COMPARISON BETWEEN CUSTOMER LIFETIME VALUE (CLV) AND TRADITIONAL MEASUREMENT TOOLS OF CUSTOMER VALUE

Monica TALABĂ PhD. Candidate
Doctoral School of Economy A.I. Cuza University, Iași
Faculty of Economy and Administrative Sciences
Email: monica.talaba@gmail.com

Abstract:
The ability to accurately predict the value of the customers of a company has huge impact on the capacity to make intelligent decisions. Knowing the individual value of each customer allows the identification of the most profitable customers and directing marketing spend towards them. This study analysis the benefits of a relative recent metric, customer lifetime value in opposition with more traditional metrics: RFM analysis, SOW, PCV, CPA. Towards these, customer lifetime value CLV is more efficient in selecting profitable customers.

Key words: customer lifetime value, RFM analysis, customer value, client segmentation

JEL Classification: M21

Customer lifetime value (CLV) concept

The concept of Customer Lifetime Value (CLV) is defined in various ways, but all approaches share the essence, the present value of the incomes brought by the customer, from which one deducts the corresponding costs along the period of time, in which the customer makes transactions with the organization. The point in which the definitions differ is the concept of corresponding costs. A similar conclusion is also reached by other researchers (Pfeifer, Haskins, Conroy, 2004; Knie-Andersen, 2001), who claim that all researchers agree to the fact that Customer Lifetime Value (CLV) is a present measurement of future sums of money, but with differences in the way of defining these future sums of money.

We intend to use here the definition given by Pfeifer, Haskins and Conroy (2004), according to which the Lifetime Customer Value (CLV) is: “the present value of future money flows attributed to the relationship with the customer”.

The utility of Customer Lifetime Value (CLV) estimation

CLV is a way to measure the value of a customer for a company. Calculating CLV for all customers helps the company systematize customers depending on their contribution to profit. This may be a base for the formulation and implementation of some specific customer strategies to maximize the duration and the profits
obtained throughout the entire relationship with the customer. In other words, CLV helps the company treat every customer differently, based on the contribution of each customer, instead of treating all customers the same (Kumar, 2006).

Calculating CLV helps the company know how much it can invest in the retention of customers, so that the investment has profit. Any company has limited resources and ideally it should invest them in those customers that bring a maximum of profit, which is possible only if one knows the monetary flow of each customer along his/her entire relationship with the organization, in other words the customer lifetime value. Once the company calculates the CLV for its customers, it may allocate resources more efficiently in order to maximize the profit.

**Identifying the most valuable customers based on their Lifetime Value (CLV)**

Studies (Reinartz, Kumar, 2000) emphasize the fact that not all loyal customers are profitable, and such research questions the logic according to which the more customers a company can keep; the higher the profitability of company is bound to be. This situation appears because for many customers, the incomes they bring are way below the costs of keeping them. Attracting and keeping these unprofitable customers acts like a leak from total profitability. Selecting customers worth keeping, i.e. those who bring a maximum of profit to the company, is a huge step to increase profitability.

**Segmenting customer’s base based on their Lifetime Value (CLV)**

On the simplest level one may distinguish two segments – customers who are worth keeping and customers who do not deserve the effort (Mulhern, 1999). This means that only those customers with a CLV value above 0 will be selected. On a more advanced level, one may distinguish more segments. For instance, one may identify a segment with the best customers, who bring the highest profits and for whom one may create an ample retention program. Another segment may be less profitable than the first, but still valuable and one may think of programs and strategies so as to make these customers migrate in the first segment of profitability (Mulhern, 1999).

If the analysis of segments is based on aspects excluding a measurement of incomes and costs, then regular segments may not be economically viable for the organization (Mulhern, 1999).

The segmentation methods that use Customer Lifetime Value (CLV) may be classified in three categories (Benoit, den Poel, 2009):

- segmentation using only CLV values (the pyramid of customers)
- segmentation using only CLV components, such as current value, potential value, loyalty
- segmentation using CLV values and information, such as the socio-demographic ones or the history of transactions.

**Traditional methods for the estimation of the customer value**

Among the tools traditionally used for the calculation of the customer value, we would like to mention here RFM, the Share of Wallet (SOW), as well as the Past Customer Value (PCV).

**RFM analysis**

RFM stands for Recency, Frequency and Monetary Value. This technique uses three measurement tools to assess the behavior and value of a customer.

1. **Recency** measures the length of time that passed since the customer placed his latest order with the company
2. **Frequency** measures how often the customer placed order in a certain period of time
3. **Monetary value** is the sum of money spent by the customer on a regular transaction.

Generally, one uses two methods to calculate RFM. The first refers to sorting out customers from databases, according to the RFM criterion, into 5 groups, which mean 5 x 5 x 5 or 125 cells. Then one analyses the resulting data. The studies show that the answer rate of the customer varies mostly according to recency, followed by frequency of purchase and monetary value (Hughes, 2005).

The second method means establishing a relative degree of importance for the three measurement tools, using regression techniques.
and then using these ponders to calculate the combined effects of RFM. RFM may be considered a sum of the pondered scores recency, frequency and monetary value of a customer. This technique may be applied only based on the information from the customer’s previous transactions and not on prospective data.

The Share of Wallet (SOW)

On an aggregated level, the Share of Wallet (SOW) is defined as the proportion of the category, taken as a value, obtained from a brand or a company at the level of the entire database of customers. On an individual level, the Share of Wallet is the proportion from the corresponding category, taken as a value, obtained by a brand or a company among all brands that the customer buys from the same category. In fact, it indicates the degree in which a customer fulfils his needs in a category, based on a brand or a company (Reinartz, Kumar, 2003).

Customer Profitability Analysis (CPA)

Used especially in accounting management, Customer Profitability Analysis is basically a technique that admits that some customers generate bigger economic benefits than others. The calculus means precisely assigning costs to particular products. Then, expenses with sales and marketing are associated to customers so as to give total costs attached to customers. Costs are compared to incomes brought by the customer and one calculates its profitability. The Customer Profitability Analysis provides information regarding the profitability of some customers or of some segments of customers for a previous accounting period. Consequently, this tool shows how profitable customers were (Baxter, Collings, 2005).

Comparison between Customer Lifetime Value (CLV) and traditional methods

Even though RFM, Previous Customer Value (PCV), Share of Wallet (SOW) and Customer Profitability Analysis (CPA) are traditionally used to calculate the customer value, one may mention the following (Kumar, 2006). These methods have no perspective and do not take into consideration whether the client is active in future or not. They only take into consideration the purchasing behavior noticed, which is extrapolated in the future so as to reach the future profitability of the customer. RFM is based on the presupposition that recency, frequency and monetary value of a purchase explain the future value of a customer. It cannot take into consideration other factors which estimate the future purchasing behavior and the value of the customer for the company. Furthermore, the ponders given to the three measurement tools significantly influence the calculus of the value of the customer. At the same time, PCV and CPA techniques do not take into consideration the factors that influence the future purchasing behavior or the expected costs to keep the customer in future. Since the SOW technique is based on the answers of a representative sample of customers, it can only provide a clear measurement tool of the future contributions of the customer.

On the other hand, the Customer Lifetime Value (CLV) incorporates not only the probability for a customer to be active in future, but also the cost of its retention. It power to identify profitable customers is so much bigger. A study done on a database of a catalogue retailer (Kumar, Petersen, 2005) shows that the use of CLV in selecting the 20% most profitable customers overshakes the efficiency of RFM by approximately 168%, the PCV method by approximately 95% and the SOW method by approximately 172%. Other researchers (Venkatesan, Kumar, 2004) support these results and show that those customers selected based on CLV bring higher profits in future than customers selected according to other specific customer tools. Other studies compare only CLV methods to RFM methods and find the former being superior to the latter. Reinartz and Kumar (2003) also used a database of a catalogue retailer and showed that the incomes obtained from the first 30% of the customers selected based on CLV are 33% higher than the incomes brought by the first 30% of the customers selected using the RFM method.

REFERENCES

2. Bell, D., Deighton, J., Reinartz, W. J., Rust, R. T., Swartz, G. (2002), Seven barriers to


