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Return on Customer[SM]

Peppers and Rogers Popularize an Important Concept

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By Patricia B. Seybold, CEO and Sr. Consultant, Patricia Seybold Group *July 21, 2005*

IMPORTANT SUMMER READING

Peppers and Rogers' New Book

I'm recommending Don Peppers' and Martha Rogers' new book, *Return on Customer,*[1] to my clients this summer. It's a seminal book—one that will no doubt catch on. It addresses a really important subject: how to make customer value (the value of customers to your firm) a core business and strategy driver, if not THE core business driver.

It's a good book to hand to your executives to make your case about the value of pursuing your customer initiatives. Whether your executives read the book or not, the message that there's a tangible financial "return on customers" to your cash flow, to your bottom line and in the eyes of your investors, is one that executives are (finally) ready to hear.

Frankly, my heart sank when I received my advance copy of this book—graciously sent to me at my home along with a cover note from Martha and Don. I realized right away that Don and Martha had managed to crystallize and brand a set of concepts that I had promulgated too early—before the market was ready—and that they had done so with a memorable title—one that would make this book a required pass-along read among business execs.

Then I realized that in this well-researched and well-footnoted book, there wasn't even a nod to my earlier book, *The Customer Revolution,*[2] in which I had introduced the concepts of the Customer Economy, customer capital, customer momentum, customer franchise, and the Customer Value Index.

Yet, Peppers and Rogers captured all of those ideas in a single, catchy, easy-to-remember concept: "Return on Customer." They may have published four-and-a-half years later, but now executives are more willing to hear this message (in the post Sarbanes-Oxley era). And Peppers and Rogers devoted an entire book to the concept, not a single chapter. In short, they did a much better job than I did.

Why do I think this is the right way to think about your business? When I published *The Customer Revolution* in 2001, I was already convinced that companies needed to begin calculating and reporting their customer lifetime value—their customer capital—as well as making explicit the calculations they used to project future cash flow and earnings based on projected income from future customers. After all, I reasoned, since all operating profits and cash flow come from the money your customers spend with you, shouldn't investors know what the basis for your projections are? Among the things I didn't do was to offer specific formulas for calculating customer lifetime value. Peppers and Rogers do offer several examples of hypothetical LTV formulas throughout their book.

I'm glad that this book will garner attention and galvanize discussion. It's worth investing the time to read it. There's good advice here. Don and Martha wrestle a number of difficult concepts to the ground.

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[1] Don Peppers and Martha Rogers, *Return on Customer: Creating Maximum Value from Your Scarcest Resource* (Random House, 2005), http://www.returnoncustomer.com.

[2] Patricia B. Seybold, with Ronni T. Marshak and Jeffrey M. Lewis, *The Customer Revolution: How to Thrive When Customers are in Control* (New York: Crown Business, 2001).

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THE RETURN ON CUSTOMER EQUATION

Return on Customer can be calculated as follows:

$$\text{ROC} = \frac{\pi_i + \Delta \text{CE}_i}{\text{CE}_{i-1}}$$

Where π_i = Cash flow from customers during period *i*,

ΔCE_i = change in customer equity during period *i*, and

CE_{i-1} = customer equity at the beginning of period *i*.

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: *Return on Customer*, p. 7, 2005

Illustration 1. Peppers and Rogers' Return on Customer equation

What's the Main Message of Return on Customer?

ROC Defined. Peppers and Rogers offer a Return on Customer equation (Illustration 1). "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."[3]

Whether or not you can turn this ROC equation into something you can actually track is still a bit questionable. I would have preferred a somewhat simpler barometer—something that all companies could do easily and all investors could agree on as a useful basis on which to project future earnings or future cash flow.

How is customer equity defined? Peppers and Rogers define it as "all the lifetime values of a firm's current and future customers." How do they define customer lifetime value? As "the net present value of the future stream of cash flows a company expects to generate from the customer." (They then go on to say that whether you use earnings from customers or cash flow from customers is essentially irrelevant; they discuss the pros and cons of the two approaches in an appendix.)

[3] *Return on Customer*, Op Cit., page 7

I agree with Peppers' and Rogers' definition of customer equity. It's the same concept I described as "the value of your customer franchise: the discounted net present value of the earnings from your current and future customers."

Why Does ROC Matter to Your Business? The main message of Peppers and Rogers' book is this: run your company to maximize the value of your customer portfolio. "Reconciling the conflict between current profit and long-term value is one of the most serious difficulties facing business today," they explain. "The most important and overriding financial goal for any management team should be to push the ROC speedometer to its limit, because by doing so they will be maximizing the value being created by their firm. A more ROC-efficient company will not only harvest current profits, but it will tend to conserve and replenish its stock of customer equity as well." This is excellent advice!

Why Does ROC Matter to Investors? In their "*Open Letter to Wall Street*" at the beginning of the book, Peppers and Rogers make the same argument I made almost five years ago: They say, "What if you could hold businesses accountable today for all the future value they had to use to make up today's numbers? You need a workable means to measure the *total* value a business creates or destroys with its actions. Return on Customer is that metric."

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I said, "What investors really care about (and you should too) is the value of your customer franchise. Your customer franchise is the total present value of the projected earnings from your current and future customers….Calculating the value of your own customer franchise is definitely doable. However, calculating the value of some other company's customer franchise is difficult because you probably won't have enough information to do a very precise calculation. Calculating customer lifetime value is tricky when you only have average profits across aggregated customers, as opposed to profits by actual customers or by customer segment. But as companies begin to disclose more complete customer information, we expect that someone in the financial community will come up with a clever 'back of the envelope' formula that will help investors calculate customer value in a way that makes it easy to compare and contrast a customer value index to the current measures of P/E ratios and market capitalization." That's precisely what Peppers and Rogers have attempted to do by popularizing the notion of Return on Customer. Their ROC formula is the formula I was seeking. Will it catch on? I'm hopeful. It may take more time than my original five-year prediction (now five years old!). At the very least, *Return on Customer* will probably become required reading in most business schools. That's a good start.

"The most important and overriding financial goal for any management team should be to push the ROC speedometer to its limit, because by doing so they will be maximizing the value being created by their firm. A more ROC-efficient company will not only harvest current profits, but it will tend to conserve and replenish its stock of customer equity as well." - Don Peppers and Martha Rogers

What Are the Most Important Parts to Read?

I recommend beginning by reading the last chapter of the book, *Chapter 14: Who Moved My ROI?* In it, Peppers and Rogers summarize the seven principles of ROC that are buried elsewhere in the book:

1. Customers are a company's scarcest resource.
2. When companies don't treat customers as a scarce resource, they focus excessively on the short term.
3. Return on Customer is a balanced metric, focused on the scarce resource.
4. Taking the customer's perspective is the first step to drive ROC up.
5. Maximizing ROC requires treating different customers differently.
6. ROC creates better leverage for your competitive strategy.
7. Success not only requires your CEO's active support and advocacy, but it also requires your shareholders to buy in as well.[4]

Chapter 13: Managing Portfolios of Customers to Build Enterprise Value is the next most important chapter to read. This is the meatiest chapter of the book, with three specific company examples. Essentially, Peppers and Rogers recommend that you assign customer portfolio managers for each group of customers. These customer portfolio managers are accountable for growing the value of the customers in the segment for which they're responsible. They combine two disciplines: customer value management and customer experience management (although Peppers and Rogers don't go far enough, in our opinion, in prescribing the importance of the customer experience management function).

The toughest argument to make to any executives or investors is that you have a handle on predicting future earnings or cash flow from current or future customers. In *Chapter 6, Predicting the Future*, Peppers and Rogers summarize the four leading indicators of lifetime value change:

[4] *Return on Customer*, page 207

1. Lifetime value drivers
2. Lifestyle changes
3. Behavioral cues
4. Customer Attitudes

The chapter provides a useful summary and a set of examples to stimulate your thinking. Essentially, you'll need to build and refine a predictive model. This chapter is not a "how to" by any means. But you'll find the discussion corroborates most of what you're probably already doing (or thinking about doing).

I also recommend reading the appendices and skimming the footnotes. In appendices 1 through 4, Peppers and Rogers provide very accessible guidance for non-accounting or non-financial executives on:

1. **Discounting Made Simple.** Appendix 1 offers the basics for calculating the risk of receiving cash in the future. What they don't discuss is the fact that the discount rates should increase the further into the future you go.

2. **Lifetime Value Accounting Issues.** Appendix 2 discusses the pros and cons of using fully allocated profit, marginal financial contribution by customer or free cash flow.

3. **Lifetime Value Equations and Examples.** Here, Peppers and Rogers give some basic formulas, discuss the pros and cons, recommend further resources, and make it clear that your LTV calculations will be only as good as your customer data and your predictive modeling capabilities. This appendix alone should be required reading for any executive who doesn't see the value of investing in customer analytics.

4. **The Economics of Customer Equity.** This appendix is weaker. It basically tells you that the more customer insight you have, the lower the discount rate you can apply to calculating future earnings.

A skim of the footnotes will give you a great overview of most of the related literature and concepts introduced in the book. The fact that the book is well-researched is important for your credibility as you pass it along.

What's Useful and What's Redundant?

Most valuable are the discussion of customer portfolio management and the exhortation that you need to convince your executives and your investors that managing by and for customer lifetime value is the most important star by which to steer the corporate ship. The myriad of anecdotes and examples help liven up the book.

However, most of the rest of the prescriptive advice in the book—how to deal with corporate culture change issues, how to take the customers' perspective, how to get into a learning relationship with customers, how to drive your company's strategy from your customers' real needs—are handled better by other authors and even by Don and Martha in their other books.

For example, Peppers and Rogers never really address the issue of how to determine what really matters to each group of customers, and how to continuously improve and monitor the results. That's the topic I treated at some length in *The Customer Revolution*, in which I provided detailed case studies of 12 companies' journeys, as well as examples of customer experience and value measurement scorecards (our Customer Flight DeckSM).

What's Missing?

We were hoping to find more and better case studies. The book is woefully weak in providing concrete examples of real companies that have managed by and for customer value. Peppers and Rogers use anecdotes. They cite others' case studies. They provide sanitized examples (with no company names). They provide hypothetical examples which are a bit too generalized to be useful. And they do provide a few discussions of actual companies (Boise Office Solutions, CIBC, Hannover Life)—but without enough detail to provide real insights.

What Actions Should You Take after Reading This Book?

You should have a stronger sense of purpose and renewed commitment after reading *Return on*

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Customer. It's always comforting to know that others are slogging down the same trail that you are.

The specific actions I suspect most readers will take (or revisit) are:

1. Educate your executives on the importance of managing by and for customer value.

2. Segment your customers into customer segments you can track and manage.

3. Improve your ability to measure customer revenues, earnings, and/or cash flow generated by each segment (and eventually by each customer).

4. Improve your ability to correlate customer behaviors, events and other triggers with customer spending in order to build predictive models of future earnings from each customer segment.

5. Assign a customer portfolio manager for each customer segment and give each manager the resources and the clout to both grow customer value and to continuously improve the Quality of the Customer Experience℠ for each customer segment. We recommend separating customer experience management from customer value management because the people you need may have different skillsets. But, if you combine the job descriptions we provide for Customer Segment Advocates[5] and VP of Customer Intelligence,[6] you'll have a good idea of what you're seeking—whether you combine these into one role or two (per customer segment).

[5] See "Customer (and Partner) Segment Advocates, Patty's Dream Team: Roles and Responsibilities You'll Need for Your Customer-Centric Organization," Patricia B. Seybold, September 9, 2005, http://dx.doi.org/10.1571/OS9-9-04CC.

[6] See "VP of Customer Intelligence, Patty's Dream Team: Roles and Responsibilities You'll Need for Your Customer-Centric Organization," Patricia B. Seybold, November 4, 2004, http://dx.doi.org/10.1571/OS11-4-04CC.

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