Managing Customers for Profit

V. Kumar

Chapter – 12

Acquiring Profitable Customers

Instructor's Presentation Slides

Relevant Issues

Is it prudent to use acquisition and retention rates as a measure of overall marketing efficiency?

Will a firm's profits be maximized by optimizing customer acquisition and customer retention expenditures, separately?

Optimizing Direct Marketing

Company	How much more/less should be spent on direct marketing to reach optimal levels?	How much profits would increase if spending on direct marketing were at the optimal level?
B2B	-68%	42%
Pharmaceutical	31%	36%
Catalog Retailer	-31%	29%

Why is it that these firms are so far from maximizing their profitability even with the increased amount of customer information?

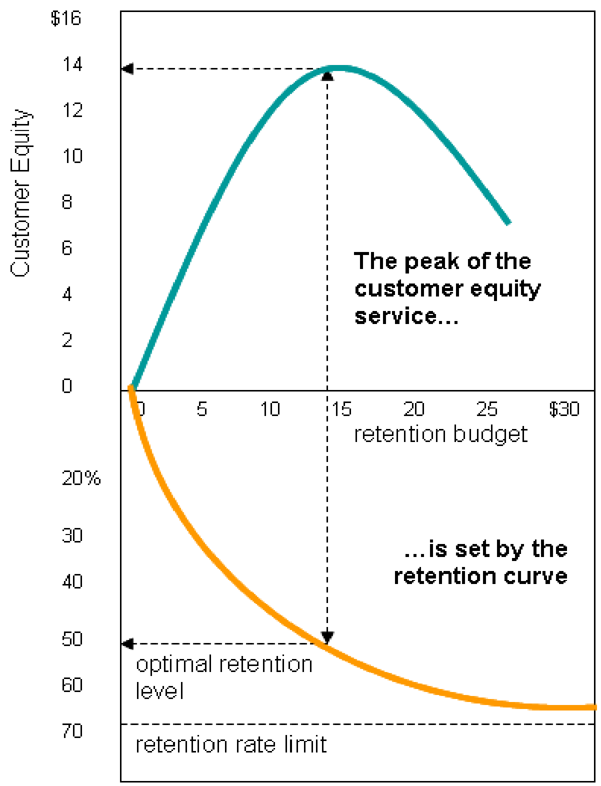
Source: Thomas J., W. Reinartz and V. Kumar (2004), "Getting the Most out of All Your Customers," *Harvard Business Review*, (July-August 2004), pp. 116-123

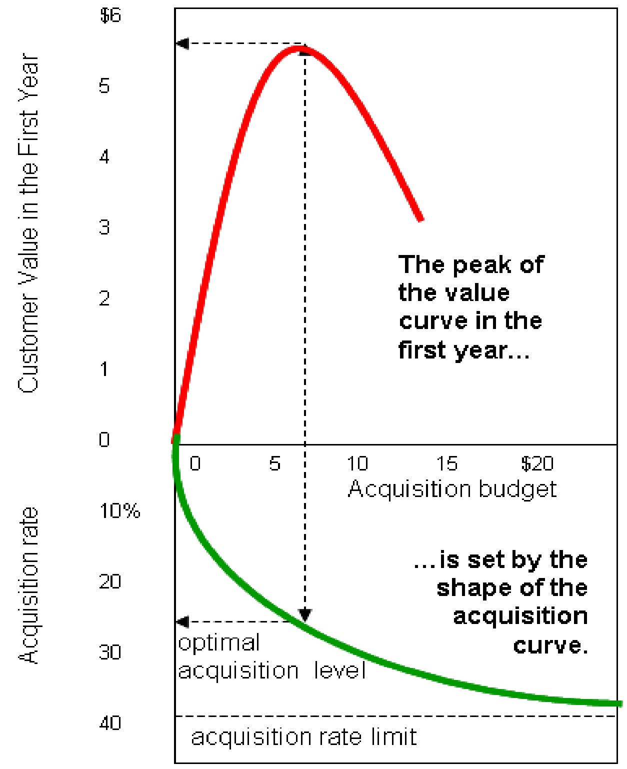
The Manager's Folly

Too often when marketers take decisions about allocating resources for direct marketing, the customers targeted by these campaigns are often those who are inexpensive (easier) to acquire and inexpensive (easier) to retain.

Managers are also too quick to try and maximize each stage of the acquisition and retention process thereby failing to look at the bigger picture of balancing acquisition and retention together.

Pitfall 1: Law of Diminishing Returns





These results show that in the cases of both acquisition and retention, there is an optimal point at which the firm can maximize its profitability by having the right acquisition rate (around 25%) and retention rate (around 50%).

http://www.drvkumar.com/books/book_mcp.html

Pitfall 2: Short-Term vs. Long-Term Outlook

	Low Acquisition Cost	High Acquisition Cost
High Retention Cost	***High Maintenance Customers*** ***25% of Customers*** ***15% of Profits***	***Royal Customers*** ***28% of Customers*** ***25% of Profits***
Low Retention Cost	***Casual Customers*** ***32% of Customers*** ***20% of Profits***	***Low Maintenance Customers*** ***15% of Customers*** ***40% of Profits***

Managers are looking to get the most out of each customer and thus spend unnecessarily on un-profitable customer to maximize profits in the short-run, at the detriment of long-term profits

Pitfall 3: Treating Acquisition and Retention Strategies as Independent

When acquisition and retention departments are independent, their goals are not congruent.

This causes The acquisition Department to seek out quantity of customers rather than quality.

Pitfall 4: Relying Too Much on Current Customers

Current customers are used to predict the potential behavior of the prospects…

The inferences made from these predictions can be very misleading causing managers to incorrectly allocate resources to a set of prospects leading to a suboptimal level of profitability

ARPRO (Allocating Resources for Profit)

Once the four pit falls have been avoided, firms must answer three key questions to optimally allocate their resources between retention and acquisition.

1 Given the budget constraint, how does the profit maximizing strategy allocate resources between the contact modes that vary in their degree of interpersonal interaction and costs?

2 Which is more critical for profitability, acquisition or retention expenditures?

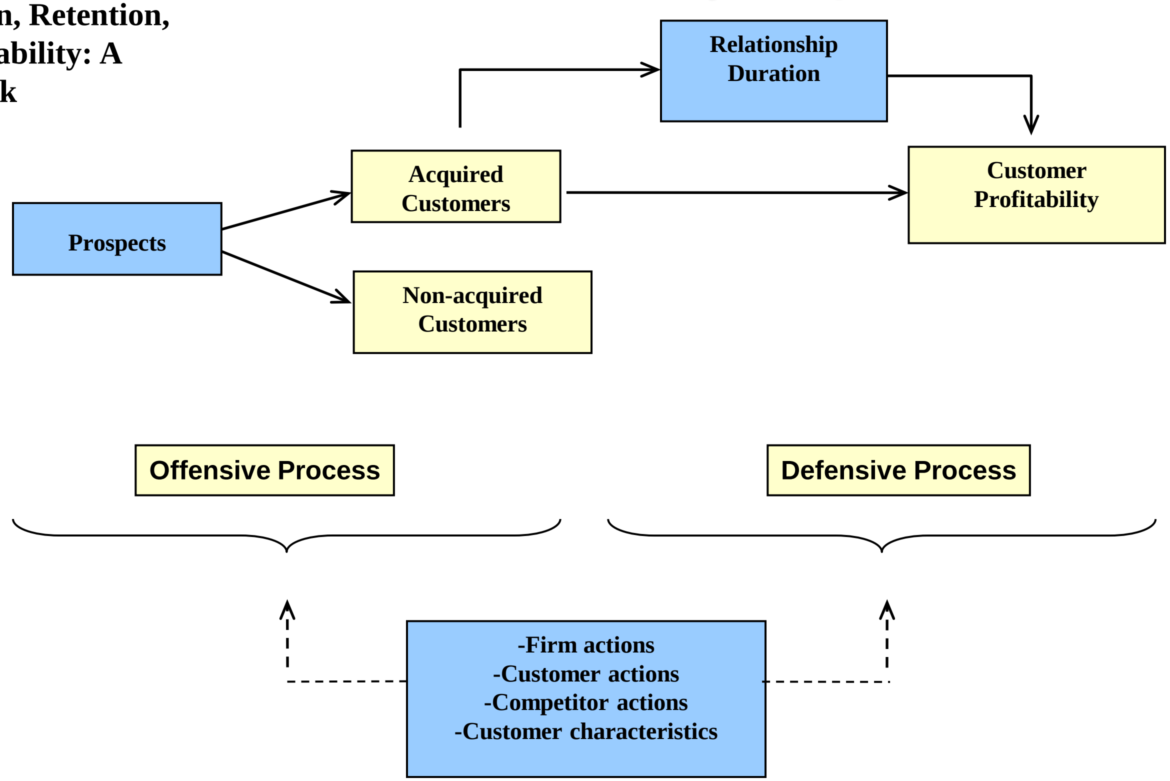
3 Does the contact strategy that maximizes customer profitability also maximize acquisition and retention rates?

ARPRO (Cont'd)

ARPO Model = complex regression analysis with long-term profitability as a function of several key factors and factors that are weighted and corrected for sample selection bias

Figure 12.3: Linking Acquisition, Retention, and Profitability: A Framework

ARPRO Conceptually



Source: Reinartz, Werner, Jacquelyn S. Thomas, and V. Kumar (2005), "Balancing Acquisition and Retention Resources to Maximize Customer Profitability," Journal of Marketing, 69 (1), 63-79.

ARPRO Drivers

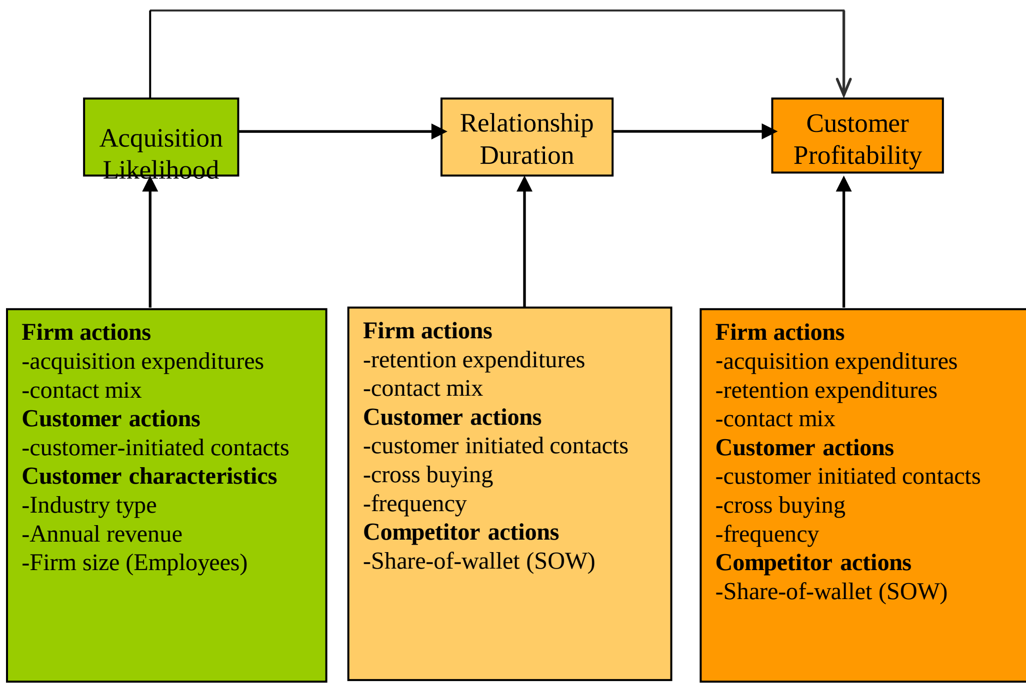


Figure 12.4: Drivers of Acquisition, Retention, and Profitability

Source: Reinartz, Werner, Jacquelyn S. Thomas, and V. Kumar (2005), "Balancing Acquisition and Retention Resources to Maximize Customer Profitability," Journal of Marketing, 69 (1), 63-79.

ARPRO Regression Model

$$\begin{cases} \text{Profitability} = f\,(\text{Firm Actions}_{\text{profit}}, \text{Customer Actions}_{\text{profit}}, \text{Competitor Actions}_{\text{profit}})\ (\text{Model 1}) \\ \text{Duration} = f\,(\text{Firm Actions}_{\text{duration}}, \text{Customer Actions}_{\text{duration}}, \text{Competitor Actions}_{\text{duration}})\ (\text{Model 2}) \\ \text{Acquisition} = f\,(\text{Firm Actions}_{\text{acquisition}}, \text{Customer Actions}_{\text{acquisition}}, \text{Demographics}_{\text{acquisition}})\ (\text{Model 3}) \end{cases}$$

The Profit-Maximizing ARPO Strategy

Based on the drivers and weights of the drivers computed for the Pharmaceutical in a recent marketing study, the optimal average acquisition spending across customers should be $10 and the optimal average retention spending across customers should be $60 (See Table 12.2).

Table 12.2: Average Customer Profitability

		Retention Spending				
		$40	$50	**$60**	$70	$80
Acquisition Spending	$1	$1,423	$1,543	$1,583	$1,543	$1,423
	$5	$1,437	$1,557	$1,597	$1,557	$1,437
	$10	$1,443	$1,563	**$1,603**	$1,563	$1,443
	$15	$1,437	$1,557	$1,597	$1,557	$1,437
	$20	$1,418	$1,538	$1,578	$1,538	$1,418

This optimal spending on acquisition and retention gives the highest overall customer profitability for the firm

The Profit-Maximizing ARPO Strategy

It is also necessary that the acquisition and retention spending should not be done in isolation

- For example, if the same firm only tried to maximize relationship duration (retention) by itself, then the optimum spending level would be at $70 per customer (See Table 12.3).
- However, the previous example showed that the optimum spending was actually $70 on both acquisition and retention - $10 on acquisition and $60 on retention per customer.
- By optimizing the relationship duration by spending $70 instead of splitting the $70 on acquisition ($10) and retention ($60), the profitability would decrease from $1,603 to about $1,543 – a drop in 3.7% (See Table 12.2 for values).

Table 12.3: Average Customer Relationship Duration

Retention Spending (per customer)	$40	$50	$60	$70	$80
Estimated Relationship Duration (days)	122	135	142	143	138

Source: Thomas J., W. Reinartz and V. Kumar (2004), "Getting the Most out of All Your Customers," *Harvard Business Review*, (July-August 2004), pp. 116-123.

Conclusion

- It is not only necessary to consider acquisition spending and retention spending at the same time, but also that profitability is based on how the two interact. This means that it is not necessarily important to consider exactly how much to spend on acquisition or retention alone, but instead on how you balance your acquisition and retention spending together to maximize profitability.

End of Chapter 12