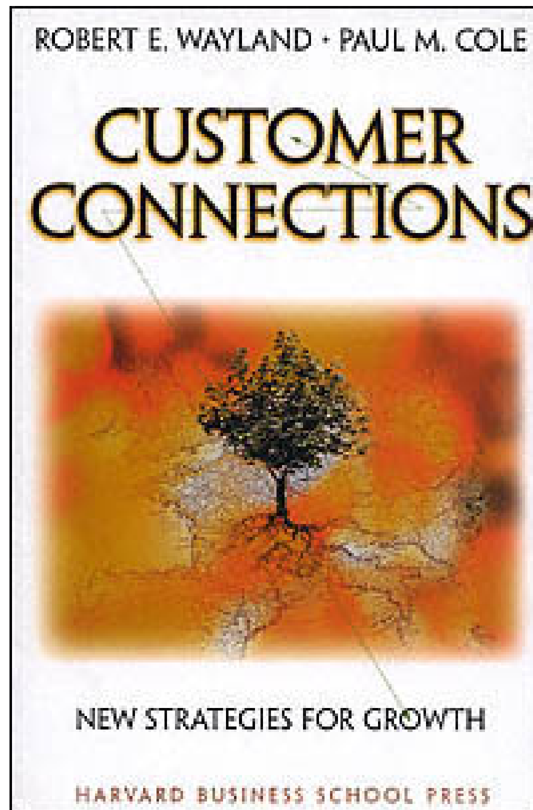

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Customer Connections

New Strategies for Growth

Robert E. Wayland
Paul M. Cole

HARVARD BUSINESS SCHOOL PRESS
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To Carole, Bobby, Katie, and Mark
R.E.W.

To Lisa, Evan, and Adam
P.M.C.

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Introduction

Today companies are caught in a cross fire of silver bullets: "Exceed customer expectations." "Achieve zero defections." "Isolate the segment of one." Derive "30 percent of revenues from new products." "Digitize and customize." Surely, the more thoughtful managers ask: Isn't there some point beyond which it is not worthwhile to either buyer or seller to increase quality? Isn't there some appropriate level of customer turnover above zero? Shouldn't the appropriate product introduction rate be based on something besides time and percent of revenues? Are there some situations in which customization just isn't worth it? In short, aren't there trade-offs?

Building Customer and Shareholder Value

Executives who search the management literature for insights into making these trade-offs will have a hard time finding them. They seem to face a choice between the soft, intuitive perspective of the customer-driven school and the hard, share-holder or profit-driven perspective of strategic planners who seem to regard business as an abstract game of chess involving the movement of financial and physical assets into the areas promising the greatest rewards for shareholders.

Several years ago, when we first became interested in what now are called *demand-side strategies*, we noticed that those people with the most to say about creating shareholder value didn't talk much about the customer's role beyond that of a buyer, whereas those who had great insights into customer relationships tended to treat the connection with shareholder value as either self-evident or as the miraculous consequence of virtuous behavior. We believe that each view alone is too narrow and that it is possible to construct a demand-side framework that can bridge the customer and shareholder value perspectives and help managers make the trade-offs they confront.

When we speak of the gulf between the customer- and profit-driven perspectives, we are not dealing simply with seemingly contrary positions that don't matter much in the end. In a recent survey of the evolution of strategic planning, Frederick E. Webster, Jr., has shown that the debate between customer-driven and profit-driven strategies (or product-market concept) has raged for decades.1 The customer-driven view, often called the *marketing concept*, was promulgated by Peter Drucker, Theodore Levitt, and others in the late 1950s. This view of the firm asserts that the satisfaction of customer needs is the firm's primary purpose. In this view, profits and shareholder wealth are the rewards for serving customers well, *not* the motivating purpose of the firm. Writing in 1983 to extend the tenets of the marketing concept, Theodore Levitt set out its basic premise: "The purpose of a business is to create and keep a customer." He went on, "[T]o say that profit is a purpose of business is, simply, morally shallow."2

Today's heirs to the customer-driven or marketing concept approach generally are found among the advocates of total quality management, customer satisfaction, and, more recently, customer loyalty perspectives. Many proponents of these concepts seem to regard profits as, at best, playing a regulating role by rewarding companies for satisfying their customers. At worst, they see profit-seeking behavior as stifling a company's true role of serving customers. Critics of the profit-driven perspective also often seem to equate profit-maximizing behavior with short-term thinking and a myopic focus on quarterly results.

Indeed, Frederick F. Reichheld, the most prominent advocate of the customer loyalty view, echoes Levitt: "The new theory sees the fundamental mission of a business not as profit but as value creation. It sees profit as a vital consequence of value creationa means rather than an end, a result as opposed to a purpose."3 Although Reichheld has made a major contribution by pointing managers back toward some basic values and insights about customer relationships, we disagree with this premise: Creating value for customers is a necessary but not a sufficient basis for strategy.

The pursuit of quality, customer satisfaction, core competencies, and customer loyalty per se do not constitute strategies. These approaches cannot tell a business which customers to pursue, how much and in what areas to invest to attract and retain those customers, or how to make the trade-offs inherent in all strategies. Such matters as the level of quality or customer satisfaction or degree of loyalty for which the firm should strive cannot be decided without an understanding of opportunity costs or yields. Without disparaging the value or importance of any of these factors, we contend that they are best viewed as significant variables to be managed within a broader strategy aimed at maximizing the value of the firm.

Neither of the two dominant schools of thought about what creates competitive advantage, the so-called *market-based* and *resource-based* views, addresses the customers' role in value creation. In the market-based view, most prominently articulated by Michael E. Porter, competitive advantage derives from a firm's positioning itself to capture the greatest possible value by pursuing a strategy of either cost leadership or differentiation.4 The resource-based view, most closely identified today with Prahalad, Hamel, and Stalk,5 approaches strategy from the internal perspective of leveraging the firm's competencies and resources either by entering markets in which those skills confer an advantage or by creating markets for products based on those competencies. In neither the market-based (despite its name) nor the resource-based view does the customer play much of a role beyond that of a buyer of the firm's output; the customer certainly is not seen as an active participant in the creation of value.

Today's emphasis on generating growth necessarily means focusing on customers. However, generating profitable growth requires focusing on the right customer relationships. In exploring customer-based strategies, we examine how a business's choice of customers affects the value of the firm, how the value proposition can be designed to enhance the value of the customer relationship, how different relationship structures affect the amount of value created, and how that value is shared by the buyer and seller. This book introduces a demand-side strategy framework that addresses these questions.

Overview of This Book

Central Themes

Our perspective on demand-side strategy is that it should be *customer-based*, not *customer-driven* or *customer-led*. Being obsequious to customers is not a strategy. However, recognizing that customers are ultimately the only sustainable source of shareholder value and rigorously working out the implications of this

fact can provide useful strategic insights. Thus, we see the customer relationship not as an end in itself but rather as a fundamental building block of business value.

We believe that a firm's strategy can be developed as rigorously from a demand- or customer-based perspective as from the more traditional product-market or competencies perspectives. Customer relationships are assets that should be evaluated and managed as rigorously as any financial or physical assets. We stress that it is the *relationship* that is the asset, not the customer. The relationship gives rise to future cash flows that we can estimate and to which we can assign a value. The basis of that relationship value is the buyers' and sellers' knowledge about, experience with, and feelings for one another.

We also believe that the value of customer relationships can be related directly to the value of a firm and to shareholder value. In other words, the value of a firm is ultimately equal to the sum of the values of its customer relationships, and this sum can grow only through the acquisition, development, and retention of profitable customer relationships. By viewing itself as managing a portfolio of customer relationships (as opposed to managing a product or asset portfolio), a firm can take actions to maximize its value by deploying effectively its customer acquisition, development, and retention resources.

Viewing its customer relationships as its most important assets does not mean ignoring the many other relationships a company must maintain with suppliers and employees, however. As John Kay points out, "It is the totality of these relationships that defines the individual firm and creates its distinctive identity."6 In our view, the form of these other relationships follows from the basis on which buyer and seller interact. We simply are establishing a starting point for the search for shareholder value.7

After reading this book, you'll see that viewing customer relationships as an asset is not a rhetorical phrase but the cornerstone of a rigorous strategic framework that will allow you to make explicit the connection between the actions you take to create value for customers and the creation of value for shareholders. In making the customer connection, you'll build your business from a new perspective; you will likely:

Manage a portfolio of customer relationships rather than of products or physical assets.

Achieve higher yields on investments by focusing on valuable customer relationships.

Find new opportunities to create value for customers and capture a share of that value for shareholders.

Leverage your knowledge of your customers to increase the value of these relationships.

View technology as a means to deliver what customers want, when they want it, and in the way they want it.

A business cannot develop a customer-based strategy simply by bolting new customer service, satisfaction, or loyalty programs onto a vehicle propelled by product-driven thinking. A firm needs to look carefully at the total design and alignment of efforts to create value for both customers and shareholders. The next section outlines the basis for this alignment.

The Strategic Connection

A strategic framework is of little use unless it can link proposed actions with their probable consequences for firm value or shareholder wealth. The concept of *firm value*defined in terms of net cash flows from operationsis well understood and forms the basis for capital budgeting decisions at many firms. The closely related concept of *shareholder value*, sometimes referred to as *excess returns* because it is created only when net cash flows are greater than necessary to compensate shareholders for their required return, has become something of a strategic mantra for growth-oriented firms.8 The connection between value created for customers and the value of the firm is illustrated in Figure 1-1.

We start with *customer value created*, which is what revenues really are. Revenues represent the value created for the customer, as evidenced by their willingness to pay for the output of the firm. The demand-side search for shareholder value begins by analyzing the size and distribution of revenues across individual customers or customer groups. From this demand-side perspective, the customer (rather than a project, product, or physical asset) is seen as the source of cash inflows or revenues.

Next we turn to *customer cash flow*, which represents the annual contribution to fixed costs and capital made by a customer or group of customers. Here we subtract the total cash costs of identifiable inputs associated with the customer relationship, including the cost of the product; acquisition, development, and retention costs; and taxes on operating income, to estimate customer cash flows. Obviously, if a customer does not cover the variable costs of serving her, the firm is destroying value.

Customer equity is the term used to describe the asset value of the relationship. The value of customer equity is determined by customers' volume of purchases, the margin on those purchases, and the duration of the purchase stream.

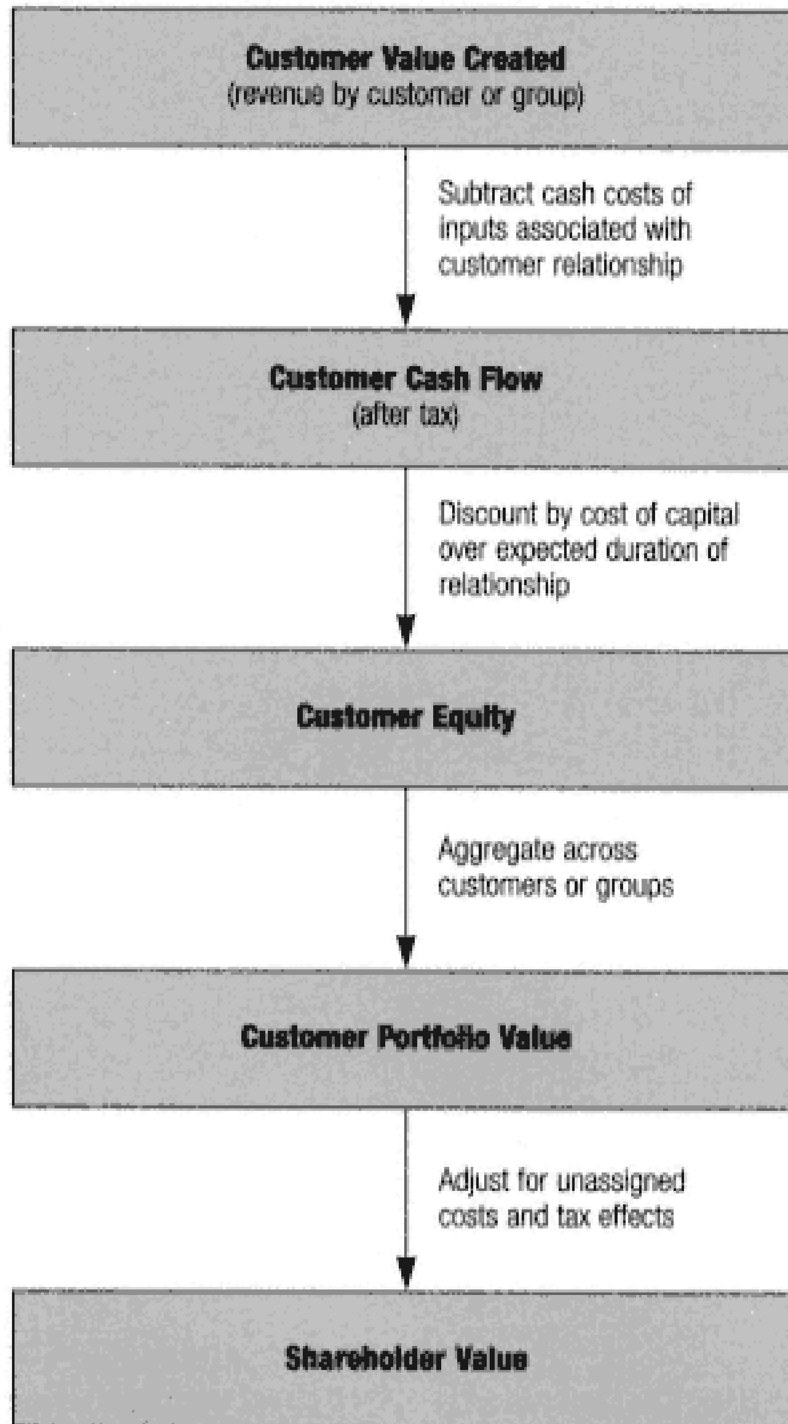

Figure I-1
Connecting Customer and Shareholder Value

To convert the cash flows from the relationship into an asset or equity figure, it is necessary to discount them by the cost of capital to the firm. The concept of customer equity is a powerful metaphor and is central to the development of demand-side strategies. We have traced the term back at least as far as 1983 in

Levitt's insightful discussion of relationship management.9 More recently, Blattberg and Deighton have advocated the use of customer equity to guide marketing decisions and investments.10 In this book, we expand the application of customer equity to embrace the selection of customers, the metric for evaluating changes in the nature of the value proposition, and the basis on which the rewards and risks of the relationship are shared by buyers and sellers.

Next, we introduce the notion of the *customer portfolio*, the aggregate value of all customer relationships, which is equal to the sum of customer equities for all customers or groups. The keys to customer portfolio management are understanding the expected value (mean) and variance of the distribution of relationship values and making choices about investments in the acquisition, development, and retention of customer relationships.

Finally, the *shareholder value* is equal to the aggregate value of the customer portfolio adjusted for joint or unassigned costs and tax effects that cannot be attributed to particular customers or groups and, if appropriate, other income-producing assets. Just as the traditional project or product view seeks to maximize firm or shareholder value by selecting an investment portfolio based on positive net cash flows, the customer portfolio manager maximizes shareholder value by choosing customer relationships with expected net values at least equal to the cost of acquiring and serving them.

Achieving alignment between efforts to create value for customers and shareholders (see Figure I-1) is the essence of demand-side strategies. To help achieve this alignment, we have developed a customer-based strategic framework. Although it will not fit all businesses under all circumstances, it is especially effective in service industries, in business-to-business settings, and in high-involvement consumer goods businesses. Many companies in these sectors will find it useful to begin their strategic thinking with a consideration of the existing and potential value of their customer relationships rather than from the more traditional starting points of industry selection or competencies. For many firms, it will be easier to define their "customer space" than to identify the precise boundaries of the industry in which they participate. Defining an industry often is difficult and, with modern advances, it is becoming even harder. For instance, what is the telecommunications industryinfrastructure, hardware, software . . .?

Though it is important to keep in mind the possibility of industry entrance or exit, such moves are infrequent. Most strategic exercises are aimed at doing better in the firm's existing business, and this necessarily involves consideration of existing and potential customers. Most firms have an installed base of

customers and likely prospects that will account for the vast proportion of the value created over the planning horizon.

Moreover, some research suggests that industry choice explains a relatively small percentage of the difference in profits across firms. For example, Rumelt found that less than 10 percent of the difference in firm profitability was attributable to industry-specific factors; business unit factors explained nearly half of the variance, whereas approximately 37 percent was due to "unexplained factors."11 In their examination of the differences between high- and low-growth firms, Gertz and Baptista also found relatively weak correlations between industries and the growth rate of firms.12

In asking you to buy this book and invest time in reading it, we think we owe you some explanation of why we believe the concepts and principles are valid. The basic concepts reflect many years of consulting, during which we were privileged to learn from many talented executives and colleagues. Our thinking also was formed and extended by the published works of others, many of whom are cited throughout the book.

The resulting ideas and concepts then were refined and tested in a number of ways. We developed an integrating framework and a supporting set of algorithms and models for estimating the key elements of the framework, because we believe it's important for readers to appreciate the structure and dynamics of the arguments and to assess their applicability to their own situations. We also tested the explanatory power of our framework by applying it to nearly two dozen case studies of companies that we sought out because they had a record of customer-based growth. These cases enable the reader to appreciate the growth issues faced by individual firms and to understand how these companies dealt with these issues.

Finally, with the help of the research firm Marketing and Planning Systems (MaPS), we conducted a survey of 200 executives of Fortune 1000 companies and followed up with in-depth interviews to explore the relationship between growth and the issues addressed in our model. Our hypotheses were that firms with exceptional knowledge of their customer portfolios would be able to focus more effectively on the most valuable customer relationships, would be able to leverage technology more effectively to connect with customers, and would enjoy a growth advantage over their peers. Though not dispositive, the results shown in Figure I-2 suggest that there is a measurable connection between growth and understanding customer relationship value, focusing on valuable relationships, and using technology to forge stronger customer relationships.

Indicator	High-Growth Companies	Low-Growth Companies
Percentage with "extremely clear view" of the most valuable customers	38%	22%
Percentage of revenue from top 10 percent of customers	46%	32%
Index of performance on using technologies to better connect with customers (1–10 point scale)	7.0	5.7

Figure I-2
The Growth Connection

Guide to Topics

The rest of this book is structured to help you discover new ways to think about value creation. The next chapter develops a four-part model of customer relationship value and illustrates the concepts by tracking the evolution of MCI in terms of its continued development of customer relationship value. The subsequent three chapters outline the foundations of customer knowledge, connecting technology, and customer economics that together enable you to navigate around our framework. With these foundations in place, we then turn to a more detailed examination of each of the four sources of customer and firm value, illustrating the representative positions with in-depth case studies. Finally, in the last chapter we step back and synthesize the implications of our approach for business strategy. With a good guide, a working model, and a plan for getting where you want to be, we believe you can maximize the customer connection.

Chapter 1
The Value Compass:
Finding Untapped Sources of Value

In Lewis Carroll's *Through the Looking Glass*, Alice found herself in a land where, as the Red Queen says, "It takes all the running you can do to keep in the same place. If you want to get somewhere else, you must run twice as fast as that."1 As managers try to keep pace with today's changing business landscape, many find themselves running in place with poor Alice.

Running faster by downsizing, reengineering, reducing product cycle time, and applying vigorous supply-chain management has left many firms leaner and meaner but little improved in terms of growth and profitability. This has prompted many to shift from supply-side strategies that emphasize cost reduction to demand-side strategies that search for new ways to build revenues, add value, and connect better with customers.

Although there is no such thing as a pure demand-side strategy any more than there are pure supply-side strategies, the notion expressed by the term *demand-side strategy* focuses on a critical need felt by many companies today: to pay more attention to increasing revenues as well as managing costs. Most businesses today are trying to foster stronger customer relationships, are building or planning a customer database, and are measuring customer satisfaction. Are these initiatives working?

The facts suggest that just running faster on the demand side won't necessarily break the Red Queen's grip. Despite annual spending of more than $4.5 billion

on primary market research, most firms are dissatisfied with their understanding of their customers.2Despite billions spent trying to understand customer needs, the cost of an industrial sales call has increased nearly 50 percent, while sales productivity has declined.3In addition, all proclamations of getting closer to customers notwithstanding, the Product Development Managers Association reports that new product failure rates remain at 41 percent.4

Speed Versus Direction

We think it might be time to look at the problem of growth from a different perspective. Perhaps running faster and doing more cannot provide the entire answer; perhaps sometimes they are even part of the problem. Business people typically look at the gap between where they are and where they'd like to be and conclude that they simply have not run fast enough. But how much of the gap is due to lack of speed, and how much is due to running in the wrong direction? How often does a business spend aggressively to capture new accounts one year, only to see most of those accounts leave a few years later? How many product-line extensions bloom briefly and then wither, leaving total sales at approximately the same level but costs a little higher? How often do costly programs to increase customer satisfaction earn unchanged rates of defection?

For many companies, the difficulty of achieving profitable growth is not a matter of running too slowly but of chasing after the wrong customerscustomers who are either unprofitable to serve or who are unlikely to form profitable relationships, and customers who drain resources and effort away from the pursuit and development of more valuable relationships. In many cases, the problem originates not in a lack of customer information but in too much attention paid to database building and not enough paid to developing and sharing useful knowledge. Equally often, businesses suffer not from a lack of product innovation but from a glut of products that blurs the company's focus and builds costs faster than revenues.

Running Together

Concern about the pace of change and the rate at which technology is shaping the future accounts for much of the emphasis on seeking ways to run faster. However, we believe that you can't get to the future on time by running after your customers; you get there by running *with* your customers and understanding their destination and the role you can play in helping them arrive