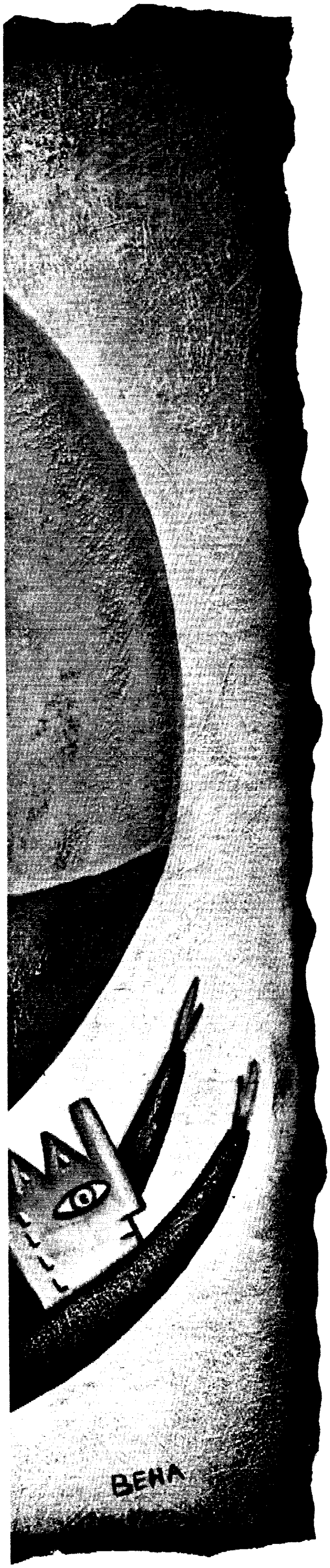


Identifying YOUR MOST Profitable *CUSTOMERS*

New technologies are enabling marketers to focus on the smaller groups of customers that create the most profit and to allocate expenditures for marketing that offer a return on investment

Mark Van Clieaf
Managing Dtrector
MVC Associates International
Toronto, Tampa

As the information age turns mass marketing on its head, how will you identify customers with the highest profit potential? How much do you need to invest in marketing to each of your customer segments in order to maximize profit and return on that investment over the long term? What new skills will you and your marketing team need in order to determine this level of investment?

"New age" marketers do not measure success by market share or response rates. They base success on such variables as how much of all their products a customer buys from their particular company (share of customer), how profitable a customer is over the lifetime of a customer relationship, and how effective they have been at maximizing revenues from customer segments with the highest profit potential. As the focus of marketers shifts from looking at their share of the total market to viewing profit from ever-smaller customer segments they are faced with the new challenges of identifying and retaining customers, and then building business with these key segments. They look for ways to enhance the value of their customer.

ilippe Beha

MARK VAN CLIEAF IS MANAGING DIRECTOR OF MVC ASSOCIATES INTERNATIONAL AND HAS MORE THAN 10 YEARS EXPERIENCE IN EXECUTIVE SEARCH AND EXECUTIVE RESOURCE PLANNING. A FORMER MARKETING AND ADVERTISING EXECUTIVE, HE ASSISTS ORGANIZATIONS ON BOTH THE CLIENT AND AGENCY SIDE ACROSS NORTH AMERICA IN BUILDING THEIR MARKETING TEAMS "FOR THE 21ST CENTURY."

To create a value enhancement customer strategy, new age marketers use several high-level acid tests. First, they acquire only those new customers whose predicted cash flow and profits (in present value terms) exceed the amount needed to be invested in marketing in order to acquire these customers. For example, AT&T recently identified the net present value of the power user consumer segment for communications. As a result, they began selling DirecTV's satellite dish and set-top box for US$199 to customers who agreed to spend at least US$5O a month for 18 months on AT&T's long distance service. The equipment had been retailing for US$599.

Second, new age marketers continue to invest in only those current customers who continue to provide more cash flow and profit than is needed to be spent on marketing to these customers (again, present value numbers).

Marketers of beer, tobacco, automobiles and customer information-intensive industries such as retail, financial services and telecommunications are already facing the need to change their marketing strategies. They are amazed to discover that 10% to 30% of their customers account for 70% to 90% of their profits and cashflow. They are even more surprised when they learn that, in the last year, 15% of their most profitable customers have shifted their spending to the competition.

Consumers are in information overload. During the last decade, North Americans have added 25 million computers, 16 million cellular telephones, 10 million fax machines, 26 million E-mail addresses, 19 million pagers, hundreds of specialty television channels and the Internet to their lives. Today's consumers wear more computing power on their wrists than existed in the entire world before 1961. And as microchips double their processing power every 18 months, the costs of computing drops about 30% a year.

Today's marketer is also in information overload. A mass of customer data is available through bar code scanners, point-of-sale systems and credit/debit/transaction cards, and a growing base of interactive media. But such data is useless if marketers can't turn it into knowledge about the customer that can be acted upon and result in a profit.

In an age where consumers want more choice yet only want offers and product information relevant to their agenda, lifestyle and stage of life, how is the marketer to balance this paradox?

Reengineering From Product to Customer Focused

First, marketers should recognize the need to reengineer their corporation's current marketing processes. While most reengineering over the past five years was focused on reducing costs, few initiatives truly focused on process design to increase revenue. Most current marketing processes in organizations are focused on selling product and not on determining the needs of customers in well-defined niche segments. Those processes that are customer focused are targeted primarily at acquiring new customers; they do not look to retain or increase the amount those customers purchase — in other words, increase the share of customer.

Few organizations have customer segment or relationship marketing managers. The customer segment manager's role is to be the customer champion and manage a portfolio of customers who are similar in terms of current and future financial value, actual purchase behavior, attitudes and preferences. This manager then develops customer investment and contact strategies, tactical programs and communications sequencing that maximize the return on investment marketing over the life of the customer relationship.

"A mass of customer data is available... But such data is useless if marketers can't turn it into knowledge about the customer ..."

In some companies, the segment manager also implements the supporting processes and technology needed for enterprise-wide customer contact. This lets such departments as customer service, government affairs and regulatory communicate with customers in ways that are in line with marketing's communication efforts.

Customer contact processes will vary by each segment's needs. For example, a very busy and highly computer-literate customer may prefer contact through telemarketing, direct computer access (such as the Internet) or CD-ROM. AMEX, Lexus and Wells Fargo all use a mix of these media to communicate with their various customer groups.

A specific customer segment's needs may also drive how you bundle the attributes of several products. For example, AT&T, Sprint, MCI and other telecommunication companies are breaking down their traditional product hierarchies, forming alliances and identifying how long distance, local calling, cellular, paging, Internet, direct television, home shopping, credit card and other service offerings can best be packaged to meet the needs of different customer segments. Such deepening and broadening of the customer relationship shifts the battle for customer loyalty from one of short-term promotions and discounts to one of long-term customer value.

Technology-Enabled Marketing

Emerging high-speed computing and data storage technologies are allowing marketers to develop sophisticated customer-marketing databases. They then use leading-edge analytical techniques to turn this overwhelming amount of data into actionable customer information. These techniques enable marketers to create portfolios of customers segmented on similarities and differences of actual past purchase behavior. This bottom-up behavioral segmentation allows markets to take action with these customers; they can pull a customer data tape that can be used to drive one-to-one communications. This is a change from past mass marketing practices in which decisions about the consumer segmentation were typically top-down and based on a relatively small statistical sample from traditional consumer research that is not actionable and at an individual customer level. This new capability allows marketers to target their most profitable customers. Using data captured at the individual transaction level, companies can design customized products and services, optimize the allocation of marketing dollars, and develop targeted promotions and communication strategies using such technologies as high-speed laser printing and customized telemarketing. The latest technologies are having a measurable impact on customer response, incremental revenue and profitability. For example, if a high-value customer just purchased a CD player and then shortly after received an offer for CDs that was generated from a customer database that captured the CD player purchase, imagine the revenue from additional sales that is possible.

A growing number of companies in the retail, financial services, telecommunications and packaged goods industries are using variable-image laser printing technology to communicate with their most profitable customers. Individual purchase behavior information can be used to produce customized bar-coded promotional coupons and catalogues. Reward statements, newsletters and direct mail offers can all be personalized. Because the communications and offer are personalized and relevant to that consumer's agenda, such one-to-one communication can help cut through the customer's information overload.

"...marketers should be able to lead teams with both statistical and computer programming competence..."

Sometimes, there may be eight to 10 different communications strategies based on the customer segmentation strategy, and possibly 50 different variable fields — beyond name and address — in each offer or communications piece based on individual purchase behavior and individual consumer expectations. When used to seg ment properly and with the right offer at the right time, such marketing communication can help to generate response rates of 20% to 50% — or sometimes greater.

Creating Customer Insight

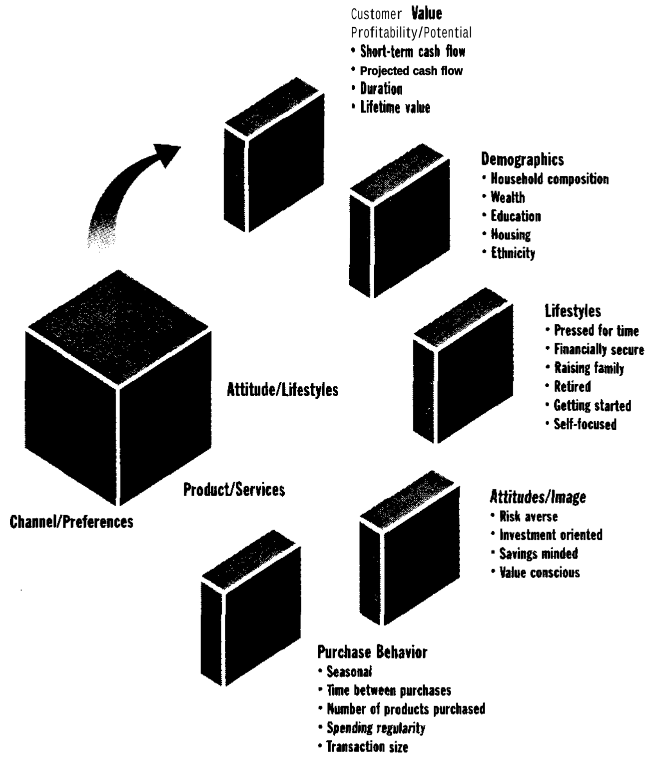
Marketers should identify their most valuable customers by:

- Analyzing their individual customer's transactional purchase behaviors and their future potential in order to effectively segment the customer base;
- Analyzing each customer's profitability in order to determine how much needs to be invested in marketing in order to stimulate, retain or win back that customer; and
- Recognizing that, over time, several different factors drive customer profitability.

To identify your most valuable customers, you should go beyond an analysis of recency, frequency and monetary value of past purchases. Several additional behavioral factors may be the real predictors of customer profitability and effective segmentation. These factors include: how buying patterns change over time; how much each customer purchases in a product category; how long customers stay as customers, and how soon before they're lost to the competition; what they purchase in complementary categories; how they respond to various promotions; their level of credit risk; the amount of disposable income they have; and their level of retirement savings and pension plan contributions.

You should determine which marketing decisions will most influence consumer behavior given the product category and the need to optimize the return on marketing investment. This will determine which specific customer data elements will best predict both current and future value of a customer, and define what customer information to capture in your database depending on customer segment.

Regression, discriminant analysis, factor analysis and cluster analysis are just a sample of the statistical techniques marketers need to broadly understand and apply. These techniques help them to identify and segment their most profitable customers based on a mountain of actual past purchase behavior and geo-demographics. To do this, marketers should be able to lead teams with both statistical and computer programming competence to turn this data into customer knowledge and insight upon which future marketing investment decisions will be made. For example, the CEO of a high-end specialty retailer thought he knew what his customers wanted in suits. He believed that the executive who would purchase a Samuelsohn suit had very conservative dressing habits and, thus, this retailer would never invest in sending a catalogue or promotion to these customers about Hugo Boss or Armani suits. But analysis of the customer database, which captured more than five years of purchase transactions from 500,000 of the best customers, showed that there was a large segment of customers who bought Samuelsohn and Hugo Boss and Armani. This customer insight directly influenced future marketing investment decisions.



But why do consumers buy, and what might they purchase in the future? To answer this, you need to go beyond actual purchase and geo-demographic data. You should determine the customer' s purchase potential and apply traditional consumer research techniques to develop insight into the customer' s attitudes, spending patterns, expectations, stages of life and lifestyles to effectively segment the customer base. High-value customers can be surveyed, and the results appended to individual customer files in the database. The key to integrating traditional customer research with transactional customer profiling is creating common reference points and definitions that allow cross-referencing of different sources of customer information on the same individual customer. What motivates an affluent young executive to purchase a mutual fund for his or her retirement planning (looking for high risk and high return in an emerging-market equity fund) and what motivates an affluent executive three years from retirement (looking for low risk, perhaps in a medium-return balanced fund) are quite different, even though both purchase the same value of mutual funds. The difference is the attitude of these two consumers toward risk and preserving capital.

When marketers identify current unprofitable customer groups, the challenge is to identify new groupings of product attributes and delivery channels that can be provided to these segments at profitable levels. In this interactive age, marketers can use customer insight to maximize a customer' s value to a company, while the value of the company relationship for the customer.

New age marketers recognize there are multiple drivers of customer profitability. No one statistical or financial analysis technique will provide the answer for targeting your most profitable customers. Marketers should develop a multifactor customer analysis and segmentation strategy. This approach assesses both past transactional consumer behavior over a multiyear period and customer potential based on income, attitudes and stage of life. Customer needs and media affinities are studied to develop strategies and processes for customer contact (communications and promotions) that are likely to generate a measurable response and change in consumer behavior. Marketers need to find a new mental model for marketing in the information age. This model balances traditional marketing strategies and tools that result in the creation of brand equity, with new marketing strategies and tools that result in the creation of customer relationship equity.

But, marketers should recognize that multifactor customer segmentation is dynamic. While customers may currently be in a specific segment based on financial value or stage of life, a change in their behavior may move them into a new segment, triggering a new set of customer contact investment strategies and tactics. Sometimes, the marketing stimuli from a targeted direct response offer may cause this shift in consumer purchase behavior. The marketer can measure this through test and control of different offers. I know of a situation in which two different offers were provided to what appeared to be similar customers in the same segment based on past-purchase

"Marketers need to find a new mental model For marketing in the information age."

financial value. Analysis showed that these two offers both provided a similar return on the marketing investment. Yet, one group responded and purchased based on a $15-off coupon, and the other group responded to no financial incentive, just education about the service offering. Thus, a significant, trackable subsegment was identified where purchase behavior could be stimulated without having to "buy the business" and lower margins.

As part of its retention strategy, another organization used relationship marketing techniques to create a reward and recognition program for its best customers. But unlike many companies that create such programs, this one made money. Through highly segmented offer development and direct response communications determined by information captured in the customer database, this program invested US$14 million, and generated more than US$200 million in additional gross revenue and US$50 million in additional gross profit in one year.

New Measurement Processes

Assessing the lifetime value of customers and their individual profit impact over time is the new foundation for marketing. Internal rate of return (IRR) and net present value (NPV) calculations are critical in translating the customer portfolio segmentation strategy into bottom-line impact on both the income statement and balance sheet.

With a 12-month cycle for annual income reporting, generally accepted accounting principles (GAPP) fail to match the marketing investments needed to acquire customers to the revenue and cash flow that may be generated by that investment over several years. The cost of acquiring a customer is a current expense and often not allocated to specific customers; the cost is not amortized over the life of the customer relationship.

One of the largest U.S. banks found that, in order to shift from a product- to customer-focused enterprise strategy, it needed to change its measurement processes and compensation structure. As long as the presidents of the mortgage, credit card, mutual fund and consumer banking groups were compensated based on their individual business unit profitability and not on the overall enterprise profitability from each customer, then the organization would never suboptimize one product group's margin to create a differentiated bundle of services that would deepen the customer relationship and overall customer profitability.

Often, getting senior management's sponsorship of the investment required to build the infrastructure for a truly customer-driven enterprise strategy is a challenge. Executive management at such organizations as Citicorp, USAA, AMEX, AT&T and Sears have a vision of the future of technology-enabled marketing, and have made multiyear infrastructure commitments ranging between US$40 million and US$700 million. Given that the personal bonuses of most CEOs and senior vice presidents of marketing are based on return-on-equity and return on total invested capital performance measures, any customer-focused marketing strategy that demonstrates the link between customer value and longer-term shareholder value should get the attention of executive management.

Learning from Other's Mistakes

The following is a list of questions that may help you avoid some early mistakes companies have made when trying to become customer centric:

- Is the CEO a committed champion of a customer-focused strategy and prepared to change the way the organization is compensated to align with this strategy?
- Is the executive team committed to a two- to five-year infrastructure investment strategy and to an organization redesign including the creation of customer-segment marketing teams?
- Is the organization prepared to hold the customer-segment team accountable for profit-and-loss while giving the team final decision authority on marketing investments for customer contact?
- Is the executive team prepared to defer short-term results while new customer-focused processes, a new organization structure and customer marketing databases are established?
- Is the organization prepared to establish new customer profit measurement processes linked to lifetime value?
- Does the organization have the marketing competencies to integrate brand equity, relationship equity and to leverage the power of technology-enabled marketing?

Without the answers to all of the above being yes, the enterprise will meet many barriers in acquiring, retaining and winning back those customers with the highest profit potential. BQ

BQ Reprint Order #BQ96210