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The value of a client

By Patrick E. Koller

Companies spend billions of Euros every year on their existing and future customers. These sums are increasingly seen as investments rather than mere marketing budgets and are therefore expected to create measurable value for shareholders. This has brought the call for an enhanced understanding of the impact these investments have on the value of the overall company. Modern customer valuation approaches help marketing managers to lift the marketing budget discussion to a level that is relevant to the board. But their real benefit is much greater. By associating a value to customers, these approaches help setting investment volumes at the right level and allocating scarce resources to the activities with the highest return on investment. In this paper, we argue that these two factors make customer value measurement and management indispensable disciplines for marketing managers, CFOs and CEOs alike.

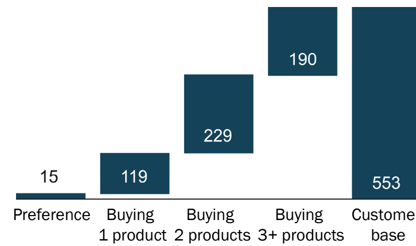
It is widely agreed that – besides tangible assets – intangibles such as brand, patents, knowledge, employees, customers and options for future action determine a firm's value. We argue that a company's customer base in most cases is the greatest determinant of value and that it therefore is an imperative for any company to understand and consciously manage the value of its customer base.

Professor Sunil Gupta of Columbia Business School in New York has shown that the value of the customer bases of companies usually comes close to their market capitalisation. He found that in relatively stable business environments, customer value explains an overwhelming part of the firm's valuation and that only a limited number of companies in more dynamic and uncertain environments (such as eBay and Amazon) are more strongly influenced by other factors such as option value and less rational growth expectations on the stock market. Professor Gupta's calculation of customer value for Capital One, one of the largest credit cards, savings and loans providers in the USA, explained around 80% of the company's market capitalisation. Using his approach, he estimated the value of the customer base at USD 11 billion at a time when Capital One's market capitalisation was at around USD 14 billion. Even for young, fast-growing internet businesses, such as Ameritrade and E*Trade, Professor Gupta's customer valuation approach managed to explain almost the full market capitalisation.

Overall value versus segment value

So using customer valuation techniques, CEOs and marketing managers can show that they are spending their big marketing budgets on one of the firm's main value drivers. But how can customer valuation help them invest the money in the right way? To answer this question, the overall value of the customer base needs to be broken down into meaningful value segments.

Abb.1: Value distribution example



Quelle: WATC Consulting AG

In order to do so, we have to recognise that the overall value of a company's customer base is the sum of the values of many diverse individual customers. In reality, every existing customer and every potential client has his or her individual value that is determined by the net present value (NPV) of the expected future cash flows they generate for the company. For practicability purposes, customers are grouped into a number of cohorts with a similar value potential.

Take a hypothetical company as an example. The value of its existing customers will largely depend on their buying behaviour – i.e., how many products they buy per year. Customers who buy three and more products will be more valuable than customers with two products a year and considerably more valuable than single-product customers. The same applies for the company's potential clients. There must be a value to people who have a preference for the company's offering and who consider buying one of its products as their probability of creating cash flows in the future is greater than that of people who have absolutely no association with the firm. So, the overall value of the customer base of our example company might be distributed along the customer decision path as shown in the figure above.

Many marketers will argue that even an individual in the awareness stage will have a value. However, we find it difficult – in most instances – to attribute a value to a person who knows a brand but does not consider buying it. Such thinking would justify marketing campaigns with the sole purpose of creating awareness. This seems highly counter-intuitive as real value creation can only come from instilling within potential customers the desire to buy. We see one relevant exception. For industries, whose products have extreme commodity character and are usually purchased in impulse situations, awareness is a direct revenue driver. Hence, for them an aware public should be credited with a value.

A four-step approach

Determining the distribution of value is not trivial, but it isn't rocket science either. In fact, to call it science would suggest that it will yield numbers with a claim for exactness down to the second digit after the comma for each individual. In reality, these calculations will always be based on averages within customer value segments and to some extend on grounded estimates. We therefore prefer to think of it as an approach that integrates all available data as well as well-founded estimates to an indispensable tool for marketing investment management. In order to uncover the distribution of value a company will need to go through four steps:

Firstly, it will have to define the customer decision path (or value segmentation) that best integrates the one or several main value driver(s) of its business. Value drivers might be the number of contracts held, the size of contracts, the consumed product or service mix, the number of transactions made or the number of products bought over a period of time. In reality, value segments will almost always be defined through a combination of drivers in order to reflect industry-specific dynamics. There is no standard value segmentation that suits all industries and all situations. Therefore, the careful definition of relevant value segments is crucial for the success of the customer valuation effort. The example used in this paper has been simplified for illustration purposes.

Secondly, the company will need to find out how many individuals it has in each of the value segments. While this might be relatively easy for existing customers, it requires some more or less sophisticated market research to get an understanding for the pre-purchase stages.

Thirdly, the firm will have to calculate the value of the future business with an existing customer. This value is calculated as the net present value (NPV) of future cash flows that can be modeled by taking into account factors such as the expected income streams, the attributable cost, segment-specific attrition rates and the company's cost of capital. In our example, such NPVs would be calculated for the last three stages (buying 1 product p.a. to buying 3+ products p.a.). The general concept is shown in the equation below in which "s" represents the expected annual sales revenue, "c" stands for the foreseen annual cost, "a" is the segment-specific attrition rate, "r" denotes the discount rate and "t" corresponds to the number of periods.

$$NPV = \sum_{t=1}^{\infty} \frac{(s_t - c_t) \times (1 - a)^t}{(1 + r)^t}$$

Finally, the company needs to account for the fact that there is a value not only in the expected cash flows of each step, but also in the probability to get to the next stage. In order to buy a company's products, people need to get to know the company and desire its offering. Therefore, having brought them to the stage of preference has already created some (moderate) value. Likewise, loyal, multi-product customers do not usually fall out of thin air. In most cases, they will buy one product and test the buying experience and service. So, selling the first product creates value to the company that is greater than the cash flows generated by this one product. This probability value – for pre- and post-purchase stages – is determined by the value of the next level, the probability of getting there and the time the conversion takes on average. Together with the discounted cash flows from step three, it builds the average customer value for the respective segment.

The result of going through the described four-step approach for our example company looks as follows:

Abb. 2: Valuation overview

Step I	Step II # of people (m)	Step III/IV Avg. value/ client (€)	Total value (€m)
No awareness	25,02	0	0
Awareness	17,40	0	0
Preference	7,51	2	15
1 product	1,18	101	119
2 products	0,97	236	229
3+ products	0,32	593	190
			553

Quelle: WATC Consulting AG

Answering the key questions

The knowledge of the average value of an individual in each value segment – or in other words all along the customers' decision path – enables firms to make conscious and fact-based decisions around the three key questions of marketing investments.

1. *Acquisition investments*: How much can we afford to invest in order to promote an individual from one step on his or her decision path to the next?
2. *Retention investments*: What level of in-vestment is reasonable to prevent a customer from dropping out of our customer base?
3. *Value creation and ROI*: Which level and mix of marketing investments yields the highest return for our company and what value does this create?

Let's go back to our simplified example. If one of the company's objectives is to acquire 1,000 new customers (i.e., promote them from preference to the buying 1 product - stage), it should not spend more than EUR 100,000. Otherwise it will destroy value.

1.000 x (Buying 1 product - Preference)

= 1.000 x (101€ - 2€) = 99.000€

Similarly, it would be unwise for our company to spend more on retaining a customer than is at stake in value terms. So if a 2-product-customer has indicated that she seriously considers defecting to a competitor (and only then), the company might consider spending up to EUR 230 worth of gifts, subsidised hardware, rebates or wining and dining to retain the client. Such situations often occur when contracts come up for renewal in industries such as mobile telephony and insurance.

Buying 2 products - Awareness

= 236€ - 0€ = 236€

And finally, our company should take the value creation potential into account when determining how much money and management attention it plans to invest into its customers (aka marketing budget) and how it wants to distribute this marketing budget between creating awareness, promoting preference, acquiring new clients, cross-selling and up-selling. These decisions must always be based on a Return on Investment view. The company will therefore need to calculate the targeted value creation using its knowledge of the various segment values and put it into relation with the sum it plans to invest.

$$\text{ROI} = \frac{\text{Value Creation - Investment}}{\text{Investment}}$$

A company should invest its scarce resources in marketing as long as the expected return on investment is positive and greater than the return it can get from investing the money in another opportunity. Doing so, it ensures that the shareholders' money is invested in a value-maximising way.

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