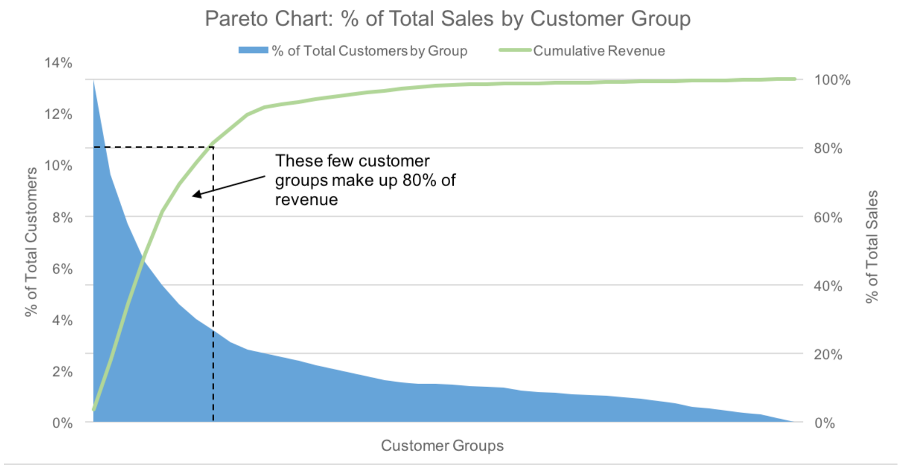
Customer Lifetime Value: Understanding the Value of Your Current Customers & Identifying Which Prospects You Really Want

Authors:
Andy Piazza, Vice President & Tyler Shiovitz, Analyst – Mather Economics

"Profit in business comes from repeat customers, customers that boast about your project or service, and that brings friends with them." W. Edwards Deming

There's a longstanding economic principle called the Pareto Principle—colloquially known as the "80/20 rule"—that might just make you rethink your customer segmentation. The Pareto Principle estimates that 80% of outcomes are often a result of only 20% of an input. In other words, 80% of profit comes from 20% of your customers, or 80% of results come from 20% of time used to produce those results, etc.

Having long been in the business of understanding customer relationships, we find ourselves frequently discussing acquisition and retention programs with clients. Many approach us, saying something along the lines of, "Look—a customer is a customer, and customers keep the doors open. If I focus too much time on a select few, won't I be missing out on revenue from a colossal group of potential customers?" We often remind them that it's important to keep Pareto in mind.



It's clear in the example above that not all customers hold equal value. In fact, it's often true that the important few are the key to real, long-term growth and profitability.

How Can I Use This Principle to Directly Affect My Bottom Line?

Identifying high-value customers at a particular point in time is, in and of itself, not very helpful. Most organizations already know the price points and contract values for their highest paying customers. In order to effectively assign value to a customer base, organizations must understand what each customer is worth to their bottom line over the long-term course of their relationship.

In a perfect world, retention is a one-for-one equation, where one new customer replaces one lost. However, in reality, this is often not the case. It may take three to five customer acquisitions to replace one high-value customer. By identifying the areas of efficiency loss, organizations are able to make informed decisions about the allocation of financial and personnel resources utilized for each and every customer.

On the opposite end of the spectrum, many customers do not pull their weight in relation to profitability. By understanding the characteristics that these customers share, organizations can create targeted cross-sell and upsell opportunities, to migrate this group towards increased profitability.

Then, the question often becomes:

"How do I identify my most important customers and prospects; and how do I hone in on and prioritize retention and acquisition efforts directed at them?"

Enter *Customer Lifetime Value.*

Customer Lifetime Value (CLV) is a long-term, margin-driven approach to understanding the true value of each customer (or prospect) over a specific time. CLV can act as a support tool to retention, acquisition, pricing, and other programs that require careful observation and application. It is an over-arching metric that can be applied in many ways.

Getting Started with Customer Lifetime Value

When it comes to CLV, there are two sides to the story: profit margins and retention. These are the factors that affect the bottom line. Profit margins are often readily available, however not dissected with appropriate granularity to be actionable. Therefore, the more specific these margins are measured for each customer, the better.

First, you'll need to consider what types of variables affect revenue and costs, such as:

- Price Point;
- Product Segment;
- Ancillary Revenue;
- Geography (delivery or service costs); and
- Acquisition Costs (for new customers).

Next, simply subtract average cost per unit from average revenue per unit:

Average Revenue Per Unit (ARPU) - Average Cost Per Unit (ACPU) = Profit Margin

The next step is determining projected retention. Many organizations will simply add in their average overall retention figure and call it a day. This may work, but they may also be selling themselves (or their products) short. Just like the margins above, the further organizations can break this down into specific segments, the better.

*Profit Margin * Expected Lifetime*

This is a very simple, beginner's version of CLV.

	Yearly Profit Margin	Expected Future Years	Lifetime Dollars	LD w/ Discount Rate	Customer Rank
Customer A	$100	5	$500	$480	2
Customer B	$200	2	$400	$390	3
Customer C	$300	1	$300	$300	4
Customer D	$500	3	$1,500	$1450	1

	Retention	Acquisition
High CLV	**Premium Perks:** Loyalty Programs Special Offers & Promotions Continued Upsell	**Catching the Big Fish:** High-value incentive offers & gifts
Low CLV	**Increased Spend:** Product promotions & offers that increase dollars spent for low CLV customers; including incentives to buy higher-value products	**Profitable Acquisition Offers:** Identify a profitable price point; including special discounts based on volume
All CLV	**Communication Triggers:** Based on the overall direction that a customer is trending, send automated messages offering products, deals, etc., to encourage CLV to rise	

Application

After segmenting and scoring customers, the information can be applied in a multitude of ways. Above are some examples that are often referred to as easy-to-build programs while getting the hang of CLV.

Taking This Approach to the Next Level

Remember Pareto? Using his 80/20 rule, successful organizations are leveraging advanced data analysis to direct their customer relationship efforts with real results. By transforming this principle into specific, measured analysis, an organization can truly understand the contributions of each customer and segment. Who, what, where, when, how and what impact each have for the future can all be continually quantified, tracked, and forecasted to **enable better decision-making and strengthen profit margins.**

To truly leverage the power of CLV scoring, the level of detail involved is important. At Mather Economics, our programs assign a unique CLV dollar amount and score to each individual customer. By balancing a bevy of transactional data, customer relationship data, family, lifestyle and social preferences, as well as macro and micro economic factors, we weigh future operating margins for each customer by the probability that the individual will remain active.

There are typically three main steps to our process:

1. Collect customer data and combine with internal demographic and industry data to create a historical snapshot of how different groups act and react over time;
2. Create custom analytical models to apply customer-level margins and pinpoint characteristics to show the effect each has on retention (individually, and all together); and
3. Identify areas of strength and weakness within this framework. Collaborate with clients to idealize, implement, and test applications across various operations.

Examples of CLV Data:

- Customer Start Source
- Customer Start Date
- Service Types & Change Dates
- Service End Date
- General Characteristics
- Product-Specific Characteristics
- Transaction Types & Timing
- Price Changes
- Costs & Revenue (by specified metrics)

Perhaps the most complicated portion of CLV is calculating an expected retention level for each

individual customer. Through survival analysis, Mather is able to estimate the amount of time until an event occurs.

In most cases, the event in question is a customer stopping or canceling service, or simply becoming permanently inactive.

With this model, Mather can then create cross-attribute retention forecasts to a degree that would be virtually impossible without the use of powerful data analysis programs.

By drilling down on each individual separately, our CLV programs allow for the most targeted and accurate retention and acquisition campaigns, resulting insights, and further application.

Mather Economics & Customer Lifetime Value

Our staff has the experience and flexibility to apply and test programs with each of our clients across multiple industries. Some examples of how we help our clients operationalize CLV scoring within their acquisition, retention, or customer relationship strategies include:

- Reallocating direct marketing budgets to support CLV segmentation;
- Identifying cross-sell and upsell opportunities with all customers;
- Transitioning less profitable customers into more profitable relationships;
- Implementing strategies to ensure that new products are launched profitably;
- Targeting new customers using “lookalike algorithms”;
- Determining profitability and sustainability of most desired customers;
- Discovering the most profitable acquisition channels;
- Segmenting customer service policies, procedures, and scripting according to CLV scores;
- Developing efficient retention strategies and customer-specific communications; and
- Automating decision criteria used in customer relationship management (CRM) systems.

CLV scoring at the individual customer level is a valuable tool when implementing retention and acquisition campaigns across multiple industries.

For example, the lifetime value of a patient, the patient’s family and the patient’s network can be accurately scored. The results of this analysis can ensure a hospital implements actionable marketing campaigns to support a patient’s decision-making process when evaluating options for the best possible care.

Or, the CLV score of a banking customer can be utilized to evaluate relationship pricing and fees, to offer loyalty incentives to high-value customers, as well as pursue cross-sell and upsell opportunities for credit cards and loans that can potentially increase customer lifetime profitability.

With access to historical data, Mather continues to collaborate with our clients to find ways to operationalize analytics and to increase immediate and long-term profitability.