

But there are two opposing forces that affect margins over time. On one hand, customers buy more when they stay longer with a company and become more comfortable doing business with it. However, increased competition over time, as well as a changing customer mix, combine to reduce margins. The customer mix changes because a company starts by attracting profitable customers and later adds less-profitable customers.

Although it's possible to build sophisticated models for estimating customer lifetime value, a useful simple estimate is the annual profit margin of a customer multiplied by a margin multiple. This multiple typically ranges from 1 to 5, and in most cases, an optimistic estimate for this multiple is 4. In other words, if a customer provides a margin of, say, \$100 per year, the lifetime value of this customer is roughly \$400. This simple idea can lead to significant insights for decision-making, such as how much to invest in customer-data collection and analytics (see sidebar, "Relevance, Not Abundance, Makes Data Valuable").

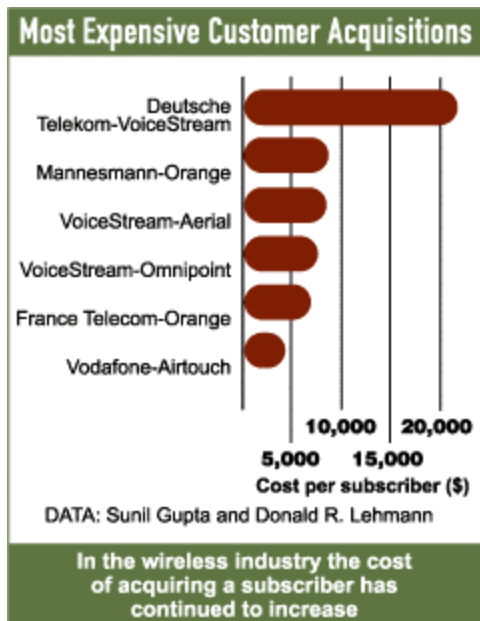
Lifetime value differs from the traditional present-value or discounted-cash-flow approach by focusing on individual customers and recognizing that customers don't stay with a company forever. It, therefore, accounts for customer retention and defection.

Acquiring customers



Because growth is critical for most companies, consistent gains in customers, market share, and revenue are typically the yardsticks for success. But if the value of a customer over his or her entire life is, say, \$400, it doesn't make sense to spend more than that to acquire this customer. Yet this simple, intuitive notion is commonly ignored in the pursuit of growth. This was most evident during the height of the Internet bubble, when companies were acquiring customers regardless of the cost. CDnow Online, for example, spent an average of about \$40 to acquire a customer even though our estimates suggest that the lifetime value of its typical customer was roughly \$25.

Such disparity has been even more dramatic in the telecommunications industry, where the potential convergence of broadband, cable, and telephone enticed several companies to spend enormous amounts of money to acquire other companies. AT&T spent a staggering \$110 billion to acquire TCI and Media One to gain access to their 25 million customers --\$4,200 to acquire each customer. Simple analysis shows that even in the most optimistic scenario, the lifetime value of this customer is below the acquisition cost. And AT&T's cost pales compared with what the wireless companies spent on acquiring customers (see chart, below). Perhaps the telecom industry would not be in such a tough situation today if it had paid more attention to customer lifetime value. But these companies fell victim to the same gold-rush, acquire customers-at-all-costs mentality that befell hundreds of dot-com startups.



The correct focus is not on sheer numbers of customers, but on the right customers --those with the greatest lifetime value. That leads to a focus not on growth for its own sake, but on profitable growth. Credit-card issuer Capital One has consistently aimed at attracting the most profitable customers. Based on its most recent financial statements, we estimate that its average customer-acquisition cost is \$55, while the lifetime value of its average customer is more than \$500.

Similarly, online-payments technology provider PayPal, launched in October 1999, quickly grew from 10,000 users at the beginning of 2000 to more than 10.6 million users by September 2001. All the while, PayPal kept a keen eye on its customer-acquisition costs. These dropped from \$3.29 per account in September 2000 to just 13 cents per account in September 2001, according to PayPal's financial statements. This may partially explain Wall Street's enthusiasm for PayPal and the \$1 billion market value on its IPO on Feb. 14. PayPal was widely considered the first successful initial public offering by an Internet company after the bubble burst.

Many credit-card companies evaluate their customers based

on their credit-worthiness. The idea is simple and intuitive: Good customers are those who repay their credit-card bills, so the company can minimize its risk of bad debts. This one-dimensional focus, however, misses an important point. One of the most lucrative parts of the credit-card business is the interest charged to customers who carry a balance. Therefore, customers who pay their bills in full every month--the best customers on the credit-worthiness measure--may not be as profitable as customers who carry a balance. In their zeal to minimize risk, many credit-card companies may miss a good opportunity.

Firing the customer

Customer focus does not imply that a company should cater to the needs of every single customer. The cost to generate revenue and growth varies dramatically across customers. Peter Carroll and Sanford Rose's study of U.S. banks in the *Journal of Retail Banking* found that in the early 1990s, only 30% of a typical bank's customers generated profit for the bank over the long run. In other words, 70% of customers were destroying value. Several insurance companies found themselves in a similar situation a few years ago when they realized, after several natural disasters in Florida, that their push to grow and add customers resulted in too many customers in disaster-prone areas.

For long-term profitability, it's imperative that these companies either convert unprofitable customers to a profitable status or "fire" them. That idea runs counter to the intuition of many managers trained to think that adding customers, increasing sales, and gaining market share are inherently good. The lifetime-value perspective suggests that market share and revenue growth may be the wrong metrics to use for gauging success.

"All animals are created equal," wrote George Orwell in *Animal Farm*, "but some are more equal than others." This basic idea holds for customers as well. All customers are important, but some are more important than others. Given that customer service is expensive, it makes logical sense to provide a high level of service only to high-value customers. This idea of "service discrimination" is similar to the concept of price discrimination that we see in the airline business and other industries.

Companies in many industries are beginning to implement such a tiered-service strategy. The best clients of Sears Roebuck get to choose a preferred two-hour time slot for repair calls while regular customers are given a four-hour slot. Similarly, Maytag provides premium service to its high-end customers that includes toll-free hot lines and personal-account reps.

This wouldn't be possible without understanding the long-term profitability of each customer, or at least each customer segment. Although such service discrimination can generate a backlash from customers, they may accept the adage that "you get what you pay for," especially if the policy is clearly defined and communicated. Price discrimination backfired at Amazon.com a few years ago because customers felt the company sprang the change upon them without adequate explanation. But airline customers readily accept the fact that last-minute tickets cost more, because people understand the value to the airlines of filling their flights in advance.

Value-based segmentation



Differences in customers' lifetime value provide a new and interesting way to segment them. With the increasing availability of customer-based information as well as sophisticated CRM software and analytics tools, businesses can rank their customers by long-term profitability. In this world, segmentation and one-to-one marketing are no longer based on demographics or customer preferences alone, but are complemented with an assessment of customer profitability. Fidelity Investments, for example, classifies its customers into more than 10 segments based on their profitability to the company.

Managers too often forget they have a leaky bucket from which old customers continually spill. Some studies show that the average customer-retention rate in the United States is about 80%. Sounds pretty good, right? But look at it another way, as a 20% annual defection rate, and it becomes apparent that a typical U.S. company, in theory, could lose the equivalent of its entire customer database every five years.

Given the increasing cost of customer acquisition, a focus on retention is highly desirable--and improvements in retention rates represent huge payoffs. In research concluded this year, we found that

while a 10% reduction in acquisition costs improves the overall value of the customer base by only 1%, a 10% improvement in customer retention increases value by 30% (see chart below).

Focus On Customer Value				
Impact of acquisition cost, profit margin, and retention rate.				
	Customer value (in \$B)	% Increase in customer value for 10% improvement in:		
	Base case	Retention	Acquisition	Cost margin
Amazon	\$2.54	28.34%	0.51%	10.51%
Ameritrade	\$1.45	30.18%	1.19%	11.19%
eBay	\$2.11	30.80%	1.42%	11.42%
E-Trade	\$1.89	29.96%	1.11%	11.11%

Base case: 70% customer retention, 12% discount

Data: Sunil Gupta and Donald R. Lehmann; company information

A large number of companies have introduced loyalty programs in an attempt to improve customer retention. For maximum return, these programs should discriminate between low- and high-value customers. Centura Banks of Raleigh, N.C., now rates its 2 million customers, with top customers getting special attention from service reps and senior management, including an annual call from the CEO. This has reduced customer attrition by 50% in the last five years and has trimmed the number of unprofitable customers by 6%.

Lifetime value also provides a metric to assess the effectiveness of various marketing programs. Consider the hypothetical scenario of a company that has 10 million customers with 70% customer retention and an average customer margin of \$100 per year. The marketing director believes she can improve customer retention to 75% by providing better customer service. To achieve that superior customer service, however, she needs to invest \$100 million in CRM software, other supporting IT, and better training for sales reps. Senior management, of course, will demand to know the ROI of that spending.

While such investments are complex and it's generally difficult to get a precise ROI estimate, the lifetime-value framework can provide useful guidelines. Under the company's current situation, the lifetime value of a customer is a \$100 margin, multiplied by a margin multiple of 1.67. The margin multiple is determined by dividing the customer-retention rate by the result of 1 plus the discount rate minus the retention rate, where the discount rate is the company's cost of capital. For this example, we assume a 12% discount rate and a 70% retention rate, which yields a margin multiple of 1.67. So the customer's lifetime value is \$167, and the total value of the entire 10 million customers is therefore \$1.67 billion. If the retention rate goes to 75%, the lifetime value of a customer improves to \$203, and the value of the customer base increases to \$2.03 billion, an increase of \$360 million. In this example, a \$100 million investment has a 360% return.

For many companies, a common growth strategy is to form alliances with others to gain access to their customers. But the economics of these deals can sour when companies fail to consider the lifetime value of those customers.

Consider the contrasting examples of medical Web site Drkoop.com and flower company Gerald Stevens. Two months before going public, Drkoop.com agreed to pay Disney's Go network \$58 million over three years to become the exclusive provider of health content to Disney's related sites. A month later, Drkoop.com announced an even more dramatic deal when it pledged to pay AOL \$89 million over four years to be a premier provider of AOL's health-care content. Clearly, Drkoop's aim was to quickly build a customer base by gaining access to the vast number of Go and AOL customers. But \$150 million was far too much to spend. The bottom line: Drkoop.com went out of business long before the full term of those deals.

Thanks, but no thanks



Flower company Gerald Stevens, founded in 1998, also was determined at first to build a powerful presence on the Net. It made deals with CNN.com, Lycos, and Yahoo, in addition to starting its own Web site. Yet Stevens declined a deal with AOL because AOL wanted \$75 for each of its several million customers. Was Stevens right to turn down the deal?

The company reportedly estimated that, on average, Internet customers would make three purchases over two years, making their lifetime value \$60--well short of the \$75 acquisition cost through AOL. By contrast, Stevens estimated that the average brick-and-mortar customer buys flowers four times per year. The company estimated the acquisition cost of that customer to be about \$50, with its lifetime value in the hundreds. In other words, by estimating lifetime value, Stevens made the right choice--favoring a brick strategy over a click deal. And it made that decision at the height of the dot-com mania.

To implement customer lifetime value as a corporate mandate throughout customer service, finance, IT, sales, marketing, and other departments, a company should take the following steps:

- **Align business units by customers, not by products.** Several decades ago, Procter & Gamble introduced the concept of product managers, and that has become the mainstay of most businesses. Yet our view of customer-based strategies suggests that companies should organize around customers rather than products. A bank should not have one manager for checking and savings accounts, another for investments, and a third for credit cards. Such an organizational structure makes it difficult to comprehend the total value of a customer and therefore can't capture important opportunities such as cross-selling.

Businesses should have customer managers, not product managers. The annual marketing plan should change its focus from product and price to customer acquisition, retention, and expansion.

- **Measure performance, not past investment.** Marketing and IT budgets' inability to show clear ROI is one of the key reasons why they're among the first to get cut. All too often, managers' requests for next year's budget are based on their previous year's budget, rather than on its return. A customer-based strategy can rectify this. It's therefore imperative that appropriate measurement systems be put in place. Market share and revenue growth are not enough. Customer-by-customer profitability and customer-retention rates are much more related to overall profitability. Those are what you should measure.

But don't overcomplicate the measures. No measure will be 100% accurate, and systems that strive for total accuracy tend to become too complicated. If only three people in the company can fully understand what's being measured, it won't do much good. It's better to be vaguely right than precisely wrong.

- **Change the culture or these systems won't work.** Make your reward systems consistent with customer-based strategies. Insurance companies typically reward independent brokers for capturing customers, not keeping them. Who can blame a broker with a poor retention rate when he says, "I'm only in charge of acquisition"? Brokers often may actually have more financial incentive to get customers, lose them, and then reacquire them.

Companies also need to disseminate the value of customers within the business. Most important, customer-contact personnel must understand the importance of their role and receive adequate training. Putting minimum-wage workers in these positions without appropriate support and training is a sure-fire formula for failure.

Customer-contact employees are at the heart of any customer-based strategy. This doesn't take fancy CRM tools. It's as simple as Domino's Pizza telling its franchisees that the lifetime value of the average customer is more than \$1,000. So when that customer says he doesn't like his \$10 pizza and wants a new one free, the lifetime-value formula is simple: Make him another pizza. ♦

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