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Economics of Customers Relationship Management

Show me the Return On Investment (ROI)

By Martha Rogers, Ph.D., Co-Founder – 1to1

When it comes to customer-based strategies, it is tough to find a Financial Services Provider as strongly committed as Royal Bank of Canada (RBC). Since its CRM journey began six years ago, the company's customer-centric philosophy is so deeply ingrained, 'We no longer view CRM as a program,' says Richard McLaughlin, VP for CRM. 'This is our core strategy,' he emphasises. 'It is our goal to make each relationship profitable.'

How is RBC's strategy faring? In 1996, the company was growing revenues at 10 per cent annual clip, with profits increasing by 10–15 per cent annually. 'That was respectable for a large, mature organisation,' says McLaughlin, 'but not attention grabbing.' Today however, performance is nothing short of stellar. 'Even in today's economy, we're running revenue growth from 10 to 15 per cent, and profit growth in the 25 per cent range,' explains McLaughlin. 'We absolutely conclude that our CRM strategy is paying us back in spades. It has enabled us to grow both the top of house revenue line, and at the same time achieve huge cost savings.'

• Staying on course —

RBC views profitable customer relationships as a journey, not a destination. 'We have to continually re-evaluate, test, learn, share learning through centres of excellence and improve our strategies,' says McLaughlin. RBC uses three sets of measures that help the company stay on its CRM course.

First, every new investment is subject to the company's standard, capital-allocation procedures. 'If we want to introduce new functionality in a CRM context, new pricing, or some new differentiated service,' McLaughlin explains, 'it goes through the same ROI/IRR business case evaluation process with everything else.'

Second, RBC watches 'micro measurements' like: deposit rates, credit limits, direct mail response rates, etc., closely; and RBC tests the impacts of these measures on new initiatives. For example, if the group wanted to try something new, it might launch the program with 50,000 customers and then compare results against a smaller, control group. As McLaughlin explains, 'Would look at both cells to evaluate how both sets perform over a period of time.'

Third, the company is keenly focused on 'top of the house' metrics like revenue growth, profit growth, cost control, risk and debt write-off. RBC is now entering its third year of reorganising around customer segments rather than products. As McLaughlin explains, 'We now have full P&L accountability at the segment level.'

• CRM's time is now —

McLaughlin believes that today's sagging economy is an ideal time for the pursuit of CRM. 'These strategies are very effective at reducing costs,' says McLaughlin; and over the past three years, Royal Bank has done just that, reducing its cost of acquiring \$1 dollar in revenue from 63 to 55 cents. 'So even if you do not manage to get the revenue up,' says McLaughlin, 'getting the costs down is a pretty effective survival technique.' And, he continues, 'When the economy turns around, it is those companies that have this wired, the will come out of the gate the fastest.'

Why is Royal Bank succeeding when the press indicates so many others are failing? 'When I hear things like "CRM is a black hole you throw money into," my response is:

"Unless you view it as a strategy, you've missed it. It is change in management. It is strategy. If you view it as a project or a piece of technology, then it becomes just a place to spend money and not get results. So it is all in your attitude and how comprehensively you approach it.'" *Links: Royal Bank of Canada (<http://www.royalbank.com>) Source: <http://www.1to1.com>

The Royal Bank of Canada uses all the metrics of CRM to achieve its goal of making each relationship profitable. Let's look at some of these concepts.

MARKET SHARE VS. SHARE OF CUSTOMER

Marketing practices have continuously evolved in the last 50 years. Mass marketing came into vogue in the United States and Europe after the World War II. As a result of the shortages of World War II, mass production coupled with mass distribution and communication created a mass consumption society, and the focus of marketing activities was on promoting, pricing and distributing products for the mass market. The emphasis was on products rather than on markets; leading companies adopt organisational forms

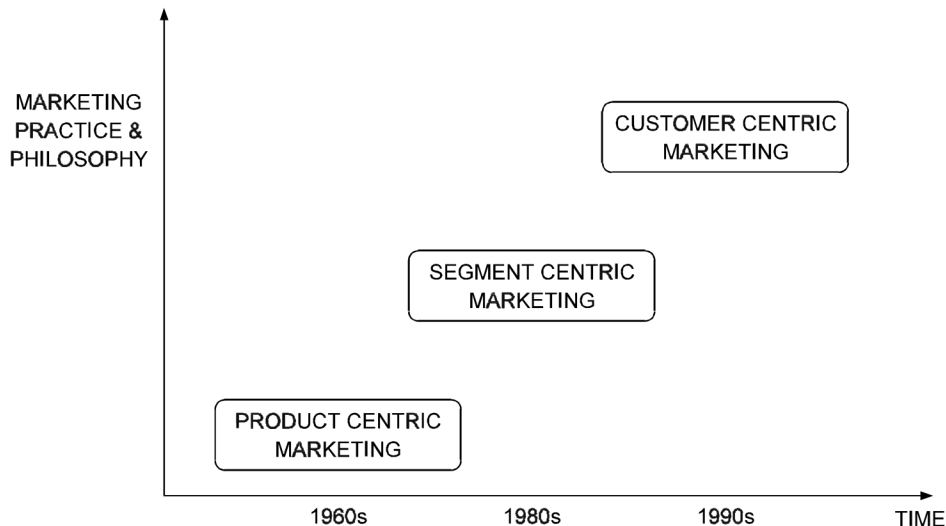


Figure 4.1 The Evolution of Working Practices

centre on products. We term this phase as **Product Centric Marketing**. The primary focus was on the production capacity of the company, its product distinctiveness and/or superiority and sales force capability. The prevailing assumptions for advantage were linked to greater production capacities, lower

costs, development of technological superior products and superior selling skills to attract customers. Some of the marketing concepts, which evolved during this phase include USP (unique selling proposition) and brand image.

As more firms entered the market, the resulting increase in product variety rendered mass-market techniques less effective. Gradually, firms started paying more attention to markets rather than products. This shift in the marketing discipline occurred primarily in the late 1950s when the marketing concept was first recognised.

With an increasing emphasis on markets, segmentation was a logical destination. Segmentation suggested a rational and more precise adjustment of products and marketing efforts to consumer or user requirements. There was an explicit recognition of several demand schedules, whereas only one was recognised. The shift from a product orientation to the marketing concept led to many changes in marketing thought and practice. The concept of market orientation suggested that organisations should focus on the markets that they serve. In practice, firms organised around markets and segments, that is, created segment-based organisations. For example, AT&T divided its marketing department into groups dedicated to household and business markets with subsequent subdivisions within each market, while IBM organised itself into vertical industry-based groups. With increased competition, marketers started defining smaller and smaller segments, including niche segments. One manifestation of this phenomenon was a proliferation of brands and channels. This phase, categorised as *Segment Based Marketing* was characterised by an emphasis on gaining competitive advantage through segmentation and positioning. The concept and practice of positioning emerged during the late 1960s to explain how consumers perceive different competing brands in their 'mind space' and recommended strategies to win this 'war in the minds'.

The third phase, which emerged in the 1980s, puts the customer at the centre of all organisational activities. *Customer Centric Marketing* emphasises understanding and satisfying the needs, wants and resources of individual consumers rather than those of mass markets or market segments (Sheth et al. 2000). In customer-centric marketing, marketers assess each customer individually to determine whether to serve that customer directly or via a third party. Also, customer-centric marketers determine whether to create an offering that customises the product and/or some other element(s) of the marketing mix or standardize the offering. These actions are guided by analysis that seeks to maximise marketing productivity, which encompasses both efficiency and effectiveness.

Efficiency entails cost-benefit analysis and seeks to maximise the output-to-input ratio of the marketing function for individual customers. Effectiveness entails the enhancement of customer loyalty and 'share of customer.' The objective of customer-centric marketing is to maximise marketing productivity at a customer level. Customer-centric marketing focuses on the needs, wants, and resources of customers as the starting point of the planning process in contrast to the product-centric approach which makes the product the starting point of planning process. In these organisations, the customer is visible inside the organization:

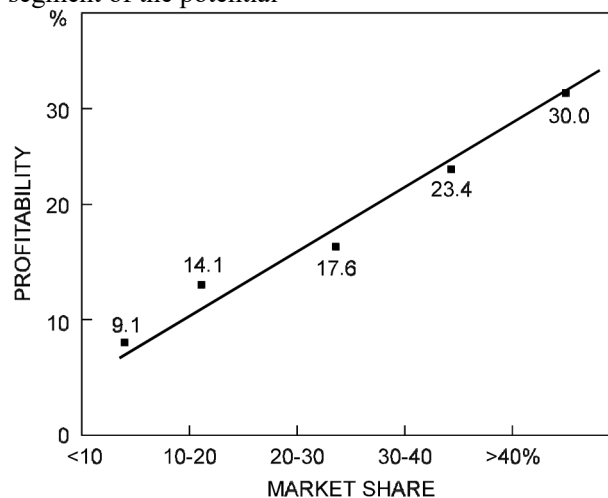
- In all key management and functional processes,
- Customer management becomes everyone's priority,
- Customer centric measures become part of every employees' performance appraisal, Customer feedback is reviewed at top management level,
- Key result areas (KRAs) include customer flow, customer acquisition value, lifetime value, customer satisfaction, customer retention and customer share.

Managers have always believed in the dictum that increasing market share can increase profitability. In many markets, a share point increase is worth tens of millions of dollars. For example, in the US

market a one-share-point gain in the soft drinks market is worth US\$120 million. Studies by PIMS (Profit Impact of Market Strategy) across a wide range of industries in over 2600 business units have revealed that a company's profitability, measured as pre-tax return on investment (ROI) rises with its relative market share of its served market. The PIMS study shows that businesses with market shares over 40 per cent earn an average ROI of 30 per cent, or three times that of those with market shares under 10 per cent. On an average, a difference of 10 per cent points in market share is accompanied by a difference of about 5 per cent in pre-tax ROI.

Other studies have identified low-share businesses that enjoyed pre-tax ROIs of 20 per cent or more specifically in the industrial components or supplies business. Most industries have a V-shaped relationship between market share and profitability. Typically there are one or few highly profitable large firms, several profitable small and focused firms and several medium size firms with poorer profit performance.

In all these cases, market share has always been a measure of organisational performance. A market share orientation can be represented on the two dimensions of 'needs satisfied' and 'customers reached'. Companies with this kind of orientation will satisfy limited needs through their products and services but try to reach a large segment of the potential



SOURCE : PIMS

Figure 4.2 Profitability is Market Share



Figure 4.3 Market Share

customers. For example, every year Maruti Udyog Ltd., the country's largest car manufacturer meets the personal transportation needs of over four lakh customers mainly through its small cars in the A and B class. Similarly, Amazon.com started out as a book store and wanted to be the largest book store in the world. To achieve this, it used competitive pricing and provided a wide array of selection in books.

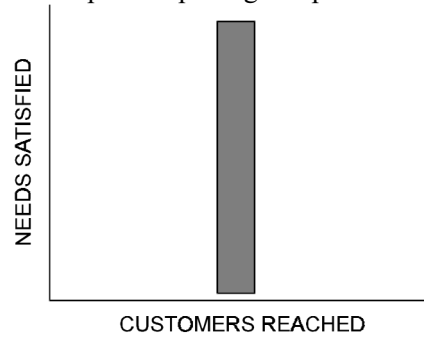


Figure 4.4 Customer Share

In contrast, a company, which adopts a customer share orientation, will try to meet all the needs of its customers. This may require the company to enter into new businesses where it is currently not operating. Consider Maruti's example again. Till recently Maruti was called a 'product company'; generating about 90 per cent of its over Rs 9,600 crore of sales revenue and over Rs. 550 crore profits in 1999-2000 through sale of cars. With a market share of 58 per cent in the 11 player car industry, Maruti is the largest producer of cars in India. Amazon.com's example again. It realized that a large portion of its customer base had other common needs. Hence, currently besides books and music which it sold earlier, it sells games, toys, apparel, electronics and software.

A typical buyer of Maruti 800, (Maruti's largest selling car) incurs the following major expenses over the assumed seven years of the car's life:

1. on a loan of Rs. 2 lakhs (80% financing) at an interest of 17% with payments spread over five years.

Item and Expense (Rs. Lakh)	0	1	2	3	4	5	6	7
Purchase			0.94					
Interest ¹								
Fuel ²					2.5			
Servicing &				1				
Spares								
Insurance					0.25			

2. assuming an average daily run of 30 kilometers, fuel efficiency of 15 km/l, and a constant price of Rs 50 per litre.

The expenses can be grouped as:

- (a) Product — Purchase price of the car,
- (b) Financial Services — Car loans as well as insurance,
- (c) Servicing and Spares, and

(d) Fuel

As can be seen from the chart, when Maruti was focussed on increasing market share by selling more cars, it was targeting only 34% of each of its customer's expenses. And attracting customers is expensive as the industry is really competitive – almost cut throat and margins have been going downhill.

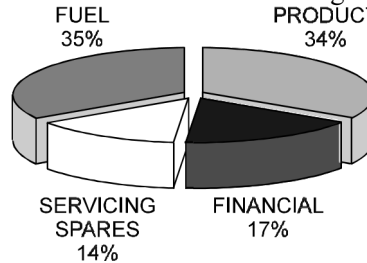


Figure 4.5 Share of Customer's Expenses

When Maruti shifts its focus towards increasing its share of each customer's expenses by:

- Providing car loans through its dealer network at the point of sale (POS),
- Car insurance and
- Servicing and spare parts, it is targeting a potential 65 per cent of all expenses incurred by the customer over a seven year period. Therefore its share of the customer can go up from 34 per cent to 65 per cent. And in all these businesses, the margins are high. Moreover from a single transaction at the beginning of the sale, now there are opportunities for many interactions spread over seven years. It is now focusing on all the needs of a car buyer and owner over a longer period of time. The 'share of customer' focus requires the companies to enter into new business areas to tap the opportunities. Some of the initiatives of Maruti include:

- (a) Maruti Countrywide Finance and Citicorp Maruti Finance for car finance,
- (b) Entry into auto insurance business,
- (c) Increased focus on service and spare parts business,
- (d) Purchase and sale of pre-owned cars through the Maruti True Value Exclusive Outlets in Delhi and Bangalore, and
- (e) N2N – targeted towards the corporate segment for fleet management.

As mentioned earlier, Amazon.com uses collaborative filtering to make suggestions to its customers about potentially interesting products. Using these cues and the customers behaviour, it is able to collect a lot of data about the customers. It leverages this knowledge about its customers to cross sell products in other categories. For example, if a person buys a book called 'What to Expect when you are Expecting,' it is reasonable to assume that they would be in the market for infant toys, lullaby music, infant apparel among other things. Hence, it may be possible for Amazon.com to cross sell these products to those customers.

By the end of the decade, Maruti plans to reduce the revenue contribution from its products to about 50 per cent from the current level of 90 per cent. It is possible only by increasing its 'share of every customer', which is currently over 3 million!

LIFETIME VALUE OF CUSTOMERS

The lifetime value calculation looks at the customers from the point of view of their lifetime revenue or profit contribution to a firm. This concept is required when a company plans to build long-term relationship with its customers. What is the financial value of the longterm relationships?

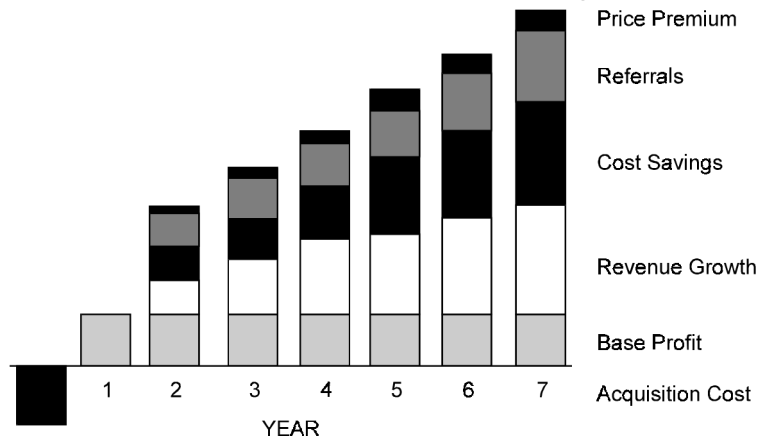


Figure 4.6 Lifetime value of Customers

The lifetime value of a customer depends on:

- The length of an average ‘lifetime’,
- The average revenues generated per relevant time period (yearly in most cases) over the lifetime,
- Sales of additional products and services during that time, and – Referrals generated by the customer over the life time.

Lifetime value refers to ‘lifetime profitability’ when cost data is readily available. In the absence of cost data, it refers to the lifetime revenue stream.

How do the companies benefit by focusing on the lifetime value of a customer? Over a period of time, existing customers increase their purchases, the costs of interaction and delivery reduces due to learning by the customer as well as the company, and these satisfied customers refer other prospects to buy the products and services of the company thus providing free advertising through word of mouth. There is also a potential for price premium with long-standing customers, as they do not easily switch even when slightly cheaper alternatives are available.

Let’s try to understand this concept with credit cards.

Acquisition Cost

Citibank, the largest player in the Indian credit card industry, spends crores on advertising and promotions every year to enrol new customers. It sells the cards through the DSAs (Direct Selling Agents). DSAs get about Rs. 500 as commission for every new customer brought in by them. In addition, the bank incurs expenses on credit verification, processing, sales and administrative overheads. Typically the acquisition costs are high and if the customer discontinues using the card within the first year, the bank loses money on the customer.

Base Profit

Once the customer starts using the card, the bank's revenues from the customer includes a combination of the annual membership fee, commission of about 3 per cent from expenses charged to the credit card, and the interest earnings whenever the customer rolls his payments (credit). The customer profit is calculated by subtracting the cost of servicing.

Profits from Revenue Growth

Initially the customer uses cash on many occasions. As familiarity with the card increase, the customer starts using it more often, thereby increasing the commission stream for Citibank. When he starts financing some of his purchases through the credit card, he generates an additional revenue stream through interest payments.

Cost Savings

As the customer becomes familiar with the services, the requirements by way of customer support goes down. This helps the company save costs. Further, most firms encourage customers to sign up for e-bills and pay their bills using the electronic clearance systems (ECS). These further reduce the cost of doing business with these customers.

Referrals

When a customer is satisfied with the service offerings, over a period of time, he/she is more inclined to recommend the service to others. These positive 'word-of-mouth' are the most influential medium to convert prospects into customers – at virtually no cost to the company.

Price Premium

Loyal customers continue their patronage even when competitors enter the market with lower priced offerings. For example, when SBI Card was launched at a membership fee almost half the price of the existing cards, Citibank did not lose many customers. Some firms overcome the low priced competitor by providing better service and offering more of products to their customers.

In the cellular industry, when MTNL launched its Dolphin services at lower prices, the existing players, viz. Airtel and Essar matched prices as a reactive measure. When Dolphin further announced tariff reductions, Airtel did not match the price reduction. It retained a price premium based on the knowledge that most of its customers would not switch.

Now let us look at the revenue and profit stream of a customer at The Resort, which is positioned as a weekend getaway hotel on the outskirts of a metro.

Table 4.1 Lifetime Value of a customer at The Resort

	(in Rs.)					
	<i>Year 0</i>	<i>Year 1</i>	<i>Year 2</i>	<i>Year 3</i>	<i>Year 4</i>	<i>Year 5</i>
Revenue^a Costs^b						
		12,000	13200	14520	15972	17569
	2000	9600	10560	11616	12778	14055
Customer Lifetime Value:						
Profit	– 2000	2400	2640	2904	3194	3514

Profit from increased purchase of rooms			800	960	1152	1382
Profit from other services ^c			1000	1200	1440	1728
Profit from reduced overhead allocation ^d Profit from referrals ^e			1320	1452	1597	1757
			1980	2178	2396	2635
Total profit	– 2000	2400	7740	8694	9779	11017
Present Value (Discounting factor–15%)	(2,000)	2087	5853	5716	5591	5477
Net Present Value						22,725

a Revenue is assumed to increase by 10 per cent every year.

b Costs increase by 8 per cent every year. Rs 2000 is the cost of acquisition in Year 0. c Other services include restaurant, travel desk, gym, etc. d Declines @ 10 per cent w.r.t revenue, to reflect lower costs of customer relationship associated with both customer and supplier learning effects. e Estimates based on the assumption regarding the importance of referrals to new customers, i.e. the frequency with which satisfied customers refer new customers and the lifetime value calculations for new customers.

One of the biggest advantages of calculating the lifetime value of existing customers is in identifying the potential of prospects. There are many customers whose current profit potential may be low. For example, when a bank provides a credit card and education loan to students pursuing professional courses like engineering, medicine and MBA, these students are not profitable in the initial years when they are studying. If the bank is able to retain them after graduation, they are profitable as most of them get high paying jobs.

Managers intuitively love the concept of lifetime value. But they face a problem when they try to apply the concept. Lifetime value is a powerful tool for identifying and managing profitable customers. Profit calculations require revenues as well cost details. While it is easy to identify revenues accrued from each customer it is difficult to apportion the cost to each customer. Why?

It has to do with indirect costs, also referred to as overhead. Although it is not difficult to determine the labour and materials that go into any product or service, it is hard to allocate costs that are spread among many products or services. These indirect costs include everything from electricity bill, rent and insurance to the wages of the supervisor overseeing many workers in the factory. Traditional cost-accounting techniques allocate costs to products based on attributes of a single unit. Typical attributes include the number of direct labour hours required to manufacture a unit, purchase cost of merchandise resold or number of days occupied. Allocations, therefore, vary directly with the volume of units produced, cost of merchandise sold or days occupied by the customer. But these allocation formulas do not produce good approximations of indirect costs. We face similar problems in trying to identify the cost to serve a customer. Therefore, many organisations now use activity based costing to determine the cost to serve a customer and identify customer profitability.

ACTIVITY BASED COSTING FOR CRM

Accurate and relevant cost information is critical to any organisation that hopes to improve its competitive position. For many years, managers operated under the assumption that their cost information actually reflected the costs of their products and services when, in reality, it did nothing of the kind. While hiding their shortcomings behind a cloak of precision, over-generalised cost systems were actually misleading decision makers. This caused them to make decisions inconsistent with their organisations' needs and goals.

Activity-based costing (ABC) emerged as a concept that can be used to correct the shortcomings in the over-generalised cost systems of the past. It is a means of creating a system that ultimately directs an organisation's costs to the products and services that required those costs to be incurred.

ABC is a budgeting and analysis process that evaluates overhead and operating expenses by linking costs to customers, services, products and orders.

It allows managers to see which products, services or customers are profitable or losing money. It measures the cost and performance of activities, resources and cost objects. Resources are assigned to activities, then activities are assigned to cost objects based on their use. Thus it is a process for performing true-cost calculations.

First, it takes traditional functional costs and allocates them to all the activities undertaken by the company on the basis of the usage of those activities. This means measuring the volume and unit of time required for activities carried out by people and equipment.

In the *second* stage of the process, the cost of each activity is then allocated to a number of cost objects based on of the activity and its uses or consumption. A cost object is typically a product or a service, a customer or a distribution channel, and the calculation can be worked out for each category, so that firms can see product, customer and channel costs.

So the basic distinction between traditional cost accounting and ABC is as follows: Traditional cost-accounting techniques allocate costs to products based on attributes of a single unit. Typical attributes include the number of direct labour hours required to manufacture a unit, purchase cost of merchandise resold, or number of days occupied. Allocations, therefore, vary directly with the volume of units produced, cost of merchandise sold or days occupied by the customer. In contrast, ABC systems focus on activities required to produce each product or provide each service based on a product's or a service's consumption of the activities.

Using ABC, overhead costs are traced to products and services by identifying the resources, activities and their costs and quantities to produce the output. A unit of output (a driver) is used to calculate the cost of each activity. Cost is traced to the product or service by determining how many units of output each activity consumed during any given period of time.

ABC not only applies to manufacturing organisations but also for service organisations such as financial institutions, medical care providers and government units. In fact, some banking organisations have been applying the concept for years under a different name — unit costing. Unit costing is used to calculate the cost of banking services by determining the cost and consumption of each unit of output of functions required to deliver the service.

Let's see how ABC can be applied to assess customer profitability. Professor Robert S Kaplan of the Harvard Business School classified customers as high vs. low cost to serve customers. Managers can recognise customers who exhibit some or all of the high cost-to-serve characteristics. It is good have high cost-to-serve customers if the company can get high margins from them. Similarly, are should not consider to be lucky if by having low cost-to-serve customers. Some of these customers demand low prices when they realise that their behaviour results in low cost to its suppliers. The following model helps classify customers on the following two dimensions:

<i>High cost-to-serve Customers</i>	<i>Low cost-to-serve Customer</i>
Order custom products	Order standard products
Small order quantities	High order quantities
Unpredictable order arrivals	Predictable order arrivals
Customised delivery	Standard delivery
Change delivery requirements	No changes in delivery requirements
Manual Processing	Electronic Processing
Large pre-sale and post-sale support	Little to no pre-sale and post sale support
Require company to hold inventory	

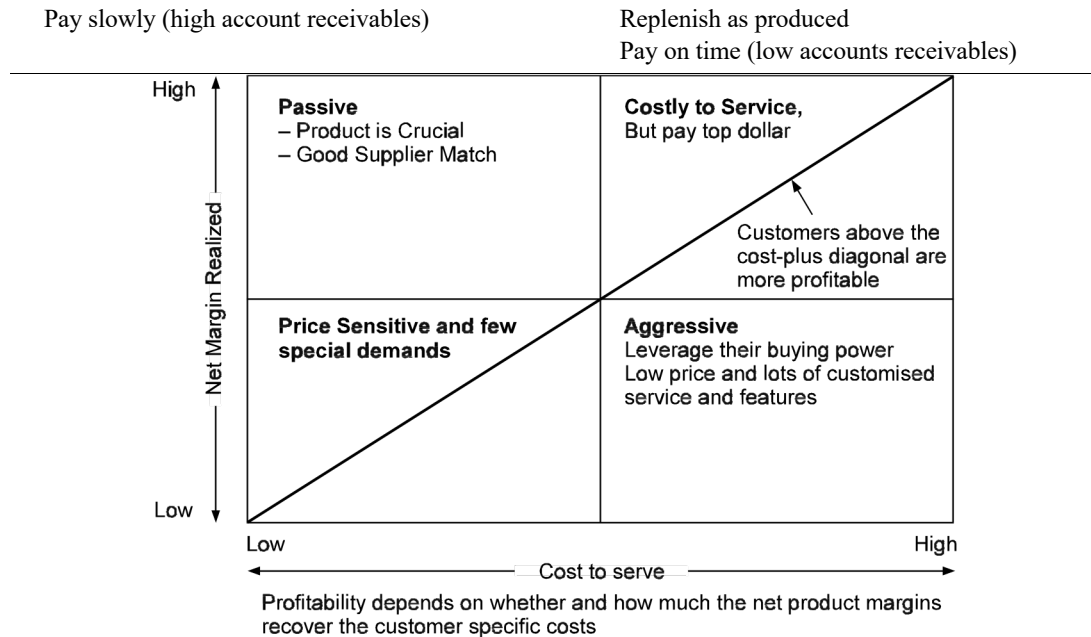


Figure 4.7 Customer Classification using ABC

Source: Shapiro, Rangan, Moriarty and Ross, 'Managing Customers for Profits (Not Just Sales)', Harvard Business Review, September – October 1987.

1. Cost to Serve: It includes order related costs plus the specific customer-sustaining marketing, technical, selling and administrative expenses associated with serving each individual customer measured using an ABC customer costing model of these expenses, and
2. Net Margin, which equals net price, after all sales discounts and allowances, less manufacturing cost (again measured using ABC costing model).

Profitable customers fall in different quadrants. The best ones are obviously in the upper left-hand quadrant. But these types are a rarity but if present, should be cherished and protected. These customers are the prime target for competitors. Therefore, they should be retained through bonding strategies.

Customers who are price sensitive but have few special demands help reduce the cost to serve. Additionally many of them are willing to work with the suppliers to improve the overall system, which help reduce costs.

The high cost: The high margin customers are also profitable, as they are more than covering their costs. These customers value unique functionality, features and extensive support and service, and pay for them.

The most challenging ones are the low margin — high cost-to-serve customers. These include

- (a) Convertibles: Some customers can be made profitable by identifying internal processes which may be costly and inefficient leading to high cost to serve, by negotiating improved ordering and delivery relationships, by reducing discounts, and by establishing menu-based pricing for special services and features.

- (b) New customers: They may not be profitable initially but have profitable potential over a period of time. Therefore, they need to be monitored carefully based on lifetime value potential.
- (c) Strategic customers: The customers who give prestige and reputation or help the supplier learn and improve internal processes. Software service providers like Infosys, Wipro and Birlasoft work with GE in spite of the low billing rates for the prestige as well as the learning potential.

SUMMARY

Customer centricity helps companies focus on increasing the share of their customers. Lifetime value analysis is extremely useful in identifying the customer's current as well as potential value. And finally, the application of activity based costing is necessary to manage customers for profits.

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