



Pearson New International Edition

Market-Based Management  
Roger Best  
Sixth Edition

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PEARSON

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# GLOSSARY

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## GLOSSARY

- acquisition cost** The marketing expense to acquire one new customer.
- adjacent segment strategy** Strategy that targets a segment of customers who have slightly different needs than current customers.
- advertising carryover effect** Sales that occurs in periods after which an advertisement was run.
- advertising elasticity** The percentage change in volume per 1 percent change in advertising expenditures.
- advocates** Customers classified as “top performers” who buy nearly everything a company has to sell.
- agents, brokers, and reps** Salespeople who work for a business on a commission basis.
- American Customer Satisfaction Index (ACSI)** A company customer satisfaction index that varies from 0 to 100, calculated every year for companies in many industry sectors.
- articulated market demand** Current market demand, calculated on the basis of articulated customer needs.
- assets** Cash, accounts receivable, inventory, plant and equipment, and other assets.
- backward-looking metrics** Metrics that track performance over a previous period (such as a month or a year).
- bottom-up marketing budget** A budget based on the cost of each specific marketing task needed to implement a tactical marketing strategy.
- bottom-up price presentation** Presentation of the lowest priced product in a product line first, followed by the next lowest priced product, and so on until the highest priced product in the product line is presented.
- brand assets** Assets that a brand can attain, considering factors such as market leadership, awareness, brand relevance, reputation for quality, and brand loyalty.
- brand encoding** The process of branding products within a business using a combination of company name, name, sub-brand name, number, letter, product name, or key benefit.
- brand equity** The attractiveness of a brand due entirely to its name and brand image. Also can be measured as brand assets minus brand liabilities.
- brand image** The perceived image represented by a brand in the mind of a target customer.
- brand interaction (information exchange)** A communications strategy designed to create a customer dialogue and information exchange.
- brand-action communications** Marketing communications intended to prompt some type of customer action.
- brand-image communications** Marketing communications designed to build a brand image and create an emotional response.
- brand-information communications** Marketing communications designed to communicate specific information about the brand.
- brand liabilities** Liabilities a brand can incur as the result of customer dissatisfaction, environmental problems, product failures and recalls, lawsuits, consumer boycotts, and questionable business practices.
- brand management** The process of naming products and managing brands and brand-line extensions to attain maximum brand equity and a brand’s full profit potential.
- brand personality** The personality a brand takes on based on human personality characteristics.
- break-even market share** The market share needed to reach a break-even volume.
- break-even volume** The number of units that a business needs to sell to produce an operating income equal to zero.
- build brand (pure brand)** A communications strategy that is designed to create an emotional customer response in an attempt to build an emotional connection between the target customer and the product.
- capital** The sum of the owner’s equity and the long-term debt the company had incurred; the amount obtained from investors and lenders that the company has invested in its business.
- captive customers** Customers who want to switch to another brand but cannot because of the cost, difficulty in switching, or lack of options.
- channel mapping** The process of mapping all relevant channels from a pocket price to target customer prices or from target customer prices to the company’s pocket price.
- channel margin** The margin required by a channel intermediary.
- channel marketing expenses** Marketing and sales expenses associated with a marketing channel.
- channel partners** Companies within a business’s marketing channels that distribute, resell, or add value to a business’s products and participate in the process of connecting businesses with end users.
- channel system** A particular combination of distribution and sales channels.
- cluster analysis** A statistical method that is used to group customers on the basis of similar needs into needs-based market segments.

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- cobranding** Combining two brand names to create a new brand.
- company benefits** The level of perceived benefit that a customer attaches to a company or brand name.
- competitive advantage** A relative advantage of one business over another that is sustainable and that translates into a benefit that is important to target customers.
- competitive benchmarking** Comparing a company with another company outside the first company's industry (the benchmark company) with regard to a business practice in which the benchmark company is known for excellence.
- competitive bid pricing** Pricing a bid using the historical success of past price-to-cost bid ratios and the competitive bid situation.
- competitive performance metrics** Marketing metrics that gauge the competitive position of a product or business.
- competitive position** A business's position relative to a benchmark competitor's position with regard to price, product quality, delivery, new product sales, and so on.
- competitor analysis** Benchmarking a key competitor with respect to important areas of performance.
- competitor orientation** The degree to which a business tracks competitors' strategies and benchmarks its performance relative to competitors.
- competitor reactive pricing** Setting price on the basis of competitors' prices without knowing what customers need or would be willing to pay for the business's product or service.
- competitor response price elasticity** The percentage change in a competitor's price per 1 percent change in the price of a business's product.
- complementary product** A product that is sold along with another product.
- conjoint analysis (measurement)** A statistical method for deriving the customer preferences for different levels of price and product performance.
- continuous innovation** Incremental improvement of products along the same technology curve.
- cost advantage** A sustainable lower cost relative to competition.
- cost of capital** The percentage paid (like interest) for capital.
- cost of purchase index** A measurement of a product's relative advantage against competing products with regard to price and other customer cost considerations.
- cost-based pricing** Pricing that is determined by a business's cost and margin requirements.
- cost-plus pricing** Pricing based on the cost of the product plus a desired profit margin.
- cross price elasticity** The percentage change in volume in one product when the price is changed 1 percent in another product.
- crowd sourcing** Obtaining ideas from consumers on-line and through other social media for product improvements or new products.
- customer focus** The degree to which a business seeks to understand customer needs and use situations and tracks customer satisfaction.
- customer life** The number of purchase periods a customer is retained by a business.
- customer lifetime value** The net present value of cash flows produced over a customer's purchase life of a company's product or service.
- customer loyalty** Allegiance on the part of customers to a particular business or product.
- customer loyalty index** A measurement of a business's level of customer satisfaction, customer retention, and customer recommendation.
- customer metrics** Marketing performance metrics that track customer satisfaction, customer retention, customer loyalty, and customer value.
- customer mix marketing budget** A marketing budget based on the cost of new customer acquisition and retention.
- customer profitability** Gross margin per customer, minus the marketing and sales expenses needed to serve a customer.
- customer reactive pricing** Setting price by reacting to customer demands for price and product features but without taking into account competitors' prices and product positioning.
- customer relationship management** A process of developing and managing one-on-one relationships with target customers.
- customer relationship marketing** Marketing programs that are designed to personalize or customize a business's offerings to selected customers.
- customer retention rate** The percentage of customers retained from one purchase period to another.
- customer satisfaction** The degree to which customers are satisfied or dissatisfied with a business, product, or specific aspect of a product or service provided by a business.
- customer satisfaction index** An overall index of a business's customer satisfaction.
- customer surveys** Marketing surveys that track customer purchases, intentions to repurchase, and performance perceptions.
- customer terrorists** Dissatisfied customers who share with others the bad experiences they have had with a product, brand, or company.
- customer touch points** The opportunities that a business has to interact with customers and thereby improve the customer's experience.
- customer value** Total benefits minus the cost of acquiring those benefits.
- customerization value pricing** A pricing process in which customers build their own product and price.
- database marketing** A database of customer purchases, preferences, needs, and demographics that is used in customized marketing communications, product offerings, and extra services.
- day in the life of a customer** A market-research approach that involves observing from the customer's point of view the process of acquiring, using, and disposing of a product.
- defensive strategy (defensive strategic market plan)** A long-run plan to protect or exit a market position.
- demographic trap** Segmenting customers on the basis of demographics alone without considering customer needs.
- differentiation advantage** A sustainable product or service advantage that translates into a benefit that is important to target customers.
- digital marketing** The use of web sites, blogs, e-mail, podcasts, mobile, and social media platforms in marketing.
- direct channel system** A channel system that retains ownership of the product and requires management of its sales, distribution, and customer service.
- discontinuous innovation** Product improvement that occurs when the current dominant technology is abandoned for a new technology (e.g., the switch from vacuum tubes to solid state electronics).
- discount factor** The net present value of \$1 when discounted from a particular point in time and at a particular discount rate.

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- discount rate** A business's cost of capital.
- discriminant analysis** A statistical method that helps identify demographic characteristics that differentiate one needs-based segment from another.
- disruptive innovation** Product improvement that occurs when the current technology is altered over time (e.g., gradually making a product smaller, less expensive, or easier to use).
- distributors** Intermediaries who take title (ownership) of a product and are responsible for its sale and distribution and for customer service.
- divest market strategy** A defensive strategic market plan to exit a market by selling or closing down a business.
- early adopters** Customers who follow innovators in adopting a new product or technology (13.5 percent of the total).
- early majority** Customers who follow innovators and early adopters in adopting a new product or technology (34 percent of the total).
- earnings per share** Net profits (after taxes) divided by the number of shares held by shareholders.
- economic profit** Net income after taxes minus capital times the cost of capital.
- economic value** The customer value created by a product, as determined by the difference in the total cost of purchase of a competing product.
- economic value-added** Net profit (after taxes) minus the product of a business's investment in capital assets times its cost of capital.
- empathic design process** An observational approach to discovering the problems, frustrations, and inconveniences that customers experience when they use a company's product.
- evocative brand names** Brand names that are designed to evoke a feeling or perception.
- exit market strategies** Defensive strategic market plans that specify a market exit strategy, ranging from immediate exit with a divestment strategy to slow exit with a harvest strategy.
- experiential brand names** Brand names that communicate the experience provided by the product, such as the experience of discovery conveyed by the brand name Navigator.
- external performance metrics** Marketing performance metrics that track external performance with respect to market penetration, competitive position, and customer satisfaction.
- fighter brands** Low-priced, lower performance brands that are designed to fight low-price competitors while protecting the price-performance position of higher priced brands in a product line.
- flagship brand** The highest priced and highest quality brand in a business's product line.
- flanker brand** A product extension of a business's core brand.
- floor pricing** Setting a price using a financial requirement, such as gross margin or return on investment.
- focus groups** A discovery method in which target customers answer questions about a product or customer use situation.
- forward buying** The practice of buying a greater volume of a product when it is on sale.
- forward-looking metrics** Performance metrics that are leading indicators of future performance.
- founder/owner brand names** Brand names that are derived from the founder or owner of a business.
- frontal attack strategies** Competitive strategies that directly attack a competitor's market share.
- functional brand names** Brand names that are derived from the basic function of a product.
- GE/McKinsey Portfolio** A portfolio matrix that uses multiple factors to index market attractiveness (on the vertical axis) and competitive position (on the horizontal axis).
- generic product life cycle** The product life cycle for a product category, or "generic product market," such as cereal or cars.
- gross profit** Total sales minus total variable costs.
- grow market share strategy** A long-run offensive strategic market plan to grow market share.
- harvest market strategy** A defensive strategic market plan to slowly exit a market while maximizing profits.
- harvest pricing** Raising price in a series of steps in an effort to improve margins and maximize gross profit until the product exits the market.
- heavy-up message frequency** A period during which a business increases its advertising effort.
- high potentials** Profitable customers who are not yet loyal to a product or business.
- horizontal brand-line extension** Extending the brand to a line of related products.
- horizontal market opportunity** A market with closely related substitute products.
- indirect channel systems** Channels in which intermediaries take ownership of a business's product and take the responsibility for its sale and distribution and for customer service.
- industry analysis** A structural analysis of a competitive environment that is based on competitor entry/exit, buyer/supplier power, substitutes, and competitive rivalry.
- ingredient cobranding** Adding a brand name to another product's brand (e.g., "Intel inside" on Dell and Compaq computers).
- internal performance metrics** Performance metrics that are internal measures of a business's operations.
- innovators** The very first customers to adopt a new product or technology (2.5 percent of the total).
- in-the-box strategy** Internal strategy that lacks both customer and competitor intelligence.
- invented brand names** Brand names that are created from root words, partial words, or names that are poetic constructions on the basis of the rhythm or the experience of saying the name.
- inventory turnover** The number of times an inventory is sold per year.
- knowledge advantage** An advantage in both customer and competitor intelligence that a business has over its competitors.
- laggards** The last customers to adopt a new product or technology (16 percent of the total).
- large-segment strategy** A segment strategy that is focused on the largest market segment in a market.
- late majority** The customers who adopt a new product or technology after 50 percent of the market has already adopted it (34 percent of the total).
- lead-user analysis** An examination of the ways in which innovators and highly involved early adopters use a new product, which can offer insights into how a product can be improved or a new product developed.
- life-cycle cost analysis** A method for discovering the total amount that a product costs a customer over the usage life of the product.

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- low-cost leader pricing** Setting price on the basis of cost of production, in an effort to have the lowest price in the market.
- loyal customers** Customers under the broader classification of “top performers” who always repurchase a business’s products or services.
- margin per unit** The selling price of a product minus all the variable costs associated with producing, distributing, and selling the product.
- market adoption forces** Market forces that affect the rate of new-product adoption.
- market analysis** An external analysis of market demand, customer needs, competition, distributors, and environmental forces that influence market demand and customer behavior.
- market attractiveness** The relative attractiveness of a market on the basis of market forces, competitive environment, and market access.
- market-based management** Delivering superior customer value and company profitability by having a strong market orientation and managing the markets.
- market-based organization** A business that is organized around markets and that uses market units as profit centers.
- market-based pricing** Pricing on the basis of the needs of target customers, competitors’ product positions, and the strength of a business’s product, service, or brand advantage.
- market definition** A specification of market scope that makes clear who the current and potential customers are.
- market development index** The ratio of current market demand to market potential (maximum market demand).
- market focus** A business orientation that is focused on customers and competitors.
- market infrastructure** Channel intermediaries and channel influencers who shape opinions and communicate information about a business and its products.
- market orientation** The degree to which a business has a strong customer focus and competitor orientation and works as a team across functions to develop and deliver a market-based strategy.
- market penetration strategies** Offensive strategic market plans that are designed to further penetrate existing markets or enter new markets.
- market performance metrics** Marketing metrics that track the attractiveness of a market.
- market potential** The maximum market demand that should occur when all potential customers have entered a market.
- market segmentation** View of a market that groups customers into segments on the basis of similar needs and differentiating demographic characteristics.
- market share** The percentage of current market demand obtained by a business.
- market share index** A hierarchy of market share factors (such as awareness, availability, interest, intention to buy, and purchase) that results in an estimate of market share.
- market vision** A broad view of the market based on a fundamental customer need that goes beyond existing product solutions.
- marketing advantage** A sustainable advantage over competitors in channels of distribution, sales force, or marketing communications.
- marketing analytics** Analytical concepts and tools that allow a company to conduct performance measurements that create specific marketing metrics.
- marketing earnings per share (EPS)** The net marketing contribution of a business or product divided by the number of shares, which provides a metric on the extent to which the marketing effort contributes to earnings per share.
- marketing expenses** All fixed expenses associated with selling, marketing, and managing a marketing strategy that is targeted at a particular market.
- marketing mix** A combination of the four Ps (product, price, promotion, and place) designed for a specific target market.
- marketing performance metrics** Metrics that track how a product or business is performing with respect to market performance, customer performance, competitive performance, and marketing profitability.
- marketing planning process** A process that starts with a situation analysis; continues with a specific strategic market plan, a tactical marketing strategy, and a marketing budget; and which results in a performance plan.
- marketing productivity** The amount of the net marketing contribution that is produced by a strategy per dollar of fixed marketing expenses.
- marketing profitability** The net marketing contribution for a product, business, or company.
- marketing profitability metrics** Net marketing contribution, marketing ROS, and marketing ROI.
- marketing profitability portfolio** A portfolio matrix that shows the positions of products or markets relative to marketing ROS on one axis and marketing ROI on the other.
- marketing return on investment (marketing ROI)** The net marketing contribution divided by marketing expenses for a product, business, or company.
- marketing return on sales (marketing ROS)** The net marketing contribution divided by sales for a product, business, or company.
- marketing strategy** The year-to-year marketing mix plan that will guide an overall strategic market plan to a desired marketing and profitability objective.
- mass collaboration** A web-based methodology that is designed to allow customers, professionals, suppliers, and employees to share their ideas with respect to improving existing products or developing new ones.
- mass customization** An individualized marketing mix in which products, prices, promotion, and place are customized to the individual needs of a niche market or individual customers.
- mass market** A market that is not segmented; all customers and potential customers are treated as one group.
- mass personalization** Individualized marketing communications that recognize individual customers by name, purchase behavior, needs, and demographics.
- message frequency** The average number of times a target customer recalls seeing or hearing an advertisement in a given period of time.
- Millennials** The generation that has been entering the consumer market since about 2000.
- misfits** Customers classified as “nonprofits” who will not remain customers due to a poor fit with the business’s product; as a result the business will never recover the cost of acquiring these customers.
- mixed channel system** A combination of direct and indirect channels whereby a business reaches, sells to, and serves some customers, but intermediaries reach, sell to, and serve others, or a business and intermediaries interact with the same customers at different customer touch points.
- monetizing strategies** Strategies that minimize marketing and sales investment and seek to maximize cash flow.

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- morphemes** Parts of words that are used to create brand names.
- multi-dimensional scaling** A statistical method that helps a business understand customer perceptions of competitors and their preferences for products.
- multi-segment strategy** The combination of two or more separate and distinct marketing mix strategies (the four Ps: product, price, promotion, and place) that were created for different needs-based market segments.
- needs-based segmentation** Market segmentation on the basis of customer needs and/or the benefits they seek in a particular buying situation or to solve a particular problem.
- net marketing contribution (NMC)** Gross profit (sales times percent margin) minus the marketing and sales expenses incurred to produce it.
- net present value** The value in today's dollars of a cash flow that occurs over time, using a discount rate.
- net profit** Sales revenues minus all expenses including taxes and interest.
- new-market entry strategies** Offensive strategic market plans that are designed to enter new markets.
- new opportunities** A business's first-time customers ("new potentials") or returning customers ("win-back customers") who are not yet profitable but who, if well managed, may become loyal and profitable.
- niche market (segment) strategy** A strategy that targets a small segment of a market often overlooked or ignored by large competitors.
- oblique strategies** Indirect, noncombative competitive strategies that lead competitors to follow a business's competitive moves.
- offensive strategies (offensive strategic market plans)** Long-run plans (intended to span 3 to 5 years) to penetrate markets or enter new markets.
- one-on-one marketing** Building one-on-one relationships with the key customers whom a business wants to retain.
- operating expenses** Overhead expenses that are not the direct result of marketing activities.
- operating income** Sales minus all expenses before taxes and interest.
- optimizing strategies** Strategies that seek to optimize the marketing mix and marketing investment needed to maximize profits.
- original equipment manufacturers (OEMs)** Businesses that manufacture new products from component products they buy from other manufacturers and suppliers.
- penetration pricing** A strategy of setting low prices to achieve a high market share or high-volume position.
- perceived value pricing** Pricing to create a greater customer value based on customer perceptions of product, service, and company benefits, and the perceived cost of acquiring those benefits.
- perceptual mapping** A display of competing products that considers their relative substitutability and includes customers' ideal products as determined by the strength of the customer preference for each competing product.
- performance-based value pricing** Selecting a price that when combined with other performance features yields a total score (value) greater than competing total scores derived from a conjoint analysis.
- performance plan** A summary of strategic thinking, given a particular market situation, that results in a sales plan, marketing and sales budget, and marketing profit plan.
- performance scorecard** A summary of a business's marketing performance using selected marketing performance metrics.
- performance timeline** A forecast of market and profit performance metrics that spans the next 3 to 5 years.
- plus-one pricing** Adding at least one differentiating feature that allows a product to price slightly above competing products that lack this product or service feature.
- pocket price** The actual price paid to a company for a product after all discounts, sales commissions, shipping charges, and other transaction costs are deducted.
- pocket-price bandwidth** The percentage difference between the lowest pocket price and the highest (a business's different channels or regional markets produce different pocket prices).
- portfolio analysis** An evaluation of a product, market, or business with respect to market attractiveness and competitive advantage.
- price elasticity** The percentage change in unit volume for a product per 1 percent change in price.
- price per unit** The selling price of a product or service.
- price premium** The dollar amount, or percentage, by which the price of a product exceeds competing products.
- price-earnings ratio** The price of a share of stock in a business divided by the business's earnings per share.
- prisoner's dilemma** A price situation in which businesses are forced to follow downward price moves by competitors in order to remain competitive.
- product adoption forces** Product forces that affect the rate of new-product adoption.
- product benefits** The overall benefit that a customer derives from the product performance and features.
- product bundling** Combining for sale two or more products at a total price that is lower than the price a consumer would pay to purchase each product separately.
- product differentiation** The degree to which a business's product is meaningfully different from and superior to competing products, as perceived by customers.
- product life cycle** The life of a product as it progresses from introduction through growth, maturity, and decline.
- product life-cycle portfolio** A product portfolio positioned along the product life cycle on the basis of percentage of total sales.
- product life-cycle profit index** A profit index that is based on the percentage of a business's sales at different stages of the product life cycle.
- product life-cycle/share development portfolio** A strategic market-planning portfolio that uses the product life cycle on the vertical axis and the share development index on the horizontal axis to depict a combination of profitability and growth.
- product line advantage** A competitive advantage due to a broader product line that offers customers more choices and that contributes to a higher level of profits.
- product line extensions** Products that are added to a product line under an umbrella brand that is well known and has an established reputation for quality.
- product line positioning** A planned sequence of alternative product offerings that differ in product performance and price.
- product line scale** The effect of product line extensions or deletions on the cost of producing and marketing a line of products.
- product line substitution** The degree to which the sales of products are cannibalized with the addition of substitute products to the product line.

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- product positioning** The relative value of a business's product features and price in comparison with competitors' product features and prices, from customers' perspective.
- product quality differentiators** Unique aspects of a product that differentiate a company or brand from its competitors.
- product quality enhancements** Features that a business offers in its product that are not offered in competitors' products.
- product quality emotional enhancements** Factors, such as a business's reputation for high quality, that foster a special bond with customers.
- product unbundling** Offering for sale an individual product that is normally sold as part of a product bundle.
- product-focused** A business that is focused internally on product development and that utilizes marketing primarily as an advertising and sales function.
- product-market** A market definition that defines the specific intended market of a product.
- product-market diversification** The degree to which a business has different products across different markets.
- promotional price elasticity** The percent volume increase per 1 percent price decrease during a price promotion.
- protect strategy** A defensive strategic market plan in which a business develops a marketing strategy to protect its competitive position and market share.
- pull communications** Marketing communications that are directed at end-user customers in an attempt to motivate target customers to seek a business's products (i.e., pull the products through the channel).
- pure promotion (stimulate action)** A communications strategy designed to stimulate action, often to motivate purchase.
- push communications** Marketing communications that are directed at intermediaries in an attempt to motivate them to sell a business's products to target customers (i.e., push the products through the channel).
- quality aesthetics** Product and service attributes that affect the perceived quality of a product.
- quality drivers** The critical product and service attributes that drive customer perceptions of performance.
- quality enhancers** Extra product and service attributes that enhance customer satisfaction.
- quality killers** Product and service attributes that do not meet customer expectations of performance at a high level all the time.
- reactive strategies** Strategies that are based on either customer intelligence or competitor intelligence.
- reduce-focus pricing strategy** A defensive market strategy that uses a planned reduction in market share (by reducing the focus to a smaller number of customers) to improve profitability.
- reference price** The price customers would pay for the full-featured product offered in the customerization value pricing process.
- relative cost** A business's cost per unit relative to a competitor's cost per unit.
- relative market share** A business's market share divided by the share of the market share leader competitor or next largest share competitor.
- relative price** A business's price divided by the price of a competitor or the average price of several competitors.
- relative product quality** An overall relative index that is based on customer perceptions of each aspect of product quality of a business's product compared with a competitor's product.
- relative service quality** An overall relative index that is based on customer perceptions of each aspect of a business's customer service compared with a competitor's service.
- repeat customers** Customers who demonstrate a high level of repeat purchase but who are not loyal and also buy other brands.
- retention cost** The cost of retaining one customer over a given period of time.
- return on assets** The net profit produced by a business divided by its total assets.
- return on capital** The net income after taxes produced by a business divided by its investment in capital.
- return on equity** The net profit produced by a business divided by its owner's equity.
- return on sales (ROS)** The net profit produced by a business divided by its total sales.
- reverse innovation/invent to order** A process that starts by listening to lead users articulate "what they want but cannot get" from present products, followed by an effort to create value with a new product that addresses these unfulfilled needs.
- sales revenue** The price times the volume sold for each of the products sold by a company.
- segment attractiveness** The attractiveness of a segment on the basis of market forces, competitive intensity, and marketing access to the segment.
- segment identification** The demographic characteristics that distinguish one needs-based segment from other needs-based segments.
- segment marketing mix strategy** A marketing mix that is developed specifically for a target market segment.
- segment marketing profitability** The net marketing contribution that a business derives from a particular market segment.
- segment positioning** The product-price position and value proposition developed specifically for customers in a given market segment.
- segment pricing** Pricing that is based on segment price sensitivity and customer need for additional product features or services.
- segment strategy acid test** A test of the segment product positioning strategy and value proposition that involves the proposed strategy and two competing alternatives.
- served market demand** The size of the target market to be served by the business.
- service benefits** The overall benefit a customer derives from the various components of service that a business provides.
- service differentiation** The degree to which a business's service is meaningfully different from and superior to competing products from customers' perspective.
- service quality differentiators** Those unique aspects of service that differentiate a company or brand from its competitors.
- service quality enhancements** Enhancements that competitors do not offer.
- service quality emotional enhancements** Service-related factors, such as a business's record for prompt and courteous service, that foster a special bond with customers.
- share development index** The percentage of current market demand obtained by a business.
- share performance metrics** Marketing performance metrics that are related to a product's market share, such as metrics

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- for customer awareness, product availability, customer preference and interest, intent to buy, purchasing, and service quality, which work in a hierarchy to collectively produce a market share index.
- situation analysis** An external analysis of market forces and an internal analysis of business performance that are used to identify key performance issues and guide strategic market planning and the development of tactical marketing strategies.
- skim pricing** A high-price position that attracts a limited number of customers but is sustainable because competitors cannot match the business's competitive advantage and value proposition.
- social media marketing** Marketing efforts that use online social marketing media, such as Twitter, Facebook, YouTube, and blogs.
- social media marketing analytics** Specific marketing analytics that track online social media marketing efforts (e.g., the number of YouTube views).
- social media marketing communications** Marketing communications that are designed specifically for online social media.
- spinners** Customers under the broader classification of "unprofitable customers" who buy only when a promotion is offered and as a result are not profitable and not loyal.
- strategic market definition** A broad definition of market demand that includes the business's served market and relevant substitute product-markets.
- strategic market planning** The process of developing of a long-run (3 to 5 years) strategic market plan that includes specific performance objectives with respect to market share, sales revenues, and profitability over the planning horizon.
- strategy implementation** The actions taken to implement, track, and adapt a tactical marketing plan derived from a specific strategic market plan.
- subsegment strategy** A further delineation of customers within a segment on the basis of demographics or product usage.
- substitute products** Products that can be substituted for one another.
- supply chain management** The management of the flow of physical materials, information, and money to and from a business and its suppliers and channel partners.
- strengths, weaknesses, opportunities, and threats (SWOT) analysis** A summary of these factors uncovered in a situation analysis.
- tactical marketing strategy** A 1-year marketing mix strategy (the four Ps: product, price, promotion, and place) for a particular target market and specific strategic market plan.
- target market** A collection of customers on whom the business has decided to focus in building a marketing mix strategy.
- team approach** The degree to which a business works across functions as a team to create and deliver market-based customer solutions and implementation strategies.
- test market** A test of a product in an isolated market in which sales can be tracked and evaluated to determine the impact of a new product or a variation in the marketing mix.
- tipping point** The inflection point in the product life cycle curve where market demand shifts from slow market growth to an exponential rate of growth.
- top-down marketing budget** A marketing budget that is based on a certain percentage of sales.
- top-down price presentation** Presentation of the highest priced product in a product line first, followed by the next highest price product, and so on until the lowest priced product in the product line is presented.
- total customer experience** The satisfactions and challenges that customers encounter during all aspects of acquiring, owning, using, and replacing a product or service.
- trade-off analysis** A research technique that uses customer preferences for different combinations of price, product, service, and company benefits, the results of which guide a business in its product development, service offerings, and pricing decisions.
- two-tier marketing channel** A channel and sales system that involves two or more intermediaries.
- umbrella brand** A core brand that is well known and under which brand extensions can be easily introduced.
- unarticulated market demand** Market demand that has not occurred because customers have not recognized a need for a product or product feature.
- underachievers** Customers under the broader classification of "high potentials" who are loyal (they buy often) but who are not profitable or are minimally profitable (they buy in small amounts).
- unprofitable customers** Customers whose purchases are too small or too few to cover the business's cost of acquiring them.
- untapped market opportunities** The gap between current market demand and market potential, also called the "untapped market potential."
- value in-use pricing (value pricing)** Pricing to create a dollar savings for a customer on the basis of a lower total life-cycle cost compared with a competitor's total life-cycle cost.
- value map** A graph of relative performance and relative price.
- value proposition** A short statement that communicates how a product or business creates value for target customers.
- value-added resellers (VARs)** Businesses that buy a variety of components from several manufacturers and package them as a system for certain market applications.
- variable cost per unit** All of the variable costs associated with the sale of one unit.
- variance analysis** A breakdown of net marketing contribution that is based on actual and planned performance and that enables a better understanding of how a marketing plan achieved its results.
- vertical brand-line extensions** Variations in the brand that add more variety and options for customers.
- vertical market opportunities** Integration along the supply chain that starts with raw materials and moves vertically through different stages of production, distribution, sales, and service.
- volume** The number of units sold of a particular product in a given period of time.
- win-back customers** Customers under the broader classification of "new opportunities" whom a business previously lost to a competitor but who are buying again from the business and, if well managed, can become loyal and profitable customers.

# Customer Focus, Customer Performance, and Profit Impact

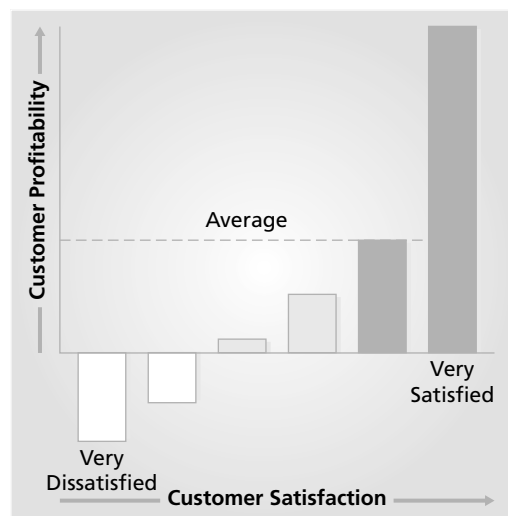
■ Customer satisfaction is a leading indicator of company financial performance.<sup>1</sup>

— *American Customer Satisfaction Index, University of Michigan*

## CUSTOMER SATISFACTION AND PROFITABILITY

“Very satisfied” customers have the greatest impact on profitability. Although results vary by industry, “very satisfied” customers often account for a major portion of a business’s profits, as illustrated in the bar chart.

Managing dissatisfied customers is equally important, as dissatisfied customers are often unprofitable and likely to share their dissatisfaction. Social networking sites and other Internet communication channels make it easier than ever for dissatisfied customers to share their experiences with large numbers of other individuals.



In today’s globally competitive world, customers expect more, have more choices, and are less brand loyal. Sears, Eastman Kodak, and General Motors are examples of companies that at one time seemed invincible in terms of their market domination. Each of these companies had to restructure (reengineer) its organization to address changing customer needs and emerging competitive forces. In the long run, the survival of every business is at risk. Although companies such as Intel, Dell, Microsoft, and Wal-Mart were business heroes of the 1990s, and Google, Apple, and Netflix were heroes of the 2000s, there is

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no guarantee that these same companies will continue to dominate over the next decade. The only constant is change:

- Customers will continue to change in needs, demographics, lifestyle, and consumption behavior.
- Competitors will continue to change as new technologies emerge and barriers to foreign competition shift.
- The environment in which businesses operate will continue to change as economic, political, social, and technological forces shift.

The companies that survive and grow will be the ones that understand change and that lead or create change. Others that are slower to comprehend change will follow with reactive strategies, while still others will disappear, unaware that change was even occurring.

## CUSTOMER FOCUS AND PROFITABILITY

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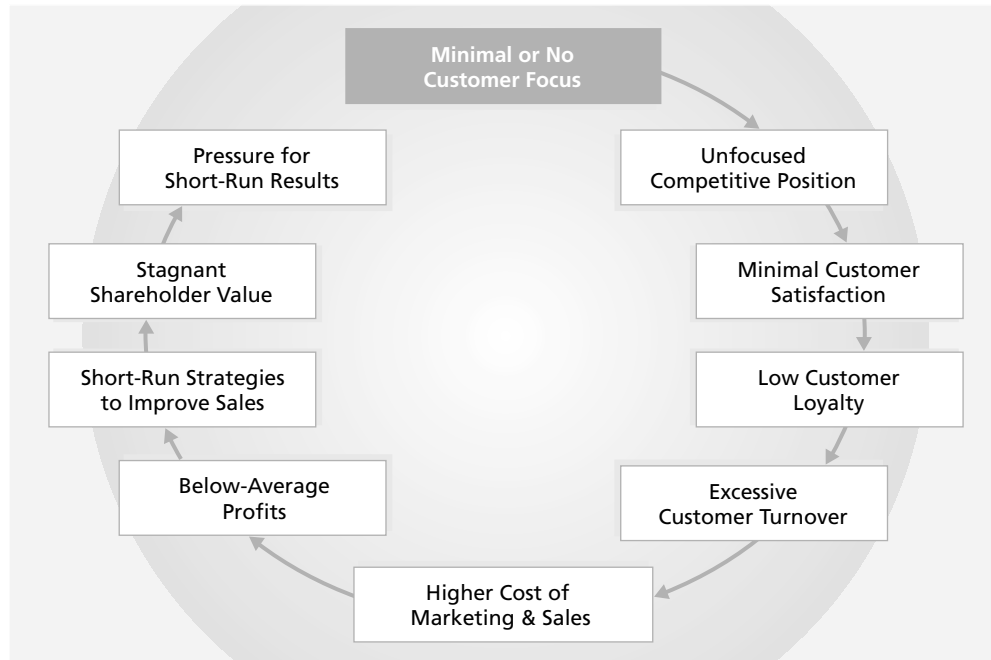
Businesses that have embedded a strong customer focus into their business culture are forward looking and experience continuous improvement as a result of their passion to fully understand the customer experience. Customer-focused businesses are in synch with customers' needs, competitors' strategies, changing environmental conditions, and emerging technologies, and they seek ways to continuously improve the customer solutions they bring to target customers. This process enables them to move with—and often lead—change.

The major benefit of a strong customer focus is long-run survival. Western cultures have long been criticized for their extremely short-term perspective. A business with a short-term perspective usually lacks a strong customer focus and is less motivated to build long-term customer relationships as a primary management goal. Managers are often judged on last quarter's results and not on their efforts to ensure the long-run survival of the business. Likewise, shareholders are more interested in immediate earnings than in long-run survival.

Although the long-run benefits of a strong customer focus are crucial to business survival and to the nation's economic health, the purpose of this chapter is to demonstrate both the short-run and long-run benefits of a strong customer focus. Businesses with a strong customer focus not only outperform their competition over the long term by consistently delivering higher levels of customer satisfaction, they also realize higher profits over the short term. A customer-focused business creates greater customer value and manages customer loyalty as a way to create above-average profits and greater shareholder value. A strong customer focus and market orientation also create a market-measurement culture in which a business uses a wide variety of marketing performance metrics to measure external conditions related to the business's marketing performance and profitability.<sup>2</sup>

### How to Underwhelm Customers and Shareholders

Perhaps the best way to understand the marketing logic that links customer focus to shareholder value is to examine the sequence of events that occurs when a business has little or no customer focus. A business with a weak customer focus underwhelms both customers and shareholders. It has only a superficial understanding of customer needs and the competition.

**FIGURE 1 UNDERWHELMING CUSTOMERS AND SHAREHOLDERS**

Moving clockwise from the top in Figure 1, we can see that little or no customer focus translates into an unfocused competitive position and minimal customer satisfaction. The result is a low level of customer loyalty because customers are easily attracted to competitors, which lowers customer retention. Marketing efforts designed to minimize customer switching are expensive, as are efforts to acquire new customers to replace lost customers.<sup>3</sup> Low levels of customer loyalty and higher marketing costs contribute to disappointing profits. In response, the company implements short-term sales tactics and accounting maneuvers to bolster short-run financial results. But investors and Wall Street analysts are able to see through these facades, and shareholder value generally stagnates. Perhaps even worse, managers come under greater pressure to produce short-run profits, diminishing their time and motivation to understand customer needs and unravel competitors' strategies. The result is a vicious circle of poor performance.

### Customer Focus, Customer Satisfaction, and Profitability

In contrast with the situation presented in Figure 1, a business that has a strong customer focus stays in close contact with customers in an effort to deliver a high level of customer satisfaction and build customer loyalty. Marketing strategies in these businesses are centered on meeting customer needs and achieving customer satisfaction. The strength of a business's customer focus also depends on how well it understands key competitors and evolving competitive forces. This aspect of

**FIGURE 2 STOCK PRICE INDEX AND CUSTOMER SATISFACTION**



customer focus enables a business to track its relative competitiveness in pricing, product performance, product availability, service quality, customer satisfaction, and customer loyalty.

**American Customer Satisfaction Index**

The American Customer Satisfaction Index (ACSI) provides an excellent customer satisfaction database from which managers can gain important insights. It measures customer satisfaction for over 200 companies in 43 industries. The ACSI company database may be used to place companies into four classes according to their level of customer satisfaction and improvements in their customer satisfaction index. To show the great impact of customer satisfaction on profit, Figure 2 illustrates how the stock price index varies for companies with high and low levels of customer satisfaction.<sup>4</sup>

For each company, a stock price index was created in year 1 based on the company’s end-of-year stock price. This way, all companies have the same starting stock price index of 100. The average stock price index for high-customer-satisfaction companies increased from 100 to roughly 300 in 10 years. For the portfolio of companies with low customer satisfaction, the average stock price index ended slightly below where it had started 10 years earlier. The S&P 500 stock price index for the same period of time increased from 100 to roughly 200.

A strong customer focus and a high level of customer satisfaction contribute to a high level of customer loyalty. Keeping good customers is the first priority of market-based managers. A business with a strong customer focus is well positioned to develop and implement strategies that deliver high levels of customer satisfaction and loyalty. In turn, customer satisfaction and loyalty drive customer profitability. We will see in this chapter that very satisfied, loyal customers are the ones who shape the profitability of a business.

**FIGURE 3 CUSTOMER FOCUS, CUSTOMER PERFORMANCE, AND PROFITABILITY**

### Building a Strong Customer Focus

A strong customer focus is built from the top down and includes all employees in the organization. As shown in Figure 3, customer leadership, attention to the voice of the customer, and the use of customer metrics are the driving forces that underlie a business with a strong customer focus. Each of these key forces is associated with behaviors and practices that individually contribute to a customer focus and customer satisfaction. Leadership, organizational training, a customer measurement mentality, and some level of investment are required to bring about full acceptance of the key forces of a customer focus across a business. The extent to which a business lives by these behaviors and practices determines its performance and the profit benefits that a strong customer focus can achieve.

#### Customer Leadership

Customer leadership is essential to a strong customer focus. Although customer leadership starts at the top, it is important for all managers and employees to be engaged in a customer focus and realize that they have a job because customers buy the company's products. It is very simple. If customers stop buying, jobs start disappearing. A company may take various approaches in making a strong customer focus part of its culture, but we believe that senior management leadership, employee customer training, and customer involvement are essential parts of customer leadership. A brief explanation of each with regard to "best practices" follows.

- **Senior Management Leadership**—It always starts at the top. Senior management sets the tone with respect to a company's customer focus. If senior managers are not fully committed to a strong customer focus, it is unlikely that the rest of the organization will adopt one. Lower-level managers and employees have an internal compass that senses what is important and what is not important. Senior management sets the tone and sends the signals. This view is evident in the following excerpt from a letter to shareholders that appeared in the *Southwest Airlines 2008 Annual Report*:

To attract new and retain loyal customers, we launched a new and innovative boarding system, coupled with a Business Select product offering, and improved the customer airport

## Customer Focus, Customer Performance, and Profit Impact

experience. The customer response has been overwhelmingly favorable. So, despite enormous challenges in 2008, we have remained profitable while maintaining our legacy of Culture and Customer Service.<sup>5</sup>

Southwest Airlines has built a culture around customer focus. All managers and employees understand that their paychecks do not come from the company but from the customers they serve. They also know that the better they serve their customers, the better the chances customers will not only come back but will share with others their positive experiences of flying on Southwest.

- **Employee Customer Training**—Employees, especially new employees, need some level of customer training. Starbucks, for example, spends the first four hours with new employees explaining their role in creating a positive customer experience. Waste Management has all its new employees, even new VPs, ride in a garbage truck for one day to see customers and learn how the company serves them. A company can take many actions to train and reward employees with respect to a customer focus. However, one thing is certain: If a business does nothing in the area of employee customer training, it is unlikely that employees will make extra efforts to create positive customer experiences. Those companies that engage employees in understanding customer needs and sources of customer satisfaction are able to build a much stronger customer focus.<sup>6</sup>
- **Customer Involvement**—Customer feedback, good and bad, is shared across the organization. Employees learn how their job affects the customer, how customers use the company's products, and what frustrations and problems customers encounter. For example, FedEx tracks 10 areas of service failure and reports the company's performance to managers and employees each day. Other companies, like Worthington Steel, have customer field trips for employees so they can see how their products are used by customers. Many companies also use focus groups and videos of customer experiences to communicate to employees the frustrations that customers might encounter in using their products.

## Voice of the Customer

Only 8 percent of customers describe their experience as superior, yet 80 percent of companies believe the experience they provide is indeed superior.<sup>7</sup>

This quote tells us a lot about the importance of the voice of the customer and the level of insight that businesses generally have regarding the customer experience. No report or management presentation can replace the words articulated by a customer. Without the voice of the customer, companies may believe they are creating a superior customer experience when in fact they are not. Customers have a different language and express both their satisfaction and frustrations in words that only they can voice. In order to build a customer-focused organization, businesses must capture the voice of the customer and share it across the organization to keep management and employees sensitized to what customers are thinking and saying about the company's products and services. The following list summarizes several ways that a business can capture and communicate the voice of the customer.

- **Customer Experience**—The best way to understand the customer experience is to see it. Intuit, makers of QuickBooks and other software products, have a “Follow the Customer Home” program to observe how customers install and use the company’s products. From these observations and customer comments on how they would like to do things, Intuit is able to improve its products and enhance the customers’ experiences in using the company’s products. For high-tech and business-to-business customers, “A Day in the Life of a Customer” examines how products are acquired, used, maintained, and replaced in order to understand the total customer experience.
- **Customer Solutions**—Companies often become overly focused on building and selling products they believe their customers want, whereas customers are often seeking somewhat different solutions to their usage situation. A product may need additional features or services to provide the solution that customers are actually seeking. For example, General Electric was selling an innovative micron filter but discovered its customers needed a filter holder that made the new product easier to use. 3M observes and talks with lead users of their products, as these customers are trying to use the products in ways that go beyond their design capabilities. Understanding the adaptations that lead users have made or would like to have helps 3M develop its next-generation products. Apple has set up online customer chat rooms for customers to discuss features that they would like to see Apple develop in its products. Customers’ suggestions in the chat rooms have led to innovations in the iPod, iPhone, and iPad.
- **Customer Complaints**—Most businesses view complaints as negative feedback and would prefer not to hear them. These businesses often make the resolution process overly difficult for customers.<sup>8</sup> That may be the natural response, but it’s not the way a customer-focused business thinks. A business with a strong customer focus views negative customer feedback as an opportunity to understand the sources of customer dissatisfaction and to address them. Domino’s Pizza listened hard to customers who said its product tasted like cardboard and improved its product. In 1 year Domino’s increased revenue by 18.4 percent and profit by 3.2 percent.<sup>9</sup> The explosion of social media platforms has afforded numerous mechanisms that make it easy for companies to solicit candid feedback from customers in the spirit of ongoing product and process improvement.

### **Customer Metrics**

Most company performance metrics are internal company metrics, such as return on sales, asset turnover, accounts receivable as a percent of sales, employee turnover, manufacturing defects, late deliveries, and many more. In contrast, customer metrics, such as customer satisfaction, customer retention, and customer loyalty, are external metrics that provide a completely different view of company performance. These customer metrics include several forward-looking metrics that can act as leading indicators of company sales and profitability metrics. For example, sales and profits could be going well, but if customer intentions to repurchase are declining, future sales and profits are likely to decline. Firms that aim to increase the value of their customer base should report forward-looking customer metrics to better align corporate goals with future customer performance.<sup>10</sup>

- **Customer Satisfaction**—The level of customer satisfaction is a key customer performance metric for any customer-focused organization. The percentage of customers who are “very satisfied,” as opposed to simply “satisfied,” and the percentage who are dissatisfied have a significant impact on profits, as we will demonstrate later in this chapter. The following quote is a great illustration of the way that a customer-focused organization views customer satisfaction.

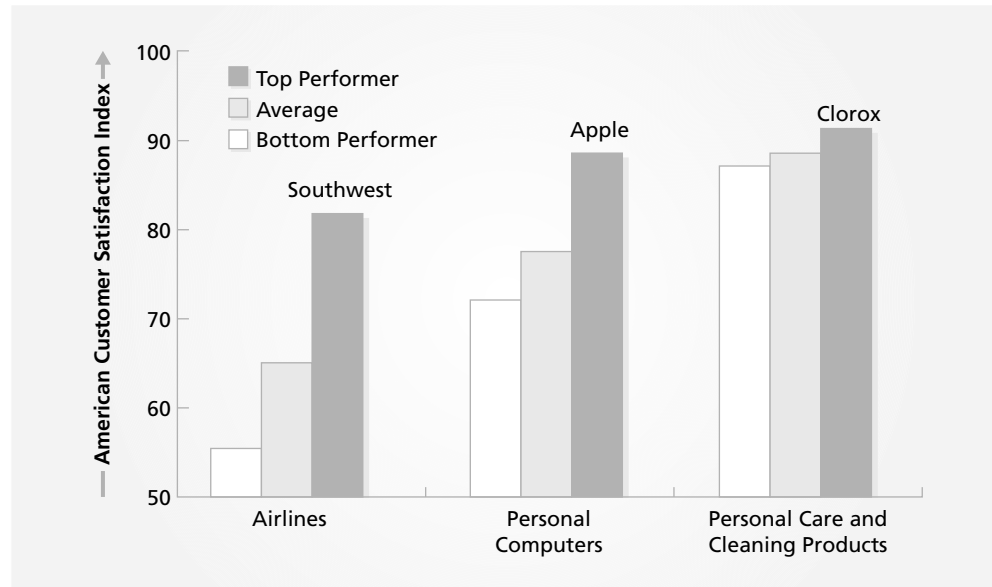
Satisfied is not good enough. Completely satisfied—that’s a big deal. A completely satisfied customer is at least three times more likely to return than one who’s just satisfied.

— Andrew Taylor, CEO, Enterprise Rent-A-Car<sup>11</sup>

Enterprise Rent-A-Car, a company with over 6,500 offices and 600,000 vehicles, is committed to having “completely satisfied” customers. Every month, Enterprise interviews a sampling of customers from each of its rental offices to determine the level of customer satisfaction. Company promotions go to those managers whose offices have above-average levels of customer satisfaction. If a customer who is being interviewed mentions an employee by name, the next morning that employee receives a copy of the customer’s comments. If a customer mentions that the vehicle was dirty or expresses any other dissatisfaction, the comment goes to the manager of the office where the customer rented it. Enterprise trains its new personnel not only in its procedures for renting vehicles to the public but in the company’s philosophy of customer focus. All employees learn what’s important to customers and what’s important in terms of being a good team member.

- **Customer Retention**—The longer a business keeps a customer, the more profitable that customer becomes. For most businesses, the cost of acquiring a customer is 5 to 10 times more than retaining one. For a given customer base, higher customer retention means less money is spent replacing lost customers. Netflix, for example, increased its customer retention from 72 to 85 percent. Because it needed fewer new customers to replace lost customers, Netflix had more money for increasing its customer base.<sup>12</sup> Later in the chapter we will demonstrate how the profit impact of customer retention can be used to determine the lifetime value of a customer in monetary terms.
- **Customer Loyalty**—Loyal customers typically have long histories with a company, buy more than the average customer, and would be more likely than the average customer to recommend a company’s products to potential customers. Loyal customers usually account for a large percentage of overall customer profits. But companies must also make efforts to improve relationships with their less loyal customers and build relationships with their new customers.

Companies that use customer performance metrics are able to identify their unprofitable customers. These are the customers the company has attracted but cannot really satisfy based on their needs and the company’s product benefits and price. These customers leave before the business can recover its investment in acquiring them. For any business, knowing which customers *not* to attract is just as important as knowing which customers to attract.

**FIGURE 4 AMERICAN CUSTOMER SATISFACTION INDEX**

## CUSTOMER SATISFACTION—A KEY MARKETING PERFORMANCE METRIC

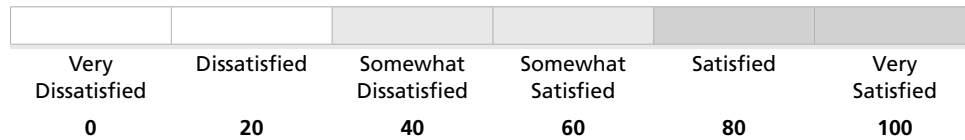
Figure 4 shows the top and bottom performers with respect to customer satisfaction for three distinctly different industries, along with the industry average.<sup>13</sup> The airline industry has the largest variance in customer satisfaction, with an average much lower than the bottom performers for personal computers and personal care and cleaning products. The American Customer Satisfaction Index for Southwest Airlines is considerably higher than for the average airline and average personal computer company. For personal computers, the top performer is Apple, and its customer satisfaction index is well above average. The personal care and cleaning products sector has a high average, with a relatively small difference between the top and bottom performers. The bottom performer in this business sector produces a customer satisfaction index that is close to the top performer for personal computers and above the top performer for the airline industry.

### Measuring Customer Satisfaction

One of the many ways to measure customer satisfaction is based on customers' ratings of their overall satisfaction. The six-category scale shown here ranges from "very dissatisfied" to "very satisfied." The levels of customer satisfaction are rated from zero for "very dissatisfied" customers to 100 for "very satisfied" customers. The scale could be used to rate the satisfaction of a sample of customers for a given product or service. It could also

### Customer Focus, Customer Performance, and Profit Impact

be used by a governmental agency or service, such as the U.S. Postal Service or Medicare. We could then compute a customer satisfaction index (CSI) based on the customer satisfaction ratings.



To determine the CSI for a sampling of customers, a business simply computes the average of the customers' satisfaction ratings. Let's assume that an interview with 100 customers of a company that sells personal printers results in a CSI of 72. By itself, an average customer satisfaction level of 72 does not tell us much and is not likely to attract management's attention. Is a CSI of 72 a good level of performance? That depends on the CSI obtained in earlier measurements, the target objective of the current measurement, and the CSIs of leading competitors. Let's say the company's CSI of 72 is an improvement over earlier measurements and that the CSI of its major competitor is 62. Those numbers could easily lead the company to be pleased with its level of performance among personal printer customers and perhaps become complacent in its pursuit of customer satisfaction. In addition, because efforts to increase customer satisfaction cost money, some may argue that the incremental benefit is not sufficient to justify the cost. That argument, however, would not have any merit for the company or any other business where customer satisfaction is a top corporate performance metric and a top priority. To really understand customer satisfaction and how to leverage its profit potential, we need to expand our view of it.

### A Wide-Angle View of Customer Satisfaction

A company may view a customer satisfaction index of 72 (where 100 is the maximum) as acceptable or even very good. However, simply managing to achieve an average or even a very high CSI can mask the opportunities that a broad view of customer satisfaction offers to increase profits.<sup>14</sup> If we expand our view of customer satisfaction by including the percentage for each category on our customer satisfaction scale, a more meaningful set of insights emerges. As illustrated in Figure 5, the CSI of 72 was derived from 80 percent of customers who reported varying degrees of satisfaction and 20 percent of customers who reported varying degrees of dissatisfaction. The 20 percent who were "somewhat satisfied" are certainly vulnerable to competitor moves, but it is the 20 percent who reported various levels of dissatisfaction who are serious candidates for exit as customers. Management's immediate concern should be the "somewhat dissatisfied," "dissatisfied," and "very dissatisfied" customers.

Customer satisfaction is a valuable marketing performance metric because it can forecast future revenues and profits. This metric deserves our high regard because customer satisfaction is a forward-looking indicator of business success that measures how well customers will respond to the company in the future. Other measures of market performance, such as sales and market share, are backward-looking measures of success or failure. They tell how well the firm has performed in the past, but not how well it will do in the future.

**FIGURE 5 CUSTOMER SATISFACTION—A WIDE-ANGLE VIEW**

Even a business that has recently produced excellent financial results may be disappointing customers. In markets where customers cannot switch to alternatives, dissatisfied customers may stay in the short run but will exit eventually. When they exit, sales and profits are likely to decline.

For many businesses, quarterly measures of customer satisfaction are an effective way to project future performance. If customer satisfaction is declining, this early warning sign gives management time to take preemptive action before real damage is done. Of course, if a business does not track customer satisfaction, it remains unaware of any coming decline in its customer base and foregoes the opportunity to correct performance problems before sales and profits also decline.

### De-averaging Customer Satisfaction and Customer Profitability

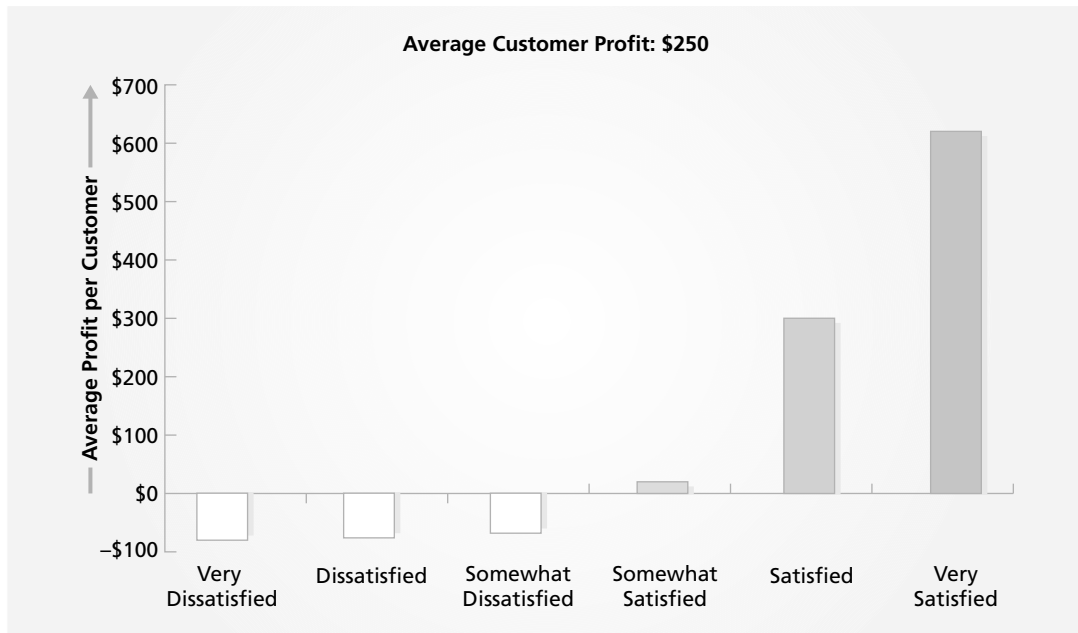
De-averaging a CSI provides a wide-angle view of customer satisfaction and allows managers to see more completely the opportunities for improvement. De-averaging, however, is even more important in understanding customer profitability.<sup>15</sup> In the example in Figure 6, the average customer revenue is \$655. More important is the fact that “very satisfied” customers spend an average of \$1,200 per year—almost twice the average.

Even more impressive is the role that “very satisfied” customers play in profitability.<sup>16</sup> Whereas the average annual customer profitability is \$250, “very satisfied” customers produce a profit of \$620. “Very satisfied” customers not only buy more, they often buy higher-margin products and services, which results in a higher percent margin on total sales.

“Somewhat satisfied” customers are profitable but are below the average customer profitability, which is largely determined by the profit impact of “very satisfied” customers. De-averaging customer satisfaction demonstrates the importance of “very satisfied” customers to the overall profits of a business. When we chart customer profitability against customer satisfaction in Figure 6, we see that the “very satisfied” customers are the ones who drive profitability.

**FIGURE 6 CUSTOMER SATISFACTION AND PROFIT IMPACT**

Customer Satisfaction	Customer Percent	CSI Score	Customer Revenue	Percent Margin	Gross Profit	Retention Cost	Customer Profit
Very Satisfied	25%	100	\$1,200	60%	\$720	\$100	\$620
Satisfied	35%	80	\$800	50%	\$400	\$100	\$300
Somewhat Satisfied	20%	60	\$300	40%	\$120	\$100	\$20
Somewhat Dissatisfied	15%	40	\$80	40%	\$32	\$100	-\$68
Dissatisfied	3%	20	\$60	40%	\$24	\$100	-\$76
Very Dissatisfied	2%	0	\$50	40%	\$20	\$100	-\$80
	100%	72	\$655	49%	\$350	\$100	\$250

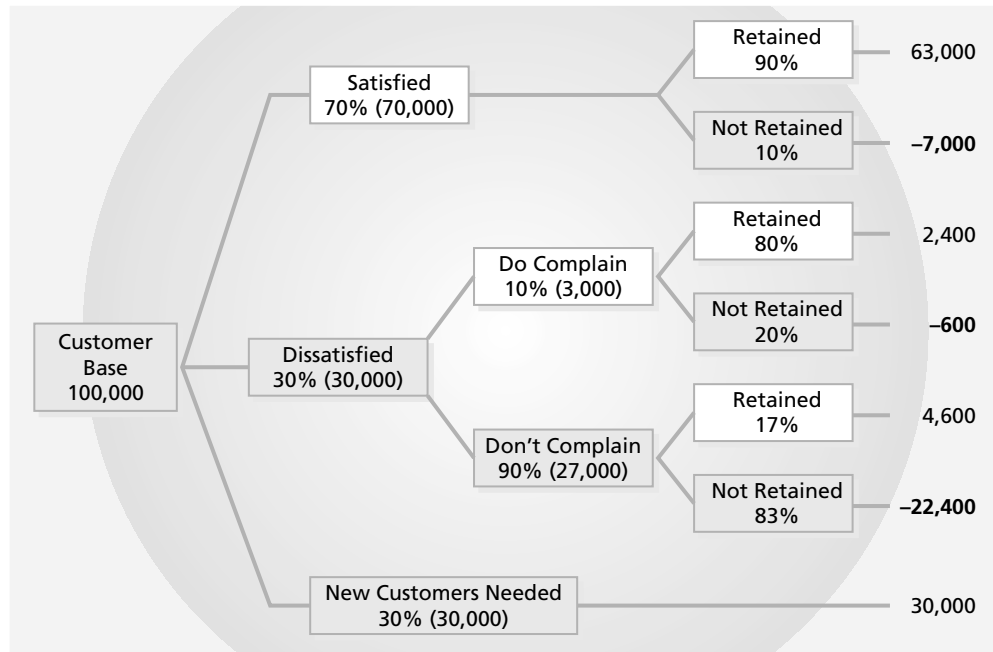


This type of analysis reveals how an effort to reduce customer dissatisfaction and improve the percentage of satisfied customers could raise the overall level of customer satisfaction. Just an 8-point increase in the CSI from 72 to 80 would increase the average profit per customer from \$250 to \$328, a 31 percent increase. Using this analysis, a manager can evaluate many different customer satisfaction scenarios with respect to overall customer satisfaction and average profit per customer.

### Managing Customer Dissatisfaction

Dissatisfied customers buy smaller amounts of product and often buy low-margin or promotional products. In the example in Figure 6, after the cost of marketing is subtracted from the customer gross profit, it is apparent that these customers lose the company money.

**FIGURE 7 CUSTOMER SATISFACTION, COMPLAINT BEHAVIOR, AND CUSTOMER RETENTION**



Yet, despite the less significant role that dissatisfied customers play in profitability, a market-based management business gives its dissatisfied customers as much attention as its “very satisfied” customers. When a dissatisfied customer leaves, a business suffers several economic consequences that lower profits. But mainly because it costs much more to attract a new customer than to retain a current customer, a market-based management business knows it cannot neglect its dissatisfied customers.

Dissatisfied customers usually do not complain, but they do walk and they do talk. Well-documented studies have found that a surprisingly small percentage of dissatisfied customers complain to a business.<sup>17</sup> In Figure 7, of the 27,000 dissatisfied customers who do not complain, 22,400 of them—or 83 percent—will exit. Exiting customers directly erode market position, and because they each tell an average of 8 to 10 other people about their dissatisfaction, they make it more difficult to attract new customers.

Figure 7 illustrates the importance of focusing on the dissatisfied customers who do not complain. The business in this example has 100,000 customers, 70 percent satisfied and 30 percent dissatisfied. Each year, the business loses 30,000 customers who must be replaced to maintain the customer base of 100,000. Of the 70,000 satisfied customers, the business loses only 7,000. The other 23,000 lost customers are dissatisfied customers, most of whom do not complain. In this example, 10 percent of the 30,000 dissatisfied customers complain and, of these, 80 percent (2,400) are retained. By contrast, 90 percent of the dissatisfied customers (27,000) do not complain and, of these, only 17 percent are retained (4,600) and 83 percent are lost (22,400). A quick calculation tells us that the dissatisfied customers who do not complain represent fully 75 percent of the customers lost by the business each year.

## Dissatisfied Customer Revenge and the Use of Social Media

It gets worse. Many dissatisfied customers become “customer terrorists”: they vent their dissatisfaction by telling others about it. Because each dissatisfied customer tells 8 to 10 others, the 30,000 dissatisfied customers will verbally communicate their bad experiences to about a quarter million others. This level of negative word-of-mouth communication makes it more difficult and expensive to attract new customers.<sup>18</sup>

Even worse, the popularity of social media—Twitter, Facebook, and YouTube, as well as customer rating sites such as Yelp and Groubal—allows dissatisfied customers to easily and quickly share their dissatisfaction with a great many people, many of whom they do not know.<sup>19</sup> For example, when an individual’s car was towed even though it was legally parked, the owner posted his dissatisfaction with the towing company on Facebook. His post led more than 10,000 supporters to express their dissatisfaction with the towing company. Many related their own bad experiences, and 20 formal complaints were filed over a 3-year period.<sup>20</sup>

Dissatisfied customer who become “consumer terrorists” pose a potential threat to brands, but companies can respond by recognizing the opportunity to convert these ranting customers into raving customers. Dell and Comcast are good examples of companies that turned threats into opportunities. When faced with harsh online criticism on ComcastMustDie.com and DellHell.net, the companies created ComcastCares (Twitter) and DellIdeaStorm.com to repair damaged customer relationships.

Social media have forced companies to be accountable for product or service issues. In 2010, Fry’s Electronics canceled without explanation a significant number of online orders that had been placed over the Thanksgiving weekend. About 1,100 angry customers signed a petition on Groubal.com, a social consumer advocacy platform. Within days, Fry’s publicly agreed to honor all the transactions, apologized to customers, and resolved the issue.<sup>21</sup>

To prevent a poor reputation from developing by word of mouth, a customer-focused business encourages dissatisfied customers to complain. For example, Domino’s Pizza simply asks its dissatisfied customers to complain.<sup>22</sup> The company’s effort to encourage complaints produces feedback from 20 percent of its dissatisfied customers. Domino’s is able to resolve 80 percent of the problems within 24 hours. When complaints can be resolved quickly, 95 percent of the complaining customers are retained. When complaints cannot be resolved within 24 hours, the retention rate falls to 46 percent.

Although it may seem odd at first, the job of a market-based management team includes not only tracking customer satisfaction but also encouraging dissatisfied customers to complain. Only after learning the details of a customer complaint can a business take corrective action.

## Profit Impact of Customer Dissatisfaction

MBNA America, now merged with Bank of America, was a Delaware-based credit card company that became frustrated with its level of customer dissatisfaction and customer defection. The company brought all 300 of its employees together in an effort to understand the problem and develop methods of delivering greater levels of customer satisfaction in order to retain more customers. At the time, MBNA America had a 90 percent customer retention rate. After dedicating itself to improved customer satisfaction and retention for several years, the company raised its customer retention to 95 percent. That may seem like a small difference, but the impact on profits was a 16-fold increase, and the company’s industry ranking went from 38th to 4th.<sup>23</sup> The marketing efforts to

Customer Focus, Customer Performance, and Profit Impact

satisfy and retain customers paid off far more than we might have expected from only a 5 percent increase in customer retention. As we saw in Figure 7, most dissatisfied customers do not complain. They just walk away and tell others, leaving the business with the task of replacing them in order to retain its market share.

## PROFIT IMPACT OF CUSTOMER RETENTION

The two tables in Figure 8 build on the data from the customer retention tree in Figure 7 to demonstrate the sales and profit impact of an increase in customer retention. For two different levels of customer retention, the tables show the average annual revenue, margin, and marketing and sales expenses per customer for retained customers, lost

**FIGURE 8 CUSTOMER RETENTION AND PROFITABILITY**

70% Customer Retention Sales and Profit Performance	Retained Customers	Lost Customers	New Customers	Overall Performance
Sales (millions)	70,000	30,000	30,000	<b>100,000</b>
Revenue per Customer	\$1,000	\$300	\$500	<b>\$940.0</b>
<b>Sales (millions)</b>	<b>\$70.0</b>	<b>\$9.0</b>	<b>\$15.0</b>	<b>\$94.0</b>
Percent Margin	45%	35%	30%	<b>42%</b>
Gross Profit (millions)	\$31.5	\$3.2	\$4.5	<b>\$39.2</b>
<b>Marketing &amp; Sales Expenses per Customer</b>	<b>\$100.00</b>	<b>\$50.00</b>	<b>\$500.00</b>	<b>\$180.77</b>
Marketing & Sales Expenses (millions)	\$7.0	\$1.5	\$15.0	<b>\$23.5</b>
<b>Net Marketing Contribution (millions)</b>	<b>\$24.5</b>	<b>\$1.7</b>	<b>-\$10.5</b>	<b>\$15.7</b>
Other Expenses (millions)				<b>\$10.0</b>
<b>Profit Before Tax</b>				<b>\$5.7</b>
<b>Pre-Tax Return on Sales</b>				<b>6.0%</b>

80% Customer Retention Sales and Profit Performance	Retained Customers	Lost Customers	New Customers	Overall Performance
Number of Customers	80,000	20,000	20,000	<b>100,000</b>
Revenue per Customer	\$1,000	\$300	\$500	<b>\$960.0</b>
<b>Sales (millions)</b>	<b>\$80.0</b>	<b>\$6.0</b>	<b>\$10.0</b>	<b>\$96.0</b>
Percent Margin	45%	35%	30%	<b>43%</b>
Gross Profit (millions)	\$36.0	\$2.1	\$3.0	<b>\$41.1</b>
<b>Marketing &amp; Sales Expenses per Customer</b>	<b>\$110.00</b>	<b>\$55.00</b>	<b>\$500.00</b>	<b>\$165.83</b>
Marketing & Sales Expenses (millions)	\$8.8	\$1.1	\$10.0	<b>\$19.9</b>
<b>Net Marketing Contribution (millions)</b>	<b>\$27.2</b>	<b>\$1.0</b>	<b>-\$7.0</b>	<b>\$21.2</b>
Other Expenses (millions)				<b>\$10.0</b>
<b>Profit Before Tax</b>				<b>\$11.2</b>
<b>Pre-Tax Return on Sales</b>				<b>11.7%</b>

customers, and new customers. The retained customers are the profit driver of this business. With the company's current customer retention rate of 70 percent, the retained customers account for 74.4 percent of the sales revenue and 80 percent of the gross profit. They produce a net marketing contribution of \$24.5 million (gross profit minus marketing and sales expenses), while lost customers produce a net marketing contribution of \$1.7 million. Because the cost of acquiring new customers is high, and because new customers generally buy less, their net marketing contribution is a negative \$10.5 million. After other fixed expenses of \$10 million are taken into account, a 70 percent level of customer retention produces a profit before tax of \$5.7 million and a pre-tax return on sales of 6 percent.

In this example, the business increased its marketing and sales expenses per customer by 10 percent for retained and lost customers, improving its overall customer retention rate to 80 percent. We can readily see that the profit before tax and the pre-tax return on sales are almost double those for the 70 percent customer retention rate. The math is simple. The marketing cost of retaining customers is much lower than the cost of replacing them. Because the business has fewer lost customers and needs fewer new customers to replace them, it can improve profits derived from retained customers and reduce the losses associated with acquiring new customers.

Obviously, efforts to retain customers are not free. In this example, the marketing and sales expenses for retained and lost customers increased from \$8.5 million to \$9.9 million. But the marketing and sales expenses devoted to acquiring new customers to replace lost customers dropped from \$15 million to \$10 million. In the end, the overall marketing and sales budget decreased from \$23.5 million to \$19.9 million.

The immense potential for increased profits and cash flow is evident. Every additional customer who is retained increases a business's net profit. The costs associated with serving dissatisfied customers and the costs of acquiring new customers to replace them are reduced. Placing a high priority on satisfying and retaining customers can provide tremendous financial leverage.

### **Customer Satisfaction and Customer Retention**

The relationship between customer satisfaction and customer retention is intuitively easy to discern. Different competitive conditions, however, modify this relationship.<sup>24</sup> For example, in less competitive markets, customers are more easily retained even with low levels of customer satisfaction because substitutes are few or switching costs are high. In markets where relatively few choices are available—such as water service, electricity service, and hospital care—customers stay even when they are dissatisfied. Businesses that have no or limited competition have high levels of customer retention even if they have low levels of customer satisfaction. In highly competitive markets, however, even high levels of customer satisfaction may not prevent customer defection. Grocery store, restaurant, and bank customers can switch quickly when they are not completely satisfied. Although the time between purchases is longer, customers who periodically buy personal computers, automobiles, appliances, and electronic products can also easily move to another brand. In these and similar markets, customer retention is much more difficult, and a very high level of customer satisfaction is needed to ensure a high percentage of retained customers.

**FIGURE 9 ESTIMATING CUSTOMER RETENTION**

How likely are you to buy this product or brand again on your next purchase?					
Definitely Will Not Repurchase	Will Not Repurchase	Probably Will Not Repurchase	Probably Will Repurchase	Plan to Repurchase	Definitely Will Repurchase
Intention to Repurchase			Percent	Probability	
Definitely Will Repurchase			25%	1.00	
Plan to Repurchase			35%	0.80	
Probably Will Repurchase			20%	0.60	
Probably Will Not Repurchase			15%	0.40	
Will Not Repurchase			3%	0.20	
Definitely Will Not Repurchase			2%	0.00	
<b>Total:</b>			<b>100%</b>	<b>0.72</b>	
<b>Customer Retention</b>				<b>72%</b>	

### Estimating Customer Retention

Banks, wholesale suppliers, and other businesses that engage in recorded customer transactions can figure their customer retention rates fairly easily. Many businesses, however, are one step removed from end-user customers and cannot determine their customer retention rates on the basis of customer transaction records. To estimate their retention rates, these businesses can use a customer survey as outlined in Figure 9.

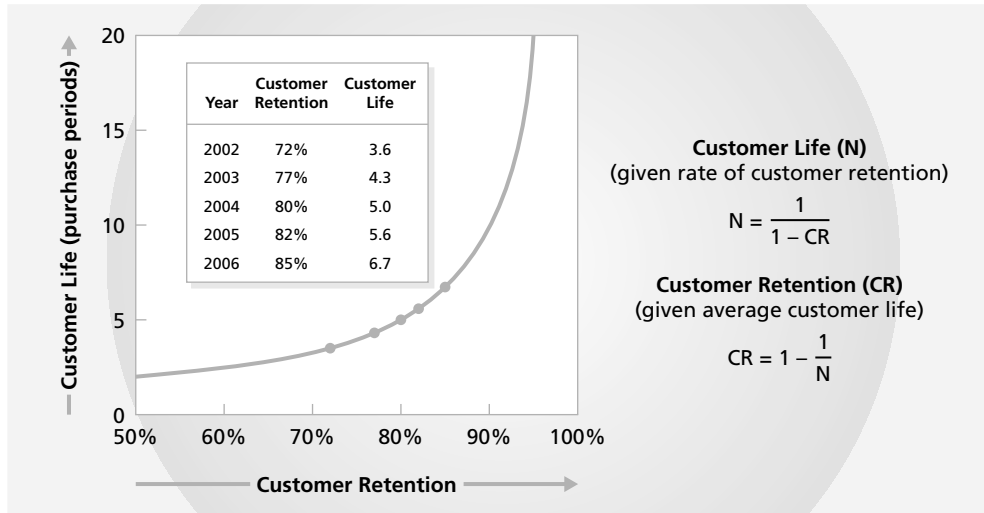
### Customer Retention and Customer Life Expectancy

Customer satisfaction and retention are important linkages to a market-based strategy and to profitability. The ultimate objective of any marketing strategy should be to attract, satisfy, and retain target customers. If a business can accomplish this objective with a competitive advantage in attractive markets, it will produce above-average profits.

The customer as a critical component in the profitability equation is completely overlooked in financial analyses and annual reports. Customers are a marketing asset that businesses have yet to quantify in their accounting systems, even though the business that can attract, satisfy, and keep customers over their lifetimes of purchases is in a powerful position to deliver superior levels of profitability. Businesses that lack a market orientation see customers as individual purchase transactions. A market-based management business sees them as lifetime partners. The *New York Times*, a good example of the latter business model, tracks its customer retention and the retention rates of competing newspapers by length of subscription.<sup>25</sup> Among mature subscribers—those subscribing longer than 24 months—the *New York Times* has a retention rate of 94 percent. Its closest competitor has an 80 percent retention rate.

The higher the customer retention rate, the greater the profit impact. In the short run, we showed this to be true on the basis of increased profits from retained customers, reduced losses from defecting customers, and the subsequent lower cost of attracting new

**FIGURE 10 NETFLIX—CUSTOMER RETENTION AND CUSTOMER LIFE**



customers to maintain the customer base. But higher levels of customer retention also have a long-term positive impact on profits because a higher rate of retention lengthens the average life of customers, increasing their lifetime value.

A business that has a 50 percent customer retention rate has a fifty-fifty chance of retaining any one customer from one year to the next. This fact translates into an average customer life of 2 years, as shown here:

$$\begin{aligned} \text{Average Customer Life} &= 1 / (1 - \text{Customer Retention}) = 1 / (1 - 0.5) \\ &= 1 / 0.5 = \mathbf{2 \text{ years}} \end{aligned}$$

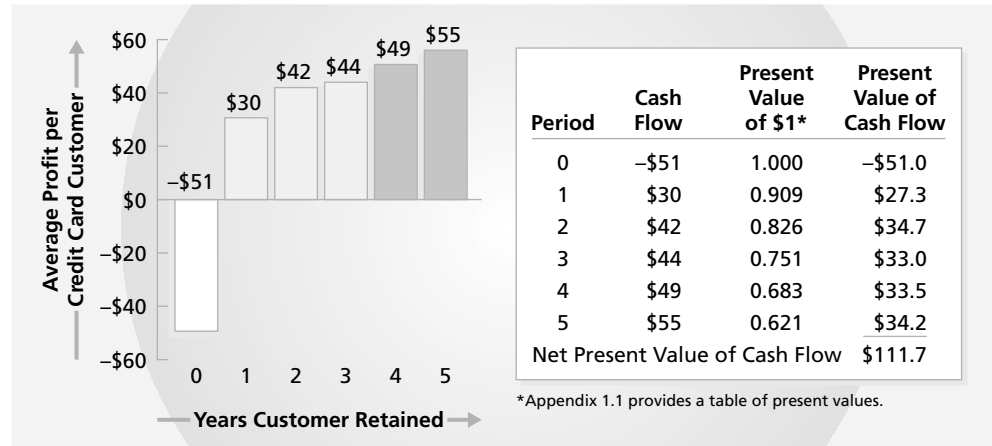
As customer retention increases, the customer’s life expectancy increases. More important, customer life expectancy increases exponentially with customer retention. As shown in Figure 10, Netflix improved its customer retention each year from 2002 to 2006.<sup>26</sup> Over this 5-year period, the ever-higher retention rates increased the average customer life from 3.6 to 6.7 years.

As an example, the average rate of customer retention among health care providers is 80 percent.<sup>27</sup> This level of retention produces an average customer life of 5 years. If a health care provider could increase its customer retention rate to 90 percent, the increase would produce an average customer life of 10 years. We can see that as a business moves to higher levels of customer retention, the life expectancy of a customer grows dramatically.

## CUSTOMER LIFETIME VALUE

A loyal Lexus customer who buys a \$45,000 Lexus and replaces it every 5 years for 30 years (seven purchases) could be worth more than \$300,000 during that 30-year period. If Lexus loses that customer after the first purchase, it loses more than \$250,000 in future sales. To replace that lost customer, Lexus would need to attract a new customer, which

FIGURE 11 LIFETIME VALUE OF A CUSTOMER



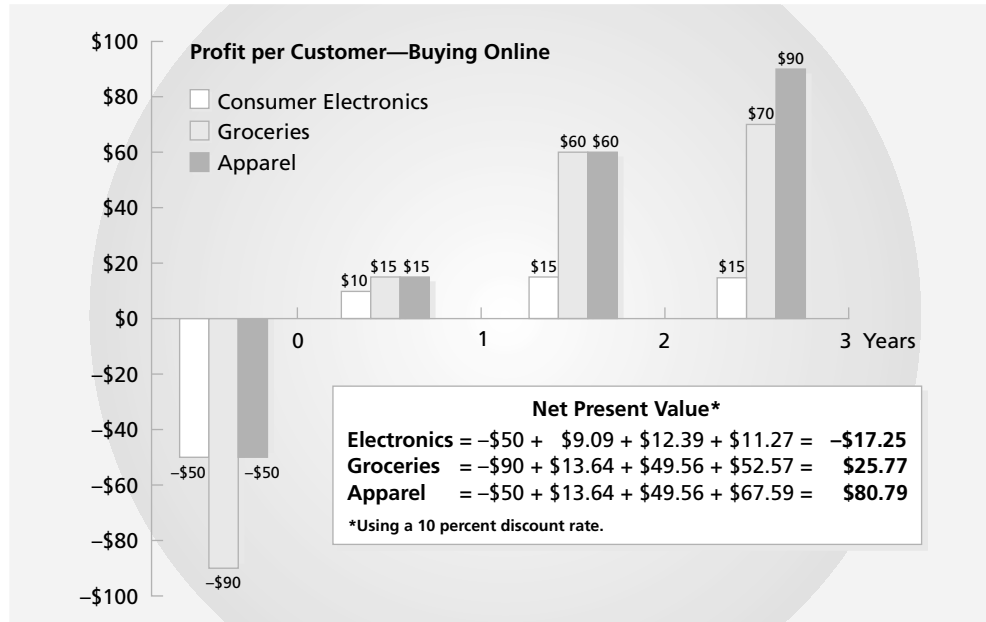
is an expensive process, as we saw in Figure 8. The cost of marketing and sales efforts to ensure customer satisfaction is small, then, compared with the current and future benefits of customer purchases, as well as the cost of replacing customers who become dissatisfied and leave. In general, it costs five times more to replace than to keep a customer.

Figure 11 illustrates the average profit per credit card customer generated over a 5-year period. Acquiring and setting up accounts for new credit card customers nets an annual loss of \$51 per customer. Newly acquired credit card customers are also slow to use their cards; new customers produce an average profit of \$30 the first year, \$42 the second year, and \$44 the third year. By year 5, the average profit obtained from a credit card customer is \$55. The value of a credit card customer, then, grows fairly significantly over time. Of course, if a credit card company loses a customer after year 4 because of customer dissatisfaction, the company incurs the cost of replacing the customer. The cost in the first year following customer exit is a considerable \$106, which includes the \$55 in lost profit from the exiting customer and the \$51 loss associated with attracting a replacement customer. In this example, the average customer life is 5 years. Working backward, we can estimate the customer retention to be 80 percent:

$$\text{Customer Retention} = 1 - \frac{1}{N} = 1 - \frac{1}{5} = 0.80 \text{ (or 80\%)}$$

To estimate the lifetime value of a customer at this rate of retention, we need to compute the net present value of the customer cash flow shown in Figure 11. The \$51 cost of acquiring this customer is immediately gone. Because it takes a year to achieve the initial \$30 in profit, the customer's present value is less than an immediate \$30 profit. In this example, the business uses a discount rate of 10 percent. Therefore, the present value of \$1 received after 1 year is \$0.909 (the rate at which \$1 is discounted for 1 year at 10 percent). Accordingly, \$30 to be received 1 year later has a present value of \$27.30 (\$30 × 0.909). The discounting is performed for each year's customer profits, and the values are totaled to provide the net present value of this cash flow. When each year's customer cash flow is properly discounted, the sum of the discounted amounts equals

**FIGURE 12 VALUE OF ONLINE CUSTOMERS**



\$111.70, the amount that this customer is worth in today’s dollars. This example assumes a 5-year life expectancy; if the customer life expectancy were only 3 years, the customer lifetime value (net present value) would be considerably smaller. The higher the rate of customer retention, the longer the average customer life expectancy and the greater the customer lifetime value.

To better understand this concept, let’s look at the customer lifetime value (net present value) over a 3-year period for online shoppers for consumer electronics, groceries, and apparel, as illustrated in Figure 12.<sup>28</sup> The cost of acquiring an online grocery customer is almost twice the cost of acquiring an online consumer-electronics or apparel customer. After 3 years, the average online grocery customer has a positive net present value of \$25.77, whereas the online consumer-electronics customer has a negative net present value of \$17.25. The average online apparel customer is the most profitable, with a net present value of \$80.79 after 3 years.

**CUSTOMER LOYALTY**

Most businesses have a mix of customers with varying levels of loyalty and customer profitability. Loyal customers have a longer customer history, are more committed to the company brand, buy more, and are more likely to recommend the brand to others. Repeat customers also have a long history but are less committed to the brand, buy less, and are less likely to recommend the brand to others.

Unfortunately, most businesses also have dissatisfied “captive customers,” but often a business does not know who these customers are. On the basis of their long customer

history and their purchase amounts, they look like repeat customers, but they are less than satisfied, have a low level of product preference, and would like to switch to another company’s product if they could. They would not recommend the brand, and many would advise not buying it.

Because customer satisfaction and retention have a positive impact on profitability, a business will always have customers it wants to keep. But it can also have customers it should abandon.<sup>29</sup> Likewise, when a business is trying to attract new customers and manage them to a level of customer loyalty, there are potential customers the business should not pursue. Attracting the right customers is part of customer relationship marketing.

We can facilitate the effective management of customer relationships with regard to customer retention by classifying customers on the basis of customer loyalty and profitability.<sup>30</sup> Not all customers are the same. Some are loyal and profitable, some are profitable but not loyal, some are loyal but not profitable, and others are neither loyal nor profitable. But we first need a measure of customer loyalty.

### Measuring Customer Loyalty

Customer loyalty varies on the basis of the five customer loyalty components included in Figure 13. Each of these customer loyalty components is assessed using three levels of customer behavior. The average of these five loyalty components provides a customer loyalty index that varies from zero to 100. The higher the customer loyalty index, the more loyal a customer is. A customer loyalty index of 80 would be considered a high level of loyalty despite a few average scores.

$$\begin{aligned}
 \text{Customer Loyalty Index} &= \frac{\text{Customer History} + \text{Purchase Amount} + \text{Desire to Repurchase} + \text{Product Preference} + \text{Would Recommend}}{5} \\
 &= \frac{100 \text{ (Long)} + 50 \text{ (Average)} + 100 \text{ (High)} + 100 \text{ (Strong)} + 50 \text{ (Maybe)}}{5} \\
 &= \frac{400}{5} \\
 &= \mathbf{80}
 \end{aligned}$$

“Customer history” is measured as simply *long*, *average*, or *short* relative to the average customer history for a company. A loyal customer has a long history, whereas a new customer has a short history. In the example calculation of customer loyalty, the customer has a long customer history.

“Purchase amount” varies from *below average* to *above average*. A loyal customer usually has an above-average purchase amount, whereas a less-than-loyal customer probably has a below-average purchase amount. The customer in the customer loyalty calculation has an average purchase amount.

**FIGURE 13 CUSTOMER LOYALTY—LOYALTY COMPONENTS AND MEASUREMENTS**

Customer History	Loyalty Index	Purchase Amount	Loyalty Index	Desire to Repurchase	Loyalty Index	Product Preference	Loyalty Index	Would Recommend	Loyalty Index
Long	100	Above Avg.	100	High	100	Strong	100	Yes	100
Average	50	Average	50	Average	50	Average	50	Maybe	50
Short	0	Below Avg.	0	Low	0	Weak	0	No	0

Customer Focus, Customer Performance, and Profit Impact

“Desire to repurchase” varies from *low* to *high*, with *average* reflecting a moderate commitment to buying again from the business. A loyal customer has a high score, a repeat customer an average score, and a dissatisfied customer a low score. In the calculation, the customer is very likely to buy again from the business.

“Product preference” varies from *weak* to *strong*. A loyal customer has a strong level of product preference relative to competing products, whereas a nonloyal repeat customer has a weak level of preference for the company’s product over a competitor’s and would buy either. A dissatisfied customer has a low product preference score and would switch to another product if possible. In the example calculation of the customer loyalty index, the customer has a strong preference for the company’s product.

“Customer recommendation,” or referral to potential customers, is also a critical factor in determining the degree of customer loyalty. Loyal customers with a long history and a strong product preference usually recommend the company’s product to others. Repeat customers are generally less likely to recommend the product, and new customers are even less likely to recommend it to others because their experience with the product is very limited. In our example, the customer rated the likelihood of recommendation as *maybe*. Although this lowers the customer’s loyalty index, an overall loyalty index of 80 still warrants classifying the customer as loyal.

**Customer Loyalty Classifications**

Measuring the loyalty of individual customers usually generates a wide range of customer loyalty scores, varying from zero to 100. Naturally, the higher the loyalty score, the more loyal the customer, and the lower the score, the less loyal the customer. Because customer profitability is correlated with customer loyalty, a higher score normally means higher customer profitability, and a lower score means lower customer profitability.

For the sample company in Figure 14, the mix of loyalty scores and the percentage of customers in each “customer classification” produces an overall loyalty score of 50. Sixty percent of the customers are loyal, repeat, or captive customers. Forty percent are either new or unprofitable customers. The company would not know any of this without measuring customer loyalty. But because the company’s marketing managers do measure customer loyalty and have the information in Figure 14, they can develop marketing programs for each classification of customer loyalty. These

**FIGURE 14 SAMPLE COMPANY—CUSTOMER LOYALTY SCORES**

Customer Classification	Loyalty Scores	Percent Customers	Customer History	Purchase Amount	Desire to Buy Again	Product Preference	Would Recommend	Loyalty Index
Loyal	70 to 100	20%	90	80	95	80	80	<b>85</b>
Repeat	50 to 69	30%	80	65	90	40	45	<b>64</b>
Captive	Under 50	10%	75	55	20	10	0	<b>32</b>
New	0 to 60	20%	10	20	50	50	50	<b>36</b>
Unprofitable	0 to 40	20%	25	15	15	20	0	<b>15</b>
<b>Customer Loyalty Index</b>								<b>50</b>

tailored marketing programs improve customer profitability, which in turn improves company profitability. One goal of customer relationship marketing is to manage these five customer loyalty classifications to obtain a higher level of overall loyalty and customer profitability.<sup>31</sup>

**Loyal Customers**

A loyal customer could have an individual loyalty score as high as 100, but it is likely that a score of less than 100 in at least one of the five loyalty aspects will result in an overall loyalty score lower than 100. For example, a loyal customer could have scores of 100 on the first four aspects of loyalty, but for personal reasons would not be likely to recommend the product to others. To be classified as a loyal customer, a customer should have a loyalty score between 70 and 100. Twenty percent of the customers of the sample company in Figure 14 are classified as loyal. Using the average score for each loyalty component for this set of loyal customers yields an overall average loyalty index of 85. Because of their above-average loyalty and customer profitability, these customers account for a large portion of the business’s profits. The following range of scores is what we would expect for a loyal customer.

**Loyal Customers—Range of Behaviors**

Customer History	Purchase Amount	Desire to Repurchase	Product Preference	Would Recommend	Loyalty Index	Lifetime Value
<b>Avg. to Long</b> 50 to 100	<b>Avg. to High</b> 50 to 100	<b>High</b> 100	<b>Strong</b> 100	<b>Maybe to Yes</b> 50 to 100	<b>High</b> 70 to 100	<b>Above Average</b>

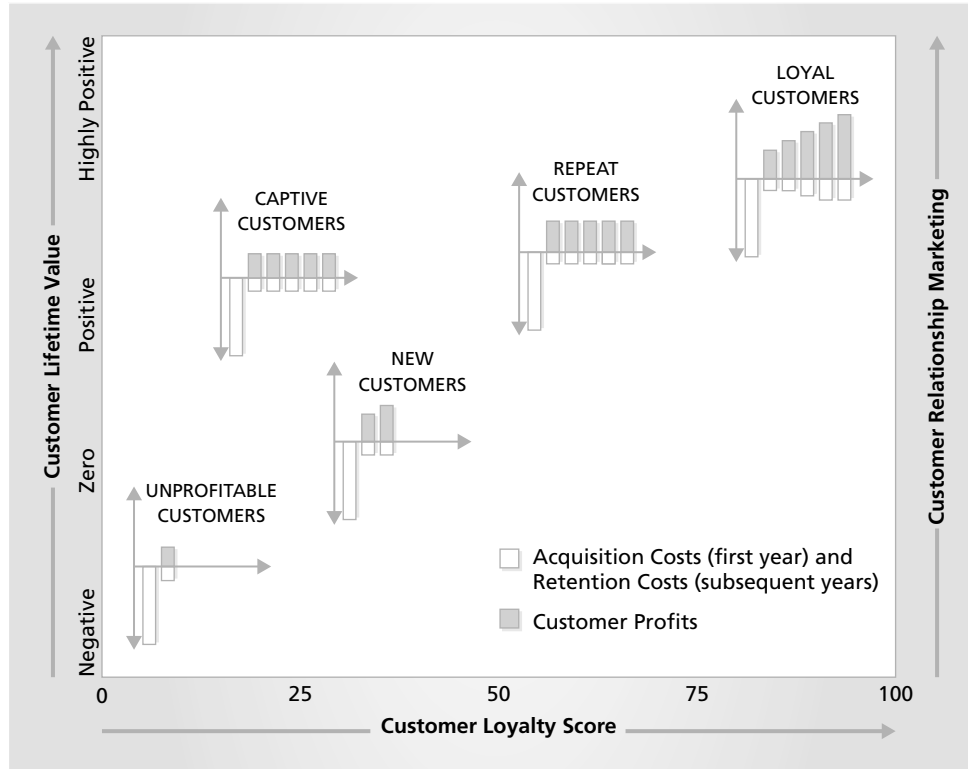
Loyal customers need to be managed differently.<sup>32</sup> They should be rewarded for their loyalty with special offers and services that are not offered to other customers. Marriott, for example, offers its loyal customers a variety of extra services and room upgrades in order to reward and maintain their loyalty. The loyalty program should include precautions against demoting loyal customers. It is better to keep them in the loyalty program even if their purchase amounts drop into a lower range.<sup>33</sup> Their loyalty goes beyond their purchase amounts. Many loyal customers produce a referral value that is over three times their customer lifetime value.<sup>34</sup>

**Repeat Customers**

Many repeat customers are simply “big spenders.” They buy a lot from many companies and do not have a strong preference for one over the other. Big-spender repeat customers buy at above-average levels and frequently purchase products for others. They are “satisfied” or “very satisfied” customers with an excellent retention rate, but they are less likely than loyal customers to recommend the product of a specific business.

Repeat customers are loyal customers in waiting. They have high profit potential, and their product preference is average to high. They may or may not recommend a company’s product to others. As Figure 15 shows, repeat customers have an average to above-average customer lifetime value, but one that is lower than that of loyal customers. Repeat customers often make up 15 to 20 percent of a business’s

FIGURE 15 CUSTOMER LOYALTY AND CUSTOMER LIFETIME VALUE



customer portfolio. A repeat customer has a loyalty index between 50 and 69 and a positive customer lifetime value, as shown in Figure 15. The following range of scores is what we would expect for a repeat customer.

**Repeat Customers—Range of Behaviors**

Customer History	Purchase Amount	Desire to Repurchase	Product Preference	Would Recommend	Loyalty Index	Lifetime Value
Avg. to Long	Low to Avg.	Avg. to High	Avg. to Strong	Maybe to Yes	Moderate	Average to Above Avg.
50 to 100	0 to 50	50 to 100	50 to 100	50 to 100	40 to 90	

Companies often mismanage repeat customers and overlook opportunities to upgrade them to loyal customers. Because competitors can easily lure them away, these customers are at risk of becoming lost customers. Companies should make an effort to build loyalty among high-potential repeat customers in order to retain them and the profits they produce. One objective of customer relationship marketing is to strengthen customers’ loyalty by offering them benefits that are designed to increase their satisfaction and retention. It is important to expand loyalty programs to repeat customers even when they have average and below-average purchase amounts.<sup>35</sup>

Many businesses have found that repeat customers increase their purchase amounts, which raises their customer lifetime value, when they are included in loyalty program benefits.

**Captive Customers**

Captive customers are dissatisfied customers who have an average to long customer history. They have a low desire to repurchase but are unable to move easily to another company’s product. They are likely to have a weak product preference and would not recommend the product to others. A PC customer who is frustrated with Microsoft Office really has no place to go and, as a result, continues to repurchase despite being dissatisfied. Many airlines with low levels of customer satisfaction, especially those serving small markets, still see the same faces, as their captive customers do not have the choice of flying on a customer-oriented airline. A public utility or group health insurance company that is unresponsive to its customers has many captive customers. In most cases the customers are locked into their next purchase or simply cannot switch. Captive customers exhibit the following range of behaviors:

**Captive Customers—Range of Behaviors**

Customer History	Purchase Amount	Desire to Repurchase	Product Preference	Would Recommend	Loyalty Index	Lifetime Value
<b>Avg. to Long</b> 50 to 100	<b>Avg. to High</b> 50 to 100	<b>Low</b> 0	<b>Weak</b> 0	<b>No</b> 0	<b>Low</b> 20 to 40	<b>Average to Above Avg.</b>

In Figure 14, captive customers have an average to above-average customer history and a positive cash flow. Their customer lifetime value is average to above average, as shown in Figure 15, but the future of their cash flow is at risk because they desperately want to switch. Businesses with captive customers often have no idea that their captive customers exist; frequently, such business also lack awareness of the frustrations with which these customers live. To make matters worse, captive customers are likely to share their frustrations with others, making the company’s efforts to acquire new customers harder.

Because many companies are unaware of the customer experience, they blissfully assume that all is well. The revenue continues to flow, and then comes the day when the dissatisfied customers up and leave. But those companies whose marketing efforts include the early detection of captive customers can manage them with respect to their customer dissatisfaction, thereby greatly reducing the possibility that they will switch to a competitor when they are able to do so.

**New Customers**

New customers can be first-time customers or returning customers. They have a low to average customer history and a below-average to average customer lifetime value. Their loyalty is low, as they have not had time to form a customer history or develop a strong product preference. Hence, they are less likely to recommend the product to others at this stage of their customer life. With respect to customer relationship marketing, they require

“critical care.” These customers have high expectations that need to be carefully managed in an effort to lift them to a higher level of customer loyalty. They could represent 15 to 20 percent of a business’s customer portfolio.

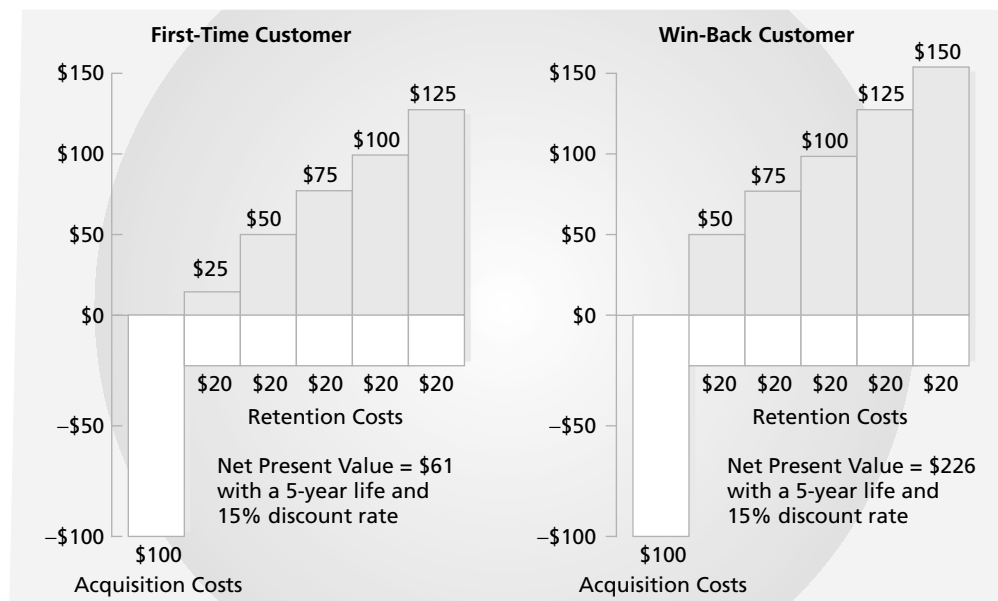
**New Customers—Range of Behaviors**

Customer History	Purchase Amount	Desire to Repurchase	Product Preference	Would Recommend	Loyalty Index	Lifetime Value
Short to Avg.	Low to Avg.	Low to High	Weak to Avg.	No to Maybe	Low	Below Avg. to Average
0 to 50	0 to 50	0 to 100	0 to 50	0 to 50	0 to 60	

First-time customers should fit the business’s profile for target customers. They should possess many of the same traits of loyal and repeat customers. How they are managed as new customers will determine how their purchasing patterns and customer loyalty develop. It is essential for the company to provide them with a positive customer experience in order to build customer satisfaction, retention, and loyalty.

Returning customers are also considered to be new, even though they have a previous customer history. Most often they are repeat customers who switched to a competitor, usually because they were mismanaged, and have for various reasons returned. Returning customers are often referred to as “win-back customers.”<sup>36</sup> They already know the business’s products and services and are likely to resume their former purchasing patterns. As Figure 16 shows, in 5 years the “second lifetime value” of a win-back customer has a net present value almost three times higher than the average lifetime value of an entirely new customer. For a company, the return of a former customer is a lost opportunity that has reappeared—a second chance to develop a loyal customer.

**FIGURE 16 LIFETIME VALUE OF WIN-BACK CUSTOMERS**



### Unprofitable Customers

Unprofitable customers are the result of mismanaged customer selection.<sup>37</sup> They are unprofitable and unlikely ever to be loyal. Unprofitable customers are a drain on a business's profits because the cost of acquiring them can never be recovered, as shown in Figure 15. They can be 30 to 35 percent of a business's customer portfolio. A business with a strong and well-managed customer focus can significantly reduce its percentage of unprofitable customers and improve customer retention and loyalty with proper customer selection as a part of its customer relationship management program. As shown in the table that follows, unprofitable customers have low to average ratings for customer history, desire to repurchase, and product preference, and they have a low purchase amount. They have little or no inclination to recommend the company or its product to others. Their loyalty index is 0 to 40, and their lifetime value is negative to below average.

#### Unprofitable Customers—Range of Behaviors

Customer History	Purchase Amount	Desire to Repurchase	Product Preference	Would Recommend	Loyalty Index	Lifetime Value
Low to Avg. 0 to 50	Low 0	Low to Avg. 0 to 50	Weak to Avg. 0 to 50	No to Maybe 0 to 50	Low 0 to 40	Negative to Below Avg.

Some unprofitable customers are known as “misfits.” They may be wonderful people and even great customers—for some other business. The offerings of the current business do not fit their needs. Although they were initially attracted to this business and its value proposition, they will never be satisfied.<sup>38</sup> They are unlikely to be retained no matter how hard the business tries. The best approach, and often the hardest, is to help them leave.

“Spinners” are another group of unprofitable customers. These customers buy one time and then exit. Typically, they buy because a product is being offered at an attractive price or with a promotional incentive. Telecom companies, for instance, are known for their incentives, and for their spinners. AT&T found that 1.7 million of its customers switched carriers an average of three times a year.<sup>39</sup> Improved customer selection management, with better targeting of promotions, would keep the number of a business's spinners to a minimum. We know that a business can do better if it avoids attracting unprofitable customers. By being aware of the general characteristics of its former unprofitable customers, a business can market more selectively to its target customers. Consider the following quote:

I will know when our businesses have done a good job of market segmentation when they can tell me to whom we should not sell.<sup>40</sup>

— Dr. Charles Lillis, Former CEO of MediaOne

Understanding the differences between target and nontarget customers is an important aspect of customer relationship marketing.<sup>41</sup> A profile that identifies people who are not target customers is just as valuable as a profile that identifies people who are target customers. A customer-acquisition process that profiles unprofitable customers and helps the company avoid them will lower the total cost of attracting new customers and improve the business's customer retention rate. In contrast, unrestrained customer acquisition will attract many customers who will be neither loyal nor profitable, resulting in a negative rather than positive impact on profits due to the cost of customer acquisition with little offsetting income.

Customer Focus, Customer Performance, and Profit Impact

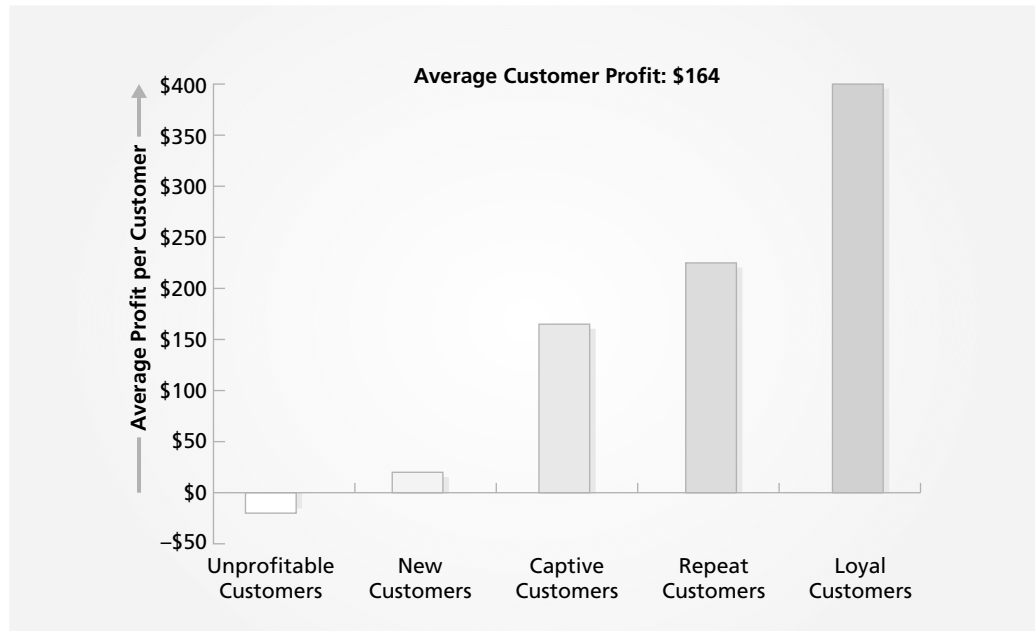
Every business loses customers at one time or another. Some were profitable customers whom the business would like to win back. Most of them were mismanaged customers who switched to a competitor due to dissatisfaction. But some were abandoned because they were unprofitable.

**Managing Customer Loyalty**

Managing customer interactions is a vital aspect of managing customer loyalty and profitability. Successful customer relationship marketing involves managing all customer relationships based on the customer’s level of loyalty and profit potential. An effective program starts by identifying the target customers a business can acquire and retain, and it includes strategies for managing new customers and abandoning

**FIGURE 17 CUSTOMER LOYALTY AND CUSTOMER PROFITABILITY**

Customer Classification	Loyalty Scores	Percent Customers	Customer Revenue	Percent Margin	Mktg. & Sales Exp. per Customer	Average Customer Profit
Loyal	70 to 100	20%	\$1,000	50%	\$100	\$400
Repeat	50 to 90	30%	\$750	40%	\$75	\$225
Captive	20 to 40	10%	\$600	40%	\$75	\$165
New	0 to 60	20%	\$400	30%	\$100	\$20
Unprofitable	0 to 40	20%	\$100	30%	\$50	-\$20
<b>Total/Average</b>		<b>100%</b>	<b>\$585</b>	<b>38%</b>	<b>\$80</b>	<b>\$164</b>



unprofitable ones. Each customer relationship has an impact on overall retention levels and profitability.

Customers who make referrals can have a higher customer lifetime value if we take into account the value of the new customers they bring to the company. Customers who refer others are special and should be rewarded for their efforts. For example, Scott Trade, an online brokerage, offers three complimentary trades valued at \$7 per trade to both referring and referred customers. Sprint Nextel offers a \$20 service credit for any customer referral and an additional \$10 service credit for referrals who become actual customers.

Figure 17 illustrates how to evaluate the profit impact of different levels of customer loyalty. The percentage of customers in each customer classification can vary, affecting profit. We can expect that managing the marketing and sales expenses per customer for different loyalty classifications will pay off in greater profitability. Each category of customers requires a different strategy for managing loyalty, with the goal of growing both the overall loyalty index and profitability of the business.

## ■ Summary

A business's effectiveness in developing market-based strategies that deliver high levels of customer satisfaction depends on the strength of its customer focus. A few years ago, many managers considered that statement to be a nice academic philosophy that nonetheless did not have any practical application for a company trying to improve its profits. Today, however, the evidence shows that businesses with a strong customer focus deliver higher levels of customer satisfaction and above-average profits. Developing a customer focus requires customer leadership, which is evident in senior management leadership, employee customer training, and customer involvement. Letting the voice of the customer be heard is also a necessary part of customer focus; it can be achieved by striving to understand the customer experience, encouraging customer complaints, and seeking to develop customer solutions, not just products. Customer metrics, such as customer satisfaction, customer retention, and customer loyalty, are key performance metrics that measure the success of a customer-focused organization.

The customer satisfaction metric has been shown to be related to profitability. A high overall customer satisfaction score is nice, but unbundling the score into different levels of customer satisfaction allows a business to better understand its overall average and the profit impact of different levels of customer satisfaction. This analysis allows a business to see the percentages of customers who are "dissatisfied" and "somewhat satisfied." Efforts to better understand customer dissatisfaction can be greatly enhanced when a business encourages dissatisfied customers to complain. Allowing them to share their complaints provides both an opportunity to understand causes of customer dissatisfaction and a way to retain customers who otherwise would be lost. Various social media platforms have provided new forums for customers to complain and an opportunity for companies to respond with efforts to repair damaged customer relationships.

Customer satisfaction affects customer retention. And higher levels of customer retention deliver higher customer profits—not only annual profits but future profits as well, due to a longer customer life. It is much more expensive to acquire a new customer

than to retain a current customer. Improving customer retention from 67 to 75 percent increases the customer life from 3 to 4 years. This adds one more year of sales and profits and spares the company the high acquisition cost of finding a new customer to replace each lost customer. In addition, customers generally buy more from a business the longer they stay with the business.

The ultimate goal of a customer-focused business is a high level of customer loyalty. A loyal customer has a long purchase history, an above-average purchase amount, a high desire to repurchase, and a strong product preference. A loyal customer would recommend the business's products to others. Loyal customers are highly profitable and have an above-average customer lifetime value. Repeat customers could have an above-average lifetime value and long customer history but are less committed to the business's product and less likely to recommend it to others. Nevertheless, they are very important to the business's profitability and need to be carefully managed with respect to customer retention. The goal is to move them to a higher level of customer loyalty.

Many businesses have captive customers but do not know it. These customers may have a long customer history and average or better lifetime value. But they are not happy and would switch to a different company if they could. As one might guess, they also share their frustrations with others and are more likely to advise others not to buy from the company.

New customers may be first-time customers or returning customers. A customer-focused business knows the customer history and purchase behavior of the returning customers and should manage them accordingly (i.e., differently from the first-time customers). Both types of new customers offer a business the opportunity to move them up in customer loyalty over time and improve profits with a higher customer profit and customer lifetime value.

Finally, some customers are unprofitable. What they need and are willing to pay does not match the business's offerings. These customers were expensive to acquire and are unlikely to ever be profitable. Another group of unprofitable customers are those chasing deals. They will never be loyal; they switch from one product offering to another, usually based on a lower price or a price promotion. The goal of a customer-focused business is to understand all levels of customer loyalty and develop the right customer marketing relationship program for type of customer in order to better manage the overall profitability of the business.

## ■ Market-Based Strategic Thinking

- 1 How would a business like Enterprise Rent-A-Car manage its customer focus using the customer-focus behaviors and practices presented in this chapter?
- 2 Why would a strong customer focus and high levels of customer satisfaction allow Southwest Airlines to be more profitable than other airlines?
- 3 Why would a very satisfied Apple Mac customer be more profitable than a somewhat satisfied Apple Mac customer?
- 4 Why would companies with high levels of customer satisfaction produce larger gains in their stock prices than the average S&P 500 company?
- 5 Lexus is known for high levels of customer satisfaction. How does this affect customer retention over time?
- 6 If Lexus has an average customer retention of 80 percent, how many purchases does the average customer make over their life as a Lexus customer?

- 7 If a new coffee company had above-average profits its first couple of years but intentions to repurchase (see Figure 9) were declining, with customer retention expected to fall from 67 to 50 percent, what would be the likely impact on future profits?
- 8 Why would extending the life of an online fashion retail customer from 4 to 5 years affect profits?
- 9 What makes an Apple customer loyal, and why are loyal customers more profitable than other customers?
- 10 How could a frequent-flyer airline customer become a captive customer? How do captive airline customers contribute to current and future company profits?
- 11 How would you manage a repeat McDonald's customer who had a below-average (low) purchase amount?
- 12 What could cause a business to attract unprofitable customers?
- 13 How could a repeat customer with a low lifetime value be more valuable than a repeat customer with a high lifetime value?
- 14 How should a first-time machine tool customer be managed differently from a returning customer?
- 15 For an industrial supply company, how could a returning new customer have a higher customer lifetime value than a first-time customer?

## Marketing Performance Tools and Application Exercises

The four interactive marketing performance tools and application exercises outlined here will add to your understanding of the ways customer performance affects profitability. To access them, go to [rogerjbest.com](http://rogerjbest.com). You can determine the answers to the questions listed for each marketing performance tool by entering data included in the questions. You can also enter other data to see the results, and you can save your work. Each marketing performance tool is based on the figure referenced in parentheses.

### 1.1 Customer Satisfaction and Profitability (Figure 6)

- A. How would average customer sales and average customer profit change for a business with 10 percent “very satisfied” customers, 35 percent “satisfied” customers, and 55 percent “somewhat satisfied” customers?

- B. How would the average customer sales and average customer profit change if this business was able to shift customer satisfaction to 35 percent “very satisfied,” 35 percent “satisfied,” and 30 percent “somewhat satisfied”?

### 1.2 Customer Retention (Figure 7)

- A. How would customer retention change if the percentage of all dissatisfied customers decreased to 15 percent and the percentage of all satisfied customers increased to 85 percent?
- B. Using the original data, how would customer retention change if the percentage of customers who complained increased from 10 to 50 percent?

### 1.3 Customer Lifetime Value (Figure 11)

- A. How would the lifetime value of the average customer change if the customer life was shortened from 5 to 4 years?

B. How would the lifetime value change if the customer life was extended from 5 to 6 years and in year 6 the net cash flow was \$60?

B. How would the average customer profit change with the following customer loyalty: 30 percent loyal, 35 percent repeat, 5 percent captive, 20 percent new, and 10 percent unprofitable?

#### 1.4 Customer Loyalty and Profitability (Figure 17)

A. How would the average customer profitability change with 25 percent loyal and 25 percent repeat customers?

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## Present Value Table

Period (N)	DR = 8%	DR = 9%	DR = 10%	DR = 11%	DR = 12%	DR = 13%	DR = 14%	DR = 15%
0	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000
1	0.926	0.917	0.909	0.901	0.893	0.885	0.887	0.870
2	0.857	0.842	0.826	0.812	0.797	0.783	0.769	0.756
3	0.794	0.772	0.751	0.731	0.712	0.693	0.675	0.658
4	0.735	0.708	0.683	0.659	0.636	0.613	0.592	0.572
5	0.681	0.650	0.621	0.593	0.567	0.543	0.519	0.497
6	0.630	0.596	0.564	0.535	0.507	0.480	0.456	0.432
7	0.583	0.547	0.513	0.482	0.452	0.425	0.400	0.376
8	0.540	0.502	0.467	0.434	0.404	0.376	0.351	0.327
9	0.500	0.460	0.424	0.391	0.361	0.333	0.308	0.284
10	0.463	0.422	0.386	0.352	0.322	0.295	0.270	0.247
11	0.429	0.388	0.350	0.317	0.287	0.261	0.237	0.215
12	0.397	0.356	0.319	0.286	0.257	0.231	0.208	0.187
13	0.368	0.326	0.290	0.258	0.229	0.204	0.182	0.163
14	0.340	0.299	0.263	0.232	0.205	0.181	0.160	0.141
15	0.315	0.275	0.239	0.209	0.183	0.160	0.140	0.123
16	0.292	0.252	0.218	0.188	0.163	0.141	0.123	0.107
17	0.270	0.231	0.198	0.170	0.146	0.125	0.108	0.093
18	0.250	0.212	0.180	0.153	0.130	0.111	0.095	0.081
19	0.232	0.194	0.164	0.138	0.116	0.098	0.083	0.070
20	0.215	0.178	0.149	0.124	0.104	0.087	0.073	0.061

$$\text{Present Value Formula: } PV = \frac{1}{(1 + DR)^N}$$

PV = Present Value of \$1.00

DR = Discount Rate (cost of borrowing or desired rate of return)

N = Number of periods before the \$1.00 will be received

**Example I:** N = 5 periods and the Discount Rate (DR) = 10%

$$PV = \frac{1}{(1 + 0.1)^5} = \frac{1}{1.611} = 0.621 \text{ (\$1.00 received in 5 years is worth \$0.621 today)}$$

**Example II:** N = 2.33 periods and the Discount Rate (DR) = 10%

$$PV = \frac{1}{(1 + 0.1)^{2.33}} = \frac{1}{1.249} = 0.801 \text{ (\$1.00 received in 2.33 years is worth \$0.801 today)}$$

# Marketing Metrics and Marketing Profitability

■ The reason for marketing's low level of credibility is largely its lack of disciplined financial-return measures to assess the value of its contribution to the enterprise.<sup>1</sup>

Marketing *metrics* measure marketing performance. Marketing *analytics* are the tools and data used to create marketing metrics. The system used to measure customer satisfaction is a marketing analytic. The overall customer satisfaction index is a marketing metric, as is the percentage of "very satisfied" customers.

Marketing metrics and marketing profitability are related to business unit and company profitability, as shown in the flowchart. It is essential for marketing and product managers to demonstrate their contributions to a company's profit. Measures of marketing profitability enable them to do so. These metrics have added importance in that they directly relate to business and company profit.



## MEASURING PERFORMANCE

BioTronics is a \$390 million business that manufactures high-tech specialty electronics equipment for the biotechnology industry. Three years ago, a new management team was put in place after the company delivered several years of disappointing performance. The new management team reorganized the business and designed programs to lower unit costs, control overhead expenses, and facilitate better management of assets. In addition, the new management team implemented an extensive sales training program that improved the productivity of the sales force from \$5 million to \$7.5 million per salesperson.

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## Marketing Metrics and Marketing Profitability

**FIGURE 1 BIOTRONICS' PERFORMANCE AND FINANCIAL METRICS**

BioTronics' Performance (millions)	Base Year	Year 1	Year 2	Year 3
Sales Revenues	\$254	\$293	\$337	\$390
Cost of Goods Sold	\$127	\$139	\$157	\$175
Gross Profit	\$127	\$154	\$180	\$215
Marketing & Sales Expenses	\$61	\$67	\$74	\$82
General & Administrative Expenses	\$20	\$23	\$27	\$31
Other Expenses	\$30	\$35	\$40	\$47
<b>Pre-Tax Profit</b>	<b>\$16</b>	<b>\$29</b>	<b>\$39</b>	<b>\$55</b>
<b>Financial Metrics</b>				
Pre-Tax Return on Sales	6.3%	9.9%	11.6%	14.1%
Sales-to-Assets Ratio	0.90	0.95	1.00	1.05
Pre-Tax Return on Assets	5.7%	9.4%	11.6%	14.8%

The results were sensational! In 3 years, the new management team increased sales by \$136 million and, more important, more than tripled net profit before taxes. As shown in Figure 1, BioTronics' return on sales grew from 6.3 to 14.1 percent, and its return on assets increased from 5.7 to 14.8 percent. On the basis of the information in the table,

- How would you rate BioTronics' performance over the 3-year period?
- Which aspects of BioTronics' performance were most impressive?
- Should BioTronics continue to follow the same strategy it used during this period?

Most of us would agree that BioTronics' performance over the 3-year period was outstanding. Who would not want to run a business with that level of profitable growth? Yet, despite the impressive increases in sales and profits, we could be making a mistake by judging BioTronics' performance solely on *financial* measures of performance. Sales revenues, net profit, return on sales, assets as a percentage of sales, and return on assets are certainly reliable measures of internal financial performance, but they do not provide an *external* or *market-based* view of performance. From the financial measures alone, we cannot tell how BioTronics performed relative to the external benchmarks of market growth, competitive pricing, relative product and service quality, and ability to satisfy and retain customers. The strategy that BioTronics used during the 3-year period may or may not have been the best way to achieve profitable growth, and continuing to follow that strategy may or may not achieve the best possible results in the future.

In actuality, as remarkable as the company's growth seems, BioTronics should have had \$41 million in additional profits over the 3 years, profits that, in effect, the corporation and its shareholders lost. This information becomes apparent when marketing performance metrics are added to the company scorecard. Had BioTronics used these marketing performance metrics to help guide its strategic thinking, rather than relying on financial metrics alone, the company would have realized it was losing share in a rapidly growing market.

## Marketing Metrics and Marketing Profitability

**FIGURE 2 BIOTRONICS' MARKETING METRICS**

Marketing Metrics	Base Year	Year 1	Year 2	Year 3
<b>Market Metrics</b>				
Market Growth (% dollars)	20.5%	22.5%	21.4%	21.3%
BioTronics' Sales Growth	15.3%	15.4%	15.0%	15.7%
Market Share	10.0%	9.4%	8.9%	8.5%
<b>Competitiveness Metrics</b>				
Product Performance	19	17	15	11
Service Quality	0	-3	-7	-9
Customer Value	28	25	16	8
<b>Customer Metrics</b>				
Customer Satisfaction Index	78	73	68	64
Customer Retention	77%	75%	69%	65%
Customer Lifetime Value	\$103.0	\$96.0	\$67.0	\$45.0

### Applying Marketing Metrics

To complement its internal financial performance metrics, a business needs a parallel set of external marketing metrics to track its market-based performance.<sup>2</sup> Although these external measures of performance may lack some of the elegance associated with financial accounting, they provide a more strategic view of a business's performance.

Figure 2 includes a set of marketing performance metrics that paint a much different picture of BioTronics' performance than the one portrayed by the financial measures in Figure 1. These marketing metrics provide three significant insights.<sup>3</sup> First, although the corporation's sales showed impressive growth, the rate of growth did not match the overall rate for the rapidly expanding biotechnology market, as shown in Figure 3. During this period, then, BioTronics was losing market share. In all, the company's market share fell from 10 to 8.5 percent. The decline went undetected because BioTronics did not track external market metrics, such as market demand, market growth, and market share.<sup>4</sup>

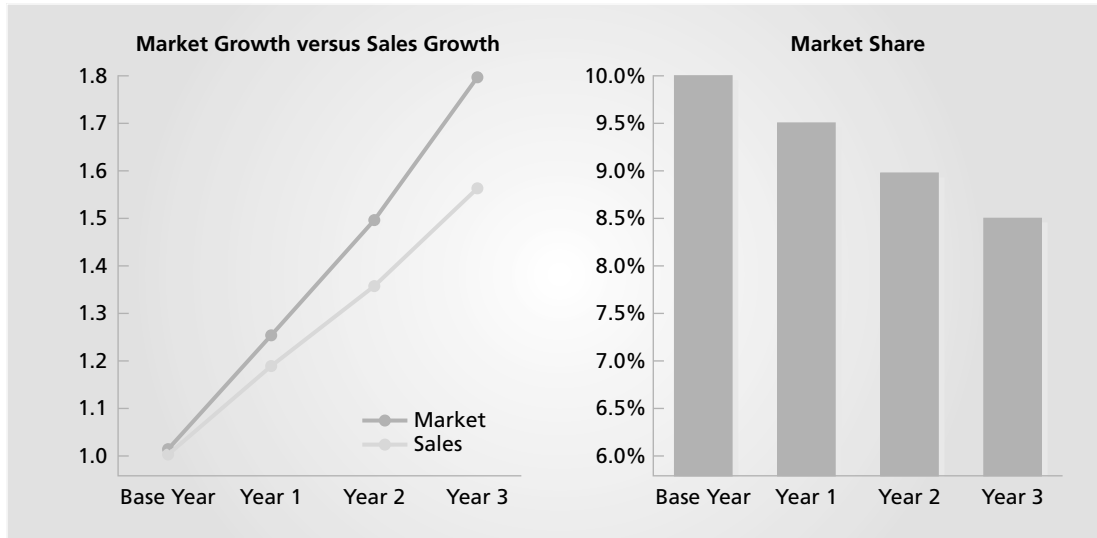
Second, product and service performance each diminished *relative to competition*. These declines do not necessarily mean that BioTronics' product and service quality diminished. Competitors may have simply moved ahead in delivering superior product and service performance. The competition's more rapid progress caused BioTronics to lose ground in these two areas *relative to its competitors*, leading to a reduction in customer value.

Third, customer satisfaction declined, probably due in part to the diminished product and service quality, resulting in a decrease in the customer retention rate and average customer lifetime value.

Instead of the highly favorable impression that the financial metrics presented, we now have a much different assessment of BioTronics' 3-year performance. The corporation's performance was marked by increased profits, true, but also by customer defection, a decline in market share, and a greatly diminished customer value. From the financial metrics, BioTronics' management and shareholders know they performed

## Marketing Metrics and Marketing Profitability

FIGURE 3 MARKET METRICS PROVIDE AN EXTERNAL VIEW OF PERFORMANCE



well, but, without the marketing metrics, they don't know how much they really lost and will continue to lose.

### A Marketing-Metrics-Based Strategy

What would have been the impact of a BioTronics strategy to hold market share? To hold its base-year 10 percent share in the growing biotechnology market, the corporation should have invested more heavily in marketing, sales, and product development to keep pace with market demand and competitors. Had BioTronics adequately invested in marketing, sales, and R&D to maintain its 10 percent market share, it would have had a good chance of achieving the results in Figure 4.

A market-based strategy to hold share would have resulted in an increase in pre-tax return on sales (17%) and delivered approximately the same return on assets as the internally driven strategy, and it would have produced an additional \$41 million in net profit (before taxes). This is \$41 million that the corporation essentially gave up in bottom-line pre-tax profit. Furthermore, BioTronics' "lost" pre-tax profits will be greater over the next 3-year period even if halts the erosion of its market share, and even if market growth completely subsides. If BioTronics' market share continues to erode and the biotech market continues to grow, the "lost profits" over the next 3 years could easily amount to \$100 million.

The BioTronics story underscores the importance of marketing performance metrics. They are the foundation of market-based management. The financial systems of most businesses are set up to track revenues, costs, factory overhead, accounts receivable, operating expenses, and profits, but they usually overlook the fact that a business's customers are its most important asset and the only significant source of positive cash flow. Not attracting new customers during a period of market growth simply means a business will have to work harder and spend more to regain its previous market share. It will need a sizeable expenditure to attract a large number of new customers.