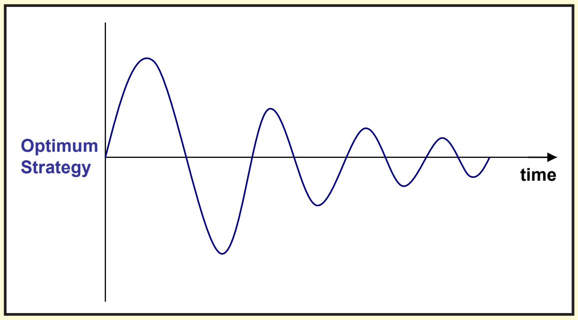
Applying Customer Relationship Valuation



Customer relationships represent one of the primary drivers of successful pricing strategies and are affected by them in turn. Thus, smart companies must consider both during their planning processes. This article explores this essential relationship and shows how firms can understand and maximize it to increase overall profitability. **The authors are: Ashok Jain, Principal (ajain@deloitte.com); Carmen Sims, Manager (csims@deloitte.com); and Joice Gil, Senior Associate (jogil@deloitte.com), all of Deloitte Financial Advisory Services LLP.**

1. Introduction

When developing an optimal pricing strategy to achieve the highest sustainable revenue levels, various factors must be carefully considered. The resulting decisions will impact different geographic, product, and/or customer segments and determine which will offer opportunities for pricing adjustments. The impact on customer segments, particularly, can be significant given the intangible nature of this asset (e.g., customer relationships). For example, numerous studies have demonstrated intangible assets represent in the range of 65 to 75 percent of the value of an enterprise. Thus, customer relationships should be considered one of the primary drivers of revenue and pricing. Yet this key area is often overlooked in the traditional price-optimization process, despite the insights and perspectives it can yield in selecting and implementing a successful strategy.

Customer relationships (along with other intangible assets) have generally been identified and defined through financial reporting and tax planning processes. For example, the Statement of Financial Accounting Standards 141 defines the term as follows: "…a customer relationship exists between an entity and its customer if (a) the entity has information about the customer and has regular contact with the customer and (b) the customer has the ability to make direct contact with the entity. Relationships may also arise from contracts (such as supplier contracts and service contracts). However, customer relationships may arise through means other than contracts, such as through regular contact by sales or service representatives."

Most industries are faced with evolving business trends that place a heightened awareness and importance on customers. The most highly valued companies are managing themselves by and for customer value. Buyers are now driving business decisions because they have increased interaction with organizations and a greater ability to make demands and request improvements. In today's marketplace, there is open access to information, switching costs are declining, and price comparisons are easier than ever. This allows buyers to more readily influence prices which in turn shifts cost pressures to producers. In short, customers are in control and pricing strategies are more challenging now than in the past. Since consumers have more choice and influence, building deep customer relationships has been a key focus of customers seeking growing and sustainable financial performance.

Corporations invest time and resources in cultivating and maintaining customer relationships. Pricing strategies affect the revenue and profitability streams from buyers, the amount of goods or services they purchase, the continuation or severance of relationships (and the costs to maintain them). For example, a company may implement a strategy that consists of increasing the price and reducing the volume of product A to shift its resources towards product B. This may result in optimum overall profit. However, buyers who purchase product A may represent a larger proportion of the customer relationship value and may be forced to find an alternative supplier. By making this decision, the company could be increasing profits but potentially giving up a portion of an important and valuable intangible asset.

2. Pricing Strategies and Customer Relationship Value

Business strategy has been defined and framed in numerous ways. One key methodology is Porter's Five Forces, which include: the threat of substitute products, established rivals, and new entrants; and the bargaining power of suppliers and customers. The pricing decisions made by sellers are often affected by all five forces. While most of these are external to the company and most believe they have little control over them, the bargaining power of purchasers can often be actively managed to improve the success of pricing strategies and to maintain and enhance the value of the customer relationship asset.

Companies, such as Apple, that effectively use pricing strategies, have gained meaningful increases in shareholder value with a significant contribution from their customers. For example, Apple has been able to maintain and, in certain cases, increase prices for their products (e.g., iMac) while most PC makers have been reducing

to Strategic Pricing Optimization

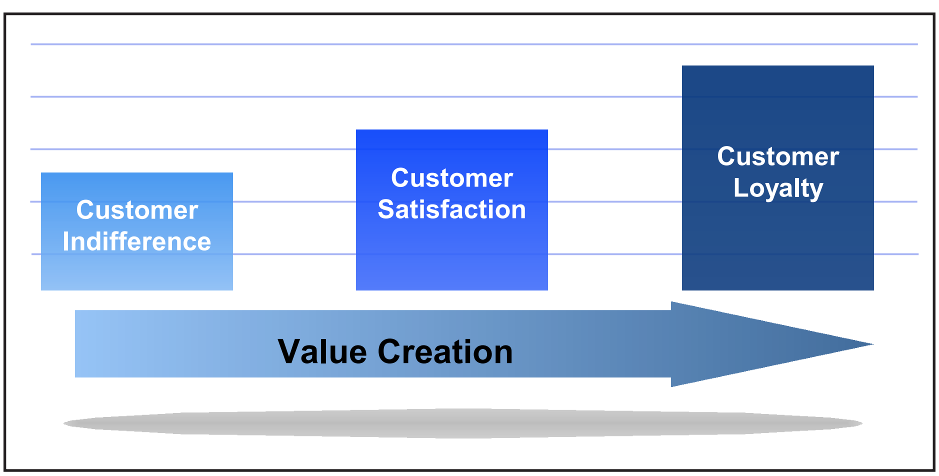
theirs for similar offerings. Apple's approach brings the company numerous financial, operational, and strategic benefits, including:

- Increased incremental *revenue* through targeted marketing of products and services;
- Improved *marketing efficiency* by reduced advertising spillage;
- Development and delivery of *differentiated product* in a timely manner;
- Improved *customer loyalty* based on evolving customer behavior and preferences; and
- Enhanced *brand building*.

These benefits are reflected in the increased value of Apple's technology assets, its brand, and its customer base. Managing customer relationship value is a dynamic process that results in value creation over time. According to Reilly and Schweihs (1998) "the process of wealth maximization begins with understanding the factors that impact the value of the particular intangible asset. The measurement of the change in intangible asset value over time is one component of the process of developing a strategy and allocating future resources." Figure 1 highlights how the successful management of customer relationships can result in value creation over time and the buyer's gradually evolving from indifference to satisfaction to loyalty.

The implementation of a pricing strategy and the resulting impact on the customer relationship asset often leads to the need for periodic valuation analyses to be performed. These enable a business to understand the impact of its pricing decisions on one of its most important assets. It also allows for a more proactive approach in managing and measuring the value creation process, which will validate not only the pricing strategy but also its implementation. This can provide the business with insights regarding the timing and pace of the strategy and highlight opportunities to reprioritize objectives and investments.

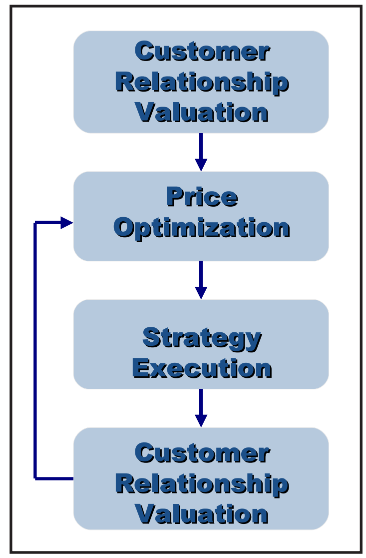
Figure 1. Value Creation Process



The price optimization and execution process can be continuously improved to maximize customer relationship value. Figure 2 highlights a pricing strategy feedback loop that emphasizes the importance of ongoing monitoring and measuring of value.

Ideally, a customer relationship valuation should be performed prior to the selection of strategy which can create a value benchmark to monitor and track its success. The feedback loop, which is highly dynamic, will typically require ongoing and periodic valuation analyses. These analyses can be performed at any stage of the implementation process to measure the change in customer relationship value along with understanding the basis for such change.

Figure 2. Pricing Strategy Feedback Loop



These assessments are particularly valid at critical stages of industry and/or company evolution, or when triggering events occur, such as changes in the economic environment, and entrance of new competitors or technologies. It can enable firms to adjust their pricing strategies to incorporate the impact of these events.

Currently, many food companies (across all stages of the production cycle) are beset with soaring raw material and fuel costs, challenges in the supply chain, and uneven supply and demand which has resulted in significant increases in prices. When faced with triggering events, companies must carefully adapt to these challenges with a continued focus on pricing and customer relationships. For example, in the last year, General Mills Inc. has decreased the sizes of its cereal boxes, resulting in a higher price per ounce of cereal. When implementing a pricing strategy, the company should ask: *What impact does this have on our customer relationships?*

The feedback loop in Figure 2 allows for a more precise understanding of the strategy's impact, while it is being refined. This dynamic process is critical since organizations can face various internal and external events that impact their decision making. It can also lead to opportunities to create an optimum pricing strategy, as shown in Figure 3.

3. Key Elements in Customer Relationship Valuation

Nearly all businesses have customers. However, not every one has identifiable customer relationships, whose value can be properly estimated. A reasonably identifiable relationship includes, but is not limited to: the ability to identify specific buyers and the income stream they generated; and the expectation of the business continuing or being renewed along with its expected duration.

Generally, if these characteristics are present, an intangible asset exists, and a customer relationship asset value can be estimated. In addition, it is important to segment the relationships based on various criteria, including the types and level of goods and services purchased, geographies, and so on. This segmentation is critical as it enables a deeper understanding of the basis for the value creation.

Once a customer relationship has been identified and segmented, one should understand the two key value drivers: the amount of *inertia* in the relationship, and the amount of *information* available about the buyer.

Customer Inertia

Companies that typically have valuable relationship assets experience "high-inertia" with their customers. These arise from various factors (including barriers to entry, high switching costs, differentiated products and services, etc.) thereby creating a "stickiness" factor enabling ongoing, and reasonably predictable, purchasing patterns.

Customer Information

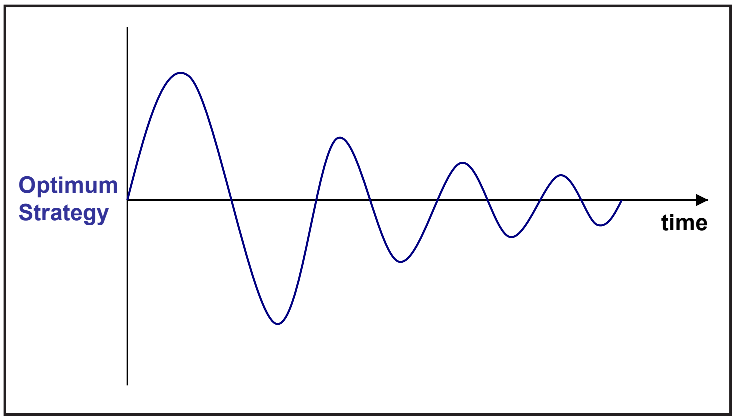
A strong and valuable relationship can be based on collecting, managing, and protecting key information. This may include: historical data on contact information, products ordered, quantity ordered, order date, ship date, payment history, marketing and satisfaction surveys; as well as past and projected financial results including revenue growth, profitability, and investments.

The key value drivers are estimated from this information, since it often serves as an indicator of the profits that will be generated over the life of the customer relationship. Understanding these drivers and their impact on customer value should facilitate the value creation process. Possibly the most important drivers are the customer attrition and cash flow profiles.

The customer attrition profile suggests the likelihood of an existing buyer continuing to purchase products and services with reasonable certainty and predictability. It also establishes the time period for estimating the value of existing customers. The cash flow profile reflects revenue components including price and volume, cost structure to serve the customers, and the impact of other assets (both tangible and intangible) in this value creation process. The customer attrition and cash flow profiles combine to form the basis for developing a customer relationship valuation analysis.

Increased revenues, decreased costs, and/or reduced risk combine to create value. Therefore, the ability to select and implement an optimal pricing strategy can influence some or all of these components. Since these are also key to valuing a customer relationship, the linkage between developing pricing strategies and identifying the value of a customer relationship asset is formed.

Figure 3. Optimum Pricing Strategy Setting



4. Conclusion

Intangible assets represent roughly 70 percent of the world's public companies' value, and customer relationships are often a significant portion of this value. As such, they must be actively managed to create, grow, and sustain their worth. Pricing strategies can impact the value of these relationships (and therefore, the overall business enterprise). Accordingly, utilizing customer relationship valuation as a key component in developing, selecting, and implementing a pricing strategy is critical. Furthermore, these ongoing valuations can help to validate the effectiveness of the pricing strategy and potentially allow a company to manage more proactively, prioritize and make adjustments more proactively on a periodic basis. Finally, this process can enable firms to understand the importance of the collection, management, and protection of customer data.

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