Customer Profitability

An Interview with Dr. Sunil Gupta, Meyer Feldberg Professor of Business, Columbia University

NOTE: Professor Gupta's expertise lies in the areas of pricing, promotion and customer management. His work in these areas has won many awards, including the best paper award for the Journal of Marketing Research. Professor Gupta is a former visiting scholar of the Teradata Center for Customer Relationship Management at Duke University and is currently a visiting professor at the Harvard Business School.

1. Is the push toward customer profitability a new trend?

Firms have been interested in customer profitability for many years. However, about seven to ten years ago, customer profitability as a measurable component of marketing really started to evolve for three main reasons. First, we now have the technology that enables us to store millions of data points.

Second, in the last ten years the sophistication in analytics and modeling has increased many folds. These models allow us to turn customer data into knowledge.

The third catalyst is the push for marketing to be more accountable. The emphasis on marketing metrics has greatly increased. More and more managers are asking themselves, how do we know we're getting a return on our marketing expenditure?

Before these three changes, businesses paid attention to profitability – just not on a customer-by-customer basis. The attention and analysis was focused on either product-level profitability or on broad customer segments. Now, because of increased data storage and analytical and modeling capabilities, we can drill down to customer level detail. And because of the need for marketing to be more accountable, we know we need to.

2. What is difference between this push toward customer profitability and current customer relationship management (CRM) programs?

Early on, CRM programs simply collected data at the customer level. There is a huge difference between that and converting CRM-based data into customer profitability.

The first fundamental component for understanding customer-by-customer profitability is to know the revenue and the costs for each customer. However, most companies' accounting systems do not allocate costs on a customer-by-customer basis. To turn CRM data into a customer profitability model, a company must switch from activity-based cost accounting to customer-based cost accounting. This means allocating costs by customers.

The second component is to move away from a brand management focus to a customer management focus. In a brand management model at a bank, for example, one manager manages mortgages, another checking accounts, and another credit cards. The managers don't know how any one customer interacts across the entire business. For each product, a customer may be a low value customer, but he may be very valuable across the entire organization. Yet because the brand managers cannot know this, they may under-invest in the customer. If the bank followed a customer manager model, however, the customer's true value would be apparent and could be managed accordingly.

One of the best examples of the customer management focus is Harrah's Casino. This company had numerous individual properties that were managed as separate profit centers. But once the company linked customer activity from property to property, the company could do a much better job of cross-marketing.

It's important to be able to change the focus so that brand or property or departmental managers don't manage customers and their information, but rather, the central organization of the company does.

3. Are boards of directors or managers of companies driving this trend toward customer profitability today?

The real reason is the push for marketing to be more accountable. The typical response of a marketing manager used to be, "I will improve customer satisfaction." Knowing customer satisfaction levels is fine and important, but it's no longer enough. Now senior management wants to know the return on that investment so they can understand exactly how much they should be spending to improve satisfaction.

4. So is there a connection between customer profitability and the actual value of a company?

Yes. Revenue comes from customers buying products. If you can value one customer, you can value the entire customer base of a company. Then you can project at what rate the company is acquiring customers and at what rate they are leaving. Combining those components enables a company to derive the projected value of the customer base, which should be close to the value of the firm. Our research shows that customer value provides a strong proxy for market value of several firms.

5. Where is the convergence between finance and marketing? Do you think there is a difference between customer value and customer profitability?

CEOs and senior management both care about the market value of the firm. Typically market value is estimated as discounted cash flow. The critical component in this approach is the projection of future cash flow. What is the basis for projecting cash flow?

A common approach is to use past data for this projection. I think this approach is simplistic and potentially misleading.

Marketing takes a bottom-up approach. Our premise is that cash flow is a result of customers buying products. Therefore, we can project cash flow and build the ultimate value of the company from the bottom up by looking at each customer as a building block.

Historically, when marketing talked about customer profitability, the notion was "How do I provide value to the customers? How do I make my product more valuable to the customer?"

What customer profitability talks about is the flip side of customer value – which is how valuable the customer is to the company. So you can think of it as two dimensions – how do I provide value to the customer and how does the customer provide value to me? If I don't provide value to the customer, he won't buy anything. On the other hand, if he doesn't provide value to me, then should I spend valuable resources on pursuing his business?

In marketing, we say the customer is the king – that we have to provide value to the customer. In finance, cash is king – how much value do I get from this particular customer? Customer profitability brings together these two dimensions.

6. Are most companies today using cost and revenue to understand customer profitability?

Revenue is easier to track because it looks at how much a customer actually gives a company. Customer cost is a harder measure to track because most companies' accounting systems were not designed to track customer-by-customer costs. Unfortunately, this means that acquisition and marketing costs are grouped together and averaged. Slowly, companies are beginning to allocate costs by customers because they can see how many times a customer uses an ATM or frequent flyer cards and so on. But I see plenty of room for improving customer-by-customer cost tracking.

7. Does the theory of detailed, behavior-based profitability make sense?

Yes, it is important not only because it makes intuitive sense, but also because a focus on customer profitability can lead to decisions that are quite different than the decisions based on other metrics, such as market share. For example, higher market share is not necessarily better because a firm may be acquiring low value customers. One study of U.S. banks found that in the early 1990s, only 30% of a typical bank's customers were profitable over the long run. In other words, 70% of the customers destroyed value! Therefore, instead of acquiring low value customers, banks may be better off focusing on profitable customers and even "firing" unprofitable ones.

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