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Customer Churn: The Stealth Enemy

Thought Leadership Monograph

By
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If not managed properly, customer churn will ruin a company and may have a severe adverse impact on the industry and the economy as a whole.

The Coming of Age of Customer-Centric Business Strategies

The subject of customer retention, loyalty, and churn is receiving much-needed attention in many industries. This is evident from the number of "customer intimacy" initiatives that are either under way or being considered in a variety of companies. Top-level decision makers are making substantial investments in developing business strategies, plans, programs and infrastructure to address the “needs” and “preferences” of customers, as opposed to deciding for them what they want and cajoling or coercing them into making purchase decisions accordingly. One manifestation of this change is the ushering in of “relationship marketing,” where individual customers (or small groups) are dealt with differentially and the objective is to build a lasting relationship with them. This is very different from the old paradigm of “transaction marketing,” where the focus is predominantly on making the current sale.

This shift in business thinking has been necessitated in no small measure by the commoditization of offerings and the intensification of competition in many industries, rendering ownership of the customer relationship the most critical business success factor. Current examples of these types of market dynamics exist in long distance telecommunications as well as the credit card, retail banking, insurance, and food and beverage industries. Arenas where this phenomenon is emerging rapidly include local telephone service, cellular phone service, cable TV, information services, and health care.

This customer-centric realization on the part of key decision makers is definitely a move in the right direction. Anecdotal data from several industries indicate the importance that business decision makers now place on customer retention and churn. For example, executives in the food and beverage industry estimate that an improvement in customer retention of 5% can result in a 25-85% improvement in profits; and in long distance telephone service, it is held that the cost of reclaiming customers is two to five times higher than that of retaining them. Customer churn, loosely defined as the percentage of existing customers lost in a relevant time period, is now recognized as a major business concern; it continues unabated even though investment in customer retention activities continues to rise. An increase in customer churn eats into the earnings of providers and has a domino effect on the industry. In fact, if not managed properly, customer churn can ruin a company and adversely impact both the industry and the economy as a whole.

The Prevailing Lack of Clarity Regarding Linkages Among Customer Satisfaction, Loyalty, and Retention

Initiatives and actions taken to date in various industries have produced less than satisfactory results in managing churn. The most critical reason for this failure is that the prescriptions for dealing with churn are based principally on customer satisfaction measures. Inherent in these prescriptions is the flawed assumption that satisfaction

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measures are good indicators of customers' propensity to stick with or switch from their current provider.

In fact, recently conducted studies on the switching actions of long distance telephone service subscribers indicate that many satisfied customers (*those who rate satisfaction with their current carrier as high to very high*) switch to other providers, whereas many dissatisfied customers (*those who rate satisfaction with their current carrier as low to very low*) stick with their current provider. Such evidence suggests that customer satisfaction beyond a basic threshold level is neither necessary nor sufficient for retention.

Furthermore, the situation is not alleviated by the position propounded by some that the critical factor undermining customer loyalty is the "gulf between satisfied customers and completely satisfied customers." The crux of this view is that the most effective way to manage customer churn for any provider is to achieve "complete satisfaction" for their customers. There are two drawbacks to this approach.

The first centers on the prevailing lack of clarity between the terms loyalty and retention. In a recent survey of business executives it was found that these two terms are used synonymously. However, to be able to gain useful insight into switching conduct of customers, it is essential to establish the distinction between the two. Loyalty has to be defined as an internal intensity of customers towards sticking with or switching from their current supplier—an inherent value. Loyalty cannot be bought. Retention is the outcome or the event that customers are retained or stays with their current provider. Retention can be bought with the appropriate incentives or stimuli. Retention occurs due to the combined effect of two forces: the internal loyalty intensity of a customer and the external incentives or stimuli that they are subjected to in the form of product attributes, pecuniary switching costs, price, advertising, communications, and customer care.

Loyalty is internal to the customer; it can only be changed by a shift in the customer's own value system. However, the provider can manipulate retention through the application of incentives or stimuli.

When reference is made to "increasing the loyalty" of a customer, what is actually meant is that the retentiveness of the customer is increased. Loyalty is internal to the customer; it can only be changed by a shift in the customer's own value system. Retention, however, can be manipulated by the provider through the application of incentives or stimuli. This bifurcation of internal versus external factors is discussed in detail below, since it forms the foundation for the new approach to customer acquisition, retention, and churn forwarded in this paper.

The second drawback, absolutely critical to business decision-making, is the fact that the "complete satisfaction" approach ignores the inefficacy of the underlying economics of achieving completely satisfied customers. Although completely satisfying customers is an admirable goal, it is not investment-justified in the case of every customer and could even bankrupt the provider, which is not desirable for anyone. Instead, a mutually beneficial "win-win" relationship between provider and customer has to be achieved that takes into account, in addition to the traditional revenue and cost measures, the differential cost of acquiring and retaining each customer (or group) on the basis of their internal loyalty intensity.

An Effective Solution to Churn: Strategic Customer Worth Management

In light of the discussion above, it follows that the key characteristics of effective customer acquisition-retention programs must include (1) taking into consideration the inherent loyalty intensity of customers, (2) ranking desirability of customers based on a combination of their spending patterns and their loyalty intensity, and (3) offering differentiated and economically optimal solutions to the various customer segments thus created. This approach leads to maximum return on investment in customer acquisition and retention, and stretches marketing and customer care budgets the farthest.

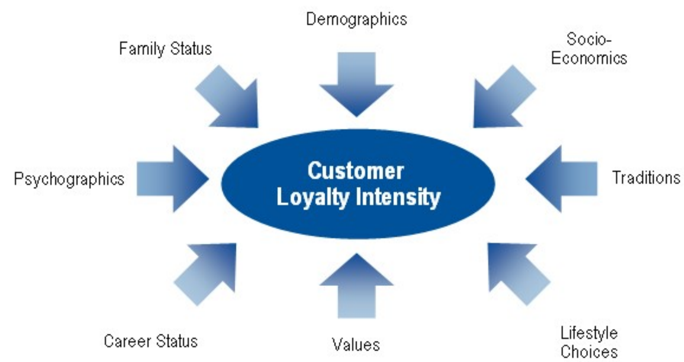
These essential ingredients form the foundation for the paradigm presented here under the rubric of Strategic Customer Worth Management (SCWM) which can be described as a comprehensive framework and infrastructure for optimally managing the most critical asset of a business—the customers. SCWM utilizes an explicit methodology that accounts for the acquisition and/or retention costs of each customer, and is implemented in the form of a dynamic business decision and execution system which "learns" and "gets better and better" over time.

Internal Loyalty Intensity-Based Customer Segmentation: A Breakthrough

A breakthrough dimension of the conceptual framework of Strategic Customer Worth Management is the dynamic segmentation of customers on the basis of their inherent loyalty intensity. Loyalty, as defined here, does not connote desirable versus undesirable behavior; it simply indicates the internal intensity of customers towards switching from their current provider. This intensity, ranging from "loyalist" to "habitual switcher," can be attributed to customers' internal "makeup," which can be captured in a composite profile defined by certain attributes. In the case of consumers these attributes belong to socioeconomic, demographic, values, tradition, lifestyle and related categories, as depicted in Figure 1.

FIGURE 1

INTERNAL ATTRIBUTES DETERMINING LOYALTY ORIENTATION FOR CONSUMERS



Note: The attributes listed above represent broad categories. In determining the robust and predictive attributes for different industries, more than 100 variables are considered.

For businesses, the relevant attribute categories are size, industry, history, culture, management structure and location. These are depicted in Figure 2.

FIGURE 2

INTERNAL ATTRIBUTES DETERMINING LOYALTY INTENSITY FOR BUSINESSES

Note: The attributes listed above represent broad categories. In determining the robust and predictive attributes for different industries, more than 100 variables are considered.

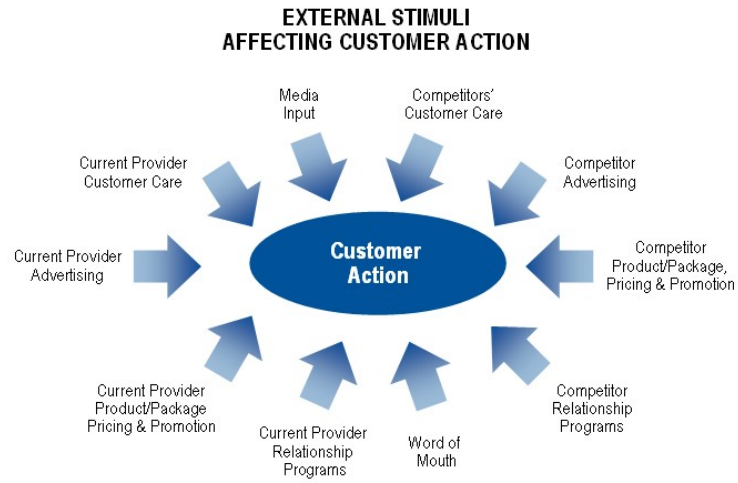
The internal loyalty intensity is also a representation of an individual's propensity to change from status quo given their internal assessment of non-pecuniary switching

costs—comfort-related and psychological. For example, customers may be “loyal” to their current provider (i.e., not switch) simply because they are “too lazy,” which means their comfort-related switching cost is high. Similarly, others may not switch because of the high psychological costs or risks they associate with dealing with an unknown entity. Whatever the source of their action or inaction may be it is sufficient to say that each customer has a different inherent orientation towards switching from their current situation.
Methodological details of the segmentation exercises will not be discussed here. However, it should be noted that segmentation models based on multivariate statistical techniques (e.g., multiple discriminant analysis) as well as neural models have produced robust and intuitively acceptable results. Necessary data were compiled from survey sampling, established consumer databases, and internal (company) data sources. (Description and summary-level results of a loyalty intensity-based segmentation study are contained in an article by this author, referenced at the end of this monograph.)
The situation described above is rooted in the fundamentals of human behavior. Every person or business (whose decision makers are people) has a certain inherent propensity to “stick” to, or “switch” from the *status quo*. The magnitude of this propensity depends on the profile of that person or business, which is a composite representation of the individual’s or business' internal attributes. Phrased another way, based on their internal orientation, people have different attitudes towards change. For example, some people like variety while others place a high value on stability, defined in this context as staying with the current situation.

It is necessary to mention two important corollaries to the above. One is that the individual’s attitude towards change need not apply uniformly over all facets of their life; it is entirely possible for a person to seek variety and stability in varying degrees in different aspects of his or her life. This means that a consumer can, for example, have a "loyalist" intensity for toothpaste and a “switcher” intensity for household appliances. Similarly, businesses also have different loyalty intensities, depending on the item.

The other corollary is that the internal intensity, although generally constant in the short term, may change over time due to life experiences for consumers and market experiences for businesses, particularly catastrophic ones. For these reasons it is essential to perform the customer segmentation on a dynamic basis as frequently as is economically justifiable. Given the inherent loyalty intensity of customers, their actions however, can be influenced through external stimuli or incentives, such as product attributes, price, pecuniary costs of switching, communications, and relationship management including customer care. And, while the internal loyalty intensity of customers cannot be impacted, external stimuli are within the locus of control of the provider. These are the instruments, which the provider can manipulate to achieve the desired action from the customer. Figure 3 depicts how various external stimuli impact customer action.

FIGURE 3



Note: The stimuli listed above represent broad categories. To determine the specific ones affecting individual customer action, dozens of stimuli are tested.

The Economics of Customer Acquisition and Retention

A critical fact that should be kept in mind is that, although, it may be possible to acquire or retain any customer, it is not economically desirable to do so for every customer. Determination of the desirability of customers should take into account, in addition to the traditional revenue and cost measures, the explicit costs of acquiring or retaining them, which vary with their loyalty intensity.

In fact, the cost of retention of customers is inversely related to their inherent loyalty intensity (i.e., the higher the loyalty intensity, the lower the retention costs, and vice versa). By the same token, acquisition costs are positively correlated to loyalty intensity: it costs more to acquire a customer whose tendency is to stick with its current provider than one with a greater propensity to switch. Acquisition and retention costs include the carefully attributed costs associated with advertising, other communications, and promotions and incentives in the form of price discounts, cash and/or other goods and services, frequent-user and affinity programs, and customer contact.

Desirability ranking of customers must take into account, in addition to traditional revenue and cost measures, the explicit costs of acquiring or retaining them, which vary with their internal loyalty intensity.

To determine the desirability ranking of a customer, the loyalty intensity measure must be combined with the lifetime value of the customer. Lifetime value is defined as the discounted value of the revenues expected from the customer over the planning period. A loyalty coefficient is assigned to each member of a loyalty segment, which represents a certain level of direct and indirect costs associated with acquisition or retention, as the case may be. This value of the retention or acquisition costs is subtracted from the lifetime value to determine the true worth of a customer.

Various “loyalty score” measures exist today which are applied by some companies to usage-based customer segments to account for the loyalty factor. These scores have not been very effective in managing churn. The loyalty coefficient discussed here is different from the existing loyalty scores in many ways. An important difference is that, although these existing measures are called loyalty scores, they are actually various measures of retentivity, e.g., they are based on past switching actions or stated switching intentions of a customer. The loyalty coefficient is derived from the profiling of customers on their loyalty intensity, defined as propensity to switch, based solely on their internal attributes. In other words, existing loyalty scores are based on events that represent the combined effects of internal intensity and external stimuli, while the loyalty coefficient measures only the internal intensity of customers towards change. The loyalty coefficient establishes direct causal linkages between switching activities and customer profile, whereas loyalty score measures make no distinction between internal attributes and external stimuli, and therefore, are not effective predictive measures since they are not indicative of whether a customer switched because of a high propensity to switch or because the customer was subjected to compelling stimuli. The true worth of a customer is highest when both loyalty coefficient and lifetime value are highest, and decreases as either measure decreases. Algorithms, whether continuous or step functions, are constructed to capture the true worth of customers. These true worth curves then form the basis for optimal acquisition and retention models. A simple example illustrates the power of the true worth approach.

Consider the case of customers A and B. Customer A has a lifetime value of $1,000 and a low loyalty coefficient, which translate to direct retention costs of $900. Customer B has lifetime value of $300 and a high loyalty coefficient with associated retention costs of $100. From a retention perspective, who is the more desirable customer? True worth of Customer A is $100, whereas true worth of Customer B is $200. The answer, therefore, is Customer B. This answer is opposite from the one we would get under prevailing practices where Customer A, with a much higher lifetime value, would be deemed the more desirable customer. By not attributing customer (or group) specific retention costs appropriately, customers (or groups) are assigned incorrect values leading to ineffective and inefficient investment in retention activities. In the case of acquisition, the principle is the same, simply the acquisition cost figures are different than those associated with retention. In either case, applying the true worth approach of SCWM ensures the maximization of return on investment in customer acquisition and retention activities.

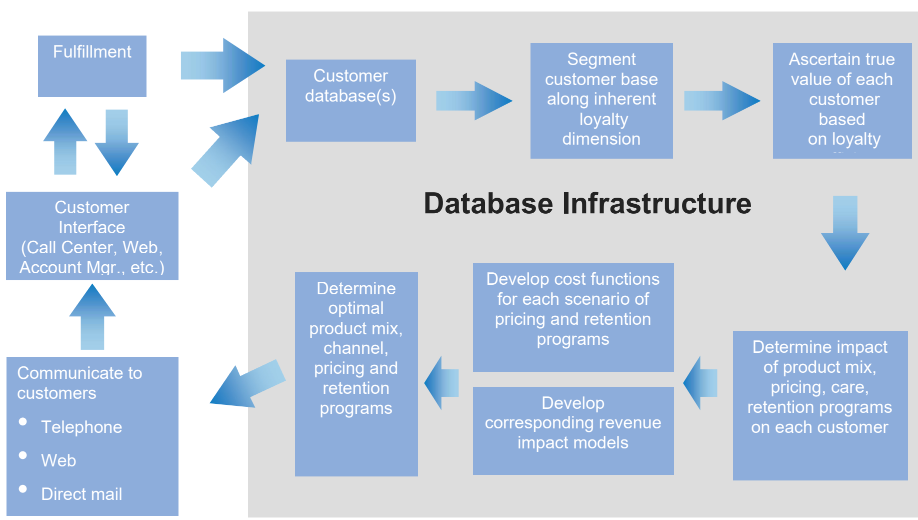
Procedurally, three true worth models are constructed: the first, for decisions regarding retention of existing customers; the second, for the acquisition of customers currently served by other providers; and the third, for the acquisition of potential customers currently unattached to any provider. The economic principle of “marginal revenue equals marginal cost” determines the cutoff point for the last customer to be retained or acquired from the continuum of customers from all three pools.

Harmonization of Loyalty-Based Customer Segmentation With Existing Ones

Another issue that needs to be addressed is whether segmentation based on loyalty intensity is the only segmentation that should be performed, to the exclusion of all other approaches, e.g., usage based. The answer is, absolutely not! In fact, loyalty-based segmentation supplements other segmentation schemes by explicitly incorporating an important predictive factor of relevant human behavior, resulting in increased accuracy and precision. As discussed above, loyalty-based segmentation adds breakthrough economic value to the overall results. Such incremental value makes the difference between winning and losing in a competitive environment. One word of caution: In adding another layer of segmentation to the existing ones, it is important to ensure that the number of segments does not proliferate to the point of becoming unmanageable and uneconomical.

Blueprint for Action

In the highly competitive environment of most industries, the battles over the ownership of the customer will soon escalate into full-scale war. Winners and losers will be determined by the effectiveness and timeliness of the business strategies of players geared towards the acquisition, retention, and churn of customers. Market evidence points out the less than satisfactory effects of current initiatives in managing this critical business front. Strategic Customer Worth Management breaks away from the current vicious cycle by offering a comprehensive solution. Figure 4 below illustrates the essential components of SCWM and can serve as an implementation blueprint.



SCWM is founded on a conceptual framework that includes a unique value-added dimension to customer segmentation—inherent loyalty intensity. Furthermore, SCWM encompasses the development and execution of marketing and relationship management programs tailored to specific customer segments, along with economic/financial models that optimize customer relationship investment decisions, supported by an infrastructure complete with database capabilities, multiple customer interfaces and fulfillment facilities that enable it to deliver value on a dynamic basis.

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