The S.C.O.P.E. of Customer Relationship Management

Francis Buttle, PhD FCIM
Macquarie Graduate School of Management
North Ryde
Sydney
NSW 2109
Australia

Phone: +61 (0)2 9850 8987
Fax: +61 (0)2 9850 9019
E-Mail: francis.buttle@mq.edu.au

Customer relationship management's definition is also its ambition: the development and maintenance of mutually beneficial long-term relationships with strategically significant markets.

The focus is on creating value for the customer and the company over the longer term. The value perceptions of the customer serve as bonds, or exit barriers, which inhibit the search for alternative sources of supply. The great American circus entrepreneur, P T Barnum, once said 'There's a sucker born every day'. One customer departs, another customer arrives. There's little doubt that Barnum provided great, spirited and inventive entertainment for his customers but he didn't expect them to come back. Once the show was over, a new 'sucker' had to be recruited. Today's businesses compete with multi-product offerings created and delivered by networks, alliances and partnerships of many kinds. Retaining customers is critical to corporate performance.

This shift away from the marketing's conventional focus on the Barnum-like transaction rather than the relationship is being driven by, and enabled by, a number of changing business conditions.

First, competition for the customer is becoming more intense. Local and national suppliers' locational advantage is being eroded as trade barriers are removed and geographic boundaries are redefined by the established and emergent trading blocs. As access to markets is becoming less localised, demands on logistics management and distribution partnering are becoming more significant.

Second, markets are becoming more fragmented. In the more developed economies, we have moved from mass marketing – always associated with the condition of demand exceeding supply – through market segmentation, towards individualised marketing. This so-called one-to-one marketing strategy is based on the premise that customers will be more loyal and utter more positive word-of-mouth if value propositions are customised to meet their particular, perhaps unique, requirements.

Third, customers are becoming more demanding. Their expectations for reliable product and responsive service are becoming more extreme. Customers demand more and are much less tolerant of failures. Customers compare their experiences against best-in-class expectations. For example, if it takes no paperwork and two minutes' interaction at a desk to hire a car, customers will want to know why it takes fifteen minutes and form-filling to check into a hotel. Expectations are a moving target. What used to delight customers a year ago is only likely to satisfy them today. What was once a motivator is now a hygiene factor.

Fourth, product quality has risen substantially in the recent past and is no longer a source of competitive advantage for many companies. Indeed, many customers tend to buy from a portfolio of more-or-less substitutable brands. For example, some 45% of Tesco shoppers also shop at Sainsbury's, notwithstanding their memberships of the respective Clubcard and Rewards schemes. Even 50% of cigarette smokers buy from a small portfolio of alternatives. Brand loyalty founded on product differentials is a relative, not absolute, matter. As product quality has risen, companies are seeking competitive advantage in closer, service-focussed relationships.

As these conditions are driving companies towards a recognition of the importance of being close to the customer, so there are significant technological advances which are enabling customised value propositions to be developed, communicated and delivered to customers. The penetration of computer hardware, software and telephony into supplier and customer environments has enabled closer relationships to be developed. The real costs of computer memory and processing, and data and process management software have fallen dramatically in recent years.

In business-to-business markets, many supplier-customer relationships are facilitated by Electronic Data Interchange. EDI, at heart, is an automated order-to-payment cycle in which computerised orders are issued, fulfilled, invoiced and paid in paperless, arms-length, transactions. Other companies have developed extranets, in which external password-enabled access by third parties is permitted to a company's computer systems. Customers can electronically enter orders, check progress, specify delivery requirements without interacting with the supplier's people. Both EDI and extranets remove transaction costs from the supply chain, therefore adding customer value.

….. strategically significant markets

Customer relationship management focuses on strategically significant markets. Not all customers are equally important. The Pareto principle suggests that 80% of a firm's profit is generated by 20% of the customers. McKinsey, the consultancy, reports that some 30 – 40% of the typical firm's revenues are from customers who would be unprofitable if treated on a fully-costed, stand-alone basis. One study of retail banking suggested that about 50% of customers generate no profit whatsoever for the bank. Customers clearly have different values for a company.

Strategically significant customers, or markets, satisfy at least one of three conditions.

1. Customers with high life-time values
2. Customers who serve as benchmarks for other customers
3. Customers who inspire change in the supplier

The life-time value (LTV) of a customer is measured by discounting back to today's value all future net margins earned in a relationship with the customer. For example, a customer who buys his first Ford car at the age of eighteen, replaces it with a new upgraded model every three years and has the car serviced at a Ford dealership using genuine Ford parts may be worth a six figure sum to Ford over a lifetime. American data suggests that the LTV of a pizza consumer is $8,000 and a Cadillac driver over $300,000. Not all customers have equal life-time values. Some customers, for example, may purchase in smaller volumes because their needs are less. Others may generate exceptional costs by making extraordinary demands on after-sales service, or call-centre resource.

It is the net margin that needs to be considered in computing LTV. All companies will know or be able to compute the historic gross margin earned from product / service sales to a customer. Most will be able to forecast future gross margins with some degree of reliability. Most companies, however, can not trace costs other than product and service to customers. Unless these other costs are traceable to customers, it is impossible to compute realistic LTVs. Costs associated with inventory, shipping, call centre, database, promotion, sales, operations need to be allocated to customers before LTVs are known. LTVs based on gross margins are misleading. Two customers may generate the identical gross margin but one may demand more sales effort, more product sampling, more part-load deliveries, more call-centre response. Indeed more demanding customers are frequently unprofitable despite buying larger volumes.

Benchmark customers serve as risk reducers for other customers. These are the customers whose adoption of your product/service legitimises adoption by others. Manufacturers of coin processing technology for vending machines would want to do business with Coca Cola, the world's biggest vending operation. Margins might be low but the Coke association would be a powerful message to deliver to other prospective customers.

The third group of strategically important customers are those who inspire change – typically product or process improvements – in the supplier. They may be customers who serve as test-beds for new products, customers who complain about product underperformance, customers with the most demanding product applications or environments, or customers who have identified new applications. For example, many software developers are technologically-oriented and know little about customer applications of their product. Customers can contribute greatly to the software company's fortunes by reporting new applications, bugs, flaws in menu construction and links to other software packages.

Given that LTVs of customers vary, it is important to be able to identify those customers who have a high probability of becoming high LTV customers. There are essentially two ways of doing this.

First, it may be possible to profile customers who have historically generated high LTV. The profile is applied to newly acquired or prospective customers. If there is a match then this is an indication of high future LTV potential. Profiling is dependent upon the availability of customer data and software to identify the profile of historic high LTV achievers and to flag those prospective/new customers who match the profile. Profiling in this way assumes a stable marketing environment and that future LTV stars will be similar to those historic successes. It is certainly possible to change the parameters in the software to identify prospects differing in profile from previous high LTV activities if you feel that the future will be different from the past.

The second method of identifying high LTV potential is to perform a detailed customer-by-customer analysis in much the same depth as stockbrokers or corporate finance specialists. In business-to-business environments, high LTV potential is likely to be found in customers serving growing markets where competition is relatively weak, where bonds to current suppliers are non-existent or fragile or where dissatisfaction with the value offered by current suppliers is high.

Customer portfolios

It bears repeating. Not all customers are of equal LTV potential. It makes sense for companies to invest in relationships where the LTV potential is greatest. To be successful in this process it is important to conduct a portfolio analysis of customers, both current and potential.

As shown in figure 1, customers can be classified on the basis of the net margin presently earned in the relationship and their future LTV potential.

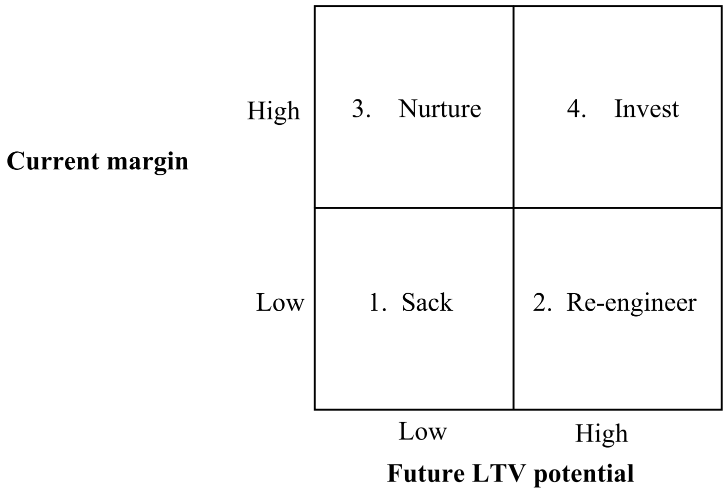

Figure 1: Customer portfolio analysis

The four cells in the matrix indicate four strategies.

There will almost certainly be some customers who contribute no value now and have no future potential (cell 1). Over a ten year period, one American plastic injection moulder sacked over seven hundred of its eight hundred customers and focused its resources on serving those with whom it could co-create and share volume.

Sometimes, however, it may be possible to re-engineer the relationship (cell 2), finding ways of stripping out cost or adding value so that the relationship becomes more profitable. For example, disintermediation in the travel industry has stripped 30% of cost out of the supply chain. Direct vendors of tourism products have a serious cost advantage over those who use traditional retail channels. This has allowed them to reach and develop previously unprofitable customers. In addition to disintermediating, it may be possible to re-engineer processes, redesign products, reduce inventory or trim service levels in efforts to cut costs from the relationship. It may also be possible to transfer cost to the customer like the courier service, UPS. Their website enables customers to trace packages in the UPS system without the direct assistance of UPS employees. An alternative to stripping out costs is to find ways of adding value thereby enhancing the margin earned from the customer. For many companies, the big challenge is to find a low-cost enhancement with high perceived value-add from the customer's perspective. The turbo-charger fitted to Bentley cars costs very little in terms of additional mechanical and electronic componentry but adds several thousands to the retail price and adds significant value for both customer and company.

There are customers who are presently profitable but offer apparently little future potential (cell 3). It may be possible to nurture these relationships in ways which improve LTV potential. For example, the causes of low future LTV may be beyond the control of the parties in the relationship. Business cycles, economic conditions and exchange rates can impact on LTV potentials. However, a joint session between the parties may identify influenceable conditions which are thought will impact on LTV potential. Perhaps the management in the customer company has changed, perhaps there is a vendor review underway, perhaps a vendor quality accreditation scheme is being implemented, perhaps a consultancy is advising on cost reductions. Not all causes of low LTV potential are unmanageable or uninfluenceable.

Finally, cell 4 contains those customers with whom present and future relationships should be profitable. Companies need to invest in these customers and reward them for the value they contribute to the business. Leading companies are taking the following actions: prioritising production, customising product/service, offering flexible invoicing dates and preferential payment terms offering loyalty awards, operating a dedicated customer service line and assigning the best staff.

Most businesses seem to have little idea of how their customer base is distributed among these four types, but here are some typical breakdowns.

Cell 4	Invest	5–30%
Cell 3	Nurture	25–50%
Cell 2	Re-engineer	30-60%
Cell 1	Sack	40-80%

The S.C.O.P.E. model

The S.C.O.P.E. model of customer relationship management defines the scope of customer relationship management. The central constituency in the model is the customer, (C). The other four constituencies – suppliers (S), owners / investors (O), employees (E) and other partners (P) – must be managed and co-ordinated to ensure that preferred value propositions are created, communicated and delivered to the selected customers.

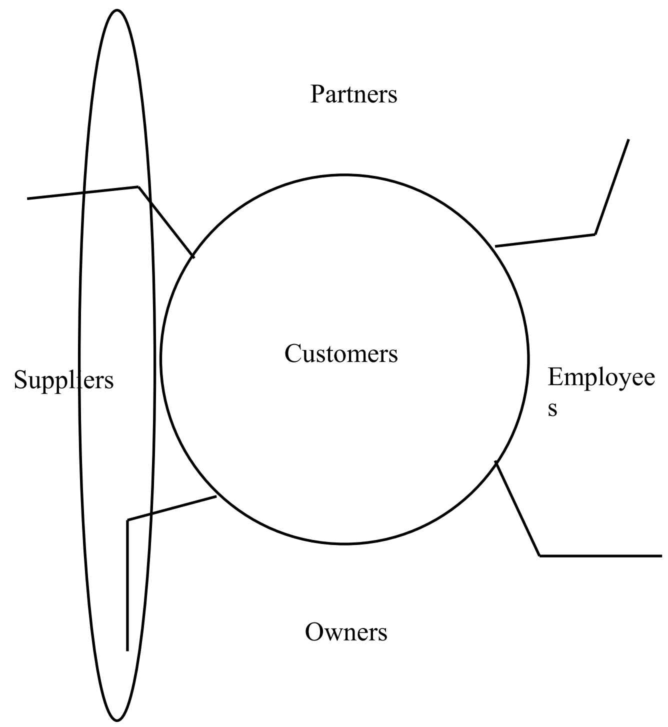

Figure 2: The S.C.O.P.E. model

Although the model features customers at the heart, not all companies would agree. Richard Branson and Bill Marriott have both claimed that their most important constituency is the internal customer, the employee. They both believe that if the employee is satisfied in their work they will give excellent service to their external customers – airline passengers and hotel guests respectively. Clearly the role of employee is that much more important in businesses where customer satisfaction is derived principally from the moments of truth, in interaction with employees. Sears, the US retail giant, has recently developed a management model which has calibrated the relationship between employee satisfaction, customer satisfaction and business performance. They estimate that a 5 unit increase in employee satisfaction provides an 1.3 unit increase in customer satisfaction which drives up revenue by 0.5%.

There are also other circumstances under which the external customer may not be the most important constituency. For example, a company entering a new market may focus initially on building close relationships with distribution partners who can take on sales, logistics and customer service roles. Similarly, following acquisition there is often a period in which management's major concern is on building a relationship based on mutual understanding with the new owners.

Despite these reservations, the company which fails to deliver customer-satisfying value propositions to its external customers is the company that will fail.

Relationships with four constituencies generate cost; it is only relationships with external customers that generate revenues.

Customised offers

Retention of strategically important customers is the goal of customer relationship management. The means of customer retention is the development, communication and delivery of value propositions which meet or exceed customer expectations. Value propositions are those multi-faceted bundles of product, service, process, price, communication, interaction which customers experience in their relationship with a supplier. It is the customer's perception of the proposition that is important, not the supplier's. A supplier may believe it has a service advantage; if the customer fails to agree, then this is not a source of value. In order to create, communicate and deliver the right sort of value to customers it is essential to understand customer expectations. Most companies contain an abundance of customer data, from sources such as sales records, complaint logs, warranty cards, credit data, returns, guarantee invocations, scanner data, market research, quality conformance reports, mystery shopping, loyalty schemes, transactional research, customer service reports and so on. These data may or may not shed light on the question of what customers expect. What is clear is that the company must be close to the customer if it is to meet and exceed expectations.

Expectations range from 'ideal' to 'intolerable'. Even excellent benchmark companies routinely fail to meet customers' ideal expectations. Your company's car fleet may enjoy excellent service from your chosen supplier, with overnight servicing, valeting and early morning delivery to specified locations. Excellent, yes. Ideal, no. The ideal car is one which requires no routine servicing. Other than identifying what expectations of excellent suppliers are it also is helpful to identify 'will' and 'should' expectations. 'Will' expectations are those your customers anticipate experiencing on the basis of previous experience. 'Should' expectations are based on promises made or inferred by suppliers in the specific marketplace and beyond. Customers benchmark their expectations against best-in-class standards. Ideal, excellent, 'should', 'will', minimally tolerable and intolerable form an expectations hierarchy in which specific performance expectations are always upwardly mobile.

In many product/markets, meeting strategically significant customers' expectations means tailoring or customising the generic offer.

The traditional focus of customisation has been the product component of the offer but equally customisation applies to service, process, people, distribution, price and communication.

- **Product**
  – Dell can manufacture twelve thousand different PC configurations
  – Ford can assemble twenty seven million different Ford Fiestas
  – Levis can manufacture an infinite number of customised jeans to meet the infinite number of body dimensions

- **Service**
  – Leigh Interests customises the time it collects commercial dry waste from key customers

– Caterpillar customises its tractor operator training programmes
– McKinsey customises its consultancy services

- **Process**
  – Royal Bank of Scotland customises the dates on which bank statements are mailed out
  – The construction process between the design-and-build company Mansell and its clients is infinitely variable
  – Extranets allow customer organisations to interact remotely, at their own convenience, with supplier computer systems

- **People**
  – Banks offer customised contacts, called relationship managers, to their most valued clients
  – Call centre software allows in-bound callers to be identified and the call routed to a specific customer service agent prior to call pick-up
  – Hairdressers, manicurists and beauticians routinely serve a known set of customers who request their attention

- **Distribution**
  – Federal Express delivers packages within a number of pre-specified windows
  – First Direct distributes its banking products whenever and wherever customers require service. This service is disintermediated
  – Motorcycle courier firms offer infinitely customised delivery to whatever address and time specified by the customer

- **Price**
  – Manchester Business School has a two-tier pricing system for its executive courses. Frequent customers are offered preferential rates
  – Barclaycard has two APRs on outstanding credit balances. The lower rate is for high LTV customers only
  – Hotels routinely discount their room rates for preferred, valued guests

- **Communication**
  – Computerised data bases allow direct marketers to customise the salutation and content of their mailings
  – Amazon.com, the internet book retailer, can offer customised information on newly published titles to customers in alignment with those customers' preferences
  – Ford dealers customise their post-sales communication to new car buyers

Competition through networks

There is growing recognition that companies don't compete but that networks do. The four constituencies in the outer ring of the S.C.O.P.E. model comprise the network of relationships that a company needs to manage, align and co-ordinate in order to deliver value to its own customers and produce value for itself. Those four constituencies are suppliers, owners/investors, partners and employees.

- **Suppliers**
  Suppliers are all those who provide input to a company's value chain. These include suppliers of raw material, components, technologies, money (relationship banks), people, knowledge and so on.

  Supply chain management is shifting towards a more relationship-oriented mode of operation. Traditionally, manufacturers have played off one supplier against another in order to force down price. Now, due in large measure to the influence of total quality management thinking, the trend is towards building strategic, long-term relationships with a smaller number of suppliers. These relationships feature co-operation to conjointly produce value for all parties – supplier, customer and the customer's customer.

  IKEA, the Scandinavian furnishings retailer, provides technical assistance, leased equipment and consultancy to its preferred suppliers in order to ensure that the appropriate value proposition is offered to IKEA's customers. Shell Retail has reduced the number of product-suppliers it does business with from fifty to thirty. Laura Ashley dropped seven of its logistics vendors to deal only with one. British Home Stores once had one thousand suppliers; now it deals with eighty, thirty five of whom supply 80% of product.

  In 1992, Ford owned car assembly plants, steamships, coal mines, iron ore mines, sheep farms, rubber plantations and railroads. It was fully vertically integrated. Now, it focuses on its core competencies and outsources its non-core activities to a relatively small number of suppliers. Indeed, Ford only produces 50% of the value of its cars. General Motors produces 70%, Chrysler 30% and Toyota 20%.

  This reduction in the number of suppliers brings with it a number of important benefits. First, there is enhanced performance brought about by improved communication, quicker problem resolution and joint investments in satisfying the joint customer. Second, purchasing costs fall because the costs of searching for 'better, cheaper' sources of supply are eliminated and because transaction costs are reduced through better alignment of management information systems such as EDI. Finally, as the number of vendors is reduced, there is likely to be increased co-operation between the remaining parties, for example, in sharing customer information and new product development. These benefits are experienced strongly by retailers who appoint category captains to manage their relationships with secondary suppliers thereby producing value for retailer, supplier and customer alike.

- **Owners/investors**
  Being successful at customer relationship management means creating value for the company and the customer over the long-term. It may mean sacking customers in the short-term, nurturing a relationship now in order to reap a future benefit, investing in technologies which facilitate customisation. The short-term for relationship marketers may not be as rosy as the long-term. Owners/investors who share this long-term orientation are the types needed by relationship-oriented firms. It has been suggested by Frederick Reichheld, author of *The Loyalty Effect*, that there are four principal ways of side-stepping the disadvantages of public ownership, in which investor churn, motivated by short-term profit seeking, is

commonplace. These are: educate current investors, shift the investor mix toward institutions that avoid investment churn, attract the right kind of core owner, and take the company into private ownership.

The main economic argument for customer relationship management is that it is capable of delivering higher shareholder value in the long run. Customer relationship management affects both sides of the profit equation: revenues and costs. Companies with a high rate of customer retention do not incur the relatively high costs of customer acquisition. These one-off costs – for example, product sampling, advertising, credit checking, prospecting – can be amortised over the relationship lifetime of a preferred customer. The longer the customer remains with a business, the greater the opportunity for cross-selling, the higher the propensity for incremental sales from word-of-mouth and the lower the relationship maintenance costs as company and customer get to know each other better.

Not all institutions are committed to long-term investments in companies. Certainly, institutions which sell index tracking investment products linked , for example, to the FTSE 100 or FTSE 250, are stable investors in those companies which fall within the indices. Similarly, sectoral investment products tend to be linked with relatively stable portfolios. However the trend, particularly in general growth or income portfolios, is away from long-term towards short-term investments.

One step beyond targeting low-churn institutions is targeting an institution or individual who will acquire a controlling interest in the company. Investors who focus only on the long-term returns – such as the legendary Warren Buffet of Berkshire Hathaway – free companies from the counterproductive pressures of short-term returns. Buffet has said 'What a company's stock sells for today, tomorrow, next week or next year doesn't matter. What counts is how the company does over a five or ten year period'. This is the type of owner/investor relationship marketers seek.

Going private is the final option. There can be considerable risks attached to this option. Share buy-backs, whether leveraged or not, can involve companies in taking on considerable debt. In 1986, the Virgin Group, chaired by Richard Branson, was floated on the London Stock Exchange, with 35% of the equity being acquired by 87,000 shareholders. By 1987, Virgin management had bought back the shares and the company returned to private hands. Branson had been concerned about institutional pressures for short-term profit which were inconsistent with his long-term investment plans. He anticipated losses in the early years of Virgin Atlantic, his airline, and felt that the institutions lacked the patience to await returns on their investment.

- **Employees**
  Employee behaviours can either enhance or damage value for the selected customers. Managers have always intuitively understood that excellent service can only be delivered by employees who are satisfied at work. It seems self-evident that unhappy, discontented employees must communicate their disaffection in encounters with customers. This intuition was backed up by

academic research in the mid-1980s when David Bowen reported that he had found a very strong link between employee and customer perceptions of the quality of service delivered and the internal climate for service. A positive climate for service is less bureaucratic (or rule driven), more customer orientated, more supportive of personal initiatives which improve service. He also found that when employees have a positive view of the firm's HR policies and practices then customers will have a positive view of the service quality they receive. He concluded that employee satisfaction, driven by astute human resource management, feeds positively into customer perceptions of quality. In other words, employee satisfaction drives customer satisfaction and, in a competitive market place where customers can switch suppliers, customer satisfaction is the *sine qua non* of customer retention.

Another review of the practices in service organisations regarded as excellent found a number of commonalities: they recognised that employee relations mirrored customer relations and that if they were to be superior in service they knew they had to be superior in their relationships with employees. They created an awareness of the importance of service in the minds of employees. They developed and implemented support systems to teach employees the behaviours which were regarded by customers as exemplifying excellent service. They set performance standards which were precise and measurable, and trained managers, supervisors and employees to perform to those standards.

Management behaviours are mirrored in employee behaviour. When a manager asks an employee 'What are your problems and how can I help you solve them?' you can expect the employee to say to the customer 'How can I help you?' Equally, if a manager says 'It's my job to run this business. You do as you are told.' the employee will communicate to the customer, most probably indirectly, 'I'm sorry, I'm not empowered or skilled enough to help you.'

Employees can be won over to service mindedness and alignment to corporate goals such as customer retention, through the process of internal marketing (IM). IM is the philosophy of treating employees as if they were customers. It is the practice of creating jobs and working environments which promote job satisfaction and positive behaviours. Employees should be viewed as part-time marketers who can create value for customers in the moments of truth where customer, employee, process and system converge. Internal Marketing may involve a number of activities and processes at a strategic or tactical level: improving management style, improving recruitment practices, integrating all employees into the planning cycle, refocusing training on interactive and service skills, open communication lines and empowerment of front-line staff.

- **Partners**
  Partnering relationships can support the creation, communication and delivery of value to strategically significant customers in many ways. Partnerships take many forms and produce many specific benefits, although the fundamental motivation for them is to combine the partners' complementary strengths to create additional value for their customers and themselves.

  Value-adding partnerships, strategic alliances and joint ventures are all forms of partnering arrangements. Partnering takes place for many reasons. A large number of partnerships allow access to technological expertise. Toshiba and Motorola, for example, share technologies and co-operate in new product development. IBM claims involvement in over four thousand strategic partnerships. They co-operate with DEC and HP to build a competitive position against AT&T and Sun. They share product development costs in partnership with Siemens. They partner Ferranti as part of their strategy to penetrate markets with the PS/2 operating system. Simultaneously, they partner Microsoft to ensure that they benefit from MS-DOS and Windows market leadership position. The partnership between Microsoft and Intel, the so-called Wintel alliance, is hugely powerful. Together they dominate the industry.

Other partnerships deliver different forms of knowledge benefit to the participants. The alliance of American Airlines and British Airways would enable each to have access to the other's customer data. According to a Wall Street Journal report this would be the greatest benefit to the parties in the alliance.

Partnerships can help strip out cost as well as deliver value-adds for customers. BP and Mobil, for example, formed a logistics partnership which was to yield significant savings in distribution costs, enabling them to compete more effectively on the forecourt.

The main benefits for participants in partnerships are as follows: economy due to the sharing of costs; accelerated learning from shared technologies and customer information; expansion by combining two customer bases; risk reduction from sharing the costs and process of new product development; enhanced customer satisfaction by delivering additional value.

Conclusion

Customer relationship management is focused on the creation and maintenance of long-term, mutually beneficial relationships with strategically important markets. It is based on the premise that customers with the highest life-time value potential are those in whom the company should invest their retention resources. Other customers might be fired. For others, it may be possible to re-engineer or nurture the relationship to create new sources of value.

Creating, communicating and delivering value to selected customers can only be achieved if the company aligns and co-ordinates its relationships with four other major constituencies: suppliers, owners/investors, employees and partners. Together, these five constituencies form the S.C.O.P.E. of customer relationship management. Another fundamental of customer relationship management is that the value proposition or offer should be customised to meet or exceed customer expectations. Traditionally, customisation has centred on the product component of the value proposition. Equally, it is possible to customise service, process, people, distribution, price and communication.

Customer relationship management is not philanthropic. It is a means to an end. Customer relationship management impacts both sides of the profit equation. The reward for a company is enhanced profitability achieved through longer customer tenure and a greater share of customer spend.