Manage Marketing by the Customer Equity Test

by Robert C. Blattberg and John Deighton

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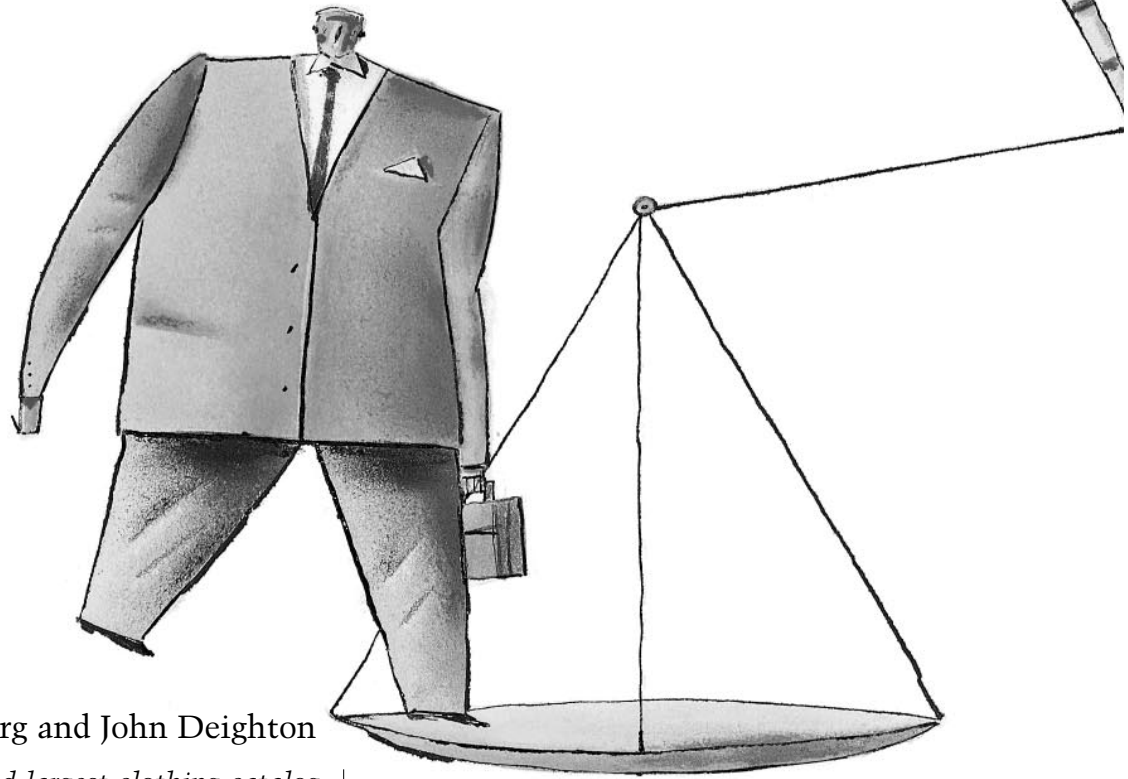
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Attracting and keeping the highest-value customers is the cornerstone of a successful marketing program.

Manage Marketing by

by Robert C. Blattberg and John Deighton

□ *Lands' End, the second-largest clothing catalog retailer in the United States, operates with unusually high inventory levels. Its managers would rather inflate inventory than fail to fill an order and risk losing a customer. "If we don't keep the customer for several years, we don't make money," said the company's CEO at the time, William End, in 1994. "We need a long-term payback for the expense of coming up with a buyer."*

□ *The main goal of McDonald's Corporation's 1995 marketing plan was to get its current customers to eat at its restaurants more often. The corporation's managers noted the value of what they call "super-heavy" users—typically males aged 18 to 34 who eat at McDonald's an average of three to five times a week and account for 77% of its sales—and they planned their marketing efforts accordingly. A senior executive offers the general rule that it is "easier to get a current customer to use you more often than it is to get a new customer."*

There is a curious similarity in the way managers at Lands' End and McDonald's articulate marketing goals. They each talk not about selling products but about keeping customers. The traditional rhetoric of customer orientation has taken on a sharper definition, in which growing the business is a matter of spending to capture the attention of high-value prospective customers and then staying with them until they are converted and retained in committed—and therefore relatively low-maintenance—relationships. For Lands' End, this style of talk is not unexpected; it is the language of direct mail. But it is also becoming increasingly common at businesses whose methods of going to market are by no means limited to the mail.

At a time when marketing methods are becoming more interactive, from frequent-user-club services to ID-card-operated kiosks to Web pages, it is not surprising that marketing talk is beginning to sound like direct-marketing talk. When most marketing communication primarily involved broad-

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the Customer Equity Test
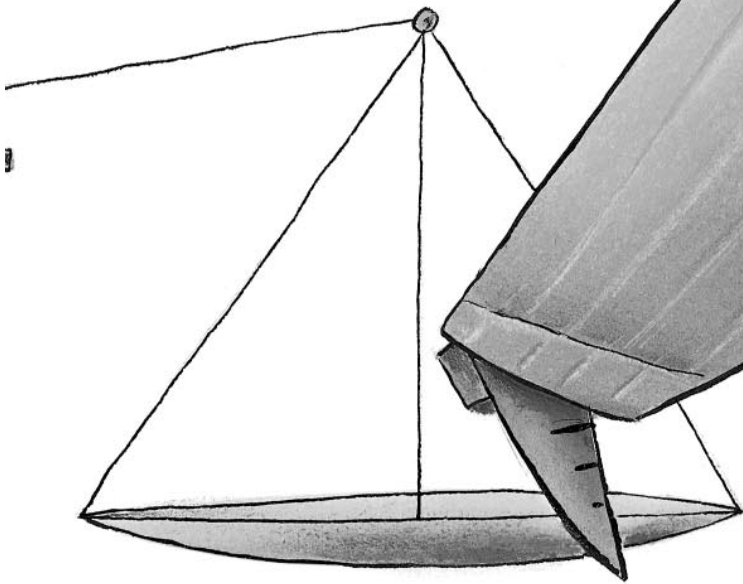
cast technologies, marketers set goals that broadcast marketing could achieve: increased share of voice or market and higher awareness and recall of products by consumers. As communication tools become interactive, marketing managers talk more about goals that pertain to individual relationships, such as share of customer requirements, customer-contact outcomes, and customer satisfaction measures. Managers have begun to think of good marketing as good conversation, as a process of drawing potential customers into progressively more satisfying back-and-forth relationships with the company. Just as the art of conversation follows two separate steps – first striking up a conversation with a likely partner and then maintaining the flow – so the new marketing naturally divides itself into the work of acquiring customers and the work of retaining them.

Growing a business can therefore be framed as a matter of getting customers and keeping them so as to grow the value of the customer base – the sum of all the conversations – to its fullest potential. In these terms, setting a marketing budget becomes the task of balancing what is spent on customer acquisition with what is spent on retention.

Clearly, not every company wants to balance acquisition and retention at the same point. In some industries, such as low-end, used-car retailing, to take an extreme example, retention strategies have no leverage, because the intrinsic "retainability" of customers is simply too low. In others, the relative importance of retention changes as the industry evolves. How can managers determine the optimal balance between acquisition and retention for their particular companies?

The criterion we propose for determining the optimal balance is the company's customer equity. The balance is optimal when customer equity is at its maximum amount. To measure that equity, we first measure each customer's expected contribution toward offsetting the company's fixed costs

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over the expected life of that customer. Then we discount the expected contributions to a net present value at the company's target rate of return for marketing investments. Finally, we add together the discounted, expected contributions of all current customers.

Appraising customer equity is conceptually similar to appraising the value of a portfolio of income-producing real estate. Two of its main determinants

The appropriate question for judging new products and customer service initiatives is, Will it grow our customer equity?

are the cost of acquiring customers and the future profit stream from retained customers. But a host of other factors, including remarketing costs and brand strategy, can also have significant influence.

Ultimately, we contend that the appropriate question for judging new products, new programs, and new customer-service initiatives should not be, Will it attract new customers? or, Will it increase our retention rates? but rather, Will it grow our customer equity? The goal of maximizing customer equity by balancing acquisition and retention efforts properly should serve as the star by which a company steers its entire marketing program.

Finding the Balance

To use customer equity as the criterion that balances spending on getting and keeping customers, we need to express it as the sum of two net present values: the returns from acquisition spending and the returns from retention spending. We use a tool called *decision calculus* to build a model of this relationship by creating two curves. The first curve relates acquisition spending to the resulting acquisition rate, and the second curve relates retention spending to the resulting retention rate. These curves characterize the company and its industry.

What is decision calculus? It is an approach to decision making in which a manager breaks down a complex problem into smaller, simpler elements, forms judgments about each element separately, and then uses a formal model to turn those small judgments into an answer to the larger question. Studies have shown that people can predict simple events better than complex ones, and models are

better than people at combining simple predictions to address a larger issue. The result of using decision calculus is only as good as the managers involved in the process, but the tool allows managers and models to do what they do best in the face of a complex dilemma.

In this case, we approach the larger question – What is the optimal balance between customer acquisition and customer retention at my company? – by asking several smaller questions about acquisition and retention. The curves we will create reveal the points at which a company is spending more than a customer is worth to acquire or retain. Those points, along with consideration of several other factors, show managers how their acquisition and retention efforts should be balanced.

Let's look at a practical example, using, for ease of description, a case in which a company markets a single product that customers buy once or twice a year. By keeping the case simple, complications – such as the problem of accounting for ancillary sales or of allocating the effect of one marketing investment to more than one product – will not distract from the essence of the process. Amending the method later to accommodate refinements will be a straightforward task.

We have chosen to work with a product that is purchased at least once a year to make it practical to express retention rates on a per-year basis. If customers' purchase cycles are longer than a year, as they are with automobiles and other durables, it is better for managers to estimate retention rates on a per-cycle basis.

Finally, and again simplifying for the sake of exposition, we gloss over the question of the lapsed customer. If a customer is not retained, we will assume that the cost of reactivating that customer will be the same as the cost of acquiring a prospect. In practice, it usually costs less.

We begin by estimating the shape of the company's acquisition curve. To do this, we ask the manager to provide two points on the curve: first, the company's current level of acquisition and second, the ceiling – the highest possible number of customers the company could reasonably acquire in a given time period. (Acquisition and retention do not increase without limit as spending increases. There is a ceiling, which will vary from industry to industry. For example, the ceiling is much lower for a property and casualty insurance company using direct mail to acquire new customers than it is for the average catalog retailer. Similarly, the retention

ceiling for banks is generally high because the relationship between the customer and the bank becomes more complex over time with the addition of direct deposit, loans, and so forth. On the other hand, in the automotive industry, even the strongest brands have low retention ceilings. On average, manufacturers seldom induce more than 40% of buyers to purchase the same brand of automobile on two successive occasions.)

We first ask the manager, What did you spend last year to attract prospects? To figure out what was spent per prospect, estimate how many prospects were converted into customers. What proportion of the prospect pool was converted?

The manager answers, We spent $5 per prospect to attempt to induce a first transaction, and we succeeded 20% of the time.

Then we ask, If for all practical purposes there had been no limit to spending, what proportion of the prospects that you targeted over the course of the last year could have been converted?

The manager answers, I don't think we could ever induce more than 40% of our prospect pool to become first-time customers.

Those answers are all that is needed to decide on the optimum amount to spend to acquire a customer. (For an explanation of the calculations involved, see the insert "Calculating the Optimal Level of Acquisition Spending.") First, we use the answers to generate a curve showing how the acquisition rate varies with spending on acquisition. The

curve has a characteristic "diminishing returns" shape. (See the graph "How First-Year Value Depends on Acquisition Spending.") Second, we use that curve, with no further information except the margin generated by a customer in a year, to compute the U-shaped curve in the upper half of the graph. That second curve depicts how the average value of acquired customers in the first year varies with spending on acquisition, first growing as the company attracts eager buyers and then declining as it goes after more reluctant prospects who require more expensive wooing. The peak of that curve tells us at what point to stop acquiring.

We now need a second dialogue to elicit the manager's insight into the shape of the retention curve. We begin by asking the manager, What did you spend last year on retention activities? Divide that amount by the number of customers you had at the start of that year to get the retention expenditure per customer. What proportion of your customers did you succeed in keeping for the year?

The manager answers, Last year, we spent at the rate of $10 per customer and retained 40% of the customer base.

Then we ask, If your budget had been unlimited, what proportion of customers in one year would have remained customers in the following year?

The manager answers, At best, we might retain 70% of our customers from one year to the next.

Those answers give us the other side of the balance point between acquisition and retention. (See

Calculating the Optimal Level of Acquisition Spending

Here we describe how to compute an organization's optimal level of acquisition spending, using the manager's answers to the acquisition questions: How much did you spend, and what is the limit to your attraction of new customers? The answer to the first question gives us $A, the acquisition expenditure per prospect, and a, the acquisition rate obtained as a result of that expenditure. The answer to the second question gives us the ceiling rate on the acquisition curve. If we assume that the curve is exponential (an assumption that is supported by our experience), then the curve of the actual acquisition probability as pictured in the lower half of the graph "How First-Year Value Depends on Acquisition Spending" is described by the equation

$$a = \text{ceiling rate} \times [1 - \exp(-k_1 \times \$A)]$$

where k is a constant that controls the steepness of the curve. Thus, knowing the two points on this curve and the ceiling rate – as given to us by the manager – we can solve the equation to find k.

Next, we compute the contribution from an acquired customer in the first year after acquisition (see the upper curve in the graph). If the margin on a transaction is $m, then

the net contribution from acquiring a prospect in the first year = $a\$m - \$A$.

Note that this quantity need not be positive; it may be that the optimum amount to spend to acquire a customer is more than the contribution generated by that customer in the first year. Whether a marketer should acquire a customer at a loss can be judged only when the retention returns have been calculated.

How First-Year Value Depends on Acquisition Spending

A customer's value in the first year is maximized when the acquisition budget is optimal.

Customer value in the first year

$6
5
4
3
2
1
0

0   5   10   15 $20

acquisition budget

The peak of the value curve in the first year...

Acquisition rate

10%
20
30
40

optimal acquisition level

...is set by the shape of the acquisition curve.

acquisition rate limit
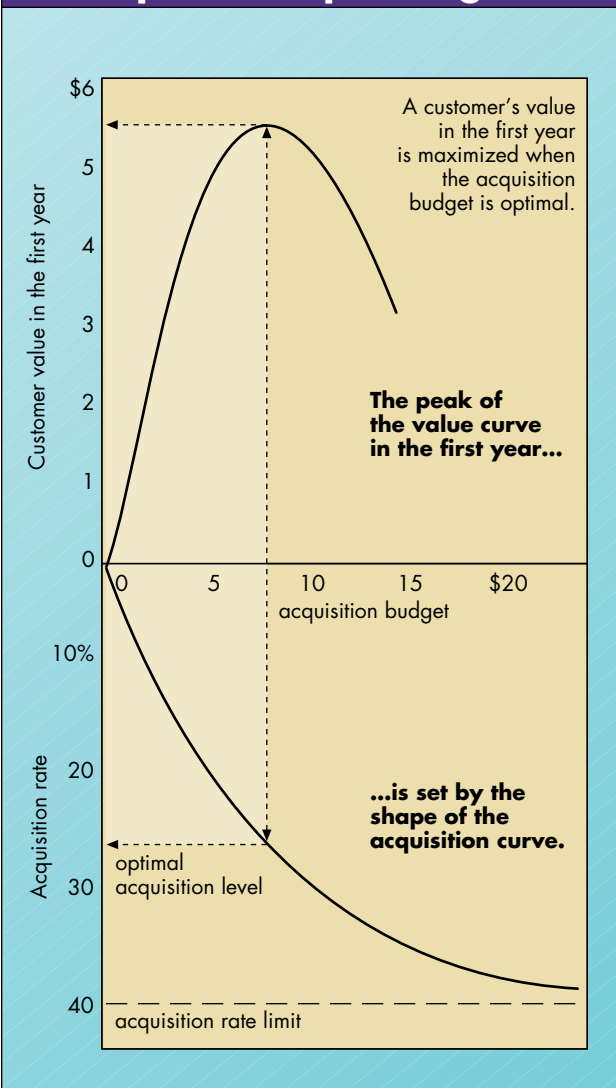
the insert "Calculating the Optimal Level of Retention Spending.") We use the answers first to generate a curve that relates retention spending to success at retention. (See the graph "How Customer Equity Depends on Retention Spending.") Again, the curve reflects the diminishing returns in efforts to retain customers. Next, we generate the curve in the upper half of the graph, a curve that grows as retention spending gives the customer more reasons to remain loyal, and then declines as customers no longer value the retention service enough to cover its cost.

Despite the simplicity of this example, it illustrates how the decision-calculus process – in this case, using four small, explicit decisions and a model to solve one large, messy problem – can pay off. Do this manager's actions coincide with his or her intui-

tions? Are the current spending levels consistent with the curves he or she believes apply in this market? Here, as we find in many of our real-world applications, breaking down the problem into components has helped, and either intuition or current practice needs to be updated if the manager is to be consistent. The actual expenditures of $5 per prospect and $10 per convert are, given the manager's own opinions about the market's responsiveness, both too low. The acquisition budget should be increased to $7.50 per prospect; the retention budget would be optimal at $15 per customer. At these levels of spending, the company's customer equity would reach its peak.

Maximizing Customer Equity

The balance between acquisition and retention spending is never static. Managers must constantly reassess the spending points determined by the decision-calculus model, keeping in mind a host of considerations. The following guidelines should help frame the issue.

Invest in highest-value customers first. In the model just described, we showed how to allocate marketing investments between only two groups, prospects and customers, and we used averages to characterize the responsiveness of each group. This logic should be applied to much finer distinctions among the company's customer base and prospect list. Instead of using averages drawn across the entire customer base, for example, a more subtle analysis would partition the base into behaviorally and attitudinally homogeneous groups that spend at different levels, and it would estimate the shape of acquisition and retention curves for each group. The analysis would then proceed to evaluate the customer equity of each group, starting with the most valuable and proceeding to the least. For each group, the analysis first would determine the optimal investment required to retain members of that group and then how much to spend to acquire more people who fit that group's profile.

Targets with particularly high equity might justify major investments. Airlines, for example, know that a large investment in retention incentives pays off. One result is the progressive structure of airline frequent-flier incentives: The more a customer flies, the easier it becomes for that customer to earn more generous benefits. Similarly, long-distance phone companies in the United States recognize that one of their highest-value customer groups is recent immigrants, who maintain phone contact with relatives and friends in their countries of origin. The phone companies work hard at retaining

that segment, serving it with native-language phone operators and offering special promotions.

Transform product management into customer management. The customer-equity perspective favors customer management over product or brand management as an organizing principle. When evaluating new products and services, keep in mind that small changes can have a big impact. Indeed, the value of improvements in customer equity is often not fully appreciated until it is expressed as a capitalized amount. Consider what happened when a major manufacturer of durable goods discovered that a component of one of its products was failing at a rate of 35% within one year of purchase. The operations manager determined that it was less costly to replace the component in the 35% of products that failed in customers' homes than it was to
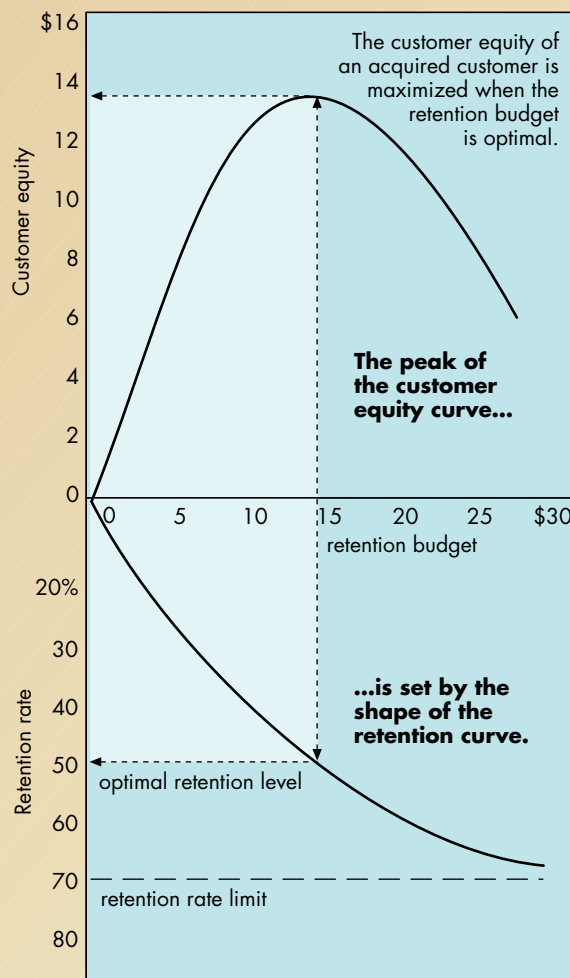
replace it in 100% of the products in inventory. His calculation accurately assessed the single-period cost to the company of each course of action but took no account of the impact on customer satisfaction or the probability of repeat purchases. When the problem was reframed from the perspective of the potential for losing customers, the managers saw immediately that replacing the component in the warehouse was the better alternative.

American Airlines' introduction of the frequent-flier program in 1981 inspired an astonishing range of industries to create membership clubs, including car rental agencies, restaurants, cosmetics companies, ski lodges, photofinishing shops, and overnight package shippers. Some critics argue that competition has negated the influence of the benefits. We would argue, on the contrary, that retention programs, if skillfully designed, can be much more than volume-discount programs. They can inspire loyalty from the market's biggest spenders. The key is to deliver benefits that appeal more to heavy users than to light users, that draw attention to a brand's claimed distinction, and that enliven the buying experience so that the heavy user becomes an even heavier user. For example, Nintendo and Lego designed clubs that showed members new ways for kids to enjoy their games and toys. Through the clubs, children also came into contact with other heavy users. For adults, Harley-Davidson and Corvette have designed clubs with a similar impact on users. And hotels have made club membership a source of customer recognition and a way to ease the strains of the traveling life.

Consider how add-on sales and cross-selling can increase customer equity. The value of a customer is reflected not only in the revenue earned from the initial purchase but also in the present value of future revenues contingent upon that purchase. In other words, if the customer buys product A, will he or she buy products that supplement or complement product A? A customer who purchases a laser printer may well buy additional memory, toner cartridges, special paper-handling devices, and supplemental fonts in the future. Someone who buys a new car will later need service visits, body repairs, and new parts. An accounting partnership can be confident that if it wins the contract to perform audits for a client, it will probably be able to sell other accounting services to that same client. Additional sales enhance the value of the customer relationship over time.

In the terminology used by direct marketers, the cost of marketing additional products and services to the installed, or existing, customer base is called *remarketing cost.* Customers who like a company's

How Customer Equity Depends on Retention Spending

The customer equity of an acquired customer is maximized when the retention budget is optimal.

The peak of the customer equity curve...

...is set by the shape of the retention curve.

optimal retention level

retention rate limit

Calculating the Optimal Level of Retention Spending

Here we describe how to compute an organization's optimal level of retention spending, using the manager's responses to the retention questions: How much did you spend last year, and what is the maximum percentage of customers you could hope to retain? The answer to the first question gives us $R, the acquisition expenditure per prospect, and r, the retention rate obtained as a result of that expenditure. The answer to the second question gives us the ceiling rate on the retention curve. Again assuming that the curve is exponential, the curve of the retention probability rate as pictured in the lower half of the graph "How Customer Equity Depends on Retention Spending" is described by the equation

$$r = \text{ceiling rate} \times [1 - \exp(-k_2 \times \$R)].$$

As before, k is a parameter controlling the shape of the exponential curve. Knowing the margin on a transaction, we can compute the value of a customer in any year after acquisition. To keep this illustration simple, assume that we earn the same margin in each year as the $m we earned in the year in which we acquired the customer. (The basic method is the same when modeling situations in which customers become more valuable over time.) Then the value of the customer in any given year (y) is simply $m, less the retention budget and discounted by the probability that the customer will still be around in that year. That is, the value of the customer in any given year is the retention rate raised to the yth power:

year y contribution from retention = $r^y (\$m - \$R/r)$.

($R gets divided by r to allow for the fact that retention investment is spent on the number of customers we attempt to keep, not on the number we succeed in keeping. The number we succeed in keeping is one rth of the number that we had attempted to keep.)

We then sum up the annual values for each year of the customer's projected life, add the value of a first-year customer, discount to a present value at a rate of return appropriate for marketing investments, $d\%$, and so obtain the amount of customer equity attributable to that customer.

The top half of the graph plots this customer equity against the retention budget for the retention curve illustrated in the graph's lower half. It is a simple matter to read the value of $R, which takes the retention rate r to its optimum level.

Alternatively, the relationship between retention spending and return can be expressed algebraically. If we define $r' = r/(1 + d)$, then the customer equity generated from investments of $A in acquisition and $R in retention is given by

$$\text{customer equity} = a\$m - \$A + a(\$m - \$R/r)[r'/(1 - r')].$$

We can find the value of $R that, when substituted into this expression, yields the greatest value for customer equity. The result is the expected customer equity of an average customer acquired by spending $A and retained by spending $R each year.

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products and services are less expensive to serve with new products and services. In this way, reduced costs of remarketing are one of the less visible rewards of investment in customer satisfaction.

Look for ways to reduce acquisition costs. Acquisition costs have a strong impact on customer equity. With high acquisition costs, retention rates and add-on sales must be high to make the product or service viable. Therefore, if the company can acquire customers at a lower cost, the long-term payoff improves significantly. Despite this potential benefit, many companies do not know what percentage of their marketing budget is being used to acquire new customers and what percentage is being spent on existing customers. Is the company's general advertising building loyalty, acquiring customers, or both?

For example, a life insurance company, noticing that its customer acquisition costs were higher than normal for the industry, introduced prequalification procedures in order to discourage agents from pursuing prospects when the likelihood of writing a policy was low. Although the procedures reduced the company's rate of sales, they reduced the cost of acquiring customers by even more and boosted both the company's profits and its customer equity.

Track customer equity gains and losses against marketing programs. A customer-value flow statement – much like an organization's cash flow statement – can highlight problems that the income statement conceals. A company that churns its customer base (acquires customers just as fast as it loses them) can report good sales and profits even as its customer equity is evaporating. As it churns, the company has an increasingly difficult time acquiring new customers cost-effectively, and, finally, when it has churned all prospects through the sys-

tem, acquisition costs become impossibly high. Whereas an income statement gives no indication of churning, a customer-value statement reports whether the company's marketing programs are building or eroding the customer base.

When American Express Company acquired IDS Financial Services, a company that markets insurance and mutual fund products through a 5,000-member sales force, it found that behind IDS's attractive rate of sales and profit growth lurked a high rate of churning. IDS was losing a client almost every time it gained one. And marketing programs implemented at headquarters were fueling the churning. IDS was spending $16 on marketing programs to generate leads for the sales force for every $1 that it spent on programs to strengthen the relationship between the company and existing clients. When an American Express study found that IDS was managing only 15% of a typical client's financial assets, the company immediately shifted its focus from acquisition marketing to retention marketing. The key was to encourage sales representatives to open up a relationship with a customer by selling a personal financial plan as the first transaction, rather than an insurance policy or a single investment. By promoting personal financial plans, IDS made it easier for reps to make additional sales to existing customers than it had been. The result was not seen in annual sales, which continued at their steady clip, but rather in much more rapid growth in the lifetime value of the customer base, which promised a more secure future for IDS.

Relate branding to customer equity. Brands don't create wealth; customers do. Despite the fashionable concern with brand power, few would dispute that highly visible brands are just one instrument among many with which to build customer equity; they are a magnet to attract new customers and an anchor to hold existing customers. Brands are never more important than the customers they reach. Once Sears reanalyzed its transaction records – asking not, What are our most valuable brands? but rather, Who are our most valuable customers? – the company began to seek shoppers for new clothing much more vigorously than ever before.

Managers should watch for signs that brand management is impeding customer management. Consider a Canadian manufacturer that makes products in three distinct markets under the same brand name. One product is strong; the other two are weak. Several years ago, each was managed by a different brand manager bent on maximizing share in his or her market, and the manager of the strong brand resisted allowing the weaker siblings to ride on its coattails. But research showed that the strong brand had as much to gain from cooperation as the other two. When experiments were conducted to measure the response to coupons for one product delivered only to users of the other two, all three brands showed impressive results. It was easier to persuade a user of two of the products to try the third than to persuade a nonuser of any of the products to try one. Brand-management myopia had been preventing the company from discovering that it could be good at customer management; it could cross-sell to increase a customer's equity more efficiently than it could acquire a customer three times over – once in each market.

Monitor the intrinsic retainability of your customers. Intrinsic retainability is determined by the way the customer uses a product or service. When that use changes, retainability changes at the same time, and companies must scramble to adjust their allocation of marketing funds.

For years, marketers in the air freight industry required expertise in customer acquisition. An efficient acquirer earned a higher return than a skilled retention marketer because customer satisfaction was out of the hands of the shipper and in the control of the airlines that carried the freight. Federal Express's innovation, the creation of an airline dedicated to nothing but freight, gave shippers more control over customer satisfaction and sharply increased the returns that could be earned through retention marketing. Suddenly, the successful companies were successful retainers.

A customer-value statement reports whether a company's marketing programs are building or eroding the customer base.

Traditionally, IBM ran its mainframe computer business as a retention business, training its sales force to follow the initial sale with attempts to sell peripheral equipment, software, a contract with its service bureau, and so on. Customers were prized because they became lifetime IBM users. But as microcomputers displaced mainframes for many applications, the company was compelled to deploy more of its marketing funds for acquisition. The

pace of technological evolution weakened brand loyalty, and a new consumer emerged who ascribed much less value to relationships. For a time, IBM tried to exploit past loyalties by endorsing selected software and attaching its brand name to peripherals, but the game had changed. Today the company has cut back on its famed sales force in favor of less expensive retention tools such as database technology and catalog-based direct sales.

When managers strive to grow customer equity, they put the customer at the forefront of their strategic thinking.

When the time is ripe to change direction, the signal usually comes from the environment, not from the organization. The winner is the company that reads the signal first.

Consider writing separate marketing plans – or even building two marketing organizations – for acquisition and retention efforts. Locating customers, attracting them, and then managing the ongoing relationships are very different tasks. They require different kinds of market research, different cost analyses to calculate the return on investment, and different measures to monitor compliance. Therefore, we recommend that once managers have determined the most appropriate ratio of acquisition and retention spending, they plan for each task separately. In direct-marketing organizations and in industries with a large customer-service component, such as airlines, it may in fact be advantageous to place acquisition activities under separate control from retention activities.

Separate marketing teams to manage customer acquisition projects and retention projects have proved effective in many companies, especially when the projects can be sharply defined by the needs of particular customer groups. British Airways, for example, identified U.S. residents who used the airline to fly *within* Europe but did not use it to fly from the United States *to* Europe. The company then formed a team to address acquisition efforts for that customer segment. Next, it charged a retention team with the task of finding what it would take to keep those customers. The team came up with a fast track for arriving transatlantic passengers that included accelerated processing of customs and immigration documents, private suites, and valet services.

An organizational structure built around getting and keeping customers, not simply selling products, has some significant benefits. It allows the marketing organizations to use tactics that are appropriate for different customer segments. Marketing research can be used to understand the needs of existing customers as distinct from the needs of prospective customers. And the performance and compensation of marketing managers can be linked to increases in the customer equity between these two groups.

When managers strive to grow customer equity rather than a brand's sales or profit, they put the customer and the quality of customer relationships at the forefront of their strategic thinking. Product sales, brand strength, and short-term financial performance are mere secondary indicators of success.

Furthermore, when managers ask how much a marketing investment will increase a company's customer equity, the interests of the marketer and the company's shareholders are precisely aligned. Just as an investment firm's interests are served if its investment managers are judged by the change in portfolio value from one period to the next, so a company is well served if its marketers are judged by the increase in the company's customer equity over time. If a marketing organization backs away from the challenge to link its fortunes to the customer-equity criterion, it either misunderstands the purpose of the marketing function or lacks the authority to carry out that purpose. ▽

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