

Successful Customer Relationship Management: Antecedents and Imperatives

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ABSTRACT

This paper argues that there are four key conceptual techniques used in Customer Relationship Management (CRM) which should be considered Imperatives for contemporary 21st century e-Business today. Customer Relationship Management itself may be defined as an attempt to find the most efficient way to focus the Marketing effort in order to generate revenue. The antecedents of successful Customer Relationship Management techniques may be found in 20th Century and even 19th Century traditional Direct Marketing constructs. Years of data from this sub-discipline of Marketing, data analysis, and testing confirm the efficacy of these key techniques. Customer Relationship Management concepts which are examined as Imperatives for 21st century e-Business are: 1) Customer Lifetime Value (LTV); 2) Customer Acquisition Cost (CAC); 3) Split-Run (A/B) Testing; and 4) Recency, Frequency, and Monetary Value (RFM) Analysis.

Keywords: e-business, Customer Relationship Management, CRM, Lifetime Value, LTV, CAC, A/B Split Testing, RFM analysis

1. INTRODUCTION

This paper explores the Nineteenth and Twentieth Century antecedents of modern Customer Relationship Management in an attempt to see how they can contribute to greater 21st century e-business profitability.

From a theoretical point of view, Customer Relationship Management (CRM) can be seen as a more efficient focus of the effort to generate revenue—the task of Marketing. The reason that Customer Relationship Management has been gaining prominence in today's economy is that it has demonstrated success at generating revenue more efficiently. [1]

The current practice of Customer Relations Management today confirms the prescience of Peter Drucker when he wrote in 1973:

To know what a business is we have to start with its purpose. Its purpose must lie outside of the business itself. In fact, it must lie in society since business enterprise is an organ of society. There is only one valid definition of business purpose: to create a customer. [2]

The foundation of CRM success today is the concept of Customer Lifetime Value (LTV). Lifetime Value may be thought of as an elaborate extension of Pareto's principle.[3] (Pareto's maxim that eighty percent of an organization's revenues will be generated by twenty percent of its customers has been well accepted for decades.)

2. ANTECEDENTS

However, Lifetime Value is but one of a series of concepts whose success has been proven and refined by a sub-discipline of marketing called Direct Marketing. In 1872, American merchant, Montgomery Ward, and later, Richard Sears sent their catalogs to a predominantly rural population (9 out of every 10 Americans lived on farms) who were unable to visit a retail store. [4] Since that time the field of Direct Marketing has developed a number of operational concepts that have grown in sophistication, power, and profitability through a range of media including catalogues, direct mail, telemarketing, and direct response advertising.

The Direct Marketing concepts which have the most to offer to today's e-commerce practitioners are the ones identified as imperatives in this paper.

The success and wisdom of Direct Marketing has been earned over the better part of a century. The principle reason is that Direct Marketing also known as Database Marketing, enjoys such success is its 100% accountability. In contrast to mass media promotion, Direct Marketing identifies exactly whom it wishes to target (individuals by actual name). This allows collection of data on exactly who responded yielding 100% accountability across a range of metrics. For example, if 100 catalogues are mailed to 100 names, the direct marketer knows the names of the 10 who responded and exactly what they bought and exactly how much each sale cost.

In addition to Lifetime Value (LTV) other operational concepts which Direct Marketing has developed and implemented over the years include Customer Acquisition Cost (CAC); Split-Run Testing (A/B); and

Recency, Frequency and Monetary Value Analysis (RFM). Each of these constructs can be adopted for use by e-business. Since all the techniques can be implemented and analyzed quantitatively, they can easily be applied across language and culture making them ideal for global application.

Because these antecedents have been so reliable and successful in the past for Direct Marketing, their promise for modern e-Business is obvious. Once fully appreciated, these Direct Marketing antecedents may be regarded as 21st century Customer Relationship Management (CRM) Imperatives.

3. IMPERATIVES

The first of four antecedents of the practice of Customer Relationship Management (CRM) which should be regarded as imperatives is the concept of Lifetime Value. This term posits that there is a lifecycle to the relationship that customers have with an organization or business. During the period of the relationship between the beginning and the end, the company has an opportunity to lengthen or shorten the relationship based on how it “manages” the relationship. “Manages” is an unfortunate choice of words since it indicates an almost adversarial nature of the relationship, or at the least, an unequal one, between the manager and those managed. Nevertheless, Customer Relationship Management is the term in accepted use today.

3.1 LifeTime Value (LTV)

Enlightened businesses realize that every time a customer has an interaction with the company (or “touch” in CRM language), the relationship can be either be deepened or weakened. If the interaction is a positive “touch,” there is an opportunity for cross-selling and increased profit. An additional benefit of deepening trust and frequency is loyalty. Loyalty extends the term of the relationship so that a customer who has been with a company five years continues for six, eight, or ten years. This extension not only increases the net present value (NPV) of the projected revenue stream, but does so at lower cost. This in turn, increases margins and leads to greater profitability. [5]

Any calculation of Life Time Value (LTV) must take three factors into consideration:

1. Margin
2. Retention Rate
3. Discount Rate

First, Margin is the annual revenue that customers generate minus the company’s operating expenses in serving them. Second, the Retention Rate is the percentage of first-year customers who can be expected to continue into the second, third or n year. And third, the Discount Rate is the current cost of capital. [6]

LTV tracks the buying behavior of a group of customers and projects it into future years. In order to compute LTV, we need to know the following: [7]

- number of customers acquired in first year of business
- cost of promotional materials needed to acquire them
- cost of promotional materials after their first purchase
- retention rate (first year customers who continue into second year)
- average order size
- number of orders per year
- cost of goods sold
- average rate of returns, exchange, and damages
- market rate of interest

The Imperative is that once Lifetime Value has been computed for each customer, an analysis can be made to identify those *customers who represent greater value to a company’s future* and those who represent less. Decisions can then be made as to which customers are the company’s best prospects, which are marginal and which are unprofitable to the company. This analysis helps decision-makers formulate promotional strategies which can most efficiently grow a company’s profitability. Managers can now make informed decisions as to whether to concentrate on customer retention, acquisition, or win-back. [8]

3.2 Customer Acquisition Cost (CAC)

The next antecedent that is integral to implementation of Customer Life Time Value (LTV) is the accurate determination of Customer Acquisition Cost (CAC).

Reichheld claims that “On average, U.S. corporations tend to lose half their customers in five years, half their employees in four, and half their investors in less than one.”[9] The implication of these facts, underscores the continuing requirement for companies to replenish their customers. The cost of new customers is seldom free. However, not all customers cost the same to acquire. Nor do acquisition programs always yield the same quality customers. Moreover, customer acquisition costs can vary wildly.

Calculating Customer Acquisition Cost is a technique that can assign a dollar cost to acquiring or re-acquiring each customer, old or new. A Customer Acquisition Cost ratio is used to help determine whether to retain an existing customer or to acquire a new one.

In hindsight, it can be seen that among the many factors responsible for the dot.com bust was lack of appreciation of CAC. At the height of the dot.com boom, to give just one example, the company, e-Toys, was reportedly spending more than \$700 to acquire each new customer. Unfortunately, each new customer’s LTV was only \$87. The inevitable result was that for

every new customer acquired, e-Toys would absorb a loss of over \$600.

To truly appreciate the value of keeping track of CAC, there is one informative general Direct Marketing principle to apply. The rule-of-thumb used by direct marketers is that it costs between 5 to 10 times more money to acquire a new customer than it costs to retain a current customer. [10]

Of particular importance is the fact that the Customer Acquisition Cost (CAC) for pure-play Internet retailers is higher than their multi-channel counterparts. Internet retailers are defined as those with physical stores or mail-order catalogs in addition to their web sites. [11]. CAC is defined as total sales and marketing expenses divided by new customers accounts. Author Morrison predicts that average Customer Acquisition Cost will rise to \$150 for web-based retailers vs. \$95 for multi-channel retailers in 2004.

One of the most difficult problems associated with computing true CAC is that it becomes difficult to distinguish between which sales and marketing programs stimulate repeat sales to existing customers and which result in new customer acquisition.

The Acroterion Company, estimates that CAC for pure-play retailers is \$82 per customer while a multi-channel retailer's is only \$31 per customer according to a survey of 221 retailers conducted by Shop.org. [12]

Compared to a multi-channel retailer, the pure-play retailer has a much more difficult task in identifying and reaching potential customers. While direct marketers can choose from more than 1,000,000 databases of names and addresses of groups segmented by demographic, geographic, and psychographic variables, the pure-play retailer has a much more difficult job. The fact is there are so many fewer lists available containing valid e-mail addresses. In this day of rampant "spam" and extraordinary privacy concerns, direct solicitation of potential customers via email no longer appears viable. Consequently, pure-play retailers must resort to more expensive methods like on-line advertising and search-engine listings.

3.3 Spit-Run (A/B) Testing

The next antecedent is key to Direct Marketing's success, the concept of Testing. Direct Marketers test every variable they can in an effort to achieve optimization in their choice of merchandise, their value proposition, and the elements of their promotional materials.

E-Commerce practitioners have much to learn in this area. First, there is the scope of what to test – everything that is important. And, second, there is the relentless

dedication to testing, the never-ending emphasis on optimization.

One of the most frequent statistics mentioned about e-commerce shopping is that 7 out of every 10 shopping attempts on line are abandoned. Clearly, this is unacceptable. It is an area ripe for improvement. It is here that ingenious testing can make a significant contribution.

The term that direct marketers use to describe their testing technique is Split-Run (A/B) Testing. On the Internet, it can be used to test such things as product features, web page design, and navigation, value. [13]

In its simplest form, the e-commerce retailer selects one--and only one--variable at a time to be tested, such as the number of steps necessary for a successful shopping cart check-out. Assume that seven is the current number of steps, called the "control." A new 6-step sequence is now constructed. Then, a method is developed so that every other visitor to the shopping site will be offered the 7-step checkout and every other visitor will get the new 6-step sequence.

By tracking how many shoppers have used the 6-step vs. how many have used the 7-step sequence, we can determine whether reducing the number of steps has any significant effect on the outcome. If the new 6-step sequence increased the number of users, then it "wins" the test and becomes the new "control" and the 7-step sequence is retired.

The imperative here is that e-commerce retailers must constantly search for variables to test and be relentless in their commitment to continual testing. Moreover, they must commit to a continual refinement of all aspects of marketing program in keeping with those test results.

The Internet offers the extraordinary opportunity for dynamic, real-time testing that traditional direct marketers can only dream about. For example, in a 24-hour period, an e-commerce retailer can vary the size of a picture of an item offered on a web page whereas a traditional direct marketer using a picture on a page in a printed catalog would only be able to compare results from the control, the current size, Size A, and the new size picture, size B. And then the retailer would have to wait to reprint the catalog in order to test again.

3.4 Recency, Frequency, Monetary Value Analysis

The final antecedent is called RFM analysis which means analysis of the Recency, Frequency, and Monetary Value of customer purchases.

RFM analysis is a refinement of Pareto's principle, commonly known as the 80/20 principle, which

translates into marketing operations as the axiom that 80% of an organizations revenues will be generated by 20% of its customers.

Recency, Frequency, and Monetary Value (RFM) Analysis predicts customer behavior. [14] Attention to RFM delivers empirical proof of a company's best customers. Moreover, it predicts exactly which promotional solicitations will be most successful by market segment. Each record of an existing database is coded to identify which customers bought most recently, which customers bought most frequently, and which customers spent the most money on the company's goods and services.

At first, RFM analysis appears counterintuitive, because it is based on the principle that customers who bought most recently will be the most likely to buy again. However, the proof of this has been demonstrated empirically time and again by Direct Marketers. Likewise, the principles of frequency of purchase and dollar amount spent have also been demonstrated to be empirically sound. Marketers code all customers into RFM cells and examine the response rates of customers in each cell when exposed to the same promotion. Generally, Recency is weighted at 50%, Frequency at 30%, and Monetary Value at 20%. [15] Chi square analysis is used to analyze the data and produce results.

3.4.1 Migration Analysis

A refinement of RFM analysis is called Migration Analysis. Results of migration analysis indicate patterns of customer migration, which allow the user to predict which cells customers will migrate to in the future. This, in turn, will permit the company to focus promotional efforts against the most likely and receptive segment cells. Conversely, those customers (cells) that will be most likely to migrate into lower ranking cells can similarly be predicted. [16]

The imperative here is that RFM analysis is based on data that is readily available to e-Businesses. Knowing the usefulness of such data is ample incentive to gather it consistently. Once RFM analysis becomes a central part of the Customer Relationship Management process, it can become a powerful tool which e-Businesses can implement to increase their profitability.

4. CONCLUSION

Finally, as modern, traditional marketing emerged during the second half of the 20th century, its emphasis was on mass distribution and mass media promotion. This type of marketing largely ignored the valuable lessons of one-to-one marketing that its earlier sub-discipline, Direct Marketing, had learned and refined.

Today, there has been an explosion of one-to-one marketing opportunities thanks to the World Wide Web, making the tried and tested lessons of Direct Marketing imperative for any e-business to study. The reason is simply that the business model closest to successful 21st century e-business is not traditional 20th century "modern" marketing, but venerable Direct Marketing. It is this body of experience that holds the greatest promise for creating a sustainable competitive advantage and greater profitability for e-Business.

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