

ESTIMATING LONG-TERM RETURN ON CUSTOMER INVESTMENT

While the previous chapter provided a framework for calculating return on customer investment (ROCI) from a short-term, business-building perspective, that is only half of step 4 in the IMC process. While most marketers are comfortable talking about communication programs that impact sales in the short term, this chapter leads to less familiar ground. Here, we focus on how to gauge the long-term, brand-building effects of marketing communication on the overall value of the organization (see Chapter 9). This task requires a new set of metrics; a new level of financial acuity; and most of all, a different set of value measures for a different set of customers—the owners or shareholders of the firm. We provide a methodology for measuring long-term communication returns. A case history then helps illustrate the approach in more pragmatic terms.

The Importance of Measuring Long-Term Returns

As we have seen throughout this book, the real value of the organization is in the cash flows it generates currently and the expected contin-

uation of those cash flows into the future. Management sees current returns as being created, to a large extent, by the firm's short-term marcom investments. These incremental returns are the most obvious result of the marcom effort, and they have traditionally received the most attention. Thus, one could argue that long-term returns are of less value to the firm—and, in most accounting and financial valuation systems, they are. The concepts of net present value (NPV) and discounted cash flow (DCF), both defined in Chapter 9, are based on the concept that dollars the organization has today have more value now than having those same dollars sometime in the future. Thus, any NPV calculation discounts future cash flows by some percentage for risk, the time value of money, loss of investment opportunity, lack of flexibility, and so on. While customer loyalty is often paramount in the marketing and communication plans of an organization, it must always be remembered that customer income flows in the future are less valuable than equivalent income flows that can be generated today. But one must also remember that these incremental gains are only a small portion of the firm's total sales and value.

Another important consideration in estimating long-term returns on marcom investments is that maintaining current income flows from present customers is generally less expensive than current time investments made in gaining or attempting to gain additional customers and their income flows. Many marketing experts suggest that it costs a firm anywhere from five to ten times as much to acquire a new customer as it does to maintain an existing one.¹ Obviously, having current customers continue to buy rather than continuously acquiring new ones is a major benefit to any organization simply in terms of current cash flows. In addition, stable customer income flows make the operational and financial management of the firm much easier.

Yet there are some problems with this idea of long-term customer income flows. Under current accounting systems, any marcom investment in a customer during the current period must be taken as a current period expense no matter when the returns occur. So, while long-term returns can and often do occur, the expense of generating those returns occurs and is accounted for in the present fiscal period.

USING DISCOUNTED CASH FLOW ESTIMATES IN IMC PLANNING

When attempting to estimate the long-term impact of communication activities, marketers invariably try to forecast the long-term earnings stream that could come from a customer or group of customers as a result. In doing so, however, they must recognize that these forecasts are subject to risk and that projected earnings should be discounted to reflect both uncertainty and the time value of money.

Financial analysts use a method to discount future cash flows by equating them to today's dollars (net present value, or NPV). Quite simply, a dollar today is worth more than it will be worth in one, two, or five years. To illustrate, assume that as chief executive officer (CEO) of a marketing firm, you are trying to decide how much investment to make in various activities the organization wants to carry out. Your choice is fairly simple. You can either fund a new marcom program or—for guaranteed income—you can take the same funds and invest them in an interest-bearing government bond or even a bank savings account. Since the marcom manager cannot realistically guarantee a return on a marcom investment, there is some risk involved in that alternative. And it is this risk, along with other factors, that provides the basis for any type of NPV or discounted cash flow (DCF) determination.

As CEO, if you are uncomfortable with risk you will likely choose the safer alternative. However, if you are willing to risk the firm's resources, you might choose the marcom investment. Much depends upon how you are running the business and what your management style is.

Consider the investment scenario of an organization that expects to make a 15 percent return on every investment, whether that investment is a new computer system, a new building, or a new marcom program. The company must also consider

the length of time it will take to generate those expected returns. Thus, an investment that will not achieve a 15 percent return until the end of three years is not worth as much as an investment that will have the same 15 percent return within twelve months. Let's see, for example, how much a \$1,000 investment would actually be worth:

Year 1:	\$869.56	or	$\$1,000/1.15$
Year 2:	\$756.43	or	$\$1,000/(1.15 \times 1.15)$
Year 3:	\$657.89	or	$\$1,000/(1.15 \times 1.15 \times 1.15)$
Total:	\$2,283.88		

An income stream of \$1,000 for three years (\$1,000 each in year 1, year 2, and year 3) is not worth \$3,000 in today's dollars. Instead, it is worth only \$2,283.88 (\$869.56 + \$756.43 + \$657.89). This is the sum that represents the net present value of \$1,000 over three years using a discount factor of 15 percent.

Discounted cash flow provides a realistic view of future income flows. It recognizes the net present value of future income from customers, and it accommodates future investments that the firm likely will make in the customer or customer group in the form of marcom programs. This discounted cash flow estimate is important for the marcom manager to be able to justify his or her programs. Remembering that money in hand now is more valuable than money received later is an excellent way to help separate out short-term from long-term returns on marcom investments. The problem, of course, is that all marcom investments are based on future returns, which presents a complicating factor.

Further, having a set of customers who are continually satisfied with the products and services of the firm and their experience with the company also provides substantial future opportunities for that company. These can come in the form of opportunities to cross sell, upsell, and

migrate customers through the product or service portfolio, thus adding additional sales and profits that might not have initially been expected. In addition, the advocacy value of satisfied customers is something many organizations are just beginning to recognize, although many find the financial value of advocacy difficult to quantify. Certainly, as the Internet and E-commerce have demonstrated repeatedly, as communities of interest develop, word of mouth about products and services—particularly from those people or firms with firsthand experience of them—becomes a powerful sales development and maintenance tool. So, there are compelling reasons to have an ongoing set of satisfied customers other than just the immediate income flows they may produce now and in the short-term future.

In spite of the challenges that discounted future income flow estimates pose, almost all investments (and marketing communication can be no exception) are assumed to have some ongoing or long-term effect on the business. Otherwise, why would those investments be made? Examples abound. Funds are expended for the construction of plants or factories that are expected to yield value far into the future. The same is true of investments used to create intellectual property, such as research and development, logistical systems, employee training programs, and so on. So, while the common focus of marketing managers is in meeting quarterly or annual sales and profit goals, it is the expected long-term returns that often provide the base for further short-term investments and returns. Indeed, in some cases, organizations often succeed in the future because they have created momentum with products, customers, or channels in the present. That momentum is then carried over to the next time frame or helps them weather difficult situations in the short term. Thus, the momentum developed has provided increased or enhanced returns beyond those that normally might have been expected.

Recall from the early chapters of this book that we suggested that the primary goal of most senior management is to grow the business. The two primary forms of scorekeeping are increases in cash flows and increases in shareholder value. Shareholder value is commonly determined based on expectations of increases in the stock prices of publicly

held companies, in larger or more lucrative dividends, or in the long-term value of the firm to the owners. Both cash flows and shareholder value have short- and long-term aspects. Yet both measures are dependent on one basic premise: holding customers and their income flows now and into the future. It is the customer who creates the value for the organization by purchasing and continuing to purchase its products and services over time, in other words, in creating present and future cash flows for the firm.

Challenges of Measuring Long-Term Returns

While there is a strong case for forecasting long-term or ongoing cash flows from customers as a result of investments in marcom programs, these are not as easily identified as are current income flows. The reason? There are a substantial number of variables in long-term measures that confound the marcom planner's ability to predict potential income flows. Four major issues or sets of issues present particular challenges.

Difficulties Inherent in Today's Accounting Systems

The accounting systems in place around the world create difficulties in measuring long-term returns on marcom investments. Much of this has to do with the challenge of valuing intangible assets or income flows in the future. Based on current accounting standards, there is simply no way for an organization to recognize future income flows until they are earned, and the rules for forecasted income are becoming more stringent each day.

The accounting system is clear. Books are opened at the beginning of the fiscal year and are closed 365 days later at the end of the fiscal year. Once the books are closed, the organization repeats the process, starting over with a clean slate. So, if an investment is made in a marcom program in the fourth quarter of the firm's fiscal year and customer income flows start to arrive in the first quarter of the following fiscal year, the current year will show only the expense of the invest-

ment and no returns, and the following year will show income but no costs. That is why a customer acquisition program, which commonly costs more to start than it initially returns and whose returns often come back in later accounting periods, creates major accounting difficulties for the organization and the marcom manager as well. In essence, the marketer invests today to get new customers today but must wait until future accounting periods to fully recover the investment and earn a profit through returns that come in the future.

For example, it is not unusual for catalog companies to invest several times more in marketing and communication to initially acquire a new customer than they receive back in profits over the first several purchase transactions. Identifying prospective customers, mailing them free catalogs, setting up billing systems, and the like are all current period expenses. These expenses are not returned until the customer actually purchases something. And that could be several months in the future, if ever.

The same is true for many business-to-business organizations. The firm hires salespeople, equips them with sales materials, and sends them out to identify and develop customers, all at considerable expense. But the sales force may not show any sales results or cash flow returns for a year or more. The toppling of the dot-coms in the late 1990s is another case in point. Building a website, setting up a distribution system, developing awareness for the site, and encouraging customers to visit and (hopefully) buy, all cost current dollars. There was a significant lag between the time the developmental expenses were incurred and when customers could begin to enter transactions. Thus, financial returns did not come for several months or, in some cases, not at all, depending on the business model. Thus, the dot-com firms simply ran out of operating capital and were forced to close.

One of the key elements the marcom manager must understand is the long-term flows of income created by customers and how those income flows are impacted by current period expenses charged against them as a result of current period financial investments in marketing communication. Part of this challenge occurs because marcom managers traditionally have been more focused on managing expenses—that

is, the dollar flow out of the organization through the purchase and distribution of various promotional efforts—rather than looking at the income flows coming into the firm as a result of marcom investments.

Difficulties Associated with Lagged Effects of Communication Programs

One of the most common responses to marketing communication is for customers to see or hear the communication but not act on it until a later time. This is what is called a *lagged effect* of the communication program. Lags in response can occur for any number of reasons, ranging from a customer's present lack of need in the category to purchase consideration timing to the need for greater information to make an ultimate purchase decision. Automobiles, replacement windows, overseas vacations, and choices of educational institutions are just a few examples of products that have a fairly long purchase consideration cycle. Some replacement window companies, for instance, have found that the purchase consideration cycle for their products is over a year. Any marcom program for replacement windows will generally come back with returns in the second or sometimes even the third year after its initial placement.

Examples of lagged effects of marketing communication abound in business-to-business marcom programs, too. Product design decisions, ingredient selection, product development, and other activities may take months or even years to develop. Business-to-business firms typically invest communication funds during a fiscal year, knowing that it will take considerable time for returns to occur.

As a result of the lagged effects of communication returns, it is often difficult for an organization to determine exactly when returns will occur, or even if they will occur at all. For the most part, organizations, when faced with this problem of understanding behavioral returns, commonly employ sophisticated statistical modeling techniques, such as *correlation analysis*, or marketing mix modeling. Here, an analysis of historical sales data is correlated to the investments and expenditures on marketing and marcom activities to provide an estimate of their mar-

ketplace returns in the past. Models like this, however, are only calculations of what happened historically, not what might occur in the future. They do not, therefore, solve the problem of identifying potential lagged effects.

Difficulties in Predicting Brand Loyalty

Loyal customers have generally been considered profitable customers, creating the best source of future income flows to the organization. Recent research, however, has begun to challenge this long-held assumption. Loyalty alone does not mean a customer will be profitable. For example, a customer who buys one bottle of Windex per year is 100 percent loyal. Yet a customer who buys ten bottles of window cleaner per year, only three of them Windex, has the potential to be three times as profitable as the one-bottle purchaser, even though the ten-bottle customer's share of requirement is only 33 percent.

Research by Frederick Reichheld and others in the early 1990s showed that increases in customer loyalty often provided substantial bottom-line future profits for the marketing firm.² For example, Reichheld reported that he found a 5 percent increase in customer loyalty increased bottom-line returns by as much as 75 percent to 100 percent. The reason for this, as discussed earlier, is that the organization does not have to invest as many resources in keeping customers buying as it did to first acquire them. Thus, customer loyalty is commonly a much less expensive investment proposition for the firm than continuous customer acquisition.

By having loyal customers, the organization can also commonly reduce the peaks and valleys of income flows brought about by erratic purchase behavior by their customers. This leads to greater stability in the financial areas of the operation. (Recall from guiding principle 4 that reducing financial volatility is one of the four primary objectives of any marketing or communication investment.) By knowing approximately what type of income flow will occur in the future, for example, over the next two to three years, the company can better manage its finite resources and thus reduce its need for external or even internal

funding. The challenge, of course, is to determine which and how many customers will remain loyal to the firm, particularly in the months beyond the current fiscal year.

From this discussion of the first three issues that challenge the long-term measurability of marcom returns, one can see that, in spite of forecasting problems, marcom investments generally meet three of the four requirements that senior management has for any type of investment. These were summarized under guiding principle 4 in Chapter 3:

- Marketing communication should increase cash flows over time. In the case of some types of communication programs, the lagged effects of that communication may play a major role in organizational success.
- Marketing communication should accelerate cash flows by moving them forward, or ahead of the time they might normally be expected. That is, if marketing communication can get customers to buy more, buy earlier, buy more often, or simply purchase at a different time, expected income flows are moved forward from the future to the present.
- Marketing communication should generate returns that stabilize or reduce the volatility of the firm's cash flows, thus providing relief from internal or external financing in the future.

The fourth requirement—that marketing communication should build shareholder value by increasing the equity of the firm or brand—presents the fourth and most difficult forecasting challenge. While there is little question that shareholder value is dependent on stock prices and dividends, these come as a result of profitable income flows from customers over time.

Difficulties in Identifying Increases in Brand Asset Value Over Time

Financial brand asset value—the value investors, as opposed to customers or prospects, place on a brand—presents a key challenge when accounting for the future value marcom programs may generate. While

there is little question that marcom has an impact on building the value of a brand both among the investment community and among customers, these two measures are quite different and must be considered separately.

Assessing stability and growth of corporate earnings is a key way in which investors compare the potential value of various stocks. Thus, if investments in marcom can create customer activity, which then translates into ongoing flows of income from customers, those marcom investments have some long-term impact on shareholder value, too. Further, if marcom investments can be made in one period and the returns enjoyed in other, long-term periods, the marketer can truthfully say that there is some contribution to future earnings and some increase in the value of the firm in the marketplace. Yet financial models that directly relate sales levels, customer loyalty, and other effects of marketing communication to stock price and, from there, to shareholder value have not yet been fully developed. (Chapter 13 suggests ways in which such correlations may be made.)

Toward a Solution: A Model for Measuring Long-Term Returns

Two frameworks help marketers overcome the four key sets of difficulties described in forecasting returns on marcom programs in the long term. The first is customer centric, focusing on ongoing income flows that can be derived from a customer or group of customers. The second is brand centric. It examines the financial value of a brand by estimating the brand's contribution to the firm's earnings streams or its asset base, or the value for which the brand could be sold to another organization. We examine the first approach in this chapter, leaving the brand-centric model to a more detailed discussion of brand equity in Chapter 14.

The customer-centric measurement framework is based around the concept of *lifetime customer value* (LTV), developed by direct and catalog marketers to explain potential future customer income flows. It is a method of estimating future returns from customers based on past or

current experience with them using probability forecasting models. Once forecasted cash flows are estimated, they are then discounted to account for their NPV and to determine the present-day value of future income.

Lifetime Customer Value

The LTV approach recognizes that some present customers will likely continue to purchase the firm's products or services in the future, thus creating future income flows. At the same time, some customers will be lost through attrition, transfer to competitors, moving, death, or any number of other reasons. It is this combination of retention, attrition, anticipated spending patterns, and estimated costs that defines each customer's LTV.

Lifetime customer value is estimated by calculating the NPV of all future revenues minus all attributable costs associated with the average customer.³ It is an extension over time of what is done in developing the short-term ROCI measurement described in the previous chapter. For example, to get an estimate of LTV, the short-term estimate of returns (those that will occur in the current fiscal year) is extended to multiple fiscal years, given certain assumptions about the level of customer retention, their anticipated levels of spending, and the ongoing marketing costs to sustain the firm's relationship with them.

While LTV projections are sometimes made in present-day prices or dollar values, such calculations do not take into account the time value of money. Thus, the IMC process takes the concept one step further to reflect *net* LTV, that is, it uses the NPV of all future revenues as the basis of calculation. To do so accurately, two additional assumptions must be established⁴:

- **A return on customer investment goal.** The goal for any marcom investment must be to deliver returns that reflect both the time and risk values of money. Usually, the ROCI goal must be at least as high as the company's traditional return on equity. Thus, if the company is generating a 15 percent return on investment for its owners

or shareholders, marcom investments that generate less than a 15 percent rate of return over time are generally not advisable. If the market is volatile, if technology is changing, and if customer loyalty is likely to shift, then a higher rate of return is commonly required to make the marcom investment worthwhile. Obviously, a stable market—one in which, for example, the firm has a patent or is in a protected niche that virtually ensures future income flows—does not require the same level of risk premium for marcom investments.

- **A realistic time frame over which customer value will be estimated.** This must reflect the period for which future purchase behavior can reasonably be predicted and for which the ongoing impact of communication programs can be estimated. That is, some products are relevant to customers only during limited periods in their lives (diapers, school uniforms, magazines directed at teenagers, and so on), so the average time during which a customer remains a customer is relatively short. Other products may span decades of loyal and repeated use (for instance, toothpaste, general-interest magazines, automobiles, various types of music). As a practical matter, however, it is generally difficult to predict with any accuracy for a period of more than three to five years for most products.

How to Calculate Lifetime Customer Value: An Example

Database consultants Jack Schmid and Alan Weber offer the following step-by-step method of calculating LTV.⁵ The example is based on a business-to-business organization that sells products through catalogs. The same analytical framework can be adapted for all types of organizations.

1. **Determine the cost of acquiring a new customer.** Let's suppose it costs a company \$0.60 to send a catalog to a prospective customer (total cost in the mail, with list rental, postage, printing, and so on). From experience, the firm expects renting an outside list of likely prospects to achieve a response rate of 1.1 percent on the ini-

tial mailing. It will therefore cost \$54.55 to acquire a new customer ($\$0.60/0.11 = \54.55).

2. **Determine how much gross profit is earned on the average sale.** Suppose that the average initial order from a new customer is \$70.00, with an average gross margin per customer of 40 percent after the cost of fulfillment (the cost to select, pack, and ship the order). The initial order average profit margin is \$28.00 ($\$70.00 \times 40\% = \28.00).
3. **Determine net gain or loss of customer acquisition.** Taking the customer acquisition cost from step 1, the marketer subtracts that from the margin on the first sale ($\$28 - \$54.55 = -\$26.55$).

Thus, the company actually has a net loss on each new customer it acquires, at least on average. Another way to look at it is that the company makes an investment of \$26.55 to acquire a new customer with the anticipation that the customer will become profitable over time through subsequent purchases. The question, then, is how long it will take for an average customer to repay the costs of acquisition, and how much profitability new customers represent going into the future.

To determine the likely future profits on newly acquired customers, the marketer must project their future purchases and subtract the cost of recontacting them as well as any service or maintenance costs that will be incurred in this process. The marketer must also consider the time value of money by factoring in the net present value of future earnings streams.

Continuing the same example, Table 11.1 summarizes the net LTV calculation. Assume that new customers will continue to actively purchase from the company for a period of three years after their initial purchase and that they receive four catalogs per year. Once a customer is acquired, any subsequent mailings cost only \$0.50 per catalog, since there is no need to rent a prospect mailing list. Additionally, the response rate from established customers is generally much higher than from prospect lists, since a relationship has already been established. Experience has shown that after the initial purchase, a group of customers will typically respond at a rate of 16 percent to each of the four

Table 11.1 Customer Lifetime Value Example

Line		Year 1	Year 2	Year 3
1	No. of mailings per year	4	4	4
2	Average response per mailing	16%	13%	11%
3	Annual response rate (Line 1 \times Line 2)	64%	52%	44%
4	Average repeat order	\$ 75.00	\$ 75.00	\$ 75.00
5	Average gross profit/order @ 40% margin	\$ 30.00	\$ 30.00	\$ 30.00
6	Gross profit per year (Line 3 \times Line 5)	\$ 19.20	\$ 15.60	\$ 13.20
7	Less annual cost for 4 catalog mailings per year @ \$.50 each	\$(2.00)	\$(2.00)	\$(2.00)
8	Net earnings per year (Line 6 - Line 7)	\$ 17.20	\$ 13.60	\$ 11.20
9	Discount factor @ 20%	1.20	1.44	1.73
10	Net present value of earnings (Line 8/Line 9)	\$ 14.33	\$ 9.44	\$ 6.48
Total net present value of earnings over 3 years		\$30.25		
Less original customer acquisition investment		- \$26.55		
Three-year return on customer investment		\$ 3.70		

offers within their first year. In the second year, the rate drops to 13 percent and in the third year to 11 percent.

4. **Determine cumulative response rate over time.** Given these response data, it is possible to achieve the following cumulative response rate, depending on the length of time since the customer was acquired. This is done by multiplying the average response rate by the number of mailings per year. That is, in year 1, customers have an average response rate per mailing of 16 percent. Multiplying this by the four mailings per year results in a cumulative response of 64 percent. For year 2, there is a cumulative response rate of 52 percent, and for year 3, customer response rate is 44 percent (shown on line 3).
5. **Determine the margin on repeat sales.** In this case, the marketer uses the same 40 percent gross margin used in the initial mail-

ing. However, the company soon discovers that it has a higher average order from existing customers, with an average of \$75.00 on each repeat order. This leaves the company with a \$30.00 gross profit margin on each order ($\$75.00 \times 40\% = \30.00).

From this, the marketer must subtract the annual cost to market to existing customers. With four mailings to each customer per year, at an average catalog cost of \$0.50, the organization would have an annual marketing cost per customer of \$2.00 ($4 \times \0.50). When the annual marketing costs are subtracted from the annual gross profit, the result is a net earnings per customer of \$17.20 in year 1, \$13.60 in year 2, and \$11.20 in year 3.

6. Discount the expected cash flows to their net present value.

Here, the marketer must factor in the time value of money. The company uses a 20 percent per year discount factor (which is the same as paying interest at 20 percent per year to investors). This time value of money discount factor for year 1 is 1.2 (the principal amount plus 20%). For year 2, it is 1.44 ($1 + 20\%$ for two years or 1.2×1.2); for year 3, it rises to 1.73 ($1.2 \times 1.2 \times 1.2$). The earnings in each year are then divided by the applicable discount factor to arrive at the NPV of the projected earnings for each year. Thus, the NPV of the forecasted earnings is \$14.33 in year 1, \$9.44 in year 2, and \$6.48 in year 3.

From these calculations, it can be stated that the total NPV of earnings over the three-year period will be \$30.25 per customer ($\$14.33 + \$9.44 + \6.48). However, to get to the final estimate of profitability, one must subtract the investment made to initially gain the customer. (Recall the company actually lost money at the acquisition stage.) Thus, one must subtract the original \$26.55 investment in order to determine if the investment goals will be met.

Acquiring new customers not only provides a 20 percent return on the initial acquisition investment but returns an additional profit of \$3.70 as well. It is possible to vary the time value of money discount factor to make the end figure zero and determine the exact projected return on investment. It is also possible to vary the time period to determine how long it takes to recover the investment with interest, based

on the initial investment in a customer. Thus, the marcom manager can adapt and adjust the returns to fit the needs of the organization or his or her own analytical requirements.

The figures shown here provide an excellent indication of how much time, effort, and financial investment the marcom manager can allow for attracting new customers. The same type of analysis can be used to determine the level of marketing efforts and investments that can or should be made to influence existing customers.

Comparison of Lifetime Value

Understanding lifetime value is especially useful when one method of marketing to customers is compared with another. Many marketers have discovered to their chagrin that it is very easy to create a consumer loyalty program that maintains customers but loses money in the long run. Alternatively, it is just as easy to "leave money on the table," that is, not generate all possible sales by not marketing to existing customers often enough.

Schmid and Weber provide another example, this time of a consumer catalog organization that is trying to decide whether it should conduct three or four mailings (contacts) per year as a means of providing incentive to encourage larger orders.⁶ Three methods are under consideration: method A would entail three mailings per year, method B would raise the number to four, and method C would have four mailings and offer a 10 percent discount on all repeat orders over \$60.00. Each method is expected to have a different effect:

- Method A will have the highest response per contact.
- Method B will have the highest annual response.
- Method C will have the highest average order.
- Method A will have lower economies of scale.
- Method B will have the lowest cost per contact.
- Method C will require explanation of the 10 percent offer.

This example compares programs the company is considering for existing customers and does not consider the acquisition costs. Thus,

Table 11.2 Likely Results of Marketing Strategies

	A	Method B	C
Number of mailings per year	3	4	4
Response rate per contact			
Year 1	12%	10%	10%
Year 2	9%	8%	8%
Year 3	6%	5%	5%
Average order	\$75.00	\$75.00	\$80.00
Profit margin (%)	40%	40%	37%
Cost per contact	\$1.00	\$0.95	\$1.00
Annual marketing cost	\$3.00	\$3.80	\$4.00
Profit per year			
Year 1	\$7.80	\$8.20	\$7.84
Year 2	\$5.10	\$5.80	\$5.47
Year 3	\$2.40	\$2.20	\$1.92
Present value of future profit			
Year 1	\$6.50	\$6.83	\$6.53
Year 2	\$3.54	\$4.03	\$3.80
Year 3	\$1.39	\$1.27	\$1.11
Lifetime return on investment	\$11.43	\$12.13	\$11.44

From John Schmid and Alan Weber, *Desktop Database Marketing*, 1997, NTC Business Books. Reproduced with permission of The McGraw-Hill Companies.

the focus is only on increasing future profits, and the most appropriate method is therefore the one that will produce the greatest value over the next three years. Table 11.2 summarizes the likely results for each method.

As shown, contacting each customer four times per year with no discount produces the most profits over the three-year period. If the discount offer had produced a substantially higher average order or if the response rate had increased, it would have been more profitable. In this case, however, giving margin dollars away simply lowers profits. Notice that reaching customers less often is more profitable when response rates are low (as in year 3). This points out why it is important to segment the customer base and contact some customers more frequently than others.

Moving On

A number of benefits can result from a well-designed program to increase LTV. Clearly, it increases profits from existing customers; improves return on investment; and leads to steady, predictable growth. Just as important, it increases customer loyalty by encouraging more customers to repurchase. Increased loyalty, by enhancing LTV, is a viable investment opportunity for the firm.

With an understanding of customer lifetime value and a framework in hand for determining long-term returns on the communication investment, we are ready to proceed to the final step of the IMC process: budgeting, allocation of funds, and evaluation.