
PART I

Principles of Managing Customer Relationships

The *Learning Relationship* works like this: If you're my customer and I get you to talk to me, and I remember what you tell me, then I get smarter and smarter about you. I know something about you my competitors don't know. So I can do things for you my competitors can't do, because they don't know you as well as I do. Before long, you can get something from me you can't get anywhere else, for any price. At the very least, you'd have to start all over somewhere else, but starting over is more costly than staying with me, so long as you like me and trust me to look out for your best interests.

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CHAPTER 1

Evolution of Relationships with Customers

No company can succeed without customers. If you don't have customers, you don't have a business. You have a hobby.

—Don Peppers and Martha Rogers

By definition, customers are every company's source of revenue. No company will ever realize income from any other entity except the customers it has now and the customers it will have in the future. Thus in many ways a firm's most valuable financial asset is its customer base, and, given our new and unfolding technological capabilities to *recognize*, measure, and manage relationships with each of those customers individually, a forward-thinking firm must focus on deliberately preserving and increasing the value of that customer base. Customer strategy is not a fleeting assignment for the marketing department; rather it is an ongoing business imperative that requires the involvement of the entire enterprise. Organizations must manage their customer relationships effectively in order to remain competitive. Technological advancements have enabled firms to manage customer relationships more efficiently, but technology has also empowered customers to inform themselves and to demand much more from the companies they do business with. The goal of this book is not just to acquaint the reader with the techniques of **customer relationship management**. The more ambitious goal of this book is to help the reader understand the essence of customer strategy and how to apply it to the task of managing a successful enterprise in the twenty-first century.

The dynamics of the customer-enterprise relationship have changed dramatically over time. Customers have always been at the heart of an enterprise's long-term growth strategies, marketing and sales efforts, product development, labor and resource allocation, and overall profitability directives. Historically, enterprises have encouraged the active participation of a sampling of customers in the research and development of their products and services. But until recently, enterprises have been structured and managed around the products and services they create and

sell. Driven by assembly-line technology, mass media, and mass distribution, which appeared at the beginning of the twentieth century, the Industrial Age was dominated by businesses that sought to mass-produce products and to gain a competitive advantage by manufacturing a product that was perceived by most customers as better than its closest competitor. Product innovation, therefore, was the important key to business success. To increase its overall market share, the twentieth-century enterprise would use mass marketing and mass advertising to reach the greatest number of potential customers.

As a result, most twentieth-century products and services eventually became highly commoditized. Branding emerged to offset this perception of being like all the other competitors; in fact, branding from its beginning was, in a way, an expensive substitute for relationships companies could not have with their newly blossomed masses of customers. Facilitated by lots and lots of mass-media advertising, brands have helped add value through familiarity, image, and trust. Historically, brands have played a critical role in helping customers distinguish what they deem to be the best products and services. A primary enterprise goal has been to improve brand awareness of products and services and to increase brand preference and brand loyalty among consumers. For many consumers, a brand name testifies to the trustworthiness or quality of a product or service. But brand reputation has become less important among shoppers.¹ Indeed, consumers are often content as long as they can buy one brand of a consumer-packaged good that they know and respect. Whether shopping in a store, online, or from a catalog, consumers are just as satisfied when a retailer carries a trusted store brand or a trusted manufacturer's brand.²

For many years, enterprises depended on gaining the competitive advantage from the best brands. Brands have been untouchable, immutable, and inflexible parts of the twentieth-century mass-marketing era. But in the **interactive era** of the twenty-first century, firms are instead strategizing how to gain sustainable competitive advantage from the *information* they gather about customers.

As a result, enterprises are creating a *two-way brand*, one that thrives on customer information and interaction. The two-way brand, or *branded relationship*, transforms itself based on the ongoing dialogue between the enterprise and the customer. The branded relationship is "aware" of the customer (giving new meaning to the

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¹Peppers and Rogers Group and Institute for the Future, "Forecasting the Consumer Direct Channel: Business Models for Success" (2000), p. 48. This fact is also particularly true for emerging global markets. See Masaaki Kotabe's chapter, "Emerging Markets," in *Marketing in the 21st Century: New World Marketing*, ed. Bruce David Keillor (Westport, CT: Praeger, 2007).

²Todd Hale, "Think All Store Brand Buyers Are the Same? Think Again!" (NielsenWire, May 5, 2009), accessed January 25, 2010, available at: <http://blog.nielsen.com/nielsenwire/consumer/think-all-store-brand-buyers-are-the-same-think-again/>.

term *brand awareness*) and constantly changes to suit the needs of that particular individual.

Roots of Customer Relationship Management

Once you strip away all the activities that keep everybody busy every day, the goal of every enterprise is simply to get, keep, and grow customers. This is true for non-profits (where the “customers” may be donors or volunteers) as well as for-profits, for small businesses as well as large, for public as well as private enterprises. It is true for hospitals, governments, universities, and other institutions as well. What does it mean for an enterprise to focus on its customers as the key to competitive advantage? Obviously, it does *not* mean giving up whatever product edge or operational efficiencies might have provided an advantage in the past. It does mean using new strategies, nearly always requiring new technologies, to focus on growing the value of the company by deliberately and strategically growing the **value of the customer base**.

What does it mean for an enterprise to focus on its customers as the key to competitive advantage? It means creating new shareholder value by deliberately preserving and growing the value of the customer base.

To some executives, customer relationship management (CRM) is a technology or software solution that helps track data and information about customers to enable better customer service. Others think of CRM, or one-to-one, as an elaborate marketing or customer service discipline. We even recently heard CRM described as “personalized e-mail.”

This book is about much more than setting up a business Web site or redirecting some of the mass-media budget into the call-center database or **social networking**. It’s about increasing the value of the company through specific customer strategies (see Exhibit 1.1).

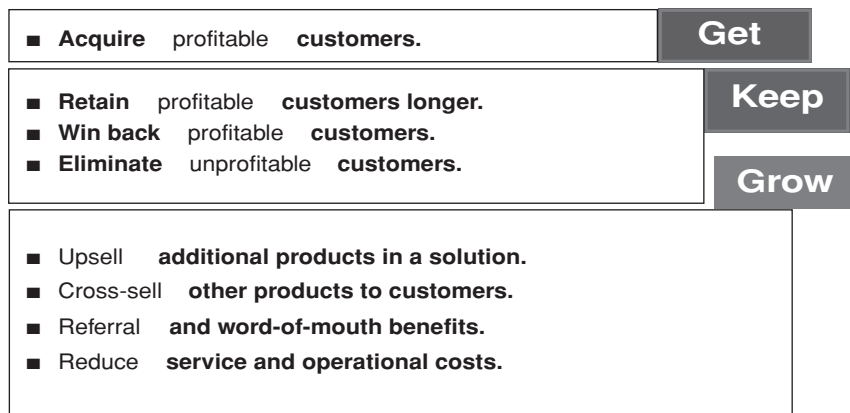


EXHIBIT 1.1 Increasing the Value of the Customer Base

Companies determined to build successful and profitable customer relationships understand that the process of becoming an enterprise focused on building its value by building customer value doesn't begin with installing technology, but instead begins with:

- A strategy or an ongoing process that helps transform the enterprise from a focus on traditional selling or manufacturing to a customer focus while increasing revenues and profits in the current period and the long-term.
- The leadership and commitment necessary to cascade throughout the organization the thinking and decision-making capability that puts customer value and relationships first as the direct path to increasing shareholder value.

The reality is that becoming a **customer-strategy enterprise** is about using information to gain a competitive advantage and deliver growth and profit. In its most generalized form, CRM can be thought of as a set of business practices designed, simply, to put an enterprise into closer and closer touch with its customers, in order to learn more about each one and to deliver greater and greater value to each one, with the overall goal of making each one more valuable to the firm to increase the value of the enterprise. It is an enterprise-wide approach to understanding and influencing customer behavior through meaningful analysis and communications to improve customer acquisition, customer retention, and customer profitability.³

Defined more precisely, and what makes CRM into a truly different model for doing business and competing in the marketplace,

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³Erik M. van Raaij, "The Strategic Value of Customer Profitability Analysis," *Marketing Intelligence & Planning* 23, no. 4/5: 372–381, accessed January 28, 2010, available at: ABI/INFORM Global (document ID: 908236781); Sunil Gupta and Donald R. Lehmann, *Managing Customers as Investments* (Philadelphia: Wharton School Publishing, 2005); Robert S. Kaplan, "A Balanced Scorecard Approach to Measure Customer Profitability," Harvard Business School's Working Knowledge Web site, August 8, 2005, available at: <http://hbswk.hbs.edu/item/4938.html>, accessed January 28, 2010; Phillip E. Pfeifer, Mark E. Haskins, and Robert M. Conroy, "Customer Lifetime Value, Customer Profitability, and the Treatment of Acquisition Spending," *Journal of Managerial Issues* 17, no. 1 (Spring 2005): 11–25; George S. Day, *Market-Driven Strategy: Processes for Creating Value* (New York: Free Press, 1999); Frederick Newell, *The New Rules of Marketing* (New York: McGraw-Hill Professional Book Group, 1997); Don Peppers and Martha Rogers, *The One to One Future* (New York: Doubleday Books, 1993); Ronald S. Swift, *Accelerating Customer Relationships: Using CRM and Relationship Technologies* (Upper Saddle River, NJ: Prentice Hall, 2001); Fred Reichheld, *The Loyalty Effect* (Boston: Harvard Business School Press, 1996).

is this: It is an enterprise-wide business strategy for achieving customer-specific objectives by taking customer-specific actions. It is enterprise-wide because it can't merely be assigned to marketing if it is to have any hope of success. Its objectives are customer-specific because the goal is to increase the value of each customer. Therefore, the firm will take customer-specific actions for each customer, often made possible by new technologies.

An enterprise-wide business strategy for managing customer relationships achieves customer-specific objectives by taking customer-specific actions.

In essence, building the value of the customer base requires a business to *treat different customers differently*. Today, there is a customer-focus revolution under way among businesses. It represents an inevitable—literally, irresistible—movement. All businesses will be embracing customer strategies sooner or later, with varying degrees of enthusiasm and success, for two primary reasons:

1. All customers, in all walks of life, in all industries, all over the world, want to be individually and personally served.
2. It is simply a more efficient way of doing business.

We find examples of customer-specific behavior, and business initiatives driven by customer-specific insights, all around us today:

- Instead of mailing out the same offer to everyone, a company waits for specific trigger behavior from a customer and increases response rates 25-fold.
- A car-rental customer rents a car without having to complete another reservation profile.
- An online customer buys a product without having to reenter his credit card number and address and looks at product reviews from other customers before ordering, significantly reducing the “returns” rate.
- A firm's product-development people turn their attention to a new service or product based on customer feedback captured by the sales force.
- Fans of a product band together on social networking sites and provide service and recommendations to each other.
- An insurance company not only handles a claim for property damage but also connects the insured party with a contractor in her area who can bypass the purchasing department and do the repairs directly.
- A supervisor orders more computer components by going to a Web page that displays his firm's contract terms, his own spending to date, and his departmental authorizations.
- Sitting in the call center, a service rep sees a “smart dialogue” suggestion pop onto a monitor during a call with a customer, suggesting a question the company wants to ask that customer (not the same question being asked of all customers who call this week).

Taking customer-specific action, treating different customers differently, building the value of the customer base, creating and managing relationships with individual customers that go on through time to get better and deeper: That's what this book is about. In the chapters that follow, we will look at lots of examples. The overall

business goal of this strategy is to make the enterprise as profitable as possible over time by taking steps to increase the value of the customer base. The enterprise makes itself, its products, and/or its services so satisfying, convenient, or valuable to the customer that she becomes more willing to devote her time and money to this enterprise than to any competitor. Building the value of customers increases the value of the **demand chain**, the stream of business that flows from the customer down through the retailer all the way to the manufacturer. A customer-strategy enterprise interacts directly with an individual customer. The customer tells the enterprise about how he would like to be served. Based on this interaction, the enterprise, in turn, modifies its behavior with respect to this particular customer. In essence, the concept implies a specific, one-customer-to-one-enterprise relationship, as is the case when the customer's input drives the enterprise's output for that particular customer.⁴

A suite of buzzwords have come to surround this endeavor: CRM, one-to-one marketing, Customer Experience Management, Customer Value Management, customer focus, customer orientation, customer centricity, and more. You can see it in the titles on the business cards: Chief Marketing Officer, of course, but also a host of others, including "Chief Relationship Officer," "Customer Value Management Director," and even "Customer Revolutionary" at one firm. Like all new initiatives, this newfangled customer approach (different from the strictly financial approach or product-profitability approach of the previous century) suffers when it is poorly understood, improperly applied, and incorrectly measured and managed. But by any name, strategies designed to build the value of the customer base by building relationships with one customer at a time, or with well-defined groups of identifiable customers, are by no means ephemeral trends or fads, any more than computers or connectivity are.

A good example of a business offering that benefits from individual customer relationships can be seen in today's popular online banking services, in which a consumer spends several hours, usually spread over several sessions, setting up an online account and inputting payee addresses and account numbers, in order to be able to pay bills electronically each month. If a competitor opens a branch in town offering slightly lower checking fees or higher savings rates, this consumer is unlikely to switch banks. He has invested time and energy in a relationship with the first bank, and it is simply more convenient to remain loyal to the first bank than to teach the second bank how to serve him in the same way. In this example, it should also be noted that the bank now has increased the value of the customer to the bank and has simultaneously reduced the cost of serving the customer, as it costs the bank less to serve a customer online than at the teller window or by phone.

Clearly, "customer strategy" involves much more than marketing, and it cannot deliver optimum return on investment of money or customers without integrating individual customer information into every corporate function, from customer service, to production, logistics, and channel management. A formal change in the organizational structure usually is necessary to become an enterprise focused on growing

⁴Ranjay Gulati, "The Quest for Customer Focus," *Harvard Business Review* 83, no. 4 (April 2005): 92–101. Also see Don Peppers and Martha Rogers, Ph.D., *One to One B2B* (New York: Doubleday Broadway Books, 2001).

customer value. As this book shows, customer strategy is both an operational and an analytical process. **Operational CRM** focuses on the software installations and the changes in process affecting the day-to-day operations of a firm—operations that will produce and deliver different treatments to different customers. **Analytical CRM** focuses on the strategic planning needed to build customer value as well as the cultural, measurement, and organizational changes required to implement that strategy successfully.

Focusing on Customers Is New to Business Strategy

The move to a customer-strategy **business model** has come of age at a critical juncture in business history, when managers are deeply concerned about declining customer loyalty as a result of greater transparency and universal access to information, declining trust in many large institutions and most businesses, and increasing choices for customers. As customer loyalty decreases, profit margins decline too, because the most frequently used customer acquisition tactic is price cutting. Enterprises are facing a radically different competitive landscape as the information about their customers is becoming more plentiful and as the customers themselves are demanding more interactions with companies and creating more connections with each other. Thus a coordinated effort to get, keep, and grow valuable customers has taken on a greater and far more relevant role in forging a successful long-term, profitable business strategy.

If the last quarter of the twentieth century heralded the dawn of a new competitive arena, in which commoditized products and services have become less reliable as the source for business profitability and success, it is the new computer technologies and applications that have arisen that assist companies in managing their interactions with customers. These technologies have spawned enterprise-wide information systems that help to harness information about customers, analyze the information, and use the data to serve customers better. Technologies such as **enterprise resource planning (ERP)** systems, supply chain management software (SCM), enterprise application integration software (EAI), **data warehousing, sales force automation (SFA)**, marketing resource management (MRM), and other enterprise software applications have helped companies to mass-customize their products and services, literally delivering individually configured communications, products, or services to unique customers, in response to their individual feedback and specifications.

The accessibility of the new technologies is motivating enterprises to reconsider how they develop and manage customer relationships. More and more chief executive officers (CEOs) of leading enterprises have made the shift to a customer-strategy business model a top business priority for the twenty-first century. Technology is making it possible for enterprises to conduct business at an intimate, individual customer level. Indeed, technology is driving the shift. Computers can enable enterprises to remember individual customer needs and estimate the future potential revenue the customer will bring to the enterprise. What's clear is that technology is the enabler; it's the *tail*, and the one-to-one customer relationship is the *dog*.

Traditional Marketing Redux

Historically, traditional marketing efforts have centered on the “four Ps”—product, price, promotional activity, and place—popularized by marketing experts E. Jerome McCarthy^a and Philip Kotler. These efforts have been enhanced by our greater (and deeper) understanding of consumer behavior, organizational behavior, market research, segmentation, and targeting. In other words, using traditional sampling and aggregate data, a broad understanding of the market has preceded the application of the four Ps, which enterprises have deployed in their marketing strategy to bring uniform products and services to the mass market for decades.^b In essence, the four Ps are all about the “get” part of “get, keep, and grow customers.” These terms have been the focal point for building market share and driving sales of products and services to consumers. The customer needed to believe that the enterprise’s offerings would be superior in delivering the “four Cs”: customer value, lower costs, better convenience, and better communication.^c Marketing strategies have revolved around targeting broadly defined market segments through heavy doses of advertising and promotion.

This approach first began to take shape in the 1950s. Fast-growing living standards and equally fast-rising consumer demand made organizations aware of the effectiveness of a supply-driven marketing strategy. By approaching the market on the strength of the organization’s specific abilities, and creating a product supply in accordance with those abilities, it was possible for the firm to control and guide the sales process. Central to the strategic choices taken in the area of marketing were the—now traditional—marketing instruments of product, price, place, and promotion—the same instruments that served as the foundation for Philip Kotler’s theory and the same instruments that still assume an important role in marketing and customer relations today.

The four Ps all, of course, relate to the aggregate market rather than to individual customers. The market being considered could be a large, mass market or a smaller, niche market, but the four Ps have helped define how an enterprise should behave toward all the customers within the aggregate market:

1. *Product* is defined in terms of the average customer—what *most* members of the aggregate market want or need. This is the product brought to market, and it is delivered the same way for every customer in the market. The definition of *product* extends to standard variations in size, color, style, and units of sale as well as customer service and aftermarket service capabilities.
2. *Place* is a distribution system or sales channel. How and where is the product sold? Is it sold in stores? By dealers? Through franchisees? At a single location or through widely dispersed outlets, such as fast-food stores and ATMs? Can it be delivered directly to the purchaser?
3. *Price* refers not only to the ultimate retail price a product brings but also to intermediate prices, beginning with wholesale; and it takes account of the availability of credit to a customer and the prevailing interest rate. The

price is set at a level designed to “clear the market,” assuming that everyone will pay the *same* price—which is only fair, because everyone will get the same product. And even though different customers within a market actually have different levels of desire for the same product, the market price will generally be the same for everybody.

4. *Promotion* has also worked traditionally in a fundamentally nonaddressable, noninteractive way. The various customers in a mass market are all passive recipients of the promotional message, whether it is delivered through mass media or interpersonally, through salespeople. Marketers have traditionally recognized the trade-off between the cost of delivering a message and the benefit of personalizing it to a recipient. A sales call can cost \$350 or even more,^d but at least it allows for the personalization of the promotion process. The CPM or cost per thousand to reach an audience through mass media is far lower but requires that the same message be sent to everyone. Ultimately, the way a product is promoted is designed to differentiate it from all the other, competitive products. Except for different messages aimed at different segments of the market, promotion doesn’t change by *customer* but by *product*.

^aE. Jerome McCarthy, *Basic Marketing: A Managerial Approach* (Homewood, IL: Irwin, 1958).

^bPhilip Kotler, *Marketing Management: Analysis, Planning, Implementation, and Control*, 9th ed. (Upper Saddle River, NJ: Prentice Hall, 1997), pp. 92–93.

^cPhilip Kotler, *Kotler on Marketing* (New York: Free Press, 1999), pp. 116–120.

^d“Hoover’s White Paper: How to Convert Prospects to Sales Faster with Pre-Call Planning” (2005), www.hoovers.com, accessed January 2010.

Dr. Philip Kotler, the highly respected marketing academic who, with Jerome McCarthy, is responsible for our understanding and practice of traditional marketing, shares his views of the transition to the customer strategies mandated by new technologies.

The View from Here

Philip Kotler

S. C. Johnson Distinguished Professor of International Marketing, Kellogg School of Management, Northwestern University

When I first started writing about marketing 45 years ago, the Industrial Age was in its prime. Manufacturers churned out products on massive assembly lines, stored them in huge warehouses where they patiently waited for retailers to order and shelf boxes and bottles so that customers could buy them. Market leaders enjoyed great market shares from their carefully crafted mass-production, mass-distribution, and mass-advertising campaigns.

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What the Industrial Age taught us is that if an enterprise wanted to make money, it needed to be efficient at large-scale manufacturing and distribution. The enterprise needed to manufacture millions of standard products and distribute them in the same way to all of their customers. Mass producers relied on numerous intermediaries to finance, distribute, stock, and sell the goods to ever-expanding geographical markets. But in the process, producers grew increasingly removed from any direct contact with end users.

Producers tried to make up for what they didn't know about end users by using a barrage of marketing research methods, primarily customer panels, focus groups, and large-scale customer surveys. The aim was not to learn about individual customers but about large customer segments, such as "women ages 30 to 55." The exception occurred in business-to-business marketing where each salesperson knew each customer and prospect as an individual. Well-trained salespeople were cognizant of each customer's buying habits, preferences, and peculiarities. Even here, however, much of this information was never codified. When a salesperson retired or quit, the company lost a great deal of specific customer information. Only more recently, with sales automation software and loyalty-building programs, are business-to-business enterprises capturing detailed information about each customer on the company's mainframe computer.

As for the consumer market, interest in knowing consumers as individuals lagged behind the business-to-business marketplace. The exception occurred with direct mailers and catalog marketers who collected and analyzed data on individual customers. Direct marketers purchased mailing lists and kept records of their transactions with individual customers. The individual customer's stream of transactions provided clues as to other items that might interest that customer. For example, in the case of consumer appliances, the company could at least know when a customer might be ready to replace an older appliance with a new one if the price was right.

Getting Better at Consumer Marketing

With the passage of time, direct marketers became increasingly sophisticated. They supplemented mail contact with the adroit use of the telephone and telemarketing. The growing use of credit cards and customers' willingness to give their credit card numbers to merchants greatly stimulated direct marketing. The emergence of fax machines further facilitated the exchange of information and the placing of orders. Soon the Internet and e-mail provided the ultimate facilitation of direct marketing. Customers could view products visually and verbally order them easily, receive confirmation, and know when the goods would arrive. Now that experience is enhanced by the way customers speak to each other. Even companies that don't really understand social networking realize they have to get on board. If 33 million people are in a room, you have to visit that room.³

But whether a company was ready for *customer relationship management* depended on more than conducting numerous transactions with individual

customers. Companies needed to build comprehensive *customer databases*. Companies had been maintaining product databases, sales force databases, and dealer databases. Now they needed to build, maintain, mine, and manage a customer database that could be used by company personnel in sales, marketing, credit, accounting, and other company functions.

As customer database marketing grew, several different names came to describe it, including individualized marketing, customer intimacy, technology-enabled marketing, dialogue marketing, interactive marketing, permission marketing, and one-to-one marketing.

Modern technology makes it possible for enterprises to learn more about individual customers, remember those needs, and shape the company's offerings, services, messages, and interactions to each valued customer. The new technologies make mass-customization (otherwise an oxymoron) possible.

At the same time, technology is only a partial factor in helping companies do genuine one-to-one marketing. The following quotes about CRM make this point vividly:

CRM is not a software package. It's not a database. It's not a call center or a Web site. It's not a loyalty program, a customer service program, a customer acquisition program, or a win-back program. CRM is an entire philosophy.

—Steve Silver

A CRM program is typically 45 percent dependent on the right executive leadership, 40 percent on project management implementation, and 15 percent on technology.

—Edmund Thompson, Gartner Group

Whereas in the Industrial Age, companies focused on winning market share and new customers, more of today's companies are focusing on **share of customer (SOC)**, namely increasing their business with each existing customer. These companies are focusing on customer retention, customer loyalty, and customer satisfaction as the important marketing tasks and customer experience management and increasing customer value as key management objectives.

CRM and its kindred customer-focused efforts are more than just an outgrowth of direct marketing and the advent of new technology. This approach requires new skills, systems, processes, and employee mind-sets. As the Interactive Age progresses, mass marketing must give way to new principles for targeting, attracting, winning, serving, and satisfying markets. As advertising costs have risen and mass media has lost some effectiveness, mass marketing is now more costly and more wasteful. Companies are better prepared to identify meaningful segments and niches and address the individual customers within the targeted groups. They are becoming aware, however, that many customers are uncomfortable about their loss of privacy and the increase in solicitations by mail, phone, and e-mail. Ultimately, companies will have to move from an

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“invasive” approach to prospects and customers to a “permissions” approach. On the flip side, customers—now in contact with millions of other customers—have never been more informed or empowered.

The full potential of CRM is only beginning to be realized. Of course every company must offer great products and services. But now, rather than pursue all types of customers at great expense only to lose many of them, the objective is to focus only on those particular customers with current and long-term potential, in order to preserve and increase their value to the company.

³Juliette Powell, *33 Million People in the Room* (Upper Saddle River, NJ: Financial Times Press, 2009), pp. 8–9.

Managing Customer Relationships Is a Different Dimension of Competition

A lot can be understood about how traditional, market-driven competition is different from today’s customer-driven competition by examining Exhibit 1.2(a) and 1.2(b). The direction of success for a traditional aggregate-market enterprise (i.e., a traditional company that sees its customers in markets of aggregate groups) is to acquire more customers (widen the horizontal bar), whereas the direction of success for the customer-driven enterprise is to keep customers longer and grow them bigger (lengthen the vertical bar). The width of the horizontal bar can be thought of as an enterprise’s market share—the proportion of total customers who have their needs satisfied by a particular enterprise, or the percentage of total products in an industry sold by this particular firm. But the customer-value enterprise focuses on share of customer—the percentage of this customer’s business that a particular firm gets—represented by the height of the vertical bar. Think of it this way: Kellogg’s can either sell as many boxes of Corn Flakes as possible to whomever will buy them, even though sometimes Corn Flakes will cannibalize Raisin Bran sales, or Kellogg’s can concentrate on making sure its products are on Mrs. Smith’s breakfast table every day for the rest of her life, and thus represent a steady or growing percentage

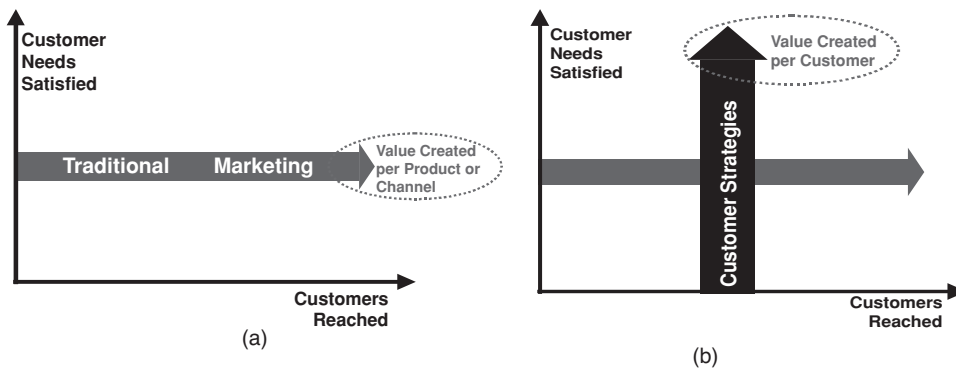


EXHIBIT 1.2 (a) Growing Market Share and (b) Growing Customer Shares

of that breakfast table's offerings. Nissan can try to sell as many Altimas as possible, for any price, to anyone who will buy; or it can, by knowing Mrs. Smith better, make sure all the cars in Mrs. Smith's garage are Nissan brands, including the used car she buys for her teenage son, and that Mrs. Smith uses Nissan financing, and gets her service, maintenance, and repairs at Nissan dealerships throughout her driving lifetime.

Although the tasks for growing market share are different from those for building share of customer, the two strategies are not antithetical. A company can simultaneously focus on getting new customers and growing the value of and keeping the customers it already has.⁵ Customer-strategy enterprises are required to interact with a customer and use that customer's feedback from this interaction to deliver a customized product or service. Market-driven efforts can be strategically effective and even more efficient at meeting individual customer needs when a customer-specific philosophy is conducted on top of it. The customer-driven process is time-dependent and evolutionary, as the product or service is continuously fine-tuned and the customer is increasingly differentiated from other customers. The aggregate-market enterprise competes by differentiating products, whereas the customer-driven enterprise competes by differentiating customers. The traditional, aggregate-market enterprise attempts to establish an actual product differentiation (by launching new products or modifying or extending established product lines) or a perceived one (with advertising and public relations). The customer-driven enterprise caters to one customer at a time and relies on differentiating each customer from all the others.

The principles of a customer-focused business model differ in many ways from mass marketing. For one thing, the traditional marketing company, no matter how friendly, ultimately sees customers as adversaries, and vice versa. The company and the customer play a zero-sum game: If the customer gets a discount, the company loses profit margin. Their interests have traditionally been at odds: The customer wants to buy as much product as possible for the lowest price, while the company wants to sell the least product possible for the highest price. If an enterprise and a customer have no relationship prior to a purchase, and they have no relationship following it, then their entire interaction is centered on a single, solitary transaction and the profitability of that transaction. Thus, in a transaction-based, product-centric business model, buyer and seller are adversaries, no matter how much the seller may try not to act the part. In this business model, practically the only assurance a customer has that he can trust the product and service being sold to him is the general reputation of the brand itself.⁶

By contrast, the customer-based enterprise aligns customer collaboration with profitability. Compare the behaviors that result from both sides if each transaction occurs in the context of a longer-term relationship. For starters, a one-to-one enterprise would likely be willing to fix a problem raised by a single transaction at a loss if the relationship with the customer were profitable long term (see Exhibit 1.3).

⁵See George S. Day, *Market-Driven Strategy: Processes for Creating Value* (New York: Free Press, 1999), for a useful discussion of the difference between "market-driven" and "market-driving" strategies.

⁶Don Peppers and Martha Rogers, Ph.D., *The One to One Manager* (New York: Doubleday, 1999).

EXHIBIT 1.3 Comparison of Market-Share and Share-of-Customer Strategies

Market-Share Strategy	Share-of-Customer Strategy
Company sees products and brands as the source of all company value.	Company sees customers as—by definition—the only source of revenue.
Product (or brand) managers sell one product at a time to as many customers as possible.	Customer manager sells as many products as possible to one customer at a time.
Differentiate products from competitors.	Differentiate customers from each other.
Sell <i>to</i> customers.	Collaborate <i>with</i> customers.
Find a constant stream of new customers.	Find a constant stream of new business from established customers.
Company makes sure each product, and likely each transaction, is profitable, even at the cost of a customer's confidence.	Company makes sure each customer is profitable, even if that means losing money on an occasional product or transaction.
Use mass media to build brand and announce products.	Use interactive communication to determine individual needs and communicate with each individual.

The central purpose of managing customer relationships is for the enterprise to focus on increasing the overall value of its customer base—and customer retention is critical to its success. Increasing the value of the customer base, whether through *cross-selling* (getting customers to buy other products and services), *upselling* (getting customers to buy more expensive offerings), or customer referrals, will lead to a more profitable enterprise. The enterprise can also reduce the cost of serving its best customers by making it more convenient for them to buy from the enterprise (e.g., by using Amazon's one-click ordering process or Web banking rather than a bank teller).

The central purpose of managing customer relationships is for the enterprise to focus on increasing the overall value of its customer base—and customer retention is critical to its success.

Technology Accelerates—It Is Not the Same as—Building Customer Value

The interactive era has accelerated the adoption and facilitation of this highly interactive collaboration between the customer and the company. In addition, technological advancements have contributed to an enterprise's capability to capture the feedback of its customer, then customize some aspect of its products or services to suit each customer's individual needs. Enterprises require a highly sophisticated level of integrated activity to enable this customization and personalized customer interaction to occur. To effectuate customer-focused business relationships, an enterprise must integrate the disparate information systems, databases, business units, customer touchpoints—everywhere the company touches the customer and vice-versa—and many other facets of its business to ensure that all employees who interact with customers have real-time access to current customer information. The objective is to optimize each customer interaction and ensure that the dialogue is seamless—that each conversation picks up from where the last one ended.

Technology has made possible the mass customization of products and services, enabling businesses to treat different customers differently, in a cost-efficient way.

Many software companies have developed enterprise point solutions and suites of software applications that, when deployed, elevate an enterprise's capabilities to transform itself to a customer-driven model. And as we said earlier, while one-to-one customer relationships are enabled by technology, executives at firms with strong customer relationships and burgeoning **customer equity (CE)** believe that the enabling technology should be viewed as the means to an end, not the end itself. Managing customer relationships is an ongoing business process, not merely a technology. But technology has provided the catalyst for CRM to manifest itself within the enterprise. Computer databases help companies remember and keep track of individual interactions with their customers. Within seconds, customer service representatives can retrieve entire histories of customer transactions and make adjustments to customer records. Technology has made possible the mass customization of products and services, enabling businesses to treat different customers differently, in a cost-efficient way. (You'll find more about mass customization in Chapter 10.) Technology empowers enterprises and their customer contact personnel, marketing and sales functions, and managers by equipping them with substantially more intelligence about their customers.

The foundation for an enterprise focused on building its value by building the value of the customer base is unique: Establish relationships with customers on an individual basis, then use the information gathered to treat different customers differently and increase the value of each one to the firm.

Implementing an effective customer strategy can be challenging and costly because of the sophisticated technology and skill set needed by relationship managers to execute the customer-driven business model. A business model focused on building customer value often requires the coordinated delivery of products and services aligned with enterprise financial objectives that meet customer value requirements. While enterprises are experimenting with a wide array of technology and software solutions from different vendors to satisfy their customer-driven needs, they are learning that they cannot depend on technology alone to do the job. Before it can be implemented successfully, managing customer relationships individually requires committed leadership from the upper management of the enterprise and wholehearted participation throughout the organization as well. Although customer strategies are driven by new technological capabilities, the technology alone does not make a company customer-centric. The payoff can be great, but the need to build the strategy to get, keep, and grow customers is even more important than the technology required to implement that strategy.

The firms that are best at building customer value are not the ones that ask "How can we use new technologies to get our customers to buy more?" Instead they are the companies that ask "How can we use new technologies to deliver more value to our customers?"

The foundation for an enterprise focused on building its value by building the value of the customer base is unique: Establish relationships with customers on an individual basis, then use the information gathered to treat different customers differently and increase the value of each one to the firm. The overarching theme of such an enterprise is

that the customer is the most valuable asset the company has; that's why the primary goals are to get, keep, and grow profitable customers. Use technology to take the customer's point of view, and act on that as a competitive advantage.

What Is a Relationship?

What does it mean for an enterprise and a customer to have a *relationship* with each other? Do customers have relationships with enterprises that do not know them? Can the enterprise be said to have a relationship with a customer it does not know? Is it possible for a customer to have a relationship with a brand? Perhaps what is thought to be a customer's relationship with a brand is more accurately described as the customer's attitude or predisposition toward the brand. Experts have studied the nature of relationships in business for many years, and there are many different perspectives on the fundamental purpose of relationships in business strategies. (You'll find two in-depth discussions on the nature of "relationship" in the next chapter.)

This book is about managing customer relationships more effectively in the twenty-first century, which is governed by a more individualized approach. The critical business objective can no longer be limited to acquiring the most customers and gaining the greatest market share for a product or service. Instead, to be successful going forward, now that it's possible to deal individually with separate customers, the business objective must include establishing meaningful and profitable relationships with, at the least, the most valuable customers and making the overall customer base more valuable. Technological advances during the last quarter of the twentieth century have mandated this shift in philosophy.

In short, the enterprise strives to get a customer, keep that customer for a lifetime, and grow the value of the customer to the enterprise. Relationships are the crux of the customer-strategy enterprise. Relationships between customers and enterprises provide the framework for everything else connected to the customer-value business model. The exchange between a customer and the enterprise becomes mutually beneficial, as customers give information in return for personalized service that meets their individual needs. This interaction forms the basis of the *Learning Relationship*, based on a collaborative dialogue between the enterprise and the customer that grows smarter and smarter with each successive interaction.⁷

Who Is the Customer?

Throughout this book, we refer to *customers* in a generic way. To some, the term will conjure up the mental image of shoppers. To others, those shoppers are *end users* or *consumers*, and the customers are downstream businesses in the distribution chain—the companies that buy from producers and either sell

⁷B. Joseph Pine II, Don Peppers, and Martha Rogers, Ph.D., "Do You Want to Keep Your Customers Forever?" *Harvard Business Review* 73:2 (March–April 1995): 103–114.

directly to end users or manufacture their own product. In this book, *customer* refers to the constituents of an organization, whether it's a business-to-business customer (which could mean the purchasing agent or user at the customer company, or the entire customer company) or an end-user consumer—or, for that matter, a hotel patron, a hospital patient, a charitable contributor, a voter, a university student or alum, a blood donor, a theme-park guest, and so on. That means the *competition* is anything a customer might choose that would preclude choosing the organization that is trying to build a relationship with that customer.

Learning Relationships: The Crux of Managing Customer Relationships

The basic strategy behind Learning Relationships is that the enterprise gives a customer the opportunity to teach it what he wants, remember it, give it back to him, and keep his business. The more the customer teaches the company, the better the company can provide exactly what the customer wants and the more the customer has invested in the relationship. Ergo, the customer will more likely choose to continue dealing with the enterprise rather than spend the extra time and effort required to establish a similar relationship elsewhere.⁸

The Learning Relationship works like this: If you're my customer and I get you to talk to me, and I remember what you tell me, then I get smarter and smarter about you. I know something about you that my competitors don't know. So I can do things for you my competitors can't do, because they don't know you as well as I do. Before long, you can get something from me you can't get anywhere else, for any price. At the very least, you'd have to start all over somewhere else, but starting over is more costly than staying with me, so long as you like me and trust me to look out for your best interests.

This happens every time a customer buys groceries by updating her online grocery list⁹ or adds a favorite movie to her online queue. Even if a competitor were to establish exactly the same capabilities, a customer already involved in a Learning Relationship with an enterprise would have to spend time and energy—sometimes a lot of time and energy—teaching the competitor what the current enterprise already knows. This creates a significant **switching cost** for the customer, as the value of what the enterprise is providing continues to increase, partly as the result of the customer's own time and effort. The result is that the customer becomes more loyal to the enterprise, because it is simply in the customer's own interest to do so. It is more worthwhile for the customer to remain loyal than to switch. As the relationship progresses, the customer's convenience increases, and the enterprise becomes more valuable to the customer, allowing the enterprise to protect its profit margin with the customer, often while reducing the cost of serving that customer.

Learning Relationships provide the basis for a completely different arena of competition, separate and distinct from traditional, product-based competition. An

⁸Ibid.

⁹Adele Berndt and Annekie Brink, *Customer Relationship Management and Customer Service* (Lansdowne, South Africa: Juta and Co., 2004), p. 25.

enterprise cannot prevent its competitor from offering a product or service that is perceived to be as good as its own offering. Once a competitor offers a similar product or service, the enterprise's own offering is reduced to commodity status. But enterprises that engage in collaborative Learning Relationships with individual customers gain a distinct competitive advantage, because they know something about one customer that a competitor does not know. In a Learning Relationship, the enterprise learns about an individual customer through his transactions and interactions during the process of doing business. The customer, in turn, learns about the enterprise through his successive purchase experiences and other interactions. Thus, in addition to an increase in customer loyalty, two other benefits come from Learning Relationships:

1. *The customer learns more about his own preferences from each experience and from the firm's feedback*, and is therefore able to shop, purchase, and handle some aspect of his life more efficiently and effectively than was possible prior to this relationship.
2. *The enterprise learns more about its own strengths and weaknesses from each interaction and from the customer's feedback*, and is therefore able to market, communicate, and handle some aspects of its own tactics or strategy more efficiently and effectively than was possible prior to the relationship.¹⁰

Cultivating Learning Relationships depends on an enterprise's capability to elicit and manage useful information about customers. Customers, whether they are consumers or other enterprises, do not want more choices. Customers simply want exactly what they want—when, where, and how they want it. And technology is now making it more and more possible for companies to give it to them, allowing enterprises to collect large amounts of data on individual customers' needs and then use that data to customize products and services for each customer—that is, to treat different customers differently.¹¹

Customers, whether they are consumers or other enterprises, do not want more choice. Customers simply want what they want when, where, and how they want it.

One of the implications of this shift is an imperative to consider and manage the two ways customers create value for an enterprise. We've already said that a product focus tends to make companies think more about the value of a current transaction than the long-term value of the customer who is the company's partner in that transaction. But building Learning Relationships has value only to a company that links its own growth and future success to its ability to keep and grow customers, and therefore commits to building long-term relationships with customers. This means we find stronger commitments to customer trust, employee trust, meeting community responsibilities, and otherwise thinking about long-term, sustainable strategies. Companies that are in the business of building the value of the customer base are companies that understand the importance of balancing short-term and long-term success. We talk more about that in Chapters 5 and 11.

¹⁰Katherine Lemon, Don Peppers, and Martha Rogers, Ph.D., "Managing the Customer Lifetime Value: The Role of Learning Relationships," working paper.

¹¹Pine, Peppers, and Rogers, "Do You Want to Keep Your Customers Forever?"

Return on Customer: Measuring the Efficiency with Which Customers Create Value

Most business executives would agree, intellectually, that *customers* represent the surest route to business growth—getting more customers, keeping them longer, and making them more profitable. Most understand that the customer base itself is a revenue-producing asset for their company—and that the value it throws off ultimately drives the company's economic worth. Nevertheless, when companies measure their financial results, they rarely if ever take into account any changes in the value of this underlying asset, with the result that they are blind—and *financial analysts are blind*—to one of the most significant factors driving business success.

Think about your personal investments. Imagine you asked your broker to calculate your return on investment for your portfolio of stocks and bonds. She would tally the dividend and interest payments you received during the year, and then note the increases or decreases in the value of the various stocks and bonds in the portfolio. Current income plus underlying value changes. The result, when compared to the amount you began the year with, would give you this year's ROI (return on investment). But suppose she chose to ignore any changes in the underlying value of your securities, limiting her analysis solely to dividends and interest. Would you accept this as a legitimate picture of your financial results? No?

Well, this is exactly the way nearly all of today's investors assess the financial performance of the companies they invest in, because this is the only way companies report their results. They count the "dividends" from their customers and ignore any increase (or decrease) in the value of the underlying assets. But just as a portfolio of securities is made up of individual stocks and bonds that not only produce dividends and interest but also go up and down in value during the course of the year, a company is, at its roots, a portfolio of customers, who not only buy things from the firm in the current period but also go up and down in value.

Return on investment quantifies how well a firm creates value from a given investment. But what quantifies how well a company creates value from its *customers*? For this you need the metric of Return on Customersm (ROCsm). The ROC equation has the same form as an ROI equation. ROC equals a firm's current-period cash flow from its customers plus any changes in the underlying customer equity, divided by the total customer equity at the beginning of the period.

Source: Excerpted from Don Peppers and Martha Rogers, Ph.D., *Return on Customer* (New York: Currency/Doubleday, 2008), pp. 6–7. Return on Customer will be discussed in more detail in Chapter 11.

When it comes to customers, businesses are shifting their focus from product sales transactions to **relationship equity**. Most soon recognize that they simply do not know the full extent of their profitability by customer.¹² Not all customers are equal. Some are not worth the time or financial investment of establishing Learning Relationships, nor are all customers willing to devote the effort required to sustain such a relationship. Enterprises need to decide early on which customers they want to have relationships with, which they do not, and what type of relationships to nurture. (See Chapter 5 on customer value differentiation.) But the advantages to the enterprise of growing Learning Relationships with valuable and potentially valuable customers are immense. Because much of what is sold to the customer may be customized to his precise needs, the enterprise can, for example, potentially charge a premium (as the customer may be less price-sensitive to customized products and services) and increase its profit margin.¹³ The product or service is worth more to the customer because he has helped shape and mold it to his own specifications. The product or service, in essence, has become *decommoditized* and is now uniquely valuable to this particular customer.

Managing customer relationships effectively is a practice not limited to product and services. When establishing interactive Learning Relationships with valuable customers, customer-strategy enterprises remember a customer's specific needs for the basic product but also the goods, services, and communications that surround the product, such as how the customer would prefer to be invoiced or how the product should be packaged. Even an enterprise that sells a commodity-like product or service can think of it as a bundle of ancillary services, delivery times, invoicing schedules, personalized reminders and updates, and other features that are rarely commodities. The key is for the enterprise to focus on customizing to each individual customer's needs. A teenager in California had gotten a text from her wireless phone service suggesting her parents could save money if she texted "4040" in an offer to switch her to a cell phone plan that was a better fit for her and the way she actually uses the service. She was so impressed she made a point of telling us about it. And of course, she told all her friends at school—and on Twitter and Facebook. The coverage, the hardware, the central customer service, and the "brand" all remained the same. But the customer experience, based on actual usage interaction with the customer—information not available to competitors—improved the customer relationship, increased loyalty and lifetime value of the customer, and positively influenced other customers as well.

When a customer teaches an enterprise what he wants or how he wants it, the customer and the enterprise are, in essence, *collaborating* on the sale of the

¹²Carrie Johnson and Elizabeth Davis, with Kate van Geldern, "Beyond Sales: Driving eBusiness with Engagement," May 15, 2009, Forrester Research, Inc., www.forrester.com, accessed September 1, 2010; Jeff Sands, "Account-Based Marketing," *B to B* 91, no. 6 (2006): 11; Ian Gordon, "Best Practices: Customer Relationship Management," *Ivey Business Journal* (November/December 2002): 1–5, reprint #9B02TF08; Ian Gordon, *Relationship Marketing* (New York: John Wiley & Sons, 1998).

¹³B. Joseph Pine II, Don Peppers, and Martha Rogers, Ph.D., "Do You Want to Keep Your Customers Forever?" in James H. Gilmore, and B. Joseph Pine II, eds., *Markets of One: Creating Customer-Unique Value through Mass Customization* (Boston: Harvard Business School Publishing, 2000).

product. The more the customer teaches the enterprise, the less likely the customer will want to leave. The key is to design products, services, and communications that customers *value*, and on which a customer and a marketer will have to collaborate for the customer to receive the product, service, or benefit.

Enterprises that build Learning Relationships clear a wider path to customer profitability than companies that focus on price-driven transactions.

Enterprises that build Learning Relationships clear a wider path to customer profitability than companies that focus on price-driven transactions. They move from a make-to-forecast business model to a make-to-order model, as Dell Computer did when

it created a company that reduced inventory levels by creating each computer after it was paid for. By focusing on gathering information about individual customers and using that information to customize communications, products, and services, enterprises can more accurately predict inventory and production levels. Fewer orders may be lost because mass customization can build the products on demand and thus make available to a given customer products that cannot be stocked ad infinitum. (We will discuss customization further in Chapter 10.) Inventoryless distribution from a made-to-order business model can prevent shortages caused in distribution channels as well as reduce inventory carrying costs. The result is fewer “opportunity” losses. Furthermore, efficient mass-customization operations can ship built-to-order custom products faster than competitors that have to customize products.¹⁴

Learning Relationships have less to do with creating a fondness on the part of a customer for a particular product or brand and more to do with a company’s capability to remember and deliver based on prior interactions with a customer.

Learning Relationships have less to do with creating a fondness on the part of a customer for a particular product or brand and more to do with a company’s capability to remember and deliver based on prior interactions with a customer. An enterprise that engages in a Learning Relationship creates a *bond of value* for the customer, a reason for

an individual customer or small groups of customers with similar needs to lose interest in dealing with a competitor, provided that the enterprise continues to deliver a product and service quality at a fair price and to remember to act on the customer’s preferences and tastes.¹⁵ Learning Relationships may also be based on an inherent trust between a customer and an enterprise. For example, a customer might divulge his credit card number to an organization, which records it and remembers it for future transactions. The customer trusts that the enterprise will keep his credit card number confidential. The enterprise makes it easier and faster for him to buy because he no longer has to repeat his credit card number each time he makes a purchase. (In the next chapter, we’ll learn more about the link between attitude and behavior in relationships.)

¹⁴Fabrizio Salvador, Pablo Martin de Holan, and Frank T. Pillar, “Cracking the Code of Mass Customization,” *MIT Sloan Management Review* 50, no. 3 (Spring 2009): 71–78; David M. Anderson, *Agile Product Development for Mass Customization* (New York: McGraw-Hill Professional Book Group, 1997).

¹⁵B. Joseph Pine II, Don Peppers, and Martha Rogers, Ph.D., “Do You Want to Keep Your Customers Forever?” *Harvard Business Review* (March–April 1995), pp. 103–114.

The Technology Revolution and the Customer Revolution

During the last century, as enterprises sought to acquire as many customers as they possibly could, the local proprietor's influence over customer purchases decreased. Store owners or managers became little more than order takers, stocking their shelves with the goods that consumers would see advertised in the local newspaper or on television and radio. Mass-media advertising became a more effective way to publicize a product and generate transactions for a wide audience. But now technology has made it possible, and therefore competitively necessary, for enterprises to behave, once again, like small-town proprietors and deal with their customers individually, one customer at a time.

Customers Have Changed Too

The technological revolution has spawned another revolution, one led by the customers themselves, who now demand products just the way they want them and flawless customer service. Enterprises are realizing that they really know little or nothing about their individual customers and so are mobilizing to capture a clearer understanding of each customer's needs. Customers, meanwhile, want to be treated less like numbers and more like the individuals they are, with distinct, individual requirements and preferences. They are actively communicating these demands back to the enterprise. Where they would once bargain with a business, they now tell managers of brand retail chains what they are prepared to pay and specify how they want products designed, styled, assembled, delivered, and maintained. When it comes to ordering, consumers want to be treated with respect. The capability of an enterprise to remember customers and their logistical information not only makes ordering easier for customers but also lets them know that they are important. Computer applications that enable options such as "one-click," or express, ordering on the Web are creating the expectation that good online providers take the time to get to know customers as individuals so they can provide this higher level of service.¹⁶

Initial Assessment: Where Is a Firm on the Customer-Strategy Map?

Recognizing that two families of technology have mandated the competitive approach of building customer value by building customer relationships, we can map any organization—large or small, public or private, profit or nonprofit—by

¹⁶See Sucharita Mulpuru, "The State of Retailing Online 2009: Merchandising and Web Optimization," August 14, 2009, Forrester Research, Inc., available at www.forrester.com, accessed September 1, 2010; Dave Frankland, "The Intelligent Approach to Customer Intelligence" (October 16, 2009), Forrester Research, Inc., available at www.forrester.com, accessed September 1, 2010; Peppers & Rogers Group and Institute for the Future, "Shopping Behavior in the Age of Interactivity," Focus Group Summary (Spring 2000): 12–13, available at: www.ito1.com, accessed September 1, 2010.

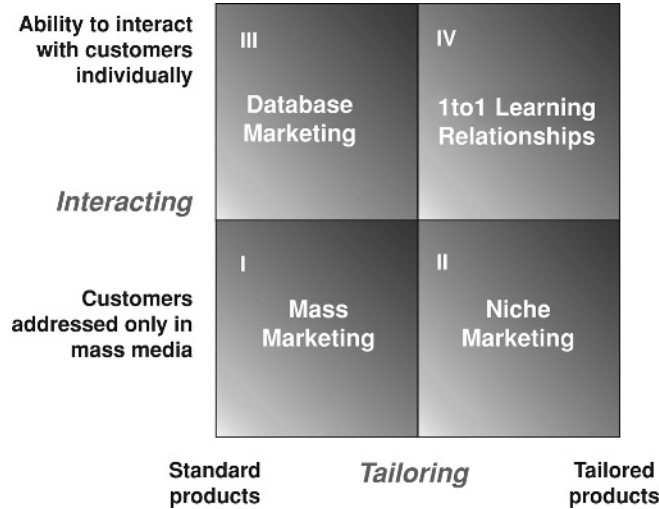


EXHIBIT 1A Enterprise Strategy Map

Source: Don Peppers and Martha Rogers, Ph.D., *Enterprise One to One* (New York: Doubleday/Currency, 1997).

the level of its capabilities in the arenas of *interacting* with customers and *tailoring* for them. A company would be rated high on the interactivity dimension if it knows the names of its individual customers and if it can send different messages to different customers and can remember the feedback from each one. A low rating would go to a company that doesn't know its customers' identities or does but continues to send the same message the same way to everybody. On the tailoring dimension, a firm would rate highly if it mass-customizes in lot sizes of one; it would rate low if it sells the same thing pretty much the same way to everybody. Based on its rating in these two dimensions, a company can be pinpointed on the Enterprise Strategy Map (see Exhibit 1A).

Quadrant I: Traditional Mass Marketing. Companies that compete primarily on cost efficiencies based on economies of scale and low price. Companies in this quadrant are doomed to commoditization and price competition.

Quadrant II: Niche Marketing. Companies that focus on target markets, or niches, and produce goods and services designed for those defined customer groups. This more strategic and targeted method of mass marketing still offers the same thing the same way to everyone, but for a small, relatively homogeneous group.

Quadrant III: Database Marketing. Companies utilize database management to get better, more efficient use of their mailing lists and other customer information. Generally focused primarily on continuation of traditional strategies but at lower costs to serve.

(continued)

(Continued)

Quadrant IV: One-to-One Learning Relationships. Companies use data about customers to predict what each one needs next and then are able to treat different customers differently and increase mutual value with customers.

In Quadrants I through III, the focus is still primarily on the product to be sold, with an eye to finding customers for that product. In Quadrant IV, the direction of the strategy changes; the Quadrant IV company focuses on a customer and finds products for that customer.

To realize the highest possible return on the customer base, the goal of an enterprise will be to move up and to the right on the Enterprise Strategy Map.

- To move up on the Enterprise Strategy Map, an enterprise has to be able to recognize individual customers' names and addresses, to send different messages to different customers, and to remember the responses of each.
- To move to the right on the Enterprise Strategy Map, an enterprise has to be able to increase its production and logistics flexibility. The most flexible production would entail customizing and delivering individual products for individual customers. The least flexible would be mass-producing a standardized product or service for a large market. (We talk more about customization in Chapter 10.)

The customer revolution is part of the reason enterprises are committing themselves to keep and grow their most valuable customers. Today's consumers and businesses have become more sophisticated about shopping for their needs across **multiple channels**. The online channel, in particular, enables shoppers to locate the goods and services they desire quickly and at a price they are willing to pay, which forces enterprises to compete on value propositions other than lowest price.

Customer Retention and Enterprise Profitability

Enterprises strive to increase profitability without losing high-margin customers by increasing their customer retention rates or the percentage of customers who have met a specified number of repurchases over a finite period of time. A retained customer, however, is not necessarily a loyal customer. The customer may give business to a competing enterprise for many different reasons.

Royal Bank of Canada's 18 Million Loyal Customers

Organizations have accelerated their customer-focused strategies during the last few years, but managing customer relationships has been a business discipline for many years. Before the Industrial Revolution, and before mass production was born, merchants established their businesses around *keeping* customers.

Small towns typically had a general store, a local bank, and a barbershop. Each proprietor met and knew each one of his customers individually. The bank teller, for example, knew that Mr. Johnson cashed his paycheck each Friday afternoon. When Mr. Johnson came into the bank, the bank teller already had his cash ready for him in twenties and tens, just as he liked it. If Mr. Johnson unexpectedly stopped cashing his paycheck at the bank, the teller would wonder what had happened to him. In short, the bank depended on the relationship with the individual customer and how much the people who worked for the bank knew about that customer. The teller's memory in this example is akin to today's data warehouses, which can store millions of data points, transaction histories, and characteristics about customers. Personal memory enabled the teller to fulfill each customer's individual banking needs and, ultimately, to build a profitable relationship with each one. The more the teller knew about a customer, the more convenient he could make banking for that customer—and the more likely the customer would continue to use the bank.

But here's the important question 100 years later: Can an international financial services enterprise with 18 million customers^a ever hope to deliver the same intimate customer service as a small-town bank? The attitude at Royal Bank of Canada (RBC), according to several of its executives, is "Absolutely."

Beginning in the 1990s, RBC developed superior computing and database power, along with sophisticated statistical programs, to analyze customer information and test specific actions it should take with specific customers. Only then could the bank's front-line personnel be able to deliver more effective personal contact and attention to individual customers.

To learn the most about its customers, RBC has undertaken an intense, ongoing statistical analysis of them. It is developing and refining the prototype for an algorithm to model the long-term lifetime values of its individual customers. Part of this effort includes a "client potential" model that measures how "growable" certain kinds of customers are to the bank. The bank also analyzes a customer's vulnerability to attrition and tries to flag the most vulnerable before they defect, in order to take preventive action in a focused, effective way.

To expand share of customer, Royal Bank also tries to predict statistically which additional services a customer might want to buy, and when. Royal Bank not only makes different offers to different customers, it also equips its sales and service people with detailed customer profiles. Thus, rather than providing a one-size-fits-all service, the bank's customer-contact people spend their time and energy making on-the-spot decisions based on each customer's individual situation and value. Note that this type of business practice not only benefits from individual customer interactions, it *requires* individual interactions to achieve the greatest success. In fact, RBC reports that the bank discovered it "could lift contributions and penetration rates by up to 10 percent by virtue of the contact alone."^b (We look at Royal Bank's customer-profitability strategies more in Part Three.)

^aRoyal Bank of Canada, 2009 Annual Report, available at: http://www.rbc.com/investorrelations/pdf/ar_2009_e.pdf.

^bMartha Rogers, Ph.D., "Royal Bank's 9 Million Loyal Customers," *Inside 1to1* (September 1999); available at: www.1to1.com, accessed September 1, 2010.

In 1990, Fred Reichheld and W. Earl Sasser analyzed the profit per customer in different service areas, categorized by the number of years that a customer had been with a particular enterprise.¹⁷ In this groundbreaking study, they discovered that the longer a customer remains with an enterprise, the more profitable she becomes. Average profits from a first-year customer for the credit card industry was \$30; for the industrial laundry industry, \$144; for the industrial distribution industry, \$45; and for the automobile servicing industry, \$25.

Four factors contributed to the underlying profit growth:

1. *Profit derived from increased purchases.* Customers grow larger over time and need to purchase in greater quantities.
2. *Profit from reduced operating costs.* As customers become more experienced, they make fewer demands on the supplier and fewer mistakes when involved in the operational processes, thus contributing to greater productivity for the seller and for themselves.
3. *Profit from referrals to other customers.* Less needs to be spent on advertising and promotion due to word-of-mouth recommendations from satisfied customers.
4. *Profit from price premium.* New customers can benefit from introductory promotional discounts, while long-term customers are more likely to pay regular prices.

No matter what the industry, the longer an enterprise keeps a customer, the more value that customer can generate for shareholders.¹⁸ Reichheld and Sasser found that for one auto service company, the expected profit from a fourth-year customer is more than triple the profit that same customer generates in the first year. Other industries studied showed similar positive results (see Exhibit 1.4).

No matter what the industry, the longer an enterprise keeps a customer, the more value that customer can generate for shareholders.

Enterprises that build stronger individual customer relationships enhance customer loyalty, as they are providing each customer with what he needs.¹⁹ Loyalty

¹⁷Frederick F. Reichheld and W. Earl Sasser, Jr., "Zero Defections: Quality Comes to Services," *Harvard Business Review* 73 (September–October 1990): 59–75.

¹⁸Authors' note: This point is not without controversy. Some research has shown that in some instances—especially those where a business is very dependent on one or a very few customers, such as automotive parts makers—a long-term customer has the power to extract so many concessions that the company's margins are squeezed sometimes to the breaking point. But generally, academic research and real-world experience have demonstrated that if a company acquires the right customers, the longer those customers continue to do business, the more profitable they become—for many reasons, especially reduction in churn replacement costs, increasing value to the customer of the relationship, and positive word of mouth and social networking by a contented or delighted customer.

¹⁹Authors' note: Which comes first, loyalty or satisfaction? In a 2008 article, Mark Johnson, Eugene Sivadas, and Ellen Garbarino questioned the directionality of the link between satisfaction and loyalty, suggesting there is more evidence to indicate that loyalty leads to customer satisfaction rather than satisfaction (customer relationships) leading to loyalty; see "Customer Satisfaction, Perceived Risk, and Affective Commitment," *Journal of Services Marketing* 22, no. 4/5 (2008): 353–362. Also see an earlier article, which originally questioned some of our

EXHIBIT 1.4 Profit One Customer Generates over Time

INDUSTRY	Year 1	Year 2	Year 3	Year 4	Year 5
Credit Card	\$30	\$42	\$44	\$49	\$55
Industrial Laundry	\$144	\$166	\$192	\$222	\$256
Industrial Distribution	\$45	\$99	\$123	\$144	\$168
Auto Servicing	\$25	\$35	\$70	\$88	\$88

Source: Frederick F. Reichheld and W. Earl Sasser, Jr., "Zero Defections: Quality Comes to Services," *Harvard Business Review* 68:5 (September–October 1990), 106.

building requires the enterprise to emphasize the value of its products or services and to show that it is interested in building a relationship with the customer.²⁰ The enterprise realizes that it must build a stable customer base rather than concentrate on single sales.²¹

A customer-strategy firm will want to reduce customer defections because they result in the loss of investments the firm has made in creating and developing customer relationships. Customers are the lifeblood of any business. They are, literally, the only source of its revenue.²² Loyal customers are more profitable because they likely buy more over time if they are satisfied. It costs less for the enterprise to serve retained customers over time because transactions with repeat customers become more routine. Loyal customers tend to refer other new customers to the enterprise, thereby creating new sources of revenue.²³ It stands to reason that if the central goal of a customer-strategy company is to increase the overall value of its customer base, then continuing its relationships with its most profitable customers will be high on its list of priorities.

On average, U.S. corporations tend to lose half their customers in five years, half their employees in four, and half their investors in less than one.²⁴ In his classic study on the subject, Fred Reichheld described a possible future in which the only business

assertions here: Ellen Garbarino and Mark Johnson, "The Different Roles of Satisfaction, Trust, and Commitment in Customer Relationships," *Journal of Marketing* 63 (April 1999): 70–87.

²⁰Jill Griffin, *Customer Loyalty: How to Earn It, How to Keep It* (San Francisco, CA: Jossey-Bass, 1997).

²¹See Werner Reinartz and V. Kumar, "The Mismanagement of Customer Loyalty," *Harvard Business Review* (July 2002): 86–94, for a different view of the value of loyalty. Reinartz and Kumar's work shows that more loyal customers are not necessarily more profitable as a class, especially using their methodology of one moment in time; but we should also point out that in the case of an individual customer, the more loyalty and the greater share of customer achieved from one customer *over time*, the more valuable by definition that individual customer will become.

²²Authors' note: Some may question the statement: "Customers are a company's only source of revenue." By definition, however, this is literally true. If a company sells products, for example, then the revenue does not come from the products; it comes from the customers who buy them. And if that same company *also* runs some ancillary businesses—say, renting out unused real estate space or spare capital—then those who make lease payments or interest payments are also customers.

²³Phillip Kotler, *Kotler on Marketing* (New York: Free Press, 1999).

²⁴Fred Reichheld, "Learning from Customer Defections," *Harvard Business Review* 74:2 (March–April 1996): 87–88.

relationships will be one-time, opportunistic transactions between virtual strangers.²⁵ However, he found that disloyalty could stunt corporate performance by 25 to 50 percent, sometimes more. In contrast, enterprises that concentrate on finding and keeping good customers, productive employees, and supportive investors continue to generate superior results. For this reason, the primary responsibility for customer retention or defection lies in the chief executive's office.

CRM ROI in Financial Services

Managing individual customer relationships has a profound effect on enhancing long-term customer loyalty, thereby increasing the enterprise's long-term profitability. Relationship strategies, for example, have a substantial effect on customer retention in the financial services sector. A study conducted in 2000 by Peppers & Rogers Group (with Roper Starch Worldwide) found that—looking at a group of “satisfied customers”—only 1 percent of consumers who rate their financial services provider high on relationship management say they are likely to switch away products. One-fourth of consumers (26 percent) who rate their primary financial services provider as low on relationship management attributes say they are likely to switch away one or more products during the next 12 months. The financial implications of these findings are staggering (see Exhibit 1B). Using a conservative average annual profitability per household for U.S. retail banks of \$100, a reduction in attrition of 9 percent represents over \$700 million in incremental profits for all U.S. households with accounts. If an individual financial institution with 20,000 customers can reduce attrition by 9 percentage points by providing excellent customer relationship management (e.g., recognizing returning customers, anticipating their needs, etc.), that institution can increase profits by \$180,000. For a similar-size financial institution with an average household profitability of \$500, the increase in profitability climbs to \$900,000.

Good customer service and:	Percent likely to add one or more products in next 12 months	Percent likely to switch away one or more products in next 12 months
LOW CRM	15%	26%
MEDIUM CRM	21%	10%
HIGH CRM	31%	1%

EXHIBIT 1B Benefits of CRM in Financial Services

Source: Peppers & Rogers Group, Roper Starch Worldwide survey, September 2000.

²⁵Reichheld, *The Loyalty Effect*.

Customer loyalty is closely associated with customer relationships and may, in certain cases, be directly related to the level of each customer's satisfaction over time.²⁶ According to James Barnes, satisfaction is tied to what the customer gets from dealing with a company as compared with what he has to commit to those dealings or interactions.²⁷ You'll read more about Dr. Barnes's views on satisfaction and relationships in the next chapter. For now, it's enough to know that the customer satisfaction issue is controversial—maybe even problematic. There are issues of relativity (Are laptop users just harder to satisfy than desktop users, or are they really less satisfied?) and skew (Is the satisfaction score the result of a bunch of people who are more or less satisfied, or a bimodal group whose members either love or hate the product?). Barnes believes that by increasing the value that the customer perceives in each interaction with the company, enterprises are more likely to increase customer satisfaction levels, leading to higher customer retention rates. When customers are retained because they enjoy the service they are receiving, they are more likely to become loyal customers. This loyalty leads to repeat buying and increased share of customer. (We will discuss more about the differences between attitudinal loyalty and behavioral loyalty, as well as ways to measure loyalty and retention, in the next chapter.)

Retaining customers is more beneficial to the enterprise for another reason: Acquiring new customers is costly. Consider the banking industry. Averaging across channels, banks can spend at least \$200 to replace each customer who defects. So, if a bank has a clientele of 50,000 customers, and loses 5 percent of those customers each year, it would need to spend \$500,000 or more each year simply to maintain its customer base.²⁸ Many Internet start-up companies, without any brand-name recognition, faced an early demise during the 2000–01 dot-com bubble bust, largely because they could not recoup the costs associated with acquiring new customers. The typical Internet “pure-play” spent an average of \$82 to acquire one customer in 1999, a 95 percent increase over the \$42 spent on average in 1998.²⁹ Much of that increase can be attributed to the dot-com companies' struggle to build brand awareness during 1999, which caused Web-based firms to increase offline advertising spending by an astounding 518 percent. Based on marketing costs related to their online business, in 1999, offline-based companies spent an average of \$12 to acquire a new customer, down from \$22 the previous year. Online firms spent an unsustainable 119 percent of their revenues on marketing in 1999. Even

²⁶Authors' note: It is generally a challenge to agree on what we all mean by “customer satisfaction.” Dave Power III has defined customer satisfaction as measuring the difference between what the customer expects to get and what he perceives he gets. More and more we are becoming capable of measuring what Pine and Gilmore call “customer sacrifice,” which is the difference between what the customer wants exactly and what the customer settles for. B. Joseph Pine and James Gilmore, “Satisfaction, Sacrifice, Surprise: Three Small Steps Create One Giant Leap into the Experience Economy,” *Strategy and Leadership* 28, no. 1 (January–February 2000): 18.

²⁷James G. Barnes, *Secrets of Customer Relationship Management* (New York: McGraw-Hill, 2001).

²⁸Banks' customer acquisition costs can vary wildly, between \$150 and \$3600, depending on the source, the product, and the channel, so \$200 is a more-than-conservative figure.

²⁹Boston Consulting Group and Shop.org, “The State of Online Retailing” (April 2000), available for purchase at www.shop.org/web/guest/research/store.

**EXHIBIT 1.5 Customer Acquisition Costs
(Q1, 2009)**

On the Web	\$63
Over the phone	\$122
In a branch/store	\$146

Source: February 2009 Global eBusiness and Channel Strategy Professional Online Survey, from “2009 Cost of eBusiness Operations and Customer Acquisition,” Carrie Johnson and Elizabeth Davis with Kate van Geldern, Forrester Research, Inc., available at www.forrester.com, accessed September 1, 2010.

with the advantages of established brands, offline companies spent a still-high 36 percent.

The problem is simple arithmetic. Given the high cost of customer acquisition, a company can never realize any potential profit from most customers, especially if a customer leaves the franchise (see Exhibit 1.5). High levels of customer churn trouble all types of enterprises, not just those in the online and wireless industries. The problem partly results from the way companies reward sales representatives: with scalable commissions and bonuses for acquiring the most customers. Fact is, many reps have little, if any, incentive for keeping and growing an established customer. In some cases, if a customer leaves, the sales representative can even be rewarded for bringing the same customer back again! Although it's always somebody's designated mission to get new customers, too many companies still don't have anybody responsible for making sure this or that particular customer sticks around or becomes profitable. Often a service company with high levels of churn needs to rethink not only how its reps engage in customer relationships but also how they are rewarded (or not) for nurturing those relationships and for increasing the long-term value to the enterprise of particular customers. Throughout this book, we will see that becoming a customer-value enterprise is difficult. It is a strategy that can never be handled by one particular department within the enterprise. Managing customer relationships is an ongoing process—one that requires the support and involvement of every functional area in the organization, from the upper echelons of management through production and finance, to each sales representative or contact-center operator. Indeed, customer-driven competition requires enterprises to integrate five principle business functions into their overall customer strategy:

The problem is simple arithmetic. Given the high cost of customer acquisition, a company can never realize any potential profit from most customers, especially if a customer leaves the franchise.

1. *Financial custodianship of the customer base.* The customer-strategy enterprise treats the customer base as its primary *asset* and carefully manages the investment it makes in this asset, moving toward balancing the value of this asset to long-term as well as short-term success of the company.

2. *Production, logistics, and service delivery.* Enterprises must be capable of customizing their offerings to the needs and preferences of each individual customer. The Learning Relationship with a customer is useful only to the extent that interaction from the customer is actually incorporated in the way the enterprise behaves toward that customer.
3. *Marketing communications, customer service, and interaction.* Marketing communications and all forms of customer interaction and connectivity need to be combined into a unified function to ensure seamless individual customer dialogue.
4. *Sales distribution and channel management.* A difficult challenge is to transform a distribution system that was created to disseminate standardized products at uniform prices into one that delivers customized products at individualized prices. **Disintermediation** of the distribution network by leaping over the “middleman” is sometimes one solution to selling to individual customers.
5. *Organizational management strategy.* Enterprises must organize themselves internally by placing managers in charge of customers and customer relationships rather than of just products and programs.³⁰

A customer-strategy enterprise seeks to create one centralized view of each customer across all business units. Every employee who interacts with a customer has to have real-time access to current information about that individual customer so that it is possible to pick up each conversation from where the last one left off. The goal is instant interactivity with the customer. This process can be achieved only through the complete and seamless integration of every enterprise business unit and process.

Summary

A customer-strategy enterprise seeks to identify what creates value for each customer and then to deliver that value to him. As other chapters in this book will demonstrate, a customer-value business strategy is a highly measurable process that can increase enterprise profitability and shareholder value. We also show that the foundation for growing a profitable customer-strategy enterprise lies in establishing stronger relationships with individual customers. Enterprises that foster relationships with individual customers pave a path to profitability. The challenge is to understand how to establish these critical relationships and how to optimize them for profits. Learning Relationships provide the framework for understanding how to build customer value.

Increasing the value of the customer base by focusing on customers individually and treating different customers differently will benefit the enterprise in many ways. But before we can delve into the intricacies of the business strategies behind this objective, and before we can review the CRM analytical tools and techniques required to carry out this strategy, we need to establish a foundation of knowledge

³⁰Don Peppers and Martha Rogers, Ph.D., *Enterprise One to One* (New York: Doubleday Broadway Books, 1997). Also see Peppers and Rogers's *Rules to Break and Laws to Follow: How Your Business Can Beat the Crisis of Short-Termism* (Hoboken, NJ: John Wiley & Sons, 2008).

with respect to how enterprises have developed relationships with customers over the years. That is our goal for the next chapter.

Food for Thought

1. Understanding customers is not a new idea. Mass marketers have done it for years. But because they see everyone in a market as being alike—or at least everyone in a niche or a segment as being alike—they “understand” Customer A by asking 1,200 (or so) total strangers in a sample group from A’s segment a few questions, then extrapolating the average results to the rest of the segment, including A. This is logical if all customers in a group are viewed as homogeneous. What will a company likely do differently in terms of understanding customers if it is able to see one customer at a time, remember what each customer tells the company, and treat different customers differently?
2. If retention is so much more profitable than acquisition, why have companies persisted for so long in spending more on getting new customers than keeping the ones they have? What would persuade them to change course?
3. How can we account for the upheaval in orientation from focusing on product profitability to focusing on customer profitability? If it’s such a good idea, why didn’t companies operate from the perspective of building customer value 50 years ago?
4. In the age of information (and connectivity), what will be happening to the four Ps, traditional advertising, and branding?
5. “The new interactive technologies are not enough to cement a relationship, because companies need to change their *behavior* toward a customer and not just their *communication*.” Explain what this statement means. Do you agree or disagree?

Glossary

Analytical CRM The strategic planning needed to build customer value, as well as the cultural, measurement, and organizational changes required to implement that strategy successfully.

Business model How a company builds economic value.

Customer equity (CE) The value to the firm of building a relationship with a customer, or the sum of the value of all current and future relationships with current and potential customers. Term can be applied to individual customers or groups of customers, or the entire customer base of a company.

Customer relationship management (CRM) Making managerial decisions with the end goal of increasing the value of the customer base through better relationships with customers, usually on an individual basis.

Customer-strategy enterprise An organization that builds its business model around increasing the value of the customer base. This term applies to companies that may be product oriented, operations focused, or customer intimate.

Demand chain As contrasted with the supply chain, refers to the demand from customers.

Data warehousing A process that captures, stores, and analyzes a single view of enterprise data to gain business insight for improved decision making.

Disintermediation Going directly to customers by skipping a usual distribution channel; for example, a manufacturer selling directly to consumers without a retailer.

Enterprise resource planning (ERP) The automation of a company's back-office management.

Interactive era or era of connectivity The current period in business and technological history, characterized by a dominance of interactive media rather than the one-way mass media more typical from 1910 to 1995. Also refers to a growing trend for businesses to encourage feedback from individual customers rather than relying solely on one-way messages directed at customers, and to participate with their customers in social networking.

Multiple channel An organization that sells through more than one distribution channel (e.g., the Web, a toll-free number, mail-order catalog). Can also refer to firms that interact with customers through more than one channel of communication (e.g., the Web, e-mail, fax, direct mail, phone).

Operational CRM The software installations and day-to-day procedural changes needed in a firm to build customer value.

Recognition The ability to recognize an individual customer as that customer through any shopping or buying channel, within any product purchase category, across locations or geographies, and over time. These individual data points are linked for a universally recognized, or identified, customer.

Relationship equity *See* Customer equity.

Sales force automation (SFA) Connecting the sales force to headquarters and to each other through computer portability, contact management, ordering software, and other mechanisms.

Share of customer (SOC) Each customer buys a certain amount of goods or services in various categories. If you are a vendor in one of those categories—say, cars—then the share of customer you have with any one customer is the percentage of that customer's business you get in that category. If a family owns four cars, and two of them are your brands, then you have a 50 percent share of garage for cars. But you may also be interested in your SOC for service and repairs and your share of wallet for your automotive credit card. SOC refers to the share of each customer's business you get, contrasted with market share, which is your percentage of the total sales in your category.

Social networking The ability of individuals to connect instantly with each other often and easily online in groups. For business, it's about using technology to initiate and develop relationships into connected groups (networks), usually forming around a specific goal or interest.

Switching cost The cost, in time, effort, emotion, or money, to a business customer or end-user consumer of switching to a firm's competitor.

Value of the customer base *See* Customer equity.

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