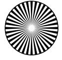
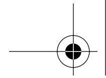
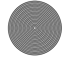
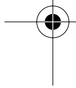
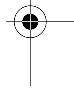
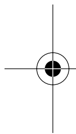
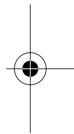


CHAPTER 1

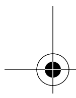
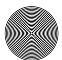
CUSTOMERS ARE ASSETS

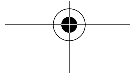
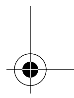
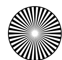



That customers are important assets of a company is not a novel idea. Scores of books have been written about the importance of customers, ways to provide value to them, and the need for a company to be customer-oriented. Most senior executives will readily agree that customers are critical to the survival of a firm and that their entire organization must be customer-centric.

In spite of the apparently almost universal acceptance of the importance of customers, the actions of most firms don't always match this talk. This is not necessarily for lack of effort. Instead, most firms are caught in a situation where millions or even billions of dollars are poured into customer-oriented programs—from satisfaction measurement to customer relationship management (CRM), where investments of $100 million or more are not uncommon. Yet executives find it very hard to explain to their CEOs or shareholders the benefits of these investments.

The difficulties in showing the tangible impact of most marketing investments often lead firms to resort to proven short-term strategies, such as promotions, cost-cutting, or financial re-engineering, that show quick and measurable results. This dilemma—believing that customers are assets but not treating customer-related programs as investments—is a consequence of their inability to measure and value customers as assets

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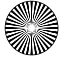
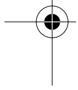
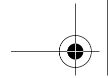
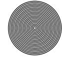
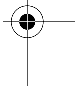
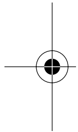
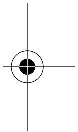


and show the tangible relationship of these assets to overall firm value. This book takes an important step in this direction.

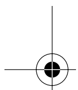
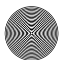
Our hope is not only to show a link between customer value and firm value, but also to identify the key levers that drive this value. We show which aspects of customer management are more critical than others and how better management of customers is also better management of shareholders' wealth. Put differently, we bridge the gap between marketing and finance by providing a common language and specific metrics that can be used equally effectively by marketing and finance executives as well as financial analysts and investors.

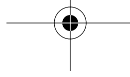
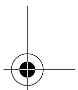
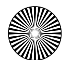
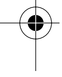
Our approach in this book is based on a simple premise: It is better to be vaguely right than precisely wrong.[1] Throughout the book, we emphasize simple and intuitive concepts and tools that can be readily used by almost any manager or investor, regardless of his or her technical expertise and the extent of available data or information resources. We have tried to avoid the complications and sophisticated models that, as academics, we have a natural tendency to embrace. Sophisticated readers will undoubtedly have many suggestions for how to improve and modify the basic approach suggested here. In fact, we will consider it a success if we are able to spark such discussion and debate around the ideas presented in this book.

IMPORTANCE OF CUSTOMERS

Customers are the lifeblood of any organization. Like many clichés, this one happens to be true. Without customers, a firm has no revenues, no profits, and therefore no market value. This simple fact is not lost on most senior executives. In a worldwide survey of 681 senior executives conducted by *The Economist* during October–December 2002, 65% of the respondents reported customers as their main focus over the next three years, compared to 18% who reported shareholders as their main focus (Figure 1.1).[2] Another study conducted in 2000 with 148 financial institutions found similar results. In this study, 72% of the companies said customer-related performance was an extremely important

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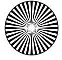
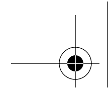
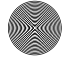
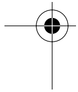
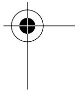


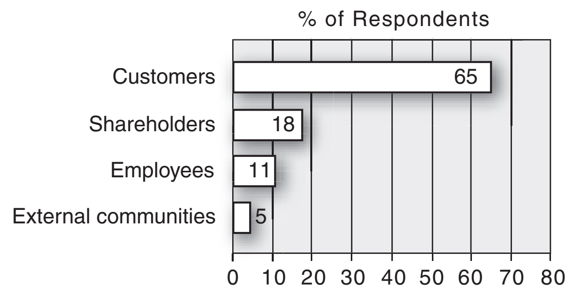
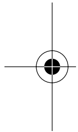
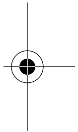


Figure 1.1 Senior management's main focus over the next three years. Source: *The Economist* Intelligence Unit online survey, October–December 2002.

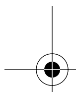
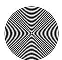
driver of long-term success, against 31% who chose short-term financial performance.[3] This echoes the thoughts of many executives and experts who argue that, contrary to the commonly held view (and the impression left by recent accounting scandals), creating shareholder wealth in the short run is not the main purpose of an organization. Instead long-run shareholder wealth is the reward for creating customer value.

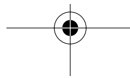
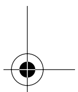
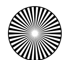



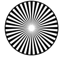
THE GAP BETWEEN BELIEFS AND ACTIONS

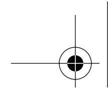
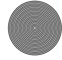
If most senior executives believe customers are critical to the survival of a firm, which they are, then what is the problem? The following brief case provides an illustration.

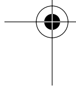
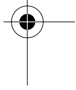
In the early 1990s, the U.K. division of Hoover, a company well-known for its vacuum cleaners, was evaluating its options for growth. Its executives decided to offer a short-term incentive to its customers to spur sales. Consequently, in the summer of 1992, Hoover announced a sales promotion for its U.K. customers. According to this promotion, anyone who bought £100 worth of Hoover products would be entitled to two free air tickets for travel anywhere between the U.K. and Europe. Enticed by this promotional offer, many consumers bought Hoover products. Company executives were very encouraged by consumer

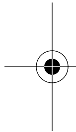
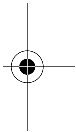


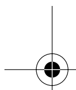
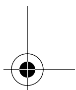
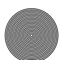
response and sales growth—so encouraged, in fact, they decided to sweeten the deal in December 1992. According to this new promotion, consumers would be entitled to two free air tickets for travel between the U.K. and the U.S. if they bought £250 worth of Hoover products. Consumer response was phenomenal—more than 200,000 consumers applied for this promotion within a few months. While sales skyrocketed and customer growth was unprecedented, the cost impact of this promotion on company profits was disastrous. This single promotion caused the company to take a charge of £48.8 million against their earnings, and many of the senior executives were fired.[4]

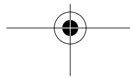
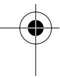
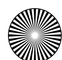
This case highlights the chasm between many marketing executives and their finance counterparts. While marketing managers are quick to boast about improvements in awareness, brand image, or customer satisfaction as a result of marketing expenditures, they do not show, or sometimes even consider, the relationship between these metrics and the overall value of the firm.

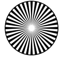



It is very difficult, if not impossible, for a marketing executive to say with precision how much an extra point of customer satisfaction is worth. Should a firm spend $10 million to improve customer satisfaction from 3.5 to 4.5 on a 5-point scale? How about $100 million? Consider that in 2002, U.S. companies spent more than $250 billion on advertising alone—more than 2% of the GDP of the United States and more than the GDP of Thailand, Hong Kong, or Indonesia! With such large expenditures at stake, senior management has good reasons to demand tangible results. Unfortunately, many of the benefits from investment in marketing and customers tend to be long-term in nature. This makes measurement much harder, and the debate between different parties becomes based more on philosophy than on facts and specific metrics.

While it is easy to berate marketing executives for focusing on short-run metrics, financial analysts and CFOs have not been completely immune to this effect either. This was most evident during the height of the Internet bubble, when the analysts had a hard time valuing firms such as Amazon, which had no positive earnings or cash flows. This made the application of trusted valu-



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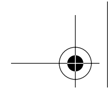
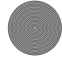
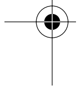
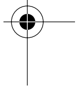
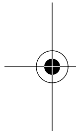
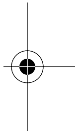





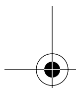
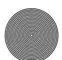
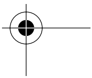
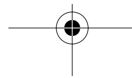
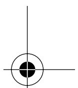
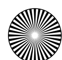
ation methods, such as discounted cash flow or price-earnings (P/E) ratio, very difficult: It is hard to talk about a P/E ratio when there is no E! The inability to use traditional financial models led many of these analysts to look at nonfinancial measures such as number of customers and customer stickiness on Web sites. It was not uncommon for the senior management of these companies, as well as financial analysts, to talk in terms of market value per customer or number of eyeballs as the relevant metrics to judge the value of Internet firms. Many academic studies implicitly validated this approach by showing a strong relationship between stock price or market value and customer-based metrics for Internet firms.[5]

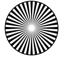



When many of these high-flying Internet companies were driven into the ground, the financial community swung the pendulum to the other extreme. In fact, many blamed the Internet bubble on the use and popularization of nonfinancial measures, such as "eyeballs" and "page views," by some of the leading financial analysts.[6] In a way, this hardened their view that finance was fine until marketing influenced it.

This view was confirmed by a recent study that found that investors implicitly capitalized both product development (R&D) and advertising (customer acquisition) expenses during the Internet boom period, thereby treating both R&D and customers as intangible assets. However, only product development costs were capitalized subsequent to the shakeout in the spring of 2000. Essentially, this means that after the end of the Internet boom customers were no longer considered assets, and marketing expenses to acquire or retain them were no longer considered investments. Interestingly, this study also demonstrated that in spite of analysts' and investors' skepticism with measures of Web traffic after the shakeout, they were still "value relevant" to the share prices of Internet companies.[7]

We argue that while focusing only on the number of customers may be misleading, focusing on the value of a customer provides a strong proxy for the overall value of a firm. In other words, both marketing and finance executives may be looking at a partial pic-



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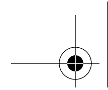
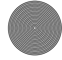
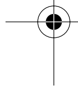
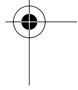
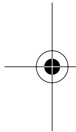
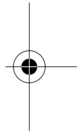





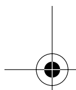
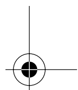
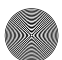
ture. While marketing executives may be too focused on sales growth and customer acquisition, finance executives may be myopic in not treating customers as assets and marketing expenditures as long-run investments.

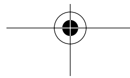
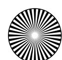
One of the major causes of this disconnect is the lack of clear metrics to assess customer value and its impact on firm or shareholder value. Using a survey of 148 financial institutions conducted in 2000, one study assessed what executives believe are the key drivers of future economic value and their organizations' ability to measure performance in these areas.[8] The study revealed that although firms perceive the importance of intangibles such as customer loyalty and innovation, they lack appropriate measurement tools. The category with the biggest gap between perceived importance and available metrics was customers (see Figure 1.2). Evidently, managers recognize the limitations of financial statements (which don't capture the value of intangibles) and the importance of customers, yet rely too heavily on financial instruments since the measurement tools are well-defined and well-developed in that area. In contrast, customer measurement and its link to financial value have been hard to articulate. This wouldn't be a surprise to someone like Albert Einstein, who put a sign in his Princeton University office that read, "Not everything that counts can be counted, and not everything that can be counted counts." In spite of such pithy advice, most of us tend to focus on things that we can easily measure.

BRIDGING THE GAP

Our approach to linking customer and firm value is based on a simple premise—customers are typically the primary source of earnings for a firm (we recognize that currency swaps and futures contracts can have an important impact in some cases). If we can estimate the value of current and future customers, then we have a proxy for a large part of the value of a firm. For example, if the average value of a customer to a firm is $100, and the firm currently has 30 million customers, then the value of its current cus-

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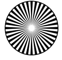
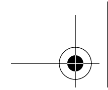
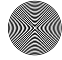
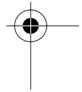


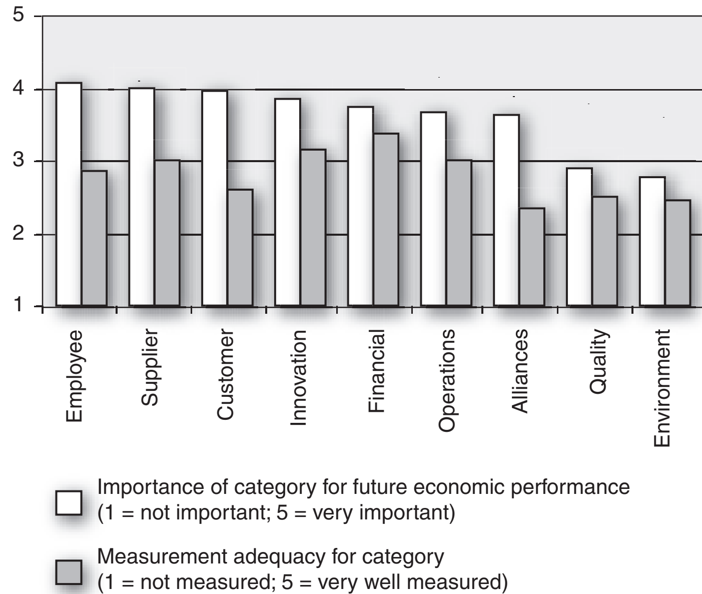
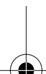
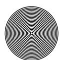
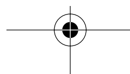
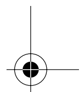
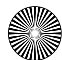


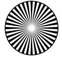
Figure 1.2 The importance and measurement quality of key performance categories. Source: "Non-financial Performance Measures: What Works and What Doesn't," http://knowledge.wharton.upenn.edu/, accessed on February 25, 2004.

tomer base is $3 billion. If we further predict this firm's future customer acquisition rate and estimate the present value of these future customers as, say, $1 billion, then the value of its current and future customers is $4 billion. After making suitable adjustments (e.g., for taxes), this estimate of customer value should provide a good proxy for the value of the firm.

Our approach differs from the traditional finance approach in two key aspects. First, unlike traditional finance, where cash flows for a firm are forecasted at an aggregate or firm level, we build from the bottom up by assessing the value of a customer. There are at least two major advantages of using this disaggregate approach. The first is diagnostic. Earnings, profits, and cash flows are a result of a variety of factors. For example, assume that a firm's





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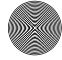
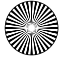


profits are constant over the last few years. By analyzing at the customer level, however, we may see that while the firm is acquiring customers at a rapid rate, its margin per customer is eroding due to intense competition. Our approach not only provides an estimate of the overall value of a firm but also highlights key drivers of value. Hence, when we exhort executives to do something to improve the stock price, these drivers can easily become actionable targets.

A related advantage of the customer-based approach is its ability to, in general, provide better forecasts. It is not uncommon for MBA students as well as financial analysts to use simple rules of thumb to forecast cash flows. For example, if the compound annual growth rate (CAGR) of a specific item of interest, such as revenue, in the last five years was 5%, it is common to assume that the future growth rate is also likely to be 5%. If market conditions are expected to be tougher in the future, an analyst may intuitively adjust this number down to, say, 4%. In our previous example of the firm with constant earnings over the last few years, an intuitive forecast is that the earnings will stay flat in the future as well. However, our customer-based analysis revealed that the firm has been gaining customers but losing margin per customer. Further analysis may reveal that customer acquisition is likely to slow down significantly in the future and margin erosion is likely to continue. This would suggest that in spite of constant earnings in the past, this firm is headed for a significant drop in its future profits. In our experience, forecasting future profitability and linking it to firm strategy is one of the biggest challenges. Our approach explicitly attempts to make this link rather than simply relying on past performance and fairly sterile number crunching to make future projections. In essence, we provide a way to forecast turning points.

A second key aspect where our approach differs from the traditional financial approach is in its treatment of marketing expenditures. If you believe that customers are indeed assets that generate profits over the long run (and we hope you do), then marketing expenditures to acquire and retain these customers should be treated as investments, not expenses. Consider a new



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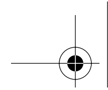
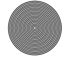
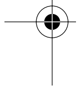
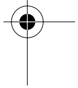
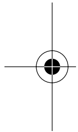
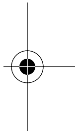
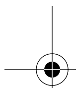
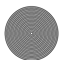





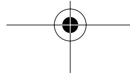
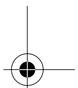
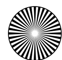
company, such as Amazon. In its early stages, Amazon spent an enormous amount of money to acquire customers. If all these expenditures were treated as expenses, as is traditionally done, Amazon was bound to end up with negative earnings. However, intuition suggests that Amazon's marketing expenses are a necessary investment to build a customer base and that these customers are likely to continue buying in the future. We show that by treating customer-based expenses as investments, we are able to assess the market value of many Internet and other fast growing firms, an area where most traditional methods fail. We also show that many investments were not necessarily wise ones—i.e., firms overestimate the value of the acquired assets.

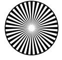



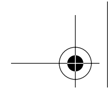
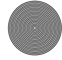
The fundamental building block for our approach is the value of a customer, also called the lifetime value of a customer, which is the present value of all future profits generated from a customer. This concept and model of customer lifetime value are not new. Scores of books and articles have been written on this topic.[9] Models of customer lifetime value originated many years ago in the field of direct and database marketing and continue, to a large extent, to focus in this tactical domain. Most applications of these models require an enormous amount of detailed customer-level data as well as the use of sophisticated models, with the objective of better targeting customers with appropriate product or communication offers. While this is of great value to database marketing professionals, it appears to be of limited value to senior managers, who are less concerned with tactical marketing decisions, or to investors, who do not have access to internal company data.

In this book, we show how most executives and investors can use publicly available information and a rigorous yet simple formula to estimate the lifetime value of a customer for a publicly traded firm. We will show that for most firms, the lifetime value of a customer is simply 1 to 4.5 times the annual margin of a customer. For example, if the annual margin that a firm obtains from a customer is $100, the lifetime value of this customer is likely somewhere between $100–450. The exact multiple (and whether it is closer to 1 or 4.5) depends on a variety of factors (e.g., retention

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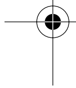
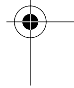
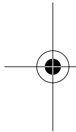
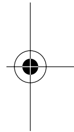



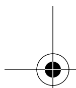
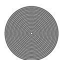
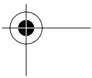
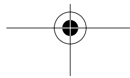
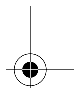
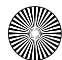
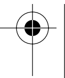
rate) that we discuss in Chapter 2. While it is certainly possible, and even desirable, for a firm to get a more precise estimate of this value by using a detailed customer database, this simple estimate is usually enough to provide the big picture that is necessary for strategic decision-making.

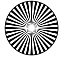
Using several examples and case studies, we show the value of this simple rule for a variety of managerial decisions. For example, we show how this can be used for marketing decisions, such as customer acquisition. We highlight this with a case study of CDNow, showing that its customer acquisition strategy was not economically viable. We also show how this rule can be used to provide guidelines for marketing investment decisions in general. We further demonstrate the value of this approach in the area of mergers and acquisitions. Using a case study of AT&T, we highlight how a customer-based approach clearly shows that AT&T's acquisition of TCI and MediaOne cable for $110 billion was overly optimistic. Finally, we provide a link between customer value and firm value. Using publicly available information for several firms (including Internet firms such as Amazon), we show how close (or far apart) are their customer and firm values. At a minimum, this provides an alternative and complementary method for managers, analysts, and investors to assess the value of a firm.

THE PLAN OF THE BOOK

We start in Chapter 2 by discussing the fundamental "building block" of our book, the value of a customer. We first show a simple method for estimating customer lifetime value. Chapter 2 also highlights the factors that affect customer value and their relative impact. Next we show how to use the concept and estimates of customer value to evaluate marketing strategy decisions (Chapter 3). Specifically, Chapter 3 discusses customer-based strategies of growth, including customer acquisition, retention, and margin growth. We show how customer value can dramatically change the strategic thinking of marketing managers.



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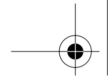
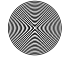
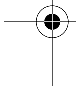
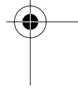
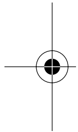
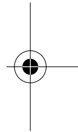





Chapter 4 illustrates how customer-based valuation provides a link between customer and firm value. This link between customer value and financial decisions bridges the traditional gap between marketing and finance. Specifically, we show how the value of a customer can be used to assess the overall value of a firm. This can help investors and analysts make better investment decisions, and can also aid senior managers in strategic mergers and acquisitions decisions.

Chapters 3 and 4 are the core of the book and show how to use the value of customers for strategic decisions related to marketing and finance. Assuming you are by this point convinced of the value of focusing thinking on the value of customers, Chapter 5 provides an outline of customer-based planning for managing and building customer value. We conclude with organizational and implementation issues in Chapter 6.

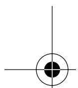
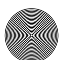
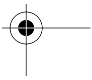
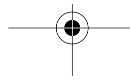
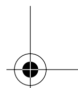
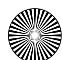



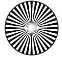
Two common themes run through the book. First, our ideas are based on simple yet rigorous concepts and methods. We provide the simple and actionable ideas in the text and put the mathematics and details in the appendices. Second, we believe these concepts are best illustrated with concrete examples. Therefore, we provide case studies to show how these ideas can be used to evaluate, manage, and enhance strategic decisions.

SUMMARY

The objectives for this book are sixfold:

- To convince you, if you are not already a "believer," that customers are best thought of as assets and that expenditures directly relating to acquiring and maintaining them should be treated accordingly.
- To demonstrate how to estimate the value of a customer.
- To show how the value of a customer provides an important basis for strategic marketing decisions and why commonly used metrics such as market share may be misleading.



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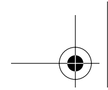
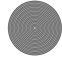
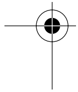
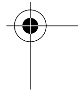

- To indicate how assessing the value of customers provides a "fundamental" approach for valuing a company.
- To suggest how a firm can structure its thinking to focus marketing on managing the value of a customer through efforts aimed at acquiring new customers, retaining existing ones, and expanding the margin generated by customers through cross-selling.
- To highlight how a focus on customer value affects the structure as well as the incentive systems of an organization.

Interestingly, we have so far observed greater receptivity to this from senior managers and people in finance and accounting than from many in marketing, who are often focused on the tactical level (i.e., advertising and promotions). We fully acknowledge that writing appealing copy, creating awareness and positive attitudes, and having promotions that provide short-term increases in sales are desirable activities. Unfortunately, those goals do not immediately translate into metrics that CFOs, CEOs, and even CMOs consider critical. It is our contention that for marketing to "have a seat at the table" (i.e., matter in the boardroom and broader corporation), it must demonstrate its "value relevance." We hope this book in some small way contributes to that end.