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# Building Customer Value in Relationship Marketing

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**Abstract**

In business, the customer as capital is not a new idea, but scientific literature has only recently begun to explore the topic in depth. Increasingly, studies are focusing on consumers as customers of enterprises. Attempts to measure the value of customers for the company have a short history and a single approach has not yet been worked out. On the basis of literature on the subject and practical approaches, this study presents several ways to measure the value of customers for the company. Strategies for the management of value for customers, with the aim of providing higher value of customers for the company, are a critical part of the operation of enterprises. Therefore, the aim of this work is to attempt to present a model for increasing the value of customers for the company through relationship marketing. The work also reveals mechanisms for increasing the value of customers with the use of modern information technology.

**Keywords:** Value of Customers, Marketing Strategies, Mechanisms of Management

## Introduction

The current thinking about how to operate a business is by maximizing the value a customer generates for the company. The value of customers for the company is also the best indicator for measuring the effectiveness and efficiency of long term resource allocation.

An important part of modern management is not only choosing the right customers, but, above all, maintaining relationships with them in order to lead to higher levels of profitability. To achieve this goal, companies must continually measure the value of their current and future customers. Developing relationships with loyal customers has value when it contributes to more comprehensive knowledge of their needs, and as a result, to the building of marketing strategies that increase the value of customers for the company.

Appropriate strategies for the management of value *for* customers often have a direct impact on the value *of* customers for the company. This is an important aspect of modern management. Investment in customers must be treated as a long-term cost. The more precise the identification of a group of customers in terms of their expectations, the better tailored the strategies for providing value *for* customers, and the more effective the strategies for increasing the value *of* customers for the company.

## Methodology of Research

Managers and employees are increasingly appreciative of the role customers have in achieving the objectives of the company, in particular in building shareholder value. However, there is still insufficient knowledge about how to manage the company so as to make the value of customers grow. The author of this publication has set a goal for himself to fill, at least partially, this gap.

The aim of this work is to present the main aspects of measuring the value of customers for the company. The work is an attempt to show the mechanisms for building and increasing the value of customers in relationship marketing. In addition, mechanisms to increase the attractiveness of customers are presented.

The methods used within this work were the study of literature and reference material in electronic form, the method of observation, and the analysis of case studies. Within the work, the method used was descriptive analysis on the basis of extensive literature study of the subject. Theoretical output in Polish and foreign, mostly English, language was used, on the subject of governance in the knowledge-based economy. The use of foreign literature turned out to be necessary due to the dearth of Polish studies. This enriched the arguments and discussion of new aspects, and permitting showing the research problem in a broader perspective.

### *The Main Aspects of the Measurement of the Value of Customers*

Customer Lifetime Value (CLV) is defined as the sum of the discounted net cash flows associated with a given client (Doyle, 2003) it is expressed as follows:

$$CLV = NCF_1 + \frac{NCF_2}{1+i} + \frac{NCF_3}{(1+i)^2} + \frac{NCF_4}{(1+i)^3} + \ldots + \frac{NCF_n}{(1+i)^{n-1}} \quad (1)$$

Where: *NCF* - Net Cash Flow; *i* -the discount rate.

Net cash flows associated with the customer throughout the period of his relationship with the company represent the difference between the revenue that the customer generates for the company and the expenditures which are incurred in the acquisition and servicing of the customer.

The amount of revenue generated by the customer in a given period is relatively easy to determine if the company tracks a given customer’s transactions. It is much harder to determine the expenditures incurred for the acquisition and servicing of the customer, as market communication costs are rarely calculated per client, although this is possible with the use of a proper costing system.

CLV is a very broad category, and companies are increasingly trying to measure it. The practical advantages of attaining this information includes the fact that it allows one to define cash flow and profitability of segments, groups or individual clients in monetary terms.

Most frequently, companies service customers from different segments, divided according to differentiation or retention ratios (the length of the period customers have remained loyal) or according to service costs or profitability.

If the portfolio includes segments with different characteristics, the value of customers can be recognized in the following way (Gupta & Lehmann, 2005)

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$$CPLV = -AC + AI + \frac{m\,r}{(1+i)^1} + \frac{m\,r^2}{(1+i)^2} + \dots + \frac{m\,r^{n-1}}{(1+i)^{n-1}} \quad (2)$$

Where: *CPLV - Customer Portfolio Lifetime Value* already achieved; *AC* - cost of acquisition of the customer portfolio, which includes customers with different retention rates (acquisition cost); *AI* - revenue from customer portfolio (acquisition income); m *r* - revenue from a segment of customers with a specified retention rate (profit from each customer in the segment is the same); *r* - customer retention rate; *i* - the discount rate; *n* - number of years.

These approaches include the following assumptions. The cost of acquiring customers (*AC*) is borne in the first period, and is deducted from the value of customers for the company. Revenue from customer acquisition (*AI*) is augmented by income from the customer portfolio, starting from the second period and is proportional to the number of customers; retention rate (*r*) may be fixed or variable.

The value of the customer portfolio will be positive if the costs of customer acquisition do not exceed the income received from the acquired customer, plus the expected, discounted profit generated in the following years through the relationship between the customer and the company.

The value of all the company's customers is the sum of the life period of successive groups of customers (newly acquired and retained) and their profitability. This model assumes that in any given period, the company acquires new customers and has lost a number of them (Gupta, Lehmann & Stuart, 2001). The value of customers for the company is shown in the following formula:

$$\text{Value of Customers} = \sum_{t=0}^{\infty} \frac{n_k}{(1+i)^k} \sum_{t=k}^{\infty} m_{t-k} \frac{r^{t-k}}{(1+i)^{t-k}} - \sum_{t=0}^{\infty} \frac{n_k\, c_k}{(1+i)^k} \quad (3)$$

pointing out that the value of the company is the sum of the life value of all customer groups; the life value of the customer for the company is calculated as:

$$CLV = \sum_{t=0}^{\infty} m \frac{r^t}{(1+i)^t} \quad (4)$$

Where: *CLV* – Customer Lifetime Value; *k*- period of life of different customers with different life cycles; *n* - the number of acquired customers in subsequent periods; *i*-the discount rate; *t*-test period; *m*-income generated by the customer in period t; *r*- customer rotation indicator; *c* – cost of acquisition per customer.

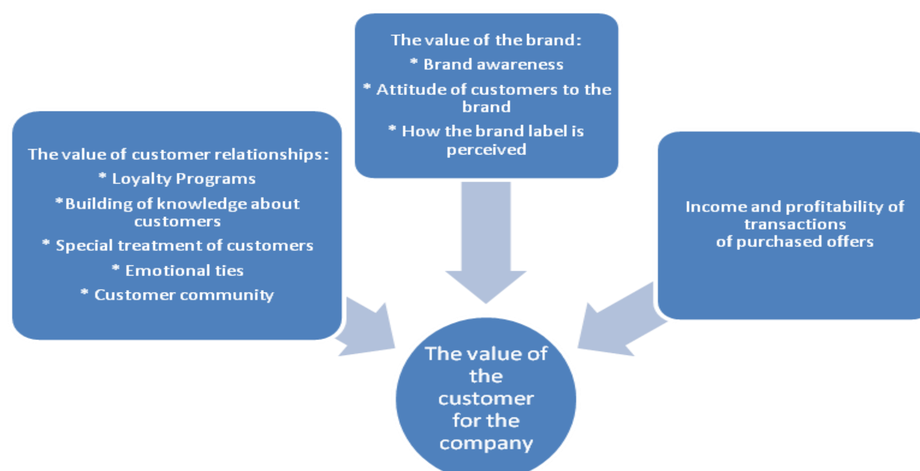
According to the above model, each customer generates income *m* for each period *t;* by using the discount rate, the value of future income can be estimated for the current period; the value of future income is presented in its current value, and the profit from each consumer varies during the test period. Customers do not remain with the company throughout the company's whole life period, which is taken into account by the customer rotation indicator. Calculating the value of customers requires an individual approach to

estimating certain indicators, such as rotation rate, which changes over time. This indicator depends on market conditions and the value offered to customers. In addition, it should be noted that the acquisition and loss of customers are continuous processes, so the company must continually take the trouble of reevaluating customers. Customer rotation has the most significant impact on the profitability of the customer through their life with the company.

The value of customers consists of three elements: the value which the customer provides by paying for the goods and services he bought, brand value, and the value of the relationship (figure 1). The value of the revenue and profitability of transactions is derived from a customer's perception of the value supplied to him in the form of goods and services, i.e. the tangible and intangible value received and the price paid for it, often compared with the price of the offer provided by competitors. The value of a brand is a subjective evaluation by customers made up of their awareness of the existence of the brand, their relationship with the brand, as well as the emotions the brand arouses, as attributes of choice for its customers. The value of customer relationships with the company is expressed in the form of accumulated knowledge about customers, the tendency to form close bonds with the company on the basis of compatibility in regard to mutually expected values (objectives) exchanged between the company and its customers, and the duration of the relationships.

Establishing strong relationships with customers allows for an increase in cash flow through revenue growth and cost reduction. Regular customers spend more money on the organization, are less sensitive to price changes, use the products and services of the organization more often, and use a larger range of products and services. Supporting regular customers leads to cost reductions resulting from lower marketing costs, lower servicing costs etc.

The proper management of customers, which are seen as important company assets, requires the forming of relationships with the right type of customers. Concentration (allocation) of resources and marketing activities should be aimed at those customers who provide the biggest reimbursement of incurred investment. In accordance with the Pareto principle, a relatively small group of customers (20%) creates 80% of the profits for the company. Studies on the financial services market in the United States indicate that just 30% of the customers of a typical American bank bring it profit. This means that 70% of customers contribute to decreasing the value of these institutions (Gupta & Lehmann, 2005).




*Source:* own work based on Rust et al., 2000
*Figure 1.* Elements that contribute to the value of customers

By using modern information technology, companies can analyze the long-term value of customers and predict the future value of this resource, using alternative scenarios for marketing activities. With this analysis, a company may be able to increase long-term revenue from individual customers and reduce costs through more efficient and effective use of financial resources.

***Mechanisms for Increasing the Attractiveness of Certain Customers***

A customer who is currently characterized as someone of low profitability for the company can become profitable in the future through the use of the right marketing instruments. However, the implementation of such actions has a long term nature, due to the fact that these actions can only be taken if the company has sufficient historical data relating to the conduct of such customers.

Transforming a customer of little attractiveness to the company into a customer of average attractiveness requires, first and foremost, the identification of the key factors determining customer satisfaction. It is all about providing exceptional quality service. Another issue is the reduction of non-financial costs of the cooperation. This includes a reduction in the effort associated with making a purchase (e.g. searching for information), risks and uncertainties, and psychological costs.

Activities which increase the value of the brand may include creating cheaper versions of prestigious brands. In the process of transforming a customer of little attractiveness for the company to one who is of average attractiveness, a large role is played by activities aimed at increasing the value of the relationship:

- development of promotional loyalty programs,
- creating special offers of complementary products for individual customers,
- creating social ties with suppliers (creating social relationships with their employees).

At present, an important challenge for modern enterprises is obtaining an in-depth understanding of customers and their individual needs, which in turn allows the enterprise to take care of these customers in a particular way. Modern enterprises often seek to create the image of a full-service provider, one which can provide comprehensive solutions for all the needs of their customers in a given field. This may require the enterprise to cooperate with outsourcers to meet the needs of theirs customers in specific tasks (e.g. IT services).

Modern organizations strive to create a strong brand image by inciting positive emotions and inspiring sympathy to the brand. Increasingly, companies create tailor-made services to the specifics and preferences of the customer. The goal is often to create close cooperation between the parties through the use of information technology (Gordon, 2001). On the one hand it increases the value of the company as a provider of services to the customer; on the other hand, it becomes a major barrier to changing providers by the customer, because it increases both the costs and risks associated with leaving the current provider. The value of the relationship can also be strengthened through the creation of appropriate guarantee services. Guarantees reduce the risk of cooperation perceived by the customer, build trust and a sense of security, and lead to the belief that, in the event of an error, immediate remedial measures will be taken.

Nowadays, a company's cooperation with its customers should be based on:

- operational flexibility,
- full individualization of offers and price conditions,
- mutual exchange of information,
- a common sense of responsibility during the course of cooperation,

- commitment to the development of the relationship in the future.

Companies are constantly looking for more effective ways to serve their customers. These activities may be related to encouraging self-service. The development of the Internet and of technologies in the realm of modern communication and customer service has opened new possibilities in this context, both for businesses and their customers. Customers have access to self-service on the internet (e.g. transferring of funds, checking account status) or, in the case of banks, through a network of ATMs.

It should be noted that in specific situations, the company may choose to service customers who are not seen as valuable at a given time. This decision is usually motivated by the possibility of increasing this value in the future. In this case, if using the strategy of relationship valuation, keeping these customers with the company is justified in view of the future potential of this group (for example, students who use bank services).

Companies sometimes try to deliver customer value in a way that reduces transaction costs, interaction costs, or other costs, and thus contribute to higher efficiency, saving time and money. Examples of ventures using this strategy are online auctions. They provide a huge range of choices, unavailable offline. By aggregating and ensuring a wide range of products and services, these companies reduce the customer's transaction costs when searching and analyzing offers he finds interesting.

There is no doubt that companies take measures to increase the involvement of the client in their operations. Increasing involvement is understood as increasing the range of values that are the subject of an exchange between a company and a customer. This means both a wider range of values generated by the customer for the company, and a greater value provided to the customer by the company. A larger range of values can mean two things- the subject of the exchange may be the exchange of the same value at a higher intensity, or the range of the values exchanged can be expanded with new ones. An important aspect in increasing the involvement of customers in online shopping is getting Internet users visiting the online shops to post product reviews and, more importantly, make purchases (Ferrel et al., 2013).

The conclusions of a study on the building of customer loyalty with companies through the use of the Internet are quite interesting. The purpose of the research was to identify leaders among e-commerce platforms in terms of loyalty and to determine the common characteristics for these ventures. The study suggested that customer loyalty on the Internet is not shaped by loyalty programs, but by the competence to satisfy the needs of customers. Companies with a high degree of customer loyalty are (Jackson, 2007): Amazon.com, eBay, iTunes, L.L.Bean, Lands ' End, QVC, Victoria's Secret, and Walgreens. Leaders, in terms of loyalty, stood out among the surveyed companies in the following areas: web site design, ease of use, description and visualization of products, perceived confidence of the reliability of the webpage, loading speed, the uniqueness of the offers, reviews of other people about the products and the ability to personalize the page.

The concept of switching costs is useful in terms of customer loyalty on the Internet. These are actual or subjectively perceived costs that must be incurred when changing suppliers, and which do not need to be suffered, if the customer remains faithful to the existing suppliers. These costs usually grow with increased involvement of the client in the process of value exchange. As a consequence, greater involvement leads to an increase in customer loyalty (Chen & Hitt, 2002).

***Relationships with customers and suppliers as the premise for the concept of effective business management***

Development of long-term relationships with customers and suppliers has become the response of companies to the changing conditions of competition. This phenomenon is seen in the development of new forms of business organizations in recent years, such as Internet organizations. The foundation of these modern, flexible and efficient structures is long-term partnerships with other market participants. Knowing which factors shape the behavior of participants in the relationship seems to be essential for more efficient business development (Lavie et al., 2012). There are more and more goods and services available on the supply side, but also a growth in demand-side barriers. The sources of value creation, along with a change in the conditions under which companies operate, are also changing. Therefore, the choice of sources used to build company value must correspond to the changes in the market, the methods used to manage it, and technology changes, since this is what determines the factors leading to competitive advantage (Dobiegała-Korona & Herman, 2006).

Increasingly, a trend gaining importance is the theoretical and practical management of customer value. A company seeks to provide value for their customers must be open to the external environment, ensuring high competitiveness of all partners, by better managing relationships.

Currently, company executives are aware of the fact that they are only one of the links in the whole value chain. The contribution and involvement of individual companies may be undermined by the lack of efficiency in other parts of the system. Thus, the maximization of value lies in integration and coordination. A company's focus on long term relationships can be seen in the interdependence they have established with their partners to achieve results over time, which is seen as a long term benefit for the company (Swiatowiec, 2006).

Companies are able to generate a competitive advantage when, by using a particular resource, they can produce and offer products that are at least comparable to the value that competitors are offering to customers, with lower costs (and price), or when goods are valued higher than those of the competition with comparable costs (Hunt & Morgan, 1997).

When building competitive advantage of a business, it is understood that one of the elements is the variety of resources which are at the disposal of the enterprise. Resources are characterized by varied usefulness and efficiency. Therefore, companies can achieve different financial results from others through more efficient production, more effective market activities and by better meeting the needs of consumers. Companies that have access to more effective resources have lower operating costs than others. Companies are somewhat forced to consider alternative ways of acquiring resources for themselves (Czarniewski, 2014).

No company can skip over aspects of integration and globalization in their strategy, which carry both opportunities and risks for the company. Building long term relationships with suppliers and buyers is becoming the foundation for running a business (Quinn, 2014). The expression of this phenomenon is the development of new forms of business organizations in recent years, such as strategic alliances and networking organizations. The purpose of these modern and efficient structures is long-term partnerships, generally speaking – creating and maintaining long-term cooperation with other market participants able to compete on a global scale.

**Conclusions**

1. The paper presented a mechanism for the construction of customer value in relationship marketing. This model also shows the use of the internet. It should be noted that

the model for the construction of customer value using modern technology is similar to that of similar models used in the traditional economy. The differences between them are in selected areas. These include competitive strategies, building confidence and increasing customer engagement. In the development of relationships with customers via the Internet, a new phenomenon can occur, called crowdsourcing.

2. Customers and established relationships with them are considered a strategic resource that can determine the sustainable competitive advantage of the company. Therefore, there is a need to adopt a long-term perspective in the evaluation of potential customers, as well as in the decision-making process related to the optimization of relationships with them. These decisions should take into account not only the present, but also the potential, long-term customer profitability for the company.

3. The foundation of modern management is the management of a portfolio of customers according to their profitability, level of relationship and commitment. The value of customers should be measured and analyzed on the basis of data concerning the value received throughout the entire length of the customer's relationship with the company. To estimate this indicator three parameters are needed: the size and profitability of purchases, retention rate and the length of the relationship.

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