the role of ABM in measuring customer value

COMBINED WITH CRM, IT CAN HELP YOU DETERMINE HOW TO INVEST YOUR RESOURCES TO SERVE YOUR BEST CUSTOMERS.

PART TWO

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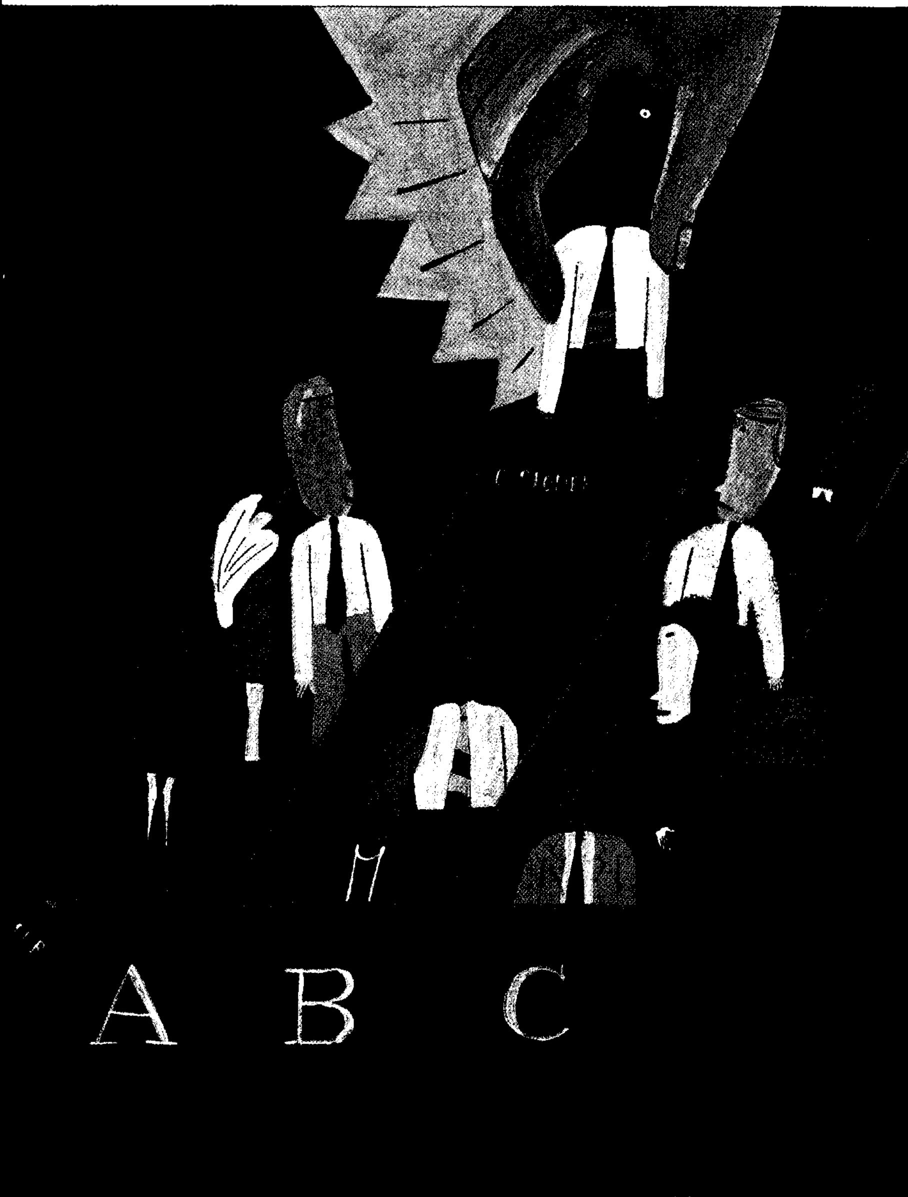
In Part One we focused on the need for customer lifetime value (CLV) and how it's used to segment customers based on value. Now we're ready to explore how to use activity-based management (ABM) to measure customer lifetime value and show how you can use CLV information to establish one-to-one customer relationship strategies.

The measurement of cost—not revenue—to the customer level poses the greatest challenge to customer lifetime value measurement. While revenue can usually be collected by customer from the appropriate billing system, cost information is aggregated into general ledger departments and accounts and requires a good deal of analysis and disaggregation before you can meaningfully attach it to individual customers. Activity-based management gives you the tool set to accomplish this.

In contrast with ABM, traditional cost management techniques are almost exclusively product focused and rarely make visible the cost to acquire customers and, later, to serve and retain them. CLV requires that costs be measurable across four dimensions: Cost to Acquire, Cost to Provide, Cost to Serve, and Cost to Retain. Figure 1 (on p. 46) illustrates the



in these areas to reacquire a lost customer as well as to position new products and services with their existing customers.

ABM plays an important role by identifying the cost of all major customer acquisition activities and associating these costs to customers based on their acquisition, and potentially reacquisition, patterns. For example, the cost to acquire an account through a competitive proposal effort would exceed by many times the cost of an unsolicited order received through the company's website.

Acquisition cost includes the cost of successful acquisition efforts and the cost of failed efforts. This gives weight to the adage, "It costs five times more to obtain a new customer than it does to keep an existing customer."

Cost to Provide—comprises all costs related to the products and services provided to customers, such as the cost to build or assemble products or to deliver services. For a manufacturing company, these would consist of materials, labor, and perhaps an appropriately assigned share of indirect manufacturing costs. For a service company, this would likely consist of the human and related support services engaged in providing its core services to that customer. For an asset-intensive company, in an industry like telecommunications or power generation, this would also include an assigned share of asset-related costs such as depreciation or maintenance and could include capital carrying costs as well.

Most companies' cost systems typically provide product or service costs, often at a unit level. Even if this is the case in your business, you should take a critical look at the quality of unit cost information because many cost systems are based on antiquated standard cost rules and may yield unreliable product or service unit costs.

For service companies, this is particularly important since a comprehensive service catalog of costs per service may be missing. In this case, ABM techniques can once again be applied to help you understand how the activi-

components of the CLV calculation.

Before you can develop these cost dimensions, you'll need to understand the activities performed. ABM plays a significant role in measuring CLV since many of these cost dimensions include indirect costs, which are measurable through ABM but aren't readily visible in financial systems.

Here are the cost dimensions of customer lifetime value and a description of how activity-based management is used to quantify them:

Cost to Acquire—consists of all costs related to the customer acquisition process. They are likely to be unique to a specific acquisition channel or even to a specific campaign. Examples are advertising, marketing, direct mail, telesales, proposal or bid development, and direct sales activities. While these are theoretically one-time costs to attract new customers, in practice companies must invest

ILLUSTRATION: LINDA HELTON

ties of the organization support the services delivered to the customer.

Cost to Serve—refers to all costs related to servicing and maintaining customers. For example, activities related to service provisioning, customer service, billing, warehousing, distribution, and accounts receivable management are derived by way of ABM, based once again on each customer's actual service characteristics.

Through the years, supply chain and pre- and post-sale customer service activities have become large and important expenditures for many companies. In addition, expedited delivery services, customer hotline support, and dedicated account service teams are but a few of the costs to serve that may be consumed by some customers at a different rate from other customers.

In many cases these costs have been considered "below the line" expenses, but they're really significant components of overall customer service cost. As customer services grow more varied and complex, relating these different service levels to customers becomes critical. This is especially true for those services that are differentiators and make up a more significant share of the overall cost structure.

Cost to Retain—includes all costs incurred for the benefit of retaining or enhancing the customer relationship after the initial sale has been made. In concept, these would include the costs of relationship building, cross-sell campaigns, and customer incentives. In practice, many of these costs may be indistinguishable from the costs to serve described above.

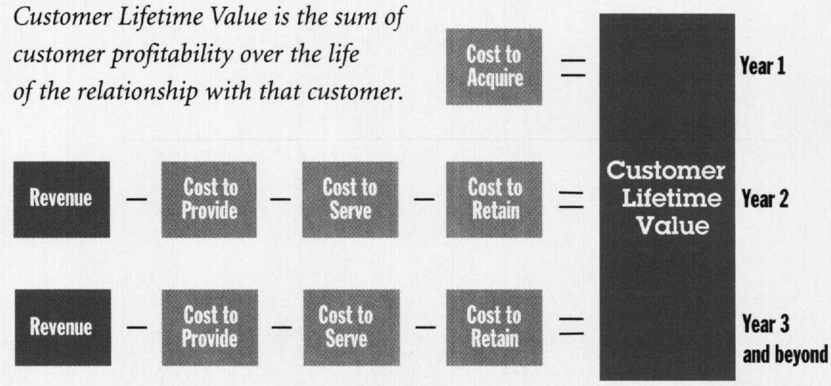
Figure 2 illustrates the ability to leverage the ABM architecture, transforming the traditional ledger structure into activities and then associating the consumption of these activity costs to customers, which results in a fully absorbed cost of the relationship with a customer.

Once you determine the cost of customers and align costs and revenues over the customer's historical lifetime, you can establish the relative value of the customers.

Figure 3 shows how these costs accumulate over the life of the customer relationship and combines the cumulative revenue from the relationship to determine the lifetime value generated from the customer.

Positive customer lifetime value occurs at the point where cumulative revenue exceeds the cumulative costs of customer acquisition, cost to provide, cost to retain, and cost to serve.

Figure 1: Customer Lifetime Value—Cost Dimensions



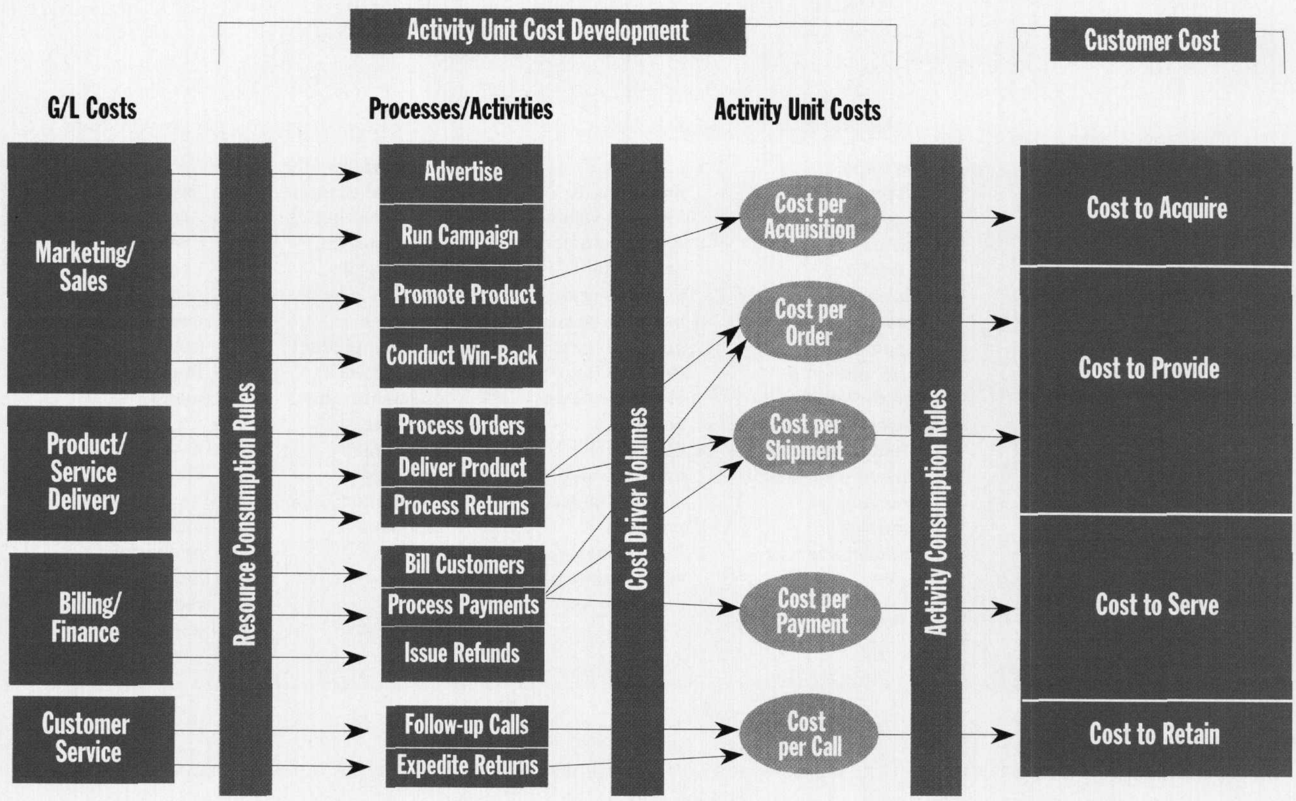
At the outset of a relationship, companies may see an initial "loss" of investment in the relationship since acquisition costs have no offsetting revenues. Over time, the cumulative margins generated by that customer will offset the cumulative cost for acquisition, service, and retention, resulting in an eventual positive contribution to profit. Once that occurs, the customer's lifetime value switches from negative to positive. From that point on, the longer a company maintains a productive relationship with that customer, the greater the customer's lifetime value.

It isn't uncommon to hear the argument that many of the costs of acquisition and service are fixed so they aren't relevant to the customer. We disagree. Our experience has shown that the behavior of many so-called "fixed" costs are highly influenced by levels of customer activity, so they tend to be variable based on the methods/approaches used to acquire and service each customer. Unfortunately, once the costs of acquiring and servicing customers are incorporated into a company's cost structure, they rarely disappear, even when the customer leaves.

Further complicating this issue, product pricing all too often doesn't distinguish between the value of product and the value of service the customer is receiving. The two components become blurred in a single price, and, over time, the customer loses sight of what they're paying for. We've found that many organizations can benefit from disassociating their pricing for product from their pricing for services. This is called menu pricing. Companies who fail to maintain their customers' focus on value for price risk losing their differentiation to an aggressive, no-frills competitor offering a slimmed-down mix of services.

While activity-based management provides a powerful set of tools you can use to measure customer lifetime value, companies who have implemented ABM realize that it

Figure 2: ABM Cost Management Methodology—Cost Flow



requires a greater commitment of resources and management buy-in than traditional cost accounting does. Our experience has shown that ABM efforts are most successful when ABM doesn't stand on its own but is closely aligned with a "strategic imperative" within the company. Customer relationship management is a good example of a strategic imperative that will benefit from integration with ABM.

TECHNOLOGY ENABLES CLV

The past few years have witnessed major advancements in customer relationship management processes and technology. Companies have moved from implementing single CRM applications such as sales force automation, customer service, marketing automation, and e-channel (B2C) to implementing integrated CRM. Integrated CRM provides a multichannel approach that brings together information from every customer touch point, stores this information within a data warehouse, analyzes this information using sophisticated data mining and customer analytics models, and delivers these results back to each of the customer touch points. Only by combining relevant financial data within the data warehouse and including CLV as an integrated part of customer analytics can companies truly be able to achieve their CRM objectives.

Figure3: Customer Lifetime Value Over Time

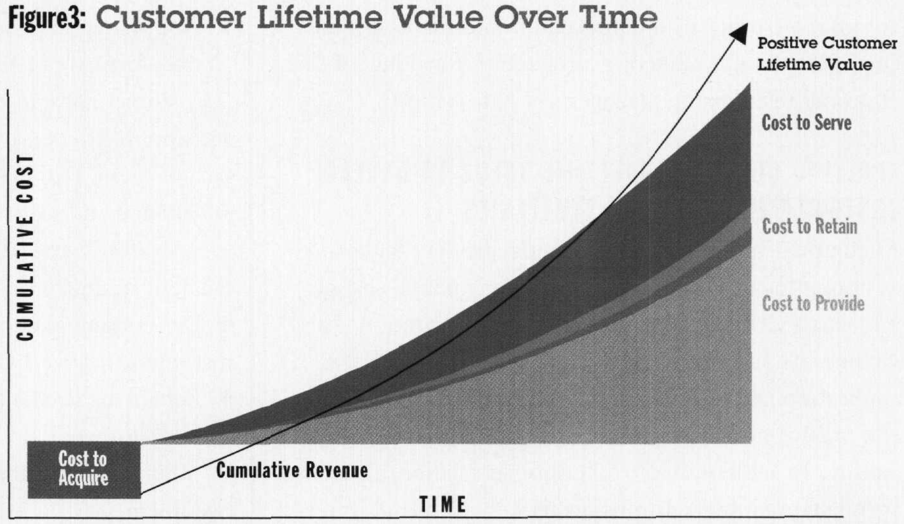


Figure 4: Customer Strategies by Value and Demographic Segments

Demographic Segments \ Value Segments	"Champions"	"Demanders"	"Acquaintances"	"Losers"
	Nurture	Grow & Reduce Cost	Grow Revenue	Improve Profitability
Super User Technology Astute Family User Frequent Communicator Basic User	▪ Preferred customer program ▪ Customer loyalty promotions ▪ "Hotline" support ▪ Personalized support for "high-tech" products ▪ Penetration pricing of high retention services ▪ Reward programs for champion referrals ▪ Personal account plans	▪ Focused marketing to increase volume ▪ Align customer service to increase value ▪ Incent to lower cost services (VRU/ Internet vs direct customer service) ▪ Direct mail offerings of segment-aligned products ▪ Reduce costs while maintaining customer service	▪ Stimulate volume usage or margins ▪ Direct marketing of cross-sales campaigns through low-cost channels ▪ Bundled product offerings of segment-aligned products ▪ Direct mail offerings of segment-aligned products	▪ No direct customer care ▪ Additional charges for customer services (e.g., charge for calling help center more than 3 times a month) ▪ Reacquire in lower-cost channel ▪ No direct marketing of products ▪ Simplify and reduce billing costs

ABM efforts can take advantage of the tremendous strides that have been made in the automation of CRM processes and the new technology that has been developed to help facilitate the collection of financial and statistical information. The implementation of integrated CRM systems has created new opportunities for companies to collect enriched information. This includes resource distribution and cost driver information to produce the outputs required for ABM and CLV. Examples include customer ordering histories and channel usage, customer call frequency and duration, marketing activities, delivery and service requirements, and product volume, mix, and revenue data. As a result of this automation, much of the information needed to produce customer lifetime value measures are a by-product of this customer relationship management automation.

APPLYING CUSTOMER LIFETIME VALUE TO DEVELOP CUSTOMER MANAGEMENT STRATEGIES

As companies shift from a traditional product focus to a customer focus, CRM represents a fundamental change impacting virtually every aspect of an organization. This includes its business strategies and operating processes, application and technology infrastructure, management and organizational structures, and sometimes even its culture. To achieve successful customer relationship management, organizations must foster behaviors and implement processes and technologies that support coordinated customer interactions throughout every customer touch point. This process often includes new ways of:

- ◆ Marketing to and caring for customers;
- ◆ Establishing sales channels tailored appropriately to customers;
- ◆ Establishing a partner community centered around common customers;
- ◆ Fostering innovation and collaboration with the aim of improving customer service and loyalty;
- ◆ Investing in the creation, capture, and dissemination of customer knowledge within the organization, among partners, and potentially with customers;
- ◆ Leveraging information technology to enable the transformed practices mentioned above.

Customer lifetime value provides a sound basis for decision making regarding investments and strategies for each of these. Through CLV and through the ability to understand and segment customers based on value, companies will be better equipped to develop customer management strategies that focus on:

- ◆ Directing marketing and sales resources toward those customers that create the greatest value;
- ◆ Enhancing loyalty programs that help retain high-value customers;
- ◆ Modifying customer service activities for low-value customers;

◆ Increasing customer service activities for high-value customers;

◆ Developing service pricing distinct from product pricing (such as menu pricing).

Customer-centric management requires differentiated customer strategies and the ability to match specific customers with "personalized" treatment. CLV measures will segment customers based on their value contribution. Understanding the value customers create will help you develop specific actions, such as those shown in Figure 4, which should result in better and longer relationships with your best customers and increased profitability for your company.

The combination of customer relationship management and activity-based management gives you greater visibility, not only into a customer's relationship with your company, but also regarding how your company invests its own resources to support customers. It lets you establish customer-centric metrics and benchmarking of progress against best practices. It's this visibility that will provide you and other members of management with the information and knowledge you need to effectively segment customers and manage both customer relationships and internal delivery processes.

By its nature, ABM can deliver accurate profitability of customers and information around the cost of customer-driven activities. This information can guide you in two directions—either move customers to less resource-intensive service delivery channels or reduce the incidence and cost of activities and processes that are delivered for the customer.

Perhaps the most valuable application of CLV is forward looking. By understanding the characteristics of profitable and unprofitable customers, you'll be better able to predict the behavior of future customers and better target your company's business development activities. If you can predict a "Loser" early in the acquisition process, you can avoid costs and resources that you would have spent on negative value creation and invest them instead in providing superior service to "Champion" customers.

MORE VALUE AND CUSTOMER LOYALTY

Customer lifetime value provides an objective approach to identifying a customer's value contribution. Activity-based management serves as the foundation and the tool for measuring CLV. As organizations put this information into motion, they are better able to develop strategies to enhance the value derived from customer relationships.

If your company is contemplating or currently implementing CRM, we invite you to consider the following suggestions:

Assess your CRM initiative—If your company is implementing CRM, do you have CLV measurements, and are they providing the correct insights?

Determine value of integrating ABM with CLV—If your organization is implementing CRM, but hasn't implemented ABM, consider the need for ABM in calculating your CLV measurements.

Align current ABM efforts—If your company has implemented ABM and is implementing CRM, there's a powerful opportunity for synergy between these two initiatives.

The result of integrating customer relationship management and activity-based management through the implementation of customer lifetime value will be greater shareholder value and creation of loyalty with customers who create the most value for your company. Organizations that aren't including customer lifetime value in their CRM toolkit, or those basing CLV solely on revenue generation, might find themselves having superior relationships with the wrong customers. ■

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