

# Measuring and Growing Customer Lifetime Value

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published on BNET.com 5/02/2007

Customer lifetime value (CLV) is a way of measuring how much your customers are worth to your business over the time they buy your products and services. A well-run CLV program can help you identify which customers are worth your greatest attention – and can help you make the most of your marketing dollars.

## What You Need to Know

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### How does CLV differ from customer loyalty programs?

Customer loyalty programs are designed to retain as many customers as possible, regardless of how much they buy from you. The CLV calculation indicates how much individual customers contribute to your profitability.

### What's so important about lapsed customers?

If they can be “revived,” they tend to behave like new customers and become regular buyers once again, with good potential lifetime value.

### What's more important: customer retention or customer acquisition?

While acquisition of new customers should never be neglected, existing customers make a comparatively greater contribution when marketing costs are taken into consideration.

### Do we want to retain all our customers?

Not necessarily; some customers may not be profitable. Using CLV, you can calculate the cost and contribution of each customer.

## What to Do

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### Understand the Benefits of Knowing CLV

Customer lifetime value is a way of measuring how much your customers are worth to you, over the length of time that they remain your customers. Customer “lifetime” will vary from industry to industry, and from brand to brand.

There are significant potential benefits in using CLV:

- A 5% increase in customer retention can create a 125% increase in profits.
- A 10% increase in retailer retention can translate to a 20% increase in sales.
- Extending customer lifecycles by three years can triple profits per customer.

### Identify the Different Categories of Customer

The CLV process is an analysis of your customers according to these four key attributes:

- frequency—how often they purchase (regular customers are more likely to purchase in the future)
- recency—how much time has elapsed since the last purchase (recent customers are more likely to purchase again)
- amount—how much they spend (higher-spending customers are likely to be more committed)
- category—what sort of product they buy (some products will be more profitable than others and some may be one-time-only purchases).

### Calculate CLV

For a consumer business, calculate CLV by analyzing the behavior of customers as groups—a group consists of customers who:

- have the same recruitment date
- are recruited from the same source
- bought the same types of product.

For business to business sales, use one or both of these approaches:

- Isolate particular customers, and examine them individually.

- Analyze the behavior of different groups, segmenting your customer database by factors such as industry, annual turnover, or staff numbers.

The basic calculation has three stages:

1. Identify a discrete group of customers for tracking.
2. Record (or estimate) each revenue and cost for this group of customers, by campaign or season.
3. Calculate the contribution to profitability, by campaign or season.

## Refine Your Calculations

You can introduce additional factors to make the calculation more useful to you. In a business-to-business environment, for example, it may be the sales representatives who generate sales. In this case, the calculation should include the representative's "running costs" and the cost of any centrally produced sales support material.

If you have a customer who falls under more than one cost/profit center of your business, you can use one of these approaches:

- Analyze purchases under each brand and ignore purchases in other lines.
- Build a more detailed model that combines and allocates the cumulative costs as well as the cumulative profit in the appropriate proportions.

## Use Customer Lifetime Value to Improve Marketing Performance

There are four important applications for CLV:

1. Setting target customer acquisition costs. If a customer is expected to generate more than one sale, the allowable cost can be greater than the cost allowed for the first sale—the classic loss-leader approach to customer acquisition. A reasonable calculation is to recruit only from those sources that yield new customers at costs less than half the estimated lifetime value. On that basis, the worst sources will have a cost per customer close to a lifetime value, while the average cost per customer should be far lower.
2. Allocating acquisition funds. Different recruitment sources will provide customers with different lifetime values. Spend more on the best sources!
3. Selecting acquisition offers. The lifetime value of a customer may depend on the type and value of their initial purchase. Use your CLV analysis to decide which products and offers to use when recruiting or upgrading customers.
4. Supporting customer retention activities. Once the typical lifetime value of a group of customers is known, tailor your activities to the customers who are most valuable. At the business that

produced the example table, the decision was made in Year 4 to reduce marketing costs on this group of customers. Equally valid may be an increase in expenditure aimed at recapturing lost customers—this is a classic retention activity.

## What to Avoid

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### **You Focus on Retaining the Wrong Customers**

Not all customers are worth keeping. Select the customers who are likely to yield the highest returns over a period of time and make them your marketing priority.

### **You Offer a Limited Range of Products or Services**

When you have identified the most valuable customers, you need to have a wide variety of products or services to offer them. Cross-selling and up-selling are the best ways to increase customer lifetime value, but this can be difficult with a limited product range. Think about “share of customer wallet” rather than just share of market.

### **You Overspend When Acquiring New Customers**

CLV analysis reinforces a traditional marketing rule of thumb: It costs less to retain existing customers than to acquire new ones. Overemphasis on new business development is often counterproductive.

## Where to Learn More

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### **Books:**

Gordman, Robert. *The Must-Have Customer*. Truman Talley/St. Martin's Press, 2006.

Peppers, Don, and Martha Rogers. *Return on Customer: Creating and Maximizing Value from Your Scarcest Resource*. Currency, 2005.

Silverstein, Michael J. *Treasure Hunt: Inside the Mind of the New Consumer*. Portfolio, 2006.

## **Web Site:**

1to1 Media, Peppers & Rogers Group, and Carlson Marketing: [www.1to1.com](http://www.1to1.com)

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