

Getting To Grips With The *Real* Customer Lifetime Value – Part 1

If only I knew... (this), then I could do... (that)

Every business owner or marketing professional has asked themselves that question at least once in their career. For some of the most successful it's almost their daily mantra.

In this 3-part mini-course I want to help you answer an important lifetime question; “How do you value a customer lifetime?”

Why bother, isn't it just another nice to know idea?

No! It's a **need to know** tool. I've been a direct marketer for more than 35 years, both as client and consultant. In that time I have not found any tool as valuable to the future of a business as knowing the customer lifetime value or LTV. And for many reasons... these are the most important:



1. *To **know*** the worth of my database should I want to sell-up. Even the dreariest of bankers and accountants value and respect the calculation.
2. *To **know*** how much to invest to recruit a new customer.

Plus such critical issues as what medium or channel to use as your database grows to a size where you can produce insightful management, as well as marketing, information.

I know of major airlines who will willingly spend £2-3,000 to get a prospect into the top tier of their loyalty scheme. Those individuals are worth in excess of £200,000 in ticket sales over their 'customer lifetime'.

3. *To **know*** how much to re-invest in retaining that customer each year.

Major direct response companies can forecast to the penny how much they have to pay to incentivise repeat sales.

4. *To **know*** the results of initiatives to extend every customer's LTV with up-sell, cross-sell and innovation strategies.

5. *To **know*** which project is the most likely to give the best return. Management is about choices; choosing the option with the greatest potential for profit makes sense to me.

I've helped several companies who were considering changes to their marketing strategies to promote to new audiences, through new media and sometimes with new products too. Simple LTV models enabled us to prioritise the options available.

6. *To **know*** that I can set targets of features within campaigns, assess performance and modify plans if necessary. What's more, once the plan is on a spreadsheet you can ask 'what if' questions to aid decisions at all times.

Are we talking about return on investment (ROI)? Isn't that something accountants handle?

Two questions, two answers – both are “No”.

OK, there some similarities between LTV and ROI. They are both concerned with how money changes in value over time – more below* – and use the same arithmetical formula to calculate it. [The calculation may put some people off so stay with me to Part 3 and I'll give you a spreadsheet that does this for you.]

More particularly ROI versus LTV is an issue of focus and use. ROI covers any project of any kind that involves the allocation of resources for any member of the management team. LTV is about people; our customers, who they are, where we find them, how we get them to spend money, for how long and the costs of doing all this... while making a profit.

So ***No*** it's not something for accountants to handle – they don't know people like we know our customers.

****Money really does change in value***

It's called inflation - if we leave aside international exchange rates. Let me give you a simple analogy. Say that last year a loaf of bread cost £1 and this year £1.10, the loaf hasn't changed but the price has gone up 10p. Money has lost 10% in value from the first year to the next.

This is important because we can't compare money amounts over 2, 3 or more years without discounting for inflation. And this is the norm in LTV calculations. One client of mine had a LTV of 25 years.

Just think how the price of his bread might have changed from year 1 - year 25!

Let's start with an example of a simple LTV

(This is the example Carol uses in her book [I Want To Buy..?](#)).

Suppose you sold an electronic gadget that normally retails at £50. It costs you £20 to buy.

When someone purchases that gadget you make a gross profit (GP) of **£30**.

Having purchased that one item you keep the customer informed of similar products. They buy another piece of equipment at £150, which costs you £80 to buy. That gives you a GP of **£70**.

So far you've made £110. Now, let's say your customer purchases an item for £230, which costs you £110 to buy in. That's another **£120** to add to your GP from that one customer.

Suppose he only buys one more item from you at £320, which costs you £180 at source. That's another **£140** in GP profit. Your overall GP from that customer's four transactions is now:

$£30 + £70 + £120 + £140 = \mathbf{£360}$.

Now that you have this information you can make an educated decision on how you'll encourage a prospect's first purchase. In fact you should test to establish whether you afford to offer the first electronic gadget at a ridiculously low price. For example at cost or even just below, knowing that your follow up marketing strategies and tactics encourage more sales on which you can make even more profits.

So, if you offered your gadget at £21 instead of £50 as a 'special offer' you could have a higher number of people purchasing than you would if you tried to retain your profit margin on the first sale.

Arguably this simple LTV calculation is sufficient if you maintain the same strategy year on year. However, it's not really precise enough in a dynamic environment for business people like us.

In Part 2 we'll go further into building your knowledge of LTV.

Getting to grips with the *Real* Customer Lifetime Value – Part 2

I now know some of ‘that’... I need to know more

We looked at many of the basics in Part 1 of this mini-course. What I didn’t do is give you a clear idea of what a lifetime is.

So what’s lifetime?

First we are talking about customers and the length of time that they buy from us before they stop. That period be it 1 year or 25 years is their lifetime.

Let me expand on that. No individual will continue to buy from you. They will fall away year on year until they are too few for planning purposes. I set that minimum at no less than 10% of the original volume unless dealing with mega databases.

A phrase you’ll also hear is the retention rate. That’s the proportion of the customers who continue buying year after year after year. If you have 3,000 customers at the end of year 1 and 1,890 buy again in year 2 you have a retention rate of 63%. Obviously you want to use tactics that increase that retention rate to as near to 100% as possible.

So the length of a customer lifetime is dependent upon the retention rate - sometimes also called the ‘churn rate’. So again you may ask, “Just how long is that lifetime?”

I wish I knew too!



experience.

When you begin to build your permission database* you don’t know how long your customer lifetime is. There is no magic formula to tell you.

Experienced marketers have data to analyse that gives them a clear guide to a precise estimate; for the rest of us we have to estimate based on

[Permission means you are legally entitled to market to your customers until they or you decide to stop. I also use ‘database’ rather than ‘list’. A list has contact details, a database has so much more e.g. transactional histories, profiles of behavioural data, channels used and more that help us to market to them with knowledge of their wants and needs.]*

From my experience a retention rate of 50% is common. It's not a certainty as I've seen both stronger and weaker rates. These are just a fair estimate to use. If you do the maths you'll find that between years 4 – 5 your database falls below the 10% limit described above. For the sake of simplicity, the average person on your database buys from you for an average of 2½ years.

To calculate lifetime value however we consider the *actual* customers, their *actual* cash transactions and the *actual* number of years they continue to buy.

Does that mean riches to rags in 2 ½ years?

No! We were only looking at your customers at the end of year 1. In year 2 you attract more customers, and in year 3 more... and so on. They haven't been included in the calculations – yet.

As your business continues you re-evaluate lifetime and lifetime value estimates, establish your own retention rate and improve the quality of your analysis.

If you're with me so far, let's look at improving the quality as your basic knowledge grows.

1. ***Not all of your customers are the same.*** Gender could be important or age or lifestage or geography or any of many profiling characteristics.
2. ***Not all of the items they buy are the same.*** Some buy the same product or selection of products each time; others buy across the range and do not repeat purchases or upsell or cross-sell between ranges.
3. ***Not all of the prices they pay are the same.*** Some may favour special deals, others unit price yet more buy in volumes only.
4. ***Not all of your customers have the same buying pattern.*** Some buy annually, others irregularly or seasonally.
5. ***Not all of your customers are individuals.*** If you're fortunate to have business or public organisation buyers as well as individuals you have yet more to consider.

You can't be expected to know any of this when you begin trading. Your previous experience may give you a head start as to the buying characteristics of your ideal customers, but you can't be sure and you won't have worthwhile numbers for some time.

So don't let this checklist overwhelm you, just be aware that the data you gather becomes more useful over time.

In Part 3, the final part of this mini-course, you get the last of the building blocks, a worked example plus a worksheet template you can use immediately for your own calculations.

Getting to grips with the *Real* Customer Lifetime Value – Part 3

The full skinny on how to build your own customer lifetime model

In Parts 1 & 2 of this mini-course I went through the essentials of why knowing your customer lifetime value is vital to your business growth and what's involved with establishing what it is for your business. In this third and last part I want to show you how to build your own customer lifetime model.

In the Lifetime Value zip file you downloaded there was this PDF (containing the 3 articles) and two Excel spreadsheets; one is a 'master template' that *does most of the work* for you. Not all, but most! It isn't complete until you input your own data. The hard work is done by the spreadsheet and the formulas it contains.

The other spreadsheet is a working example for you to study.



Before you do anything else, create a template-master file of the spreadsheet then use it to open a second file to create your 'what if' or personal working file. Only enter your own data into your working file. That way you always have the template-master to go back to.

Please open your work file. Inside you will find two worksheets labelled 'Detail' and 'Model'.

The Detail Spreadsheet – Assembling the information

Here you have a basic checklist of the factors that you may want to include in your own LTV model. Where these factors have a cost, the more precise your definition is, the more accurate your LTV model will be. You can add or delete data rows above the 'Total' without affecting the addition formula.

In my experience it is also the area where direct marketers get things wrong. Despite their interest in getting their metrics right they often seem to run away when they see the £ or \$ signs. Of course they are different, but they're not difficult. Plus you'll be able to defend your results when others ask questions.

The important idea to remember is to be consistent in the elements you include so that all versions can be comparative. For example, if you have a telephone response option then including those costs in one version and not in another must affect the end result and any comparison between those results is not viable.

You also don't need to go overboard in the costs you include. You'll have set your product prices to cover your overheads so there's no need to consider them.

What must be included are the extra costs associated with the specific segment you are modelling. For example, the costs of recruitment, subsequent costs of communication and handling promotional costs – except discounts as they are already accounted for in the sales value.

There's one factor that is a bit more of a challenge to deal with. You'll remember from Part 1 that I wrote about needing to account for inflation. This is done by applying a discount rate but, where do you get this from? Some will try to tell you that the discount rate is equivalent to the prevailing interest rate. It's not!

Sure, if you had to borrow the money you'd pay a bank's lending rate, but that's only a start. You also need to allow for risk and more which I would need another course to describe.

So use these 'rules of experience' - if the bank rate is:

- **less than 5%** use a discount rate of 10%
- **from 5- 10%** double it to establish the discount rate
- **over 10%** add another 10%
- **if it is over 10% then god help us!**

The Model Spreadsheet - Making The Maths Simple

The major formula in the spreadsheet is shown below and it's not that simple to understand! That's why the model worksheet takes care of the mathematics for you.

$$NPV = \sum_{i=1}^n (R_i - C_i) / (1 + j)^i + (R_n - C_n) / (1 + j)^n$$

But there are two issues with this formula of much greater relevance:

1. You want tools to help you make better decisions. You don't want to become a mathematician. This LTV model is one of the most useful marketing tools that everyone can use.
2. The formula gives you a single figure result. In the example attached the Customer LTV is [£98.22](#) based on net cumulative sales over 5 years. When we refine the calculation based on profit earned over 5 years the Customer LTV is [£39.29](#). Of course those are results we set out to establish but they hide too much essential information.

When you look at the example spreadsheet you'll see the impact of the retention rate on the decline in the customer numbers year on year. This may be a factor that you may not have appreciated in hard numbers before. And there's much more to review besides.

Run spreadsheet tests to examine what you would need to do to increase Customer Lifetime Values. If you use realistic alternatives and the results are positive then you have removed some of the risk before you organise a live test.

Please go through the spreadsheets to familiarise yourself with the information they reveal. There'll be a surprise or two for you I'm sure

If this mini-course has been useful, and you think that another article at a later date to build on how to get the best out of your customer LTV please let us know by adding a comment below or sending an email to carol@carolbentley.com or direct to Terry at terry_savage@ntlworld.com

To your planned success

Terry Savage: BA, DipM, FCIM, FIDM, FISMM, AMRS, Cert Accy

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Terry Savage has been advising, training and mentoring direct marketers successfully for more than 35 years. From individual addresses on metal to highly complex online applications he's managed them all and helped develop a few of them too.

His consultancy continues to work with major direct marketing companies in building new online strategies and resources. Now he's distilling his skills and experiences via online products and services for everyone.

People seem to think he knows what he's talking about (I certainly do! *Carol*)