



RFM, LTV & OTHER PROFIT BUILDING TOOLS

Every business person and every consultant talks about existing customers being more valuable than new ones, how making sales to existing customers is more profitable than sales to new ones. There is a great deal of evidence to support those claims. However translating that belief into effective strategies is remarkably rare. The main reason why is that few businesses have the necessary information to do the analyses necessary to support the strategies – information like customer churn, average customer spend and cost of customer replacement. Unfortunately, for most, and especially for Kiwis who love to be doing new things, pursuing new adventures, the thrill of the chase, the pursuit of new business and new customers distracts us from building long term profitable relationships with the people that we already have – so unwittingly we encourage customer churn. This report examines some analyses and strategies that business interested in realising the value in their existing customers can apply.

Placing a value on customer relationships - RFM

A customers value can be defined in terms of RFM. RFM stands for

- **Recency** - *How recently did the customer purchase?*
- **Frequency** - *How often do they purchase?*
- **Monetary Value** - *How much do they spend?*

RFM is used in direct or database marketing as a tool to identify the most valuable customers. It is founded on the assumption that the more recently a customer has shopped, the more regularly that they shop and the more that they spend, the more likely they are to buy again. To some extent it is counter-intuitive. For example, we might think that a person who has just purchased a home appliance is less likely to buy another one soon, but the exact opposite is true. By extrapolation, techniques that increase purchase frequency, identify potentially lapsed customers and up-sell and cross-sell, should theoretically all encourage “loyalty” or customer retention.

RFM analysis is semi-quantitative. Categories are created for each attribute. For instance, the Recency attribute might be broken into three categories: customers who have purchased within the last 90 days, between 91 and 365 days, and longer than 365 days. Once each of the attributes has appropriate categories defined, segments are created from the intersection of the values. If there were three categories for each attribute, then the resulting matrix would have twenty-seven possible combinations. Identifying the most valuable RFM segments also helps businesses capitalise on chance relationships in the data used for this analysis. More sophisticated database marketers are constantly mining their data for these sorts of relationships and then feeding that into their strategies. They may be looking for associations between purchases and demographics/psychographics, between purchases and events, even between purchases and the time of day.

Placing a Value on Customer Relationships - LTV

Customer Life-Time Value (LTV) is a tool to predict the net profit attributable to the entire future relationship with a customer. The prediction model can have varying levels of sophistication and accuracy, ranging from a crude heuristic to the use of complex predictive analytics techniques including the use of Net Present Value (NPV) analysis. For example, we might know that the average customer spends \$350 per year and has an average duration as a customer of 4.5 years. With a contribution margin of 30% we can calculate the future value of the customer (their contribution to overheads and profit) as $\$350 \times 4.5 \text{ years} \times 30\% = \472.50 . (In the present low inflation environment, the net present value of the future income will not be greatly eroded, however more sophisticated analysis requires application of discounted cashflow/net present value analysis). We now know that provided the average customer costs less than \$472.50 to acquire and service, that they make a positive contribution to the business.

More importantly, when the LTV of a customer or customer category can be estimated, rational decisions can be taken on how much can be spent in acquiring and retaining that customer.

On Apportioning Overheads

Gross profit is the common measure of sales performance. It can however be profoundly misleading as each sale has to carry its share of overhead. There are many different ways of apportioning overhead and these vary greatly in sophistication. In a manufacturing operation you might use hours of machine time, floor area or similar bases. In retail, shelf space is common. These all require quite sophisticated information and analyses. A very simple approach is to apportion on the basis of cost. In a retail environment for instance, we can assume (not strictly ideal but a reasonable starting point) that every item carries an equal share relative to its cost price. So for each dollar of cost we can apportion a share of overhead. An example will help. Let's say that the business turns over \$800,000 with a gross profit of 33%. The cost of goods sold (COGS) will be \$536,000 leaving a gross profit of \$264,000. The mistake that many businesses make is to think that each sales unit is delivering them the full gross margin. So an item purchased for \$5.00 sells for \$7.50, leaving them \$2.50. That seems like a fair deal for business and customer. But the reality is, by the time that the item carries its share of overhead, the number can be a great deal less. Let's say the business has overheads of \$200,000. We can apportion them across the COGS so each dollar of COGS carries $\$200,000/\$536,000$ or 37 cents/\$ (0.37). This means that the item that we purchased for \$5.00 and sold for \$7.50, giving a gross profit of \$2.50 in fact has a net profit of \$2.50 less $\$5.00 \times .37 = \0.65 . That's a great deal less than the \$2.50 that the gross profit analysis suggested to us that we were making! An important, if not key strategy for every business therefore is margin maintenance and where possible incremental increase.

The Perils of Discounting

Discounting has a seductive lure to Kiwis. We won't haggle over price but we do expect to be presented with discounts. Firms like Briscoes build their whole strategies around "discounting". At *Forté Management* we regularly hear clients, generally retailers, say things like – I'd sooner keep my prices down and sell more. Generally speaking the assumed relationship is correct – as the price is lowered more product will sell. But for the most part that is where any positive association ends.

When contemplating discounting, businesses need to have a very clear understanding of why they are doing it. If it's to quit stock or convert stock to cash where just getting the cash is important then it may be a sound strategy. But if the goal is to increase profit, then unless you have squeezed your supplier for better prices, discounting to increase profit is extremely difficult.

Obviously a discounted price requires an increase in sales to maintain the same profit but the amount of increase is not always so obvious. The following table shows the sales increase needed for a range of discounts and margins. For example, if your present margin is 25% and you discount your price by 8%, you need to increase your sales volume by 47% to maintain the same gross profit. Discounting is a strategy that should be used with great care. Remember too that discounting tends to focus attention on price. Unless your business model is built around discounting – your goal should be to reduce the focus on price and increase attention paid to quality, service, choice

Forté Management Discount/Sales Calculator

If your present margin is →	20%	25%	30%	35%	40%	45%	50%	55%	60%
And you reduce your price by ↓	To produce the same profit your sales volume must increase by:								
2%	11%	9%	7%	6%	5%	5%	4%	4%	3%
4%	25%	19%	15%	13%	11%	10%	9%	8%	7%
6%	43%	32%	25%	21%	18%	15%	14%	12%	11%
8%	67%	47%	36%	30%	25%	22%	19%	17%	15%
10%	100%	67%	50%	40%	33%	29%	25%	22%	20%
12%	150%	92%	67%	52%	43%	36%	32%	28%	25%
14%	233%	127%	88%	67%	54%	45%	39%	34%	30%
16%	400%	178%	114%	84%	67%	55%	47%	41%	36%
18%	900%	257%	150%	106%	82%	67%	56%	49%	43%
20%	-	400%	200%	133%	100%	80%	67%	57%	50%
25%	-	-	500%	250%	167%	125%	100%	83%	71%
30%	-	-	-	600%	300%	200%	150%	120%	100%

etc.

Incremental Profit Building Strategy

In the Western world we have been seduced by the “big-bang” approach to business – searching out the one thing that we can do that will transform the business. The magic silver bullet you might say. The reality is, for 99.9% of businesses the stars just do not align that way and we have to be a lot more considered when it comes to building our businesses. Here is a way of thinking about growing profitability that we use at *Forté Management*. Picture this. Your current KPIs are as follows:

- Sales \$1,000,000.
- Average sale \$150 (meaning that you make 6667 sales per year).
- Purchase frequency 4 times per year (meaning the average customer spends a total of \$600pa and you have 1667 customers).
- Gross profit 35%.
- Customer churn 20% pa (Most businesses are surprised when they measure their churn rate. 20% is not high for most businesses).
- Customer replacement cost \$100 (This is a very conservative figure!)
- Fixed costs \$300,000 (excluding the cost of customer replacement).

We can now do some base calculations:

Churn: With a 20% churn, just to stand still you have to acquire 333 new customers each year at a cost of \$100 each or \$33,333 in total. Unless you are measuring this figure it is completely hidden – buried in your advertising and promotions costs. For many businesses the majority of their advertising and promotions spend is dedicated to attracting new customers, the vast bulk of whom will merely replace existing customers.

Net Profit Before Tax (NPBT): 35% gross profit on sales of \$1,000,000 = \$350,000 less fixed costs of \$300,000 = \$50,000 less the cost of customer replacement (\$33,333) = \$16,667.

Now at *Forté Management* we say to a client “Do you think that you can improve your NPBT by 100%?” we usually get some doubtful (“You have to be kidding”) looks but when we say do you think that you could improve each of the above factors by 2% the answer is almost always a look meaning “Do you think we are stupid?” and an adamant “Of course we could” – and sometimes “But it’s hardly worth the effort”.

So let’s look at the new figures, each 2% better than the old figures:

- Average sale $\$150 \times 1.02 = \153 .
- Purchase frequency $4 \times 1.02 = 4.08\text{pa}$.
- Gross profit $35\% \times 1.02 = 35.7\%$.
- Customer churn $20\% \text{ pa} \times 0.98 = 19.6\%$.
- Customer replacement cost $\$100 \times .98 = \98 .
- Fixed costs $\$300,000 \times .98 = \$294,000$.

Now let’s assume that we have the same 1,667 customers and see what happens:

1667 customers make 4.08 purchases at an average of \$153 = \$1,040,608 (which is a whisker over 4% increase in sales) – but now the magic of compounding really sets in.

Sales of \$1,040,608 at 35.7% gross profit =	\$371,497
Less fixed costs of \$294,000 =	\$77,497 less
Customer acquisition cost = $1667 \times 19.6\% \times \$98 =$	\$32,019 =
NPBIT = \$77,497 less \$32,019 = \$45,478 (compared to the earlier \$16,667), an increase of 172%!	

By the way - if the increase on each element was 5%, the NPBT jumps to \$89,210! These are just theoretical examples but they demonstrate well the impact of an integrated whole of business approach to profit building.

As a bonus, for most businesses, most of these 2% improvements can be achieved without spending very much money – managing inventory better, improving customer service, reducing waste, better rates on your overdraft, maybe squeezing a few cents extra into your prices. To achieve even 2% increases consistently and sustainably requires careful analysis, diagnosis, planning and action, spread across all four major areas of the business – finances, operations, strategic innovation and people (inside and outside your business).

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