Research Report

Customer Equity Reporting

WHARTON SCHOOL OF BUSINESS AT UNIVERSITY OF PHILADELPHIA HAS JUST LAUNCHED AN 8-WEEK ONLINE PROGRAM "STRATEGIC VALUE OF CUSTOMER RELATIONSHIPS – ONLINE" TAUGHT BY MARKETING PROFESSOR AND AUTHOR PETER FADER. HE INVITED PROFESSOR SKIERA, DIRECTOR OF THE E-FINANCE LAB, TO PHILADELPHIA TO LEARN ABOUT HIS THOUGHTS ON "CUSTOMER EQUITY REPORTING". THIS ARTICLE SUMMARIZES SOME OF PROFESSOR FADER'S QUESTIONS AND PROFESSOR SKIERA'S REPLIES.

***Peter Fader:* What is the basic idea of Customer Equity Reporting?**

Bernd Skiera: Current accounting systems and most performance measurement systems are backward-looking. That means that they summarize what has happened in the past, say the past 12 months. They do not capture what is going to happen with current customers in the future. That is problematic because we all know that it is easy to increase current profit at the expense of future profit.

For example, a bank can reduce customer service and save substantial cost. Customers will recognize this but most of them will not react immediately. This slow response leads to fairly stable revenues while costs decrease. As a result, current profit increases. Yet, customers will adapt their future behavior and will do less business with the bank in the future. Thus, future profit will decrease and the increase in current profit is unlikely to compensate for this decrease in future profit.

Another example is a cut in marketing costs, in particular concerning efforts in acquiring new customers. The decrease in marketing costs leads to fewer new customers. Quite often, new customers add very little to the profit line in their acquisition period because acquisition costs are often as high as their first year profit. Thus, the result of a decrease in marketing efforts for new customers is an increase in current profit. However, next year's profit is certainly lower because of the lack of new customers.

These examples illustrate that we need forward-looking systems with metrics that measure both current profit and future profit. One such a metric is customer equity (see also Wiesel et al., 2008).

What are the key metrics to calculate customer equity?

The key metrics to calculate customer equity are the number of current customers, the profit per customer, the retention rate, the acquisition cost per customer and the retention cost per customer. The retention rate measures the probability that a customer who did business with you in the previous period will continue to do business with your company in the current period. For example, if you had 100 customers in the previous period and 80 of them continue to do business with you in this period, then the retention rate will be 80% and the churn rate 20%. Retention rate and churn rate will always add up to 100%.

The acquisition cost per customer is the cost to acquire a customer and the retention cost per customer is the cost to keep the customer. Usually, the average acquisition cost is much higher than the average retention cost. In the banking industry, for example, acquisition costs are very high. You frequently pay for a click that refers customers to your website 2-5 Euros. In case of a conversion rate of 1%, you have acquisition costs that are between 200 and 500 Euros (see Skiera and Nabout, 2013).

How do you calculate customer equity?

Customer equity, here defined as the value of the current customer base, can be easily calculated by summing up the long-term value of all current customers. A simple approach is to determine the long-term value of an average customer (frequently called customer lifetime value) and then to multiply this value by the number of current customers. A more advanced approach is to calculate the value of each customer and then the sum of these values. In either way, we end up calculating the long-term value of the current customer base, reflecting customer equity.

How do you calculate customer lifetime value?

Customer lifetime value consists of the current and the future value of one particular customer. Current value is the current profit of the customer and usually already captured by current accounting systems. The calculation of the future value is certainly much more difficult. One simple approach is to use the retention rate as a metric that indicates the likelihood that the customer will continue to remain a loyal customer in future periods. For example, if the retention rate is 80%, then there is a probability of 80% that the customer remains a loyal customer in the next period, a probability of 80% times 80%, thus 64% of remaining a loyal customer for the next two periods, a probability of 80% times 80% times 80%, thus 51.2% of remaining a loyal customer for the next three periods and so forth.

From a mathematical point of view, these probabilities represent an infinite series that enable us to come up with simple formulas to calculate the long-term value that relates to these probabilities. Together with the discount rate, they allow us to determine how much higher long-term value is compared to the short-term

Bernd Skiera (University of Frankfurt, E-Finance Lab) and Pete Fader (Wharton School of Business)

value. Stated differently, we can use profit per customer, the retention rate and the discount rate to calculate the present value of a customer, called customer lifetime value.

Don't we need to consider different segments of customers?

Sure. The logic that I just outlined should be applied for each segment of customers if those segments differ very strongly. In a current research project with a major German bank, we also derive the value of the current customers for each of their branches.

For which companies is customer equity most useful?

It is useful for all companies that aim at creating long-term and, thus, sustainable value, and those who have many customers. If you have very few customers, then you tend to have very close relations to those few customers and you know them very well. Your gut feeling is frequently good enough to determine changes in long-term value. If you have thousands of customers, then you cannot maintain close relations with all of them and a more formal system like Customer Equity Reporting is certainly more appropriate.

Can all companies determine customer equity?

You need to be able to determine the key metrics, which are the number of current customers, the profit per customer, the retention rate, the acquisition cost per customer and the retention cost per customer. That is usually not a problem for companies that can track the transactions of their customers. Financial service providers, such as banks, are certainly in the position of doing so.

How does Customer Equity Reporting relate to Customer Satisfaction or Net Promotor Score?

Customer Satisfaction, Net Promotor Score (NPS) and other comparable metrics are essential measures that serve as early warning indicators. The logic is that you are less likely to remain a good customer if you are less satisfied or less willing to recommend the bank. Thus, acting on these metrics contributes to making a business more sustainable. Yet, these metrics are frequently costly to measure and usually not available for every single customer.

An alternative to these survey measures is the analysis of transactional data, in particular for companies that benefit from repeat business with their customers. Among these are banks. They can track the activities of their current customers very well and develop indicators that reflect future development. A good customer analytics system makes it fairly easy to determine such metrics at very low cost.

Why are still so many companies reluctant in reporting customer metrics?

There is a tradition in accounting and finance to not put much emphasis on customer metrics, which I consider to be a big mistake. It will change in the future for two reasons. First of all, stock-market listed companies will receive more questions from analysts and other stakeholders about their customer metrics so that they will disclose more information about these metrics in their external reporting. Knowledge about how to effectively utilize these metrics will increase and banks will start to demand these metrics from other companies, in particular if these companies start to ask for loans.

The second reason is that top executives start to put these metrics and the resulting customer equity on their internal reporting systems. Initially, this may simply encompass small details such as replacing total profit by number of customers, profit per customer and estimates of retention rates. I would also recommend distinguishing between acquisition cost and retention cost instead of marketing and selling.

Thank you very much for this interview!

More information about the class of Professor Fader see *http://executiveeducation.wharton.upenn.edu/for-individuals/all-programs/strategic-value-of-customer-relationships?roie=1631&slx=tw14whsvc.*

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