MAXIMIZING CUSTOMER EQUITY

Long-term products require a long-term approach to the question of value. Malcolm Oliver explains the principles of customer equity.

The total customer equity of a company is the sum of the lifetime values of each of its customers, discounted to a net present value, after deducting any unallocated costs. It is in effect the total economic value of a company's customers and potential customers, and is driven essentially by four factors: acquisition costs; retention rates; re-marketing costs; and additional sales. Marketing must focus on these four areas.

This emphasizes the point often missed, that specific external marketing activity must be divided between acquisition of new customers, and re-marketing: the nurturing, development and harvesting of retained customers. These activities are separate, if complementary: in some organizations they are best handled by separate teams; in others the benefits of integration will be dominant.

But it is also clear that it is not just a question of acquiring as many customers as possible; or of maximizing the cross-selling rates. Each of these activities has a cost as well as a benefit, and striking the right balance is vital.

The first year value of an acquired customer is the difference between the margins on the product sold and the acquisition costs. The former increases in proportion to the value of the products sold; the latter follows an exponential curve – small levels of expenditure at first produce significant growth in acquisition rates, but gradually a law of diminishing returns sets in, and eventually a maximum achievable acquisition rate is reached. The optimum level, which maximizes the customer value, is well below this point.

The product margins are clearly defined internally, although sometimes with a degree of difficulty in the case of life insurance products – simply because historically the approach to costing has focused on *total* expenses, and also because of the different approaches to accounting for profit.

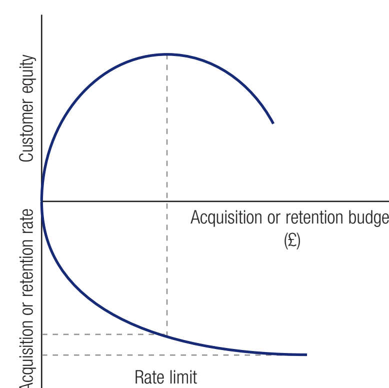
Although the exponential curves may look a little more daunting, they are easy to define and quantify – using data on current retention/acquisition rates and costs, and estimates of the maximum achievable rates, all of which are readily available.

A similar analysis can illuminate the value of a retained customer, or the customer equity, in relation to re-marketing expenditure. The power of this technique is that a relatively simple procedure reveals very clearly the efficacy of the allocation of marketing expenditure, and allows a precise alignment to be made between marketing activity and customer potential.

The optimum balance between customer retention and the generation of additional sales can also be analysed in this way, with results that are sometimes counter-intuitive: in many senses the best way to generate additional sales in the long-term is not to seek them in the short-term. Provided that the customer's expectations and understanding are properly and consistently managed, an unforced approach can be the most effective. Potential waste of marketing expenditure is clearly avoided, and also the risks of "customer burn out" from over-zealous attention, and of staff discouragement from over-optimistic short-term targets.

Customer equity is clearly valuable to the company and to its owners: properly managed and properly specified, it can be regarded just as any other asset on the balance sheet. But effective use of the customer equity approach can also add value to the other stakeholders – the customers and the staff (whether employed or independent) involved in servicing the customer.

Acquisition/retention rates and customer equity



Source: Malcolm Oliver – *The Future for UK Retail Financial Services* – University of Nottingham 1997.
Adapted from R.C. Blattberg – *Harvard Business Review* July/August 1996

For the customer, there is the opportunity to share directly in some of the added value that their continuing quality relationship with the insurer generates, and also the peace of mind that develops from dealing with an adviser and a company that have *earned* the customers' trust and future business.

Staff can obviously share directly in the identified added value, but the *quality* of their work experience can also be altered. Sales staff in particular will see a radical change: in a company that focuses on customer equity management, the dominant activity shifts radically from the pursuit of new customers and new business to the generation of repeat business from established clients, and most staff will find this change very satisfying.

Copies of a more comprehensive paper by the Editor, from which this note has been extracted, are available on request.