

Linking customers to the bottom line

Many companies use customer satisfaction to measure their performance in meeting customer expectations and as a guide to the future health of the business.

Beyond satisfaction

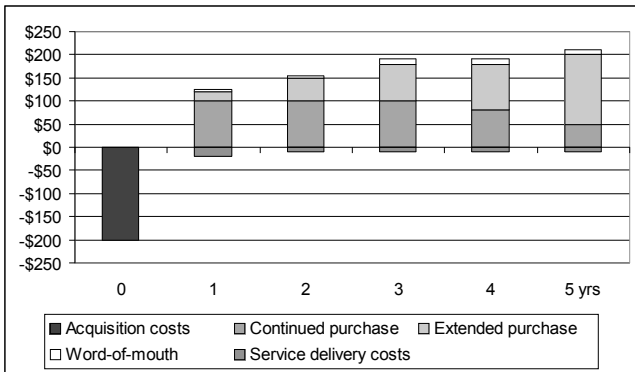
When it comes to deciding how to allocate finite resources, however, satisfaction is not enough. Management needs sharper tools that define customer perceptions of current performance, and the impact of potential initiatives, in terms of bottom line consequences.

Net present value

The bottom line consequences of healthy customer relationships are:

- Continued purchase of the products or services that initiated the relationships
- Extended purchase of products or services that are cross- or up-sold
- Favourable word-of-mouth
- Straight-forward and realistically costed service delivery

We can think about customer value in a way that is entirely consistent with the standard Net Present Value (NPV) techniques used to value assets like shares or factories. This chart shows the expected profitability profile of a customer:



Equate the expected future net profits from the customer with the future net cash flows. These can be discounted at a suitable rate that reflects their risk, to convert them to equivalent current dollars. For a customer to be acquired, acquisition costs can be subtracted, to reveal the customer NPV. For example, the net cash flows in the above chart are set out in the formula below, which discounts them at a rate of 10% per annum and then subtracts the acquisition cost. The NPV of the customer is \$398.

$$NPV = \frac{\$105}{1.10} + \frac{\$145}{1.10^2} + \frac{\$180}{1.10^3} + \frac{\$180}{1.10^4} + \frac{\$200}{1.10^5} - \$200 = \$398$$

Customer value = shareholder value

The value of a business, or a share in it, is generally accepted to be the present value of the future profits expected to be generated. Given that a business generates its profits from its customers, then valuing a customer portfolio and valuing the business are one and the same thing. Customer value maximisation is the same as shareholder value maximisation.

The real world

Few companies have the data or resources needed to value customers or the impact of business initiatives with this precision. In practice, it is generally sufficient to:

1. Segment customers simply, such as into "high, medium, low and negative" NPVs. A related way of classifying customers is as follows:
 - *Loyalists* are receptive to opportunities to do business and, within the loyalists, the *apostles* are keen to volunteer their warm regard to others
 - *Defectors* want or have found a way out, and *adversaries* also want to warn others away
 - *Mercenaries* may be satisfied but they offer little repeat business, and are probably expensive to acquire
 - *Hostages* may not be satisfied but continue to do business because they have little or no alternative, and are possibly expensive to service
2. Examine how specific aspects of current product or service quality and service delivery impact on customer NPV. Also examine the impact of potential improvements. A simple "strong, medium or weak" and "positive or negative" analysis usually suffices.
3. Use the knowledge gained to assess the ROI of potential improvements and allocate finite resources accordingly.

Next steps

Evaluate has a suite of products and customised solutions that help you to understand and develop your core asset – customer value.

For further information contact Wayne Croker on 02 9006 9006 or visit www.evaluate.com.au.