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The Path to Profitability

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In difficult economic times businesses need every possible advantage to reap profits. Utilizing the Customer Lifetime Value (CLV) measurement has provided that advantage to many companies, from giants such as IBM and an upscale global fashion retailer to a variety of smaller firms throughout the world.

In its simplest terms, CLV is a formula that helps a marketing manager arrive at a dollar value associated with the long-term relationship with any given customer, revealing just how much a customer relationship is worth over a period of time. It differs from other formulas in that it is a forward-looking measurement of customer performance and takes into consideration all elements of revenue, expense and customer behavior that drive profitability. CLV helps marketers adopt the right marketing activities *today* to increase profitability tomorrow. It rewards not those who have been the best customers, but those who *will* be the best customers in the foreseeable future.

Why CLV is Better

None of the other well-known customer performance measurements is as all-encompassing as the CLV metric.

The *Share of Wallet* (SOW) measurement, which represents the spending that a business captures from a customer in products and services in relation to the total spending in that category, does not explain when a customer is likely to buy next and how profitable a customer will be in the future. A second method, the use of *historical profit* assumes that the past spending behavior of the customer is going to continue in the future. This is not always the case. Finally, there is the widely used *Reach, Frequency and Monetary Value* (RFM) metric, which measures the number of days/weeks/months since the last transaction occurred, how much the customer has contributed to revenues in the past, and how frequently these customers have been buying from the firm. However, it does not reveal any information about whether or not a customer is loyal, when a customer is likely to buy next, or how much profit a customer is likely to give. CLV overcomes these three issues by incorporating the probability of a customer being active in the future and the marketing dollars to be spent to retain that customer.

Implementing CLV

To put CLV in place takes assistance from the top management, availability of customer-level data and a strategy/structure for campaign management. All are essential. My team and I have implemented CLV in both B2B and B2C companies. When IBM implemented our CLV-based framework, including optimally re-allocating resources to profitable customers, they saw a ten-fold increase in their revenues the following year. Similarly, when a B2C fashion retailer implemented our framework, they were able to analyze their profitability both from a customer level and a store level. On a customer level, they observed that the top 20 percent of their customers accounted for 95 percent of profits, and they were actually losing money with the bottom 30 percent of customers. Through implementing these CLV-based strategies, this B2C firm realized a 42 percent increase in store revenue for the bottom 10 stores in one year and a 30 percent increase in stock price or shareholder value compared to other B2C firms in this industry.

Customer Benefits

Customers benefit from CLV because businesses better understand their needs. They receive better targeted and higher-value offerings. The customer receives a greater perceived value from the firm and, finally, the customer feels more satisfied with the firm.

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Benefits to the Firm

By implementing CLV, companies can:

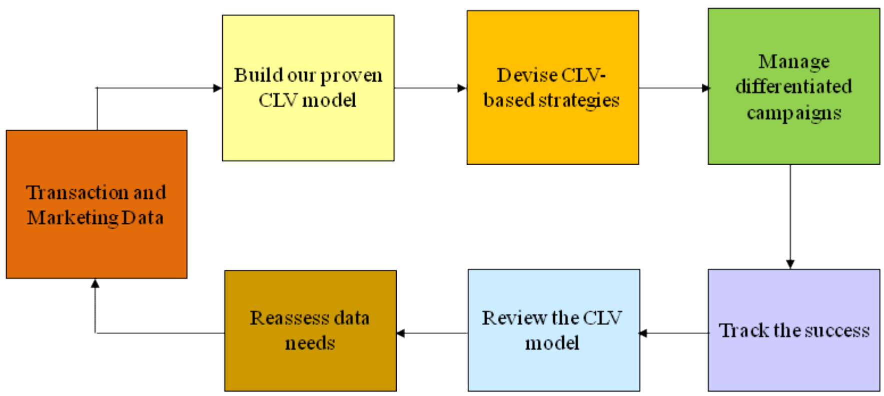
- Provide better customer experience
- Increase customer loyalty
- Increase the likelihood of customers repurchasing from the firm
- Increase the likelihood of customers actually recommending the firm

Making the CLV Framework a Permanent Feature

The application of CLV in a firm is a cyclical process and it all starts with the data as shown below. The firm should collect customer-level transactional data. This data should include information on every touch point with the customer (i.e. a direct mail piece, a phone call, and/or an email, etc.). This information can be gathered periodically to refine the model and make appropriate changes to the customer strategies so that profitable customer management is ensured.

Spinning the Wheel

Calculation of CLV for all its customers is only the first step that firms can take to implement customer-level strategies. CLV is a metric, which can be a basis for a firm's investments in infrastructure and ongoing marketing activities. Firms can use the CLV framework to identify which customers are most likely to bring maximum profit to the firm in the future, what factors lead to higher CLV, and the optimal level of resource allocations to various channels of communication. Dynamic customer management based on CLV can improve the shareholder value.



Called *the Wheel of Fortune*, these strategies enable firms to ensure future profitability by targeting the right customers with the right message, plus acquiring and retaining customers with the highest profit potential. The success of a firm in exploiting a CLV framework lies in the firm's ability in identifying and implementing the most effective customer-level marketing decisions based on the CLV metric so that the future profit from the customer is maximized. These strategies will increase the customer lifetime duration and the lifetime value.

As illustrated by *the Wheel* (see Figure 1), the CLV cycle starts with selecting the right customers based on future profitability (Customer Selection Oval—upper right of chart). The next step is to manage loyalty and profitability of these customers simultaneously. If you chase loyalty first and then expect profit from those customers, it is not going to happen. Loyal customers demand more and are unwilling to pay higher prices given what they are used to paying. The ROI (Return on Investment) from limited marketing resources can be maximized by allocating more resources to more profitable customers and contacting them through the most effective communication channels at the most appropriate time with the right message. Also, preventing the attrition of customers is another key step in retaining the most profitable customers. This can be achieved by obtaining a good understanding of the spending patterns and intervening at the right time to prevent the customer from terminating the relationship with the firm.

By encouraging customers to buy from multiple channels (online, catalog, and physical stores) and to use the lower-cost channels to make their transactions also enables firms to maximize profits. Subsequently, firms can link a customer's perception of the brand value to customer profitability and then increase firm

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profits by optimally allocating resources to improve the brand value.

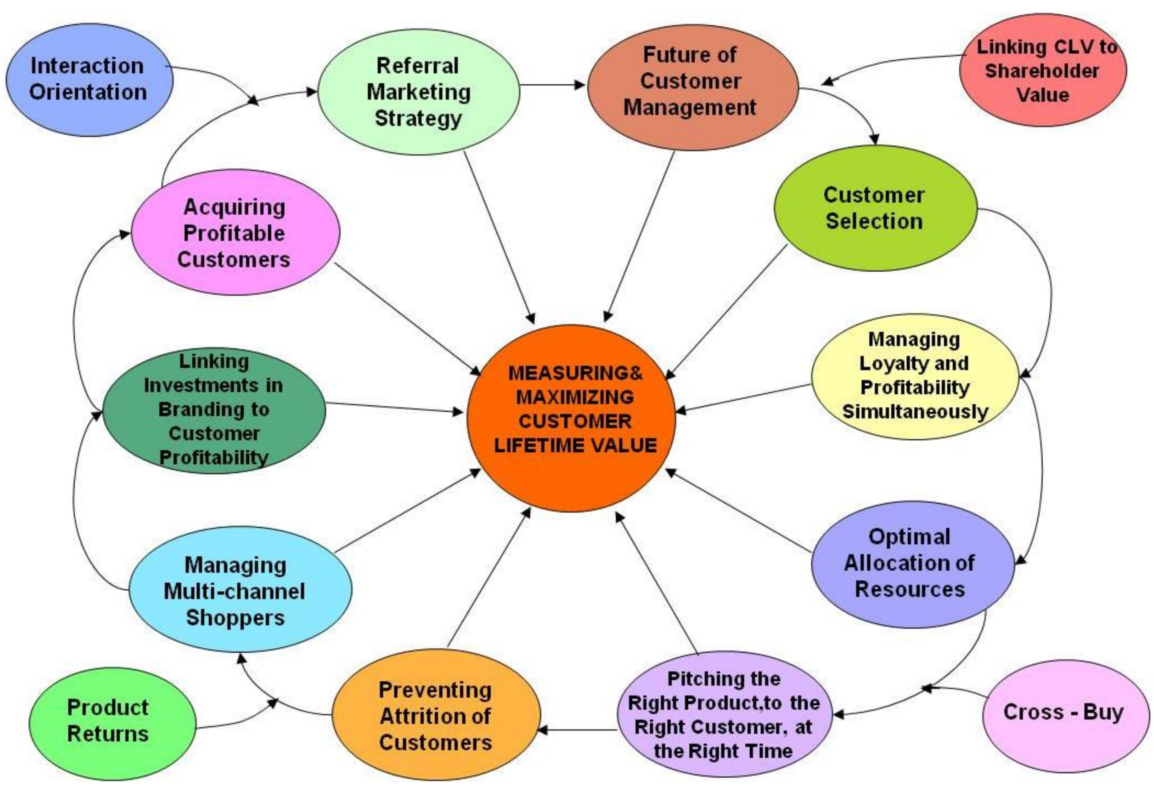
The last strategy links the acquisition and retention of customers to profitability by targeting the right customers who are expected to be acquired, stay longer with the firm, and are also expected to provide profits. Thus, by retaining customers with higher profit potential, firms can ensure future profitability.

And Finally

Firms often get into the trap of calculating CLV for their customers once and not using it to maximize their profitability. They limit the use of CLV scores only to segment the customers but not to implement customer-specific communication and marketing strategies that maximize the customer equity of the firms. Organizations have to understand CLV as a dynamic measure that changes as a result of customer-specific marketing actions. Further, CLV can be used to optimally allocate resources, predict future purchases of customers, and reach the right customers with the right message through the most apt channels. Unless an organization is effectively using CLV to achieve these results and maximizing the profitability, it is not making the most of the CLV framework.

Using CLV as a metric has been proven to be a valuable resource for firms across industries to simultaneously maximize profits and shareholder value as well as customer satisfaction and loyalty. On average, firms that have implemented our CLV based framework realized an average of 25% to 30% increase in stock price or shareholder value over firms in this industry that have not done so during the observation period.

Below: **Figure 1—Wheel of Fortune Strategies**



ABOUT THE AUTHOR

V. Kumar (VK). Ph.D. is the Lenny Distinguished Chair Professor of Marketing, and Executive Director, Center for Excellence in Brand & Customer Management, J. Mack Robinson College of Business, Georgia State University. He has been recognized with seven lifetime achievement awards in Marketing Strategy, Inter-Organizational Issues, Retailing, and Marketing Research from the AMA and other professional organizations, the Paul D Converse Award, and the 2011-12 Gary L. Lilien ISMS-MSI Practice Prize Award. He has published over 190 marketing articles in many scholarly journals including the HBR, Sloan Management Review, JM, JMR, Marketing Science, Management Science and Operations Research. His books include Managing Customers for Profit, Customer Relationship Management, Customer Lifetime Value, Marketing Research, Statistical Methods in CRM, and International Marketing Research. He is frequently invited to conduct executive education programs for the Global Fortune 1000 firms as well as to teach at major universities worldwide. VK spends his "free" time visiting business leaders to identify challenging problems to solve. He plays tennis and basketball to relieve his stress from the academic world. Recently, VK has been included in the Legends in Marketing series, where his papers will be published as a 10-volume collection with commentaries from the marketing scholars worldwide.

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