# Customer Value Governance
## The Emerging Corporate Imperative

by Richard J. Frazier and Gerard F. McDonough

Most corporate leaders and financial analysts would agree that long-term shareholder value is created by consistently providing value to customers in an *economically* profitable manner. Customer value governance is a strategy to achieve this corporate imperative. It ensures growth is both profitable and capital efficient while building reliable indicators of *future* performance.

*"Maximizing customer value is the surest and safest way to create long-term shareholder value."*

Customer value makes an eye-popping contribution to the market value placed on companies with large, complex customer portfolios, yet investors and analysts are seldom provided with sufficient information to accurately gauge the health of this core asset. This unnecessarily creates higher perceived risk, and in turn, increases your cost of capital. The uncertainty surrounding this lack of information is alleviated by opting to disclose how customer value is being measured, monitored and maximized. Customer value governance makes this option possible.

### What Is Customer Value?

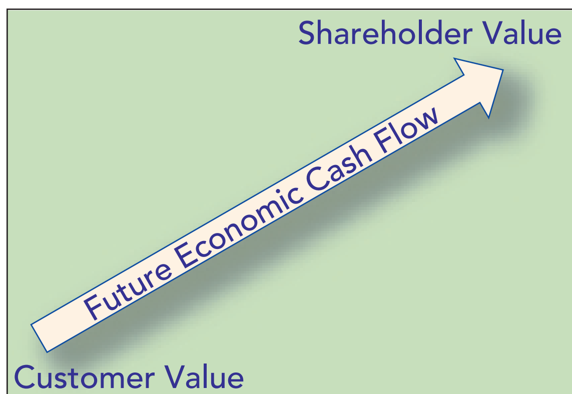
Customer value is an intangible asset comprised of the annuity value of the customer portfolio and the value customers perceive from their relationship with your company. The first part is a clear-cut calculation, the second a more subjective, yet still quantifiable perceptual measure.

**Defining Customer Value**

| The Corporate Perspective | The Customer's Perspective |
| --- | --- |
| The present value of lifetime sales to all customers net of the costs of attracting, serving and retaining them, including the **cost of capital** employed in doing so. Customer value can also be calculated by customer segments and by individual customers. | Value = Utility/Price. Utility includes tangible product quality and usefulness, non-product utility such as service and information, and intangible perceptual utility such as brand comfort or appeal. Price includes the base price, sign-up fees, late fees, disposal fees, flexible payment terms, and discounts. A shift of a few degrees in this value equation can make an enormous difference. |

## The Future Cash Flow Rationale

Embedded in all stock prices is an expectation of a company's ability to generate a sustainable stream of earnings that provides future cash flow. Only earnings backed by cash flow have value. For all companies, customer value is a prime source of sustainable earnings that provides future cash flow. Therefore, maximizing customer value is the safest and surest way to create shareholder value. For companies with large, complex customer portfolios, it is the only way.




Does the market place more value on short-term performance (i.e., quarterly earnings) than long-term prospects? The answer to this basic question deserves consideration because it sets the tone for corporate governance. Investors react to the *implication* of quarterly earnings on long-term cash flow, not quarterly earnings per se. It is the present value of a company's future cash flow that determines corporate value.[1] In the absence of reliable, forward-looking information, investors have little choice but to use quarterly earnings to loosely gauge a company's long-term cash flow prospects. Although quarterly earnings is a crude indicator of future cash flow, investors can hardly be blamed for using a measure they can easily lay hands on.

*"The best companies understand that cash flow, not revenue, sustains corporate success."*

Louis V. Gerstner, Jr., *Who Says Elephants Can't Dance?*

Equity investors often pay close attention to operating cash flow, and more recently, free cash flow, as a foundation for corporate valuation. Creditors do the same for sustained debt service. Both tend to believe there is less room for "gamesmanship" with these performance metrics than with other financial measures. Nonetheless, the Statement of Cash Flow does not *predict* future cash flow. It was never designed to do more than report historical cash flow information.

The market does not lack interest in companies' long-term prospects, it lacks information. The bulk of investor perceived risk stems from a chronic lack of reliable indicators of a company's ability to generate *future* cash flow. Customer value governance, fully executed, capably fills this void.

### Deliver Value to Customers—But Not At Any Cost

Many companies weaken their capacity to maximize shareholder value by offering too little or too much value to customers with distinctly different priorities. Point "A" on the graph in Figure 1 represents a level of value delivered to customers that also maximizes shareholder value. Customer needs and expectations are being met at prices customers are willing to pay and that contribute to shareholder equity.



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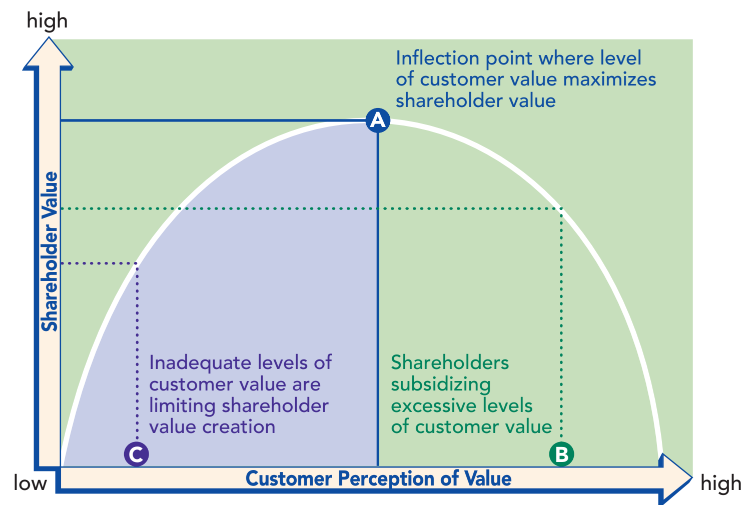


*Figure 1*

It's quite possible to deliver high levels of customer perceived value and yet be unable to translate this seeming advantage into adequate returns for shareholders. At point "B" on the graph, shareholders are subsidizing the delivery of excessive value to customers who either haven't been asked, or are unwilling to pay for it. This may be justifiable if these customers have a high probability of evolving into an *economically* profitable range. Otherwise, it represents a terminal long-term strategy as shareholders are asked to perpetually subsidize economically unprofitable customer relationships. Satisfied customers and dissatisfied shareholders is the end result. As a quick example, one of our clients avoided this situation by substantially lowering service costs for approximately 25,000 economically unprofitable customers. These customers were encouraged to make service inquiries through a self-serve web site. The majority of these customers adjusted to this new service policy and migrated into a higher value relationship with the firm.

Conversely, at point "C" customers are being shortchanged and will leave if a superior offering presents itself. If a large portion of these customers are making a significant contribution to economic profit, a significant amount of long-term shareholder value will be destroyed in the process. (See Case Study, page 6)

Long-term shareholder value is inevitably put at risk when the total number of customers is increased by attracting a disproportionate number of economically unprofitable customers. This "bad growth" situation will usually go undetected when companies calculate a rough accounting measure of average customer profitability, but fail to consider "economic" profitability, which is always unevenly distributed.

## Three Key Ingredients: Baseline, Baseline, & Baseline

The first step on the path toward customer value governance is to establish the baseline that will be used to monitor, safeguard and maximize the future value of the customer "asset." The initial baseline ensures opportunities to create shareholder value are not overlooked by depicting where you are now on the customer value–shareholder value curve; enterprise-wide, by business unit and by discreet customer segments.

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*"The customer value audit enables strategic and tactical choices to be made with greater clarity."*

Every company makes a certain investment in attracting, servicing and retaining each customer. The return on this investment depends on how customers behave and how long they remain customers. As with other corporate investment analyses, alternative investments in different customers should be made which yield the highest return to shareholders. Conventional accounting, as well as cost-of-capital approaches like EVA, are not well-suited for this type of investment allocation. These are retrospective systems that were never designed to consider the annuity value of intangible assets such as customer relationships. What's required is a customer accounting apparatus that is: 1) fully-cost-loaded for *economic* profitability analysis; and 2) statistically-oriented for computation of lifetime *economic* value. Once this apparatus is in place, the customer asset can be audited, measured and managed with the same rigor applied to tangible assets.

Auditing customer value involves more nuances than auditing, say, inventory turnover or revenue recognition. This is so because of its future orientation and because customers, after all, are human, with perceptions, values, and motivations that often go unspoken and may even be ambiguous to customers themselves.[2] Customers telling companies something that is later contradicted in the marketplace is a common and very costly problem. As part of the audit, customer knowledge obtained from all corporate listening posts (*what customers say*) is verified with transaction activity (*what customers do*).

Since the Customer Value Audit deals with cash flows over an extended period, a discount rate is applied to the future streams of customer revenues and costs to compute present value. Depending on the debt and equity structure of the firm, a weighted average cost of capital may be used as a starting point for computing the discount rate in the analysis.

## First-rate Intelligence, Top-notch Decisions

The intelligence derived from an initial audit enables strategic and tactical choices to be made with greater clarity. Baseline audit outputs are used to develop value profiles for members of each customer segment.[3] These profiles consider every aspect of your relationship with customers and answer such questions as: Which



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customer groups are most viable from an economic profit perspective? Which segments are most highly differentiated? What do various customer groups value? How can we deliver that value at a total cost that maximizes shareholder value? CV audit results also frame trade-off discussions among managers seeking to achieve their individual targets while at the same time optimizing enterprise-wide customer and shareholder value.

In some cases, audit results will indicate the need to dramatically revise service levels for specific customer groups. In other cases, acquisition efforts will need to be accelerated to add greater numbers of economically viable customers. For some customer groups, product or service utility will need to be added; in others, utility attributes for which the customer is unwilling to pay, but which add cost, will need to be pruned. Differentiated brand strategies may be required for some customer groups. Price increases might be needed to cover total economic costs for certain customer groups, whereas price reductions may be indicated for others.

*"Few companies are equipped to objectively gauge the health of their customer portfolio."*

As the organization concentrates on these issues and more, precision strategies and tactics evolve for maximizing the annuity value of the customer portfolio. The organization quickly sees where it wants to go and how it will quantitatively know when it gets there.

## The Initial Audit—An Outside Job

Customer Value Governance is ultimately an inside job. However, rarely will a company possess, from the outset, the cold-eye objectivity required to conduct the initial customer value audit. It's difficult, if not impossible, to completely shield an internal team from cultural and other forces that might undermine its objectivity. For this reason, the initial effort should be launched by a competent third party, similar to an outside accounting audit. Even an outside audit team will require a mantle of protection from executive leadership to ensure an unvarnished, dispassionate assessment of customer portfolio performance.

As information feeds are consolidated, customer value models constructed and requisite capabilities developed, an internal "customer value team" should be prepared to conduct ongoing audits with only periodic checks performed by an outside party.

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# The Customer Satisfaction Trap: A Case Study

Rapid advances have been made in the methods for understanding customer value and its correlation with shareholder value, yet most executives remain ill-informed about these methods. Stark evidence for this is seen in the many organizations that continue to measure customer satisfaction while neglecting customer value. The prevailing, overly simplistic view is that if we get the satisfaction numbers up, good things will happen.

*"The prevailing, overly simplistic view is that if we get the satisfaction numbers up, good things will happen."*

As the following case study shows, long-term shareholder interests can be compromised when customer satisfaction is overemphasized to the neglect of customer value. Data for the case study were tabulated beginning January 1997 through September 2000 for one of the ten largest bank holding companies in the U.S.

The chart above plots the bank's stock price growth on a percentage basis against the S&P 500, as well as customer satisfaction metrics and customer value metrics—both indexed to March 1998. The data reveal that substantial customer value erosion preceded a more substantial stock devaluation, even as overall customer satisfaction improved. In fact, customer value declined 46 percent for the seven-month period from September 1998 to March 1999, precipitating a 77 percent stock devaluation for the eight-month period from August 1999 to March 2000. During this same period, overall customer satisfaction improved by nearly 25 percent.



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How can customer satisfaction improve while customer value is eroding? The answer to this question is crucial for executives to understand and apply in their governance activities. In this case, an overly aggressive customer acquisition engine masked the company's inability to retain *economically* profitable customers. During the study period, on average, 325,000 customers per month were defecting. These customers were driven away by inadequate levels of service and pricing designed to extract short-term profits. It appeared this catastrophic attrition rate was being offset by a new customer acquisition rate of 800,000 customers, on average, per month (a net gain of 475,000 customers per month). This was accomplished by offering a host of incentives to attract new customers. However, careful analysis of this customer churn revealed that the overall quality of the customer portfolio—the value of the customer asset—had rapidly declined. The company was unaware that a majority of high value customers were among those who had left. As a result, a much larger, lower value, yet highly satisfied customer portfolio had emerged from this churn. The economic impact of this value decline was unavoidable and eventually erased nearly $33 billion of shareholder value.

*"Customer satisfaction can dramatically improve while customer value is eroding."*

**The case study provides at least three key learning points:**

1. Customer satisfaction is a primitive gauge of the health and productivity of the customer asset. Customer value is a far more discriminating measure.

2. Customer value is a reliable "upstream" indicator of a company's capacity to create shareholder value.

3. Once customer value problems crop up on the balance sheet, it is too late to prevent the trouble.

In 2001, Providian Financial Corporation was recognized with a national quality award as an industry leader in customer satisfaction and retention—the same year in which the stock price fell from $59 to $3. An erosion in the overall value of the customer portfolio was behind this devaluation.

## The Inevitability of Customer Value Disclosure

It is now possible to predict the future economic profitability of the customer asset with nearly as much certainty as accounting for past customer profitability. Investors need this information to make a more informed assessment about your company's future performance. Providing this information will reduce investor perceived risk, and in turn, lower your cost of capital.[4] Board members also need this information to fulfill their fiduciary responsibility of safeguarding the value of this most valuable asset. And managers need it to safeguard the long-term health of the business.

*"The case for providing more useful, forward-looking information to investors is stronger than ever."*

First and foremost, customer value governance is about achieving impressive financial performance in the near-term. Once this occurs, it makes sense to exercise the option of describing how you've achieved such performance and why you expect it to continue over the long-term. By that time, the correlation between customer value and shareholder value will be obvious and easily withstand the scrutiny of analysts and investors. Management credibility—an intangible asset that investors and analysts already evaluate—will most certainly be enhanced by such a disclosure policy.

As companies increasingly rely on intangible assets as the source of their value, the gap between market values and the value conveyed by financial disclosures has grown significantly wider. As much as 80 percent of the equity value of the S&P 500 is attributable to intangible assets, yet current GAAP essentially rules out all intangibles from being recognized as assets.[5] This situation is, well, ridiculous.

In remarks before the Practicing Law Institute, SEC Chief Accountant Robert Bayless pointed to the need for fuller discussion of:

- The underlying causes of reported financial results and the relationship to the long-term value of the business.
- The intangible assets of a company and how these contribute to its value.
- What steps management is taking to develop, protect and exploit these intangible assets.

"Management's Discussion and Analysis (MD&A), as well as the Description of Business should contain such information," Mr. Bayless said.

The case for providing more useful, forward-looking information to investors is stronger than ever. Competition for capital will create better disclosure standards and ward off excessive regulatory intrusion. Industry by industry, good disclosure practices will drive out bad as the market rewards "best-in-class" transparency standards. Those who begin customer value governance with that end in mind, will


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be setting the disclosure bar for their industry. Those who choose the illusive safety of waiting to see how competitors fare, or until regulatory deliberations end, will experience higher capital costs as they scramble to catch up. (There are no shortcuts for building reliable customer value indicators). Investors will clamor for disclosure quality much like customers demand product and service quality. In many ways, these developments are already here.

Westpac Bank discovered that disclosing credible customer value information can make an eye-popping contribution to corporate value. Westpac has been generously rewarded by the market with a 50% stock appreciation since the company began providing analysts with forward-looking indicators based on customer value. The indicators demonstrate how well the company is managing the customer asset as a means for delivering value to shareholders.

### Seeing Is Believing

As previously pointed out, shareholders are largely left to guess about a company's ability to generate a sustainable stream of earnings that provides future cash flow. Making customer value explicit eliminates much of this uncertainty. The supplement on the next page shows how annual reporting can be augmented with customer value information. In this example, customer value governance has sufficiently matured to warrant such disclosure.

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# Customer Value Analysis

## Year End 2001 and Projected 2002

We view customer value as the core, intangible asset of our business and a leading indicator of long-term shareholder value. As such, we have established customer value management as a governance objective. We offer this customer value analysis as evidence of our commitment to this objective. Our intent is to help investors assess the economic health of our customer portfolio and its ability to generate future cash flow. We believe shareholders will be amply rewarded if we consistently attract and retain customers in an economically profitable manner.

The difference between our $1.2 billion book value and our $9.2 billion market value (year-end 2001) is largely attributable to customer value—the lifetime value of the relationships we forge with our customers. During the year 2001, the overall value of our customer portfolio increased 17 percent from $7.2 billion to $8.4 billion (figure 1). Much of this increase can be credited to our refined customer listening systems which enable us to identify customers who are particularly well-served by the products, services and value propositions we bring to market. We project the value of the customer portfolio at year end 2002 to be $10.4 billion, a 24% increase over 2001.

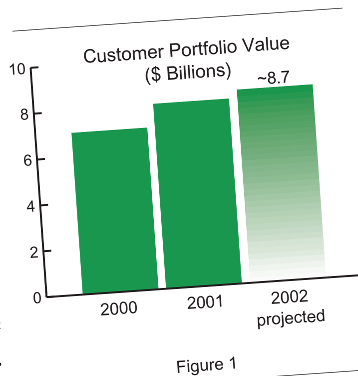

Figure 1

The overall quality of our customer portfolio has improved significantly from this time a year ago, a trend we project will continue in 2002. The portfolio is segmented by lifetime value (Figure 2) and all product and service improvement initiatives are focused on developing a rich experience for each customer group we most want to serve. The result has been an increased volume of high-value customers and a lower volume of unprofitable customers in the portfolio. In addition, total customer costs (capital and operating) are being employed more productively with fewer unprofitable customer relationships being subsidized by shareholders (Figure 3). Figure 4 projects the economic profit vs. total customer costs at year end 2002.

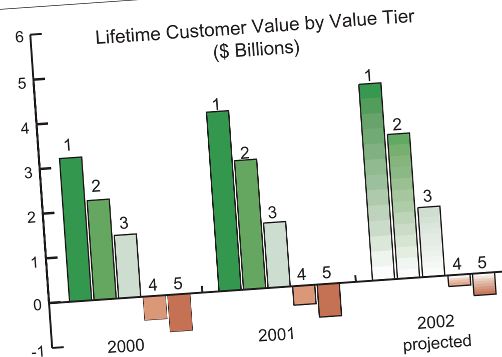

Figure 2

Year over year, the lifetime value of economically profitable customer groups increased by $1.2 billion as the composition of our customer portfolio changed for the better. Approximately 13% of our Tier 4 and Tier 5 customers moved into more profitable tiers. Our Tier 3 customer base grew 39% to 9.8 million customers, Tier 2 grew 19% to 4.3 million customers, and Tier 1 grew 50% to 1.2 million customers.

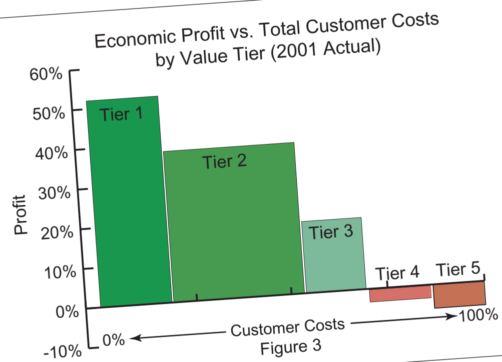

Figure 3

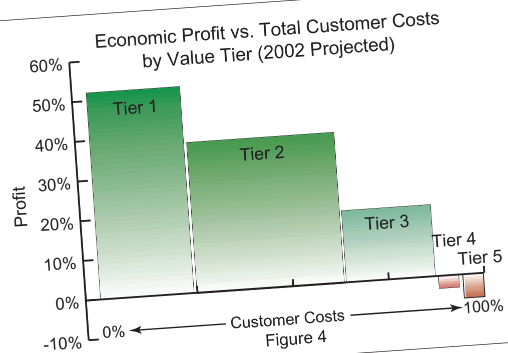

Figure 4

## Long-Term Performance Ambushed by Short-Term Pressure

The long-term view is instinctively difficult to marshal as the pressure to play the quarterly earnings game remains a stubborn reality. Unfortunately, this pressure can foster opportunistic adjustments to achieve short-term, per-share income targets that can stunt a company's ability to deliver long-term shareholder value. Fortunately, an increasingly receptive audience is building for a longer-term perspective than next quarter's earnings.[6] Customer value governance allows you to quantitatively show this growing number of investors how long-term shareholder value will be safeguarded.

*"Long-term performance does not have to be sacrificed on the altar of short-term earnings."*

Long-term governance attracts long-term investors. The governance principles expressed by the CEOs quoted below clearly demonstrate their commitment to long-term shareholder value.

> "We have never managed for the maximization of short-term shareholder value. It doesn't make sense. If you want to keep bumping up your top line and fattening up your bottom line, you are forced to make all sorts of extraordinary onetime changes and fixes." "I'm not saying that it's easy to withstand market pressure. You need strong nerves—the financial markets can penalize you for taking a long-term view. But you shouldn't care because when all is said and done, the customers' and the shareholders' interests must come first. And I know for a fact that the majority of our shareholders prefer a long-term, profitable development of our business to short-term profit maximization that, over time, would hinder growth, or in the worst-case scenario, put the business in danger."[7]
>
> —Peter Brabeck, CEO, Nestlé

> "The goal of transparency is to give the shareholder an opportunity to form an opinion about you, to make a judgment. That's not to say one has to be naive and publicly share information that will harm your company from a competitive standpoint. But in general, one has to be transparent to a degree that allows fair judgment of both the company and the strength of the underlying business. As important as what you do say is what you don't. I don't believe that I, as CEO of Novartis, should give specific quarterly guidance to analysts. That's their business. The analysts can, on their own, make their own estimates. If we say exactly how much we will earn in the next quarter or the next three quarters—and then hit it each and every time—it means we are playing with the numbers."[8]
>
> —Daniel Vasella, CEO, Novartis

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Investors justifiably become skeptical when they are asked to focus on the long-term, only when short-term performance is lousy. As long as shareholders are convinced your commitment to long-term value creation is authentic, long-term performance does not have to be sacrificed on the altar of short-term earnings.

## Strategy That Pays

*"New questions get asked, old rules get broken and new metrics take hold as the organization steadily becomes more outwardly focused."*

When strategies are comprised of universal objectives, sweeping proclamations or too much complexity, they don't mean much for a randomly selected person in a company. The execution of strategy is always easier with clarity that verges on common sense. And the payoff is always higher when it focuses the organization on the "upstream" pressure points which correlate most highly with shareholder value.

For companies with large, complex customer portfolios, the upstream pressure point is the customer asset. As such, corporate strategy can be boiled down to the following components, all of which are embodied by customer value governance:

- identify customers we most want to attract, serve and retain;
- obtain deeper insights than competitors about what those customers are willing to pay for (i.e., what they value most);
- develop empathic connections with customers so they feel we truly understand their circumstances, needs and motivations;
- devise plans for serving *value distinct* customer groups in an *economically* profitable manner (i.e., manage customer value as a derivative of shareholder value); and,
- build customer value indicators to better inform analysts and investors about our capacity to generate a sustainable stream of earnings that provides future cash flow.

Customer value governance is one of the most demanding and most rewarding objectives a company can set for itself. As always, superb execution will spell the difference between outstanding and unimpressive results. Most notably, success will require overcoming any hesitation to change systems and policies (e.g., compensation incentives and performance measures) in support of customer value governance.

## The Ripple Effect

As customer value becomes the nucleus for improved performance, the impact is felt throughout the organization. What follows are some examples of how customer value governance transcends organizational walls.


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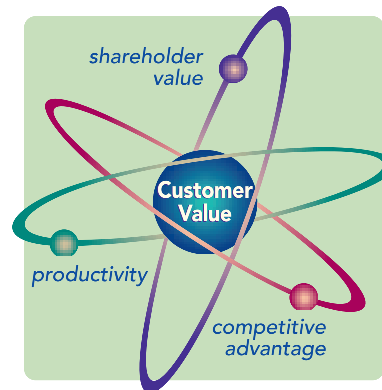
■ **Innovation**—The combination of dramatic differentiation with operational efficiency always yields superior levels of economic profitability.[9] Most organizations are geared more for efficiency than for innovation however, which is why customers often perceive product and service parity in many industries.




*Customer Value:*
*The Nucleus of Performance*

The customer asset is a wellspring for innovation and growth. When customer value is a company's "North Star," innovation more readily occurs—idea generation becomes more systemic—as the organization searches for ways to measurably increase the value of the customer asset. Experimentation increases, but it also becomes less of a crap shoot as customer listening systems are finely tuned for monitoring shifts in customer perceived value. Conventional wisdom is often put aside as aggressive goals are established for attracting more high-value customers. Customer Advocacy Teams (CATS) continuously identify and objectively challenge policies and processes that are straining relationships with customers. New questions get asked, old rules get broken and new metrics take hold as the organization steadily becomes more outwardly focused.

■ **Acquisition Due Diligence**—Few acquisitions fulfill shareholder's expectations. A clear description of why and how you expect to deliver value from an acquisition would distinguish you in the eyes of shareholders.

Acquisition due diligence can be greatly enhanced by analyzing the current quality and value producing potential of an acquisition candidate's customer asset. This is rarely done in a thorough manner. *Goodwill* is sometimes used as a surrogate valuation of a customer base, but this is a stab in the dark compared to the type of customer value analysis described in this paper. The fog surrounding valuation of the customer asset is lifted when you become steeped in customer value governance. Auditing your own customer portfolio provides a point of comparison for evaluating an acquisition candidate's portfolio.

An abridged customer value audit can be used in the due diligence process to gauge how well, or how poorly, an acquisition candidate is managing the customer asset. Ideally, acquisition candidates would be companies who are *not* maximizing the value potential of their customer asset. In such cases, significant post-acquisition value can be unleashed by transferring your customer value competence to the acquired firm. An acquisition candidate that *is* maximizing the customer asset can also contain an untapped store of corporate value if the organization has not yet formulated a disclosure plan.

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■ **Cost Reduction**—Cost reduction is a continuous task, but while costs must come down, few organizations can "cut" their way to success. For cost cutting to contribute to both short-term profits and long-term value, it must occur within a larger strategic framework for economically profitable growth. Eating next year's "seed corn" to improve short-term profits inevitably leads to disaster.

*"Customer Value Governance ensures costs get cut without cutting your throat."*

Customer Value Governance provides a directed way to link subordinate cost cutting initiatives with the superior intent to create long-term shareholder value. Simply put, it ensures costs get cut without cutting your throat. Cost reduction plans are rigorously canvassed for repercussions that might tax relationships with high-value customers, jeopardize brand equity, hinder customer acquisition opportunities, or otherwise harm the value producing potential of the customer asset. It also ensures that efficiency-based methodologies, such as Six Sigma and Process Redesign, are deployed with a dual role in mind: reducing errors and their associated costs *and* optimizing customer value—where the larger payoff resides.

■ **Technology Applications**—Depending on the study, between 20% and 30% of technology projects in the U.S. are canceled before completion, and of the remainder, the majority fail to deliver the value that was expected. One study concluded that nearly 80% of CRM implementations are failing to meet expectations.[10]

These sobering statistics have triggered a renewed emphasis on ROI as a valuation tool for IT investments. But while "business as usual, only cheaper" type projects will fit neatly into an ROI framework, IT-based value creation opportunities will defy any straightforward valuation model, including ROI.[11] For these types of investments, time is better spent on improving the IT project selection process, rather than refining valuation models.

Customer value governance inevitably improves IT project selection by controlling the tendency of IT projects to take on a life of their own. Projects are screened for their potential to increase customer perception of value, migrate certain customer groups into higher-value tiers, or otherwise improve the overall value of the customer asset. When customer value governance is exercised, a process for weeding out technology initiatives with the highest value producing potential naturally falls into place.

Projects that pass muster will conform to the evolving needs and desires of diverse customer groups. Large-scale, enterprise-wide initiatives will be subject to the most intense scrutiny since such projects rarely provide equal value to all customer groups. In some cases, lower-tech, higher-cost solutions will prove to be both economically prudent and offer more promise in strengthening customer relationships. (Southwest Airlines, fabled for its cost management, still answers incoming calls with live operators despite the obvious cost advantages of automated voice systems. And the ever efficiency-minded Royal Bank of


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Scotland—pretax profit of $6.2 billion in 2001—shuns call centers entirely.) In other cases, technology will be the only way to prevent shareholders from subsidizing economically unprofitable customer groups.

Information technology applications are important to the know-thy-customer challenge, particularly for better managing customer data. Still, at the end of the day, we all should remember that customer relationships cannot be fully automated. Quicken became the leading accounting software for individuals because Intuit formed an empathetic connection with customers that remains unmatched in the software industry. Empathy—identifying with and understanding customers' circumstances, feelings and motives—is the foundation of durable relationships. No technology or mathematical protocol has a capacity for empathy.

*"Despite a Boolean cornucopia of customer information, we often hear claims that customers are harder to attract, sell to and keep today than ever before."*

Despite a Boolean cornucopia of customer information, we often hear companies claim that customers are harder to attract, sell to and keep today than ever before. But knowing customers' buying histories and demographic profiles is not the same as knowing *them*. Ironically, in our desire to automate nearly every interaction with customers, it becomes more difficult to form lasting relationships with them. The term CDM, for *Customer Data Management*, would be a useful substitute for CRM (*Customer Relationship Management*) because CRM is more about managing data than building relationships. Such a view would better align expectations with achievable outcomes.

At the height of the CRM movement, we predicted a backlash.[12] We claimed disappointment and risk would become endemic because most CRM technologies were being implemented on shaky customer value foundations. Rhetorically at least, some CRM vendors have acknowledged this shortcoming as they reposition and enhance their offerings accordingly. The message one hears is that "this next round will be better." The check-and-balance power of customer value governance will ensure it is.

■ **Customer Research**—Customer research is a $6 billion industry with a record of failure that is beyond rational defense. (Someone had to say it.) The biggest cost of research is typically the *unintended* costs of decisions based on what customers tell us that turn out to be bad decisions.

Neuroscientific research conducted by Dr. Antonio Damasio, head of neurology at the University of Iowa, has uncovered why customers often tell researchers something that is later contradicted by their purchase behavior. When customers evaluate researchers' hypothetical questions, they mainly use "left-brain" reasoning. However, in exercising real-life purchase options, they mainly use "right-brain" emotions. A research team from the Open University and London Business School made the same discovery using brain scan technology to measure

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customers' brain activity when making choices. They found that if, and only if, a customer truly prefers something, a region of the brain called the right parietal cortex becomes active—the emotional region of the brain involved in making conscious decisions.

The Center for Cognitive Neuroscience at Duke University also discovered that as we age, decision processes are predominantly guided by the right hemisphere of the brain. In other words, as we get older, something has to "feel" right for us to choose it—we increasingly become more subjective, more qualitative, more relationship sensitive customers. This particular insight has enormous implications for many U.S. businesses since sales growth in many categories must come from the new customer majority—the 45 to 65 age group which is projected to grow by 16 million this decade.

*"Marketing decisions too often depend on statistical pictures of customer behavior."*

Most seasoned marketers already know that a customer's perception of value has emotional underpinnings, yet few organizations strive to understand the emotional dynamics of their relationships with customers. Marketing decisions too often depend on statistical pictures of customer behavior. The thinking is that if the numbers are right, there's no need for the emotional stuff because numbers don't lie. But they often do. Otherwise the failure rate of new product launches would be much lower than the 80% mark it's at today.

Customer survey methods typically assume analytical or "left-brain"reasoning lies behind customers' behavior and decision processes. However, as the evidence above reveals, customers' decision processes are more influenced by "right-brain" emotions. One of our clients used this knowledge to ask more emotionally based customer satisfaction questions. For instance, "How pleased were you with our service during your stay?" was changed to, "Did you have any experiences with us during your stay that are memorable enough to tell your friends about?" The old, analytical question was easier to tabulate, but the new, emotionally based question provided much more insight. Establishing empathetic connections with customers requires knowledge of their *key emotional drivers*. (Anthropologies, a new and highly successful retail store, was built upon a deep understanding of customers' *key emotional drivers*.)

A finely tuned customer listening system is critical for maximizing customer value. The baseline customer value audit includes an assessment of all customer listening posts, customer information systems and research data to determine whether the company is extracting the maximum amount of insight from these sources. The audit often reveals a number of these customer listening channels to be outdated, redundant, of little value in strategic decision-making or incapable of discerning customers' *key emotional drivers*. Just as often, the audit uncovers useful customer data that has been overlooked, ignored, or buried beneath a blanket of complexity.


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## Partial Customer Value Governance

Customers are now calling the shots in most sectors of the economy—they have more choices, more information sources and exhibit more resistance to advertising than ever before in U.S. commercial history. To cope with customers' newfound ascendancy, many companies are initiating some form of "customer focus," "customer-centric," or "customer relationship management" game plan. This response is reminiscent of U.S. manufacturers' reaction to rising consumer demand, kindled by Japan, for higher quality products.

It took U.S. manufacturers some time to master *total* quality management and the incubation period involved a lot of trial and error. In the beginning, fragments of TQM were hastily adopted with predictably meager results. Some companies dismissed TQM as a failure, but others kept at it and eventually discovered the huge difference between *partial* quality management (PQM) and *total* quality management (TQM). This intellectual breakthrough was much more responsible for the amazing recovery staged by American manufacturers than any specific quality tool or technique.

*"Partial customer value governance is a fitting description for most of the 'customer focus' initiatives now underway."*

Today, everyone in business acknowledges that paying attention to customers is important. Our purpose in writing this document was to show that *how* we pay attention to customers is crucial. We are sloshing through the beachhead of an incubation period in which *partial* customer value governance is a fitting description for most of the "customer focus" type initiatives now underway. How long we linger in this incubation period entirely depends on how long it takes companies to move beyond *partial* customer value governance. Those who convert soonest will distinguish themselves from the mass of others competing for investor support.

## The Two Pillars of Customer Value Governance

The absence of the fundamental building blocks described below is a tell-tale sign an organization is viewing the world through a *partial* customer value governance lens. As an initial exercise of honest self-evaluation, compare your current "customer focus" initiatives against these two pillars.

1. **A customer profitability system matches total customer costs, including the cost-of-capital, to revenues at the individual customer level.** An inductive approach to customer profitability analysis is required for an accurate valuation of the customer asset. Rather than deduce customer profitably from aggregated accounting data, customer profitability analysis should begin at the individual customer level, then move up to the business unit and enterprise levels.

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The objective is to first segment the customer portfolio by lifetime *economic* value and then by differing customer groups that fall within these value tiers. The contribution each customer value tier makes to market capitalization can then be computed and regularly monitored. Ideally, an executive owner is assigned to each value tier and a portion of executive discretionary compensation is allocated to tier performance.

An accounting-based profit model often overstates the value of the customer portfolio. Only an economic profitability model (profits computed net of activity costs and capital costs) will enable the correlation between customer value and shareholder value to be credibly estimated. To do otherwise is to forfeit the "end game" of lower capital costs—a main objective for any corporate strategy.

2. **Customer Value is recognized and safeguarded as the organization's most valuable asset.** Annual reports often describe the customer as "our company's most important asset," but few companies are equipped to objectively gauge the health of this most important asset. Tangible assets—the sole focus of internal and external audits—receive much more scrutiny. From a governance perspective, customer value is worthy of more disciplined examination given the resources it consumes and the far greater contribution it makes to corporate value than most, if not all, tangible assets.

   All public companies are wrestling to comply with the governance mechanics of regulatory driven reform. In the end, jumping through these mandated hoops is unlikely to create additional value for shareholders of any single firm. By comparison, a third-party customer value audit is conducted as a voluntary, opportunity-driven governance initiative with the determined intent to maximize shareholder value. It provides information that enables executives and board members to exercise a proactive, rather than reactive, governance agenda. According to the Institute of Internal Auditors, safeguarding assets (tangible and intangible) is one of the most important fiduciary roles of executives and their boards. Authorizing a third-party audit of the customer asset offers vivid proof that, "the customer is our most important asset," is more than just lip service in your organization.


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## How We Can Help

**CEO/CFO Briefing—**This two-hour session provides executives with a thorough grasp of what's required to successfully execute a customer value governance strategy. We'll also provide you with comments from industry analysts who have evaluated our approach. In fact, we recommend you invite an analyst to attend the briefing to hear their firsthand critique.

**Situation Analysis—**This maiden assessment reveals what, if anything, is required to bring the customer asset into an audit able state. It can usually be completed in less than a week.

### Our Purpose

We will ensure the future stability and strength of our clients by helping them increase investor confidence, lower their capital costs, and reduce share price volatility.

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## Notes


1. LEK/Alcar Consulting Group analyzed the stock prices of the 30 Dow Jones Industrial companies and found that typically between 80% and 90% of their prices were attributable to expected cash flows or dividends beginning *after* five years. In a study conducted by Randolph Cohen, Paul Gompers and Tuomo Vuolteenaho, *Who Underreacts to Cash-Flow News?* (NBER Working Paper No. 8793) the authors found that a one standard deviation improvement in cash flow news causes the average institutional investor to buy an additional 4 percent of outstanding shares. Also see C. Cheng, C. Liu, and T. Schaefer, "The Value-Relevance of SFAS No. 95 Cash Flows from Operations as Assessed by Security Market Effects," *Accounting Horizons* (September 1997), pp.1-15.

2. See *Listening to Customers* at http://www.boothmorgan.com/listening

3. A customer portfolio is comprised of different customer segments representing varying levels of economic profitability. Customer segments should be defined such that variation of economic profit within a segment is small while variation across segments is large. An economically profitable segment is a portion of customers that generates cash flows that exceed the aggregate cost of attracting, developing and retaining all customers in the segment, including the cost of capital employed in doing so. An entire customer portfolio is economically profitable when it generates cash flow that exceeds the aggregate cost of attracting, developing and retaining all customers in the portfolio, including the cost of capital employed in doing so.

4. Companies that deliver the most information in their shareholder reports realize a capital cost advantage as much as 970 basis points lower than companies delivering the least information. See "Evidence That Greater Disclosure Lowers the Cost of Equity Capital," Christine A. Botosan, University of Utah, Journal of Applied Corporate Finance, Volume 12, number 4.

5. Lev, Baruch. 2001. *Intangibles: Management, Measurement, and Reporting*, 105-128.

6. *Value and Reporting in the Banking Industry: A Capital Markets Survey Overview*, PricewaterhouseCoopers, 2000. (In this survey of analysts, investors and banking executives, all three groups expressed dissatisfaction with the market's emphasis on short-term earnings. More than half of investors and an even greater percentage of analysts said this short-term orientation discourages managers from committing to longer-term growth activities. More than half the banking executives said the market's short-term emphasis could result in decisions based on near-term stock price rather than long-term value creation.)

7. Suzy Wetlaufer, "Interview with Nestlé's Peter Brabeck," *Harvard Business Review* (February 2001): pp. 115-116.

8. Clinton Leaf, "Interview with Novartis CEO Daniel Vasella," *FORTUNE* (November 18, 2002): p. 109.

9. The statistics supporting this conclusion are drawn from an analysis of over 3,000 U.S. and European corporations (PIMS database) tracked over twenty-five years, through several business cycles.

10. Michael Moaz, "CRM: What's Right for Customers Is the Correct Approach," The Gartner Group, July 9, 2001.

11. See Martha Amram, *Value Sweep: Mapping Corporate Growth Opportunities* (Boston: Harvard Business School Press, 2002) Chapter 12 for further detail.

12. See Richard Frazier, *Avoiding CRM Backlash*, (Executive Excellence, November 2001) or at http://www.boothmorgan.com/backlash



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