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Linking customer lifetime value with shareholder value

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Abstract

The measurement of customer lifetime value has become a key issue for developing and maintaining long-term profitable customer relationships. It plays a significant role in customer acquisition and retention decisions. Given the growing importance of creating value for shareholders, market strategies have to be evaluated by their capacity to achieve this goal. Accordingly, both the acquisition and maintenance of customers must result in superior cash flows and augmented shareholder value. However, little attention has been paid to the link between customer lifetime value and shareholder value. The authors of this paper provide a conceptual framework for linking customer lifetime value to shareholder value. It is argued that customers have to be treated as assets that increase shareholder value by accelerating and enhancing cash flows, reducing cash flow volatility and vulnerability and increasing the residual value of the firm.

Keywords: Customer lifetime value; Shareholder value

1. Introduction

With the growing importance of shareholder value as a guiding principle for managing a firm, traditional performance yardsticks have come under scrutiny. It is argued that accounting-based profitability measures do not adequately reflect the value of a firm. The main reasons are that (1) accounting methods differ widely, (2) risks are not adequately taken into account, (3) investment requirements are ignored, (4) dividend policy is not reflected and (5) the time value of money is ignored [1]. It is generally agreed that the market value of a firm emanates from the net present value (NPV) of future cash flows generated by the firm's assets, discounted at an appropriate interest rate and adjusted for inflation and risk [2]. Hence, proponents of the shareholder value approach claim that strategies and initiatives must be evaluated against the NPV of the cash flows they generate.

Marketers, however, have been reluctant to adopt this approach [3,4]. There are only a few studies that deal with the relationship between marketing activities and shareholder value in terms of the underlying concept [3–5] or with respect to measurement issues [6–10]. This can be attributed to the lack of a comprehensive, coherent and integral framework that helps marketers in assessing the value of marketing activities, as well as in measuring and communicating outcomes of marketing activities in terms of shareholder value [3]. This is also true of the customer lifetime value. Customer valuation has become an important issue, given the rise of relationship marketing. Several measures of customer profitability have been developed [11]. Nevertheless, the link between customer lifetime value and shareholder value has not yet been fully investigated.

Beginning with the work of Srivastava et al. [3], this paper develops a conceptual framework for the assessment of customer profitability based on their contribution to shareholder value. It is organized as follows: First, the notion of customer lifetime value and requirements for its computation is discussed. Then a framework for a shareholder-value-oriented measurement of customer profitability is presented. It is argued that customers have to be seen as assets that may positively contribute to the shareholder value by accelerating and enhancing cash flow, reducing its volatility and vulnerability and increasing the residual value of the firm. Finally, the link between the four components of customer lifetime value and the drivers of shareholder value is explored.

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2. Customer lifetime value

Relationship marketing constitutes a major shift in marketing theory and practice. Rather than focusing on discrete transactions, it emphasizes the establishment, development and maintenance of long-term exchanges [12]. Such relationships are thought to be more profitable than short-term relationships as a result of exchange efficiencies. This is especially true of customer relationships [13]. However, since not all customers are financially attractive to the firm, it is crucial that their profitability be determined and that resources be allocated according to the customer's lifetime value (CLV). It is argued that customer relationships are viewed as investment decisions and customers as generators of revenue streams. Customer relationships also generate costs. Hence, in order to measure the customer lifetime value, all revenues and costs pertaining to a customer relationship must be assessed. It is then possible to calculate the current value of cash flow streams [14]. Though, for example, law firms seem to be able to assign even minor costs such as phone calls or photocopying to specific customers, accurately estimating the revenues and costs of a relationship remains a challenging task for a number of reasons:

1. Standard accounting does not allow for allocating costs to specific customer relationships.
2. Only monetary benefits of customer relationships are taken into account.
3. Revenues and costs vary over time.
4. Cash flow streams are generated at different points in time and at different levels of risk.

Consequently, the following requirements have to be fulfilled in order to measure customer profitability accurately:

Requirement 1: All costs must be allocated to customers commensurate with the amount of supplier's resources that the customers absorb.

Many companies assume that customers with the highest sales volume are the most profitable customers and believe in the Pareto Rule, which states that 20% of the customers generate 80% of the profits. They use Pareto Analysis as an indicator of customer profitability, with sales volume being the most commonly used measure [15]. Volume-based measures can, of course, be very misleading. Typically, the highest-volume customers also exert the greatest bargaining power, thus enjoying the lowest prices at a high level of pre- and after-sales service. Low-volume customers, on the other hand, generally pay the highest prices but may absorb even more sales and service resources than high-volume customers.

As a result, medium-volume customers tend to be the most profitable. Unfortunately, standard accounting systems focus on periods instead of individual customers or customer groups [16]. If overhead costs are allocated on a volume basis, customer profitability is skewed by penalizing the "easy" customers and favoring the "demanding" ones. Thus, in many cases, low-maintenance customers subsidize those with high service demands. To avoid such twists, customers need to be treated as a bundle of cost drivers. This is precisely the principle of Activity-Based Accounting (ABC) [17]. It implies that customers are the cause of activities and that resources are employed to carry out activities to serve them. Costs are thus allocated on the basis of transactions. ABC therefore provides a fairly accurate means of measuring costs related to customer relationships.

Requirement 2: Both monetary and nonmonetary benefits have to be taken into account.

Typically, customers are evaluated on their present and future monetary revenues. There are several well-established analytical techniques for predicting future purchase behavior [11,14]. However, if only monetary revenues are included, customer profitability is likely to be underestimated. A more comprehensive concept of customer lifetime value is based on the following four value components (Fig. 1).

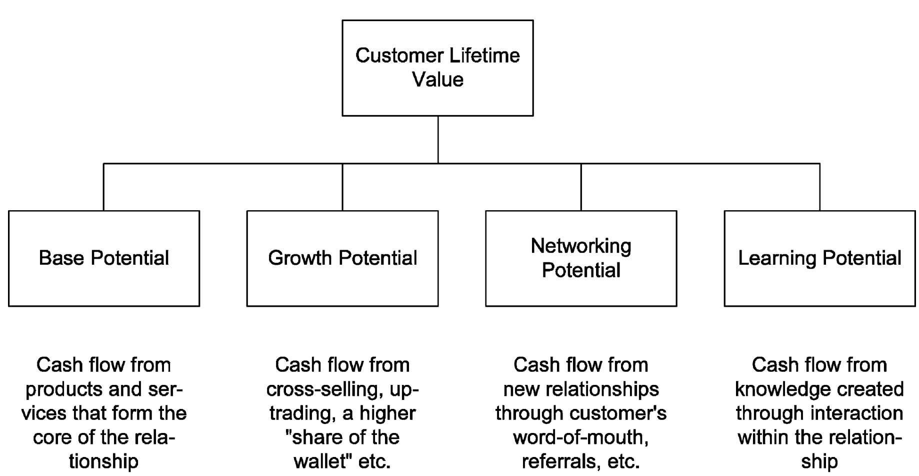

Fig. 1. The four components of CLV.