Available online at www.sciencedirect.com
ScienceDirect
Journal of Interactive Marketing 23 (2009) 147 – 156
JOURNAL OF INTERACTIVE MARKETING
www.elsevier.com/locate/intmar

Reversing the Logic: The Path to Profitability through Relationship Marketing

V. Kumar [a,*], Ilaria Dalla Pozza [b], J. Andrew Petersen [c] & Denish Shah [a]

[a] J. Mack Robinson College of Business, Georgia State University, Atlanta, GA, USA
[b] Rouen School of Management, France
[c] Kenan-Flagler Business School, University of North Carolina at Chapel Hill, Chapel Hill, NC 27599, USA

Abstract

Many firms have experienced greater success through implementing relationship marketing strategies. This is achieved by gaining knowledge about their own customers through database marketing and about the general marketplace through marketing research. Over time, this has led firms to adopt a general framework which we call the conventional path to profitability. This conventional framework suggests that new product innovation leads to acquisition, acquisition combined with a rich experience leads to satisfaction, satisfaction leads to loyalty and customer retention, and loyalty/retention leads to profitability. However, we show that some of the links in the framework are weak based on both academic research and marketplace realities. Consequently, we reverse the logic of the conventional path to profitability. We introduce a new approach that starts the customer relationship management strategy with customer profitability and the notion that different customers should be rewarded and satisfied differently. In addition, we outline a strategy that relationship marketing firms can implement, leading to higher levels of customer profitability and offer directions for future research.

Keywords: Customer relationship management; Relationship marketing customer life time value; Profits

Introduction

It is widely recognized that many successful firms have gained a competitive advantage in the marketplace by implementing a *relationship marketing* strategy. The success of this strategy has been built upon the constant advances in information and communication technology that allows firms to gather large amounts of information about their own customers (database marketing) and about customers in the general marketplace (marketing research). As a result, this has led to what marketers believe is the conventional path to profitability through relationship marketing (see Fig. 1). The conventional path to profitability starts with innovation being the foundation to acquire customers — where the better the products and services, the better the rate and quality of acquisition. Then, it is expected that when the newly acquired customers are given a richer experience, those customers will achieve a higher level of satisfaction. As a result, these highly satisfied customers will show stronger signs of loyalty, both through their behavioral loyalty (retention) and through their attitudinal loyalty (e.g., positive word of mouth). The improved level of retention gives the firm opportunities to cross-sell and up-sell to these customers, providing enhanced revenues and subsequently higher profits. Finally, the profits are then reinvested in new innovations of product and services, strengthening loyalty programs, and increasing the satisfaction of the firm's customers.

Intuitively, this conventional path to profitability might make sense. For example, consider a loyalty program from a firm where \$1 gives the customer 1 reward point. Say, there are two customers who both enter the store on the same day and purchase \$100 worth of products and services. Should both of these customers receive 100 reward points? The conventional path to profitability would suggest that by giving every customer 1 reward point for every \$1 spent the firm builds loyalty — and in turn profitability. However, there is a significant amount of evidence in both the marketing literature

* Corresponding author.
E-mail addresses: vk@gsu.edu (V. Kumar), ilaria.dalla-pozza@groupe-esc-rouen.fr (I.D. Pozza), Andrew_Petersen@unc.edu (J.A. Petersen), shah@gsu.edu (D. Shah).

1094-9968/\$ - see front matter
doi:10.1016/j.intmar.2009.02.003

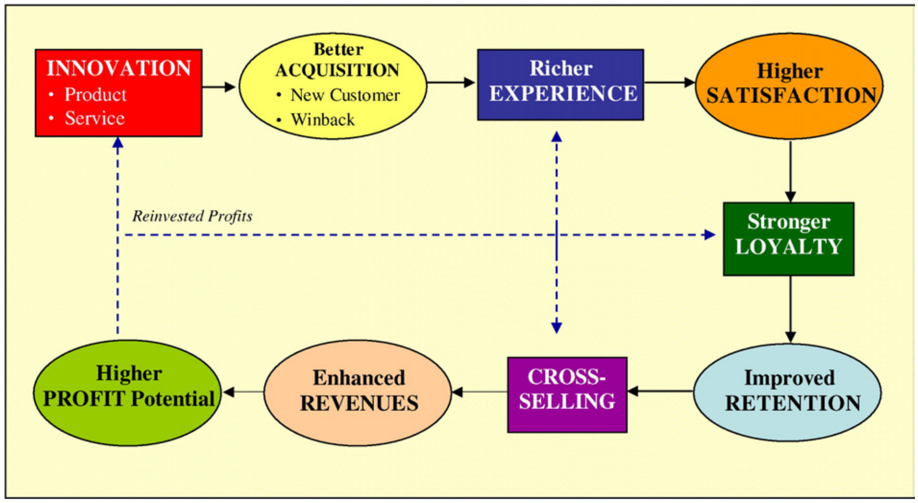

Fig. 1. The conventional path to profitability.

and in the marketplace today that suggests that this conventional path to profitability needs to be questioned and a new path to profitability needs to be developed.

Consequently, there are many firms that are beginning to deviate from this conventional path to profitability. They are doing this by first looking at each customer's profitability and then later thinking about customer loyalty and customer satisfaction. Take Sprint Nextel for example. Recently, they decided to 'fire' around 1000 of their 53 million customers for calling the call center too frequently. Sprint Nextel's justification for firing these customers was purely based on the lack of profitability from these customers.[1] A typical Sprint Nextel wireless customer spends about \$55 per month, of which about \$24 is profit for the firm. In addition, it costs about \$2–\$3 dollars per minute for Sprint Nextel to have a customer talk with a customer service representative. So, if a customer talks with a customer service representative for more than 8–12 min per month, then Sprint Nextel is going to lose money on that customer. These customers made similar calls multiple times within a month for several months.

This generates a very interesting set of questions for marketers. First, is the conventional path to profitability in Fig. 1 still the proper framework for firms to use for achieving maximum profitability through relationship marketing? Second, if it is not ideal to follow the conventional path of profitability, when firms like Sprint Nextel fire customers based on a measure of customer profitability, are they taking the right approach in building the foundation of their marketing strategy around customer profitability? To answer these questions in this paper, we proceed with the following three specific topics:

1. Questioning the strength of the links between each part of the conventional path to profitability.
2. Reversing the logic of the conventional path to profitability and proposing a new path to profitability.
3. Outlining how managers can implement a successful relationship marketing strategy using the new path to profitability proposed in this paper.

The conventional wisdom: questioning the links

In this section, we analyze each of the links in the conventional path to profitability from new product innovation to firm profitability. We provide a summary in Table 1 describing the different links in the conventional path to profitability, the weaknesses of those links, and the strategies that will lead firms to a new path of profitability.

Anatomy of the relationships

It is evident from Table 1 that the conventional path to profitability is not the ideal framework to maximizing profitability for firms using a relationship marketing strategy. Each link making up this path is only weak at best. Take some examples from the marketplace regarding the satisfaction–loyalty link. Reichheld (1996) observed that between 65% and 85% of satisfied customers will defect, calling it 'the satisfaction trap'. In some industries it is potentially worse than others. For the automobile industry, 85% to 95% of the customers surveyed report that they are satisfied with their automobile, but fewer than 40% return to buy the same brand (Reichheld 1996). This suggests that for certain industries because employee incentives are tied directly to satisfaction or loyalty metrics, the results are biased from the start. Some academic evidence does exist suggesting there is a link between satisfaction and behavioral loyalty, especially in the context of service. For example, Oliver (1980) found that a consequence of a satisfactory experience with a flu inoculation leads to a revision in future intentions. Bolton (1998) shows that customer satisfaction was more positively related to relationship duration for customers with longer prior experience with the service provider in a telecommunication context. Bolton and Lemon (1999) show for two different monthly service providers that customer

[1] For the full article, see: http://www.foxnews.com/story/0,2933,288635,00.html.

Table 1
A comparison of the conventional and new paths to profitability.

Link	Conventional path to profitability	Weaknesses of the conventional link	New path to profitability
Innovation–Acquisition	Innovation of products and services is believed to be the lifeblood of every organization and cornerstone of successful customer acquisition. The Chief Marketing Officer for Procter & Gamble says it is crucial in today's market to understand people's routine and how products fit into them. P&G and other companies believe that if they investigate customers' needs and innovate, they will acquire new customers easily.	New product development is risky and many new products fail, often accompanied by huge investments in both research and design and in promotional campaigns. Having a good market orientation helps firms become more strategically efficient in their innovation process (Atuahene-Gima 2005). One key aspect of the new dominant logic of marketing is that the customer is a co-producer (Vargo and Lusch 2004).	Determine the needs and wants of your most profitable current and potential customers. Engage in new product innovations that appeal to that segment of customers to maximize effectiveness of innovation.
Acquisition–Satisfaction	When a firm produces products and services of high quality, it will inevitably lead to higher levels of satisfaction for all customers.	The level of satisfaction that a customer has with a product or service is dependent not only on the richness of the experience the customer has, but also on expectation that the customer has with regard to the product or service (Parasuraman, Zeithaml, and Berry 1985). Even when the experiences customers receive are rich, if the gap between expectation and perceived service is small, the level of satisfaction will not be high.	Target customers for acquisition that have a higher potential for future profits. This can be done by identifying the profiles of current customers who are profitable and seeking similar customers out in the prospect pool that fit those profiles (Reinartz, Thomas, and Kumar 2005).
Satisfaction–Loyalty–Profitability	Higher levels of satisfaction lead to higher levels of loyalty, which in turn lead to higher levels of profits. In essence, this means that if a firm *creates value* for customers that in turn, customers will *create value* for the firm (Armstrong and Kotler 2008). The satisfaction–loyalty–profitability chain has been one of the fundamental approaches in the marketing literature and business practice (Anderson and Mittal 2000), often justifying a firm's spending on increasing customer satisfaction. In addition, it is widely believed that satisfaction ratings are a means to a strategic end (e.g., loyalty and retention) that could directly affect profits.	Doubts on the effectiveness of customer satisfaction in enhancing loyalty came from an impressive array of evidence that of those customers claiming to be satisfied, the majority defect (Reichheld 1996). Similarly, other studies provide empirical evidence that questions the loyalty–profitability link (Reinartz and Kumar 2000, 2002).	Determine your current and potential customers who are likely to be the most profitable in the future, i.e., highest CLV (Rust, Lemon, and Zeithaml 2004; Venkatesan and Kumar 2004). Next, work to build loyalty with those profitable customers and try to increase their satisfaction with the firm. Do not spend resources on unprofitable customers to increase their levels of satisfaction.

satisfaction was positively, but weakly, related to future usage. In this case most of the variance in future usage was explained by past usage rather than customer satisfaction. Similarly, in Capraro et al. (2003) the customer knowledge about competitive alternatives accounts for more variance in defection than customer satisfaction. In addition, some authors, even if they confirm a positive link between satisfaction and loyalty, recognize the presence of additional variables that can moderate the relationship. For instance, Shankar, Smith, and Rangaswamy (2003) surveyed customers who used either online or offline methods for obtaining a hotel room and found that the strength of the positive link varies for online and offline customers; Homburg and Giering (2001) recognize a variation in the strength of the relationship due to customer heterogeneity (such as age and income). Moreover the strengths of these results are limited since both studies suffer from common method bias and do not show a causal relationship between satisfaction and loyalty.

Then, take some examples from the marketplace regarding the loyalty and profitability link. A recent study showed that the correlation between behavioral loyalty and profitability for four different firms from four different industries was weak to moderate (Reinartz and Kumar 2002) — (1) grocery retailer: 0.45, (2) corporate service provider: 0.30, (3) direct brokerage firm: 0.29 and (4) mail-order firm: 0.20. This evidence from the marketplace shows that not only is each of the links weak, there is strong evidence that the satisfaction–loyalty–profitability chain should not be at the foundation of the path to profitability. In addition, many firms have spent huge amounts of resources to build loyalty (e.g., CRM systems) that did not result in increases of profits. Similarly, investments in customer satisfaction often resulted in high satisfaction scores, but low profitability.

This happened because customer satisfaction and loyalty initiatives were not linked to profitability from the start. Profitability was just the desired outcome, not a key player in the foundation of the marketing strategy. Investments in customer satisfaction and loyalty were made across the entire customer base without taking into account customer heterogeneity in preferences and future value. As a result, many resources were devoted to unprofitable customers for the purpose of building their loyalty and satisfaction. There are three main reasons that firms should not base the foundation of their relationship marketing strategy on satisfaction or loyalty.

1. *Forward- vs. Backward-Looking Metrics*. Satisfaction and loyalty are often perceptual and attitudinal measures that look back into the customer's past behavior. This makes it difficult for firms to develop any methods to predict future customer behavior based on satisfaction and loyalty metrics. However, current measures that firms use for customer profitability, such as CLV or Customer Equity, look to predict the future purchase behavior of customers based on past and current customer information that is transactional, attitudinal, and/or demographic (Zeithaml et al. 2006).
2. *Current vs. Potential Customers.* Satisfaction and loyalty focus only on current customers and often ignore potential customers. This can be problematic since potential customers can be and are often just as important to future firm profitability as current customers. On the other hand, measures of future customer profitability (e.g., CLV) have sought to include metrics that take into account the proper investments in retention and acquisition efforts to maximize profitability by appropriately balancing resources spent on retaining and acquiring profitable customers (Blattberg and Deighton 1996; Jain and Singh 2002; Reinartz, Thomas, and Kumar 2005).
3. *Competition.* Satisfaction and loyalty do not incorporate competitive effects, which play a key role in customer churn (i.e. customer defections to competitors). Many satisfied customers and customers who say they have a high intention to repurchase can still be lured away by competitors who make better offers. While it is difficult to always track competitive information, measures of future profitability do include some competitive effects that can help firms anticipate changes in the marketplace and gauge the effect of those changes on the firm's future profitability (Rust, Lemon, and Zeithaml 2004; Kumar et al. 2008).

Consequently, the traditional product-centric approach, where metrics measured across all customers (e.g. satisfaction) are used for new product innovation and customer acquisition, is collapsing to give way to the customer-centric way of doing business (Shah et al. 2006). However, this new approach has been misunderstood and firms have not focused their efforts on the right elements. A customer-based approach emphasizes optimal customer selection (Kumar and Petersen 2005), that is, the acquisition and retention of the "profitable" customers for the firms. The emphasis is on allocating financial resources among a heterogeneous base of customers with the most resources being devoted to the most profitable customers, where the most profitable customers usually make up a small percentage of the firm's customer base (i.e., the Pareto Principle or the 80/20 rule). As a result, there is a need for strategies that incorporate differentiation between more and less profitable customers when trying to allocate marketing resources for customer retention/loyalty and customer satisfaction.

Reversing the logic: the new path to customer profitability

We explore an alternative path to profitability where customer profitability is at the origin rather than the destination (as shown in the conventional path). Consequently, we propose a reverse logic framework (RLF) that follows a similar path as the conventional path but in the reverse direction. The RLF draws upon the state-of-the-art customer relationship management research that puts the emphasis on *future* customer value. The future value of customer profitability can be efficiently measured through the customer lifetime value (CLV) metric (Berger and Nasr 1998; Kumar, Ramani, and Bohling 2004).[2] In recent years, the importance of CLV has evolved from merely being an important metric to a way of thinking and doing business (Yu 2002). Fig. 2 shows the new path to profitability. The reverse logic is manifested by the fact that future customer profitability potential (or CLV) forms the basis for any CRM based marketing interventions.

Our first contention is that customer profitability (or CLV) needs to be taken into account *before* making cross-selling/up-selling decisions. Is this tantamount to putting the horse before the cart? Recent empirical evidence has shown that the CLV metric outperforms all other metrics when it comes to selecting customers for appropriate marketing intervention (Kumar, Shah, and Venkatesan 2006; Reinartz and Kumar 2003). Hence, managers need to be cognizant of the customer's lifetime value before deciding to selectively up-sell/cross-sell the right product(s) to the right customer. For example, up-sell/cross-sell initiatives could be made more relevant for a low CLV or a medium CLV customer as compared to a high CLV customer, thereby increasing the customer value to the firm.

Up-sell/cross-sell marketing initiatives (such as direct mailing or promotion) result in enhanced revenues for customers that favorably respond by buying more number of products or by increasing their level of spending with the firm. At the same time, there may be some low CLV customers that choose to ignore up-sell/cross-sell initiatives of the firm. In such a scenario, should the firm strive to earn the loyalty of all of its customers? Under our reverse logic framework, we contend that customer loyalty strategy of the firm should be contingent upon the profit potential of the customer. This implies rewarding customers differentially. Take the case of a typical loyalty program as introduced in the beginning of this paper. If a customer spends $100 in a retail store, then any retailer that follows the conventional path to profitability will reward the customer 100 points or points proportional to the dollars spent by the customer. This approach is based on the notion of building customer loyalty as a means to customer profitability. Now compare that approach with the reverse logic framework

[2] For complementary discussions on CLV and customer-based metrics, see Blattberg, Malthouse, and Neslin (2009) and Gupta (2009).

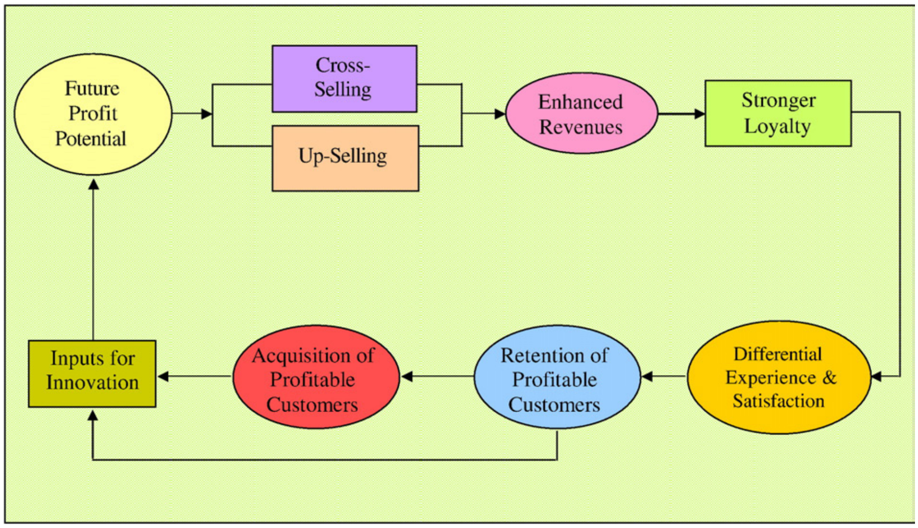

Fig. 2. The reverse logic framework: the new path to profitability.

where the retailer would *first* evaluate the profitability of the customer *before* rewarding loyalty points. So, if the customer spent $100 on high margin goods such as perfume and/or jewelry, then the retailer would award base points (say 100 points) that are proportional to the dollar amount spent by the customer. In addition, the retailer would award bonus points (say 50) as an additional reward over and above the base reward as a recognition of the customer's higher profitability. In contrast, if the customer had spent $100 on low margin items such as apparels on clearance sale, then the retailer would have awarded only base points (i.e. 100 points). We are beginning to see evidence of such differential treatment in rewarding points across industries (see Kumar & Shah 2004 for a detailed discussion). For example, the airline industry traditionally rewarded customers based on the miles flown. That is, if a customer flew 1000 miles, he/she would get 1000 points. This is changing. Airlines have now begun rewarding points based on the price paid for the ticket. For example, Continental Airlines accounts for only 50% of the miles flown towards an elite status on a discounted fare ticket, 100% for economy class ticket and 150% for a full published fare ticket.[3]

Firms that try to generate profitability by following the conventional path (i.e. build customer loyalty first in the hope of gaining customer profitability later) have often ended up in mismanaging customer loyalty (see Reinartz and Kumar 2003, and Kumar, Shah, and Venkatesan 2006 for empirical evidence). Lately, we see an increasing trend of firms differentiating their loyalty rewards programs by rewarding their most profitable customers through both tangible and/or intangible rewards while minimizing or eliminating rewards for the most unprofitable customers. Kumar and Shah (2004) identify this shift in approach as the emerging dominant logic of customer loyalty programs. Consequently, firms are increasingly striving to satisfy *different* customers to *different* extents by varying the level of customer experience with the firm. Take the example of Virgin Airlines. This airline goes out of its way to provide a royal service for its most profitable customers, i.e., the first class (or upper-class) passengers. Starting from the time the upper-class passenger leaves his/her home, Virgin sends a chauffeur-driven car to transport each of its upper-class passengers to the airport. Upon arrival, the upper-class passengers have exclusive access to Virgin's business lounge (called the clubhouse) that is equipped with facilities ranging from beauty treatments, business rooms, stylish bars and delectable dining to golf driving ranges. While in flight, the upper-class passengers have the privilege of getting a personal massage therapy.[4] Similarly, Harrah's Entertainment Inc, a major chain of casino hotels, rewards its high-rollers by offering exclusive privileges such as complementary show tickets, spa treatments, Diamond Lounge, free hotel rooms, and limousine service. A common underlying theme is that both firms seek to maximize the satisfaction of their most profitable customers by offering them special privileges. These privileges are *exclusive* to the most profitable (or high CLV) customers and not offered to less profitable (or customers with low to medium CLV). In essence, both firms have deliberately designed their customer service to create a wide difference in customer experience and satisfaction across customers based on their profitability to the firm.

Rewarding the most profitable customers (at the expense of less profitable or unprofitable customers) bears the promise of increasing the retention rate of the most profitable customers. This is evident from the fact that both Virgin Airlines and Harrah's have reported strong fiscal performance in terms of both growth and profitability relative to their competition.

According to the Pareto Principle or the 80–20 rule, in most firms, 20% of the customers typically account for the 80% or more of firm's total value. Recent empirical research of Kumar, Shah, and Venkatesan (2006) shows an even greater disparity of profitability across customers. Fig. 3 shows the distribution of customer's profitability (as measured by CLV) across 10 deciles. Each decile represents 10% of the customers and the

[3] Source: www.continental.com.

[4] Source: www.virgin-atlantic.com.

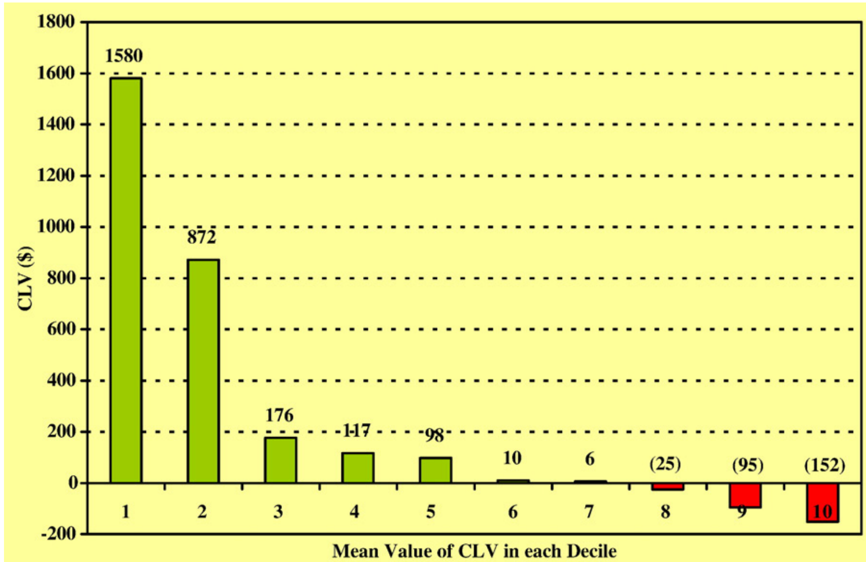

Fig. 3. Distribution of CLV across deciles.

deciles are arranged in descending order of customer profitability. Given the distribution of the CLV values of the customers in Fig. 3, the top 20% of the customers (or the first 2 deciles) are accounting for as much as 95% of the firm's total profits! Hence, selective retention of the profitable customers becomes all the more important when firms witness a skewed distribution of customer value.

Retained customers that are also highly profitable represent a greater fit between the customer and the firm's products and services. Clearly, any firm would be interested in maximizing the number of such customers. Consequently, firms should profile its retained profitable customers and then acquire new customers that match the retained customers' profile. In other words, acquisition strategy should learn from retention of profitable customers as depicted in the RLF figure.

Acquisition and retention of profitable customers can offer valuable insights in terms of what product/service innovation matters the most to the firms' most valuable customers. For example, British Airways was the first airline to offer a true flat-bed to its first class passengers and later to its business class passengers. This service innovation directed at its most profitable customers was a huge success. Hence, new product/service innovation based on the needs of the firms' most profitable customers will positively impact the future value (or CLV) of its customers and hence the overall profitability of the firm. The next section describes how our proposed framework can be operationalized to efficiently and differentially manage customers.

Maximizing customer profitability using the reverse logic framework

Profitability can vary widely across customers. Fig. 3 offers empirical proof in the context of a Fortune 500 retailer firm. This is consistent with results from other research studies (e.g., Rust, Lemon, and Zeithaml 2004; Venkatesan and Kumar 2004). Based on the distribution of CLV, we can divide the customers into different profitability segments such as high CLV, medium CLV, and low CLV segment. For example, the CLV distribution of Fig. 3 may be divided into the following three segments: (a) High CLV customer segment representing customers from deciles 1 and 2, (b) Medium CLV customer segment representing customers from deciles 3, 4, 5, 6 and 7 and (c) Low CLV customer segment representing customers from deciles 8, 9 and 10. The dollar value associated with each decile represents the average CLV of the customer in the respective decile. Since the CLV value is nothing but the expected future profits from the customer, firms should not exceed this amount while deploying marketing initiatives to manage customer relationships. So, if a firm's customers show CLV distribution as in Fig. 3, then the firm should not spend more than $10 on an average for a customer in Decile 6. In contrast, the firm can spend as much as $1580 on an average for a customer in Decile 1. In essence, the CLV not only serves as a basis for differentiating across customers based on their profitability but also gives the dollar value limit within which the firm should manage its customers.

While CLV serves as an excellent measure to evaluate the future profitability of the customer with the firm, it does not provide information on the overall profit potential of the customer. To *maximize* the profitability of each customer with the firm, it is useful to evaluate CLV along with the customer's *size of unused wallet* (SUW). The SUW represents the incremental profit potential of the customer. For example, Customer A may be purchasing $200 worth of apparel from a Retail Store X each year. However, Customer A, based on his/her demographic profile (or when surveyed), may possess the capability of purchasing apparel worth $500 each year. In that case, the SUW for Customer A from Store X's standpoint is $300.

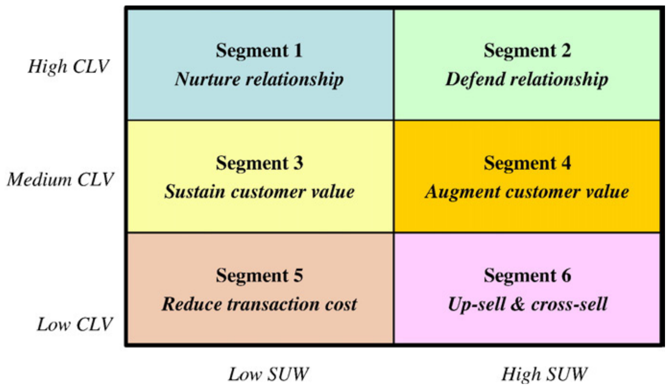

Fig. 4. Customer segmentation based on CLV and SUW.

Advances in marketing intelligence and information archival systems make SUW data accessible and/or feasible to infer for most firms. For example, IBM infers the share of wallet information of its business customers based on two sources the size and revenue of the firm as well as from an external vendor. Likewise, retailers can infer the profit potential of their customers based on key demographic and psychographic data at their disposal. Consideration of CLV and SUW in conjunction leads to 6 customer segments as shown in Fig. 4 where CLV is divided into 3 segments: high, medium and low; and SUW is divided into two segments: high and low.

Managing high CLV customers: Segments 1 and 2

Segments 1 and 2 in Fig. 4 represent high CLV customers. High CLV customers are every firm's pride and competitor's envy. These customers usually generate disproportionately high profitability for the firm as compared to customers in the medium and low CLV segments. However the high CLV customers could vary on the SUW dimension. Segment 1 represents high CLV customers with low SUW. Customers in these segments typically represent true loyalists who prefer to spend most of their entire share of wallet with the firm. Consequently, firms must act to *nurture* the relationship with these customers. Applying the RLF, the firm should offer special rewards and privileges to these customers through its loyalty program. The rewards can be tangible or intangible and should be directed at cultivating the attitudinal loyalty of these customers (Kumar and Shah 2004). For example, Neiman Marcus's InCircle program rewards its best customers by offering a private six-day European golf tournament with 15 guests traveling in a private luxury jet.[5] The objective is to touch upon higher level goals and attitudinal aspects of the customers that may not be ordinarily met through tangible rewards.

On the other hand, Segment 2 represents high CLV customers with high SUW. Customers in these segments represent extremely high net worth individuals that bear the potential of providing even greater revenue to the firm. Since these customers have a high SUW, they are susceptible to competition. Consequently, firms must act to *defend* the relationship of these customers. This can be accomplished by directing the loyalty program's objective towards retaining customers or augmenting their relationship with the firm through up-sell/cross-sell. For example, Sprint currently offers complimentary additional cellular lines to family members of its high value customers. Also, it offers free handsets to existing customers in lieu of extending their contract with Sprint by another 2 years. Direct TV tries to evaluate its customer's SUW based on the customer's credit score and residential address. Then, it uses that information to determine what kind of a free gift to offer to its newly acquired customer. The gift comprises of several options such as an Apple iPod or a portable DVD player. In addition, firms may want to offer lavish rewards to this segment of high CLV customers that may be financially infeasible for competition to emulate. For example, American Express Card selectively chooses customers from its dataset and bestows exclusive privileges such as 24-hour trip advisors, personal shopping assistants and complimentary stays at 5-star hotels (Kumar and Shah 2004). An important thing to keep in mind here is that not all customers with a high SUW may respond favorably to the firm's efforts to augment relationship through incentives directed at up-sell/cross-sell and/or tenure extension. In such a scenario, the firm may want to consider increasing the incentives offered to these high CLV customers by an amount that is equivalent to the cost of acquiring a new high CLV customer. In other words, we recommend that the firm may be better off investing the cost of acquiring a high CLV customer in the form of additional incentives to retain (or defend) an existing high CLV customer. For example, if the acquisition cost of acquiring a high CLV customer is $100, then the firm can offer *additional* incentives worth up to $100 to retain (or defend) an existing high CLV customer that is susceptible to leaving the relationship with the firm. This is because it makes better marketing sense to hold on to a profitable customer rather than try and acquire a new one. As the age-old proverb goes — 'A bird in the hand is worth two in the bush'.

Managing medium CLV customers: Segments 3 and 4

The medium CLV segment typically is comprised of the largest number of customers. Firms need to analyze this large customer segment carefully to evaluate whether there is any scope for augmenting their CLV through up-sell and/or cross-sell marketing initiatives.

Segment 3 represents medium CLV customers with low SUW. Such customers offer limited scope for migration to the high CLV segment. Consequently, the firm should offer rewards directed at maintaining the customer's current level of spending. Marketing initiatives aimed at relationship building or cultivation of attitudinal loyalty should be limited to a fraction of CLV for these customers owing to their low SUW. However, the medium CLV customers of Segment 4 tell a different story. These customers offer great potential for CLV augmentation through up-sell and cross-sell initiatives. Consequently, firms

[5] Source: Colloquy Talk, Paper 6.03, July 2003.

should focus their marketing initiatives towards buying more products from the firm or spending more on the existing products. For example, New York & Company selectively targets its customers and sends a discount coupon that offers $25 off purchases worth $75 or more. Cox Communications offers its customers a steep discount if they purchase all three services offered by the company viz. high-speed Internet, digital cable and digital phone line. Clearly, such marketing initiatives are directed at inducing cross-sell and up-sell. If the high SUW customers of Segment 4 do not respond favorably to the firm's effort of up-sell and cross-sell, then the firm should reduce its marketing cost on such customers and instead focus on deriving profits from every transaction of these customers with the firm.

Managing low CLV customers: Segments 5 and 6

Segments 5 and 6 represent low CLV customers. Firms typically view these customers as a drain on the company's resources. Companies like Sprint Nextel view these customers as misfits and prefer to fire them (as discussed in the earlier section of the paper). From the business standpoint, the action of Sprint Nextel might make commercial sense. However, we are not sure whether Sprint made the decision to get rid of its customers based on the past value or the future value of its customers. Even if the decision was taken by looking at the expected the future value of the customer, Sprint may have missed out on evaluating the CLV (or the future value of the customer) along the customer's overall potential to provide more business in future. For example, a customer in Segment 6 having low CLV but high SUW could prove to be a great candidate for up-sell and cross-sell marketing initiatives. Our recommendation is that firms should aggressively roll out up-sell and cross-sell marketing initiatives to customers in this segment. However, such an approach can backfire if the customer's SUW is perceived to be low. In such a scenario, losing a customer may be relatively more profitable than over-spending on marketing programs for customers in this segment. Nevertheless, the decision of Sprint to fire its unprofitable customers was a drastic measure and can invite the wrath of other customers or potential new customers through bad word of mouth or negative publicity in the press. A more feasible approach would be to reduce transaction cost. For example, customers in this segment may be migrated to low cost transaction channels such as the Internet.[6] Alternatively, firms may strive to profit from every transaction for customers in this segment by minimizing or eliminating virtually all investments in relationship building initiatives for these customers.

Future directions

The reverse logic framework advocates discrimination of marketing initiatives based on the future value/potential of the customer. This entails allocating greater marketing resources towards high value customers at the expense of low value customers. Recent empirical studies have shown the beneficial impact to the firm in terms of increase in firm profitability. However, it is not clear whether and to what extent such a marketing approach can have some unintended consequences on a certain set of customers. For example, the framework advocates providing higher levels of customer satisfaction and experience to only high value potential customers. Could such discrimination antagonize the low value potential customers? Consequently, what if the low value customers engage in negative word of mouth and deter acquisition of their friends and relatives who could have been potentially high value customers? These are interesting questions that need to be investigated in further research. This is especially important given the fact that we have seen real world instances where firms like Sprint Nextel have fired their loss-making customers. The long-term implication of such marketing actions needs to be carefully studied and addressed in future research.

Our proposed framework is strongly rooted in the tenets of customer relationship management and hence enforces a strong focus on customer value as the basis for all marketing decisions (Kumar 2008a). Consequently, effective implementation of the framework can pose certain organizational and people related challenges. This is particularly true in the case of large old firms that are still internally organized around products and not customers or customer segments (Shah et al. 2006). In such a scenario, several implementation related problems could arise. For example, the practice of selective up-selling and cross-selling to only high value/potential customers could conflict with the individual product sales managers who would rather push their products to every customer possible than miss their sales target. Similarly, the concept of selectively building loyalty and subsequently delighting select customers could conflict with different departments who may view the customer through the lens of their own division or department alone and not from the company's standpoint. For example, a high net worth bank customer having a large investment trading account with the bank but zero balance on the bank's credit card may not be treated as warmly by the credit card department. Another issue could arise in the form of customer ownership and sales incentive structure. Consider the case where a customer initiated the relationship with a firm due to the persistent effort of sales manager A. Subsequently, pleased with the service and approach of sales manager A, the customer ends up buying additional products and services of higher value from sales managers B and C. In such a scenario, who owns the primary ownership of managing the relationship with the customer? More importantly, does the sales manager A get any additional incentive for being indirectly responsible for the customer buying products from sales managers B and C? Such issues are often overlooked and hence need to be investigated and addressed in future research to ensure successful implementation of the reverse logic framework.

Finally, future researchers can explore different ways to extend and refine the proposed reverse logic framework. For instance, recently, there has been an increasing number of

[6] For in-depth discussion on strategies for multiple channels, including the mobile channel, see Neslin and Shankar (2009), Ratchford (2009), and Shankar and Balasubramanian (2009).

research studies (e.g., Kumar and Shah forthcoming) that have attempted to link marketing activities to firm value (as measured by the stock price or an equivalent metric). An interesting and valuable extension of this framework would be to include a linkage to firm value. For example, Gupta, Lehmann, and Stuart (2004) have already showed a relationship between customer equity and firm value. Consequently, one possible way to improve the proposed framework could be by justifying a linkage between the future value of the customer and some measure of firm value such as the stock price. Inclusion of such a linkage could serve to link tactical customer level marketing initiatives (such as cross-selling and up-selling) to a more strategic and higher order metric such as the stock price. The implications could have a far reaching effect towards making marketing more accountable as well as elevating the relative importance of the marketing organization in general.

Conclusion

The conventional path to profitability has dominated the corporate landscape for several years. However, the conventional path comprises links that are weak or questionable. Recent research has introduced a powerful metric to the marketing world — CLV. This metric has proved its superiority at selecting and managing customers for maximizing firm's profits. Our reverse logic framework is firmly grounded on the philosophy and principles of the CLV metric (Kumar, 2008b). In the new framework, the CLV is the starting point for all subsequent customer relationship management decisions. Consequently, our proposed new path to profitability reverses the direction orientation of the conventional path to profitability. Does this make sense? Would such a framework really work in the real world? For example, IBM implemented the CLV metric and deployed CRM strategies based on the CLV metric. The outcome was an incremental profit of about $20 Million (Kumar et al., 2008). Moving forward, we expect the RLF based on the CLV metric to prevail as the most effective framework to manage customer profitability in the twenty-first century.

Acknowledgment

The authors thank Renu for copyediting the manuscript.

References

Anderson, Eugene W. and Vikas Mittal (2000), "Strengthening the Satisfaction–Loyalty–Profitability Chain," *Journal of Service Research*, 3 (2), 107–20.

Armstrong, Gary and Philip Kotler, (2008), *Marketing: An Introduction* (9th ed.). Upper Saddle River, NJ: Prentice Hall.

Atuahene-Gima, Kwaku (2005), "Resolving the Capability–Rigidity Paradox in New Product Innovation," *Journal of Marketing*, 69 (October), 61–83.

Berger, Paul D. and Nada I. Nasr (1998), "Customer Lifetime Value: Marketing Models and Applications," *Journal of Interactive Marketing*, 12 (1), 17–30.

Blattberg, Robert C. and John Deighton (1996), "Manage Marketing by the Customer Equity Test," *Harvard Business Review*, 74 (4), 136–44.

Blattberg, Robert, Edward Malthouse and Scot Neslin (2009), "Customer Lifetime Value: Empirical Generalizations and Some Conceptual Questions," *Journal of Interactive Marketing*, 23 (2), 157–68.

Bolton, Ruth N. (1998), "A Dynamic Model of the Duration of the Customer's Relationship with a Continuous Service Provider: The Role of Satisfaction," *Marketing Science*, 17 (1), 45–65.

Bolton, Ruth N. and Katherine N. Lemon (1999), "A Dynamic Model of Customers' Usage of Services: Usage as an Antecedent and Consequence of Satisfaction," *Journal of Marketing Research*, 36 (May), 171–99.

Capraro, Anthony J, Susan Broniarczyk, Rajendra K Srivastava (2003), "Factors influencing the likelihood of customer defection: The role of consumer knowledge," *Journal of the Academy of Marketing Science*, 31 (2), 164–76.

Gupta, Sunil (2009), "Customer-based Valuation," *Journal of Interactive Marketing*, 23 (2), 169–78.

Gupta, Sunil, Donald R. Lehmann, and Jennifer Ames Stuart (2004), "Valuing Customers," *Journal of Marketing Research*, 41 (1), 7–18.

Homburg Christian and Annette Giering (2001), "Personal characteristics as moderators of the relationship between customer satisfaction and loyalty - An empirical analysis," *Psychology & Marketing*, 18 (1), 43–57.

Jain, Dipak and Siddhartha S. Singh (2002), "Customer Lifetime Value Research in Marketing: A Review and Future Directions," *Journal of Interactive Marketing*, 16 (2), 34–46.

Kumar, V. (2008a), *Managing Customers for Profit,* The Wharton School Publishing, Philadelphia, PA.

——— (2008b), *Customer Lifetime Value: The Path to Profitability,* now Publishers, The Netherlands.

——— and Denish Shah (2004), "Building and Sustaining Profitable Customer Loyalty for the 21st Century," *Journal of Retailing*, 80 (4), 317–29.

——— and J. Andrew Petersen (2005), "Using a Customer-level Marketing Strategy to Enhance Firm Performance: A Review of Theoretical and Empirical Evidence," *Journal of the Academy of Marketing Science*, 33 (4), 504–19.

———, Girish Ramani, and Timothy R. Bohling (2004), "Customer Lifetime Value Approaches and Best Practice Applications," *Journal of Interactive Marketing*, 18 (3), 60–72.

———, Denish Shah (forthcoming), "From Customer Equity to Market Capitalization: Expanding the Scope of Marketing," *Journal of Marketing*.

———, Denish Shah, and Rajkumar Venkatesan (2006), "Managing Retailer Profitability — One Customer at a Time!" *Journal of Retailing*, 82 (4), 277–94.

———, Rajkumar Venkatesan, Timothy Bohling, and Denise Beckmann (2008), "The Power of CLV: Managing Customer Value at IBM," *Marketing Science*, 27 (4), 585–99.

Neslin, Scott A. and Venkatesh Shankar (2009), "Key Issues in Multichannel Management: Current Knowledge and Future Directions," *Journal of Interactive Marketing*, 23 (1), 70–81.

Oliver, Richard L. (1980), "A Cognitive Model of the Antecedents and Consequences of Satisfaction Decisions," *Journal of Marketing Research*, 17 (4), 460–9.

Parasuraman, A., Valarie A. Zeithaml, and Leonard L. Berry (1985), "A Conceptual Model of Service Quality and its Implications for Future Research," *Journal of Marketing*, 49 (3), 41–50.

Ratchford, Brian T. (2009), "Online Pricing: Review and Directions for Future Research," *Journal of Interactive Marketing*, 23 (1), 82–90.

Reichheld, Frederick F. (1996), *The Loyalty Effect.* Boston, MA: Harvard Business School Press.

Reinartz, Werner and V. Kumar (2000), "On the Profitability of Long-life Customers in a Noncontractual Setting: An Empirical Investigation and Implications for Marketing," *Journal of Marketing*, 64 (4), 17–35.

——— and V. Kumar (2002), "The Mismanagement of Customer Loyalty," *Harvard Business Review*, 80 (7), 86–94.

——— and V. Kumar (2003), "The Impact of Customer Relationship Characteristics on Profitable Lifetime Duration," *Journal of Marketing*, 67 (1), 77–99.

———, Jacquelyn S. Thomas, and V. Kumar (2005), "Balancing Acquisition and Retention Resources to Maximize Customer Profitability," *Journal of Marketing*, 69 (1), 63–79.

Rust, Roland T., Katherine N. Lemon, and Valarie A. Zeithaml (2004), "Return on Marketing: Using Customer Equity to Focus Marketing Strategy," *Journal of Marketing*, 68 (1), 109–27.

Shah, Denish, Roland T. Rust, A. Parasuraman, Richard Staelin, and George S. Day (2006), "The Path to Customer Centricity," *Journal of Service Research*, 9 (2), 113–24.

Shankar, Venkatesh and Sridhar Balasubramanian (2009), "Mobile Marketing: A Synthesis and Prognosis," *Journal of Interactive Marketing*, 23 (2), 118–29.

———, Amy K. Smith, and Arvind Rangaswamy (2003), "Customer Satisfaction and Loyalty in Online Environments," *International Journal of Research in Marketing*, 20, 153–75.

Vargo, Stephen L. and Robert F. Lusch (2004), "Evolving to a New Dominant Logic for Marketing," *Journal of Marketing*, 68 (1), 1–17.

Venkatesan, Rajkumar and V. Kumar (2004), "A Customer Lifetime Value Framework for Customer Selection and Resource Allocation Strategy," *Journal of Marketing*, 68 (4), 106–25.

Yu, Larry (2002), "Does Diversity Drive Productivity," *MIT Sloan Management Review*, 43 (2), 17.

Zeithaml, Valarie A., Ruth N. Bolton, John Deighton, Timothy L. Keiningham, Katherine N. Lemon, and J. Andrew Petersen (2006), "Forward Looking Focus: Can Firms have Adaptive Foresight?" *Journal of Service Research*, 9 (2), 168–83.