

Understanding Customer Value

*Bradley Rukstales
President*

Customer Asset Consulting Group, Inc.

Customer value, sometimes called customer lifetime value, can serve many roles within an organization. It can be used for identifying high-value customers for special treatment or program, for understanding the profitability of different customer groups or segments, and for assessing the overall “health” of a customer portfolio.

However, there is a lot of confusion around the terms “customer value” and “lifetime value”. Are we looking at historical value, future value, future potential value, or the true value of a customer over their entire lifetime? Furthermore, are we merely looking at revenue, or gross margin, or pre-tax, fully-loaded profit? Let’s examine some of these issues.

FINANCIAL VALUE MEASUREMENTS

Revenue-based Value

A big issue in defining customer value, whether looking historically or projecting into the future, is to define what is meant by value. The loosest definition is to use net revenue (gross revenue minus returns or additional credits). This is just fine as a ranking mechanism, as long as all of the following are true:

1. The customer-specific marketing costs are identical for all customers
2. All customers pay the same price for the same product
3. The gross margin percentage for all products is identical
4. The costs of servicing each customer is the same

It is rarely the case, however, that all of these are true. Direct-to-consumer communications costs will vary based on how often a customer has been selected for promotions, and the costs of those promotions. In addition, some customers, prevalent in retail environments, will only purchase on markdown or discount, resulting in customers providing different levels of margin for the same product.

While gross margin percentages generally vary a lot in retail environments, in other environments the marginal cost of products and services is very low. In telecommunications, it does not cost the company to add call waiting to one phone line, for example. Customer service costs also can vary quite a bit. For e-tailers offering free shipping, for example, the cost of shipping to the next town varies from the cost of shipping cross-country.

Marginal Cash Flow

When measuring a customer’s cash flow contribution, it is best to think of net revenue minus marginal, or variable, costs. The difficulty, of course, is defining what constitutes a marginal cost. The marginal cost should contain any costs that can be directly attributable to the behavior or characteristics of a specific customer. Examples include the cost of the items they purchased, and the direct marketing costs for that customer. Costs that should not be included would be those that are generally considered overhead costs. For instance, one would not consider the lease costs of a retail location a customer-level cost item. Almost any cost item that must be “allocated” to a customer

should not be considered for this type of customer value calculation. The key here is “almost”. If a company has some customers that spend a lot of time on the phone with technical support or customer service, one could allocate some of these costs based on the number of minutes a customer is on the phone.

Marginal Cash flow, using the principles and examples above, is the most useable calculation, as one can fairly evaluate and rank-order customers with a meaningful metric. In work with one large apparel retailer, it was found that there were two groups of customers that provided a similar level of revenue. However, one had an extremely high customer value, and another had extremely low. Additional analysis revealed that one group purchased the latest fashions at the beginning of a season, and the other group purchased at the end of the season, cleaning up the clearance rack. This study resulted in a promotional strategy that recognized that both customer groups served a purpose: The fashion-oriented customers were not offered big discounts, but rather were notified of seasonal merchandise arrival. The price conscious customers were notified when the end of the season was coming, with a moderate incentive (the items were already on clearance). They cleaned out the merchandise, reducing inventory levels prior to the next season. While one can’t make a living from these customers, and would rather have all fashion-oriented customers, there is an appropriate role for them that can be exploited.

Fully Loaded

The final type of customer value measure is one in which all (or almost all) of the costs of a company’s operations are included, to get a financial measurement tool for analysis. In this scenario, the total overhead costs are divided by the number of customers, and the resulting figure is a fixed allocation to each customer for the costs of the company. There are also

variations on this, whereby every dollar of revenue from a customer has a commensurate overhead cost assigned, which would be a revenue percentage allocation of overhead costs. This can also be broken down into business units, whereby the costs of a business unit are allocated to customers of that business unit. Overall non-direct marketing costs (newspaper, electronic) can also be allocated, using geography or “target segment” definitions for allocations.

The problem from an economic standpoint is that, regardless of the methodology by which the overheads are allocated, the result is still an arbitrary assignment of a fixed pool of costs, which are not due to any individual customer’s behavior. From a marketing standpoint, this calculation does not provide much value. From a financial point of view, it provides the basis for tracking the efficiency of different cost reduction efforts on final customer value, and one can develop simulations that aide in the development of these strategies.

TYPES OF CUSTOMER VALUE CALCULATIONS

Now that we’ve covered the financial component of defining value, let’s discuss the types of customer valuations that commonly exist today. There are many variations of customer value, but almost all common methodologies will fall into one of the categories below.

Current Value

Current value is meant to be a snapshot of the customer’s relationship with a business today, given current spending by the customer. It is typically based on the last 12 months of spending, although this could vary based on the type of or specific needs of the business. Value, using one of the financial metrics listed above, is

a fairly straightforward calculation based on historical product cost, service cost, revenue, and promotional expense / contact history data. In this calculation, since it covers a very limited period of time, there is no need to discount to represent the present value.

Remaining Life Time Value

This is the measure commonly referred to as Life Time Value. This is a forecast, or prediction, of the future spending of a customer, under the current operating conditions of the company (same products, same channels, same marketing). It is typically developed using predictive modeling techniques, based on looking at a customer base at a prior point in time, and predicting the value of a customer into the future. While it may be analytically possible to forecast far into the future with proper assumptions, the forecast is generally not reliable. Most methodologies use a limited period of time, say, three to five years, for this measure.

From a customer behavior standpoint, it is best to predict customer expenditures (revenue), rather than profit. The models are more robust, and are not complicated with internal product margin issues. After a revenue prediction is made, some assessment of cost must be applied. One such technique is to use a customer's prior margin percentage and apply it to the future expected revenue stream. For example, suppose two customers have an expected revenue stream of \$1000. One has a historical margin of 30%, and another 50%. The actual value of the revenue for these customers would be \$300 and \$500, respectively.

In most circumstances, if a rank-ordering is all that is required, there would be no need to discount the future value. However, to get the value of a customer in today's dollars, each future period's expected value should be

discounted by the firm's weighted average cost of capital.

Potential Value

A more tricky value measurement is one that assesses the potential value that a customer could represent. What makes this difficult is that it is not a directly observable measure, and is largely based on assumptions that could be subjective. The concept is to try to evaluate what type of "upside" there is to the relationship with a customer. Based on demographics, and general purchase behavior, one can calculate the expected revenue of customers. If a customer's actual revenue is below this, the difference would be the potential increase in value. Alternatively, one can model how similar a customer looks relative to "best" customers, and, through the calculation of revenue by model score, can identify the potential revenue of a customer, based on how closely they look like high-value customers. Variable selection and methodology are very important in building this type of measurement.

It should be noted that potential value does not prescribe what needs to be done to increase a customer's value, but merely indicates what that value *could* be. Bad service experience, location, change in lifestyle that is not captured on the database, as well as other reasons, all could lead to why the potential value is not realized for a customer. Concepts such as wallet share and wallet size come into play in some methodologies, as well.

Expected Value

In many circumstances, marketers want to understand the value of a prospect. In these cases, the calculation is based on models developed from external (largely demographic or alliance-type) data. There are two components to this calculation. The first is a prediction of a revenue stream for a prospect,



given that they become a customer (“conditional revenue”), similar to the Remaining Life Time Value calculation. These predictions will not be as robust as the customer predictions, since there is no purchase or relationship information to use for prediction. It is also customary to use an average margin percentage across all prospects to calculate the margin on that revenue stream.

The second component of Expected Value is an estimate of the probability of a prospect to become a customer. This is typically the result of a predictive model, predicting responsiveness to a direct marketing campaign. The multiplication of the two (conditional revenue and probability of response) results in an expected value of a prospect. Since there is a cost to acquire the customer through direct marketing, the cost of the marketing piece should be subtracted from the expected value to calculate the expected value of the prospect, if they are targeted for a campaign. Where this value is greater than zero, there is a financial benefit in marketing to the customer. If it is less than zero, it is predicted that the customer will not provide economic value to the company.

There are many different versions of these types of models, but almost all will fall into one of the categories listed above. It is important to understand for what applications the customer value calculation is being designed, in order to create the right calculation, using the right level of financial detail within.