

Using Real Options to Help Build the Business Case for CRM Investment

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The long-term benefits of implementing a Customer Relationship Management programme are widely accepted as being: learning from customers, building customer retention, and reduced market uncertainty. Yet high rates of failure in CRM can originate right at the stage where the investment decisions are made. Traditional discounted cashflow analysis alone does not value or focus managerial attention upon the strategic long-term benefits of CRM. Through a simulated case study analysis, this paper illustrates how the *addition* of Real Options to discounted cashflow can improve CRM investment decision making, encourage managers to verify critical assumptions and reduce both investment and business risk.

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Introduction

Customer Relationship Management appears to be a win:win strategy whereby companies secure and learn from their customers who in turn receive customised solutions, reduced costs and superior service. However the difficulty in quantifying the effect of CRM from a financial perspective often results in it floundering at the stage where the investment decisions are made. Perversely, the financial framework most often used in preparing business cases for CRM may inhibit such programmes from achieving their strategic and business objectives. Arguably, the traditional cashflow analyses based upon Discounted Cash Flow (DCF) and Net Present Value (NPV) calculations are too limited a basis on which to make CRM investment decisions. This is because they undervalue returns, and focus management attention on short-term cashflow when, perhaps, the main benefits of customer relationship investments lie in building a strategic customer relationship asset. In other words, the long-term benefits of closer, deeper relationships with selected customers are difficult to quantify in cash terms as they can lead to reductions in the volatility of sales, market uncertainty and business risk. Given that CRM investments are usually strategically significant, with a value in the range of \$60m to \$200m for a highly complex

installation, the risk of business failure needs to be fully quantified.¹ In the 1990s, the climate for CRM investment was more favourable and companies invested without fully considering any risks. Research suggests that 55 per cent of all CRM projects have not produced results, and some 20 per cent of users report *actual damage* to long-standing customer relationships.²

Today, business leaders are demanding a more rigorous approach to developing and presenting the business case for CRM investment. As a consequence, the senior managers involved in delivering the business case, usually a project team drawn from Marketing, Sales, IT and Customer Service, need to address fully the questions: ‘What steps can we take to reduce the uncertainty in the business case for CRM?’ and ‘How do we reduce the risk of business failure if we adopt a more customer-centric approach through CRM?’

In this paper, we first identify the potential benefits of CRM investments both to customers and the company. Then we explore the limitations of DCF and NPV in assessing how the CRM business case is presented. To counter the problems of risk and uncertainty left largely unanswered by a cashflow analysis, we introduce the idea of Real Options as a risk-reduction step to build the business case for CRM investment. This we do through a simulated case study of a telecoms equipment manufacturer considering a CRM investment. Initially, we develop a range of business case scenarios for the company, together with a cashflow calculation for each. These scenarios show wide variability, depending upon the business assumptions made, and we conclude that they significantly undervalue the likely effects of the company’s CRM investment and look very high risk indeed.

The ability to gather customer data, identify the most valuable customers and increase customer retention is highly desirable

To help mitigate the uncertainty of such a large-scale investment, we introduce the idea of using Real Options, in conjunction with traditional cashflow analysis, to quantify the effects of trialling CRM as an alternative pathway for building the case for CRM investment. Although Real Options have been used to manage other IT investment risks, as far as we are aware, this is the first time Real Options have been applied in the context of a CRM investment.³

We close the paper by exploring the managerial implications of how this combination of cashflow and Real Options helps reduce uncertainty in the CRM investment and discuss our contribution to the marketing literature.

The promise of CRM

The promise of customer relationship management is captivating. For customers, CRM offers the potential for customised solutions, superior service and reduced costs over the lifetime of their relationship with the company as shared knowledge of their business strategy, buying preferences and processes can be developed systematically. For the company, the ability to gather customer data swiftly, identify the most valuable customers and increase customer retention is highly desirable as it positively impacts profitability. Reinartz and co-researchers define CRM as ‘a systematic process to manage customer relationship initiation, maintenance and termination across all customer contact points to maximise the value of the relationship portfolio’.⁴ Thus, CRM offers a potential win:win scenario for both the company and its customers. However, the underlying reasons why both customers and companies choose to restrict the width of their business relationships require a fuller explanation of the mutual benefits that CRM offers.

The customer perspective

Economic theory predicts that customers will buy from many suppliers to reduce costs and improve service. In reality, they restrict their choice to a few preferred suppliers or brands with whom they

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