STRATIVITY

01.STRATEGY 02.CREATIVITY

White Paper

Economics of Customer Experience™

Building the Business Case for Customer Experience Transformation

ECE WP 0808

Strativity Group, Inc. – 365 West Passaic Street, Suite 255, Rochelle Park, NJ 07662, USA
www.Strativity.com info@Strativity.com

Table of Contents

Executive Summary

Customer Experience is *hot* today. As the battle to attract new customers intensifies, companies are increasingly proclaiming a renewed commitment to their existing customers. They are creating positions with titles like Chief Customer Officer and Vice President of Customer Experience. In many cases, entire teams are dedicated to improving the customer experience. Companies rush to measure their customers' loyalty. Yet, despite this increase in focus on the customer experience, fewer than 44% of the 379 global executives surveyed in our recent customer experience management benchmarking study believe that their companies deserve their customers' loyalty.

This white paper focuses on the key factor standing between the good intentions of corporate executives and actual transformation in the customer experience. It has been our experience that, when it comes to customer experience, most companies suffer from a language problem. On one side of the language barrier are customer experience executives who speak in terms of loyalty, satisfaction and 'common sense'. We have found that it is uncommon for companies to adopt "common sense" customer-centric strategies.

On the other side of the language barrier stand those who make investment decisions. They speak the financial language of profit and loss. Companies select investments based on the returns they expect to receive on those investments. Companies that successfully transform their experience do so because they have learned to translate the "soft" language of customer experience, loyalty and satisfaction into the "hard" language of return on investment, revenue and profit. The Economics of Customer Experience™ provides a framework and a methodology for translating customer experience into the language of finance so customer experience initiatives can compete successfully against other, more familiar investment opportunities like re-engineering efforts and direct marketing campaigns that are framed in the context of profit and loss.

Armed with the financial truth about the economic power generated by loyal and devoted customers, customer experience executives will gain a critical seat at the table when investment decisions are made because they will be able to demonstrate how specific investments, resources and prioritization in customer experience will lead to higher spending, reduced attrition, increased customer referrals and greater interest in other products and services.

The Challenge of Customer Experience

Senior executives often delegate customer experience initiatives to some unlucky middle manager. This unlucky manager tries for months to build buy-in from siloed functions who either claim that they are "already doing customer experience" or that they "have no time to do it" because end of the quarter is approaching and they need to hit their numbers. Lacking buy-in, the unlucky middle manager has little to show for his efforts besides some training sessions and the annual (or quarterly) customer survey. No significant transformation took place and, while there may be loads of customer survey research, they are no closer to becoming a customer-centric company like Ritz Carlton or Nieman Marcus than they were when they "launched the strategy."

The challenge facing customer experience practitioners is the need to create a shared sense of urgency across the organization so everyone collaborates to create a customer-centric culture that leads to increased loyalty. Unfortunately, this cannot be accomplished when individuals within the organization are unable to translate how an improvement in customer satisfaction or loyalty scores will help them achieve their goals and earn their incentives. Customer experience practitioners must find a common language that links customer loyalty to business economics if they are going to successfully recruit allies in the organization to be part of the transformation process.

Speaking the Language of Finance

The challenge of finding a common language takes place every day in corporations around the world. Take Zen Airlines, for example. Zen Airlines has $1M to invest in new initiatives this year. The investment optimization committee of the airline is evaluating three potential investments:

- A direct marketing investment that will have a response rate of 50 basis points from .5% to 1%
- A call center initiative that will increase first contact resolution from 85% to 90% while increasing average handling time by 1 second
- A customer experience initiative that will boost customer loyalty from 40% to 45%

Which investment should the committee select? Zen Airlines needs to find a common language with which to evaluate seemingly different investment opportunities. Luckily, such a language exists; it is the language of finance. This common language makes it possible for direct marketers, used to the language of response rates, to speak with contact center executives who speak the language of service levels and handling times. Through the language of finance, a distribution center head who speak the language of cycle times and inventory turnover, can communicate with a branding executive who speaks the language of brand equity. By translating each of the individual roles into a common language that focuses on profit and loss, investment and opportunity, company executives can evaluate investment opportunities that, at first glance, have no common bond whatsoever to select the ones that will return the greatest return to the stakeholders.[1]

[1] Throughout this paper, we will refer to stakeholders because the principles included within apply equally to for-profit corporations that are responsible to their shareholders and to non-profit corporations that are responsible to their stakeholders to reinvest their profits to deliver services to their clients.

Just like all other executives, customer experience professionals must be able to communicate the value they bring to their organizations using the language of finance if they want their initiatives to have a chance of securing the limited investment dollars that are necessary to transform their company's customer experience. Only by translating satisfaction and loyalty metrics into revenue increases and costs savings will customer experience professionals be able to quantify the value they will generate for the company through their proposed initiatives.

From Satisfaction and Loyalty to Revenues and Costs

Study after study has proven that loyal customers are more profitable than other customers. Loyal customers:

- Spend more
- Attrite less
- Recommend the company to others
- Are more likely to purchase additional products and services

Further, many of the causes of dissatisfaction also increase company costs. For example:

- Customers hate calling more than once to resolve an issue. Additional calls cost the company.
- Customers get angry when they receive defective goods. To pacify them, companies need to process returns and ship replacement items; this can be expensive.
- Customers don't like to wait to get issues resolved. Long cycle times increase costs.

Given the natural relationship, then, between loyalty and financial return, translating from the language of customer experience into the language of finance is eminently doable. We have found that communicating about customer experience using the language of finance is best done by focusing on:

- The Five P's of Revenue
- Customer-centric Cost Units

Revenue Drivers

When viewed from a customer-centric lens, the revenue side of the income statement is relatively simple to decipher. Revenue is driven by:

- The number of customers who purchase your product or service
- The amount they spend on your product or service

Number of Customers

Breaking this down further, the number of customers who purchase your product or service is determined by the number of:

- Customers you have at the beginning of a time period
- New customers you gain
- Existing customers who leave

Amount Spent

Similarly, the amount customers spend on your product or service is governed by three factors:
1. The total budget customers spend on a type of product or service
2. The portion of that budget that customers spend on your products or services
3. The price customers are willing to pay for your product or service

The Five P's

Each of these factors is influenced by the experience you deliver to your customers and is captured by the Five P's:

- **PREFERENCE of Company or Product** – Preference captures the number of new customers who purchase your products or services in a given year. To prevent double counting, Preference excludes new customers who are referred by existing customers.
- **PROMOTION of Company or Product** – Promotion captures the number of new customers who purchase your products or services based on referrals of existing customers. Referred customers often behave differently than other new customers and, therefore, the value should be quantified separately. Referred customers often spend more and attrite less than other new customers.
- **PERMANENCE of Overall Relationship** – Permanence quantifies how long customers continue to purchase your products and services. As customers stay with a vendor longer, the relationship becomes deeper, stronger and more meaningful. These relationships will yield more profitable business, referrals and insight.
- **PORTION of Overall Customer Budget** – Portion combines two factors that drive how much a customer spends on your products or services: their total budget for a category of spending and the portion of that budget that the customer chooses to spend with your company. Loyal customers tend to spend a higher percentage of their budget with one company and other customers do.
- **PREMIUM Price** – Premium Price quantifies the willingness of customers to pay a higher price for your products and services than for your competitors. Loyal customers tend to be less price sensitive than other customers because they focus more on the value they receive than on the price they pay.

Each of the Five P's is driven by actual customer behavior not on customer intentions. New customers buy your products or not; customers continue their relationship with you or they leave. Customers buy your products and services or those of your competitors. Customers pay a premium price or seek discounts or a low-cost provider.

Calculating the Customer Experience Revenue Opportunity

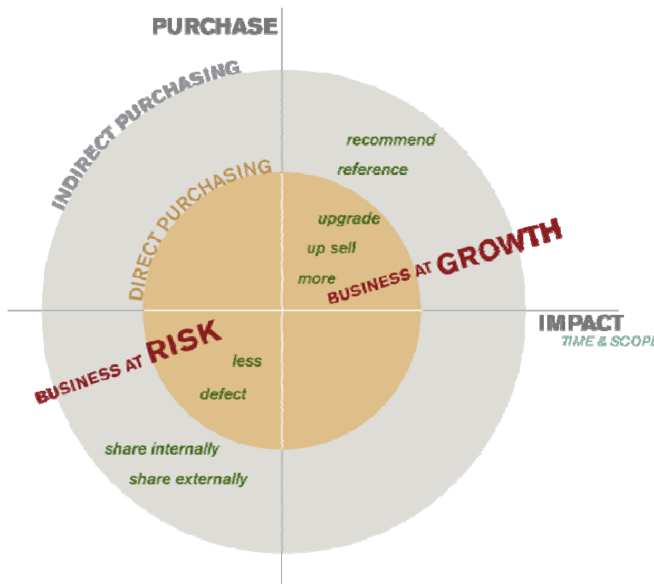
Changes in a company's revenue, therefore, are based upon the Five P's. When evaluating the revenue impact of a customer experience initiative, customer experience professionals should team with their partners in finance to quantify the impact the initiative will have on one or more of the Five P's.

Revenue Opportunity = Preference + Promotion + Permanence + Portion + Premium Price

Although a given initiative may impact all five of these factors, we recommend focusing on the one or two P's that the initiative will impact the most to simplify the analysis. Let's now look at how each the Five P's is calculated.

Growth versus Risk

When calculating the Five P's, it is helpful to consider whether the investment under consideration will save current business that is at risk due to a sub-par customer experience (**Business at Risk**) or whether it is designed to capture new business by offering a new and differentiated experience (**Business at Growth**). The distinction between the two is important. In every organization, there is some existing business that it is at risk of losing because its current customers are dissatisfied. The risk is that their customers will attrite, spend less, criticize the organization to other customers or prospects, or a combination of all three.

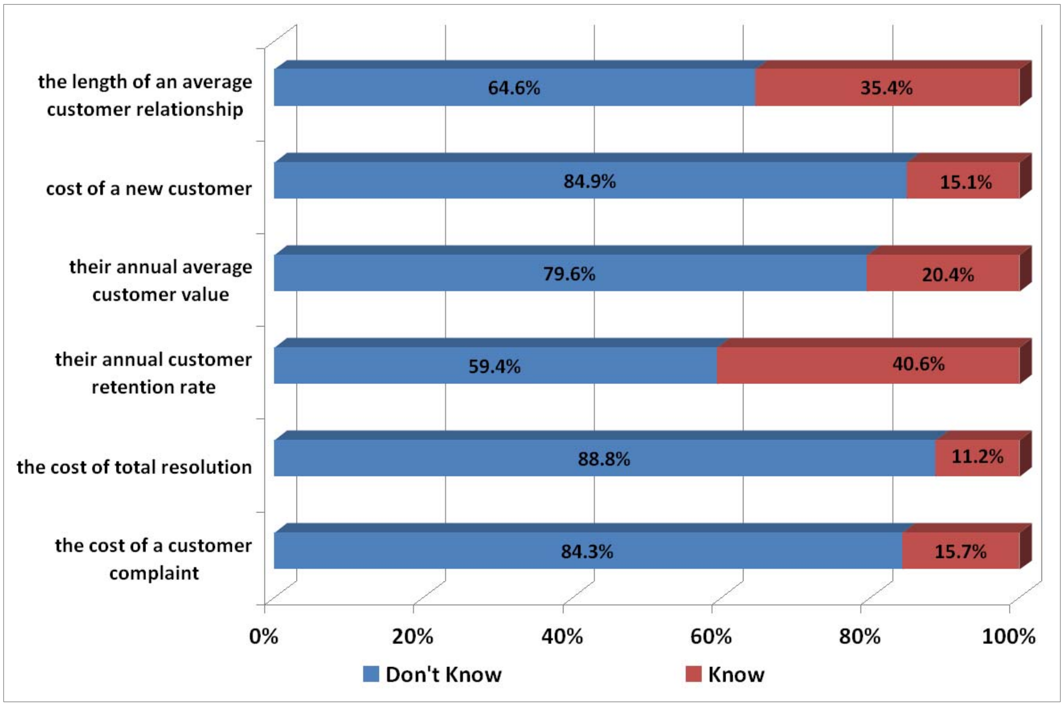


Business at Risk is that portion of the Five P's that calculates the business that an organization is likely to lose unless the organization invests to improve the experience for its existing and dissatisfied customers. **Business at Risk** will be of great interest to those executives who are responsible for customer retention. By calculating and explaining the financial opportunity to reduce attrition and reductions in spending, customer experience professionals can partner with customer retention executives to generate support for their initiatives.

In contrast, **Business at Growth** measures the opportunity to capture new business by transforming an organization's customer experience. It includes increasing the number of new customers and referrals and getting existing customers to spend a larger portion of their budget with the organization. **Business at Growth** will be of greatest interest to those responsible for customer acquisition because it will quantify the opportunity to increase acquisition through the customer experience initiatives. Demonstrating the way improved customer experience will increase referrals and new customers will facilitate partnerships with sales, marketing and customer acquisition executives.

Customer-Centric Cost Units

Strativity's most recent Customer Experience Management Benchmarking study reveals that most corporate executives continue to lack a basic understanding of the actual cost of their current customer experience. For example, of the 379 executives surveyed, almost 85% knew neither the cost of acquiring a new customer nor the cost of a customer complaint.



This ignorance of a company's costs from a customer's perspective is disconcerting but unsurprising when one realizes that most companies calculate cost units at a functional rather than a customer level. Take the cost per call that many contact centers use to manage their cost structure. The cost per call treats each individual call as an isolated event and factors in the time it takes an agent to handle the call and the per minute cost of handling a call. To minimize the cost per call, a company can push agents to spend less time on the phone or simply pay them less. This makes sense when one is managing to a cost unit based on an individual call.

The challenge is that this does not capture the true cost of servicing the customer. A customer who is rushed off the phone or who is serviced by a low-paid (and likely less skilled) agent will often call a second time to resolve the issue that was not resolved the first time. Further, cost per call does not factor in the initial reason for the call, which often lies outside the call center. Reducing the cost per call doesn't eliminate the call that results from the corporate web site lacking key functionality or that result from a confusing offer or improperly filled order. As such, a company can have a contact center that handles individual calls very efficiently but wastes an incredible amount of money taking calls that could be avoided through a better customer experience.

Continuing with this example, the company in question can understand the cost benefits of a better customer experience only if it moves from the functional cost unit of cost per call to the customer-centric cost unit of cost per customer inquiry. The cost to service a customer inquiry factors in all aspects of the interaction with the customer, including: the cost of attempting to self-service via the web or interactive Voice Response and the cost of each call made by the customer to resolve the inquiry.

The key cost units from a customer's perspective are:

Customer–Centric Cost Units

- Cost of generated lead
- Cost of new customer
- Cost of service inquiry
- Cost of complaint handling
- Cost of customer retention

Cost of a generated lead – These are the marketing costs of an organization expended in order to generate new sales leads. Total Marketing costs divided by the number of leads generated per campaign is the actual cost per lead.

Cost of a new customer – When factoring in the cost of sales, organizations must remember to factor in all costs related to sales not simply the cost of the sales organization. For example, a business-to-business company that flies its CEO to close the deal with a major client needs to remember to factor all costs associated with the trip, including a portion of the CEO's salary.

Cost of service inquiry – As noted in the example above, the cost of service should be based on solving a customer's issue not on an individual call or email. Companies need to estimate or track the cost to service across all customer channels. The cost of the service inquiry includes not only the cost of handling the call or responding to the letter or email but also the cost of all back-office operations required to resolve the issue and all overhead costs associated with the service inquiry such as systems, HR, employee education, etc.

Cost of complaint handling – A subset of service costs, the Cost of Complaints calculates the cost of those service inquiries that are the result of an unsatisfactory customer experience. Unlike a normal service inquiry, like placing an order or paying a bill, a complaint is an inquiry that can be prevented entirely through a better customer experience. Investing in proper order fulfillment or promotions processing prevents entirely the cost of resolving the complaint of the customer who did not receive the proper order or promotion.

Cost of customer retention – Retention costs should include any and all costs incurred to keep an existing customer.

Example

A mid-sized business-to-business company has a four-person sales team whose salaries and benefits total $1M per year. This sales team has a travel and entertainment budget of $200K. The sales team often brings in senior executives to meet with prospective clients. The cost to involve these executives, both in terms of travel costs and time that could be spent focusing on other initiatives, is $75K per year. Finally, it costs $100K each year to support this team when preparing proposals. The total cost of sales is therefore $1.375M. Since each team member brings in between 2-3 new clients each month, the team brings in 100 new clients each year. As a result, it costs $13,750 to acquire a new client. Given the high cost of acquisition, it is critical that this company create an experience that will allow it to recapture the cost of acquisition.

When thinking about these customer-centric cost units, we have found it helpful to consider the relationship between the five cost units and investments in customer experience. We have found that companies that invest in their customer experience reduce their costs. Loyal customers:

- Tend to recommend companies more frequently, thereby reducing the costs associated with lead generation and marketing
- Cost less to service
- Are less likely to complain, reducing the total cost of resolving complaints
- Attrite less frequently, reducing the cost of retention

As such, companies have a choice regarding their investments. They can invest in improving their customer experience, or they can increase the costs of lead generation, sales, service, complaint resolution and retention. Investments need to be made either way. Understanding the relationship between customer experience and the costs of running the business will help companies realize that customer loyalty is the more profitable investment.

ABC Image In Color - A Case Study

ABC Image In Color Corporation is a regional distributor of printers and toner to small and medium-sized businesses in the Kansas City area. The company services 2000 customers who on average, remain with the company for five years. Additional facts include:

- 200 new customers are acquired each year
- $400 is the cost of a printer. $150 is the cost per toner
- On average, customers purchase 1 printer and 20 toner cartridges per year from ABC Company
- This accounts for 60% of each customer's total average printer and toner budget
- 50 customer referrals are generated from existing customers each year
- On average, new customers referred by existing customers purchase 1.5 printers and 30 toner cartridges per year
- Each year 10% of existing customers attrite

Assumptions

ABC Image In Color brings together company executives to analyze their customer data and to use their business judgment to estimate the impact improving the customer experience they deliver. After performing their analysis, the team develops the following set of assumptions regarding the impact that transforming the customer experience will have on the business:

- Preference –the average number of new customers will increase 15%
- Portion of Budget – customers will increase their average annual spend by 10%
  Premium Pricing – customers will demand less discounting, resulting in a 5% increase in product prices
- Promotion – customers will increase their referrals by 20%
- Permanence – customer attrition will decrease from 10% to 8% per year

By using the Economics of Customer Experience™ model, ABC Image In Color Corporation was able to calculate the potential benefits of their customer experience strategy.

Preference: ABC Image In Color Corporation stands to gain **$102,000** each year from a 15% increase in new customer preference.

Portion of Budget: ABC Image In Color Corporation can capture an additional **$680,000** in missed revenue each year.

Premium Pricing: ABC Image In Color Corporation stands to gain **$340,000** from premium pricing each year.

Promotion: ABC Image In Color Corporation stands to gain **$51,000** from incremental referral or promotion revenue each year.

Permanence: ABC Image In Color Corporation stands to gain **$136,000** from reducing annual attrition from 10% to 8%.

Total Opportunity

ABC Image In Color Corporation has an opportunity to capture an additional totaling $1,309,000 by providing superior experiences to its customers. This represents a 15.5% increase in revenue over the current annual revenue of $8,415,000 per year.

Please note that the proposed model does not incorporate any changes to consumer spending and product pricing as a result of the economy, general market trends or competitive dynamics. Each organization will need to determine the impact of external factors and apply them as they see fit. Additionally, the model is constructed so that individuals can extract those relevant components that will best illustrate the impact of customer experience transformation on their respective organizations. Finally, the model is designed so that the value generated by each of the 5 P's is mutually exclusive from the value generated from the others to ensure that companies don't double count the potential benefits.

Summing Up

Designing and deploying a customer experience strategy can no longer be considered as a "nice to have" but should be viewed as a critical component of an organization's long-term sustainability and overall success. Any successful customer experience strategy must use the language of revenue and expenses to demonstrate the financial benefits that it will deliver as the result of customer experience transformation. The Economics of Customer Experience™ methodology translates the loyalty and satisfaction benefits into economic terms that will help companies approve initiatives that will transform the customer experience. Only by looking at a customer experience strategy through the lens of economics of relationships, will organizations be able to place customer experience strategy at the top of the corporate agenda, thereby gaining the highest sense of urgency.

About Strativity Group

Strativity Group, Inc. is a global customer experience research and consulting firm which assists organizations with the creation of differentiating experiences and profitable customer relationships. Utilizing research, consulting, education and communication programs, Strativity creates and implements customer experience strategies for its clients. At the core of its methodology is the development of action plans that are used to drive organizational change.

Strativity Group, Inc. works with Global 2000 companies as well as emerging businesses around the world. Our clients include Akibia, American Management Association, AMO, Capital One, CATIC, Circle K, CA, Crown Plaza Hotels & Resorts, Dimension Data, DVTEL, FedEx, Herbalife, ICMI, Honeywell, Jacada, Lockheed Martin, Nokia, Nordea, Nortel, RightNow Technologies, Sage, SAP, Seagate Technology, Siemens, The Fund, University of Pennsylvania, Verint Systems and Wyeth.