Customer Equity: Measurement, Management and Research Opportunities

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Customer Equity: Measurement, Management and Research Opportunities

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Abstract

Despite the recent academic interest in the study of customer equity (CE henceforth), a comprehensive discussion of the prevailing research issues has not been provided. There is a shift in the interest of managers and researchers from a traditional focus on product management to a more recent focus on customer relationship management (CRM). We believe that research on CE could provide the necessary tools to link CRM to long-term financial performance. In this paper, we (a) discuss the academic and strategic importance of CE, (b) provide an extensive literature review, and (c) prioritize future research. We argue that there are two major agendas for future research in CE. The first is to provide better measures (e.g. the measurement of customer lifetime value), and the second is to identify the strategies that lead to CE maximization. We emphasize modeling approaches that have been used or could be used to tackle the suggested research questions. A special focus is given to statistical models that are capable of incorporating long-run dynamics.

Contents

1

Introduction

The Customer Equity paradigm (CE henceforth) recognizes customers as the primary source of both current and future cash-flows. In this framework, the firm is interested in maximizing the net present value of both current and future pools of customers, which is considered a good proxy for the value of a firm (Gupta et al., 2002). Thus, CE models emerge as powerful tools to maximize the return on marketing investments, and to guide the allocation of the marketing budget (Blattberg and Deighton, 1996, Rust et al., 2004, Reinartz et al., 2005).

The roots of the current research in CE can be found on several overlapping research streams: direct marketing, service quality, relationship marketing, and brand equity (Hogan et al., 2002c). Although relationship marketing has become widely popular during the 1990s, it was used long ago by some direct marketers, small enough to address their customers individually (Petrison et al., 1997). Like direct marketing, the research streams of relationship marketing, service quality, and brand equity have focused on customer retention as one of their primary objectives. Not surprisingly, some researchers have warned against an inadequate implementation of some of these approaches. For example, it has been argued that many firms lack a clear understanding of what consumers want, and annoy customers by trying to build long-lasting relationships when a transaction approach might be more adequate. Thus, these firms might be obtaining exactly the opposite of what they intended (Fournier et al., 1998). Researchers have also criticized firms obsessed with providing increasing levels of service with the objective of satisfying their customers well beyond what is economically reasonable, falling into a "satisfaction trap" (e.g., Reichheld and Teal, 1996). It has also been pointed out that, after spending huge amounts of money in Customer Relationship Management (CRM henceforth) technologies, some firms do not know how to manage customer relationships with these new databases, and have therefore achieved negative returns for these investments (Rigby et al., 2002).

In an attempt to complement the previous research streams, the literature on CE has two well-defined objectives: (i) the economic measurement of customer relationships; and (ii) the identification of strategies that build profitable relationships. Thus, CE models are about guiding resource allocation with the objective of maximizing the value of a firm.

Early work on the economic measurement of customer relationships introduced the Customer Lifetime Value model (CLV henceforth), which measures the discounted stream of cash flows of an existing customer. Nevertheless, direct marketers and firms in financial industries had implemented these techniques much earlier (Jackson 1989a, 1989b, 1989c). Recently, however, more interesting models have been developed. For example, to guide optimal resource allocation between the acquisition of new customers and the retention of existing ones (Blattberg and Deighton, 1996), or to measure the value of a firm through the value of both its current and future relationships (Gupta et al., 2002).

Eventually, the maximization of CE can be decomposed into smaller problems through the optimization of the acquisition, retention and add-on selling processes (Blattberg et al., 2001). Yet, these processes tend to be interrelated among each other and models that do not incorporate the nature of those links may be biased (Thomas, 2001).

We believe that research on Customer Equity and Customer Lifetime Value is particularly promising because it can help management practice in the following areas:

(i) allocating marketing spending for long-term profitability,
(ii) understanding the connection between marketing spending, marketing metrics and financial performance,
(iii) providing a customer focused approach for measuring firm value,
(iv) providing much needed frameworks, tools and metrics for enhancing the productivity of CRM platforms.

Put differently, managers who do not embrace a CE view of the firm, are at risk in several ways: (i) allocating resources (e.g., management focus, money) to marketing actions that produce larger short-term gains at the expense of long-term performance (e.g., investing in acquisition channels that generate lots of new customers who subsequently defect at the first opportunity), (ii) spending on actions or monitoring metrics that do not meaningfully impact customers' behavioral change, (iii) investing in firms that may seem attractive from a standard financial perspective, but whose customer metrics (such as the monthly evolution of acquisition costs, new customers, retention rates, margins per customer) tell a different story, and (iv) investing in expensive CRM platforms without careful consideration of how these platforms will be used to grow CE.

With this paper, we try to achieve several objectives. First, we are interested in reviewing current models of CE and in providing a typology of them. Second, we are interested in reviewing models that can increase CE by optimizing each of its drivers: acquisition, retention, and add-on selling. Third, we want to posit the more fundamental questions of whether a CE orientation of a firm is beneficial when competing with other firms or not, and if firms should discriminate loyals with respect to switchers when it is possible to do so. Finally, we want to provide directions for future research in this important stream of research.

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