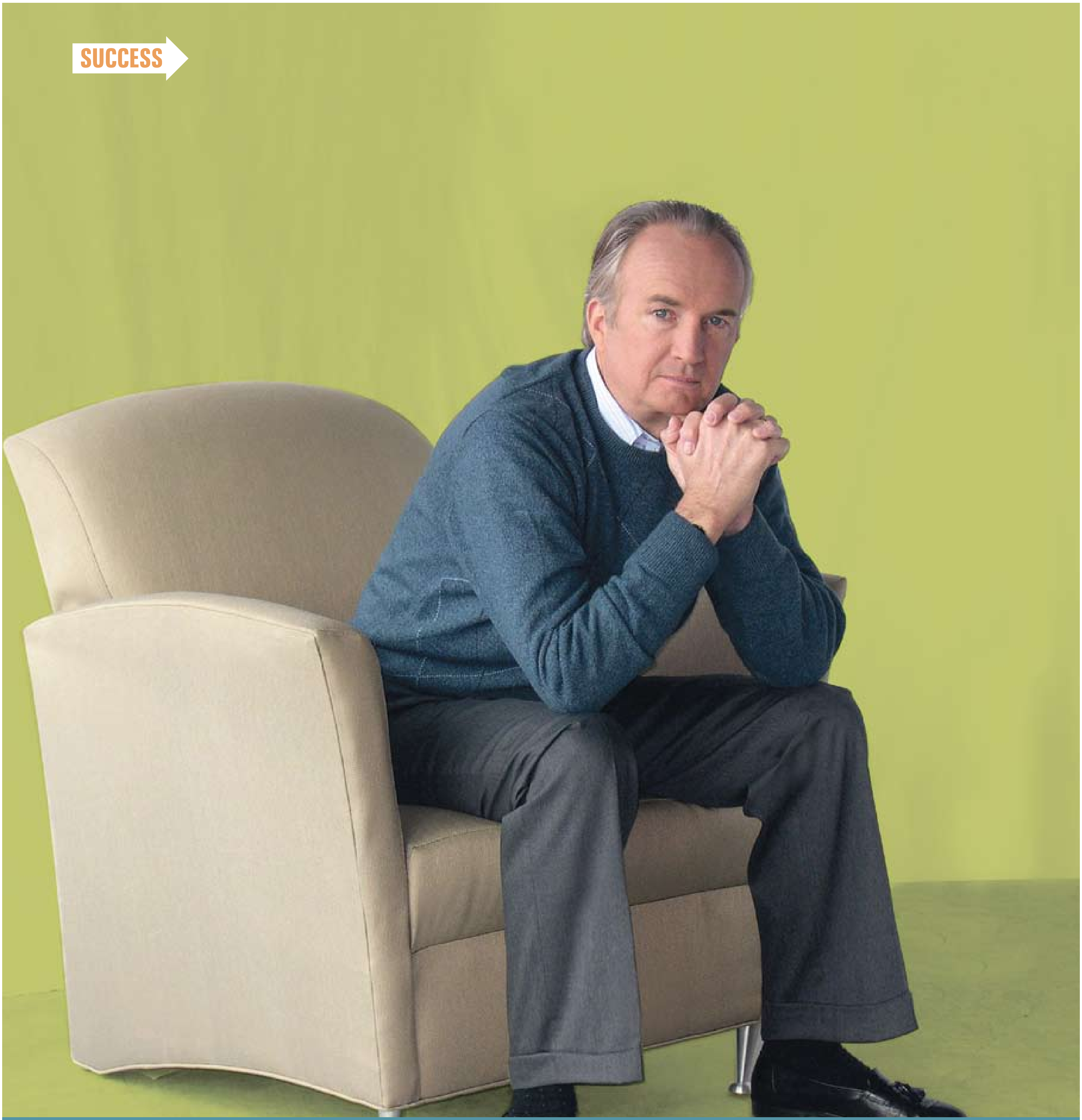

MANY HAPPY RETURNS

Building and nurturing customer loyalty is fundamental to achieving business success. Yet gaining a precise picture of the true lifetime value of customers has been an elusive concept – until now.

STORY GRANT ARNOTT

Return on investment (ROI) has penetrated the business vernacular to such an extent that few would not immediately recognise the abbreviation. Its application in measuring how effectively and efficiently a company uses its capital to generate profit has become ubiquitous – but it's no longer enough.

As strategic ROI thinking has now become the norm rather than the exception, businesses are seeking a new edge for competitive advantage.

Enter ROC – return on customer. The brainchild of customer relationship marketing thought leaders Don Peppers and Martha Rogers, ROC delivers a new methodology for businesses to better understand and increase customer value. In a world where it is more difficult than ever to acquire and maintain customers, ROC gives businesses the means to monitor, manage and leverage the value of each one.

For many years, Connecticut-based management consultant firm the Peppers & Rogers Group has been at the forefront of customer-centric marketing strategies. Founding partners Peppers and Rogers, acclaimed authors and keynote speakers, are credited with creating the term "one to one" to describe best-practice direct marketing. Now they're spreading the word on ROC – and businesses are responding.

During a recent visit to Australia, Don Peppers spoke at length to senior marketing professionals about the importance of ROC as a business principle and detailed how to implement ROC methodologies into a company's strategic planning.

"We've been talking for years about the importance of putting the customer at the centre of the business," he says. "We all know intuitively that one of the benefits of doing this is that you garner customer goodwill later. Customer loyalty has obvious value to the business. Plus, when the customer refers others, that can be exponentially valuable."

But how valuable? One of the issues Peppers and Rogers felt was affecting businesses was being too focused on the short term – measuring customer value by counting only the sales made immediately to a customer, less the cost of serving them.

"Too often, businesses just weren't looking at the future contribution customers would make and the way that contribution might increase if the customers were happy with the business," says Peppers. "We wanted to come up with a solution that would simplify how businesses can better take account of the way customers create value in the future, as well as in the present."

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Peppers and Rogers found that the basic limitation of businesses focusing on ROI analysis and payback analysis was the presumption that cash is the scarcest resource, and maximising your return on the cash you use must be the goal of a business. Looking deeper into modern business practices, the pair realised that it is far harder to source customers than it is to source cash, and this epiphany catalysed the development of the ROC model.

"The truth is, to create any kind of value at all, customers must engage with a business. Therefore, customers are scarcer than cash," explains Peppers. "In cash terms, if I have a good investment I can go to the bank and borrow against that investment and get a return. But there's no secondary market for customers – you can't go to a bank, borrow some customers, create some value and pay them back to the bank later with interest in the same way as you can with cash.

"We realised that if businesses were really going to create long-term value rather than short-term value from those customers, they had to have a financial metric that addressed three fundamental issues: that customers create all value; that this value is both long term and short term; and that customers are a scarce resource, so you want to maximise the value you can create from each customer."

All well and good in theory, but the next challenge was to model the concept into a practical tool that businesses could understand and implement effectively.

PUTTING ROC TO WORK

In simple terms, the ROC metric works just like the ROI metric.

"Imagine you are going to buy shares and measure the return on your investment," explains Peppers. "If you bought a share for $100 and it gave you a dividend of $5 during the year [ie short-term value] and it also increased in value by 10 per cent to $110 [ie long-term value], then your ROI during that period would be 15 per cent in total.

"ROC works the same way, only instead of talking about cash, we talk about customer lifetime value. So if I start the year with a customer who has a lifetime value of $100 and during the year I sell that customer something generating a profit of $5 while I also increase the customer's lifetime value over the course of the year by 10 per cent, then my ROC is 15 per cent."

To break it down, the lifetime value of a customer is the net present value of the future stream of cash flow attributable to that customer. ROC involves the profit a company makes on the customer in the short term plus the change in the customer's lifetime – or long-term – value.

"In order to maximise ROC, you need to know how to predict customers' likely lifetime values based on historical records," says Peppers. "You also need to enter into that calculation any change in the customers' lifetime value that might be caused during the current period.

"For instance, if you have 10,000 customers with an average retention rate every year of 80 per cent and, through effective marketing, you're able to increase that rate to 81 per cent, that will effect a change in those customers' lifetime values."

For smaller businesses, Peppers concedes there are challenges in setting up a fully capable ROC model. The degree to which a business can measure, predict and leverage ROC is determined by its analytics capabilities. However, any business can implement the fundamental principles of ROC using some basic formulas to understand customer value.

"For companies really to be able to implement ROC and use it, they need not only to have analytics capable of modelling the customer lifetime value but also to be sophisticated enough to be able to identify the events occurring today that are likely to have implications for those customer lifetime values.

"That's the key issue. It's complex but it's not rocket science in a company with a good customer database that's reasonably sophisticated with analytics capability."

THE TRUST FACTOR

While the ROC model is still in its infancy, there are very few companies that are actually using this kind of tool on an ongoing basis. However, many do apply the principles of ROC without applying the calculations.

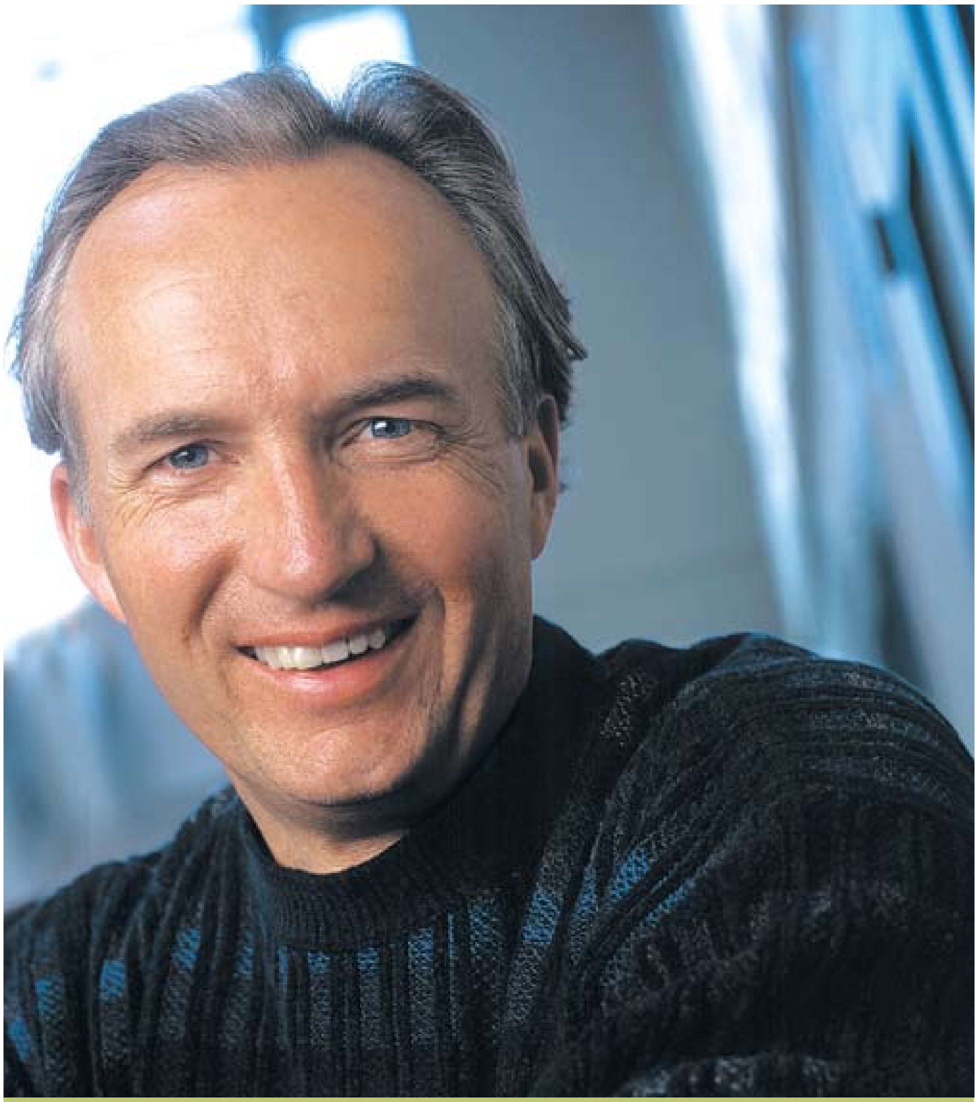
"There is much research that says customers choose one vendor over another primarily because of trust," says Peppers.

"Customers buy from vendor A instead of vendor B because they trust vendor A more than B. That might boil down to the fact that they have heard of vendor A and never heard of vendor B, or it might be that their friends have dealt with vendor A and liked them. Or it might be that they have dealt with both those vendors before but always felt that A acted in their interests and considered their preferences.

"One way or the other, customers buy from the companies they trust."

Only by earning customers' trust can a business actually create long-term value from the customer, says Peppers. He cites a great example from a leading customer-focused business.

"I'm a very frequent Amazon customer – I buy five to 10 books a month," he says. "One day I read an article on a book I thought



HOW TO IMPLEMENT ROC

According to Don Peppers, businesses of any size can and should build return on customer into their company strategy. The degree of commercial advantage will vary according to what level of support a company gives the following ROC fundamentals.

1. Understand the essential formulas for measuring customer value – ROC is the profit made on a customer for a particular period plus the change in the customer's lifetime value for the same period, with that sum divided by the original lifetime value.

2. Focus the business on being customer-centric and take into account the long-term value of a customer rather than just the short-term profit or cost. Create trust and actively encourage repeat business and loyalty at every touchpoint with customers. The long-term impact of a positive customer experience is usually of far greater value than short-term cash gains made from the hard-sell approach.

3. Invest in building the analytics capability of your organisation – the more you can track the factors and events that affect the lifetime values of your customers, the more you'll be able to implement marketing strategies to increase customer lifetime value and ward off competition. Plus, you gain a solid financial metric to demonstrate actual customer value.

I wanted, so I visited Amazon and ordered the book with one click, as per my usual routine. Suddenly a message popped up: 'WARNING: You already purchased this book from Amazon.com – do you want to buy it again?'.

"They had my money! But they didn't want my money; they wanted my trust. To Amazon, my long-term trust was worth a lot more than the short-term profit they would have made on the sale of that book. That is the foundation of ROC."

As Peppers spreads the ROC message throughout Australia and other parts of the world, businesses battling the difficult economic climate are highly receptive to the concept but daunted by the analytical complexity of the ROC metric.

As a compromise, many businesses are applying the ROC model with non-financial metrics, such as "willingness to recommend", "net promoter scores", "customer satisfaction" measures or other factors easily tracked via market research.

There's no problem with that, says Peppers, who is pleased to see businesses adopting the ROC approach at whatever level they are comfortable with. However, the ultimate advantage of ROC lies with those businesses that find a way to apply the full financial metric, especially in the current climate.

"What we have found overwhelmingly is that chief financial officers are way more interested in ROC than chief marketing officers are," says Peppers. "In a competitive situation, or a downturn, if you build your entire customer strategy around non-financial metrics – and a financial officer doesn't want to see non-financial figures, he wants to see exactly what the pay-off is – ROC can give you that ammunition."

With businesses focused more on accountability than ever before, ROC looks set to make a significant impact, and with Don Peppers' track record of introducing new business thinking, expect to see this three-letter buzzword sweeping the marketing world as a new wave of customer-centric strategies emerges. ■