Marketing

The Value of Keeping the Right Customers

by Amy Gallo

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Depending on which study you believe, and what industry you're in, acquiring a new customer is anywhere from five to 25 times more expensive than retaining an existing one. It makes sense: you don't have to spend time and resources going out and finding a new client — you just have to keep the one you have happy. If you're not convinced that retaining customers is so valuable, consider research done by Frederick Reichheld of Bain & Company (the inventor of the net promoter score) that shows increasing customer retention rates by 5% increases profits by 25% to 95%.

The bottom line: keeping the right customers is valuable. One of the key metrics in understanding whether your company is retaining customers is customer churn rate. But what exactly is that? And how to do companies use it?

To better understand this key marketing concept, I talked with Jill Avery, a senior lecturer at Harvard Business School and an author of HBR's Go To Market Tools.

What is customer churn rate?

"Customer churn rate is a metric that measures the percentage of customers who end their relationship with a company in a particular period," says Avery. Typically the churn rate is measured by month, quarter, or year, depending on the industry and the product you're selling. An annual rate is the default for most companies but any company that prices product on a monthly basis — think mobile phone service providers, gyms, and software as a service companies — looks at customer churn rate by month. Some other firms — those who have a faster churn rate or for whom losing customers is a big issue — will also look at it monthly.

Avery says that many executives prefer to monitor and report churn rate's opposite: retention rate, or how many customers stay. Whether you prefer to look on the bright side or mourn your losses doesn't matter — both figures look at the same thing. And Avery says she is seeing churn used more often these days.

It’s not just marketers who look at churn, however. Many investors will use the metric to evaluate the underlying health of a firm. The higher the churn rate, the more they question the company’s viability.

How do companies typically use it?

“If I’m interested in keeping customers, I’m interested in understanding how many leave and the underlying reasons why they are ending their relationship with me,” says Avery. Changes in a company’s churn rate could be a signal that something is working well (if the number goes down) or needs addressing (if the number goes up). The idea is that when you know that more customers or subscribers are cutting ties with your firm, you can work to adjust your marketing strategy or customer service approach. “Looking at churn rates by customer segment illuminates which types of customers are at risk and which may require an intervention. It’s a nice simple metric that tells us a lot about when and how to interact with customers,” says Avery.

Marketing managers will typically look at churn rate at a segment level — how many of our 18-25 year old customers left this month, for example. But sophisticated, data-rich firms are also starting to look at the number on an individual customer level. In fact, the rise of big data is making it possible for firms to act more expediently and precisely on churn rates. “I’ve seen a lot of firms use churn rate to not only understand what happened in the last period, but also to predict what’s going to happen in the next.”

Avery points to HubSpot, a Boston-based firm that provides “inbound marketing” software tools to small and medium-sized businesses to attract prospective customers to their websites, as one of the more “sophisticated churn managers”. The company’s software is available to customers through the cloud so it is able to track real-time customer usage of its tools and features. “Churn is really important to their profitability as a software-as-a-service business so the firm takes it seriously. When the economy crashed in 2008 and the company’s churn rate shot up, HubSpot delved deep into its churn data to see what it could find out about which customers were more likely to leave and when. Using that analysis, the firm targeted customers they suspected might cancel and offered services, like extra training on particular features, to convince them to stay. “They worked to eliminate road blocks to usage so that customers could unlock the value of the product,” says Avery.

How do you calculate it?

Since churn rate is simply the percent of customers who end their relationship with your company in a given period, calculating it is pretty straightforward. You take the total number of customers who left your company during that period divided by total customers at the beginning of the period. As you can see, this is a lagging indicator, meaning you can only look at what’s happened, which is one of the metric’s downsides.

What are common mistakes managers make when using it?

Avery says that there are four mistakes companies make when looking at their customer churn rate. The first is “taking churn rate as a given rather than as an opportunity,” she says. Jonah Lopin, HubSpot’s vice president of services, summed up this problem well in Avery’s HBS case on the company’s development of a Customer Happiness Index: “By the time you see an increase in your churn rate it is six or eight months after the point in time when you actually failed the customer. If churn is your only measure of customer happiness, then you’re always six months too late to influence your future.” HubSpot and many other firms have developed analytics and accompanying metrics to predict who is going to leave. “The most innovative firms are using churn rate analysis as an opportunity to get ahead of losing customers rather than just accept it,” says Avery.

The second mistake that companies make is to look at churn as simply a number or metric rather than as an indicator of behavior. The questions managers should be asking themselves are: What are we as a company doing to cause customer turnover? What are our customers doing that’s contributing to their leaving? How can we better manage our customer relationships to make sure it doesn’t happen? Dissecting what’s behind the number will help you determine what to do to change it.

Third, many marketers believe there is a magic number. “The truth is that what’s acceptable varies widely by business model and is largely dependent on how quickly and efficiently a company can acquire customers and how profitable customers are in the short and long term. Some business models thrive despite high churn rates and others rely on low,” says Avery. Instead of fixating on a certain number, the best managers look at what their churn was last year and ask themselves how they can do better. “It’s really a metric that shows how well you’re managing your customer relationships, and you can usually always improve your performance in that area.”

The final mistake is not seeing that often a high churn rate is the result of poor customer acquisition efforts. “Many firms are attracting the wrong kinds of customers. We see this in industries that promote price heavily up front. They attract deal seekers who then leave quickly when they find a better deal with another company,” she says. This was the problem many pointed out with Groupon’s business model. Those deals may have helped companies bring on new customers, but they were typically high-churning customers who didn't stick around to make another purchase when a heavy discount wasn't offered.

Before you assume you have a retention problem, consider whether you have an acquisition problem instead. "Think about the customers you want to serve up front and focus on acquiring the right customers. The goal is to bring in and keep customers who you can provide value to and who are valuable to you," says Avery.

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Amy Gallo is a contributing editor at Harvard Business Review, cohost of the *Women at Work* podcast, and the author of two books: *Getting Along: How to Work with Anyone (Even Difficult People)* and the *HBR Guide to Dealing with Conflict*. She writes and speaks about workplace dynamics. Watch her TEDx talk on conflict and follow her on LinkedIn.

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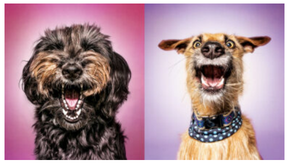

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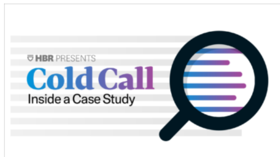

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