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The importance of focus for generating customer value

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Abstract

A carefully chosen customer value proposition (CVP) is essential to create customer value. Both value creation from the customer and the corporate viewpoint gain from consistent and deliberate focus on key market segments and core competences. The result is a mutual exchange of value, thus stabilising and strengthening the competitive position in the market. Conversely, failure to maintain a consistent focus puts value creation at risk, and potentially causes one's competitive position to break down. System Theory offers a useful framework to integrate value creation from both the customer and the corporate perspective. [PUBLICATION ABSTRACT]

Full Text

INTRODUCTION

The term 'customer value' is typically used in one of two ways. Either it is used to denote the value a customer gets from using a product, or it is taken to mean the profit a customer is generating for the company. In parallel, the business literature has two strands. One is considered a 'soft', and the other a 'hard' approach to value creation. The soft approach seems to deal just with how to please the customer. The hard approach deals with the creation of shareholder value.

In this paper, the author will take a holistic view, embracing both the soft and the hard approach to value creation. System Theory provides a framework in which both value *for* and *from* the customer can be studied and integrated. It also provides a powerful model to deal with the complexity and intricate interdependencies of real world problems. System Theory enables the presentation of these causal dynamics in a simple yet comprehensive way.

It is somewhat of a paradox to consider the value for the customer as if this were opposed to the value for the company. There really should not appear to be a conflict of interest between value *for* and value *from* the customer, since this is not a zero sum game. A customer that is getting excellent service (that is, getting a lot of value) is therefore less likely to shop around, compare prices and maybe even churn. Good service and satisfied customers are needed to avoid a product being perceived as 'merely' a commodity and to command a premium price. This then comes back to enhance the profitability of a customer and thereby accelerates the creation of shareholder value.

There is no reason to suggest that value created for the customer is in any way opposite to value generated from the customer. The trick lies in matching the offer to the customer needs, or finding the 'right' customer given a company's offering.¹ To achieve this goal, it is essential that a purposely chosen customer value proposition (CVP) be pursued. The strategy should then consistently be supported by everyday tactical decisions. There exists no quality of strategy *per se*. What constitutes quality in a strategy is the manner in which each and every decision that is made within the company, on a daily basis, is aligned with its ultimate strategic choices.^{2, 3}

MEASURING CUSTOMER VALUE

There are many possible criteria to measure corporate performance like market share, turnover, profit, number of products sold, etc. These performance criteria can be used to evaluate how a company is doing at a given moment in time (*ad hoc*), periodically or continuously.

Aggregate turnover, sales volume or market share do not necessarily provide a reliable picture of the (financial) performance of a company. For instance, a large market share could have been acquired at too high cost; as a result the profit per customer may become too low. It is better not only to rely on aggregate performance figures, but also on criteria that are determined at the individual customer level. The question then is: what are the most useful performance criteria to determine how a company is doing? Such performance criteria should also provide guidance on how to change course 'in mid-air', to offer help with tactical decision making. In general, aggregate numbers do not give sufficient insight to help everyday decision making at the operational level.

Not all customers are created equal; some are more profitable than others. For this reason, it is highly desirable to have some kind of measure in place to discriminate between customers on the basis of their value to the company. If a company wants to measure profitability at the individual customer level, it will need to calculate both revenue and cost at the individual level. Often, it is not possible to determine exact variable costs at the individual customer level. What this would require is an integral account of each service request, each customer contact, and all transactions. Multiplying the contacts by an itemised cost would then give total variable costs.

In many cases it will be a challenge to consolidate such detailed data across all customer touch points. If consolidation is not feasible, some fair approximation of costs per customer needs to be determined.

Usually the hardest part in determining individual customer profitability is dealing with the fixed costs. With regard to the cost per customer, one needs to set up an allocation scheme that takes into account how fixed costs should be distributed among customers. This is not easy, but necessary, to establish an individual profitability calculation. As an example, suppose hardware is needed to host a new voice response (VR) system. If only 10 per cent of customers have started using this system in the first year, it seems hardly reasonable to charge these customers with the full hardware costs. Another difficult question can be to determine whether costs should be allocated at the customer or the account level. These questions challenge the fundamental business model, and are not straightforward.

Besides current profitability, one can also take future profitability into account. One would like to make decisions on the basis of not just the present value, but also the potential future value of a customer. In order to make such decisions, it is necessary to estimate the discounted future cash flow that is to be expected from every customer. Such measures have been labelled 'life time value', or more realistically 'long-term value'. Such calculations are not easy to realise, if only because they rely on very high quality data to reach a level of accuracy that is acceptable for practical business purposes.⁴

Measuring customer profitability is very important in order to target the right prospects. Companies want to spend their marketing resources where they will generate the highest payoff. This requires insight in cross- and up-sell potential. It is not just current profitability, but also the development of customer profitability over time that is important. These together need to be known to evaluate the return on investment (ROI) of marketing spend efficiently.

FROM AGGREGATE TO INDIVIDUAL CUSTOMER DATA

Businesses are increasingly run 'by the numbers'. CRM, the new marketing paradigm, has helped to shift the focus from aggregate company sales to financial measures at a lower level of aggregation: the individual customer. It is certainly no longer enough to know that one's market share went up. The underlying 'quality of growth' needs to be monitored as well. The percentage of new customers and attrition of the existing base for example, can have a very big impact on bottom line figures, and further potential for growth.^{5,6} According to many,^{7,8} CRM has failed in many respects. Even if this were true, it has nonetheless brought about a lasting change in focus on the kinds of numbers that are used to steer businesses.

In this new marketing paradigm, the focus is now on customer lifecycle management, on developing and maintaining customer relations. Marketing spend is seen, not just as an expense, but rather as an investment in the relation with the customer. At the moment, generally accepted accounting practices (GAAP) do not allow customers as assets in the books. In the same vein, marketing expenses cannot be booked as investments. Yet at the same time, companies are publicly valued on the basis of number of customers, customer acquisition and churn rates, and cross-sell ratios. So the financial markets clearly value companies in ways that appear at odds with GAAP.

VALUE FROM OR FOR THE CUSTOMER?

Sometimes the debate on generating value is treated as a zero sum game: by doing more for the customer the company is earning less. But this is only an apparent paradox.⁹ Sustainable value can only be created if the supplier can afford to offer the current service level and still maintain profitability.

From the customer perspective, they consistently need to get more value, a better overall deal than they could get from the competition.¹⁰ If dealing with the current supplier does not generate excess value, instability will result. Excess value means more than just offering a better price. As an example, a private banking client may get a less favourable transaction rate with a high street bank than with a discount direct broker, but as long as the 'total experience' is better, the high street bank still provides more value.

For the company, value creation comes in the form of a steady cash flow, which can be counted on also to extend into the future. These future projections are where a difference becomes apparent between traditional valuing methods and the new marketing paradigm.

Value is created in marketplaces where both suppliers and customers are in a win-win relation. Only then will the supplier be able to sustain its market position, and only then will it be in the customer's best interest to maintain the relationship with this supplier.

Loyalty is not something that can be bought, at least not profitably for prolonged periods of time. In fact customers cannot even be owned. Customers can be rented from the marketplace, but this comes at a price, namely acquisition and retention costs. Loyalty is a privilege one can earn by consistently delivering superior value to the customer. Essentially, it is the customer who chooses where to do business.

Deep promotions can (temporarily) seduce the customer into a trial. But this has nothing to do with owning a customer, nor with creating sustainable value. Earning money, generating shareholder value, comes from offering value to customers that is convincing enough to give the company a chance to rent a customer's business from the marketplace over prolonged periods of time.

THE DYNAMICS OF GROWTH

System Theory has generated templates, fundamental mechanisms that are useful to apply to real world problems. They are also sometimes labelled 'systems archetypes'.¹¹ These are structure diagrams that describe causal patterns where cause and effect are intertwined. Therefore, the question 'what is cause and what is effect' becomes trivial. These are powerful models to describe and simplify business concerns in ways that allow for dealing with real-life complexities.^{12, 13}

The basic model here looks like Figure 1 - See PDF,. Providing value to the customer leads to growth, which in turn leads to a better understanding of the reasons behind success (customer feedback and research), which then leads to providing even more value. This way the cycle can continue growing. It is a so-called reinforcing cycle, and therefore it has a plus sign in the centre.

The objective of this paper is to demonstrate the central importance of managerial focus in this reinforcing cycle. Focus is a leverage point in that it can make or break success. A loss of focus will cause the cycle to break down gradually over time.

The risk that lies within growth is that success can blind one to the reasons behind it. Success in the marketplace comes from a match between the company's CVP and meeting needs of customers. This is matched by a focus on core competencies as they relate to generating value for customers. What is it about the service that customers value the most? By putting effort where this is most appreciated, one can stay 'lean and mean'.

It is vitally important to determine the company's core competencies. One needs to define exactly what the benefits are for the customers that are most appreciated. Then it is necessary to specify the needed processes, systems and communication that are required to deliver the unique benefits. Why is it that (high value) customers like the company? Then, focus all energy towards meeting those goals. If not, there is a real danger of diffusion of the CVP, as in the next system diagram, (See Figure 2 - See PDF,.)

A more elaborate value/growth model might look something like Figure 2 - See PDF,. Given an organisation's infrastructure and value proposition, certain customers can be profitably targeted, others may not be. The constellation of organisation structure, systems in place, and the value proposition a business is working with (its 'capabilities'), together comprise the most important elements that will influence the costs of an organisation. Moving outside these core competences brings with it a risk of inefficiencies. This risk comes in added cost in relation to the marginal increment in number of customers. Customer acquisition costs, and the investments needed to cross-sell to customers will rise

gradually (at the group level). That is why the loop on the right of Figure 2 - See PDF, has a minus sign in the centre, indicating this mechanism will bring growth to a halt.

The reason why the loop on the right of Figure 2 - See PDF, is so pernicious has to do with the fact that only after a while will it become apparent that a cohort of new customers is of the wrong kind. Only after repeated unsuccessful cross- and deepd-sell attempts will it become apparent that there is a misfit between new customers and CVP. But typically, these customers will have been around for quite a while before this becomes apparent.

RISKS OF AN UNDIFFERENTIATED APPROACH

What are the risks of an undifferentiated growth strategy? This results in the 'drag' that is caused by the right loop in Figure 2 - See PDF,, the one with the minus sign in the centre. This will result in a loss of value in four places:

There is less of a match between the value proposition and the new customers. As a result, one becomes increasingly dependent on customers choosing the company, instead of the other way around. This risks devaluation of the brand for two reasons. First, for many customers one can not deliver what they expect. And secondly, one loses its differentiated position. The brand becomes an 'average'; there is no longer a way to differentiate oneself from the competition. ¹⁴

One loses focus on core competencies given the CVP-segment match. Because of heterogeneity in new customers, pressure arises to diversify activities, to fulfil more different kinds of needs. For example, there will be more processes to manage, more different kinds of questions and requests from customers, and one risks running into service and communication problems. It is inevitable that lack of a clear priority of service and value will lead to higher operating costs. The bottom line is that there will be more errors in fulfillment because one has been forced to offer more diverse services.

Once the wrong customers have entered the base, it becomes much harder to cross- and hard-sell. Also, developing new products becomes much harder: who to develop them for? This will then further amplify the difficulties in cross-selling.

The leverage on the market goes down, costs go up, and therefore there is even less competitive power. One does not know the customers, simply because there is no typical customer any more. And the customers do not know the company, due to lower average tenure. Service costs are likely to go up when customers are less familiar with the company's services. ¹⁵

For these four reasons higher costs will be inevitable, thereby making it even harder to compete. Margins have eroded and more cumbersome operations negatively affect the ability to move quickly into new market segments. Heterogeneity in customer needs will lead to a mismatch with the CVP, therefore it will become harder to satisfy existing customers. In particular, loyalty and referral rates will go down, leading to a downward spiral.

HOW TO MEASURE PROGRESS

How can the match between CVP and customer needs be established? This will require some key metrics to track over time. To monitor developments over a period, it is necessary to compare successive cohorts in terms of cross-sell, profitability and tenure. This means comparing groups of customers who entered in successive years, and normalising their profile. This means comparing all groups at the start, after being a customer for one year, two years, and so on. For older cohorts this means going back to their historical profile.

In this way, a new perspective on the customer portfolio is given. Growth in the number of customers may lead to slightly lower cross-sell and tenure figures. It is important to strike a balance here, and any steep drop in cross-sell, tenure or profitability should be cause for concern. In a saturated market one should aim to 'raise the bar', and attempt to see these numbers rise.

Another important source of input is customer feedback. Ask customers how and when they find value, in particular ask very profitable customers. Preferably this should be done with a standardised instrument with known psychometric properties.

It is also desirable to analyse profitability from the internal, cost side of the business as the cost structure of a business is subject to change. Technological innovations change the channel mix of customers. All this can then be related to customer concerns and needs.

Of course one should focus effort where the cost/value payback is highest, but where internal cost is high one might reconsider operations strategy, business process re-engineering (BPR), outsourcing, streamlining, etc. Customers' needs are a moving target, and aligning with customer desires requires continuous innovation and adaptation.¹⁶

WHICH CUSTOMERS TO TARGET

In the remainder of this paper the author will demonstrate why value for the customer is in large part the result of quality and appropriateness of the customer selection. Although the misfit between CVP and customer cohort only shows after a while, it originates at the moment when customers enter into a relationship. The right new customers to try to acquire are those who have the potential to take up one's extended offer. That means not just taking the basic core product (maybe even a loss leader) that comprised the initial reason for starting a business relationship with the bank, but also the extended products and services. This is essential because it is well established that only customers to whom one can cross-sell successfully are the ones who are likely to become profitable.¹⁷

How does one determine which customers should be targeted? There are two essential ingredients needed here. The first is an activity-based costing (ABC) scheme. It is important to break down customer profit into the constituent components. This allows an analysis of relative contribution of profit per product category. The second ingredient is a longitudinal breakdown of cross-sell. What this implies is that customer data need to be represented relative to their origination date. This way, one can display profiles of customers after one, two, three years etc, but also make comparisons relative to when the relation began (start year 2005, 2004 and so on). Customers to whom one can cross-sell effectively, are the ones to target.

There is one minor complication. The way customers 'look' after successful cross-and up-sell might be quite different from *the way they looked when they first became customers*. Yet their initial appearance is what the targeting should be aimed at. One searches for look-alikes of prospering customers, the way they looked when they first became customers. The fact that these customers prospered under the current value proposition is living proof that these are the kinds of customers for which the offering has the most appeal. There is a good match between the CVP and inherent needs.

What to do when there is a mismatch between customers and CVP

Suppose it is concluded that there is a mismatch between the CVP and new customer acquisition. This becomes clear when too many new customers are not developing well. What can one do to get back on track?

There are basically three approaches to take now.

Install barriers : prevent certain (low value) customers from entering into a relationship with the bank. For example, one could establish a business rule that private banking customers can only enter into a relationship with the bank with a minimum starting deposit of at least EUR2 m. One could even choose to be explicit about this, and there can be several ways to communicate such a policy. This effectively prevents more of the wrong kind of new customers from entering.

Demarket : employ a cost control strategy. Freeze all marketing investments and simply stop making offers. It is possible to cut down on customer service, for instance by giving these customers a lower service priority at the call centre. This part of the tactics is meant to prevent more waste on customers where the investment will bring insufficient returns.

Differentiate on price : when some customers only use part of the proposition (take only a few product categories) the price/service strategy can be adjusted. This can be done by offering bundled service packages at a discounted price. This establishes a financial incentive to entice cross-selling. What this effectively does is make the overall CVP more interesting for the customers one is seeking (with a large share of wallet), and make the offering more expensive for customers who are only 'cherry picking'. Such a strategy kills two birds with one stone because it mitigates the costs low value (low wallet share) customers are creating, and it communicates the appeal of a 'full deal' to customers one aims to attract. This part of the tactics transforms the CVP into mutual value creation.

CONCLUSION

In this paper some arguments have been put forward to demonstrate why focus on a purposely chosen CVP and targeted acquisition of new customers are key to success in financial services.

Purposely choosing and shaping one's CVP is an ongoing strategic process. The choice of a given CVP should come from an assessment of core competencies,¹⁸ in combination with existing market needs and financial potential.

Constantly reshaping CVP should be the result of evaluating customer feedback; making the best possible use of what customers particularly like about the service, implicit or explicit. Implicit feedback is displayed, for instance, in higher response rates. A high response rate implies relevance of the marketing offer. Explicit feedback can be gathered either by dedicated research, or at moments of customer interaction (for instance in the call centre). The next step is to continue to make an effort to provide more value to customers. It is much more powerful to build upon existing strength than it is to try and do something the company is currently incapable of fulfilling.

Another important point that has been made is the central importance of the customer acquisition process. Customer acquisition is not something to submit to, it is an activity every company engages in. Whether the resulting new customers are left to chance, or are the result of careful planning is a voluntary choice. The author has asserted how important it is to target customers who have high potential for *future* growth. New customers are rarely very profitable at the outset. What is important is that they be managed throughout the lifecycle, and then high profits from a broad product portfolio will follow. Successive cohorts of new customers need to be tracked.

The risks of an undifferentiated growth strategy, of not selectively acquiring new customers, are pernicious. This is mainly because the consequences are usually only felt much later. Due to the time-lag between cause and effect, the relationship with inappropriate acquisition may not become evident. Also, the diagnostic measures needed to improve profitability may not be obvious and easy to obtain. The fit

between CVP and market segment has two sides to it: the company offering good value, and the customer becoming valuable to the company.

The good news is that a consistent focus on customer value, whether seen by the customer or the company, will drive towards a mutually beneficial optimum. By acquiring the right customers in the light of the chosen CVP, cross-sell will do better, and therefore market leverage will be greater, service will be better and less costly. Create value for the customer, make sure the CVP and chosen segments match well, and keep a sharp eye out for future profitability of customers. This is precisely why it is so important deliberately to choose and shape a CVP in such a way that customers will engage in a full-blown relationship, and can therefore become highly profitable to the company.

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