Customer Lifetime Value — The Path to Profitability

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Abstract

This survey talks about Customer Lifetime Value (CLV) as a metric that would help managers make informed business decisions. While there have been prior articles that take an extensive and in-depth look at Customer Equity (CE)(Villanueva and Hanssens, 2007), this survey reviews the CLV metric in particular. The definition and approaches to compute CLV and the concept of customer equity are discussed in detail. Specifically, this survey provides methods for measuring CLV, the strategies for developing customer-centric strategies, the implementation of CLV strategies in a B2B and B2C setting, and the challenges faced by an organization in implementing a CLV-based framework. This survey details the importance of CLV as a metric in a marketer's toolkit and how it is relevant to managing customers.

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Introduction

Hewlett-Packard (HP) was going through a phase where the business was not too good. The company planned to initiate a customer relationship program to increase revenues. In the process, they had to confront organizational inconsistencies and inadequate customer information before starting the customer relationship program. Meanwhile, HP's multiple product teams were independently sending emails to their IT and non-IT customers armed with little knowledge of their customers' communication or product needs. Each team offered its customers only product promotions, as against a comprehensive HP solution.

HP wanted to launch a consolidated email marketing program that would enable them to gather and analyze useful data about new and current customers. Using this information, they planned to offer personalized and relevant communications on a consistent schedule. Initial research showed that customers wanted support information rather than marketing information. IT customers indicated the types of content they wished to receive, whereas non-IT customers expected HP to "figure out" what they wanted. After analyzing the problems, HP decided to provide customized marketing communications to improve customer satisfaction from IT and non-IT professionals. The solution was in establishing a one-to-one email personalization "engine" that periodically sends personalized email messages based on the customer's product ownership, IT professionals, and content preferences. The personalized engine micro-segmented HP's customers (rather than just segmenting the audience into large clusters) and sent out 50,000 to 100,000 different content combinations each month. The engine drew information from HP's customer and content profiles, and placed the content in templates to create a customized monthly newsletter. Customers received information that is only relevant to them, with no overlap or duplication from other HP product teams.

Each content item in the message included a link to a web page, which enabled them to track the customer's activity. Over time, their click-through behavior was recorded, and added to the information they provided when the customers subscribed to the newsletter. The newsletter was designed to provide usage tips at the right time to assist with business problems, to help the customer understand HP's offerings, and to encourage the customer to continue ordering from HP. About half of the newsletter's content relates to where the customer is in the product life-cycle at that time.

The results that were realized led to increased revenues, decreased costs and thereby increased profitability of customers. Apart from realizing annual sales of over $300 million, HP saved nearly $3.6 million annually in total marketing cost savings. A test comparing direct mail to the online incoming newsletter showed that an email costs only $7 per lead, while direct mail costs $163. Similarly, HP avoided costs by driving customers to direct inquiries to HP via email rather than by phone. Since HP spent only 3 to 8 cents per inquiry via email, rather than $15 for a phone call, almost $4.2 million was saved annually.[1]

The above example is a direct demonstration of the how effective management of customer relationships can be used to maximize profitability. HP, by concentrating on revenue maximization and cost minimization, has increased its profitability, and thereby has paved way for a market-based growth while carefully evaluating profitability and return on investment (ROI) of marketing activities. In other words, the

[1] http://www.acxiomdigital.com/clients/hp.asp

key to success lies in optimal allocation of resources across profitable customers and cost effective customer-specific communication.

This is very relevant in today's dynamic business environment, where the changing face of customers is a challenge to reckon with. Companies are increasingly faced with the arduous task of keeping track of their customers, maintaining consistency within the organization and satisfying customers' needs so as to enjoy continued patronage. It is imperative to build and maintain successful individual-level customer relationships in order to maximize profitability and ensure customer loyalty for future profitability. This is not an easy task to accomplish. Relationships with customers are not always secure. It is difficult to predict for how long a customer is going to stay with a firm in a non-contractual setting. Firms have to adopt innovative customer relationship management (CRM) strategies to manage customers and ensure higher profitability. Customer management strategies are aimed at addressing the needs of every customer and by developing a one-to-one relationship with them. CRM-based strategies can be adapted and implemented in a wide range of companies and sectors, and both in B2B and B2C settings. Companies, across various sectors, that have implemented this approach have increased their profitability significantly. However, all firms need not have individual-level relationships. For instance, in cases like a mass-merchandiser or a CPG company it may not be necessary to build one-to-one relationships.

It is important to note that the basic philosophy of customer-centric approach is to serve customers and thereby try to provide customized services to customers. Product-Centric firm is more focused at the portfolio of product and thereby concentrate on increasing the product line for customers, whereas Customer-Centric firms concentrate on portfolio of customers. Several new firms have challenged the product centric approach and have gained huge profits by adopting customer-centric approach. The product-centric and customer-centric approaches are explained in greater depth in Section 8 of this survey (Kumar, 2008). Therefore, in a customer-centric approach, assessing the value of a firm's customers becomes important. But, what is the value of a customer? Can customers be evaluated based only on their past contribution to the firm? Which metric is better in identifying the future worth of the customer? These are some of the questions a firm has to deal with before assessing the value of its customers. While answering these questions, it is important to note that customers' value has to be based on their contribution to the firm across the duration of their relationship with the firm. In simple terms, the value of a customer is the value the customer brings to the firm over his/her lifetime from the current period. Recent studies have shown that past contributions from a customer may not always reflect his or her future worth to the firm (Reinartz and Kumar, 2003). Therefore, there is a need for a metric that can objectively measure future profitability of the customer to the firm (Berger and Nasr, 1998).

This survey talks about Customer Lifetime Value (CLV) as a metric that would help managers answer these questions and make informed business decisions. While there have been prior articles that take an extensive and in-depth look at Customer Equity (CE) (Villanueva and Hanssens, 2007), this survey reviews the CLV metric in particular. The definition and approaches to compute CLV and the concept of CE are discussed in detail, later on in this survey. Specifically, this survey provides the methods of measuring CLV, the strategies for developing customer-centric strategies, the implementation of CLV strategies in a B2B and B2C setting, and the challenges faced by an organization in implementing a CLV-based framework. The following section details the importance of CLV as a metric in a marketer's toolkit and how it is relevant to managing customers.

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