Editorial

Measuring the value of customers to a company, understanding what factors influence customer profitability, and managing the lifetime relationship with the customer — to maximise the value created for the company — are three closely linked and related topics in marketing. All three are examined in this special issue.

In this editorial, the importance of customer lifetime value is discussed. Not all marketers, however, support the idea that customer lifetime value should be a key tool in the development of customer management strategies. We are delighted to have a short comment by Tim Ambler which puts forward the opposing view.

The first two papers deal with how to calculate the value of a customer to a company. Gurau and Ranchhod's paper looks at a model of how to calculate customer profitability. Then, Hopkinson looks at the issue of risk as well as returns, applying some of the thinking about shareholder value creation to the problem of valuing customers. Developing our understanding of what drives customer profitability, Garland reports on the relationship between service quality and customer profitability at a bank and deals with the difficult area of cost allocation. Gustafsson and Johnson look at similar issues for Volvo, exploring the link between service, quality and business performance. Both papers demonstrate the importance of employees in building profitable customer relationships.

Understanding the financial value of customers to a company is not enough however; true customer relationship management is about developing customer-targeted strategies to maximise the value that both sides obtain from a relationship. Weinstein looks at a method of customer segmentation based on usage and customer value. Dias *et al.* focus on the recognition that customers are not, in fact, all the same and demonstrate that advertising has differential effects. They go on to explore the implications for customer-specific strategies in service businesses. Finally, Jarrar and Neely explore some of the issues in implementing CRM.

THE VALUE OF LIFETIME RELATIONSHIPS WITH CUSTOMERS

Since the emergence of relationship marketing, with its emphasis on customer retention, there has been a growing body of research on the relationship between customer retention and increased profitability suggesting that customer relationships are one of a business's most important assets. Various writers on marketing have emphasised that the relationship with the customer is a fundamental driver of business success and that marketing and, more recently, the implementation of relationship marketing through customer relationship management, has an important role to play in creating shareholder value.

Yet marketers have, until recently, focused largely on creating value for customers rather than for companies: customer value rather than shareholder value. There are, perhaps, two reasons for this. The first is that it is simply more fun doing creative, costly things that customers like; it is high profile and sexy, brings you the love of customers and the esteem of colleagues, and can lead to highly-paid jobs in fields such as brand management. The second reason is that most organisations are structured in a way that tends to suggest it is products, rather than customer relationships, that drive profits. Of course, companies need good products and/or services to survive and prosper; but companies with strong and lasting relationships with their customers make substantially greater returns over the lifetime of their customer relationships.

The management accounting systems of almost all companies insidiously foster this view, providing product profitability numbers and often treating the costs of marketing and customer service as marmalade overheads to be spread evenly over the top. In fact, as CRM managers know, it simply is not true that customers buying the same amount of goods or services need the same amount of time and attention. Some customers demand higher service levels than others — more customer service time, customised packaging, special invoicing or other paperwork and so on. The costs of providing these services are escalating. The costs of sales, marketing, administration and customer service are the fastest-growing cost elements for most organisations; in fact, in many organisations, manufacturing and raw materials costs have actually fallen over the past few years. Therefore, these costs are now the costs that make the difference between profitable and unprofitable customers.

CRM AND CUSTOMER LIFETIME VALUE

CRM's focus on longer-term relationships with customers has increased interest in the concept not of customer profitability (which measures the profit from a customer over a short period, typically a single year) but of customer lifetime value. Customer lifetime value measures the stream of profits generated by customers over the course of the entire relationship lifetime.

Customer lifetime value is of more use to CRM managers than customer profitability. Customer profitability can be very volatile. Short-term changes in customer behaviour can make customers who were profitable in one year, unprofitable in the next. Other customers can be so costly to acquire that they do not become profitable during the first year. Single-period customer profitability analysis is of limited usefulness in formulating customer management strategies. What do you do with customers who were unprofitable last year? If you stop serving them, you will lose some of your new accounts that have not yet had time to become profitable. If you continue to serve all of them, you run the risk that your cost base becomes uncompetitively high. Customer lifetime value is a far better basis for developing customer management strategies.

CRM STRATEGIES USING CUSTOMER LIFETIME VALUE

Analysing customers in terms of their customer lifetime value enables companies to identify their most profitable and least profitable customers in the longer term. The customers with the highest lifetime value are the customers that companies most want to retain. Customers with low lifetime values require different management

Figure 1 The customer lifetime value matrix

strategies. Customers with negative lifetime value are a problem area.

Comparing the stream of revenues over the customer lifetime (that is, actual revenues in the current year plus forecast revenues over the remainder of the relationship lifetime) with the likely costs of managing that customer relationship this year and in future years (in other words, the costs that would be incurred in obtaining that revenues stream) enables CRM managers to construct simple but useful matrices of customer lifetime value like the one shown in Figure 1.

In the matrix customers are categorised as relatively high/low revenue, and relatively high/low cost. Customers in the bottom left quadrant have high revenues and low costs. These are the customers with the highest lifetime value and should be retained. They are, however, likely also to be attractive to competitors. Suitable

strategies might focus on longer-term retention (long-term contracts, shared information systems, loyalty reward schemes etc). Customers in the top left quadrant generate lots of revenue but are costly to serve. It makes sense to look for cost-reduction strategies here (eg e-commerce), as long as this does not damage the revenue stream from these customers.

Customers in the bottom right quadrant are low revenue, low cost. Sometimes, revenues from customers who fall into this quadrant can be increased through cross-selling or up-selling. If not, these customers should properly be recognised as 'commodity customers'. They may have an important role to play in keeping volumes up and unit costs down, but care should be taken not to allow the costs of serving these customers to creep up.

Customers in the top right quadrant are relatively low revenue, high cost

customers. They may still be profitable but efforts should be made to increase revenues, reduce costs or both.

Customers falling in the extreme top right of this quadrant are candidates for a reduction in service levels. Sometimes, CRM managers will approach such customers to discuss their relationship beforehand. It may not be the customer's fault; many of these customers are blithely unaware that they are relatively unprofitable to their suppliers and have been happily luxuriating in the exceptional service offered by their supplier for some years.

SUCCESSFUL CRM

Successful implementation of CRM should build value for both customers and for companies. Creating value for

customers helps build retention, as advocated by relationship marketing. To be truly effective, however, CRM should focus on retaining those customers that are most profitable for the organisation, thereby creating value for the company. So it can be argued that CRM has three objectives: to develop relationship management strategies; to identify the most valuable customers and target them successfully with retention strategies; and to reduce the risk that valuable customers defect to competitors. In delivering these objectives, information about customer lifetime value is critical.

LYNETTE RYALS

Director of the Executive MBA
Programme
Cranfield School of Management
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