



THE IMPORTANCE OF CUSTOMER RETENTION – PART 1

by Leigh Wallinger

This is the first in a series of articles that look at the importance of customer retention, why it is critical that you develop long-term customers, how you can keep customers and what happens to your profitability if you don't – even if you replace them with new customers.

For many organisations customer retention is something that just happens. It may occasionally be discussed at Board level and when it is, more often than not, it is referred to in vague terms. Most companies would agree that it's good for the business to have a high customer retention rate, although few bother to analyse the benefits in terms of their profitability. It "feels" the right thing for the company to strive for but this, in fact, may not always be the case.

First, select the right customers

Before embarking on a strategy of improving customer retention, you should begin to understand the profitability of your customers. It is possible that you might actually be better off, and your profitability increased, without some of your existing customers. If you have any high maintenance customers, be sure they are contributing at an acceptable level to your profits before deciding to retain them. Some customers may simply not be worth keeping, and your best strategy with these is to off-load them onto your competition.

Having filtered out the unwanted customers, you can now look at the compelling reasons to establish some sort of customer retention policy. Few companies really understand how customer retention rates impact their profitability. The results are often surprising. In his book titled "The Loyalty Effect", Frederick Reichheld found that a 5% increase in customer retention rates will improve profitability by between 25% and 100% in a wide range of industries.

Most likely, the Pareto Principle will apply to your business. Around 80% of your current profits will be produced by only 20% of your current clients. This means that 80% of your clients only produce 20% of your profits and some will be producing very little profit indeed. These low profit yielding customers will need to remain your customers for a considerable time simply to repay their acquisition cost.

Next, understand your customer acquisition cost

The acquisition cost of a new customer, especially in the B2B (business to business) marketplace is very high. Even in the B2C (business to consumer) marketplace, gaining new customers often involves the offering of expensive inducements. For example, a mobile phone company will offer new subscribers a free handset and special tariff reductions for an initial period. Here, the mobile phone company is hoping to get its investment back over the lifetime of the consumer's use of their mobile network. Such is the cost to acquire new customers in this way, the phone companies are having to get their subscribers to commit to a minimum contract period – often 18 months.

In another example, a credit card company will offer to new account holders a period of interest-free credit as an inducement for consumers to switch to their card. Again, the credit card company is hoping to recoup the cost of this inducement over the lifetime of the customer using their card. There are many cases of consumers simply switching to a new credit card company once the interest free period expires. For such "card-hoppers", the cost of acquiring this customer exceeds their contribution to profits from the use of their account. The credit card company would be more profitable if it had not signed up a card-hopper as a new customer.

So, if you do have to offer inducements to gain new customers add the cost of these to your marketing costs when you work out how much it costs to win a new customer from the



competition. By determining the acquisition cost for each customer and comparing this to the customer's ongoing spend patterns and their contribution to profits, you can quickly identify their "payback period". This is the length of time a new customer has to remain an active customer to enable the acquisition costs to be recovered. At this time, the relationship starts to contribute to your ongoing profitability.

Long-term customers are key

Given this analysis, it is easy to see why your long-term customers will be the ones that contribute the most to your profits. Let's look into this a bit deeper.

Firstly, your long-term customers will have already repaid their acquisition costs in the form of their contribution to profits. Once their acquisition costs have effectively been repaid, they will then be contributing to "real" profits.

Secondly, the cost of "running" long-term customers is likely to be less than with a new customer. They will understand more fully your product or service so will contact your Helpdesk less often, if at all. They are less likely to make demands of your technical support or service staff.

Thirdly, you can begin to streamline your interactions with them. You should introduce and use less expensive ways of keeping them "locked in" – such as email, telephone calls and newsletters instead of expensive personal visits (especially in B2B situations). However, be absolutely sure you don't go too far with this – see the next article in this series to learn why great care should be exercised in this area.

So, given the option you should work extra hard to retain your long-term customers. Simply replacing a number of established customers with the same quantity of new customers will really hurt your profitability. This profit impact is unavoidable when there is "customer churn" but in today's high-activity business world it is seldom given the attention it warrants and deserves.

Customer churn reduces profits

To illustrate this point, consider you run a company that has 20 long standing customers and each contributes £500 to profits each month. Because they have been customers for a considerable period, their acquisition costs have been recovered. Their £500 accrues directly to increasing profits. This generates £10,000 profit per month, £120,000 per annum.

Consider what happens when 3 of these customers defect and are replaced by 3 new customers. The acquisition cost of these new customers is £8,000 – the cost of sales staff, technical advice, special offers, discounts and simple "give-aways" to get the first order from each new customer.

At the superficial level, 3 old customers being replaced by 3 new customers seems a neutral position. The company still has the same number of customers, each contributing £500 per month.

In the first year, the contribution from these new customers simply goes towards repaying their acquisition cost. Therefore, even though the number of customers is the same, the annual profits are generated totally from the remaining established clients. Profits fall from £10,000 per month to £8,500 per month, a drop of 15%. In this scenario, "full" annual profits are not recovered until Year 3.

The loss of just 3 customers will hurt profits for the subsequent 2 years.

Some industries, such as those involved with mobile phones, credit cards and household utilities, see their customer turnover rates at much higher levels. Consider the above example, in which the company loses 15% of its customers over a 3 year period and the



impact this has on profitability. Compare this with a company that loses 30% of its long term customers per year - it has to replace virtually all its entire customer base every 3 years.

The benefits of working hard, hard, hard on retaining your existing customers are obvious. The only surprise is why so many businesses fail to give sufficient attention to customer retention. The next article in this series looks at some of the reasons why you lose your existing customers. And sometimes they do just leave you, regardless of how good you are.

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