his land will remain productive for many years.

In farming, land is the scarce resource. For a business, customers are the scarce resource. A business must make the most of its customers in the same way that a farmer must make the most of his land. A prudent farmer must strike the best possible balance, between over-using his land and under-using it. A prudent manager must strike the same type of balance with customers. It is worthwhile remembering that farmers face short-term temptations, just as business executives do. In any given year a prudent farmer can always make more money by foregoing conservation, that year. Smart farmers never do that, of course, because it is self-defeating and destructive. It would be stupid, right?

Maybe so, but business executives do it all the time. The survey said: Yes, three out of four would definitely do it. You've probably been at one of those year-end meetings yourself. Maybe, like the magazine publisher, a company simply suspends its customer win-back efforts temporarily – but in business today, the dilemma between short-term and long-term barely even qualifies as a dilemma.

What if you could hold businesses accountable today for all the future value they had to use up to make today's numbers? You need a workable means to measure the total value a business creates or destroys with its actions. Return on Customer is that metric. (See "Unintended Consequences.")

ROC: Speedometer for organic growth

The most important and overriding financial goal for any management team should be to push the ROC speedometer to its limit, because by doing so they will be maximizing the value being created by their firm. A more ROC-efficient company will not only harvest current profits, but it will tend to conserve and replenish its stock of customer equity, as well, through investments in new-product development, customer service, relationship building, customer prioritization, retention efforts, new-customer acquisition, and so forth.

Return on Customer can be applied to a company's entire customer base, or to any subset of customers and prospective customers within it, all the way down to the molecular level of the individual customer. For whatever group ROC is applied to, a firm is creating the most overall value possible from that group of customers and prospects when ROC is at its maximum. In fact, for an operating business, Return on Customer is equivalent to Total Shareholder Return. (See "Return on Customer = Total Shareholder Return.")

Because ROC is a "bottom up" rather than a "top down" calculation, it is prescriptive. That is, some groups of customers and prospects will offer more leverage for creating value than others will. The detailed customer insights that underlie a firm's Return on Customer numbers will suggest different actions management should take with respect to creating value with these different groups.

In the final analysis, however, what it boils down to is measuring the extent to which a firm is creating actual value for investors with its actions. Which is more valuable, a telecom company that cuts its prices in order to hold on to the customer contracts it has, or one that produces more satisfied customers who trust its recommendations and thus tend to buy more and remain loyal? Which would you rather invest in, a commodity natural gas producer selling into a heavily competitive, deregulated market, or a natural gas producer that collaborates with its largest industrial customers to monitor and maintain their heating environments? Which would you consider to be a better long-term risk, a ferry line operating on a monopoly sea route, but with an abysmal service quality record and a host of highly dissatisfied customers, or a ferry line operating on a competitive route, but with highly satisfied customers who talk about it and frequently recommend it to others?

No amount of discounted-cash-flow analysis will discriminate among these different types of companies, with their quite different values. But Return on Customer is a metric that can tell them apart easily.

So the point of this open letter is as follows: In the not too distant future, as you Wall Street analysts meet with the companies you follow, ask them for more than a review of quarterly results and earnings projections for next year. Ask to see figures documenting their Return on

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Customer. Not only will doing this corroborate and sharpen your own analysis, but it will also directly help the companies themselves, improving their economic performance, their financial stability, and even their management culture. You'll be forcing them to be better companies.

If you're worried about how any firm can take a current measurement of increases or decreases in a customer's lifetime value, or if you're bothered by the possible costs to a company of adopting this perspective in operating its business, or even if you're just not sure what types of new and different management decisions might be made from an ROC perspective – then keep reading this book. We'll address each of these issues, and more. We're going to make the case – really – for building long-term, permanent value in a short-term world.

The Return on Customer equation

Return on Customer can be calculated as follows:

$$ROC = \frac{\pi_i + \Delta CE_i}{CE_{i-1}}$$

Where: π_i = Cash flow from customers during period i,
ΔCE_i = change in customer equity during period i, and
CE_{i-1} = customer equity at the beginning of period i.

ROC equals a firm's current-period cash flow from its customers plus any changes in the underlying customer equity, divided by the total customer equity at the beginning of the period.

Unintended consequences

Many companies have noticed a decline in their overall marketing productivity over the last decade or so. Either they have to spend more marketing money to generate the same sales results, or their response rates to traditionally strong solicitations are falling. The fact is, however, that this general decline in marketing productivity could easily be the result of their own over-solicitation of their customers, over a prolonged period of time. Their overall ROC is probably much lower than their reported profit might indicate, resulting in a steady decline in the productivity of their customer base. Their ROC may even be negative.

To model a very simple example of unintended value destruction, consider a company that has a million customers, each with a 1% likelihood of responding to a direct-mail sales offer. (In direct marketing, a 1% response rate is not unusual.) Let's assume that each solicitation costs $1 to send out and each positive response generates $125 in cash flow. Thus, with the first campaign the company spends $1 million on solicitations, and generates $1.25 million in cash flow, for a $250,000 profit. The firm can do up to six solicitations a year, and each campaign pulls a 1% response from the customer base.

As Table 1 illustrates, these customers represent customer equity of $6 million for this firm. The firm's Return on Customer remains constant in subsequent years, because it is continuing to generate a steady 1% productivity rate on these customers, year after year.

Table 1

	Year 1	Year 2	Year 3	Year 4
Total prospects	1,000,000	1,000,000	1,000,000	1,000,000
Response rate	1.00%	1.00%	1.00%	1.00%
Cost per campaign	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Cash flow per campaign	$1,250,000	$1,250,000	$1,250,000	$1,250,000
Profit per campaign	$250,000	$250,000	$250,000	$250,000
Profit per year (6 campaigns)	$1,500,000	$1,500,000	$1,500,000	$1,500,000
Year-end customer equity	$6,000,000	$6,000,000	$6,000,000	$6,000,000
Change in customer equity	–	$ –	$ –	$ –
Total value created	$1,500,000	$1,500,000	$1,500,000	$1,500,000
Return on Customer	–	25%	25%	25%

But what if, after six unsuccessful solicitations each year, the customers were to become just slightly less likely to take the company's offer during the next year? Let's build into our model a .05% annual decline in response rate, accounted for by increased annoyance, or just lack of relevance. It's not unrealistic to imagine that customers who begin to see a company's messages as irrelevant will just stop opening them. If the annual decline were only .05%, as is shown in Table 2, then every year this firm would actually be destroying about a quarter of its customer equity – more customer equity, in fact, than it was harvesting in profit. The result: Its ROC is negative the very first year, and accelerates downward as the company continues to burn out the value of its customer base.

Table 2

	Year 1	Year 2	Year 3	Year 4
Total customers	1,000,000	1,000,000	1,000,000	1,000,000
Response rate	1.00%	0.95%	0.90%	0.85%
Cost per campaign	$1,000,000	$1,000,000	$1,000,000	$1,000,000
Cash flow per campaign	$1,250,000	$1,187,500	$1,125,000	$1,062,500
Profit per campaign	$250,000	$187,500	$125,000	$62,500
Profit per year (6 campaigns)	$1,500,000	$1,125,000	$750,000	$375,000
Year-end customer equity	$ 6,000,000	$4,500,000	$3,000,000	$1,500,000
Change in customer equity	–	$(1,500,000)	$(1,500,000)	$(1,500,000)
Total value created	$1,500,000	$(375,000)	$(750,000)	$(1,125,000)
Return on Customer	–	(6.3%)	(16.7%)	(37.5%)

If you look carefully at the example in Table 2, you'll see that "profit per year" remains positive, although it's decreasing because response rates are declining. Because of this, the company probably thinks it is creating value. But customer equity is declining each year by an amount exceeding the year's "profit," with the result that "total value created" each year is actually negative. Because of this, the company's Return on Customer is negative, and while it might think it has a profit to report, it is actually eating its own customer base.

Year 4 is the very last year that the company in Table 2 will generate any current-period profit at all, having completely destroyed the productivity of its customer base, at least with respect to this type of campaign. Even though this is a hypothetical model, the fact is that a decline in customer response rates is a leading indicator of a general decline in the value of the customer base. If that is as far as a firm's analysis goes, however – an erosion in marketing efficiency – then it might still choose to continue with its solicitations, as long as the annual profit number is positive at all.

Only by calculating Return on Customer will it actually learn that each year it is destroying more value than it is harvesting in profit.

Making the jump from this firm's annual income statement to a calculation of actual value created or destroyed will be difficult. If a firm isn't measuring ROC, then value destruction can easily remain completely invisible, even to a trained accountant. An executive at this company might pat his team on the back for each of these "successful" campaigns, but in fact he should be chastising them! Shouldn't investors want to see the ROC results too?

Return on Customer = Total Shareholder Return

"Total Shareholder Return" is a precisely defined investment term, and refers to the overall return a shareholder earns from owning a company's stock over some period of time. According to one financial authority:

"Total Shareholder Return (TSR) represents the change in capital value of a listed/quoted company over a period (typically one year or longer), plus dividends, expressed as a plus or minus percentage of the opening value."

This definition is based on what a shareholder's actual cash flow would be if he were to buy the stock at the beginning of the period and sell it at the end. The shareholder gets cash dividends during the period, and by the end of the period there may also have been some up-or-down change in the capital value of the stock itself. This definition of total shareholder return relies on a retrospective calculation. As a shareholder you can always tally the exact return you experienced during some previous period, provided your share price is set by the market. (You can't use this formula to predict total shareholder return going forward, however, because you don't know what your share price is going to be in the future. Nor can you use the formula to calculate total shareholder return for a privately held firm, because if the company's shares aren't listed or quoted, then there's no easily defined share price.)

In a perfect world, a publicly-traded firm's market-driven "capital value" would equal its discounted cash flow (DCF) value. There's no way to prove or disprove this, because no one really knows what any company's discounted cash flow is going to be in the future. Nevertheless, it's widely accepted that the market price of a public company's stock at any point in time reflects the marginal investor's best guess as to the company's discounted future cash flow value. (You'll find a more extensive discussion

excerpt

of discounted cash flow in the appendix, in case you enjoy this sort of thing.)

To understand the ROC = TSR argument, all we need to do is start with the premise that all value created by any company's business operation must come from its customers at some point. There are a few exceptions to this, but not many. Asset sales can create value, perhaps, but such gains aren't usually considered part of operating income – and in any case, the asset buyer could often be considered a type of "customer." Rents and royalties could also be considered to come from customers, in many cases.

If the discounted cash flow value of an operating business is created entirely by customers, then its discounted cash flow is composed of a whole lot of individual lifetime values. All the firm's current and future customer lifetime values added together (i.e., its customer equity), will equal its total discounted cash flow.

Therefore:

> Return on Customer (ROC) equals a company's current-period cash flow, plus the change in its discounted cash flow value during the period, expressed as a percentage of its beginning discounted cash flow value.

In other words, Return on Customer is simply a different route to prospective Total Shareholder Return – a method that breaks the economic value of a business down into smaller, customer-specific units, all the way down to specific, individual customers. ROC calculations don't rely on changes in share price, but if your shares are publicly traded then stock price can still provide an important additional reference point for validating your firm's total customer equity.

A final note about shareholder return: All companies have "shareholders." For a publicly traded company, shareholders are the independent and institutional investors who hold the shares. For a small company, it may be a founding entrepreneur and a partner. Whether you calculate your shareholder return in order to flesh out an SEC filing or just to decide how much everybody gets paid this year, and whether your shareholder meetings take place on the 68th floor or around the kitchen table, shareholder return is the most fundamental metric of value creation for any kind of business.

Shareholder return and Return on Customer apply to every company that needs a bookkeeper. ■

Other books from Peppers and Rogers

The One to One Future

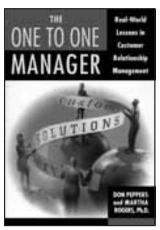
In 1993, Don Peppers and Martha Rogers Ph.D., introduced the concept of one-to-one marketing in their book *The One to One Future: Building Relationships One Customer at a Time.*

Enterprise One to One

Don Peppers and Martha Rogers Ph.D., turned to the tools needed to accomplish one-to-one in their 1997 best-seller, *Enterprise One to One: Tools for Competing in the Interactive Age.*

The One to One Fieldbook

In 1999, *The One to One Fieldbook: The Complete Toolkit for Implementing a One-to-One Marketing Program,* transformed one-to-one theory into a practical working guide.

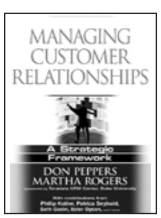


The One to One Manager

The One to One Manager: Real-World Lessons in Customer Relationship Management documents real-world stories of one-to-one marketing. Here, Don Peppers and Martha Rogers Ph.D., examine the issues companies face while implementing CRM programs.

One to One B2B

One to One B2B: Customer Development Strategies for the Business to Business World applies one-to-one principles to the tasks businesses face when they are selling to other businesses, rather than consumers.



Managing Customer Relationships

Don Peppers and Martha Rogers, Ph.D. present a comprehensive framework for CRM. *Managing Customer Relationships* provides corporate management, professors and students with a logical overview of the background, the methodology and the particulars of managing customer relationships for competitive advantage.

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About Peppers & Rogers Group

Peppers & Rogers Group is a management consulting firm, recognized as the world's leading authority on customer-based business strategy. Founded in 1993 by Don Peppers and Martha Rogers Ph.D., the firm is dedicated to helping companies maximize the value of their business by maximizing the value of their customer base. The goal: Develop and execute customer strategies that create immediate return on investment and long-term customer value. In this way, we help clients optimize their most valuable asset: their customers.

Peppers & Rogers Group is headquartered in Norwalk, CT with a domestic and international network of 11 offices. The firm maintains a global client list that includes: AT&T Wireless, BMW of North America, Boise Office Solutions, Electronic Arts, Hewlett-Packard, Lincoln-Mercury, Marriott Vacation Club International, Merial, Microsoft Business Solutions, Pitney Bowes, SAP, Saturn, Sony, Unilever, United States Postal Service, Verizon Communications, and Xerox.

In 2003 Peppers & Rogers Group was acquired by Carlson Marketing Group, the leader in relationship marketing. Peppers & Rogers Group's customer strategy expertise combined with Carlson Marketing Group's implementation capabilities offers an end-to-end solution for clients who are working toward the development and deployment of best-in-class customer-based business strategy.

About 1to1® Media

Peppers & Rogers Group maintains a significant voice in the marketplace through its media properties. Led by 1to1® Magazine, these print, electronic and custom publications explore the best practices, trends and developments in customer strategy, demonstrating how customer-based initiatives are driving bottom-line impact. With Don Peppers and Martha Rogers, Ph.D., Peppers & Rogers Group's speaking division also brings Peppers & Rogers Group's expertise to a broader audience. Our partners, consultants and experts help articulate the customer vision to CRM leaders and practitioners.

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