

# CUSTOMER LIFETIME VALUE APPROACHES AND BEST PRACTICE APPLICATIONS

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## MARKETPLACE

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Each customer varies in his/her lifetime value to a firm. A firm would like to estimate the lifetime value of each customer and use this information in planning differential marketing initiatives targeted at each customer. Customer lifetime value computations require different approaches depending on the business application that a firm is looking at. The authors present two approaches of computing customer lifetime value and offer some best practice applications. The authors also address challenges that firms typically face in implementing the customer lifetime value approach to marketing.

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## INTRODUCTION

It is no secret that firms treat customers differentially. At the same time that one customer spends 10 minutes on the phone navigating through automated menu options, only to find out that there are no seats available on that evening flight to Chicago, a “Gold” customer whose phone call gets picked up on the second ring by a friendly service representative is offered a window seat and a complimentary companion pass on that very flight. How do firms decide the customers to whom they should provide preferential and sometimes personal treatment that clearly costs more money and resources, which customer they should interact with through inexpensive channels like the Internet or the touch tone phone, and which customer to let go? How do firms decide the timing of an offering to a customer? How do firms decide which prospect will make a better customer in the future and is therefore worthwhile to acquire now? Having got the customer to transact with the firm, what kind of sales and service resources should the firm allocate to conduct future business with that customer? How should firms monitor customer activity, in order to readjust the form and intensity of their marketing initiatives?

Firms have used many techniques and methods to make these critical decisions. The notion of “customer value” is a common thread across these methods, even if it is not explicitly stated. What firms do is develop a measure of what they consider to be the best indicator of the total profits that a customer is likely to provide the firm and use that indicator to base their marketing decisions. But some firms have been more successful than others in managing their customers profitably.

We will outline some of the best practices in the area of customer value management that firms can adopt for the business conditions that they are in. We also look at the organizational and implementation challenges that surround the adoption of customer value management by a firm. We draw from existing literature on customer value and observations from a cross section of firms. We offer illustrations from a business-to-business (B2B) vendor, a catalog retailer, and a financial services company. We propose two customer lifetime value approaches as a guide to best practice applications that can be adopted by firms to make critical business decisions.

## CUSTOMER LIFETIME VALUE

We define Customer Lifetime Value (CLV) as the sum of cumulated cash flows—discounted using the weighted average cost of capital—of a customer over his or her entire lifetime with the firm. It is important to note here that we adopt the perspective of the focal firm, rather than the general view of what the total worth of a customer is to all the firms operating in a given market. Customer Equity is the sum of the CLVs of all the customers of a firm. However, there are approaches where, in the absence of individual customer level modeling, the aggregate measure of Customer Equity is computed directly and the average Customer Lifetime Value is computed by dividing Customer Equity by the number of customers in the firm’s database. Although this approach is based on strong assumptions, it may be justified for evaluating and comparing several firms, since individual customer activity data for several firms at a time are typically unavailable to analysts. But to make customer level marketing decisions, it is necessary that we measure profitability, based on the marketing expenses and the revenues obtained for each customer of a firm.

First, we introduce the concept of average CLV for a firm. Second, we outline some applications of average CLV. Third, we illustrate how individual CLV can be predicted for each customer in a dynamic fashion. We then outline approaches and present best practice applications of individual CLV analysis where firms that are able to capture and analyze data on their individual customers’ transactions and other observable behavior can monitor customer level spends and maximize customer level revenues to ensure higher profits. CLV can thus become the metric that guides investments in infrastructure and ongoing marketing activities for all firms that view customers as manageable assets. Thus, from the perspective of CLV, customer management gets defined as *“the processes for achieving a continuing dialogue with customers, across all available touch points, through differentially tailored treatment, based on the expected response from each customer to available marketing initiatives, such that the contribution from each customer to overall profitability is maximized.”* The challenge for a firm today is to implement an optimal blend of differential levels of treatments so that over every customer’s lifetime, the profits earned by the firm are maximized (Kumar & Ramani, 2003).

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