

The Retention Imperative

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**Abridged Version. To read the complete article with detailed study analysis visit Loyalty360.org*



EXPO WORKSHOP PART 1: PREPRATORY READING!

Sign up now for Loyalty Expo Workshop Sessions held Sunday, May 31st. Join Tom and John from DataCo for phase two of “The Retention Imperative” as they workshop an in depth conversation on *Pre-emptive Retention*.

Acquisition programs perform better when teamed with pre-emptive retention programs because stabilizing your customer base is absolutely required in order to grow it.

CHURN HAS BECOME the major issue for many businesses in today’s economy, and it may threaten their existence if they panic and lose sight of some key drivers to address it. Unfortunately, as budgets get stretched, shortcuts get taken, and desperation takes residence in the Marketing Department, the chance of a miscalculation increases dramatically

Recent work on the relative efficiencies of using pre-emptive retention programs versus acquisition programs to stabilize customer populations has led us to a counter-intuitive conclusion. It is not just: the convergence of growing recession forces, general consumer dissatisfaction, and the failure of programs designed to hold on to customers, which forces marketers to measure, test, and evaluate their acquisition techniques before they commit shrinking budgets to them. It is the need to avoid miscalculations that can destroy a business. Our current modeling makes it clear that acquisition programs alone are not the best or even most efficient way to stabilize your customer base. In fact, they must be teamed with pre-emptive retention efforts to offset the costly inefficiencies of most acquisition programs. By the same token, ill-conceived or margin-destroying retention programs, applied preemptively, can start a tail spin that is hard to pull out of.

The key to maintaining margin and successfully addressing churn is pre-emptive retention. Most retention programs do not address the person who is about to leave, and most acquisition programs are structurally too inefficient to economically deliver the new customers the business needs to survive. When you address both the need for more new customers and can slow down attrition rates without destroying your margin, we have found that you have the elements required to stabilize and grow your customer base.

The analogy we like to use is a bucket. Probably because when I was a lad, my father told me that one of the ‘truths of life’ was that no matter how small a hole in a bucket is, the water would still eventually run out. By the same token, most people realize that if you are losing customers—even at a very slow rate—you will eventually be out of business if they aren’t replaced. But in a highly competitive world; in a world of commodity products and pricing; in a world of fluid consumers with almost no barrier to movement; and in a world which is increasingly uncertain economically; the problem that most marketers face is that, the hole in the bucket is actually quite large. Facing double digit churn rates, the task of maintaining or growing your business by

simply filling the bucket through acquisition alone will prove nearly impossible. So it is time to take a deep breath and begin to work smarter.

Our goal for analytics in this situation is to try to determine the most efficient way to handle this churn. Do you focus on putting more water in the bucket or fixing the hole? In other words, how do each of the tactics—acquiring more customers or retaining the ones you have—compare on effectiveness. Can any one technique—in and of itself—solve the problem? Can moving budgets around help? If not, what is the best approach to take?

Analytics can provide the guidance you need to evaluate the consequences before you execute your plan. Just as testing usually provides unexpected insights into the best solution for a particular problem you are investigating, trying to determine the efficiencies of various approaches to the problem of ‘churn’ has once again led us to a surprising conclusion. Going in to this project, we fundamentally felt that acquisition, attrition and retention were all related in a functional way. It just was not clear how, until now.

OUR BASE CASE

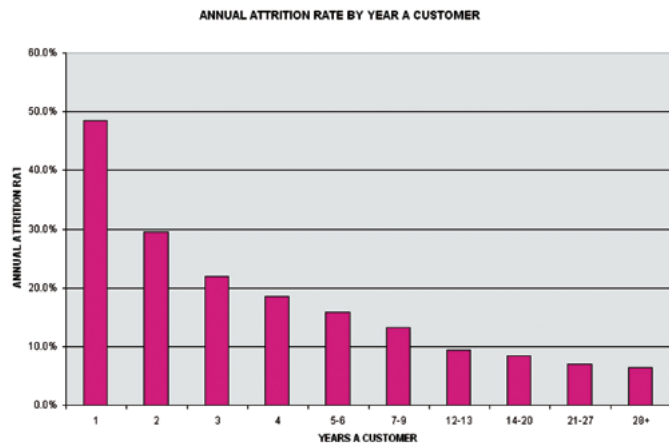
In order to analyze the effect of one approach or another on the churn problem, we had to build a Base Case model that simulates the situation these companies find themselves in. The model is actually a composite of any number of similar clients we have worked with over the years, and will realistically reflect changes in the variables we are testing.

In our Base Case, as in many continuity businesses, the length of time that the customer has been with the company is a critical indicator of likelihood to churn, and, that value changes over time. Consequently, to make the model sensitive to a significant predictor like ‘years as a customer,’ we actually age the entire 1.5 million hypothetical customers in our Base Case to reflect a typical customer mix.

Consequently, the model is going to act upon attrition patterns and performance in the same way we would see it with a client.

We have set the Base Case, and the scenarios we will test, to run over a five year period. This will demonstrate the affect the scenarios make on the model dynamically, and allow us to create a more realistic idea of what is happening over time.

Creating any model relies on making assumptions. In order not to be overly distracted by that caveat, we have included a graph titled ‘Annual Attrition Rate by Year a Customer,’ which is our decay curve. That curve affects the performance of the scenarios we are running against our Base Case. Consequently, the model is predictive against the real world companies that this curve reflects, and is derived from actual experience, not a Ouija board.



TO SET THE STAGE, OUR BASE CASE COMPANY:

A continuity-model company ended last year with 1.5 million paying members. In 2009, they are going to lose 271,283 of those subscribers in spite of their best efforts. By spending \$50 million the company will be able to add 201,449 new customers in 2009, but it will end the year with a net loss of 69,949 customers. Five years later—when 2013 comes to an end—they will be losing another 273,932 customers a year. And in spite of their spending growing to \$83 million to add 248,261 new customers in that year, they will finish 2013 with a little over 1.262 million customers. The cumulative loss of those customers over five years means that the annual revenue for our Base Case company will have fallen by \$120 million.

“Acquisition programs alone are not the best or even most efficient way to stabilize your customer base.”

Given their own dismal projections, we can imagine that the Base Case company’s Marketing Department would be actively pursuing a better way to handle their residual attrition. So here is what they are going to look at through the following scenarios to better handle their churn. First, they will compare two diametrically opposed scenarios, in an effort to answer the burning questions of:

“Am I better off by continuing to focus on acquisition and pouring even more money into that tactic/program,

or

Am I better served by starting a pre-emptive retention program to retain customers who are getting ready to bolt?”

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Summary of findings

Let's take a look at how the two scenarios affect the Base Case model, and then try to see if there is way to improve the performance by combining the different tactics.

SCENARIO 1

RELY SOLELY ON INCREASED ACQUISITION SPENDING

RAMPING UP ACQUISITION spending is probably the one strategy that most Marketing Departments would attempt without even bothering to model it. And we confess that we thought we could get the growth we wanted by just throwing everything we had at the problem. However, if you increase the acquisition effort significantly, the first problem you will face is the decreasing acquisition efficiency. Consequently, you will end up spending more money and getting relatively fewer customers! If your product is regulated or if your market is small or finite the problem can become insurmountable. You will eventually run out of prospective new customers at any price

Since the highest attrition rates in your customer base come with the newest customers you add, you are ultimately diluting your customer base by putting these expensive, uncommitted, and churn-prone customers in to the mix. If you are being measured on 'bodies in,' then the results may look good in the short run. If you are being measured on the ability to develop a sustainable revenue stream out of them, the results should not be surprising. The good news is that these customers eventually become longer-tenured customers, and hence more stable. The question is whether you can afford the cost and time.

“We would recommend that you build value with the customers who have the highest likelihood of leaving.”

SCENARIO 2

IMPLEMENT A PRE-EMPTIVE RETENTION PROGRAM ON TOP OF THE BASE MODEL

JUST AS TURNING up the acquisition efforts in Scenario 1 intuitively seems like the best approach to grow your customer base, any kind of retention effort – especially one put against existing customers—might just as casually be dismissed. Intuitively you know that a retention program isn't a very effective way to build up a customer base. However, this approach is actually extremely efficient and outperforms the acquisition program in a couple of important ways once you scrutinize it with predictive analytics.

By retention efforts we are not talking about pre-emptively cutting your prices, ramping up your existing loyalty program's benefit structure, or dumping more money into the win-back or re-capture effort. None of which would significantly address the immediate attrition problem. Rather, we would recommend that you build value with the customers who have the highest likelihood of leaving. Consequently, you are spending your marketing dollars directly against the attrition problem, rather than casting a wider and wider net with the hope of finding a better prospect!

There are two reasons why this approach performs better than you might expect. First, part of the effort is being directed against longer tenured customers. So by adding value to the customer relationship and increasing their inertia to stay put – you get better gains from a statistically more stable customer. Second, slowing down the attrition of the newer customers you have acquired has a significant effect on their lifetime value in the model. Consequently, reducing the attrition rate of this customer can have significant revenue impact even if your overall churn rate reduction appears to be modest. Saving a more stable customer for several dollars a month, instead of acquiring an unstable one for hundreds per individual turns out to be a more efficient tactic. Think of it as the process by which you transition churn-prone customers in to longer-tenure customers and you will understand why this scenario drives healthy revenue growth.

SCENARIO 3

MOVE SOME MONEY FROM THE ACQUISITION PROGRAM TO THE RETENTION PROGRAM

TO MAKE IT a little more interesting, the proposition we decided to test was two-fold. First, decrease the marketing budget in the Base Case by 10%; figuring that many Marketing Departments could be seeing those reductions or more, and then we wanted to re-allocate the budget—without relying on the model—to test and gauge any performance issues we might illuminate.

Convinced that any pre-emptive retention effort funded by existing acquisition budgets would improve the company's performance; the results surprised us! For what had seemed like a reasonably good idea – more retention requiring less acquisition—we found that combining the two programs in this way gave us the worst of both worlds rather than the best.

Almost every indicator went south except the fact that the model remained positive on net revenue. So while it actually made some money we had to consider this approach to be a failure.

Many people think that they can 'prune' their way out of this market, by surgically cutting back. However, in the light of this scenario, we remain convinced that cutting expenses for acquisition and retention in the current market will come with significant consequences. Many that will turn up in the out years. It is just as important to realize that indecision—and compromise based on cutting-the-baby-in-half—is not a strategy that will serve your company well. Marketers who want to do more than weather the times and challenges we face will need to test, analyze, make an informed directional choice and then fund the strategy to the level it needs to be effective. Anything less is a prescription for failure. Half-way measures may be worse than none at all

“Cutting expenses for acquisition and retention in the current market will come with significant consequences.”

SCENARIO 4

MATCH PRE-EMPTIVE RETENTION WITH NEW CUSTOMER INCREASES

SINCE ANALYTICS DOES work, we were able to combine the programs to produce the best results we had seen against the model. Remember, this time we let the model help us determine the right mixture of the programs to optimize our goals. Could it be tweaked further? Of course! But the improvement over the three earlier scenarios is significant in almost every way that we measure it!

The Retention Imperative

LIKE ANY BUSINESS, the Base Case company can wait and see if the model becomes reality in 5 years, or if they can do something about it now. Clearly their present marketing effort will not get the job done, and so they have decided to model several different strategies to fix the problem—aggressive acquisition marketing; aggressive pre-emptive retention marketing; or a combination of the two.

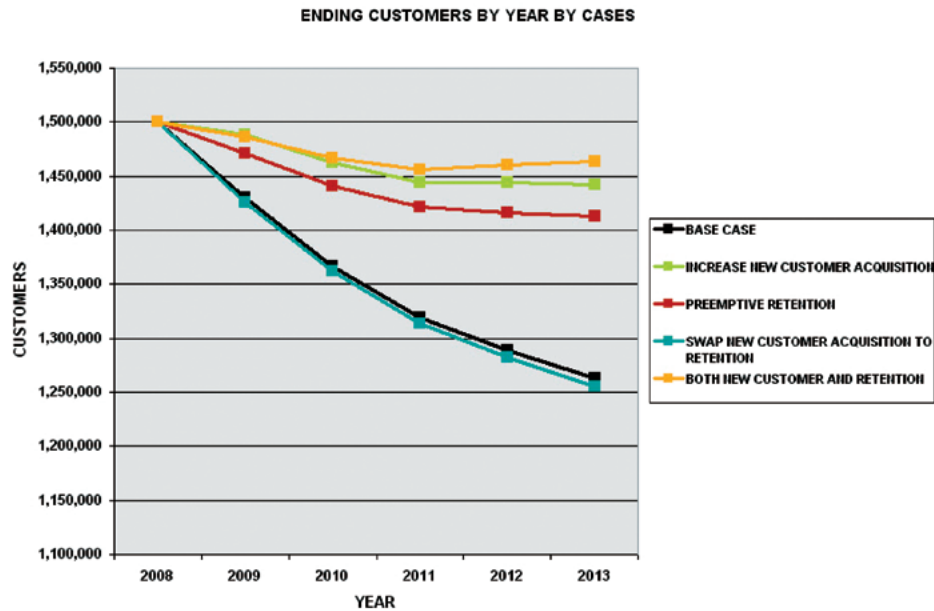
When the scenarios were run out over the five year period, this chart shows the summary of how each of them performed against the Base Case model. Most people would be surprised to find out that—from a revenue point of view—it is substantially better to retain customers [Scenario 2] than to add them [Scenario 1]:

SCENARIO RESULTS COMPARISON	SCENARIO 1	SCENARIO 2	SCENARIO 4
NET REVENUE AFTER MARKETING	\$3,958,028,656	\$4,124,482,644	\$4,163,598,839
INCREASE IN ENDING CUSTOMERS	614,149	496,897	759,046
INCREASE IN NEW CUSTOMERS	419,341	-1,250	160,382
INCREASE IN ATTRITION	241,405	-151,667	-67,296
INCREASE IN REVENUE	\$335,746,844	\$267,958,735	\$410,415,977
INCREASE IN MARKETING COST	\$280,875,149	\$46,633,052	\$149,974,100
INCREASE IN NEW CUSTOMER COST	\$280,731,708	\$599,400	\$102,498,312
INCREASE IN NET REVENUE	\$54,871,695	\$221,325,683	\$260,441,878
ROI OF INCREMENTAL NET REVENUE AS A PERCENT OF INCREMENTAL MARKETING	20%	475%	174%

While there are many factors, the main reason for these results is that it is less expensive to incentivize a current 'at risk' customer to stay—than it is to add a new customer to replace them, which is why we call pre-emptive retention an imperative.

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The Retention Imperative (continued)



IN THE FOURTH scenario, with a combination of both aggressive acquisition and aggressive retention, the company will end 2013 with a customer base of a little over 1.491 MM customers, which has actually begun to grow. You can see that growth as a rise in the top line of the graph [Scenario 4] comparing the ending customer numbers.

Acquisition efforts and costs were helped substantially by the lower cost retention program which also increased the lifetime value of the customers, and required fewer new customers be added to the base. In effect you can have your cake and eat it too—with an approach that has low costs, high revenue, and still ends with more new customers. Significantly, the same approach without regard to the model [Scenario 3] turns in the worst performance of the four scenarios and provides only a negligible improvement to the Base Case.

IN CONCLUSION...

As we said earlier, the particulars of any business can be quite different, but the universal lesson that this exercise demonstrates is that prudence requires marketers to always model and test their assumptions about customer growth and the interplay of acquisition, attrition, and retention dynamics. It is far too easy to make decisions based on faulty intuition and assumptions that could prove to be tragically wrong.

The most important conclusion you can draw from this analysis is that a pro-active retention program is an imperative. If you could only pursue one tactic, then retention is clearly it. Contrary to your intuition, the models demonstrate that retaining your existing customers performs almost as well—from a revenue point of view—as aggressively acquiring new ones. The difference is that with a retention approach your risk is lowered, your costs are lowered, and consequently you keep substantially more of what you make.

Our message for the bold leaders who actually want their companies to grow in this environment is: a tactical strategy is available to you. Integrate a pro-active retention program with an effective acquisition strategy. Use analytics to help you achieve the balance you need between those efforts, and you will keep more customers longer, and grow a larger customer base by adding fewer new ones. It has never been more important to analyze, understand, reward, and retain. You will benefit from the efficiencies you will be able to achieve.

Growing your business with lower costs and higher margins is a strategy that works in any economic climate.

Footnotes:

[1]Teleconference: The Science of Churn, Sally M. Cohen, Analyst, Forrester Research PowerPoint, March 4, 2009
http://www.forrester.com/rb/teleconference/science_of_churn/q/id/5474/t/1

[2]T-Mobile Aims To Keep Subscribers with a \$50 Plan, by Frederick Lane, <http://www.newsfactor.com>, February 19, 2009 3:09PM

[3]Deep Discounts During the Recession Can Damage Brands, New Yankelovich Study Finds, PRNewswire, Chapel Hill, NC, March 11, 2009 <http://news.prnewswire.com/DisplayReleaseContent.aspx?ACCT=104&STORY=/www/story/03-11-2009/0004986557&EDATE=>