Week 6 – CUSTOMER CENTRICITY:

How Can Customer Centricity be Profitable?

How Can Customer Centricity be Profitable?

Customer Centricity: Focus on the Right Customers for Strategic Advantage

The traditional product-centric business model is showing some cracks
- Commoditization, well-informed customers, globalization…

Customer centricity is a promising alternative but is not clearly understood
- Many firms that are touted to be customer centric really aren't

Celebrate customer heterogeneity: distinguish the profitable customers from the less profitable ones
- Emerging metrics such as Customer Lifetime Value (CLV) make this possible

Show me the Money!

Customer centricity can lead to improved profitability through greater effectiveness/efficiency in:
- Customer acquisition
- Customer retention
- Customer development

You can't expect to be world-class on all three dimensions, but doing very well at even one of these could be highly lucrative for the company as a whole. But mastering each of these critical functions is a lot trickier than you think…

Mo Money

Balancing acquisition, retention and development requires considerable skill (and tactical insight).

If you had an extra dollar to spend, which of these activities would you allocate it to?
- 5% of companies spend it on acquisition
- 95% of companies spend it on retention/development

Let's examine each tactic separately in order to learn the answer…

Customer Acquisition

What metric is used by most firms to gauge and guide their acquisition activities?

- CPA = Cost Per Acquisition
- Big mistake!
- Customers are assets! Would you use CPA for other kinds of acquisition activities: employees, technology, lawyers…?
- Firms should focus instead on: VPA = Value Per Acquisition → Which is CLV!

Measuring the Lifetime Value of Customers Acquired from Google Search Advertising

Tat Y. Chan, Chunhua Wu, Ying Xie
Olin Business School, Washington University in St. Louis, St. Louis, Missouri 63130
{chan@wustl.edu, chunhuawu@wustl.edu, xie@wustl.edu}

Our main objective in this paper is to measure the value of customers acquired from Google search advertising accounting for two factors that have been overlooked in the conventional method widely adopted in the industry: (1) the spillover effect of search advertising on customer acquisition and sales in off-line channels and (2) the lifetime value of acquired customers. By merging Web traffic and sales data from a small-sized U.S. firm, we create an individual customer-level panel that tracks all repeated purchases, both online and off-line, and tracks whether or not these purchases were referred from Google search advertising.

To estimate the customer lifetime value, we apply the methodology in the customer relationship management literature by developing an integrated model of customer lifetime, transaction rate, and gross profit margin, allowing for individual heterogeneity and a full correlation of the three processes. Results show that customers acquired through Google search advertising in our data have a higher transaction rate than customers acquired from other channels. After accounting for future purchases and spillover to off-line channels, the calculated value of new customers using our approach is much higher than the value obtained using conventional method. The approach used in our study provides a practical framework for firms to evaluate the long-term profit impact of their search advertising investment in a multichannel setting.

Key words: customer lifetime value; multiple-channel shopping; customer acquisition; sponsored search advertising
History: Received: August 8, 2010; accepted: April 25, 2011; Eric Bradlow and then Preyas Desai served as the editor-in-chief and Peter Fader served as associate editor for this article. Published online in *Articles in Advance* August 25, 2011.

> "Customers acquired from Google on average have a higher lifetime value (mean CLV at $1,002) than customers acquired from other channels (mean CLV at $808). The difference is even larger for those whose first-time purchase was off-line (mean CLV at $1,226 versus $959, respectively)…"

You have to constantly "tag" your customers, to accumulate datas, so that you can understand the best sources of value.

<u>Customer Acquisition Summary</u>

- ✓ **Avoid having a "CPA mentality":** focus on ceilings instead of floors…
- ✓ **Celebrate heterogeneity:** by using CLV to drive acquisition strategies and tactics
- ✓ **Be more patient/forward-looking:** when judging acquisition efforts
- ✓ **Firms tend to underspend:** in customer acquisition

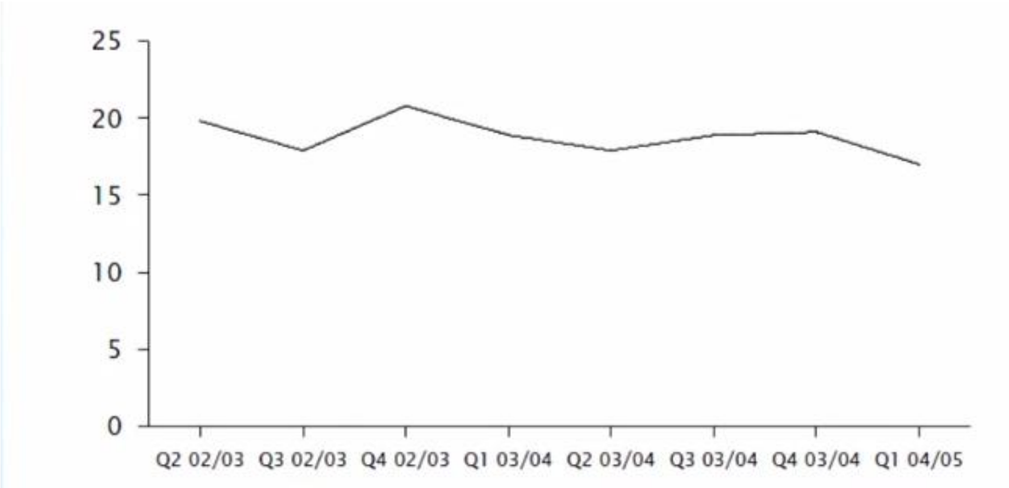
Customer Retention

Customer Retention

What metric is used by most firms to gauge and guide their retention activities?

- Churn/attrition rate (or retention rate) = How many customers stay with us/leave?
- This is a good metric, but you need to examine it at the right level…

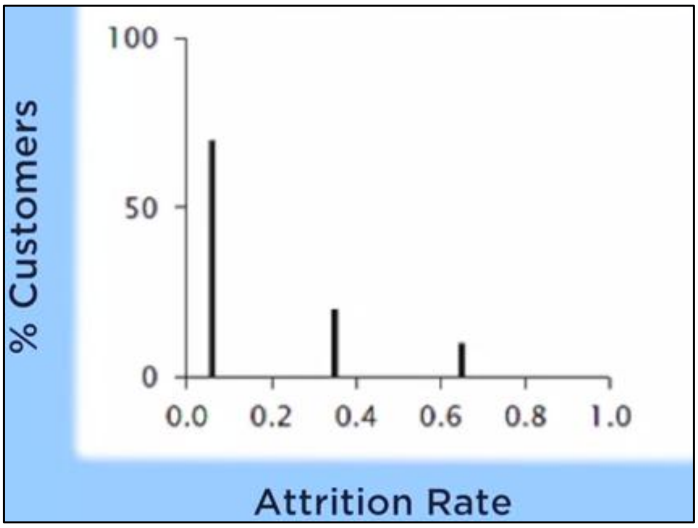
Example with Vodafone:



Their attrition rate is around 20%, it means they lose 20% of their customers in that period of one year. So the lifetime of a customer is around 5 years.

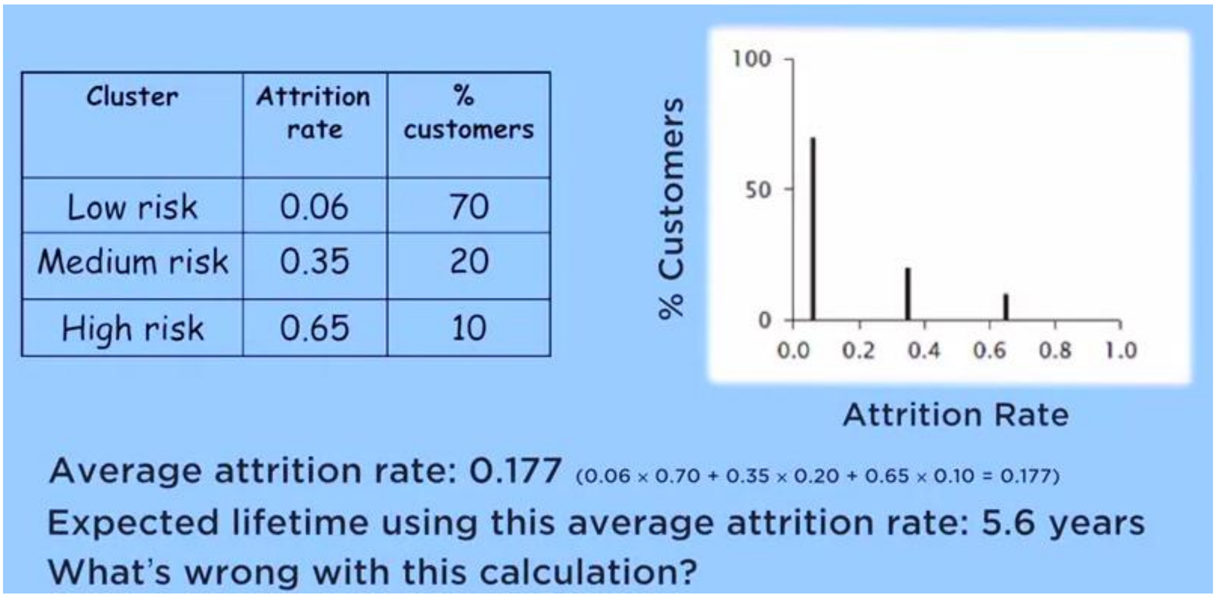
What's wrong with that information?

We don't see how the attrition is distributed across the customer base!
Example with Vodafone: it's very typical for every business with contracts!
Attrition rate = chances that the customer will leave Vodafone



- A big group of customers is very loyal to the brand and don't want to leave.
- A medium group doesn't really care and could leave, no matter how good the marketing is.

<u>Translation to CLV</u>



We find the same results as above, with the average lifetime of customer, but it's not a good way to approach things!

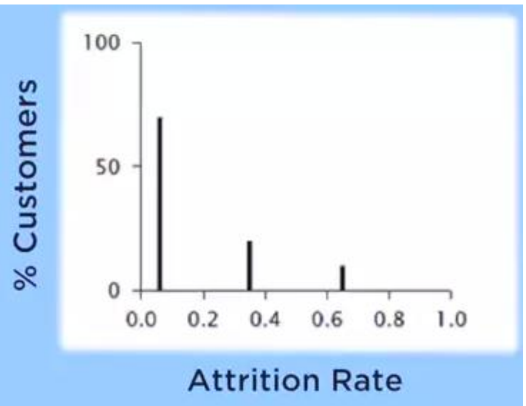
There is no average customer!

Ho w can we truly celebrate heterogeneity?

<u>The key insight</u>

> "Because we can't get accurate calculations with averages, we must work with the actual rates for each separate class of customers."
>
> REICHHELD, "The Loyalty Effect"

Cluster	Attrition rate	% customers	Expected lifetime
Low risk	0.06	70	16.7
Medium risk	0.35	20	2.9
High risk	0.65	10	1.5



Average attrition rate: 0.177 (0.06 × 0.70 + 0.35 × 0.20 + 0.65 × 0.10 = 0.177)

Expected lifetime using this average attrition rate: 5.6 years

Correct average lifetime: 12.4 years (16.7 × 0.70 + 2.9 × 0.20 + 1.5 × 0.10 = 12.4)

Every time you ignore customer heterogeneity, you leave money on the table!

Customer Retention: Summary

- ✓ **There is no "average" customer:** calculations based on such a notion will always underestimate the value of a customer base, the difference can be huge!
- ✓ **When heterogeneity is accounted for, the "attrition elasticity" is much lower than in the homogeneous case:** investments in reducing attrition will have more modest returns than expected!
- ✓ **Some companies spend too much on retention:** because they spend on customers that have a high attrition rate! Instead, they could spend on customer acquisition, to acquire customers with low attrition rate!

Customer Development

Customer Development

Main idea: make your existing customers as valuable as possible!

Efforts to increase the profitability of current customers:

- **Cross-selling:** purchasing additional products/services ("do you want fries with that", featured products on Amazon…)
- **Up-selling:** to higher-level services/products ("would you like the bigger menu for just 1$ more?")
- **Increasing the frequency/volume** of purchases of current products
- **Premium pricing:** perhaps bundled with special services…

What metric is used by many firms to gauge and guide their development activities?

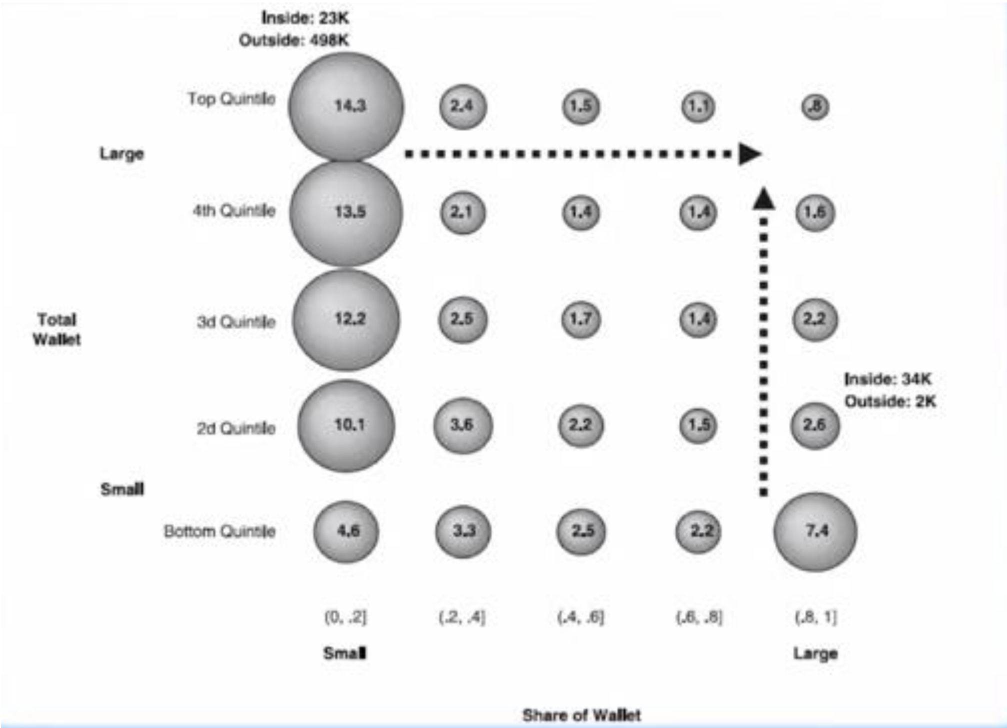
- Share of wallet = how many of the firm's products are used to respond to a particular need
- This is a descent metric, but it doesn't tell the whole story…

Rex Yuxing Du, Wagner A. Kamakura, & Carl F. Mela

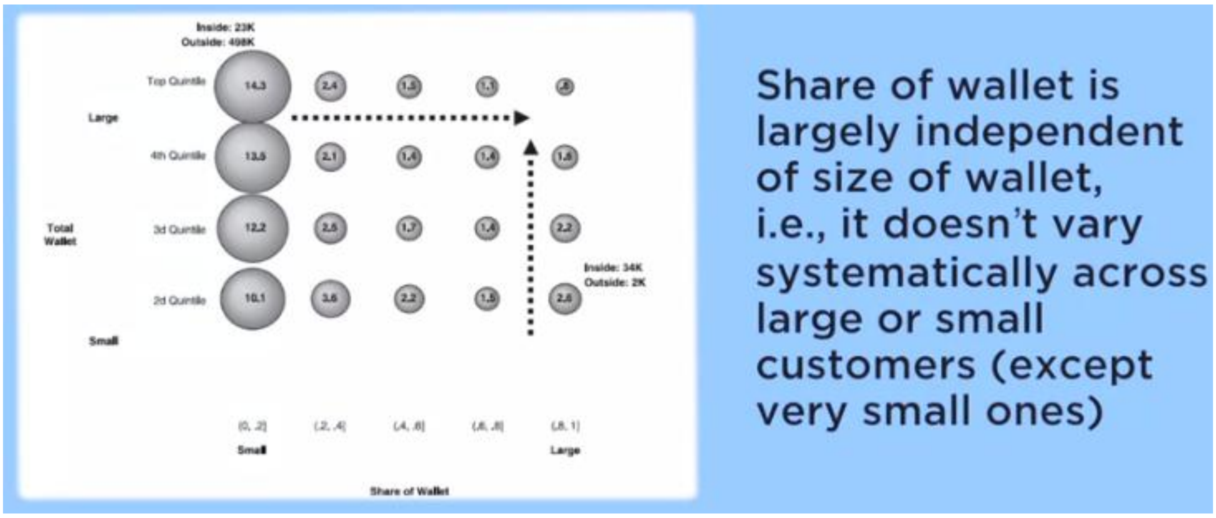
Size and Share of Customer Wallet

Many companies collect substantial information about their interactions with their customers. Yet information about their customers' transactions with competing firms is often sparse or nonexistent. As a result, firms are often compelled to manage customer relationships from an inward view of their customers. However, the empirical analysis in this study indicates that (1) the volume of customers' transactions within a firm has little correlation with the volume of their transactions with the firm's competitors and (2) a small percentage of customers account for a large portion of all the external transactions, suggesting the considerable potential to increase sales if these customers can be correctly identified and incentivized to switch. Thus, the authors argue for a more outward view in customer relationship management and develop a list augmentation–based approach to augment firms' internal records with insights into their customers' relationships with competing firms, including the size of each customer's wallet and the firm's share of it.

Analysis of a Major US Bank



Customers who have a very small wallet size put all their eggs in one basket! Customers with low value, low CLV, have a high share of wallet.



The Good News and Bad News about Cross-Selling

"Customers with high share in one category also tend to have high share in another category, indicating that customers' share decisions are positively correlated…"

Customer Development: Summary

- ✓ It is useful to look for development opportunities: but the upside to these activities is more limited than most managers think
- ✓ Due to massive customer heterogeneity, there is more opportunity to "move the needle" via acquisition than development
- ✓ Development is "icing on the cake"
- ✓ The goal is not to change the customers, but to unlock the value in the most valuable ones.

Balancing Acquisition, Retention and Development

If you had an extra dollar to spend, which of these activities would you allocate it to?

Not to minimize the importance of retention and development, but at the margin I favor acquisition…

There are exceptions, especially in saturated markets!

Consider the conventional wisdom:

"It costs 5-10 times more to acquire a new customer than to retain one, so work hard to keep the ones you have"

This may be true, but it totally misses the point: **focus on value instead of costs**!

Overall Summary

- ✓ Customer centricity can only succeed by "celebrating heterogeneity"
- ✓ The greatest upside to improve customer profitability arises through "smart acquisition"
- ✓ Don't overspend on retention – the flighty customers will fly away no matter what you do (or they'll be unprofitable)
- ✓ View development as "icing on the cake."Attempting to turn persistent "detractors" into "promoters" is a difficult task, and the resources required to do so can be better invested elsewhere
- ✓ Don't have blind faith in the conventional wisdom about these tactics

Wrap up

Making Customer Centricity profitable

- Regularly calculate/estimate individual CLV (Customer Lifetime Value): about customers, distributors…
  - You have to gather the datas on a regular basis (daily, monthly, quarterly…)
- Break customers into segments based on relevant characteristics (time/nature of acquisition) and calculate the CLV of these segments
- Allocate retention/development resources appropriately – create and target marketing communications based on segment characteristics
- Constantly experiment with these tactics (and analyze results at the customer/segment level)
- Use these "bottom up" perspectives to drive product-line decisions (and possible new service offerings)
- Identify which segments are the best "role models" for future acquisition activities
- **Repeat these steps on a periodic basis! It's not a onetime process.**

Example: Harrah's Casinos describe their best customers as "wells"

You have to know that if you find the best customers, your competitors are going to find them too by using your information.

The companies that do the best with customer centricity:

- Experiment
- Are patient
- Fail and try again
- Accumulate datas about their customers
- Invest efforts in the long run
- Evaluate on a regular basis

CONCLUSION

1. **Cracks in product centricity:** the list of the cracks is going to be bigger and bigger
2. **Focus on the right customers:** customer centricity is not about providing the best service ever to every customer. Find the right balance between rolling out the red carpet for everybody and trying to be everybody's best friend all the time.
3. **Paradox of customer centricity:** don't forget regular customers. You have to focus on the best customers, but you have to deliver good service to regular ones.
4. **Celebrate customer heterogeneity:** analyze the differences between your customers to focus your efforts on the right ones. Don't spend too much on retention of "bad customers", prefer spending on acquisition of good customers.
5. **Think long term:** consider the CLV, not the CPA.
6. **Experiment:** Try experiment and figure out what are the best strategies.
7. **Not for everyone:** not all firms are made to be customer centric.