Customer Relationship Management

A CRM Approach To Customer Profitability

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Customer relationship management demands that you understand which customers create profits and those that destroy it. This paper explores how a CRM strategy that is coupled profitability measurements and predictive modelling can create sustained competitive advantage.

Historic profitability measures just don't measure profitability - financial accounting systems fail the test. To be successful you must consider long term/life time value (LTV) and make informed assumptions about the customers' tenure with your company. You must then couple this with your CURARE type plans to make it all happen.

About The Author

Michael Meltzer is a managing partner of Active Management Techniques that specialises in advising organisations on the use and the benefits of information to support relationship management in all its forms. He is a hands on partner who has experience spanning financial services, telecommunications, education and retailing. He has specialised in uses of information to support internal and external customer relationship management, e-business, customer knowledge and building organisations where innovation and learning can flourish. He is a respected author, sought after speaker, educator, consultant and experienced business manager.

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CRM – Inside Out – I-CR®

A CRM approach to customer profitability

Whenever I read about CRM today I get very confused as vendors and consultants talk of multimedia customer service centres (MCSC), sales force automation (SFA) systems as if that is all there is to CRM. Others continue to talk about CRM's failure to deliver on the promise. For some of us that have been around relationship marketing and technology for some time we know that for many major organisations CRM has been a roaring success since before MCSC or SFA's was a twinkle in Siebel's eye. CRM is that all encompassing philosophy about customer centricity and believe it or not mutual profitability based on relationships of some kind.

In this short paper, I want to talk a little about the benefits of understanding customer profitability and lifetime/long term value[1]. The purpose is to help doubters out there about CRM's true aim which is to build relationships founded on profitability and not merely good feelings and heavy handed salesmanship that can easily destroy profits as build them.

On the Road Again

On the road to customer profitability, many organisations began by attempting to carry out product profitability. Initially we could see this attempt at product profitability and hence better costing as a manifestation of an organisation's fixation on being product driven as opposed to customer focused. However even this approach has been difficult to implement as a product's profitability was often managed only vertically, from development through sales, with no measurement of costs borne horizontally through an organisation's administrative and back-office functions. Manufacturing had overcome this problem but the more service focused industries found it difficult because of the many attributes their products/services have. A television may have many working parts but it performs one function and does not have a range of service or risk elements attached to it. After you have bought a TV apart from some service needs if it goes wrong there are no other relationship cost or connections. A current account or mobile phone service actually has many functions acquiring and dispenses many costs and charges during the lifetime of usage.

Although the product or service an organisation offers may have many relationship opportunities companies remain in the past and cling to outmoded product centric practices. There is a fixation by many companies on being product driven whilst paying lip service to being customer centric and espousing all the CRM words yet they remain product-aligned organisations. This makes it difficult for them to understand the real cost and benefits of customer relationships. The other

[1]For fuller introductions to customer profitability please review: Customer Profitability just isn't enough and Segment Your Customers Based On Profitability by M.Meltzer at www.amt.eu.com

considerations centre on the concepts of cost allocation and cost attribution which also very tough on a product centric organisation.

The History of Accounting Systems

Accounting systems were not set up to measure Customer profitability

To determine customer profitability you would normally look to your existing costing systems. These systems that are invariably based on the standard accounting rules will only look at profits for the current year. Accounting systems take no account of the potential profits or losses attached to individuals and customer segments or the ranges of products - they take. Cost attribution is focused on cost/profit centre profit and loss that eventually rolls up to the business overall profit and loss statement and balance sheet. The accounting system is not focused on customers or organisational performance but on income and cost allocation. Management accounting systems were created in the industrial revolution (textile industry) and were further developed in the 19th century to account for the railways, manufactured goods, retailing and machine tools. Material costs and direct labour were the largest proportion of total costs in a manufacturer's world; all the rest were overhead. In the new world of service-dominated economies, the old accounting methods distort profitability. Almost every activity can be seen as undifferentiated overhead. The whole process is top down as there was no granularity to the actual customer transactions. In the past the technology was just not available to enable a company to see the trees for the wood!

Consider Time

To bring customer profitability alive and to dovetail it into the CRM vision we need to consider the customer over time. Some major lifecycle events that affect customers' product needs and potential profitability include finishing school, graduation from college, marriage, first home purchase, birth of a child, children leaving home, retirement and to finally prospective death. So in order to model these we must also introduce other methodologies to predict customer behaviours. Once this information is integrated with predictive capabilities what was static although useful, becomes a valuable tool amongst the firms range of analytical tools.

Lifetime/Long term Value (LTV)

The concept identifies that a customer normally has a relationship of sorts with the organisation that spans a particular period of time. There isn't any customer relationship management if there is no relationship to speak of. However, organisations consider loyalty that is repeat purchase may in infer brand loyalty that in itself many believe represents a relationship exists. By taking into consideration a customer's age, the anticipated length of his/her relationship with the company, his lifestyle stage, demographics and potential future product/service needs a set of cash flows are assumed to occur stretching into the future.

To understand the value of the customer to the organisation today discounting techniques such as net present value (NPV) are used. So a company can review the potential worth of different types of customers and make appropriate offers and methods of offering service in line with the revenue/profit expectations.

Assumptions

In order to calculate the future value of a customer's tenure, assumptions have to be made. Assumptions regarding the length of time a customer is likely to remain with you could include information relating to their age, their lifestyle, occupation, geographic location and income. From this information certain predictions have to be made regarding the types of products he/she is likely to purchase; the income that will be derived from those products; and the costs associated with marketing and providing those products. Based on analysis of existing customers using particular products predictions are made for similar looking customers. Current customer relationship characteristics, such as average length of the relationship, average phone usage (ARPU and APPU – average revenue per user and average profit per user) average account balances, and default or prepayment rates for example. A range of revenue and profit patterns are compared to other customer attributes representative of relationship behaviour. These can include age, income, education, usage history, and life stage. Based on this analysis, longevity predictions are made about customer's relationship tenure, product/service holdings, ability to pay, and other inputs that will affect future profitability.

HOW LONG DOES A CUSTOMER REMAIN A CUSTOMER?

In addition, a start can be made in identifying for each customer what actions or dynamics have the potential to change his or her value to the organisation. Product development and pricing strategies, including channel migration strategies, cross-sell activities, up-sell and fee structures, can positively or negatively impact the customer's value, as can customer service and retention treatments. Profitability measures coupled with LTV numbers enable an organisation to better profile their potentially profitable customers and to identify look-alikes amongst its prospective customers. An organisation can use the information it has pulled together in its customer knowledge infrastructure (CKI) to enable it to retain customers, develop customers and to acquire new customers. So that the CRM mantra can really be applied, the one view of the customer is a mandatory part of the development of any CKI.[2]

Retention

By identifying just how profitable some customers really are and those it really must retain a company can undertake specific customer retention treatments. The idea behind this is that it normally cost five times as much or more to find new customers as it does to spend a little more on retaining those customers you already have. These customers when

[2] 'Getting started building a customer information infrastructure' – Michael Meltzer www.amt.eu.com

matched up to similarly looking customers can form specific treatable groups that can then receive special services. They can be given relationship managers or special telephone numbers linked to assigned customer service representatives (CSR's) plus access to an extranet where they can manage their own relationship with the organisation and whatever else is required to keep their business as long as there is value in the relationship for both parties. By knowing both the current and who the potentially profitable customers are treatments and ways of delivering services to the less profitable customers can be altered.

Cross sell, Up-Sell

To increase their share of the customers wallet many firms believe that a depth of products taken means profit. But, buying lots of unprofitable products/services form an organisation still doesn't make a customer profitable. However armed with profitability and LTV information an organisation can now consider a CURARE based approach such as cross-selling other products or up-selling more valuable services and products. They would then have a higher degree of certainty that they are contributing towards the bottom line. There is also the opportunity to move that marginally profitable customer into profit if you understand the customer dynamics involved and are able to either find a way of lowering the cost to serve or finding them more mutually profitable services to take. For every decision or action, there is a likely pattern of behaviour, cash flow and risk outcomes that can be anticipated. Any cross-sell action includes estimates of all cash flows associated with the actual marketing decision. Costs would include up-front acquisition expense, ongoing account maintenance and servicing, and potential risk weightings. Revenues would include potential LTV from fees, commissions paid and ongoing costs to serve. With an understanding what components make up a customer's profitability, organisations can analyse the potential impact of various cross-sell initiatives on individuals, segments, and down to the segment of one profitability.

Cross-sell
Up-sell
Retention
Acquisition
Reactivation
Experience

CRM Realities

CRM can become a reality when you start using information about customer lifecycles whether business or consumer, their LTV and their overall profit you get from their relationships. Armed with this information you can then start using it to drive your business plans. There is a need to build up information about your customer to feed the new systems you want to buy. This was noted in study when speaking of firms that did not achieve the returns of their investment or increased productivity they expected. "They invested in popular customer relationship management systems before they had built repositories of consistent and reliable customer data. Not surprisingly, the CRM investments fell well short of expectations."[3] Without good customer or profitability information, why should you invest in a new call centre or a

[3] The real new economy – Diana Farrell - Harvard Business Review – October 2003

SFA system? Add to this the typical failure invest in the people and processes then either or both of them could merely be driving the firms costs up to serve or create new customers that may never turn a profit!

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