

Beatles fans
outside
Buckingham
Palace, 1965





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ARE YOU UNDERVALUING YOUR CUSTOMERS?

It's time to start measuring
and managing their worth.



THE TRUE PURPOSE of a business, Peter Drucker said, is to create and keep customers. Most managers understand this, but few behave as if they do. Under relentless earnings pressure, they often feel cornered, obliged to produce quick profits by compromising product quality, trimming services, imposing onerous fees, and otherwise shortchanging their customers. This short-termism erodes loyalty, reducing the value customers create for the firm.

Spotlight

It should not be this way. Earning customer loyalty is firmly in the interest of both shareholders and management. My research shows that loyalty leaders—companies at the top of their industries in Net Promoter Scores or satisfaction rankings for three or more years—grow revenues roughly 2.5 times as fast as their industry peers and deliver two to five times the shareholder returns over the next 10 years. Yet companies and investors continue to prioritize quarterly earnings over customer relationships, for three main reasons: Public-company financial disclosure rules and corporate accounting practices require little to no reporting on customer value; most firms lack the capabilities needed for managing it; and organizations’ traditional structure puts functional priorities ahead of customer needs.

The roots of the problem can be traced to the 1890s and the birth of modern financial accounting, but the situation worsened in 1970, when Milton Friedman introduced the age of shareholder primacy, which held that companies exist to maximize shareholder value. Since then, companies have perfected sophisticated systems and practices for delivering on that promise. A decade ago, Roger Martin, then dean

of the University of Toronto’s Rotman School of Management, inverted this notion. He espoused a new “age of customer capitalism” in which companies that put customers first would create even greater value for shareholders. He was not taking issue with Friedman’s basic assertion but pointing out that its practical application had gone awry. The blind pursuit of shareholder value had devolved primarily into managing investor earnings expectations.

Few acted on Martin’s vision. Even if leaders agreed with his premise, they reasonably worried that prioritizing customers could threaten short-term earnings, causing investors to rebel. Further, the technologies, operational skills, and performance measurement systems needed were nascent at best. Pursuing such a strategy was generally a risky proposition a decade ago. The time was not right.

Now, though, the missing pieces are falling into place: the emergence of new accounting tools and technologies, a fundamental shift in the way companies organize work, and, perhaps most critically, the realization among at least some investors that customers are the ultimate source of corporate value. CEOs themselves are beginning to acknowledge this idea. In August 2019, the Business

Roundtable, representing many of the largest U.S. firms, issued a statement on the purpose of the corporation in which members put delivering value to customers, among other goals, on equal ground with creating shareholder value.

In working with hundreds of companies in a range of industries over 30 years, I have identified four broad strategies that loyalty leaders rely on for superior performance. Those leaders create systems for measuring customer value and invest in the necessary enabling technology, use design thinking methods to build customer loyalty, organize the business around customer needs, and engage the organization and stakeholders—employees, board members, investors—in the transformation. Before we examine each one, let’s take a closer look at customer value.

ACCOUNTING FOR CUSTOMERS

“Customer value” has several definitions. I use the term to mean the total lifetime value of a company’s customer base. Companies can increase this value by acquiring more customers, earning more business from existing ones, retaining them longer, making their experience simpler (and often less expensive to deliver) through digital improvements,

IDEA IN BRIEF

THE PROBLEM

Leaders recognize that they should manage their businesses to maximize the value of the customer base. But too often, earnings pressure results in cost-cutting measures that hurt customers.

THE APPROACH

Smart companies use new models, technologies, and marketing metrics to increase the number of profitable customers, boost retention, and maximize purchases.

A NEW STANDARD

Given the importance of customer value, leaders should track it as rigorously as they track other key assets. And they must report on it in formats that allow investors to make informed judgements.

Previous spread: Hulton Deutsch/Getty Images



Loyalty leaders grow revenues roughly 2.5 times as fast as their industry peers and deliver two to five times the shareholder returns over the next 10 years.

and so on. Visionary, customer-focused leaders such as Amazon's Jeff Bezos, Costco's Jim Sinegal, and Vanguard's Jack Brennan have long understood the importance of concentrating on customer value as an asset rather than pursuing short-term profits or quarterly earnings, and they've become enduring customer loyalty leaders in the process. It's worth noting that a disproportionate number of loyalty-leading companies are able to resist shareholder pressure, or avoid it altogether, because they are founder-led, customer-owned, or not publicly traded.

Companies can destroy customer value in a variety of ways: To boost revenue, enterprise software companies sometimes charge corporate customers change fees that can raise the total cost of ownership to as much as three times the original bid. To cut labor costs, call centers often give agents incentives to minimize call-handling times. To reduce operating costs, restaurant chains sometimes substitute frozen and precooked ingredients in place of fresh and made-to-order food. The resulting profits may look good on the income statement. Such tactics may even lead to short-term earnings growth. But they also scare off potential customers, encourage defection, and make the company vulnerable to poaching by customer-centric competitors.

Given the importance of customer value, leaders should track it as rigorously as they track other key assets, such as buildings, machinery, inventory, and marketable securities. They also should disclose it in their quarterly and annual earnings releases in consistent formats so that investors can make informed judgments about company

performance and how it compares with that of industry peers. But most companies wrongly believe that measuring customer value is too difficult or costly. They continue to rely on a centuries-old accounting tradition that emphasizes physical and financial assets, and neither income statements nor balance sheets offer much visibility into the value of a company's customers.

As investors wake up to the importance of customer value, however, many growth-stage companies preparing for an IPO—most so focused on acquiring customers that they're unprofitable—now explicitly direct investors' attention to success in growing the value of their customer base. My team at Bain examined the SEC S-1 registration filings of 309 companies that were preparing for public stock offerings in 2018. Nearly one-quarter of them included non-GAAP metrics such as active customer count, new customers acquired, purchases per customer, and revenue per new-customer cohort.

Some public companies, such as Costco, AMC Entertainment Holdings, Humana, and American Express, increasingly report various types of customer value metrics. Most telecommunications companies—including Verizon, AT&T, and T-Mobile—do as well. The utility company E.ON reports year-over-year customer counts in its audited financials. Its 2018 annual report noted a decline of 200,000 customers in the UK and an increase of 100,000 in Germany, while other regions were flat. "As a customer-focused company," E.ON noted, "we see our ability to acquire new customers and retain existing ones as crucial to our success." E.ON began

tracking loyalty metrics in 2013 and discloses its performance relative to competitors. Insurance giant Allianz has been doing that even longer.

This is a start, but because there are no customer-value reporting standards or requirements, investors still have an incomplete picture. The minority of companies that do provide customer value information decide for themselves what to disclose. Further, firms may calculate customer metrics differently or tweak them to tell a desired story, or simply stop reporting them if they fail to align with the company's preferred narrative.

We won't truly enter the age of customer capitalism until financial-accounting standards bodies enact rules that require reliable, auditable disclosure of customer-relationship health. This has long been a topic of debate in the accounting world. Over the years the Financial Accounting Standards Board, the International Accounting Standards Board, and others have attempted to improve reporting on intangible assets including customer value. Those efforts have consistently run into challenges related to valuation methodology, differences in industry practices, and the cost of compliance.

I propose a straightforward approach to disclosure that simplifies the accounting task for companies and places the burden of valuation onto investors.

WHAT INVESTORS NEED TO KNOW

While we await clear standards and rules, companies should take the lead, disclosing reliable and consistent information about the progress they are making growing customer value as part

Spotlight

Top: Outside of an Elvis Presley concert, Florida 1956; Bottom: Elvis Presley signing autographs, 1956

of their earnings releases. Only then can investors systematically reward those investments. Three new, auditable metrics would suffice in most instances:

- number of gross new customers acquired during the reporting period and number of net new customers remaining at period end
- number of existing (or tenured) active customers (existing customers are those who have been customers for a year or more; active customers have made a purchase in the past year)
- revenue per new and existing customer

Using just these metrics, investors could readily estimate the changing value of a company's customer assets. (See the exhibit "An Investor's View of Customer Value.")

Gathering the data shouldn't be difficult; nearly every company already tracks these metrics. Methods for calculating customer value will differ slightly between subscription-based businesses (think retail banking, cable companies, and software-as-a-service providers) and nonsubscription ones (grocery stores, for example, or parts suppliers), but the basic principles are the same. For subscription businesses in which customers also make discretionary purchases, one additional metric is required: the number of orders placed by new and existing customers during the period.

To help investors develop more-nuanced valuations, companies could disclose what it costs them to acquire and serve customers in various segments, and provide a breakdown of customer counts and revenue by cohort. Likewise, disclosing the volume of purchases and retention rates among the top



Top: Charles Trainor/Getty Images; Bottom: Bettmann/Getty Images



New accounting tools and technologies enable managers to model customer value and report on the impact of their actions.

20% of customers relative to the remaining 80% would materially improve investors' ability to value a company's customer base. Many companies may consider this information proprietary, but it is so important to corporate valuation that I believe investors should have it. (For more on customer cohorts, see Daniel McCarthy and Peter Fader's article "How to Value a Company by Analyzing Its Customers," on page 51.)

Qualitative measures such as Net Promoter and customer satisfaction scores are also of use to investors in assessing customer loyalty. Companies should source such measures from independent third parties that publish their methodology and present them in consistent formats. Short of that, firms should provide auditable evidence that their metrics are accurate and can be reliably compared with metrics reported by other companies.

MANAGING FOR CUSTOMER VALUE

Disclosure is an essential element in bringing customer value to center stage, but what generates the outcomes to be reported on? Let's turn now to the four strategies used inside a company to achieve consistent and sustained growth in customer value.

1

Develop robust customer-value management processes and tools. To engage employees in the

work ahead and to sell investors on the necessary investments, leadership first needs a clear understanding of the size of the prize: the current total lifetime value of the customer base and the potential

financial value that lies in increasing customer loyalty. New accounting tools and technologies enable managers to model customer value and report regularly on the impact of their actions. (Providing tools will typically be the responsibility of the finance organization.)

For example, to improve the loyalty and profitability of new customers, managers need periodic reports on the performance of each new-customer cohort. How much did it cost to acquire new customers in each cohort? What percent of customers in each remains active? How frequent are their purchases? How much does it cost to serve them? What is the revenue per customer? By comparing the performance of different cohorts, managers can monitor real-time improvements or declines in lifetime value.

Managers can also use analytics and reporting to track how experiments and changes in products, pricing, customer policies, processes, promotions, and services affect each cohort's performance over time. Using time-series analytics, for example, they can monitor customers who have been exposed to specific initiatives—say, a service personalization effort—to determine how that experience will affect lifetime value. Operational measures, such as the number of abandoned calls or the first-time success rate in a digital self-service experience, can be combined with qualitative data, such as customer feedback scores and comments, to sharpen the picture.

This just scratches the surface, of course, but it conveys the type of robust analytics and reporting managers could have at their disposal to compete for customer loyalty.

2

Combine design thinking with loyalty-earning technologies. Companies earn loyalty when they

anticipate and meet fundamental, often unexpressed, customer needs. Doing this depends on two sets of capabilities: design thinking and careful application of cutting-edge technologies.

Design thinking is about seeing the world through customers' eyes and learning through direct observation. Managers, frontline employees, and even C-level executives should engage in the exploration and design process. Design thinking combined with a constant flow of customer feedback helps product groups create highly personalized offerings. It also informs loyalty-driven sales and marketing efforts. Messaging can be tailored and targeted to put the right offering in front of the right customer in the right way at the right moment. The goal is not simply to induce customers to buy. It is to improve their lives so effectively that the company earns their trust and continued business.

Data, analytics, and AI capabilities are key to human-centered design. Consider how an insurance company might use AI to enrich service interactions. A customer, Mary, calls with a question related to a recent claim. Before she even speaks to a live rep, the AI-enhanced routing system predicts what her need is on the basis of her profile data, latest mobile and web interactions, and recent purchases. The system uses this context to route Mary not to the next available agent but to the one whose interaction style and technical proficiency are best suited to the issue at hand. Once the call



Each department aggressively managed its own metrics and celebrated its wins. It seemed that only the customers lost.

is connected, an AI-enabled coaching system analyzes Mary's tone of voice and rate of speech during the call and provides guidance to the agent in real time about ways to improve her experience. Instead of trying to prevent customers from ever reaching a live human—so often the default cost-cutting strategy—such systems focus on speeding calls to the right human.

Examples of such intelligent personalization are growing in number and variety. The best of them share a focus on using technology to enhance the customer experience, which often also reduces the company's delivery cost. Beginning in the early 2000s, companies such as Amazon, Netflix, and Google have given us a taste of what the future could bring. The question today is not whether to make investments in data and technology but how best to leverage those that have been made. Big companies often face complex legacy IT system and data challenges that digital-native firms do not, but they also have a significant advantage: They typically have amassed vast customer databases over decades and have the resources to take full advantage of them, including by conducting many simultaneous customer experiments that can speed innovation.

3

Organize around customer needs.

Rich customer-value data and design-thinking practices

will remain locked in silos unless companies embrace new operating models that push decision-making down to frontline employees, reduce cross-functional friction, and focus the organization on customers.

Since the early 1900s, large companies have employed operating models built around functional and product expertise and accountability. Finance, legal, marketing, sales, operations, compliance, and other functional departments or product teams form the “strong arms” of the company matrix, generally controlling resource allocation, goal setting, and decision-making. This structure fosters localized accountability, expertise, and efficiency, all of which are critical for competitive performance. However, the model also gives rise to silos, each of which seeks to optimize its own performance. Even when functional goals are more or less aligned, in-group bias—the tendency to favor one's own group and view others with suspicion—leads to conflicts among silos and even among members of a team drawn from different silos.

Consider how this played out at one large logistics company, where a cross-functional initiative to tackle the problem of shipping damage—a big cost for the company and perhaps the largest frustration for customers—foundered in a sea of misalignment and noncooperation. The issue appeared to be simple: Large, heavy packages often crushed smaller ones in the company's trucks. But the sales department, with an eye toward meeting or exceeding its targets, refused to stop accepting orders for large packages or to charge more for them. The shipping department, mindful of its cost goals, resisted setting up a separate handling process for large items. Customer service, to minimize costly time on the phone taking claims, made it more difficult to reach reps to file a complaint. And risk

managers did their best to cut payouts by rejecting most claims and reducing payment on claims that were accepted. Each department aggressively managed its own metrics. The results were impressive: Shipping costs were kept in line, revenue grew, phone center costs held steady, and damage payouts went down. Each functional team celebrated its wins. It seemed that only the customers lost.

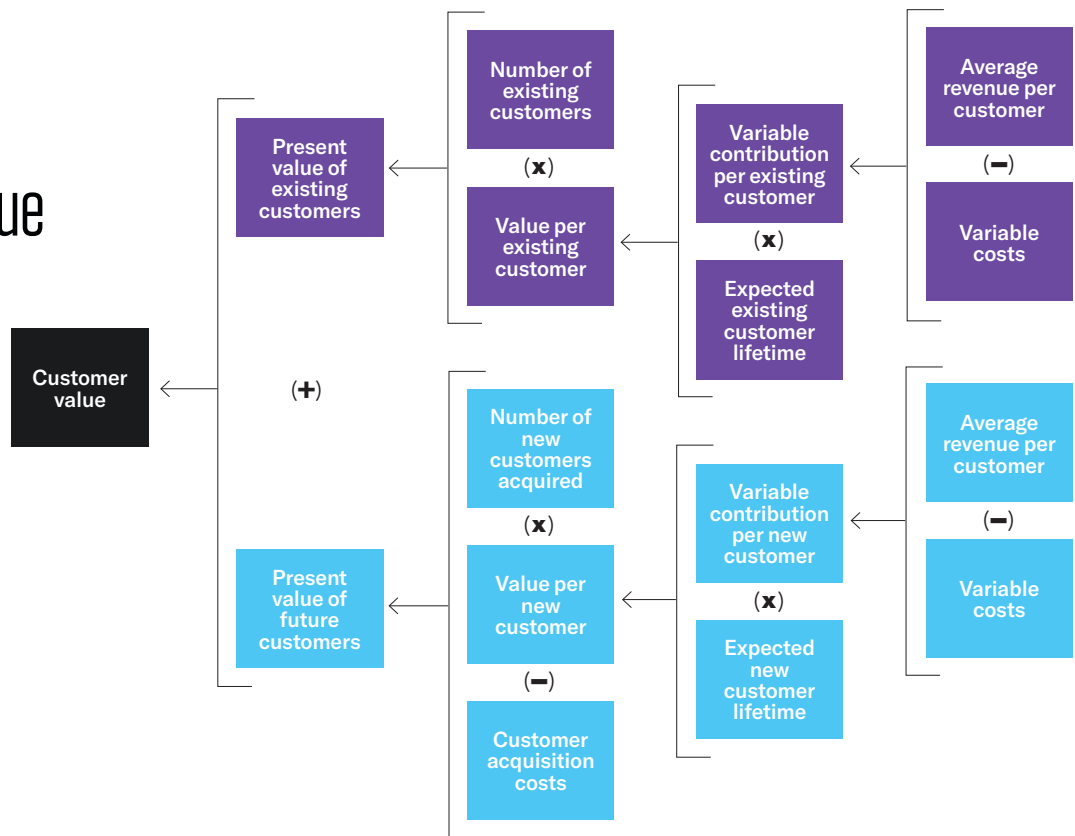
Instead of fighting or ignoring in-group bias, some companies now harness it for the benefit of customers by aligning cross-functional teams around a specific customer need. Although members are drawn from different functions, they are fully dedicated to the team, with authority for decision-making and accountability for outcomes. Many digital-native firms, such as Warby Parker and Stitch Fix, are organized around teams whose “products” are better described as customer experiences, including try-on programs in which eyeglass frame options or personalized clothing selections are shipped to customers' homes for consideration. No purchase is required, and easy returns are guaranteed. The teams are composed of representatives from each discipline necessary to deliver the experience—IT, marketing, fulfillment, and finance, for example—and each team focuses on meeting a defined need. Team members, whatever their functional provenance, view addressing the customer need as their primary goal, with individual performance measured and rewarded through their contributions to the team's results.

Legacy businesses are now following suit. Consider the insurer and bank

An Investor's View of Customer Value

The value of a firm's customer base is the sum of the value of existing and future customers.

In practice, some investors now incorporate the components of customer value—along with their assumptions and projections about the future competitive and regulatory environment—into their traditional valuation models. For an interactive look at how to calculate customer value, go to bain.com/customer-value.



USAA. It historically assigned separate product groups to manage its various offerings. For example, when a customer purchased a car, one group would help secure financing while another helped with insurance. The process worked, but USAA's leaders believed the company could do a lot better. Following the digital natives' lead, USAA now organizes around customers, with employees from different product lines and functional groups working as a team to address an overarching customer need. People seeking to buy a car can choose and locate the best model, negotiate its purchase, and finance and insure it as a seamless experience. Customer-needs-based objectives sit alongside product and operational goals; success is measured across key outcomes such as customer satisfaction, loyalty, and product sales.

When teams are organized around the customer, the functional and

product expertise that often worked at cross-purposes when employees were locked inside silos can act as powerful accelerants to innovation and competitiveness, particularly when backed by huge storehouses of data and the capabilities required to mine it.

Reorganizing around customer needs requires rewiring the organization and its decision-making pathways. Agile ways of working can dramatically speed up team processes, but leaders must accept that this involves letting go and allowing the frontline employees closest to the customer to make decisions that once came from the top. That can make traditional leaders uncomfortable, because it depends on experimentation, struggle, occasional failure—and relinquishing some control. But the shift is inevitable. At the current rate of transformation, I estimate that within 20 years more

companies will organize around customer needs than around traditional functional models.

4 Lead for loyalty. The job of leadership in any major organizational shift is to articulate an inspiring vision, lay out a path, and engage every employee in the work ahead. The first thing leaders must do is get everybody on board. Building the case for customer value should be easy: When a company focuses on loyalty, it makes customers' lives so much better that they keep coming back, and they bring their friends. Employees become inspired by the satisfaction that comes from making customers' lives better. And don't forget the superior performance of the companies that lead their industries in Net Promoter Score or satisfaction. Their revenue growth and shareholder



It would be irresponsible for any leader to ignore customer value as a proven source of profitable growth.

returns far surpass those of their peers. Companies that don't pursue customer value risk being put out of business by those that do.

Loyalty leadership demands persistent attention. Although the new customer focus is in part about pushing decision-making down the ranks, that doesn't mean that leadership focus can be fleeting or insincere. Look at the case of Telstra, an Australian telecommunications company. CEO David Thodey recognized that providing a far better customer experience was necessary for achieving and sustaining growth. He set out a clear vision for the company and its employees: Telstra would lead its industry in customer advocacy as gauged by Net Promoter Scores. He declared that customers would be his top priority. He demonstrated his commitment by beginning every business-unit review meeting with a discussion of progress on customer advocacy. He regularly made calls to customers. He insisted that his own leadership team devote time in standing meetings to knocking down barriers to delivering a great customer experience. He supported changes in policies and pricing to improve the customer experience, often at the expense of short-term business performance.

Thodey couldn't have done this without support from Telstra's investors. He worked hard from day one to educate them about the company's efforts to strengthen customer relationships, and they supported him. During his six years leading Telstra, the company improved customer loyalty in every major product, customer segment, service process, and point of contact with customers. It

gained 10 points of market share in the lucrative mobile business, and its stock price increased by more than 70%. Yet soon after Thodey departed, customers figured less prominently in Telstra's strategy. Competitive pressures forced the company to focus on improving its cost position rather than continuing to invest more in initiatives that had earned customers' trust. Since Thodey's retirement, in 2015, Telstra has slipped to the middle of the industry loyalty rankings.

As Telstra's experience shows, loyalty leadership requires ongoing attention to the actions of employees across the organization—changing decision criteria, supporting policy changes, and celebrating customer loyalty wins. This signals commitment to customers and gives employees confidence that the loyalty strategy is not an empty promise.

Loyalty leadership also calls for managing up and out. Top managers must gain and maintain the support of board members and investors by educating them about the loyalty-based strategy and how its progress should be evaluated. This is particularly important early in a customer value transformation, because management will be making decisions (such as investing in technology) that may depress short-term earnings. Leaders need to demonstrate to investors and board members that those decisions will yield larger payoffs down the road, in the form of increased customer acquisition or retention, growing revenues, lower cost to serve, or other measures of improved customer value.

IT'S EASY TO blame companies' short-termism on shareholder pressure and a

bias toward quarterly financial reporting. But managers share the blame when they fail to educate investors about the customer value their company creates or when they resort to quick profits instead of investing in long-term customer loyalty. Several iconic founder-led companies have paved the way for decades. A handful of independent public companies are doing so too. And they deliver outsize growth, profitability, and returns to shareholders.

It would be irresponsible for any leader to ignore such a proven source of profitable growth. Boards and shareholders should demand that companies grow customer value, support the necessary investments, and push for new accounting standards that make the returns on these investments visible. All stakeholders will benefit: Customers will experience products and services that make their lives easier, richer, and more enjoyable. Employees will reap the benefits of making customers' lives better. Management and investors will see increasing profits and shareholder value. And society will enjoy the economic growth that derives from innovation and investment. With transparency and reliable disclosure, investors and management teams can strike at the heart of short-termism and run their businesses for sustainable value. ☺

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