Introduction: the evolution of customer equity

V. Kumar and Denish Shah

Customer equity is defined as the sum of the lifetime value of all customers of the firm. The customer lifetime value (CLV) may be defined as the net present value of future profits from a customer. The important keywords embedded in the definition are 'future' and 'profits'. Computing *future profits* of a customer makes the customer equity metric inherently forward looking, thereby enabling marketers to invest the right amount of marketing resources in a customer *today* to get the expected value from the customer in the *future*. In contrast, traditional backward-looking metrics such as past customer value and past customer profits provide limited (if any) guidance to managers in terms of the expected revenue stream from a customer in the foreseeable future.

Today, customer equity has established itself as one of the most dominant metrics for managers to measure and manage firm performance. In fact, it has evolved into a way of thinking and doing business as evinced by numerous research and business case studies. Consistent with the developments in the marketplace, this *Handbook* covers a broad range of tactical and strategic issues related to understanding, measuring, managing, and implementing the customer equity metric for maximizing firm performance.

The content of the *Handbook* is divided into 21 chapters drawn from a global pool of leading scholars in the field and offers different dimensions of insights with respect to the customer equity metric. Figure I.1 offers a synthesis of the broad range of topics included in this *Handbook* relevant to understanding, measuring, managing, and implementing the customer equity metric for enhancing firm performance.

As illustrated in Figure I.1, both customer acquisition efforts (or how a firm acquires a customer) as well as customer retention efforts (how a firm retains a customer) influence customer equity. Given the importance of the customer equity metric, it is imperative for firms to understand the drivers of the customer equity metric and the appropriate measurement and methodological approach to apply correctly the lifetime value of each customer and hence the customer equity. The drivers of customer equity may be impacted through a firm's marketing or how a firm acquires and

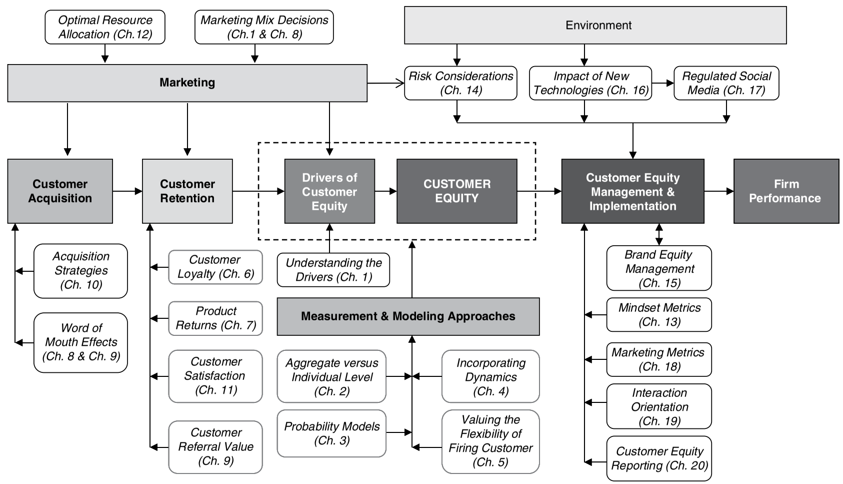

Figure I.1 An integrated framework for understanding, measuring, managing, and implementing customer equity for enhancing firm performance subsequently manages a customer in the firm. A thorough understanding of these factors is critical for managers to identify and understand the levers that can lead to an increase (or decrease) of customer equity.

Finally, several issues arise related to the proper implementation and strategic management of customer equity in a firm. For example, environment-related factors in the form of new technologies, competitive changes, proliferation of new media, as well as internal factors such as the brand equity of the firm bear important implications for the strategic management of customer equity. In addition, firms need to have a clear understanding of the role of the right metrics, orientation, and reporting practices in enabling the customer equity metric to enhance firm performance upon implementation. Overall, the *Handbook* serves as a comprehensive and authoritative guide to customer equity for marketing scholars, practitioners, and students.

HIGHLIGHTS OF THE BOOK

The *Handbook* is organized in five parts. Each part contains several chapters, deals with a particular theme related to customer equity, and addresses a set of key questions, as illustrated in Figure I.2.

Part 1: Understanding and Measuring Customer Equity

The first part of the book delves into topics related to understanding and measuring customer equity. Chapter 1, aptly titled 'Drivers of customer equity' by Rust, J. Kim, Dong, T.J. Kim and Lee, addresses the most fundamental question: what are the core building blocks of customer equity? The chapter discusses in detail three different types of drivers of customer equity: value equity, brand equity, and relationship equity. Although all three drivers of customer equity are important, the relative strength of influence of these drivers on the customer equity of a firm can vary across firms and different industries. For example, brand equity is important for low-involvement goods such as toilet paper and soda, while relationship equity is important in industries such as financial services or airlines, where repeat purchase is important and the evaluation of quality for a good or service is difficult. The chapter further breaks up the three main drivers into their respective sub-drivers and discusses when a firm should invest most in which driver (or sub-driver) of customer equity. Each of the sub-drivers is conceptualized as either a means or the end to achieving customer equity. All of the sub-drivers correspond to both a marketing program driven by management and a customer response, thereby

Figure I.2 Overview of the Handbook

rendering each sub-driver measurable. The authors conclude the chapter with a discussion on how a return on marketing model can be adopted for implementing an actionable customer equity program based on the aforementioned drivers of customer equity.

Customer equity measurement can be performed at the aggregate (i.e., at a customer segment or firm level) or the individual customer level. In Chapter 2, Kumar and Pansari offer a comprehensive discussion on *when* and *how* firms can measure customer equity at the aggregate versus individual customer level. Both approaches have their share of benefits and drawbacks. For example, an aggregate-level measurement of customer equity is relatively easy to compute with data related to marketing activities of the firm at the overall firm level or customer segment level. The relevant insights can enable firms to evaluate the overall effectiveness of their marketing programs and their impact on the overall profitability of the customer base of the firm. In contrast, customer lifetime value measurement at the individual customer level is relatively complex and requires marketing and revenue data specific to each customer of the firm. Individual customer lifetime value measures offer richer insights that can enable the respective firm to identify profitable customers and hence differentiate marketing resource allocations and strategies based on the profitability of each customer. Given the relative pros and cons of the two approaches, it is imperative for firms to choose the right approach in the light of their overall marketing objectives, data constraints, and ability to implement differentiated marketing programs. The chapter concludes with a framework in the form of a flowchart to help managers decide which customer equity measurement approach would be the most optimal to implement in their respective firms.

Forecasting buyer behavior over a multi-period time horizon is central to estimating the future revenue stream from a customer and hence the customer equity of the firm. In Chapter 3, Fader and Hardie review stochastic probability models that can be applied to predict future buyer behavior in different business scenarios. The chapter classifies the models on the basis of two important criteria: (1) whether the buyer behavior is occurring in a contractual versus non-contractual setting and (2) whether the opportunities for transactions are restricted to discrete points in time or whether they can occur at any point in time. For example, participation in academic conferences represents a contractual setting where the revenue from the participants can only occur at discrete points in time (at the time of registering or attending the conference). In contrast, customers shopping from say an online retailer represents a non-contractual setting where the revenue from the customers can occur at any time, as there are no constraints as to when the customer can purchase from the retailer.

The chapter recommends application of different models to measure the CLV (and hence the customer equity) given the business context of the firm and underscores the need for the managers to distinguish between (1) the expected lifetime value of an as-yet-to-be-acquired customer, (2) the expected lifetime value of a just-acquired customer, or (3) the expected residual lifetime value of an existing customer.

In Chapter 4, Lewis discusses the need for incorporating the dynamics of customer behavior in CLV models. Customers are intelligent entities that not only learn from their experiences transacting with the firm but also develop expectations of the future. As a consequence, when firms implement different marketing programs, consumer preferences and expectations are likely to evolve over time. For example, firms' promotional discounts can decrease future revenues by changing reference prices or by training consumers to wait for future promotions. Standard CLV calculations typically do not account for the dynamics of customer behavior as they assume that customers' revenues, costs, and retention rates stay constant. Such assumptions lead to incorrect estimation of the CLV and hence sub-optimal managerial decisions based on the CLV. However, modeling customers as intelligent and dynamically evolving actors greatly complicates the modeling of customer decisions. In addition, the creation of optimal relationship marketing strategies by itself is a challenging endeavor. Drawing upon the dynamic programming approach employed by the marketing and economics literature, this chapter discusses in detail how the dynamics of customer behavior can be accounted for in the CLV computation. The methodology entails treating customer relationship marketing (CRM) of the firm as a stochastic dynamic optimization problem. The solution of an appropriate dynamic programming model is potentially of great value to firms as it yields policies that map marketing actions to customer states in a manner that maximizes CLV and hence the customer equity of the firm.

In Chapter 5, Haenlein argues that standard CLV calculations assume that, once a customer has been acquired, a company will continue to retain the customer, regardless of whether that customer turns out to be profitable. In reality, this assumption is likely to be violated as firms typically have the flexibility to directly or indirectly abandon (or fire) their unprofitable (or problem) customers. For example, the US telecommunications firm Sprint Nextel directly fired customers in July 2007 by terminating the contracts of 1000 clients, while the brokerage house Charles Schwab is claimed to have implemented indirect abandonment by making low-profitability accounts wait longer in call center queues. Consequently, a more realistic computation of customer equity should entail incorporating the firm's *option* to fire unprofitable customers in the CLV computation.

The chapter elaborates on how this may be accomplished by applying the concept of the valuation of (real) options from the interface of the strategic management and finance literature. A related issue is whether some abandonment strategies of the firm (for example: direct versus indirect approach) are associated with more severe negative consequences and higher abandonment costs than other ones. Interestingly, the negative effects of unprofitable customer abandonment in response to direct as well as indirect strategies result in approximately the same levels of exit intention among remaining customers, purchase intention among potential customers, and boycott likelihood for both customer types. The chapter concludes with a discussion of future avenues of research with respect to this relatively unexplored area from both the methodological as well as the managerial perspective.

Part 2: Identifying Key Drivers to Augment Customer Equity

The second part of the book discusses important aspects of customer behavior that managers can leverage to augment customer equity. For example, loyal customers can have a substantial impact on customer equity through their extended lifetime duration with the firm. However, loyal customers are not necessarily profitable. In Chapter 6, Reinartz and Eisenbeiss highlight the complex processes involved in generating customer loyalty. The complexity arises from the fact that the satisfaction–loyalty–profit chain links are almost always non-linear, asymmetric, and industry and customer specific. Thus, the current industry practice of using customer satisfaction or customer loyalty as a simple proxy measure for customer profits is not sufficient. Consequently, the chapter discusses why and how the CLV metric offers an elegant way to measure and quantify customer loyalty in the context of the satisfaction–loyalty–profit chain and directly connects loyalty with profitability. In addition, this forward-looking metric supports long-term decision-making. As a flexible measure, it can adapt to the specific business context of any industry and evaluate each individual customer according to his or her expected contributions to the company. The chapter concludes with a discussion on how firms can profitably manage customer loyalty through (1) a cross-functional integration of processes, people, operations, and marketing capabilities, enabled through information, technology, and applications, (2) adoption of a distinctive customer orientation, and (3) a proper alignment of the management processes and activities with the different (and changing) phases of a customer–firm relationship.

One of the interesting aspects of customer behavior (specific to product-based industries) is returning previously purchased products. Firms have often seen customer product returns as just a cost of doing business and a drain on profitability. However, recent research has shown that customer product return behavior plays a more integral role in the firm–customer exchange process than just a cost to the firm. In Chapter 7, Petersen and Anderson find that firm decisions on managing product return behavior through return policies and marketing mix variables impact the way the customer thinks about the products and the firm, what the customer does in terms of purchase and product return behavior, and in turn the profitability of the firm. This raises two important questions: (1) Can firms manage customers' product return behavior? (2) If so, given the known and potential costs along with the benefits of customer product return behavior, how can firms optimally manage customer product returns to maximize customer equity? The chapter explains how this can be accomplished by linking relevant marketing metrics to the product return behavior of the customer. Consequently, the product return behavior of the customer is integrated in a customer value framework. With such a set up, firms can optimally plan their return policies and marketing mix elements with the objective of leveraging customers' product return behavior to maximize customer equity.

In Chapter 8, Hanssens, Villanueva, and Yoo discuss the word-of-mouth and marketing effects on customer equity. The authors argue that contrary to the popular belief, effective customer equity management should not only focus on customer retention efforts but also on customer acquisition efforts. This is because a firm acquiring the wrong customers will have difficulties in trying to retain and grow the value of the potentially problem customers subsequently. Consequently, in the first part of the chapter, the authors first discuss different customer acquisition channels and underscore the strategic importance of word-of-mouth vis-à-vis traditional marketing channels for acquiring customers. In the second part of the chapter, the authors discuss different methodological approaches for measuring the contribution of marketing efforts on the evolution of customer equity. Broadly speaking, these methods fall under three categories: judgment-based methods, switching matrices based on stated preferences, and econometric methods based on transactions databases. The authors illustrate the application of these methods to measure, manage, and maximize customer equity in the context of relationship businesses (e.g., insurance) as well as product-centric sectors (e.g., automobiles and consumer packaged goods).

In Chapter 9, Leone and Christodoulopoulou argue that a customer's value to the firm should not only be based on the respective customer's purchase behavior but also on their non-purchase behavior such as customer referrals that indirectly create value for the firm. This chapter builds upon the discussion of Chapter 8 concerning the importance of customer referrals as an important customer acquisition tool, characterized by lower costs and a relatively higher value of newly acquired customers, thereby offering the potential for significantly increasing the customer equity of the firm. This chapter conducts a detailed examination of the customer referral process, explains how firms use referral programs, discusses the value of referred customers, presents strategies for initiating the referral process by pursuing different seeding strategies and defines the referral rewards in detail. The chapter also discusses how to measure customer referral value (CRV), highlights the strategic importance of this metric, and explains how firms can enhance customer equity by using CRV to evaluate and manage customers based on their referral activity, and in tandem with their CLV. Finally, although the concept of customer referrals is mostly used in consumer markets, its application in the context of business markets is also discussed in this chapter.

Part 3: Applying the Customer Equity Concept to Enhance Firm Performance

The third part of the book broadly focuses on how firms can implement the customer equity metric to manage the overall performance of the firm. In Chapter 10, Peters, Verhoef, and Krafft demonstrate and discuss the important role of customer acquisition in customer equity management. This is because (1) success in cross-buying, retention, and win-back strategies is to some extent conditional on what the firm does for acquisition in the first place, and (2) even with generally successful retention, natural attrition requires continuous replacement with new customers through effective customer acquisition efforts. The authors discuss the fundamental aspects of customer acquisition and illustrate the complex nature as well as the relevant challenges related to proper implementation of customer acquisition processes in firms. The authors conduct a detailed literature review and discuss the state-of-the-art research findings related to customer acquisition. The authors conclude with a set of recommendations for managers. The overarching message of this chapter is that 'customer equity management should govern acquisition strategies as they predetermine later outcomes to a substantial degree' (p. 228).

Customer acquisition and retention efforts of the firm go hand in hand. Customer satisfaction is a necessary condition to retain customers. However, managers often struggle to consistently achieve a positive financial outcome (or customer equity) from their customer satisfaction and retention efforts. In Chapter 11, Keiningham, Aksoy, Komarova, and Nejad identify how and why the links in the chain of effects from satisfaction to firm performance break down. The authors identify three primary issues in connecting satisfaction to customer behavior and to financial performance: (1) share of category spending – not retention – the most relevant behavioral metric, (2) satisfaction's impact can only be understood relative to competitive alternatives, and (3) not all customers can be profitably satisfied. The authors propose that firms should attempt to maximize share-of-wallet, revenue, and profitability simultaneously to fix the links in the chain of effects from satisfaction to firm performance.

Any customer acquisition or retention efforts of a firm typically entail investment of marketing resources. The question then is, how to determine the right amount of marketing resources to allocate across different customers of the firm? The complexity of the task is often compounded by the fact that firms typically encounter marketing budget constraints. In Chapter 12, Venkatesan proposes a five-step process for managers to optimally allocate marketing resources at the individual customer level based on their lifetime value. The first step requires developing the appropriate CLV formulation for a business considering its targeting capability and contractual versus non-contractual relationships. The second step is to break CLV down into its components. The third step in the resource allocation process is to determine the unknown CLV components that must be predicted (for example, a customer's margin, retention cost, retention rate and so on). The fourth step involves developing a predictive model for each of the unknown components. The final step is to find the optimal level of marketing resources to maximize CLV while considering factors such as budget constraints. The chapter offers managerial guidance on implementing these steps. Consequently, managers can maximize the overall firm performance given the marketing budget constraints of the firm.

In Chapter 13, Shuba Srinivasan develops a conceptual framework that investigates the effects of customer mindset metrics on firm performance. The objective here is to illustrate the two routes through which marketing impacts firm performance: (1) a transaction route where 'customers-as-assets' directly impact firm performance through increase in cash flows and (2) a mindset route where 'customers-as-information' indirectly impact firm performance through changes in customers' mindset metrics and customer equity. Focusing on the link between customer mindset metrics and firm performance, the chapter provides a metrics overview and offers extant findings on the customer-mindset-metrics/financial-performance interface. The chapter concludes with an agenda for future studies that addresses gaps and challenges in this important and growing area of research.

Part 4: Strategic Management of Customer Equity

The fourth part of the book comprises an eclectic set of issues concerning strategic management of the customer equity metric in a firm. For example, one of the most important determinants of customer equity is the expected stream of cash flow from the customers. In Chapter 14, Bolton and Tarasi discuss why it is critical for firms to understand the risks associated with the unexpected variability in customers' cash flows in order to effectively forecast, allocate resources, manage customer equity, and prepare for the future. The variability or unpredictability of future cash flows arise from underlying customer interactions, consumption patterns and purchase behavior – as well as from organizational processes that support them. This chapter summarizes alternative approaches to reducing variability in future cash flows without adversely affecting cash flow levels. First, firms can target customers with low cash flow variability or low risk. Second, since customers do not have fixed cash flow characteristics, the variability of individual customers' future cash flows can be decreased through appropriate management actions. Third, firms can allocate resources to specific customers and market segments (through their marketing plan) to yield future cash flows that complement each other and thereby decrease aggregate variability of future cash flows. The chapter offers a practical roadmap for firms to strategically manage customer equity through optimization of their customer base by balancing return and risk.

Another important aspect of strategically managing customer equity is its linkage to brand equity. Brand equity and customer equity are marketing assets that enhance short-term profit and long-term firm value and are essential to the success of marketing management. Most of the literature views brand equity as a determinant of customer equity. In Chapter 15, Luo, Lehmann, and Neslin argue that customer equity feeds back to brand equity. The managerial upshot is that brand equity and customer equity need to be managed strategically, taking into account both the more immediate-term impact of brand equity on customer equity, and the longer-term feedback of customer equity on brand equity. The chapter refers to this as 'co-management' of brand and customer equity. The chapter demonstrates how brand equity and customer equity can be co-managed in a firm using a matrix with customers as the rows and brands as columns.

Rapid advances in technologies such as Internet, mobile telephony, and related technologies can have a significant impact on how firms manage customer relationships, with important implications for customer equity management. In Chapter 16, Srinivasan's insightful review of emerging technology developments suggests many dramatic effects on businesses in general, but customer relationship management in particular, resulting in a double-edged effect presenting opportunities and threats for customer equity management practice. The chapter identifies the challenges and threats posed by new technologies to markets, customers, basis of competition, customer relationships, marketing program effectiveness, and customer value propositions – all key elements of the customer equity management framework. The chapter discusses the important managerial implications for customer equity management arising from the effects of new technologies.

Technological developments have contributed to the proliferation of social media, which have revolutionized the way consumers go about their purchase decisions, as well as the way consumers and businesses stay connected with each other. In Chapter 17, Kumar, Krishnamoorthy, and Shukla discuss the latest trends in social media as well as the inherent flaws associated with taking a short-term approach to social media marketing (SMM) by offering discount coupons, standalone offers/promotions and one-dimensional advertisements in the light of findings from a recent business case study of the topic. Consequently, the chapter recommends a novel 'regulated social media marketing' (regulated SMM) approach that integrates group purchases, social networks, and mobile marketing. This approach empowers businesses to identify and target the most influential customers on the basis of their customer influence effect (CIE) and customer influence value (CIV), so that they serve as word-of-mouth (WOM) agents of the business and channelize its message across their social networks in a regulated, measurable, and effective way. Regulated SMM can enhance not only customer acquisition, but also customer equity, shareholder value, and the overall profits of firms.

Part 5: Implementing Customer Equity in Firms

The fifth part of the book discusses important issues related to the implementation of the customer equity metric. Given the current competitive environment, marketing managers are under intense pressure to make sound decisions. In general, besides the customer equity metric, several other performance metrics exist that are widely employed by managers across firms. However, several surveys of managers in the past decade indicate a general disconnect with the marketers' ability to improve marketing decisions and the performance metric being implemented by the firms. In Chapter 18, Sexton argues that the relative success of implementing a marketing return metric such as the customer equity metric is linked to the effort invested by an organization in developing and utilizing metrics, the data and skills available, and the overall environment created by the organization's leadership.

Since customer equity represents an inherently customer-centric way of dealing with customers, successful implementation of the metric is likely to result in firms adopting a customer-centric orientation with respect to their marketing practices. In Chapter 19, Ramani and Knox talk about how an 'interaction orientation' can enhance a firm's ability to interact with individual customers and take advantage of information obtained from them through successive dyadic interactions in order to achieve profitable customer relationships. The chapter reviews the concept of interaction orientation and traces the adoption of interaction orientation by firms. The chapter also extends the interaction orientation framework by discussing the usefulness of the framework in the context of customer complaints and the company's superior capability to recover from product and service failures.

In Chapter 20, Wiesel and Skiera present a compelling argument for why firms should report customer equity on their financial documents. Current financial reporting practices are primarily backward oriented or based on reporting business that was realized in the past. However, managers and investors typically need more information about the future performance of a company, in particular the long-term value of the company's customers. Customer equity reporting presents a mean to focus on the long-term value of the company's customers. It measures the long-term value of a company's customer base, which is the discounted profit that a company will make with its current customers. Its reporting supports decisions that are long-term rather than short-term value oriented. As such, it avoids the risk that short-term profits are increased at the expense of long-term value creation and its central metric, customer equity, and allows for monitoring companies' performance with respect to the value of their current customers.

Collectively, the different chapters of the *Handbook* offer the following important takeaways with respect to customer equity:

- Both customer acquisition as well as retention efforts of the firm are important to manage the customer equity of the firm.
- To compute customer equity, different measurement and modeling approaches exist. It is imperative for firms to fully understand the nuances of the different approaches in order to apply the best approach – given the specific marketing objectives, data availability, and resource constraints of the firm.
- Customer equity can be augmented in different ways. The differ-

ent drivers of customer equity may be impacted through marketing interventions and prudent customer management.

- Strategic management of customer equity can enable firms to regard customer equity as a means to enhance the overall performance of the firm.
- Adoption of the right orientation, performance metrics, and reporting practices enable successful implementation of the customer equity metric in firms.
- Customer equity is more than a metric. Proper measurement, management, and implementation of the metric renders customer equity as a way of thinking and doing business.

In the concluding section (Chapter 21) of the book, Kumar and Shukla discuss how business practices based on the customer equity metric will evolve further due to the following three major forces of change: (1) explosion and availability of data, (2) development of more sophisticated modeling techniques aided by an increase in computation prowess, and (3) spatial diffusion of the implementation of the customer equity metric across markets (developed versus emerging) and different industries.