Bringing Marketing to Wall Street - the role of CLV

MASB Marketing Accountability Standards Board of the Marketing Accountability Foundation

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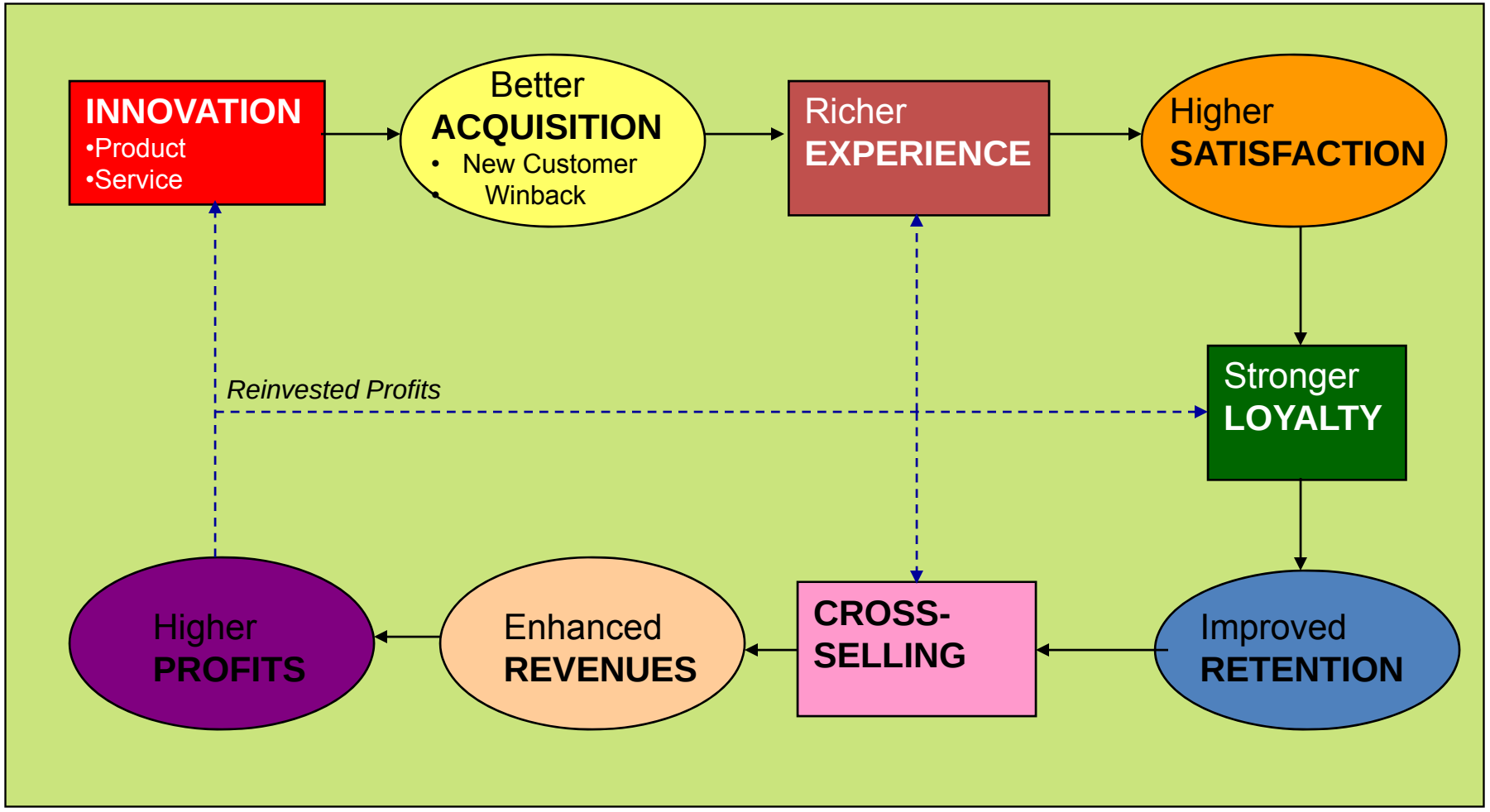
Agenda

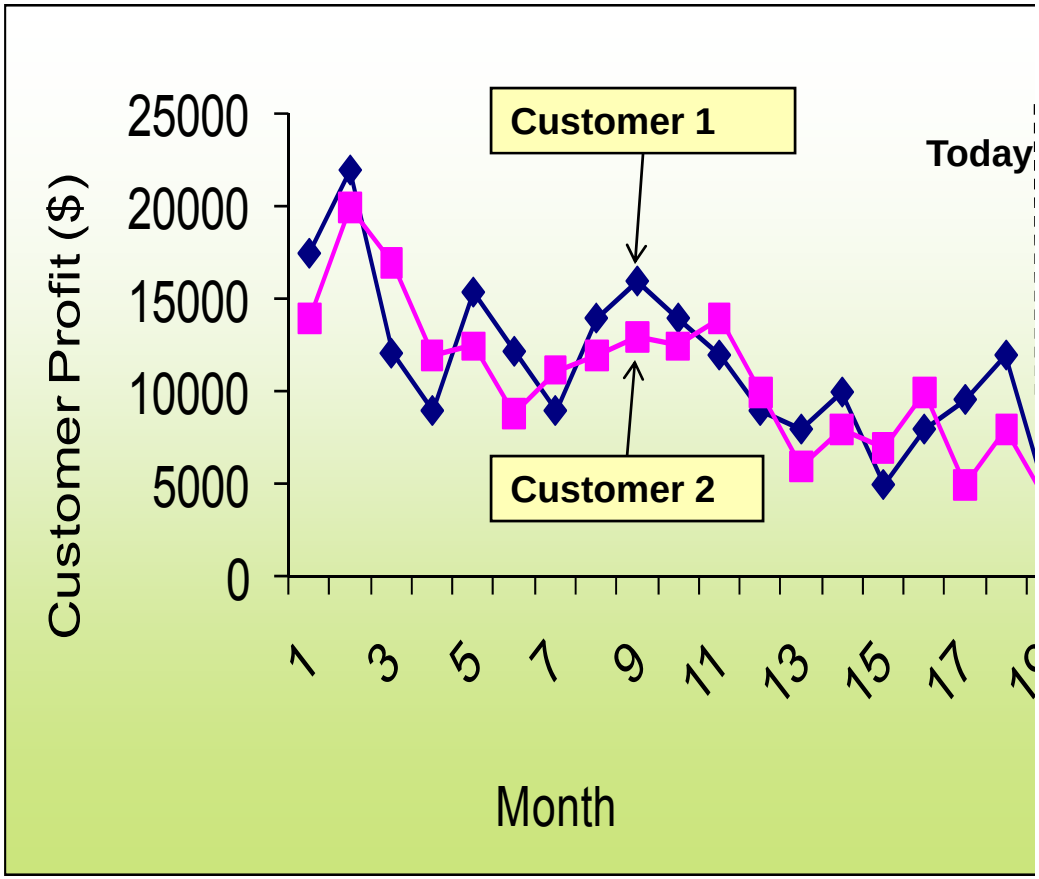
- Managing Loyalty and Profitability
- Marketing Paradigm Shift
- Computing Customer Lifetime Value (CLV)
- Case Study – Implementing CLV in the B2C scenario
- Case Study- Implementing CLV in the B2B scenario
- Linking CLV to Shareholder Value (SHV)
- Reversing the Wisdom– The Path to Profitability

Conventional Wisdom: Path to Increased Profitability

- A Differentiated & Sustainable Strategy



Which customer is most loyal and profitable?



What drives Profitable Customer Loyalty?

Exchange Characteristics

- Customer's spending level - Share of Wallet
- Cross-buying behavior
- Focused buying behavior
- Average Interpurchase Time
- Merchandise returned
- Ownership of loyalty instrument
- Mailing efforts of the company
- Majority Product category

Customer Heterogeneity

- **Age**
- **Spatial Location**
- **Income**

Marketing Paradigm Shift

	Traditional Approach	CLV Based Approach
Management Dimension	Manage products	Manage customers
Focus	Focus business on products that are most profitable	Focus business on customers that are most profitable
Selling Approach	How many customers can we sell this product to?	How many products can we sell this customer to?
Decision Orientation	Marketing decisions based on historic measures or past value of profitability	Marketing decisions based on forward-looking measures or the customer lifetime value metric

"Look, let me get back to you while I find out how important you are."

Computing the CLV metric

Computing CLV

Recurring Revenues - Recurring Costs

↓

Gross Contribution Margin - Marketing Costs

↓

Net Margin for Single Event X Expected Number of Purchases/Events over next 3 years

↓

Accumulated Margin - Acquisition Costs

↓

Adjusted for Present Value

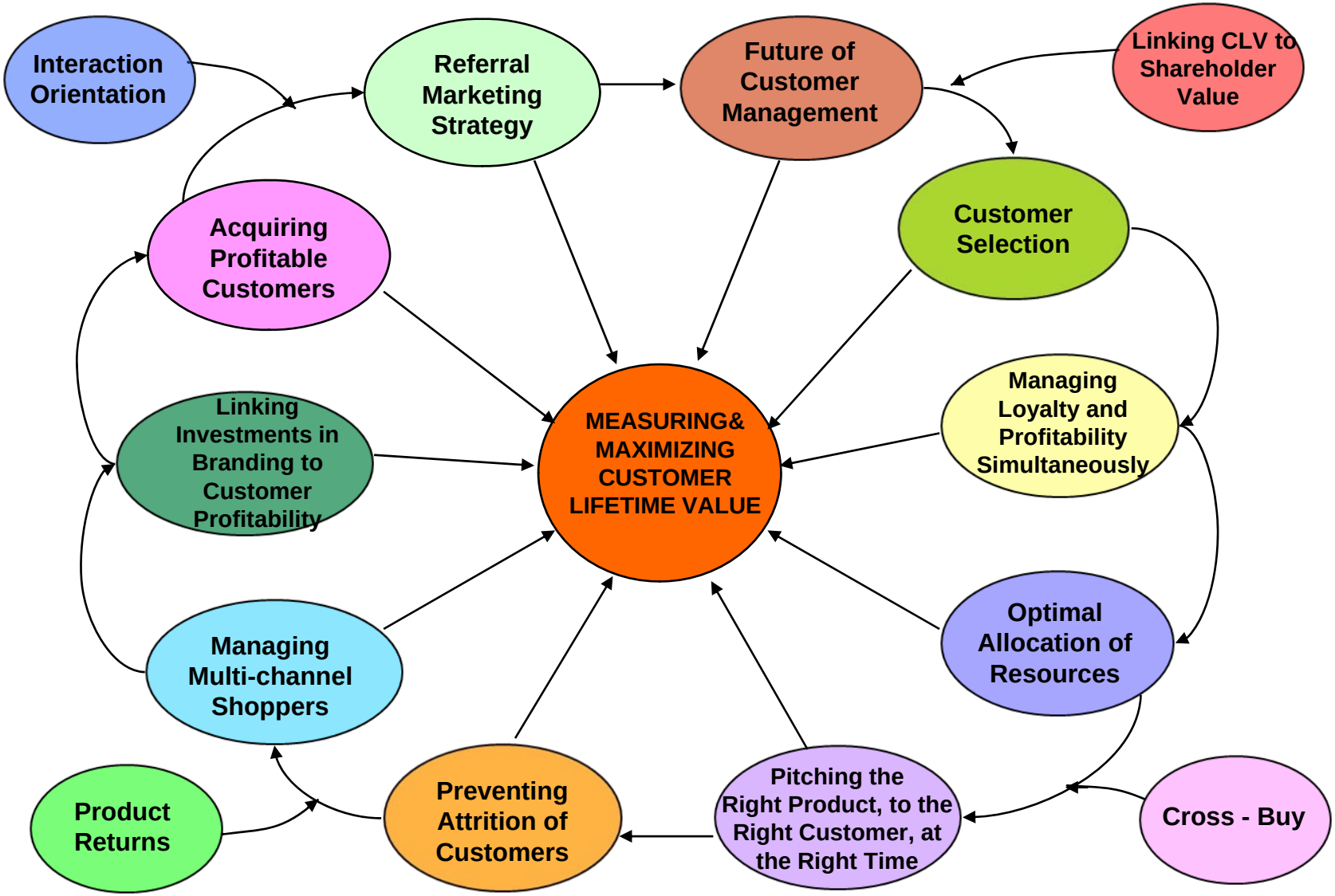
↓

Customer Lifetime Value

Why CLV?

- Forward looking metric unlike other traditional measures (that include past contributions to profit)
- Helps marketers adopt the right marketing activities 'today' to increase profitability 'tomorrow'
- Can be used to understand current clients as well as prospects
- The only metric that incorporates all elements of revenue, expense and customer behavior
- Focuses on the customer (rather than products) as a driver to profitability

The Wheel of Fortune Strategies Used for Maximizing CLV



Source: *Kumar, V., "Managing Customers for Profit", The Wharton School Publishing, January 2008; February 2009*

Case Study:
Implementing the CLV Framework in the B2C scenario

Background

- Fashion retailer having retail stores across USA

Challenges:

Develop a suitable metric to measure and manage customer level profitability

Identify the right metric to manage customer loyalty

Step 1: Identify the Drivers of Loyalty

The retailer used several measures to identify loyal customers:

- Regularity of Purchase
- Frequency of Purchase
- Tenure

Question: Do these 'measures of loyalty' drive profitability?

Result:

	Regularity	Frequency	RFM	Tenure
CLV	**r= - 0.09**	**r= 0.17**	**r= 0.19**	**r= 0.44**
N	**172,688**	**470,932**	**470,932**	**470,932**

Except for tenure, the traditional metrics of loyalty showed poor correlation with loyalty.

Step 2: Measuring CLV

The lifetime value is computed for each customer using this formula:

$$CLV_{it} = \sum_{t=1}^{T_i} \frac{GC_{i,t}}{(1+r)^{t/frequency_i}} - \sum_{l=1}^{n} \frac{\sum_m c_{i,m,l} * x_{i,m,l}}{(1+r)^{l-1}}.$$

Where:

$GC_{i,t}$ = Gross contribution from customer *i* in purchase occasion *t*

$c_{i,m,l}$ = unit marketing cost, for customer *i* in channel *m* in time period *l*

$x_{i,m,l}$ = number of contacts to customer *i* in channel *m* in time period *l*

$frequency_i = 12/expint_i$,

$expint_i$ = expected inter purchase time for customer *i*

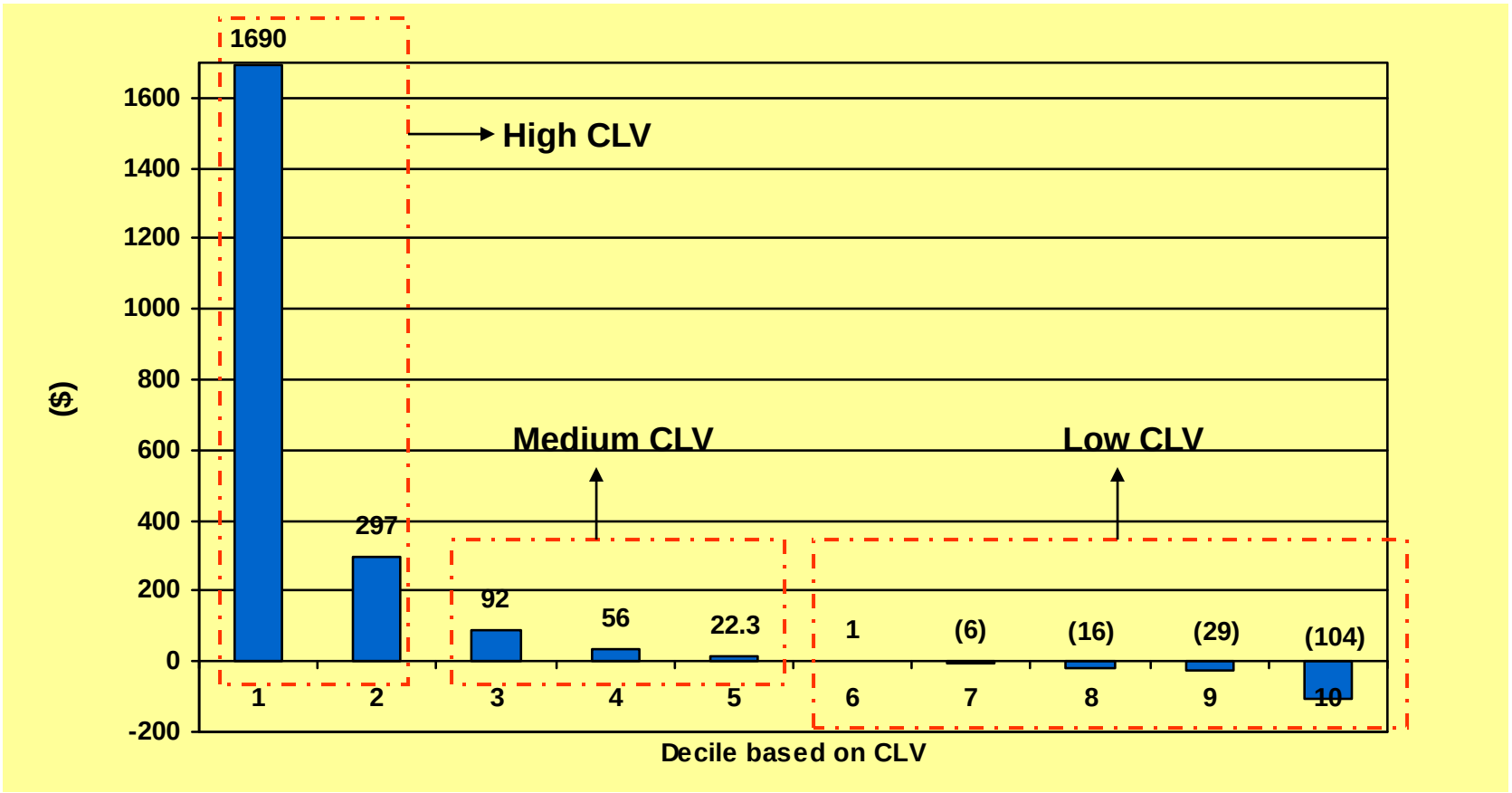
r = the discount rate for money

n = is the number of years to forecast

T_i = total number of purchases made by customer *i*

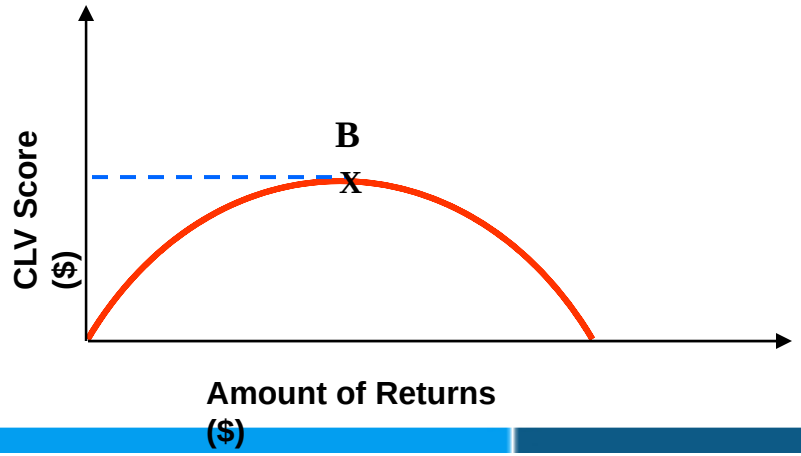
Step 3: Scoring & Segmenting the Customers

Customers are rank-ordered into deciles and segmented based on the distribution of CLV across the deciles



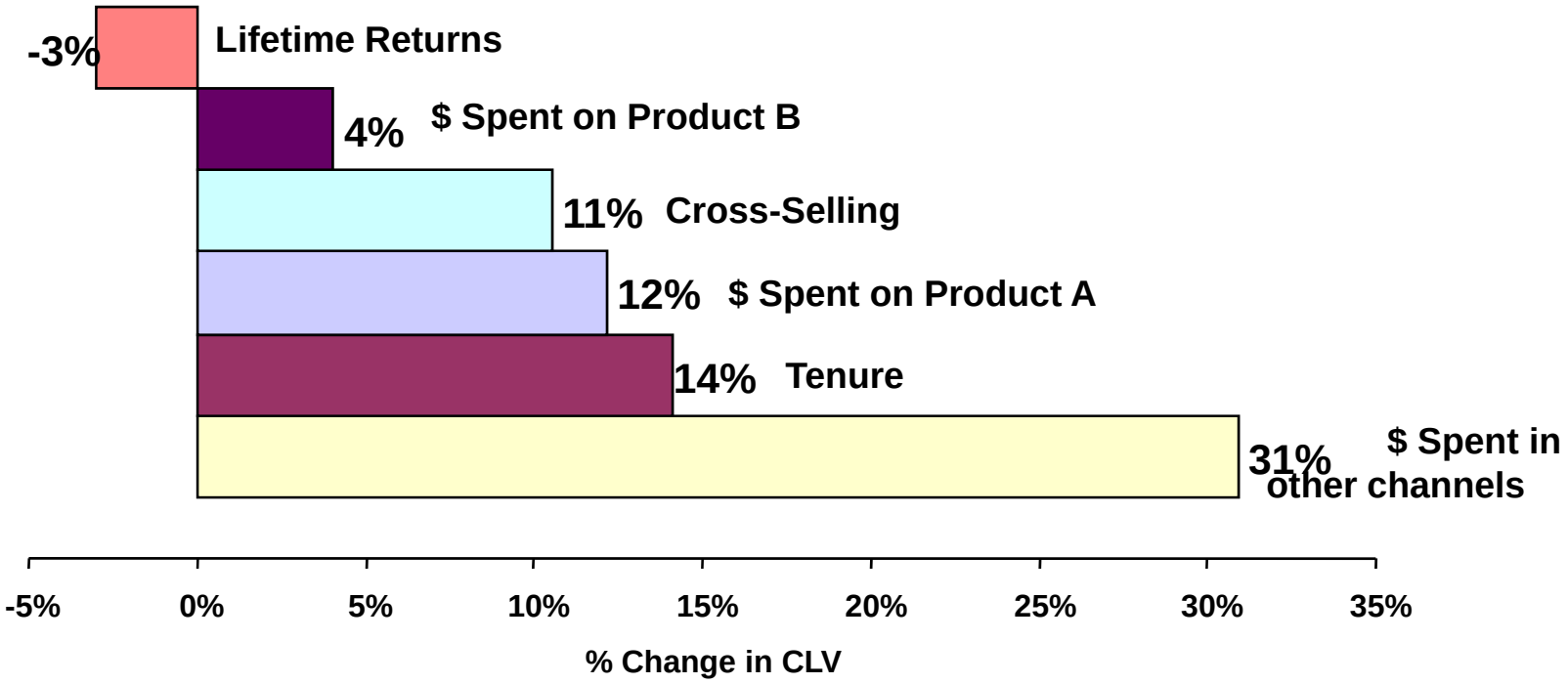
Step 4: Identifying the drivers of CLV

Top Drivers of CLV
▪ $ Spent in other channels (Multi-channel shopping) (+) ▪ Tenure (+) ▪ $ Spent in Product A (+) ▪ Cross-Buying (+) ▪ $ Spent in Product B (+) ▪ Lifetime Returns (∩)



Step 5: Interpreting the impact of the drivers

A 15% increase in cross-channel spending by customers in the top 2 CLV deciles results in 31% increase in their CLV for PRC stores.
Similar interpretation holds for the remaining variables illustrated below.



Step 6: Profile Analyses

Develop profile analyses for the High and Low CLV Customers

Typical High CLV Customer

Gender: Female
Age: 35-54 years
Marital Status: Married
Presence of Children
Estimated Household Income: $125,000+
Stays closer to retailer
Loyalty Card Member
Mail Order Shopper
Shops frequently in upscale stores

Typical Low CLV Customer

Gender: Male
Age: 25-34 years
Marital Status: Single
Presence of no children
Estimated Household Income: < $50,000
Stays further away from retailer
Not necessarily a Loyalty Card Member
Single Channel Shopper

Case Study:
Implementing the CLV Framework in the B2B scenario

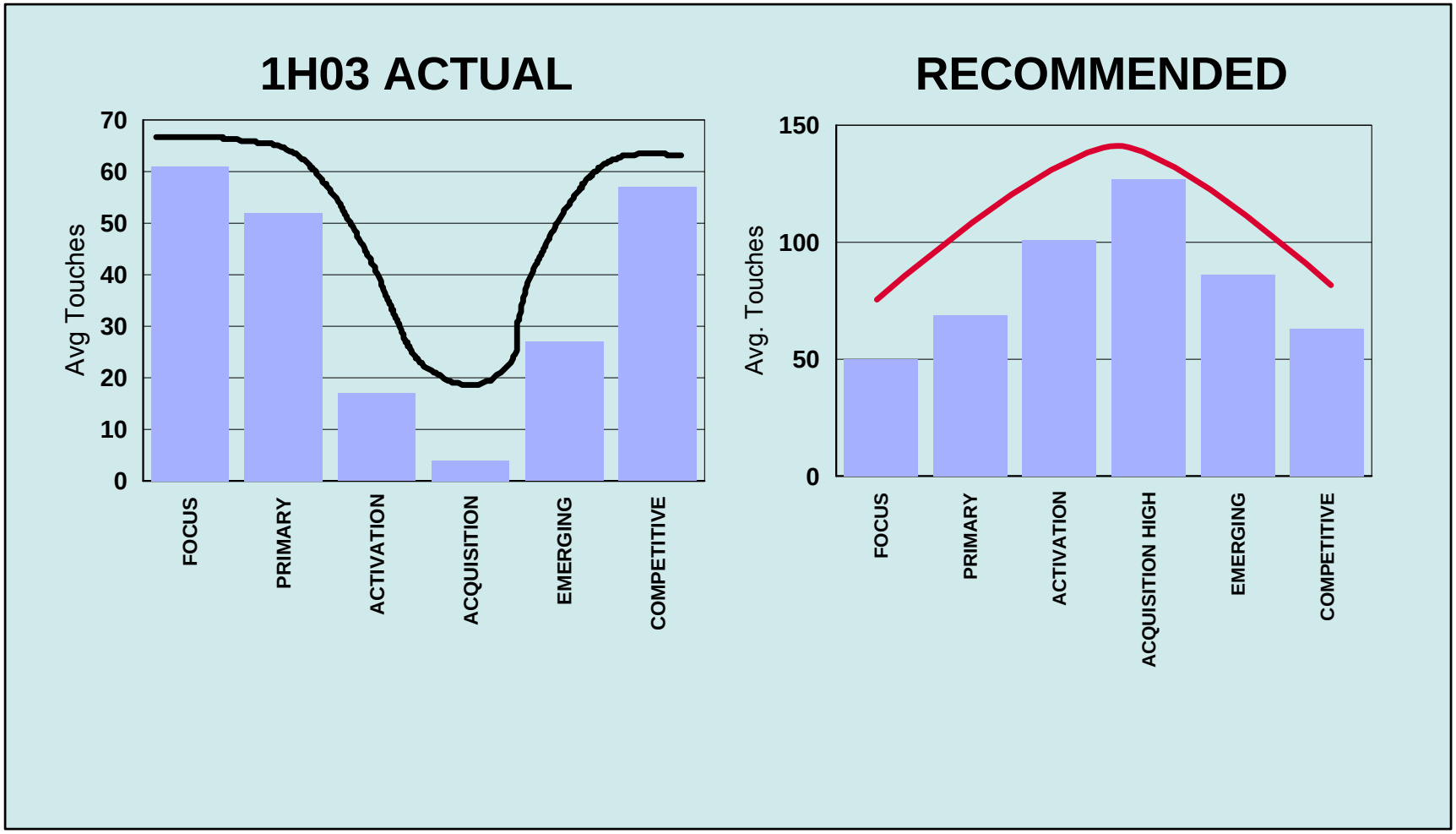
How did we get there?

Process	Purpose
Measure Customer Lifetime Value (CLV)	To measure the potential value of IBM customers
Identify the Drivers of CLV	To influence the CLV
Determine optimal level of touches for each customer that maximizes their CLV	To determine the level of investment required for each customer
Develop propensity models to predict what product(s) a customer is likely to purchase	To develop a product message when touching a customer
Reallocate marketing touches from low CLV customers to high CLV customers	To maximize marketing productivity

A key hypothesis that we want to test is…..

Can an increase in touch create high value from low value customers when all other drivers are similar?

Average Number of Touches/Establishment (B2B firm)



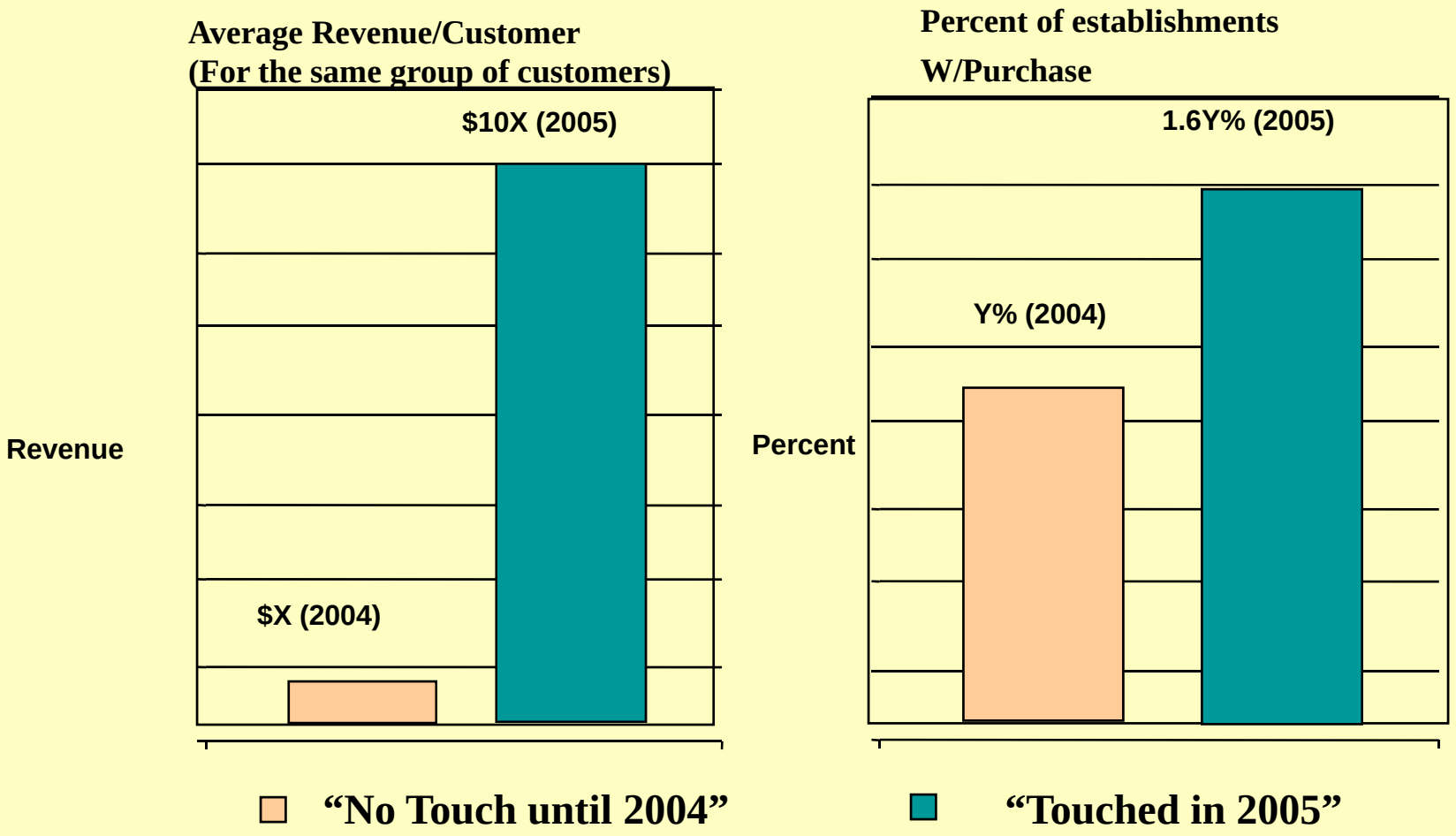
Optimal Resource Allocation Matrix

Customer Lifetime Value	Share of Wallet: Low	Share of Wallet: High
High	**Cost Reduction($):** *Currently Spending $1,008* *Optimal Spending Limit $2,197* **Face to Face Meetings:** *Currently meets once every 6.6 months* *Optimal meeting interval is 4.6 months* **Direct Mail/Telesales:** *Current Interval is 4.82 days* *Optimal Interval is 1.9 days* **Profits:** *Current Profit is $109,364* *Optimal profit is $178,092*	**Cost Reduction($):** *Currently Spending $1,385* *Optimal Spending Limit $2,419* **Face to Face Meetings:** *Currently meets once every 2.5 months* *Optimal meeting interval is 1.2 months* **Direct Mail/Telesales:** *Current Interval is 6.3 days* *Optimal Interval is 5.3 days* **Profits:** *Current Profit is $534,888* *Optimal profit is $905,224*
Low	**Cost Reduction($):** *Currently Spending $819* *Optimal Spending Limit $433* **Face to Face Meetings:** *Currently meets once every 4.5 months* *Optimal meeting interval is 12.5 months* **Direct Mail/Telesales:** *Current Interval is 9.7 days* *Optimal Interval is 12.6 days* **Profits:** *Current Profit is $7,435* *Optimal profit is $12,030*	**Cost Reduction($):** *Currently Spending $1,291* *Optimal Spending Limit $612* **Face to Face Meetings:** *Currently meets once every 2.4 months* *Optimal meeting interval is 10 months* **Direct Mail/Telesales:** *Current Interval is 8.4 days* *Optimal Interval is 8.3 days* **Profits:** *Current Profit is $10,913* *Optimal profit is $28,354*

Resource Reallocation based on CLV

Decile	*Not Reached Until 2004*	*Reached by 2004*	*Customer Segment*
1	**$350,471**	$2,124,483	Super High CLV
2	**$993**	$125,460	High CLV
3	**$669**	$43,681	Medium CLV
4	$638	$23,624	
5	$623	$17,499	
6	$611	$13,675	
7	$534	$10,513	
8	$444	$8,051	Low CLV
9	$369	$5,023	
10	$80	**($35)**	

Impact of the Touch Strategy



On a small pilot of <1% of the establishments in a single country

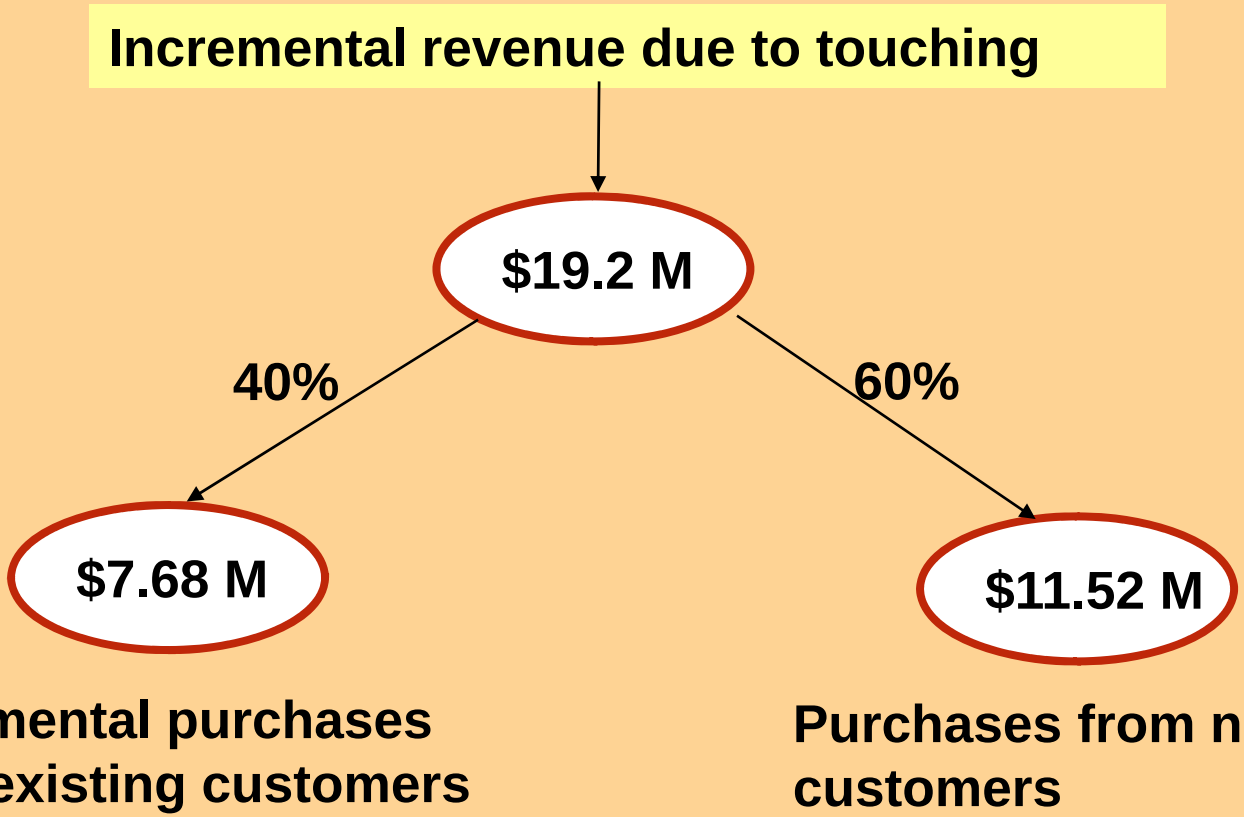
Impact on the Bottom Line

Touched in 2005	Touched Until 2004: Yes	Touched Until 2004: No
Optimal # of touches	28[a]	8.1[a]
Observed # of touches	37[a]	8.9[a]
Revenue in 2004	$751 M	$2.0 M
Revenue in 2005	$793 M	$22.2 M
Incremental Revenue	$42 M	$19.2 M

[a] Average per customer

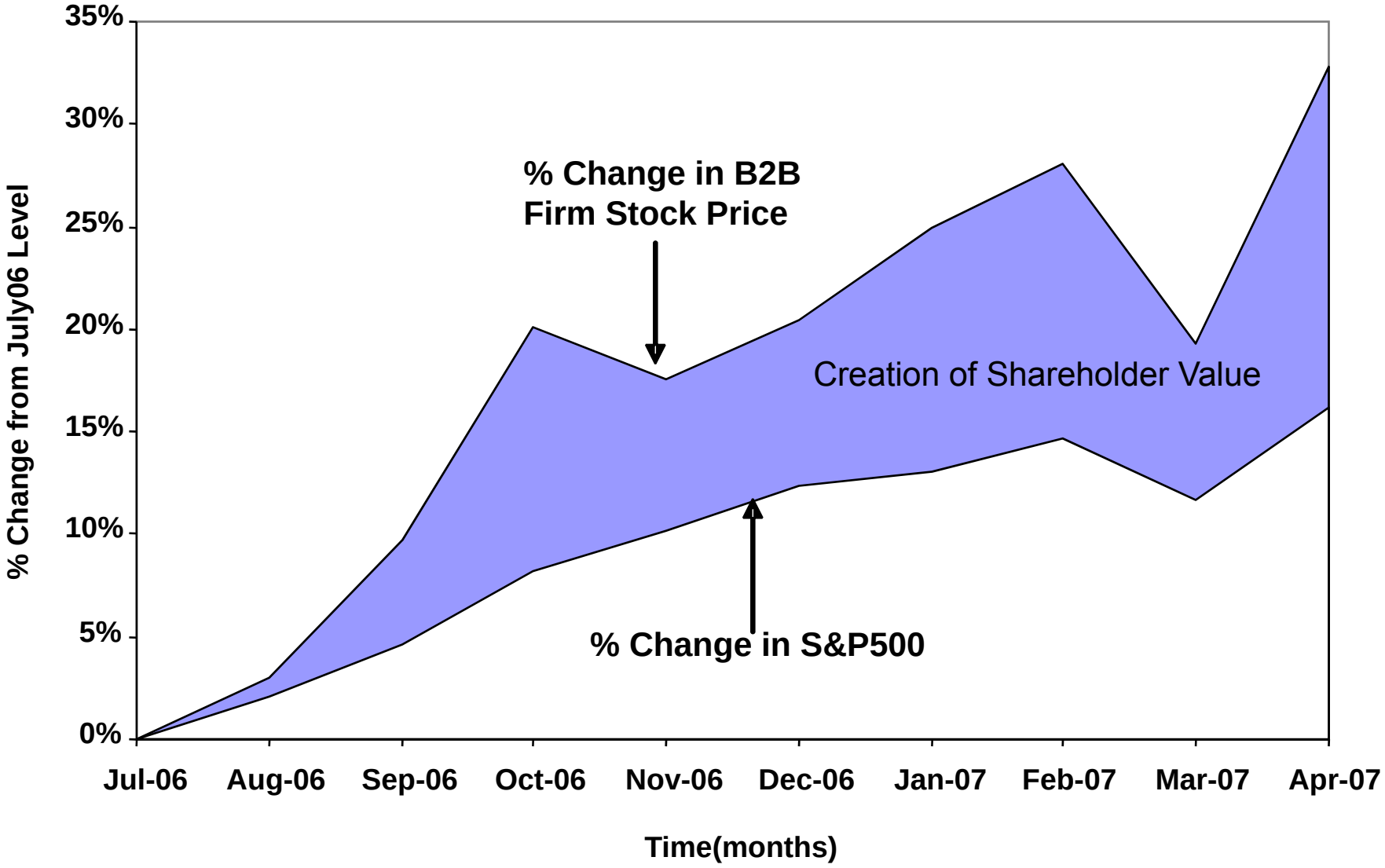
- The CLV model did not miss out on identifying the existing valuable customers as evident from the incremental revenue of $42 million.
- Incremental Revenue attributed to net new accounts touched using CLV Model recommendations = $ 19.2 million.

How to induce incremental sales?

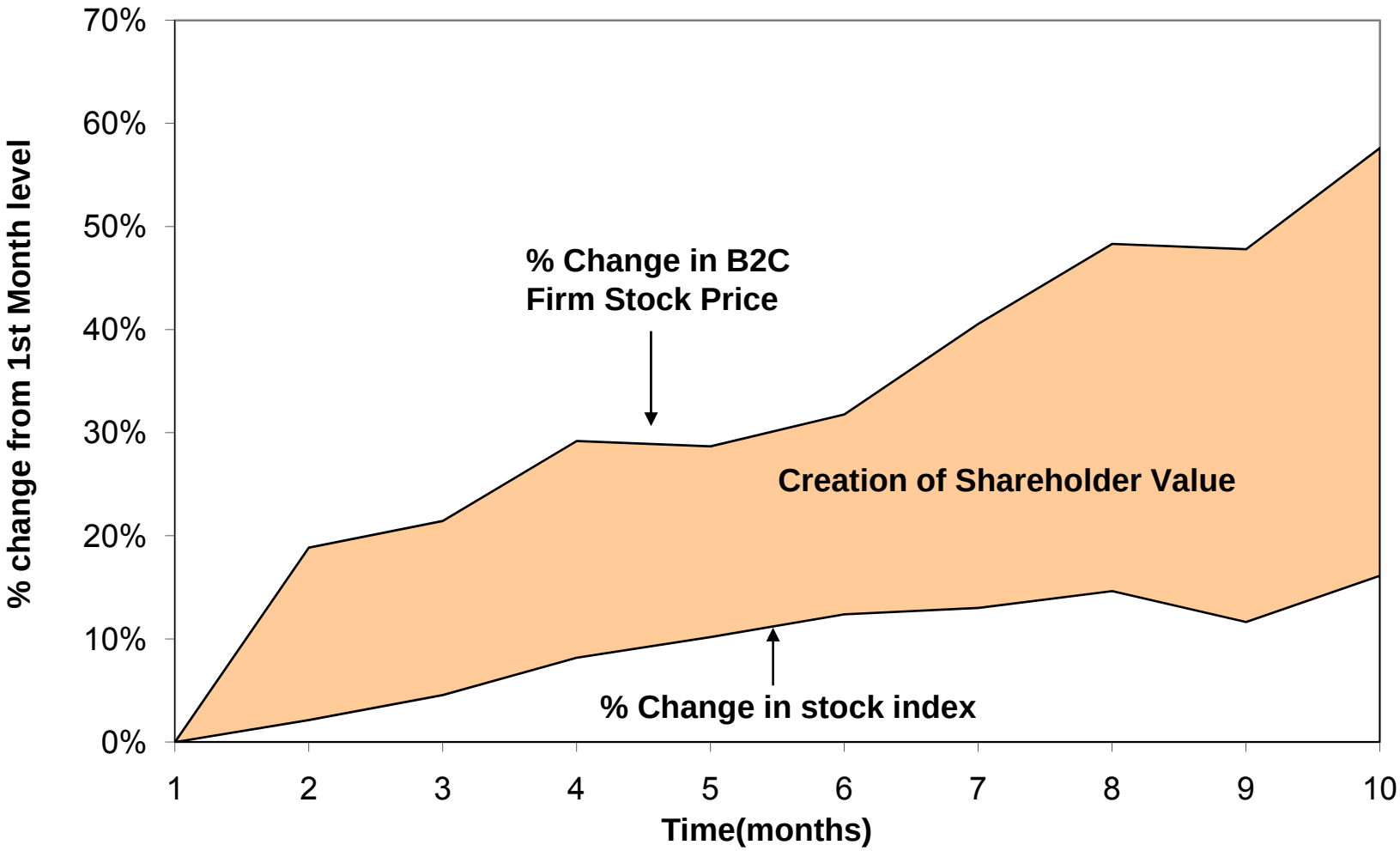


Linking CLV to Firm Metrics

Comparison of B2B firm's Stock Price Movement with the S&P 500 Index

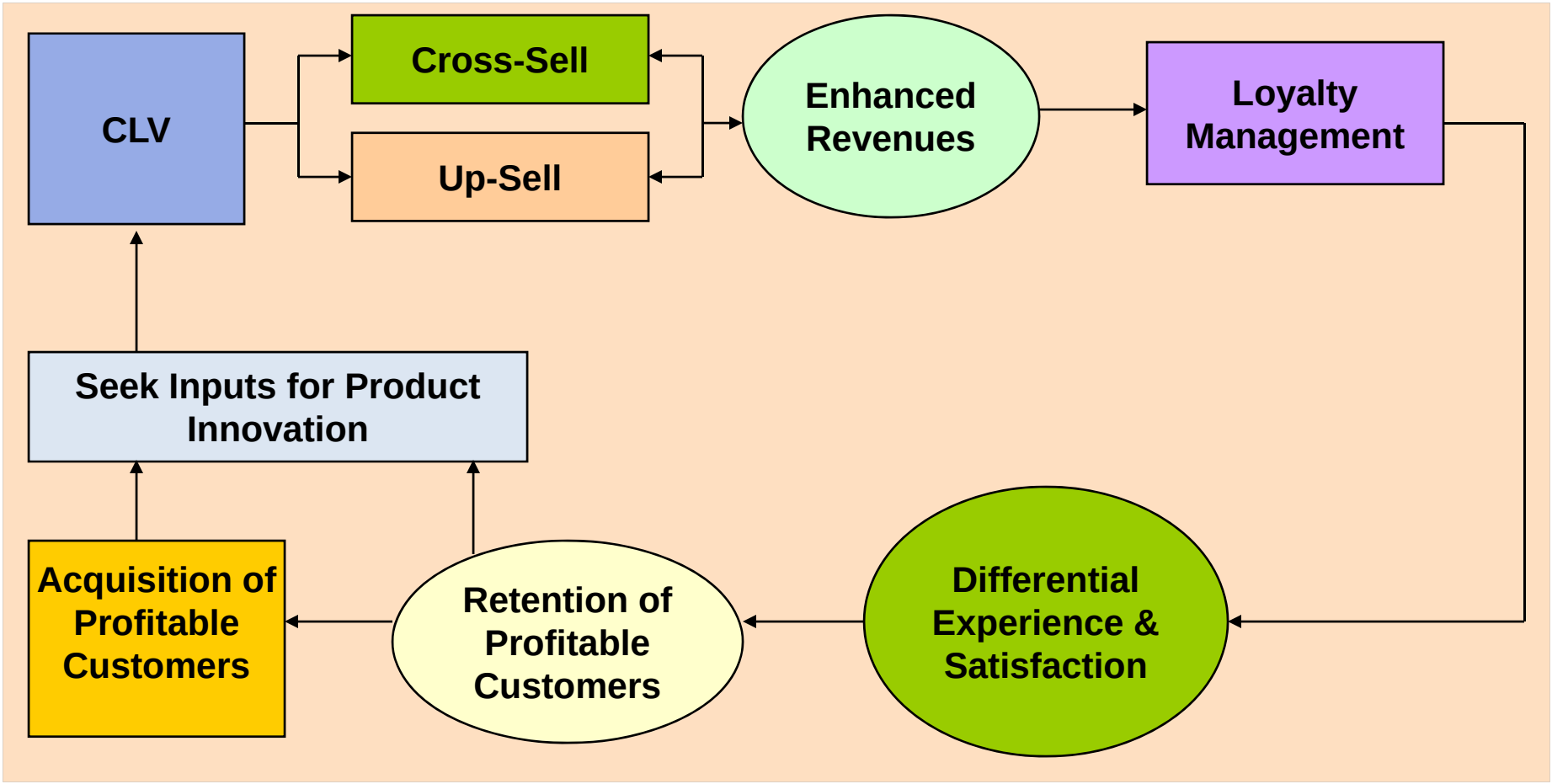


Linking CLV to Share Holder Value (SHV)

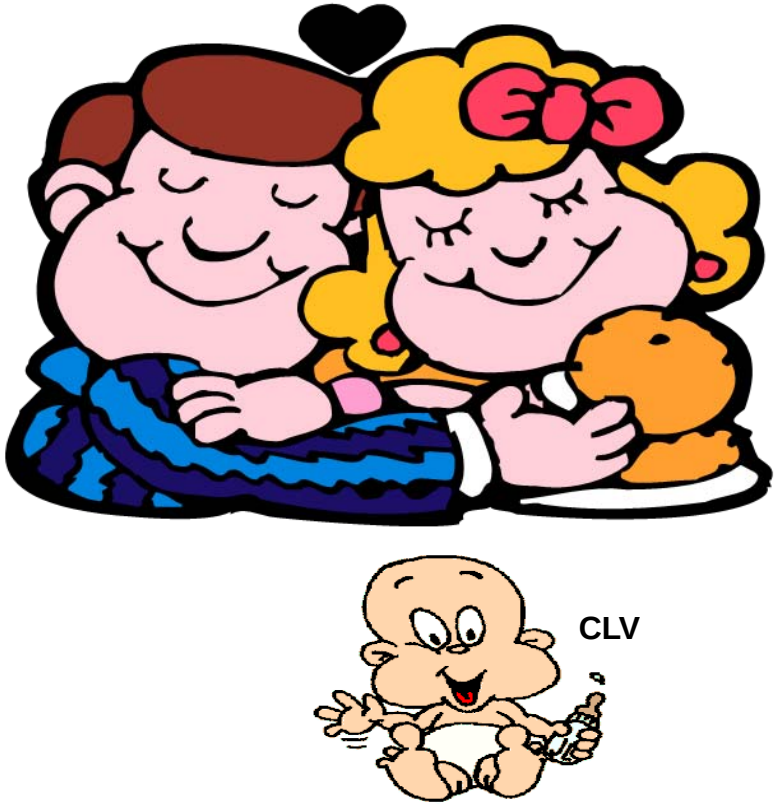


Path to Profitability

Reversing the Conventional Logic

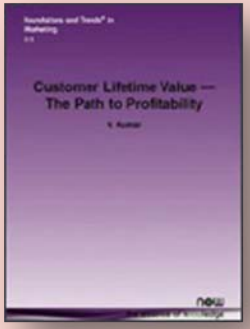


Firms & Customers

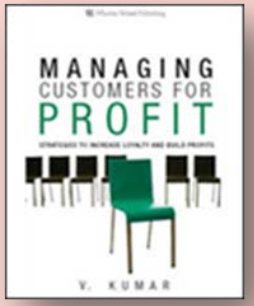


…..need to end up together in an eternal blissful marriage so that the managers can live happily ever after.

Relevant Books

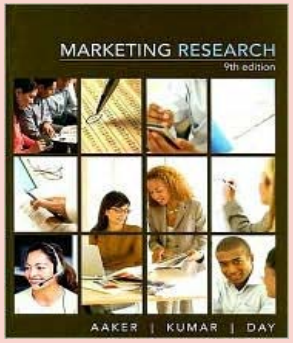


Kumar, V., "Customer Lifetime Value- The Path to Profitability", *now Publishers*, Delft, The Netherlands, 2008



Kumar, V., "Managing Customers for Profits", *Wharton School Publishing*, Philadelphia, PA, 2008.

Kumar, V., and Werner J. Reinartz, " Customer Relationship Management- A Databased Approach", *John Wiley & Sons*, Hoboken, NJ, 2006



Aaker, David A., Kumar, V., George Day, " Marketing Research"-9th Edition, John Wiley & Sons, Hoboken, NJ, 2007

Thank You!

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Which customer is most loyal and profitable?