Seven Barriers to Customer Equity Management

David Bell
John Deighton
Werner J. Reinartz
Roland Rust
Gordon Swartz

Journal of Services Research, forthcoming
March 12, 2002
David Bell  
Associate Professor  
1400 Steinberg Hall  
The Wharton School  
3620 Locust Walk  
Univ. of Pennsylvania  
Philadelphia, PA 19104  
FAX: 215-898-2534  
Email: davidb@wharton.upenn.edu

John Deighton  
Harold M. Brierley Professor of Business Administration  
Harvard Business School  
Morgan Hall 177  
Soldiers Field Road  
Boston, MA 02163  
Voice: 617-495-6545  
FAX: 617-496-5637  
Email: jdeighton@hbs.edu

Werner J. Reinartz  
Assistant Professor of Marketing  
INSEAD  
Boulevard de Constance  
77305 Fontainebleau Cedex, France  
Voice: 33-1-60-71-26-48  
FAX: 33-1-60-74-67-17  
E-mail: Werner.reinartz@insead.edu

Roland T. Rust  
David Bruce Smith Chair in Marketing  
Robert H. Smith School of Business  
University of Maryland  
College Park, MD 20742  
Voice: 301-405-4300.  
FAX: 301-405-0146.  
Email: rrust@rhsmith.umd.edu

Gordon Swartz  
Vice President  
MarketBridge  
4550 Montgomery Avenue  
500 North Tower  
Bethesda, MD 20814  
Voice: 301-907-3800  
FAX: 301-951-3297  
Email: GSwartz@Market-Bridge.com
David Bell is Associate Professor at the Wharton School, University of Pennsylvania. John Deighton is the Harold M. Brierley Professor of Business Administration at the Harvard Business School. Werner Reinartz is Associate Professor at INSEAD. Roland Rust is the David Bruce Smith Chair in Marketing at the Robert H. Smith School of Business, University of Maryland. Gordon Swartz is Vice President, MarketBridge, Inc.
Seven Barriers to Customer Equity Management

Abstract

The paper reviews the evolution from brand-centered marketing to customer-centered marketing and the beginnings of a focus on viewing the customer as an asset. It illustrates the practice by describing the use of a loyalty program to identify and respond to high-potential customers in the market for business-class hotels. Next it considers seven challenges that impede wider adoption of customer equity management, and concludes with a schematic model of customer-centered marketing management.
Seven Barriers to Customer Equity Management

Introduction

The idea that marketing should be concerned with the profitability of individual customers is not new. Nearly thirty years ago Sevin (1965) laid out a method to compute a single customer’s profitability by allocating functional cost groups to specific customers and subtracting them from each customer’s annual revenue. Recently, however, the topic has been taken up with new vigor, as advances in point-of-purchase data collection and database technology have made it possible to capture and analyze not only the accounts of large corporate customers, but also the purchase histories of households and people in categories where annual per-customer expenditures are quite small. New forms of data have inspired new kinds of analysis. In its modern incarnation, individual customer analysis looks beyond the computation of a single year’s profitability to the forecasting of the stream of profits attributable to the customer and the computing of a discounted present value. Customers come to be viewed as assets (Rust, Zeithaml and Lemon 2000) or equity of the firm (Blattberg and Deighton 1996; Blattberg, Getz and Thomas 2001; Rust, Zeithaml and Lemon 2000), and a measurement literature is developing (Berger and Nasr 1998; Gupta, Lehmann and Stuart 2001; Jain and Singh 2002; Mulhern 1999; Reinartz and Kumar 2001; Rust, Lemon and Zeithaml 2002).

Hand-in-hand with the measurement literature a prescriptive literature is growing (for example Peppers and Rogers 1993, 2001; Seybold 2001; Wolf 1996) which generally advocates allocation of resources away from low-value customers and toward those of highest value to the firm. This philosophy is, however, easier articulated than implemented. To confidently classify
customers into high and low value groups poses many conceptual, empirical and practical challenges, and the hazards of embracing the prescription are not always immediately obvious. A recent Business Week article “Why Service Stinks” (October 23, 2000) describes the potential for consumer backlash when not all customers are treated equally. Other critics of the prescriptive literature point to the sensitivity of customer lifetime value projections to forecasts of customer cash flows and the timing of the cash flows (Jain and Singh 2002) and the irreducible uncertainties associated with these forecasts.

The objective of this paper is to review the arguments for the customer equity management paradigm in marketing, and to develop implications for research and practice. Although we seek to be dispassionate in our review, we are motivated by the expectation that the customer equity paradigm will ultimately be the dominant paradigm guiding marketing management, that it will shape how business schools teach marketing, and that consequently it needs to influence the research agenda of many marketing academics. The paper is organized as follows. First, we describe the rationale that has lead to the emergence of the customer equity paradigm, with examples of the paradigm in practice. Second we review the state of measurement practice. Third, we present seven challenges that practitioners and academics need to attend to in refining the customer asset approach. Fourth, we outline a simple conceptual model that describes how a customer equity perspective can be applied in practice.

BACKGROUND

For much of the 20th century the efficiency with which supply could be matched with demand was low in most mass markets because, while products were identified by brands,
consumers were largely anonymous. To cope with this anonymity, manufacturers invested in unilateral signaling strategies (e.g. Wernerfelt 1988). They vested brands with reputations that corresponded to what they thought segments of consumers wanted. Attention to brand profitability and managing brand equity became cornerstones of consumer product and service marketing, and of increasing interest to business-to-business vendors. The understanding of the needs of segments was, however, error-prone. In particular, membership of benefit segments and high-spending segments was gauged by imperfect indicators such as media audience membership, retail patronage and demographics. Because aggregate market responses to marketing actions were lagged and multiply determined, the ability to learn from experience was poor and marketers operated with little accountability for their actions.

In some mass markets, however, customers and prospects were not anonymous. In the U.S. long distance telecommunications market, for example, the address and transaction history of every subscriber was recorded as a by-product of service delivery, and following the breakup of the monopoly supplier it was made available to all would-be vendors. The result was an intensive use of direct marketing, and direct payments to selected customers for their patronage, with the payments a function of the future value suggested by the customer’s past transaction history.

With the steady, steep decline in the cost of data storage and handling during the latter part of the previous century and into this one, more industries could invest in giving identity to their customers, and, less commonly, their prospects. The catalog retailing industry became a pioneer in the development of efficient methods of promotion that made use of customer transaction histories (Petrison, Blattberg, and Wang 1997), and, after the formation of the Abacus Alliance,
the industry pioneered the construction of a prospect database from the pooled experiences of over a thousand ostensible competitors, creating an industry-wide universe of identified households and their histories. Other industries that accumulated customer identities as a by-product of service delivery followed suit – airlines, hotels, banks and financial service providers. The most recent development has been the building of individual-level customer histories in industries that have not routinely needed to do so – supermarkets by the adoption of frequent shopper programs, video rental stores such as Blockbuster in the same manner, and Dell Computer Corporation with its ‘personal page’ e-commerce initiative.

The transformation from brand-centric to customer-centric marketing can be seen also in Unilever’s recent decision to cut the number of brands in its portfolio from 1800 to 400 at the same time as launching a “Customer Re-Connect Strategy” in an attempt to build more direct relationships with customers. The point here is not that product- or brand-driven initiatives are unimportant, or that the focus is misplaced, but that the shift to a customer focus enables marketing tools to be more directly accountable for their intended results and to learn by a process of adaptive experimentation.

Direct accountability is one consequence of the ability to market to identified customers. Another, perhaps more important, is the ability to compute a customer’s lifetime value, and thereby to select customers and measure marketing results by the criterion of customer worth. By effectively leveraging the capabilities of information technology, marketing is entering a stage where investment and returns can be credibly measured, and indeed marketing functions can be related to market capitalization and shareholder value creation.
THE MECHANICS OF CUSTOMER EQUITY MANAGEMENT: AN ILLUSTRATION

To illustrate marketing as a systematic process of customer asset building, consider the example of Hilton Hotels (Deighton 2001). The introduction of a frequent guest program about a decade ago has allowed Hilton to manage its network of hotels as a demand chain cultivating the loyalty, and hence the asset value, of a relatively small proportion of the 18 million guests who stay in its hotels each year.

The business class hotel industry is intensely competitive. Four major brands (Marriott, Starwood, Hyatt and Hilton) share about half of the global market, while the other half is largely in the hands of independent owner/operators. Hotels break even when occupancy exceeds about 68%, so that at higher occupancies most of the revenue becomes gross margin. Since entry barriers are low, if occupancy rises much above 68% new construction tends to take place, so that the market operates at close to break-even occupancy. The major brands, commanding a larger pool of committed customers than the independent properties, can operate at above break-even occupancy if they manage the pool efficiently. Given this industry structure, programs to cultivate relationships with high-value customers are central to marketing management. The head of Hilton Hotels Corporation’s guest rewards program calls them, “the industry’s most important marketing tool.” Despite the fact that each member belongs to an average of 3.5 hotel loyalty programs, management is optimistic that they can be used to cultivate loyalty. Membership constitutes permission for the chain brand to build a customer profile for each member, assess the potential value of each member, and to measure marketing’s efforts to realize the potential value.
One way that the hotel group can realize the potential value of these high-potential customers is to protect them in the event of a service failure. Diskin explains, “In a sense, the loyalty program is a safe haven for the guest. If there is a problem and it is not taken care of at the property level, the guest can contact our customer service team. It’s a mechanism to make sure we hear about those problems. We also do outbound after-visit calling, and we call HHonors members because they’re the best database, and the most critical guests we have. They have the most experience; and the highest expectations. We do feedback groups with members in addition to focus groups and quantitative research. We invite members in the hotel down for dinner, and we say we want to talk about a subject. I get calls from people that are lifelong loyalists, not because of any changes we've made, but because once we invited them and asked them their opinion. People care about organizations that care about them.”

More generally, however, the loyalty programs allow a hotel group to identify a small group of customers whose cultivation will have disproportionately large consequences for the customer asset base. Of the 18 million guests who stay with the chain annually, 12 million are “group” guests who do not choose their own hotels and whose rates are set by negotiation with convention and conference organizers or tour organizers. These rates are discounted and they contribute less to profitability than the rates charged to loyal customers. Loyal customers also enable chains to economize on customer acquisition spending. Hotels like Hilton spend about $750 a year per room on advertising and promotion to acquire guests for properties, a cost that is significantly less for members. Loyalty programs also economize on retention costs because the many of the incentives for increased patronage such as room upgrades are awarded only if they would otherwise have been unused. In summary, although only nine percent of all the guests who
stay in a Hilton hotel in a year belong to its frequent guest program, and only three percent earn elite silver, gold and diamond status, these groups contribute disproportionately to chain profitability as the following table suggests:

<table>
<thead>
<tr>
<th></th>
<th>Percent of guests</th>
<th>Percent of revenue</th>
<th>Percent of net profit*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Diamond + Gold Hilton HHonors members</td>
<td>1%</td>
<td>6%</td>
<td>28%</td>
</tr>
<tr>
<td>Silver Hilton HHonors members</td>
<td>2%</td>
<td>5%</td>
<td>18%</td>
</tr>
<tr>
<td>Blue Hilton HHonors members</td>
<td>6%</td>
<td>7%</td>
<td>10%</td>
</tr>
<tr>
<td>Non-member business travelers</td>
<td>25%</td>
<td>21%</td>
<td>(6%)</td>
</tr>
<tr>
<td>Convention and resort travelers</td>
<td>66%</td>
<td>61%</td>
<td>49%</td>
</tr>
</tbody>
</table>

* Net profit is computed as revenue minus real estate and operating costs, minus advertising. While real estate and operating costs are allocated to customer categories in proportion to number of nights stayed, advertising is allocated in proportion to number of guests in each category on the assumption that advertising is primarily a customer acquisition tool. While real estate costs are sunk costs for the purpose of short-run decisions, they are variable over a horizon that allows for franchising and leasing of properties.

The introduction of frequent guest programs has altered the basis of competition in the hospitality industry. Brand positioning matters less than the cultivation of commitment from a core group of frequent travelers. By customizing its service offering to meet the expressed preferences of these consumers an incumbent hotel chain can defend its customer asset base against less-informed competitors. A customer has few reasons to risk anonymity by staying with a new chain except when the chain cannot offer a property at the traveler’s destination. Consequently the shift to customer-based competition has been associated with sharply increased
concentration in the business hotel segment in recent years, including Starwood’s acquisition of the Sheraton and Westin brands and Hilton’s acquisition of Promus.

While the hotel industry has a decade of experience with customer-centric marketing, there is little evidence yet of migration beyond a customer profitability focus to one that treats customer asset value growth as the criterion by which to judge management effectiveness. In the next section we explore seven reasons why that may be so.

CHALLENGES CONFRONTING CUSTOMER EQUITY MANAGEMENT

As managers seek to embrace the customer equity philosophy and implement it within their own organizations, they will be faced with several challenges. In formulating a way ahead for customer equity management, we offer the following seven action items:

Challenge #1: Assemble Individual-level, Industry-wide Consumer Data

Those firms that must accumulate customer data to perform their order fulfillment, such as direct marketers, subscription service providers, vendors offering warranties or insurance, extenders of credit like credit card issuers and banks, and membership organizations, have led the migration to customer equity management. The trailing firms are those that have to incur special-purpose costs to assemble end-customer data, a group that includes manufacturers who sell through supermarkets and other retail stores, providers of casual services like gas stations, entertainment and fast food restaurants, and in general those who serve a broad, shallow customer base with little potential for repeat business.
The risk facing the trailing group is that competitors with customer-specific data stand to learn more about customer needs and about efficient ways to meet those needs than those without. This threat may come from within an industry by firms that bet that the investment in customer-level data collection will pay out, or from outside the industry as others, for example credit cards, assemble the data and profit from its marketing insights.

The leading group faces challenges too. Most prominent is the difficulty of compiling individual-level prospect data. The learning from experience that customer data facilitates can be myopic if it is not informed also by learning from non-customers. For example, a key metric for a customer-oriented company is a measure of the share of a customer’s requirement it serves. This information is crucial for determining which customers are potentially the most growable and one way to obtain these data is by cooperating with competition. The mail order catalog industry learned that pooling the experiences of 1,000 catalog retailers with 100 million mail addresses yields benefits from cooperation that exceed the costs that come from loss of private knowledge. The global airline industry is following the same path with the creation of pooled frequent flyer databases. But most industries still value private customer information over pooled information.

Challenge #2: Track Marketing’s Effects on the Balance Sheet, Not Just the Income Statement

Customers are assets, acquired at a cost that is justified or not by a flow of income into the future, just as are the fixed assets of the firm. If that cost is routinely expensed through the income statement in the period in which it was incurred, there is a risk that firms will under-invest in customer acquisition. But the appraisal of customer assets has no place in contemporary accounting practice. In that respect, brand assets have an advantage. In Britain and Australia, for
example, accounting principles require that brand assets must, under certain circumstances, be shown on a balance sheet.

Customer asset metrics—customer lifetime value and customer equity—are clearly related to commonly applied financial measures, such as EVA and ROI. Given this, it makes sense to draw on their heritage and to use them as a starting point (for a good discussion on this point see Gupta, Lehmann and Stuart 2001). CLV is the value of the customer relationship to the firm in monetary terms. The CLV depends upon assumptions about the future stream of income from a customer, the appropriate allocation of costs to customers, the discount factor, the expected “life” of a customer, and the probability that the customer is “alive” at a particular point in time. As one might expect, small changes in the assumptions associated with key model variables can give rise to vast changes in the computed values.

Marketing scientists have made progress in modeling CLV (for example, Columbo, Morrison and Schmittlein 1987; Gupta and Lehmann 2001, Rust, Lemon and Zeithaml 2002, Schmittlein and Peterson 1994,) but much work remains. Also, investigating the drivers of customer lifetime value is only a recent endeavor (Reinartz and Kumar 2003). Moving forward, it will be important to move toward the development of some accounting standards for the measures of CLV and customer equity that could lead to their placement on the balance sheet, much in the same way as firms such as Interbrand and Young and Rubicom have enabled firms to quantify and account for brand equity.
Challenge #3: Model Future Revenues Appropriately

It is unlikely that research on customer lifetime value appraisal will converge on a single model to capture the timing and probability of revenue flows, yet to date there is no good typology of revenue generation models. The early work in direct mail marketing assumed that the appropriate model depended on characteristics of the transaction. For example, the catalog was characterized as constituting multiple simultaneous offers and repeated solicitation, with the probability of purchase declining monotonically with time since last purchase. By contrast the continuity transaction constituted a single offer with solicitation repeating only if the first solicitation succeeded. Purchase probability was not necessarily monotonically decreasing. Negative options constituted a single offer with no subsequent solicitation. Each model differed in its structure and the data required for its parameterization.

Early work on the more general problem of customer asset valuation suggests that a similar typology of business formats will be found. Berger and Nasr (1998) model businesses in which the customer, once lost, is gone for good, and in which income is received at regular intervals. Gupta, Lehmann and Stuart (2001) keep the gone-for-good characteristic but do not require all customers to buy on the same periodicity. They analyze the problem of single-brand direct-to-customer marketers in high-growth businesses, specifically Amazon, Ameritrade, EBay and E*Trade. Rust, Lemon and Zeithaml (2002) relax the gone-for-good assumption by modeling customer acquisition and retention using Markov chains. Other typologies that have been suggested in this context are those of contractual versus non-contractual businesses and retention
versus migration models. Jain and Singh (2002) begin to develop a typology of business formats, but clearly the topic will be a formidable challenge for future research to address.

**Challenge #4: Maximize (Don’t Just Measure) CLV**

Measurement of a customer’s lifetime value is necessary, but certainly not sufficient. Managers need to implement marketing initiatives (such as loyalty programs, customer reactivations, cross-selling and programs to anticipate and forestall defection) that maximize the value of the customer franchise.

Models of lifetime value must account for the impact of the competitive environment. While most organizations have access to information on their *own* customers, not all have access to information about the behavior of competitors with respect to *their* customers. Yet without such information there is no way to estimate a model of the effect of marketing actions on CLV. Likewise, without that information it is hardly possibly to prioritize customers based on measures such as greatest share-of-wallet potential.
Challenge #5: Align Organization with Customer Management Activities

When a firm adopts a brand or product management structure, it typically organizes the enterprise so as to facilitate broadcast marketing functions like advertising and new product development. Firms with large customers often supplement the brand or product line focus with a major accounts focus, often imposing a matrix relationship between the two in which a creative political tension is cultivated between the demands of product rationalization and customer demands for customization and integration across products. The matrix organization falls far short of the radical customer management focus found in some organizations.

Some firms in the industries that pioneered the application of customer asset management have aligned their organizations to focus on customer management functions. Thus catalog retailers or credit card companies commonly separate the prospect acquisition team from a customer conversion team from those responsible for the ongoing customer retention and servicing activity. They may assign a team to work on reactivation of dormant accounts. Management performance is assessed by results in each step of the customer cultivation process taken in isolation from the others. For example, the credit card issuer Capital One has separate management teams for customers that represent low and high credit risk (Reinartz 2002). Once the “high-risk team” succeeds in migrating high risk customers into the low risk segment, the “low-risk team” takes over. The marketing instruments that these two teams use may vary considerably. Long distance phone companies tend to follow a related structure, with the difference that customer retention is partitioned into teams responsible for customer groups with similar usage patterns, such as recent immigrants who find it difficult to interpret English online instructions yet make heavy use of operator-assisted international calling.
A related challenge is to staff the marketing function with people with relevant skills. Where once brand management experience was considered an appropriate background for a marketing professional, the customer-centric firm often places more emphasis on a direct marketing, database marketing or customer service work background in its recruitment.

An additional challenge for firms is to embed CRM activities into the fabric of the entire organization. That is, from a strategic perspective CRM is not confined to the marketing or to the sales function. Rather, the deployment of specific CRM activities is most likely to succeed when other functions such as IT, operations, R&D and human resources are integrated. For example, shifting employee incentivization away from revenue or satisfaction measures towards customer profitability measures represents a substantive challenge for firms. At the same time, this measure is most likely to lessen coordination problems between functions.

**Challenge #6: Respect the Sensitivity of Customer Information**

The notion of a consumer’s entitlement to privacy is in flux, and rules and conventions that have acquired stability through testing over generations in the practice of traditional marketing are being challenged and re-examined in customer-centric data environments. Disclosures that consumers were happy to make in familiar retail environments arouse suspicion in online retail environments. For example the Abacus Alliance discussed earlier, which pooled customers’ offline catalog purchase records, was unable to expand its pool to include online records when this organization merged with DoubleClick, the Internet advertising delivery service.
As a firm’s responsibility to address customers’ personal privacy concerns collides with the firm’s wish to demonstrate the value to customers of sharing personal information, one useful principle is to decentralize customer information storage. Where possible, data should reside with the consumer, on personal computers or smart cards, rather than in central data repositories. A second principle is to allow consumers the right to audit and contest the accuracy of their profiles. While the right of personal data audit and contestation is implemented by law in Western Europe, it is not yet the case in the USA.

Challenge #7: Evolve CRM from an Efficiency Tool to a Service Improvement Tool

Industry studies consistently associate “successful” CRM implementations with comprehensive efforts to re-evaluate and refine all customer-facing business processes, to develop, motivate and re-culture customer-facing as well as back-office service and support personnel, and to select and tailor appropriate CRM-enabling technologies. Indeed, the Conference Board identifies the three top areas of change required to build a customer-oriented philosophy as: attitudes of customer-facing employees, corporate culture, and attitudes of non-customer-facing employees (Bodenberg 2001, p. 22). Though few firms characterize their CRM implementations as outright “failures”, large-firm implementations can take three to four years, and fewer than twenty percent of the world’s largest 2,500 firms have completed this work (Amuso, Close and Eisenfeld 2000).

While these seven challenges form an agenda for advancing the customer asset paradigm, a model-based approach is also useful. In the next section, we outline a customer-asset marketing model to help the firm think through implementation.
A CUSTOMER ASSET-BASED MARKETING MODEL

The previous discussion highlights key challenges posed by the external environment. What will be the consequences of transcending these challenges? We expect that a window of opportunity will open for the customer-centered firm. Specifically, an opportunity will emerge to offer value to customers through customized marketing interventions and products and through providing relational exchange. Granted that the firm can better extract the desires of individual customer and/or of segments, and subsequently can create added value for these targets, customers are likely to reward this value with repeat transactions. Thus, firms should be able to derive market advantage through the learning about individual customers or small segments and the subsequent utilization of this knowledge. The key managerial challenge in pursuing this path is the equitable management of the customer-firm relationship. Managers are facing an interesting conflict here. By designing the value proposition, it is the firm who determines what part of the value is appropriated by customers and what part falls to itself. When firms provide great value, for example through low prices, it typically comes at the expense of profit and thus shareholder value. If firms extract most of the surplus, they leave customers little reason to engage in repeat purchase behavior which again leads to profit deterioration in the long run. Clearly the optimal path is somewhere in between. Thus, the management of customer-firm relationships can also be seen as designing the fine line of partaging surplus (in form of utility for customer and in form of profit for the firm). Given that it is the firm who sets the constraints in the first place (e.g. price), the natural question that arises is “How can firms maximize the assets that arises out of the entirety of its customer relationships?”. Maximizing the firm’s customer asset is tantamount to optimizing value appropriation between the two parties, firm and customer. The customer-asset based
marketing model conceptualizes the duality of managing the customer-firm relationship: it combines the shareholder perspective with the customer perspective.

[Insert Figure 1 about here]

The customer-asset based marketing model, recognizes that different stakeholders have different expectations towards the organization. It also allows us to integrate these different expectations in that it provides a normative characterization of how to manage value provision to both sides. It furthermore provides an opportunity to examine the unanswered aspects in order to arrive at a better process of managing customer-firm relationships.

The model describes the customer management process (or in other words, the value allocation process) on two levels: the aggregate level, which is of shareholder interest and the individual or segment level which is of customer interest. In the following section, we want to describe each component and want to raise challenges and questions around each component.

**Evaluate the customer base**

We believe that evaluating the customer base in economic terms will become standard practice in the future. Being able to evaluate the monetary worth of the customer base to the firm gives shareholders a much-needed perspective on effectiveness and efficiency of the marketing function. “Is Marketing really adding value to the firm?” is a frequently asked question these days. Srivastava et al (1999) mention that the marketing function has played a limited role in the process of strategy formulation. They argue that the reason for this has been the notorious difficulty to identify, measure, and communicate to other disciplines and top management the financial value created by marketing.
We suggest that in order to arrive at a valuation of the worth of the aggregate customer base, methods and approaches are needed that yield both, relative and absolute evaluations. Relative evaluation means answering questions like: “How does the value of the customer base compare, relative to last period and relative to our expectations or forecast?” Absolute evaluation needs to focus on the specific metrics. How many customers do we have? What is the average revenue per customer, number of orders per customer? What does the distribution of revenue and number of orders look like? How many customers did we lose? How many customers did we gain? The outcome of this assessment is a dollar-metric figure, which represents an overall “health index” for the total customer franchise. We are probably just seeing the beginning of a widespread use of such a customer health index (similar to Rust, Zeithaml, and Lemon 2000; Blattberg, Getz, and Thomas 2001). Besides measuring the aggregate value of the customer base, it’s a different feat altogether to grow or to maximize that value. This maximization has to be accomplished in the light of customer interactions, which is described in the next three sections.

Evaluate customer retention, acquisition, and abandonment

Both managers and researchers have been drawing increasing attention to measuring individual-level or segment-level customer value. The reason for this increased attention is the objective to align the value the firm derives from a given relationship with the resources it spends to build or maintain that relationship. It is exactly this alignment that promises to improve marketers ability to allocate resources in the most desirable fashion.

The issues that have received already attention are those calculating customer value (Berger and Nasr 1998) or methods for evaluating response and choice likelihoods. Likewise,
analyzing the characteristics of customers that are more likely to be retained or more likely to
defect seems to be straightforward marketing analysis.

However, issues that are not yet resolved are the following. First, how to measure customer lifetime value in non-contractual relationships. The question of “When is a customer a customer?” hasn’t been satisfactorily answered until today. Since the concepts of customer value and customer lifetime duration are thoroughly linked, we have to develop a valid measurement framework that adequately describes the process of birth, purchase activity and defection. Once such a measurement framework is established, an investigation into the factors that impact lifetime duration can be performed. If lifetime analysis is to be conducted in a contractual context, the actual lifetime is finite and typically known. In this case, the analysis of lifetime is straightforward with appropriate statistical methodology. The study by Bolton (1998) represents a good example for this case. The situation is far more difficult where a customer purchases completely at his/her discretion. This situation is by far the most common across different product categories. While researchers have fallen back on stochastic models of consumer behavior (Reinartz and Kumar 2000; Moe and Fader 2002), we still have some way to go. For example, the richness of customer-firm interactions and the attitudes of customers are notoriously hard to capture.

Secondly, projecting lifetime value into the future seems to be a cumbersome exercise. Most often, researchers use the term lifetime value however, they refer to a window of past consumer behavior. While it is true that individual level customer databases have given us tremendous potential in analyzing actual disaggregate behavior, they are still in a look in the past. However, it remains doubtful whether we will ever be able to make reasonable predictions about disaggregate future long-term customer behavior.
Thirdly, more work needs to be done with respect to the ‘right’ level of analysis. While an analysis of true individual level behavior is feasible in certain product categories (e.g. financial services) it remains doubtful whether that model can be extended to other categories as well (e.g. FMCG). Two things need to be considered here. What are the cost and benefits of making resource allocation decision on the individual level and what is the statistical reliability of these decisions.

Select customer specific marketing actions

The result of the previous step is an evaluation of sorts (scoring, ranking) of customers or segments. The objective for the scoring can be manifold – for customer acquisition, retention, cross-selling, or relationship termination. The practice of aligning resource allocation with a customer lifetime value metric has been traditionally applied in the direct marketing domain. However, we are currently observing that this practice is applied increasingly in other product categories as well. However, several obstacles need to be resolved before we can make serious progress.

First, it seems quite challenging to manage customers according to their value to the firm and at the same time to maintain a sense of fairness amongst the set of customers. For example, even though that individual level price discrimination has been touted as one of the achievements of Internet technology, customers have strongly resented the notion of paying different prices. It seems that we still need to make theoretical progress that allows us to integrate economic and psychological predictions about this phenomenon.

Secondly, we are still struggling to make resource allocation decisions that are future oriented. While resource allocation based on past behavior is one approach, it clearly seems to be
desirable to make more future-oriented decisions. This holds especially in the area of acquiring high-potential customers. How can firms hedge the downside of low customer performance given that the firm may have large acquisition efforts?

A third challenge for firms is to manage the overall value allocation. As already explained the value metric is very different for firm and for customer. The objective function to maximize is the simultaneous optimization of utility to the customer and monetary value to the firm.

Naturally, the issues that have been raised so far find their implementation in the traditional marketing tools such as the 4 P’s. In particular, it remains to be seen in as how much the 4 P’s need to be adapted for this purpose.

Observe customer-specific results

Given customer or segment-specific resource allocation, the final step in the chain is to measure outcome in terms of customer behavior or customer attitude. Similar to the previous steps, establishing the best level of aggregation/disaggregation seems to be a major challenge. Another key aspect that arises at this point is the process perspective of this management approach. Measuring the response of resource allocation to customers and feeding the result into future rounds of resource allocation is part and parcel to the customer management philosophy. While the process perspective is nothing new to marketing per se, it is far from standard usage in practice. However, the customer-asset based marketing model requires the process perspective as a key principle.
CONCLUSION

In this article we describe the evolution of the customer equity management philosophy. In seeking to advance the philosophy, we note seven challenges that will have to be met if the philosophy is to take hold and generate positive results. We conclude the paper with a customer-asset model that illustrates how a firm can realize a customer equity management program. While the customer equity approach is certainly not going to be the last innovation in marketing thinking, it is clearly one of the most important of recent times. Firms that embrace it and do so effectively are in a position to realize tremendous competitive advantage.
REFERENCES


Figure 1: The customer-asset based marketing model

1. Evaluate the Customer Base

2. Evaluate Customer Acquisition/Retention/Abandonment

3. Select Customer/Segment-Specific Marketing Actions

4. Observe Customer/Segment-Specific Results

5. Observe Aggregate Results

Aggregate level

Individual/segment level