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Building a Customer-Centric Organization With Customer Experience and Customer Profitability

By Sunil Gupta and Bernd H. Schmitt

Customers are the lifeblood of any organization and the heart of the demand-driven economy. 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. Senior executives in all industries readily agree that customers are critical to the survival of a firm, that customers are their most valuable asset, and that their entire organization must be customer-centric.

Yet, in spite of the apparently universal acceptance of the importance of customers, the actions of most firms don't always match this talk. Despite billions of dollars spent by firms on advertising, customer satisfaction, and customer relationship management programs, many firms still fail to put customers at the center of their organization.

How many times as a customer have you found yourself waiting on hold listening to a phone message saying how important you are to the firm? Or discovered that when you are ready to cash in thousands of hard-earned points from your loyalty program that you have suddenly become a second-tier customer? Or entered a national restaurant chain only to find that the service, cleanliness, and even the products look nothing like what you saw in their appetizing TV commercials?

To become customer focused, a company needs to be able to deliver the right customer experience. Growing customer demand comes from a focus not just on products, but on the total experience. Think of Starbucks. The small Seattle start-up did not become a global business leader on the basis of its dark roasted beans alone. Starbucks revolutionized the coffee category (and indeed the casual dining category) by providing an experience that includes service, ambience, product naming, even the smell as you walk in the door. This kind of customer experience management is essential if companies are to succeed in providing real value to their customers.

However, when providing value to the customer, companies also need to be realistic and keep in mind that they are making a business decision. Any investment in your customer must bear in mind what their value of the customer is to your company, and what the anticipated return will be. This is a point lost on over-eager marketing departments. In 1992, as part of a strategy for growing their customer base, the U.K. division of Hoover decided to offer two free plane tickets to Europe for anyone who bought 100 of its vacuum products. The promotion was such a success that at the end of the year they sweetened the deal: 250 in Hoover products would win you two tickets to the US. More than 200,000 customers answered the promotion, but the result was that the company lost 48.8 million against their earnings (and many senior executives lost

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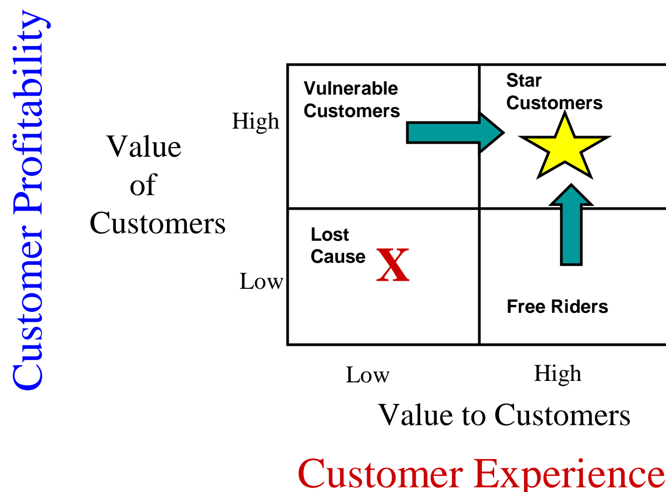
their jobs). In order to avoid a fiasco like this, companies need to be able to measure the value they receive from their customers – customer profitability – and utilize it in decision making.

Companies thus need to master two sides of customer value (see Diagram). The first is to provide value *to* their customer – which can be managed strategically through customer experience management. The second is to get value *from* their customer – which can be measured strategically through customer profitability. The first part is the investment, and the second part is the return on this investment.

The Two Sides of Customer Value



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NOT ALL CUSTOMERS ARE EQUAL

Looking at the two sides of customer value, it becomes clear that not all customers are equal. The diagram shows four types of customers, based on whether their value to and from the company is high or low. Each requires a different strategic approach from an organization.

Star Customers receive high value from a firm's products and services and provide high value in the form of high margins, loyalty, and retention. The result is a mutually beneficial (win-win) relationship. Companies should identify and build on this type of customer. The opposite of the star customer is the *Lost Cause* who does not get much value from firm's products and services. If they provide any marginal value to the firm it may be to allow for economies of scale. Otherwise, companies should consider reducing investment in them.

This may sound counterintuitive – be customer-focused, but don't invest in some customers! But a study of US Banks in the early 90's found that only 30% of customers were profitable over long run -- 70% of customers destroyed value! In other areas like the insurance industry, companies also often take on unprofitable customers in their zeal to grow. When a company finds their own "Lost Cause" customers, they need to convert them to profitable customers or else "fire" them.

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A third type of customers is *Vulnerable* customers who provide high value to firm but do not get lot of value from firm's services. These may be new large customers who are not receiving a good customer experience, or longstanding customers being taken for granted and only sticking around from inertia. This is a dangerous situation and Vulnerable customers are prone to defection unless the firm invests in better products, additional services, and a better customer experience. This investment should be targeted, in the way that airlines and casinos have long given preferential treatment to better customers. Charles Schwab call centers have been designed so that their very best customers never wait longer than 15 seconds, while others could wait up to 10 minutes.

The fourth type of customers is *Free riders* who get superior value from a firm's products and services but provide little value, whether because of their large size or intensity of competition. For a supermarket, the Free Rider is the customer who buys only the promotional sales items that are priced to get traffic in the door, but never picks up anything else while they are there. The aim for companies is to reduce service or to raise prices for free riders; this will increase the risk of losing them, but also enhance their value to the firm. As someone once said "the difference between a sales and marketing person is that a good marketing person knows when to walk away from a sale."

These four types of customers show why companies need both customer experience management (CEM) and customer profitability management (CPM). Without measuring customer profitability, companies can easily waste efforts providing too much value to low value customers. But once they identify who are their high value customers, companies also need to know how to provide right customer experience to them, in order to retain customers, acquire new customers, and expand the margins they are generating per customers.

Managers thus need to be familiar with two key tools – customer experience and customer profitability – and employ each one strategically

CUSTOMER EXPERIENCE AS STRATEGIC MANAGEMENT TOOL

As Bernd Schmitt of Columbia Business School explained in his book "Customer Experience Management," the customer experience can be looked at in terms of three key components -- the brand experience, the customer interface, and innovation.

The *brand experience* encompasses the "look and feel" of logos and signage, packaging, and retail space; it includes messages and imagery in advertising, collaterals, and websites; and includes the design and experiential features of the product itself.

Whereas the brand experience is mostly about static design elements, the *customer interface* includes all the dynamic exchanges and contact points where the company interacts with a customer. This includes face-to-face in a store, in a sales visit, at a hotel check-in, or a customer event; it includes automated interactions such as e-commerce or an ATM machine; and it includes mediated human interactions such as call-centers, email, or instant messaging.

The third component of the customer experience is *innovation*. A great customer-centric company does not sit on its laurels with the same experience year after year. Innovations include anything that improves end consumers' personal lives and business consumers' work life.

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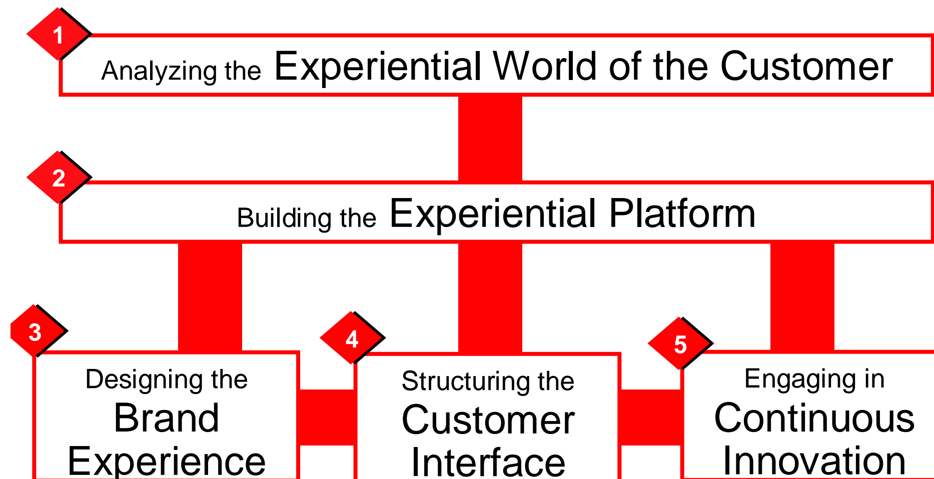
Innovations demonstrate the company's commitment to the customer and are what keep the experience compelling, relevant, and unique. They can range from major new products to small innovations in design to fresh marketing campaigns and customer events.



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Managing the right customer experience across all the brand experience, the customer interface and new innovations requires an integrated framework. The five-step CEM framework presented in "Customer Experience Management" begins with analyzing the experiential world of the customer. This can draw on a range of experiential research techniques that immerse the marketer in the world of the customer. When Carnegie Hall was undergoing a major renovation to add Zankel Hall, the leadership wanted to know how to strengthen the Carnegie brand. We conducted a research project where current and potential customers were brought to a concert and interviewed in real time before the event, as they entered the building, within the hall, visiting various amenities during intermission, and in a focus group after the concert. The rich data resulting from this immediate real-life stimulus proved invaluable in understanding what the Carnegie Hall experience meant to visitors and how to communicate that through the brand.

Insight from this analysis is then used to develop an experiential platform that will allow for integrated experience across all three domains. To be effective, the experiential platform must be simple and easy to translate into actual customer experiences. (This is not another branding exercise that results in words like "excellence" and "innovation.") Apple Computers has a clear experiential platform of creativity and originality which is understood by employees and customers alike. It is that core experience which is expressed in the branding ("Think Different"), in new products (the iPod and other design wonders), and the focus of the retail stores on helping users achieve creative personal computing solutions. Following analysis of the experiential world of the customer, a strong experiential platform allows for the successful management of customer experiences across the brand, the customer interface, and ongoing innovation.

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CUSTOMER PROFITABILITY AS STRATEGIC MEASUREMENT TOOL

What is a customer worth? Customer Lifetime Value (CLV), which is the present value of all current and future profits generated from a customer, provides the answer to this important question. CLV focuses on long-term customer relationship and ensures that a company does not spend more on a customer than they are worth to the firm. While extensive databases and sophisticated models can be used to assess CLV, Sunil Gupta and Donald Lehmann (also of Columbia Business School), have developed a simple but rigorous formula to estimate the CLV. Their research shows that CLV is simply the annual margin of a customer times a “margin multiple”. This margin multiple depends in a firm’s cost of capital and customer retention rate, and is generally in the range of 1 to 4.5. For a company with 90% customer retention rate and 12% cost of capital, this multiple is about 4. For such a company, if the annual margin from a customer is $100, then his CLV is simply $400. In other words, the company should not spend more than $400 to acquire this customer. Companies can use CLV to develop strategies for customer acquisition, customer retention, and customer expansion.

Consider the case of CDNow, a high-flying web startup launched in 1994. It embarked on a quest for customer acquisitions—both to become a viable business and to answer Wall Street pressures. Using traditional promotions, affiliate programs, mergers and acquisitions, CDNow grew its customer base to more than 3 million customers within five years. But was this a sound investment in customer profitability? Gupta and Lehmann show that even under the most favorable assumptions, CLV of a CDNow customer was less than $30 while it was spending anywhere between $30 to $55 to acquire each customer! In other words, the business model of CDNow was fatally flawed. Not surprisingly, CDNow reported a loss of over $100 million at end of 1999 and was bought by Bertelsmann in 2000.

Customer profitability and CLV is also a valuable tool in managing high-level valuation decisions such as mergers and acquisitions. When AT&T acquired Media One and TCI for $110 billion, one of their key motivations was to gain access to their 28 million households. In effect, AT&T spent $4,200 to acquire each cable household. Assuming a very optimistic margin multiple of 4 (with 12% cost of capital and over 90% retention), this translates into annual profit per customer of $1,050 to break even on the acquisition. Was it feasible for AT&T to achieve this goal? Even the most optimistic estimates suggest this to be an impossible goal. Tragically, AT&T’s disastrous overpaying was typical of many others in its industry.

Customer profitability can also provide an estimate of firm value, thus providing a link between marketing investment and shareholder return. The premise of customer-based valuation is simple. If customers are the key profit generators of a firm and we can estimate the lifetime value of each customer, then the current and future customer base of a company should provide a good proxy for its market value. Using data for several companies, Gupta and Lehmann show how customer-based valuation can provide good estimates of firm value even in situations where standard financial methods fail. They illustrate this approach and show why Netflix was overvalued in early 2004.

This approach allows managers and investors to not only estimate the value of a firm but also provides them diagnostics about what drives firm value. Gupta and Lehmann find that, on

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average, a 1% improvement in customer retention improves firm value by almost 5%. In contrast, a 1% improvement in company's cost of capital increases firm value by only 0.9%. These metrics provide a framework for managers to link investment in customers to firm value.

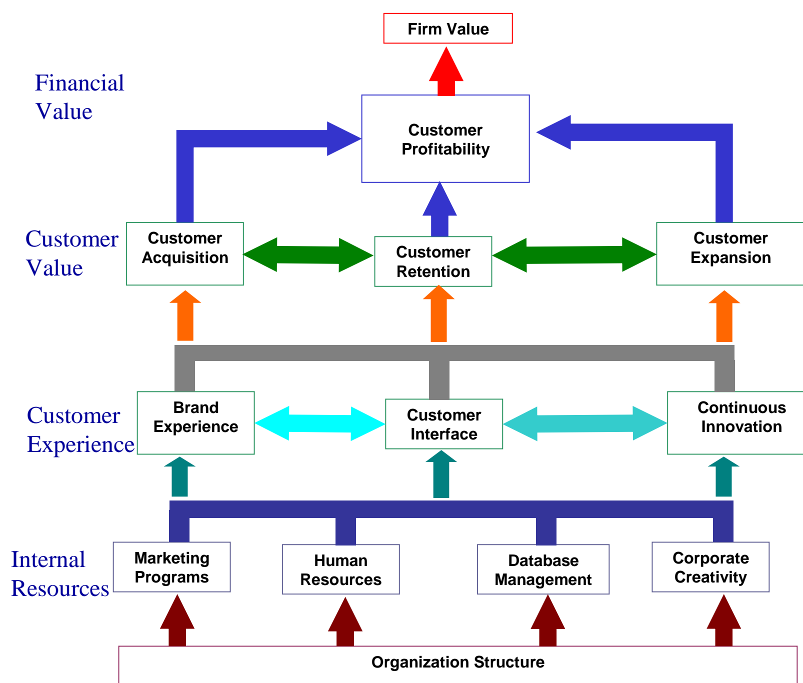
The full power of customer profitability as a strategic measurement tool, however, lies in its ability to provide a measure not only of firm value, but of the drivers of that value – e.g. whether is being driven by new customers, increasing margins per customer, or decreasing retention rates. Gupta and Lehmann find that, on average, a 1% improvement in customer retention improves firm value by almost 5%. Typical churn rate in the cell phone industry is 30%, so imagine the room for major improvement in profitability and company value if a firm can effectively invest in increasing its customer retention. But to act on the insight into these drivers, companies need to utilize customer experience management.

LINKING CEM AND CPM

To maximize growth, senior executives need to not only utilize both customer experience management (CEM) and customer profitability management (CPM) –they need to know how to *link* these two strategic tools.

Customer profitability measurements can then be used to optimize CEM investments in customer acquisition, retention, and expansion, so that the right customers are targeted and the ROI on each customer is understood. In turn, where customer profitability tracks the financial value that customers offer to a firm, CEM can provide strategic guidance for increasing that value and can specify precisely *which* aspect of the customer experience is likely to impact *which* aspect of customer profitability.

The diagram below provides a model for how these two frameworks can connect.



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The three aspects of the customer experience (brand experience, the customer interface, and innovation) are the key drivers of customer profitability. Moreover, each implementation domain typically affects a different component of customer profitability (acquisition, retention, and expansion).

The brand experience usually affects customer acquisition because it represents the customer's perception of a brand's attractiveness. You are most likely to acquire new customers when you increase the value of the brand experience for them by managing and improving on the look and feel and communications.

The customer interface is usually the key driver of customer retention because these exchanges and interactions determine whether customers are satisfied with their relationship with the company and whether they buy again. If you provide the right experience by making the interface convenient and pleasant for customers, they will give you their repeat business.

Finally, innovation is critical for customer expansion. Customers are most likely to buy more from a company that they know, but the additional offers pitched to the —whether a small product enhancement, or a breakthrough new service—must be innovative to expand the company's margin for that customer.

These three relationships between the aspects of the customer experience and customer profitability are good rules of thumb. Accurate measurement for your own company requires you to model the relationship between the customer experience and customer profitability by constructing metrics for each of the three aspects of customer experience, and assess them in market research. We have developed such customized measures as part of our work with companies. The next step is to link these customer experience drivers to the customer profitability measure, for example, through a regression model. The regression weights will indicate the degree of importance of each experience component for your business.

With a model that shows how changes in customer experience impact customer profitability, senior managers can pinpoint where things are going right, where they need improvement, and what returns to expect from their investment in CEM. Expenditures on improving the drivers of customer profitability can be treated as capital investments and measured for their impact on profitability.

SUMMARY

Customers are the demand generators for every organization and the key to any successful strategy. To achieve growth, companies need to identify and increase customer value—both the value the company provides to the customer (increased through CEM), and the value the company derives from its customer (managed through customer profitability). By using these two models together, a company can reap the rewards of the two sides of customer value.

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Bernd Schmitt is Robert F. Calkins Professor of International Business and an expert on branding, consumer behavior and experience management. He is the author of *Experiential Marketing* and *Customer Experience Management* and contributed articles to the Financial Times, the Asian Wall Street Journal and The New York Times.

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