Not All Customers are Created Equal: Looking at Lifetime Value

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Customer Lifetime Value

Not all Customers are Created Equal
Looking at Lifetime Value

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Customer Lifetime Value (CLV) refines customer profitability analysis to view customers as assets. Thinking in terms of CLV provides the impetus to target customer acquisition efforts on the right customers, and to improve the profitability and duration of the relationship with existing customers. This article introduces the concepts and benefits associated with CLV and actions to improve value.

Many companies invest more on acquiring new customers than they do on purchasing new equipment. This customer investment can include the cost of marketing, sales effort, administration associated with establishing the new customer and the time involved in learning the customer’s business.

Most companies will perform significant pre-purchase analysis to ensure that a new physical asset purchase adds value to the organisation. Physical assets, once purchased, are generally maintained to maximise utilisation and asset life. Few companies, however, analyse their substantial customer investments and ensure value is maximised once the investment is made. Can your company answer the following questions?:
♦ How much does it cost to acquire and establish a new customer?
♦ How much profit is a customer expected to generate?
♦ How long is a customer expected to stay with the company?
♦ What is the value of a new customer to the company?

Would your company invest in a new physical asset if the above questions could not be answered? Not all customers are created equal. Some are easier to sell to, others generate higher revenues, some are more costly to serve and others are more loyal. If you can’t answer the above questions for each major type of customer, the chances are that your company is investing in value destroying customers and/or not getting full value from existing customers.

Customer profitability reporting assists organisations to become customer focused and to improve profitability. However this reporting often considers customers in terms of current period profit/loss not as long term assets. Customer lifetime value (CLV) refines customer profitability analysis to view customers as assets.

Thinking in terms of customer lifetime value highlights to management that profitability can be improved substantially by treating customers as assets. This includes:
♦ Investing in customer assets wisely and efficiently,
♦ Maximising profits derived from customer assets, and
♦ Maintaining customer assets in order to lengthen the life of the relationship.

CUSTOMER LIFETIME VALUE
CLV involves projecting the cash flows associated with customers or customer types over the life of the relationship and discounting these cash flows into current dollars (Net Present Value (NPV)). Exhibit 1 shows a graph of typical customer cash flows.

Exhibit 1 indicates that customer related cash flows are similar to those of any other asset that a company purchases. Generally the cash flows have the following key components:

1. Acquisition costs – this may include marketing, sales and customer establishment costs. This equates to purchase and set up costs for other assets. Activity Based Costing (ABC) is often used to calculate the cost of acquiring customers through different sales channels.

The cost of acquiring customers can be much higher than expected, as the cost of successfully acquiring new customers includes the cost of unsuccessful sales bids.

2. Annual cash flows – the profits earned from the sale of products/services to those customers less the cost of servicing those customers is often used as a proxy for cash flow. This would equate to cost savings or profits.

Adapted from Reichhold’s ‘The Loyalty Effect’ HBS Press
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generated from other assets, such as equipment. Customer profitability analysis can be performed using ABC.

A customer may contribute greater profits to your business than the profit derived from the sale of products and/or services to that customer. It is necessary to consider and, if possible, estimate other benefits from the relationship eg winning a prestigious client may make it possible to sell to others or a customer may enable the company to develop skills, products and services.

3. Duration of relationship – this is the period that the customer is expected to continue to buy the company’s products or services. This ties specifically to the period an asset or piece of equipment would be expected to be in service. As indicated in Exhibit 2, the duration of the relationship has a significant effect on CLV. The example in Exhibit 2 indicates that this customer would need to stay with the company for over two years to generate value.

Many companies take one or more of these three components into account. However few tie them into lifetime value to ensure their actions create rather than destroy value. For example, some organisations raise prices in order to improve annual cash flows, but see a drop in the duration of relationships. Others focus on customer satisfaction to improve duration, but effectively give all of the profits away and/or retain negative CLV customers.

Case Study 1: Customer Lifetime Value in Telecommunications

CLV analysis assisted a Telecommunications company to establish that a marketing campaign was destroying shareholder value by obtaining customers with negative lifetime value. The costly campaign focused on selling the virtues of having a mobile telephone to safety conscious people.

The campaign was extremely successful generating many new customers for the company. However, CLV analysis showed that the low profits generated by these customers (emergency mobile use only) did not recoup the substantial cost of acquiring these customers (advertising costs, dealer commissions and mobile phone subsidies). The company stopped the campaign and began focusing customer acquisition efforts on profitable corporate customers.

CUSTOMER LIFETIME VALUE AND CUSTOMER PROFITABILITY REPORTING

CLV and Customer Profitability Reporting (CPR) are complementary to each other. CPR and the underlying Activity Based Costing (ABC) can be used as significant input into CLV calculations. CPR can be used to identify the costs of acquiring customers and the on-going profits generated by different types of customers. Some organisations initially estimate CLV and then come back and use CPR to put some rigour into the estimates. Exhibit 3 compares and contrasts customer profitability reporting and customer lifetime value.

CPR provides comfort to the accountant in us as it uses actual costs that can be reconciled to the general ledger and treats customer acquisition costs in the same manner as financial accounting requirements. Thinking in terms of CLV, however, can improve analysis of customer profitability in the following ways:

♦ Customers change over time. The young professional who is not profitable to her bank today is likely to be an extremely profitable customer in the future complete with housing loan and investments. CLV forces future profitability to be considered in customer profitability analysis.

♦ A successful customer acquisition drive can make a customer segment appear unprofitable in the period that customers are acquired. This is due to the single period CPR including acquisition costs in the current period profitability while future profits that are expected to be generated from these new customers are ignored. CLV recognises that where the customer segment is growing and customers have a positive lifetime value, the organisation is better placed through investing in these customers. This is especially important for rapidly growing companies.

♦ CLV highlights the importance of the duration of the customer relationship. This can assist management to ensure that customers and long term value are not sacrificed in the attempt to increase current period profitability.

WHEN CAN CLV PROVIDE VALUE?

CLV analysis can provide significant benefits to management when:

♦ The cost/effort of acquiring new customers is significant,
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- Customers purchasing and profitability profiles change over time, or
- The company’s culture focuses on acquiring new customers and the company has significant turnover of existing customers.

Examples of industries where CLV is relevant include telecommunications (case study 1), financial services (case study 2). CLV is also relevant to other industries including professional services (consider the cost of acquiring a new consulting or audit client) and distribution companies.

Case Study 2 – Customer Lifetime Value in Insurance

Through CLV analysis, an insurance company identified that many customers had negative CLVs. Due to large agent commissions, many policies took in excess of six years to generate positive CLVs, however many customers were lapsing policies prior to that period. Detailed investigation identified that:
- Brokers were transferring customers to competitors to maximise commissions, and
- Pricing did not reflect the administration costs associated with the high churn of some customer segments.
- CLV and overall profitability were improved by:
- Working with brokers to lengthen the tail of commissions, ie lower sales commissions and higher ongoing commissions during the life of the policy, and
- Repricing products to reflect the different churn of customer segments. This changed the mix of customers to lengthen average policy life.

IMPROVING CUSTOMER LIFETIME VALUE

As shown in Exhibit 4, there are four main areas on which management can focus in order to improve CLV:
1. Developing customer focussed offerings,
2. Investing in the right customers in an efficient manner - customer acquisition,
3. Increasing profits derived from customer assets - annual cash flow, and

Exhibit 4. Improving Customer Value

- Develop customer focussed offerings
- Increase the profitability of existing customers
- Improve customer acquisition activities
- Improve retention of high CLV customers

It is obvious, at the component level, that the objectives are to minimise acquisition costs and maximise the annual cash flows and duration. However, examining lifetime value brings out some of the trade-offs in these objectives, eg
- Minimising acquisition costs, may lead to the company acquiring a significant number of customers that generate low profits and remain with the firm for a short period. This would be like buying a cheap, low quality piece of equipment.
- Maximising annual cash flows could involve raising prices or reducing service levels. Both of these may alienate customers, causing them to defect and destroying CLV by impacting on duration. This would be like saving money by failing to maintain a machine, but having to replace the machine well before its normal useful life.
- To some companies, customer retention is all and they provide products and services for free or spend significant dollars to ensure customers are satisfied. This can destroy value as profits earned on those customers are given away or customers retained have a negative CLV.

CLV assists managers to determine operational strategies, which maximise value given these trade-offs.

CLV Changes Behaviour

Thinking in terms of CLV is likely to result in a number of substantial changes in behaviour for some organisations. These changes can be across the whole organisation including sales, marketing, operations and performance measurement. Some of the major changes are shown in Exhibit 5.

Exhibit 5 – CLV - Likely Changes in Behaviour

- Need to consider customers as customers.
- Gain a strong understanding of customer needs.
- Treat customer acquisition costs as an investment for decision-making purposes, not as an expense.
- Treat customers as long term assets.

CONCLUSIONS

Customers are vital assets of a company, generating the company’s revenues. Organisations spend millions of dollars on winning new customers, yet few organisations treat customers as the valuable assets that they are. Customer profitability reporting (CPR) increases an organisation’s customer focus. Customer Lifetime Value
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can improve on CPR as CLV looks at customers as investments by considering the whole customer relationship not just current period profitability.

Thinking in terms of Customer Lifetime Value provides the impetus to target customer acquisition efforts on the right customers, and to improve the profitability and duration of the relationship with existing customers.

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