CHAPTER I

INTRODUCTION

1.1 Overview

One of the interesting changes in the last twenty years as the developed economies became service economies is that the emphasis in marketing changed from transactions to relationships. This shift is still not fully comprehended by many business people, but it is radically reshaping the effective methods of doing business. In the twentieth century, mass marketing took over, thanks to the existence of new mass media such as radio and television, reinforced by the mass production methods made possible by assembly-line standardization. This product-focused era, which held roughly from 1920 to 1960, resulted in a view of sales as transactions. As business gradually changed, service became most of every developed economy, and the things that mattered in service were different.

The relationship between the customer and service provider became more important than any individual transaction, and customer satisfaction became more important than any ad. This shift meant that the transaction view of revenues and profits was deficient. This meant that the business needed to consider the long-term view of profitability, rather than short-term transaction view.
The emergence of relationship marketing with its emphasis on customer retention has sparked considerable interest in how these customer relationships can be managed more effectively since they are now regarded as one of the firm's primary assets (Gupta, Lehmann, & Stuart, 2004; Hunt, 1997; Kutner & Cripps, 1997; Srivastava, Shervani, & Fahey, 1998).

Traditional accounting practices focus mainly on measuring tangible assets as a statutory requirement on the balance sheet. However, nowadays it is more usual for intangible assets such as brand, employee and customer relationships to be the critical and often dominant determinants of shareholder value (Amir & Lev, 1996). Therefore, so many questions come to surface. Such as, “Is traditional marketing approach which emphasizes customer acquisition and a transaction-based view of sales still valid these days?”

The importance of retaining customers and tracking the customers that a firm loses is emphasized in articles published by Reichheld and Sasser (1990). Reinartz et al. (2004) show that insufficient allocation into customer-retention efforts will have a greater impact on long-term customer profitability as compared to insufficient allocation into customer-acquisition efforts. Firms should also factor in the probability and cost of wrongly estimating a customer’s future profitability in their customer retention and relationship-building efforts (Malthouse and Blattberg 2005).
In balancing the need to develop customer acquisition and retention strategies, Reichheld and Sasser (1990) and Reichheld (1996) argue that firms can improve their profitability as customer retention increases; their research shows that a small improvement in customer retention rates from, say, 85% to 90%, results in net present value profits rising from 35% to 95% amongst the businesses they examined. On the other hand, 80% of firms tend to over-invest in customer acquisition, whilst 10% spend too much on customer retention activities. Only about 10%, the “profit maximisers”, consider they have the balance about right (Christopher, Payne and Ballantyne, 2003).

So, as firms develop their marketing strategies based on the principles of customer retention by forging deeper, closer relationships with key customers (Reichheld, 1996; Reichheld & Sasser, 1990), the risk and returns of these customer relationships also need to be assessed more systematically. In his seminal paper, Doyle (2000a) argues that, as marketing is the custodian of customer insights and responsible for customer relationships generally, it needs to take the lead in developing more transparent metrics for measuring these risk and returns. He also argues that since marketing investments are often directed towards building intangible, off-balance sheet assets that can be difficult to quantify.

The Economist Intelligence Unit (1998) found that customer profitability and customer lifetime sales were two of the top three most important customer-related performance measures that the companies in their survey would be
monitoring in the future. However, they also found that most firms were measuring customer profitability in a top-down way based on the level of sales, the increase in order volume and the size of transactions. This approach, also known as RFM (Recency, Frequency and Monetary Value) is considered to be flawed (Reinartz and Kumar, 2002).

A frequently-encountered difficulty for companies wishing to measure customer profitability is that management accounting and reporting systems tend to reflect product profitability rather than customer profitability. Where product profitability is known, the direct product costs of customer purchases can be determined with reasonable accuracy. Indirect costs (principally the costs of sales, marketing and general administration [SGA]) are then allocated across the customer base, often in proportion to the total sales of each customer.

However, this approach assumes each customer uses equivalent amounts of company time and effort in relation to sales revenue; whereas some customers are just more costly to serve than others, often due to their behavior. For instance, new customers may demand more information about products and service levels, seek to customize the offer as far as possible and then buy on a limited basis as a trial measure. The costs to serve this customer, excluding acquisition costs, point towards an overstatement of profitability in the period. By contrast, customers who purchase on a regular basis and whose purchasing habits are routine and
predictable, are relatively easy to serve. Thus, the profitability of such customers stemming from a proportional allocation of costs can be *understated*.

It is no secret that firms treat customers differentially. Here are some samples of issues about customers (Kumar, Ramani and Bohling, 2004).

- 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 Internet or the touch tone phone?
- Which customer has to be 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?

### 1.2 Issue in Marketing Relationship and Shareholder Value

While it is axiomatic that effective marketing is closely dependent upon understanding customer motivation, behaviors and purchasing styles, it is perhaps
less well established how marketing strategies, particularly CRM, should be adapted as more is discovered about the risk and returns of particular customers and what impact these customized CRM strategies have on shareholder value creation (Ryals & Knox, 2006). For example, simple customer retention strategies need to be adjusted as firms come to understand that they destroy value if the costs of retention exceed the benefits (Reinartz & Kumar, 2002; Thomas, Reinartz, & Kumar, 2004). Ryals (2005) presents striking evidence to suggest that by developing profitable customer retention strategies with selected customers over time, for instance by targeting marginally unprofitable customers and either cross-selling to them and/or reducing their costs-to-serve, the firm's overall performance is likely to improve. As customers become ever more demanding, she calls for further research on measuring customer profitability, risk and returns as well as into the impact that customized CRM strategies have on shareholder value creation.

To create shareholder value, investments in projects or in marketing assets must return more than the cost of capital (Mariotti, 1996; Cornelius and Davies, 1997). If marketing’s contribution is to create shareholder value (Doyle, 2000), then customer relationships should be measured – and managed – for value rather than profit. Therefore, the word risk is essential for the concept of shareholder value. When revenues exceed the cost of capital, shareholder value is created. The cost of capital reflects risk. This is why there are still problems with both customer profitability and CLV calculations.
Research shows that most companies do not measure customer profitability despite acknowledging its importance (Reinartz and Kumar, 2002). A fundamental problem which applies to all current (and historical) customer profitability analysis is that it does not necessarily act as a guide to the future (Wilson, 1996). This is a problem for CRM which aims to maximize the longer-term value of close customer relationships and hence contribute to shareholder value (Zablah, Bellenger, & Johnston, 2004). As companies move towards one-to-one marketing, they need to develop a longer-term view of the value of their customer relationships than current data can provide (Peppers and Rogers, 1994; 1997; 1998). Effectively, relationship marketers need to predict the future purchasing behavior of key customers to arrive at their Customer Lifetime Value (CLV; Ryals, 2002b). For this reason, customer lifetime value may be a more useful and appropriate measure of the value created.

Recently the issue of customer risk, expressed as the probability of securing customer lifetime value, has re-emerged alongside interest in customer equity measures and marketing returns (Rust, Lemon et al., 2004). As indicated earlier, these researchers demonstrate an elegant statistical approach to measuring marketing returns in a data-rich, consumer marketing environment. In contrast to this research, the work I report here deals with business-to-business marketing in which the risk of the customer is assessed through key account profiling so that the shareholder value generated by customer relationship investments can be estimated.
1.3 The Risk of Customer

As the fundamental source of a business’s cash flows, customers, too, are assets-risky assets. As with stocks, the cost of acquiring (or retaining) them is supposed to reflect the value of the cash flows they are likely to generate down the line. Some have a history of generating bigger cash flows than others; some have a history of steadier cash flows. Because the bigger generators of cash often prove to be unsteady, it helps to have some steady customers around, even if they have a history of being less profitable. In short, the value of customers we are considering acquiring (or retaining) depends on the effect they will have on the riskiness as well as the profitability of the customers group they may join. The particular combination of customers we arrive at will determine how closely our business approaches what would be for it the optimal relationship between risk and reward.

As we know about risk, therefore the needs of tools to measuring and managing risk become more crucial. Managing risk is not a simple task. Managing risk is a dynamic effort and it requires tools that help identity and reduce the sources of risk. Therefore, the requirement of effective utilization to obtain the desired risk profiles becomes more and more unavoidable.

But, as we know, we can’t just manage without measure first. From a few brainstorming about manage, “to manage” is almost similar with “to control”. But before we manage a task, make sure that that task is measurable. The more a problem can be quantified, the better it can be managed.
1.4 Customer Relationship Risk in Indonesia

Nowadays, especially in Indonesia, customer relationship risk is still a new area for companies. Most of the companies still use the traditional method that customer acquisition is more important than customer retention. Based on traditional accounting approach, most the profit can only be achieved from product profitability, not customer profitability. Although the importance of customer retention already have been acknowledged, but still only few of companies in Indonesia use the practice of this concept.

1.5 Scope

This thesis will only cover:

- The evaluation of XYZ’s key account with Customer Lifetime Value and Customer Lifetime Value Adjusted approach.
- The evaluation will use 9 group businesses.
- The object of this research is XYZ Company. XYZ is an insurance company in Indonesia.

1.6 Problem Statement

As companies move towards relationship marketing strategies involving CRM, they need to develop a longer-term view of the value of their customer relationships than current data can provide (Peppers & Rogers, 1994, 1998, 2001). But, with so many research gaps both in theory development and managerial practice which connect CRM investments with the creation (or destruction) of
shareholder value, companies need tools to measures customer relationship in order to develop their marketing strategies based on the principles of customer retention by forging deeper, closer relationships with key customers (Reichheld, 1996; Reichheld & Sasser, 1990), the risk and returns of these customer relationships also need to be assessed more systematically.

Based on that, this research try to prove an empirical measurement by measure CLV and EV of a key account customers in order to measure risk-adjusted of key account customers which will led to changes in their relationship marketing strategies and improvements in shareholder value for the firm.

The problems can be stated as follows:

1. There are lack appropriate metric for measuring the value of customer relationship risk.
2. Customer profitability analysis nowadays does not act as a guide to the future. Furthermore, it could be damaging longer-value creation.
3. There are so many companies, especially in Indonesia, still focus on customer acquisition rather than customer retention in order to measure customer profitability.
1.7 Objectives and Benefits

1.7.1 Research Objectives

1. To calculate risk-adjusted CLV (Customer Lifetime Value), which is termed the CLV-Adjusted of a customer, as the means for marketing to assess both customer profitability and shareholder value gains.

2. Explore differing approaches to measuring customer risk and the creation of shareholder value through customer relationship risk.


1.7.2 Research Benefits

1. This research offer a tool that managerially useful and helps marketing with their relationship marketing strategies. Not only to improve the quality of their relationships with the customer, but also can be used to evaluate both existing and potential customers in terms of their potential to create or to improve shareholder value.

2. This tool can supply information in order to make the appropriate relationship management strategy with analyze the components of defection risk and manage the relationship so as to reduce the risk.
1.8 Organizations of the Entire Paper

Chapter 1 consists of introduction of the research, which comprises the overview, issue in marketing relationship and shareholder value, customer relationship risk in Indonesia, scope, problem statements, objectives and benefits, and organizations of the entire paper. Chapter 2 deals with the literature review of the analysis. The chapter points the concept of marketing mix, relationship marketing, shareholder value, customer relationship risk, and customer profitability, the cost of risk, customer lifetime value, and economic value. Chapter 3 consists of data collection, reasons why using the data and models and the calculations. Chapter 4 discusses the calculation of two key accounts with CLV and CLV-Adjusted approach in XYZ Company and the aspect of key account strategy. Chapter 5 covers the results of the research, including conclusions of the results of the implementation and recommendations, which should be taken in solving the problem.