MEASURING
CUSTOMER LIFETIME VALUE

By: **Robin Foster,** *Practice Leader for ROI Analysis, Avaya*

The next question, having understood the importance of customer lifetime value (CLV) to an organization, involves what to measure and how to calculate CLV within the business. CLV spans the entire organization from its strategic objectives and goals to daily operations and enablers. As such, everyone plays a role in influencing the customer experience and CLV.

Measuring Customer Profitability

Let's simplify the CLV equation by focusing on two of its core components: margin on customer revenue and customer cost, which determine overall customer profitability.

Both the revenue and cost components have strategic objectives related to CLV. They also have key performance indicators (KPIs) that can be measured across business, operations, and technology.

- **Customer revenue.** The strategic objectives we consider in the subject of revenue are retention, loyalty, and advocacy. With retention comes a sustained relationship during which time transactions can deliver revenue. Loyalty is considered because customers display different behaviors in terms of the frequency of purchases, the product mix they buy, and the discounts and coupons they use— all of which can affect margin. A customer's advocacy can shape the choices and actions ➲

Figure 2.4: Customer Retention Provides Efficiency Advantage

	Company A	Company B
Current year's revenue	$ 20,000,000	$ 20,000,000
Revenue lost due to customer churn	$ (4,000,000)	$ (3,600,000)
Revenue gained through market growth	$ 800,000	$ 800,000
Next year's revenue target	$ 22,400,000	$ 22,400,000
New sales needed to reach next year's revenue target	**$ 5,600,000**	**$ 5,200,000**
Efficiency advantage of Company B relative to new sales		**7%**

Source: Avaya internal research.

of others, for better or worse. How do you measure these elements? From a strategic standpoint, retention rates, average support costs, margin per sale, Net Promoter Scores®, and referral rates can all be measured. These strategic KPIs are calculated using operational and technology data. For example, operational KPIs for retention rates could include first contact resolution and Customer Effort Score (Dixon, Freeman & Toman, 2010). Technology KPIs related to revenue could include application and infrastructure uptime and availability, IT cost-to-revenue ratio, and IT investment over business growth.

- **Customer cost.** Strategic objectives we consider here are acquisition costs and support costs. Strategic and operational KPIs could include frequency of customer service interactions, the mix of self-service versus agent-assisted interactions, average handle time, transfer rates, cost per campaign, and cost per acquisition. Technology KPIs related to cost could include employee productivity, technology and maintenance cost, and IT cost per employee.

While the CLV framework looks simple on paper, companies struggle with it every day. It is essential to understand the business, operational, and technology drivers that affect CLV. By breaking the CLV equation down into revenue and cost components, it becomes easier to identify what impacts them. For example:

- **What impacts customer revenue?** A variety of factors influence revenue, including average order value, campaign success rates, retention rates, and referral rates.

- **What impacts product gross margin?** Clearly, some customers are driven by discounts and coupons, while others do not need these lures to purchase higher-end goods with higher margins.

- **What impacts acquisition costs?** Marketing campaign costs, lead purchasing costs, and the costs of sales collateral, promotions, closure rates, and other sales and marketing activities can affect the cost per lead and cost per acquisition.

- **What impacts support costs?** Contact handle times and the number of contacts a customer makes, the mix of self-service versus agent-assisted interactions, technology (or lack thereof), product quality, employee turnover, and other factors can affect support costs.

Figure 2.5: Net Profitability per Customer

(Where acquisition costs = $50 and annual profit = $50)
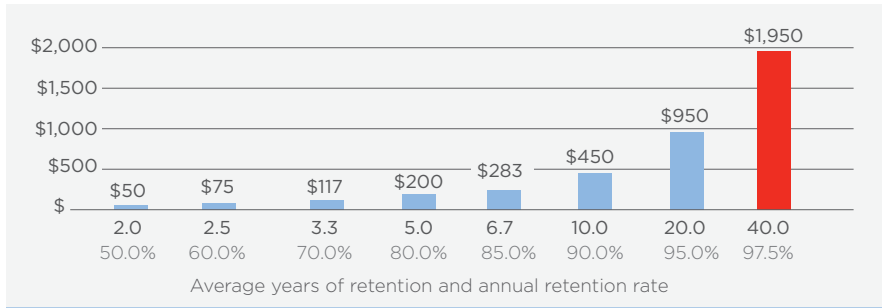
Source: Avaya internal research.

Not only can each of these factors be measured and quantified, they can be tweaked to increase revenue, reduce costs, and ultimately increase customer profitability. When combined with the final factor of the CLV equation (average length of the customer relationship), the result is CLV.

Customer Retention Drives Revenue

Let's focus on the impact that customer retention has on revenue, because something very significant happens as annual customer retention increases: Revenue increases significantly, too.

Better retention rates give organizations an efficiency advantage. Consider the example of two businesses with identical annual revenue of $20 million. (See Figure 2.4.) If the market were growing by 4 percent per year, each of these businesses could expect to gain about $800,000 per year in sales. However, each firm wants to grow at three times the market rate, which means each firm has a growth target of 12 percent in revenue, or $2.4 million in incremental revenue. Next year, each firm wants to report annual revenue of $22.4 million.

The difference between these firms is customer retention. Company A has an annual customer retention rate of 80 percent, while Company B has an annual customer retention rate of 82 percent. Company A should expect 20 percent of its customers to disappear, taking their revenue with them. Company B should expect loss as well, but only anticipates that 18 percent of their customers will disappear. Company B needs to generate 7 percent fewer dollars in new sales revenue ($5.2 million instead of $5.6 million) to reach the same target of $22.4 million in annual revenue. The company with higher retention loses fewer customers—and so it needs to find fewer new customers to meet its revenue target for the next year.

The impact of retention on an organization's profitability is clearly highlighted in Figure 2.5.

Imagine that it costs $50 to acquire a customer and that the annual profit per customer after all other costs is $50. Acquisition costs wipe out the first year's profit, which is not an unusual situation.

Average CLV at various rates of customer retention ranges from 50 percent to 97.5 percent. At 50 percent retention there is a two-year relationship, so total lifetime profitability is two years multiplied by $50 profits from sales minus the $50 customer acquisition costs, resulting in a CLV of just $50.

An increase from 50 percent to 60 percent retention gives us $25 ⟳

more lifetime profitability, which is a 50 percent bump in profitability over the customer relationship. The shift from 70 percent to 80 percent retention means an increase from 3.3 years to five years. This is a 51 percent increase in years, but it results in a change in CLV from $117 to $200—an additional $83, which is a spectacular 71 percent increase in CLV. Look at the CLV figures for 80 percent and 90 percent retention: Lifetime value rises by 125 percent for a company that can make that jump. In other words, small increases in customer retention rates lead to huge boosts in your overall customer lifetime profits.

In summary, increasing annual customer retention significantly increases revenue.
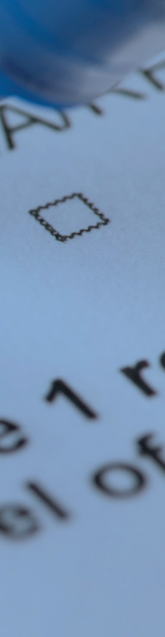
- **Revenue growth** favors those with higher customer retention.
- **Higher customer retention** means fewer lost customers and less lost revenue.
- **Fewer sales** to new customers are needed to reach next year's revenue target.
- **Higher retention rates** increase overall customer value.

Internal Impacts on CLV

The daily actions of virtually every employee—from the top down—affect customer experiences, which in turn affect CLV. A manager responsible for delivering on any one of these business, operational, or technology drivers (such as improving staff attrition or ensuring uptime and availability) must be able to understand how his or her actions affect CLV and, at a higher level, company profitability. At the same time, those that interact with customers—from contact center agents and technical support personnel to delivery drivers, retail clerks, sales professionals, and others—must also understand their roles in improving the customer experience and how that relates to the company's health.

CLV Requires Change

The CLV framework is not just about being friendly and helpful; it is all about the long-term financial performance and bottom-line growth of the company. By breaking the CLV equation into its revenue and cost components and their KPIs, it becomes possible to set benchmarks and

While a framework for customer lifetime value looks simple on paper, companies struggle with it every day.

strategic business, operational, and technology goals.

The metrics used to measure the quality of a customer interaction must change as well. Where call duration and number of calls per hour were once standard indicators of agent performance, the complexities involved with delivering a positive customer experience require different metrics. For example, in the past, most customer interactions involved basic requests, such as looking up account balances or the status of a shipment, that didn't require a great deal of time from the agent. Thus, call duration reports were a reliable indicator of efficiency. Agents are now responsible for the quality of the interaction and are tasked with more complex interactions such as helping customers fill out loan applications or insurance claims forms. They may also be required to identify opportunities to cross-sell products and services. Average handle time is no longer a valid measurement; customer surveys, Net Promoter Scores®, revenue conversion, and other metrics are better choices for measuring performance.

Improving the lifetime value of a customer is essential for the long-term financial performance of organizations today. Customer experience management and the CLV framework work together to nurture customers throughout their journeys by reducing acquisition and support costs and fostering growth and revenue through improvements in retention, loyalty, and advocacy. [A]

Robin Foster is the Practice Leader for ROI Analysis at Avaya, supporting customers worldwide, and is a former Member of Technical Staff at Bell Laboratories. She holds 27 U.S. and numerous foreign patents, many for predictive and adaptive resource strategies in the contact center.