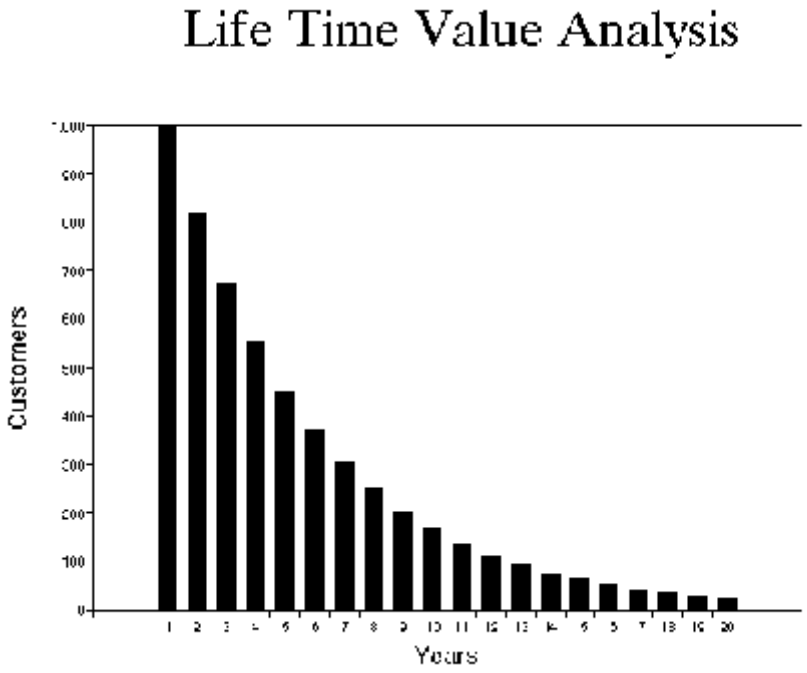
What Are Your Customers Really Worth?

By John Miglautsch

Direct marketing is built almost universally on the principle of getting and (especially) keeping customers. Practitioners therefore tend to be excessively analytical, keeping close track of customers gained and lost in each period, while trying to make decisions based on long term customer worth.



Analysis

Lifetime Value (LTV) had it's origin several decades ago, but the concept may well be timeless. It probably dates back to an ancient inn keeper who realized that if he could keep a few dozen local people well served, the inn would be profitable.

Modern retailers are beginning to tell regular customer's contribution apart from that of that of casual purchasers. Internal credit card customers are much better retail customers than non-credit card holders. And this brings us to Pareto's Rule (the famous 80-20 principle), which says 80% of your sales will come from 20% of your customers.

Direct marketers have taken this concept at least one step further. Direct response advertising employs codes which track orders to the promotions that produced them. Tracking allows mailers to discern the profitability of their buyers compared with non-buyers.

The traditional life time value (LTV) model originated in the direct response life-insurance industry. People were acquired as policy holders with a particular offer, they got a policy number and they kept paying on that policy until they cancelled it (or died). It was not difficult to keep track of them, and after a few years we had a pretty good idea of the cancellation curve. This cancellation curve allowed extrapolation to what could be spent in acquisition. To build the curve we simply tracked retention and revenue through time.

Though this probably makes sense in the life-insurance field, where policy number transcends change of name and address and where there are no subsequent selling efforts related to reactivation, it doesn't fly with many other direct marketing applications.

Unlike life insurance, magazine subscriptions or continuity offers, most original purchases are not ongoing; they must be reinforced with subsequent offers. The traditional LTV attrition model must be based on long-term trends, but any significant change in customer acquisition, retention or reactivation programs will change the curve, limiting its application. Both internal and external factors of competition, economic strength, product quality and customer service can nullify the curve!

Accurate modeling requires more than just a decay curve. Substantial variables must be included to reflect changes in the external variables. Your customers do not pledge to buy again; the only constant is change. It must be possible to examine the long term profit based on recent data.

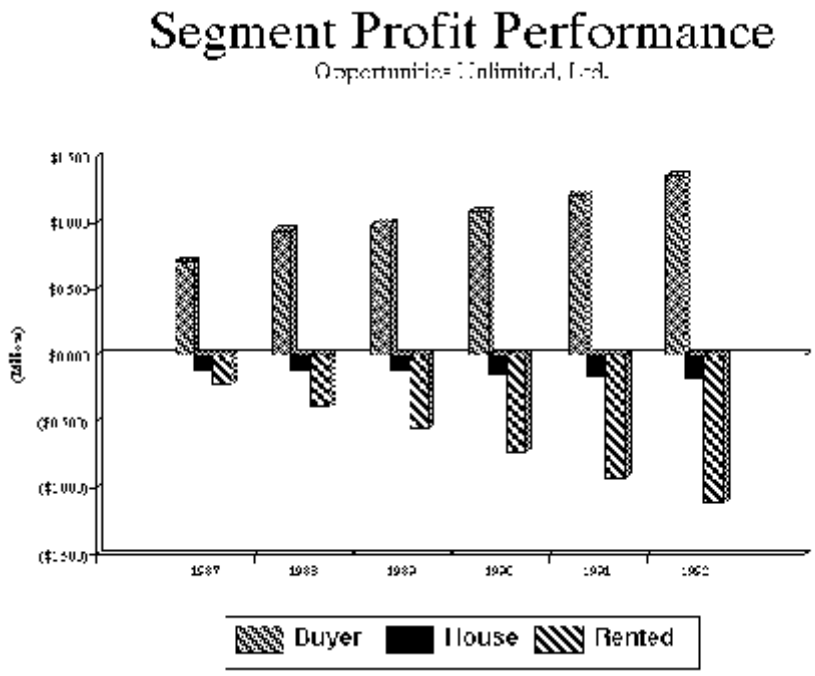
For the rest of the direct marketing community, customers die, move away or, for any number of reasons, simply stop buying. In both business-to-business and consumer programs, names and locations change, making it difficult to track back to original purchasers.

To build an accurate picture of long term expected profit, it is necessary to profile customer loss, not just acquisition. Customer-file contact segmentation makes it difficult to track exactly what has been mailed to whom over the customer life span.

I bought from Lands' End while in college. I moved back home and my parents started ordering. They bought gifts, shipped to friends who started buying. I got married and my wife now orders. I placed orders from work and now they all get catalogs. The point is that significant numbers of customers are added through pass-along of the offer. If key codes are recovered from the new buyers, they refer back to a buyer mailing. This means a specific (but unknown) buyer gets the credit for the referral. In addition to pass-along, all mailers have a significant number of orders without tracking codes. I defy any computer system, no matter how omniscient to trace all this business back to the original source of my first purchase!

Instead of attempting to modify the LTV model, or gather more data or build more sophisticated matching algorithms, it is possible to apply a different approach. The key in modeling is to find the important variables and eliminate others. There is always a tension between accuracy and precision.

We should attempt to model known factors and their change rather than try to track the unknowable relationships between buyers (through time). For example, we know how many buyers are active at any given time. We also know with fair certainty how many new buyers are added. What we really don't know (and probably never will) is how many buyers have tired of us and are really lost. Unless we can convince ex-buyers to call us just before they die, we had find a way to better recognize and gauge buyer



attrition.

Imagine dumping all your customers into a giant bathtub. If we jiggle it a bit, it is easy to draw a line showing how full the tub is. Next imagine opening the faucet and watching new buyers pour in. Every time a new one hits, the level will rise just a bit.... But wait . . . it didn't go up as much as you expected because customers are also going down the drain. Now if we calculate the difference between where the level *should* rise and where it actually does, we know the customer-file attrition rate.

The fact is, your company has a certain number of customers within any period of time. To determine the number, you define what a buyer is (say, someone who has placed an order in the last 12 or 24 months). With a relatively short time table (unlike traditional decay curves), identifying new and old buyers becomes simpler. Next it is important to determine how much of the total sales comes from the buyer file. Again, this is relatively easy to determine from the list analysis key codes. If we look up the key-code number for orders within the analysis period, we can attribute the sales to the buyer file. This simplistic approach allows us to value the total customer file (or appropriate segments) without really worrying whether the order was from an existing buyer or a pass-along. In either case, the order was probably a result of a happy buyer coming back again.

This simple approach also allows us to allocate unknowns based on the percentages of known-buyer vs. nonbuyer recovery. For the best understanding, compare all new buyers (new on your buyer file) and determine what percentage came from pass-along keys. You still won't know which buyer passed the offer along, but you will know the sales and profit generated by the buyer contact.

The real number we're after is profit, so we must apply a cost-of-goods multiplier Next we subtract the mailing (or contact) costs for the period. Again, we're not interested in which buyers were mailed, but the total mailing costs. Finally, we apply both the variable costs of order processing, picking and shipping and an overhead figure.

This overhead calculation can be simple (i.e. take total overhead for the previous period and divide by the number of orders processed times the number of buyer orders for the current period) or very complex (i.e. proportion variable expenses as a percentage of sales and ask the buyers to cover all fixed expenses). Whatever method is used, it becomes obvious that the old buyers generally keep the doors open. We now have a simple method for determining how valuable our active customers are (buyer sales period)-(buyer costs period) = (buyer profit per buyer per period). Rather than looking down the road at an open-ended value for each customer, we look at a definite pay back period.

By performing the same analysis on the prospecting efforts, we can also track how much it costs to acquire each new customer. Obviously, the same principles also apply to the house file (non-buyers on your file like ship-to's, inquirers or leads).

We now know precisely how much profit we can expect from our aggregate buyer file in the next period. Based on our projected marketing plan and the effectiveness of our prospecting efforts, we know how many new buyers will be added to our file. Further, with every improvement in buyer retention (fewer go down the drain) the profit-per-buyer-per-period rate increases because there are more purchases. With greater profit per buyer, we can afford to spend more on new-buyer acquisition and still have greater cumulative profit.

With these pieces of information, we can project the ideal mailing quantities and thus maximize growth and maintain profit. Circulation is increased with an eye on cumulative profit per period until no greater profit is achieved. If we do not extend the period through the full expected life of the customer we build in a revenue pool, just in case variables decline dramatically. I believe it is possible to maintain indefinite relationships through generations. The model will be both financially conservative yet aggressive in circulation.

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The concept of Lifetime Value has been tossed around for years. Because true LTV calculations require elaborate tracking, efforts to apply it all end with cries for larger and more complex databases. The truth is, it is virtually impossible to keep track of buyers once they fall into the bathtub. The good news is that such tracking is not necessary.

By looking at your files in a less precise model, you will reap accurate, usable results. You can take into account changes in recent buyer response. You can also find the balance between maximum growth and optimum profit!