Customer loyalty and customer value - 8
The need for continual validation

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Any research or theory based model cannot be assumed to be correct unless some kind of validation procedure is applied. Just because a model fits one set of data, it does not follow that the model is valid i.e. it will apply to other data sets. The ultimate validation requires that the model be repeatedly applied and tested against some measurable criterion. In practice, less rigorous criteria such as testing the model on one or two other data sets and using advanced statistical testing procedures are commonly used.

Tracking studies

No serious attempt to develop customer loyalty is complete without undertaking ongoing tracking research. Once we identify the key factors that promote loyalty and slow down churn, we need to take three steps:

1. Set up an action programme that addresses the issues relating to churn and loyalty;
2. Set up a tracking programme to measure how well we are delivering on factors that would increase customer loyalty and slow down churn; and
3. Use the tracking programme to measure how effective our initiatives are increasing loyalty and slowing down churn.

Loyalty vs. churn

Let us suppose that we carry out a marketing research study of clients with different loyalty scores. At the end of the year we find the following relationship:

Loyalty Index	% defections	Revenue + or -
80+	2	+35%
60-79	20	+ 15%
40-59	40	- 10%
20-39	60	-20%
Under 20	80	-30%

If we take steps to build customer loyalty as measured by the index, will the churn rate change by the magnitude index suggested by research? For instance, will a customer whose loyalty index is between 40-59 generate revenue that is 10% less compared to overall average monthly revenue? If we increase their loyalty to the next level (i.e., loyalty index of 60-79), will the overall profitability of this group continue to be 15% above the overall average?

Actual results vs. model predictions

Contrary to what most modellers seem to assume, model predictions do not always come true. The first problem is that the initiatives taken by the organization may not succeed in moving customers from one level to another, despite its best efforts. The second problem is that an increase in measured loyalty may not result in increased revenue.

How can this be so?

The first problem has to do with gaps that inevitably arise when customer requirements are translated into processes. Such gaps include misinterpreting customer requirements or designing processes that do not adequately address the concerns of customers. In the last few articles we discussed this problem in some detail.

The second problem can result from a number of factors. For instance, the model that created the loyalty index could be weak and not sufficiently stable. As a consequence, the relationships between the loyalty index, churn and the revenue index are disturbed by the process of measurement itself. This is akin to research figures having a large margin of error or even a bias component.

Even when our measurement methods and models are sound, we may not see an immediate improvement in churn rate or profitability when the loyalty index is increased. The main reason for this is the lag effect. The loyalty index score may not immediately translate into actual loyalty. An increase in the loyalty index score (attitudes) may have to be reinforced before attitudes are translated into changes in behaviour (fewer clients leaving the company).

However, it is not always possible to know what the problem might be. We could be doing things wrong or we could be doing things right but need to wait for a while before the effects of our efforts begin to manifest themselves.

It is important for us to know what the problem might be since the course of action we need to undertake will depend entirely on a correct diagnosis of the problem. Unfortunately, there is no easy way to isolate the causes. Modellers should spend time validating the model in as many ways as possible when it is being constructed. Although the ultimate validation of a model is that it works in practice, failure can be significantly reduced by early attention to details and statistical principles. The previous articles in this series discussed many of the issues related to such early validation.

Exhibit 1 - Problems of model validation

Validation problems- (Why does the model not work)		
Process operationalization	Response lag	Changing environment
Consider gaps in translating customer requirements	Check model's preliminary validity	Continually reevaluate the model
if valid continue tracking		

Updating the models
There is a third reason for continually tracking our customers: the rapidly changing marketing environment. Even when we have validated our model through statistical and empirical means, our model can gradually (sometimes abruptly) fail to hold true. This can be because a model is built at a point in time and the relationships that once held are not valid anymore. Historically, this problem has never been very serious since both technology and human attitudes do not usually change rapidly. However, over the past decade, the accelerated use of technology has been instrumental in changing customer expectations. While customers' basic motivations may not have changed very much over the years, the means through which the motivations are satisfied may well have changed. For instance, a customer's motivations for dealing with a financial institution may not have changed (e.g, the institution offers flexibility, stability, efficiency, and value). However, what constitutes flexibility, stability, efficiency and value keeps changing as more and more options become available to customers. Since motivations are abstractions and cannot be delivered except though operationalized processes, it is important to be aware that the 'hot buttons' or the triggers that satisfy basic needs and thus enhance loyalty can change so quickly as to make the original model partially or totally obsolete.

It is important to note that these considerations are not theoretical niceties but practical problems in a rapidly changing environment. Even if customers don't clamour for change, your competitors will prompt customers to reevaluate what they are receiving in light of what is available elsewhere.

We are aiming at is a moving target and thus static strategies are likely to fail. Any organization that is slow to recognize this fact will be at a competitive disadvantage.

Activity-based vs. lifetime value solutions

Before leaving the topic of customer loyalty and churn, we need to consider one more topic: the cost of customer loyalty. How far should an organization go to keep their customer loyal? Earlier in this article (and in this series) I suggested that the return should be related to rewards. But in some cases it is not clear what benefit should the cost relate to.

The most common way of relating cost to benefits is activity-based. For instance, if rectifying a complaint from a customer would cost much more than the amount a customer paid for a product or service, the organization may choose not to act. From an activity-based point of view, this would make sense. However as one reviews the cost of acquiring new customers, activity-based cost-benefit analysis seems short-sighted.

Consequently, many organizations have been attempting to compute the lifetime value of a customer.

Lifetime revenue can be estimated by using factors such as expected lifetime of a customer (derived from historical data), revenue trends, and segmented churn rates. Once we have the lifetime revenue of a customer, the value of a customer can be computed by subtracting the cost of service from the lifetime revenue. (Cost of service in turn is computed by estimating activity based cost, activity projection based on historical behaviours and expected lifetime).

Stripped of all technical jargon, the lifetime approach takes a long-term view of the customer. A company does not have to make money or even breakeven on every business activity. What is important is to have a long-term relationship with the customer in which benefits to the organization outstrip costs during the lifetime of a customer.

As the costs of acquiring new customers keep escalating, more and more organizations are turning to lifetime value estimation. Another no-so-obvious payoff to the organization is the increased probability that a loyal customer will recommend the company to others thereby increasing his or her indirect value to the organization.

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