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Customer Equity Management

Charting New Directions for the Future of Marketing

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The authors present an overview of a new approach to marketing—one that seeks to maximize customer equity by managing the customer asset. Using a resource-based view, the article provides a framework for approaching marketing through the lens of the customer asset. The authors propose that the ability to acquire, manage, and model customer information is a key asset of the firm that can be a source of sustained advantage. Challenges to the implementation of this approach and the changes that the approach necessitates in marketing strategy are discussed. The authors propose several areas for future research in the area of customer equity and management of the customer asset.

> Products come and go, but customers remain
>
> —Rust, Lemon, and Zeithaml (2001, p. 3)

In the last few years, marketing managers at leading companies have begun to organize their marketing efforts around customers rather than product lines. In these firms, the product-oriented concept of brand equity is gradually being supplanted by customer-focused concept of customer equity. In the process, marketing expenditures that were once viewed as short-term expenses are now being viewed as investments in customer assets that create long-term value for the firm and its shareholders. This fundamental shift in perspective is causing many to question previously accepted paradigms and business practices to manage customer assets more effectively. We refer to this emerging management approach as customer equity management.

The shift toward customer equity management has been driven by several substantial and long-lasting changes in the marketplace. First, managers are under increasing pressure to be more accountable to shareholders. Increasing competition brought about by globalization and deregulation is forcing managers to seek the highest possible return on each investment or face swift response from more efficient competitors. Second, firms are confronted with a tidal wave of detailed customer information pertaining to attitudes, preferences, and shopping behaviors. Massive investments in customer relationship management (CRM) technologies and data warehouses have outstripped the ability of managers to synthesize the data and, therefore, necessitate a new approach to strategic decision making. Finally, emerging technologies have enabled firms to personalize products, customer service, communications, and even pricing in ways that were undreamt of just a few years ago. In the rush to create systems capable of supporting individual-level marketing efforts, firms have inadvertently raised customer expectations.

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Belatedly, many firms are now asking the question, Is it worth it?

As a result of the changing marketplace, marketers are struggling to develop more effective ways to develop and implement strategies that can lead to sustainable profit streams. In the process, they are rethinking the nature of marketing and its role within the firm. The purpose of this article is to advance the discussion about the customer equity approach as an emerging marketing paradigm by describing key aspects of how marketing can be done in today's more turbulent environment. We define customer equity management as *a comprehensive management approach that focuses the efforts of the firm on increasing the lifetime value of individual customers (i.e., the firm's customer assets) in a way that maximizes customer equity.* Managing the customer as a strategic asset of the firm creates a number of management challenges that require a new understanding of the role of marketing in the firm.

THE ROOTS OF CUSTOMER EQUITY

The customer equity approach to marketing management finds its roots in several overlapping research streams including direct marketing, service quality, relationship marketing, and brand equity. Research from each of these streams has contributed substantially to a more effective approach to managing customer assets. Taken alone, however, none of these areas provide a complete solution to the challenges facing firms today. In this section, we trace these conceptual roots and demonstrate how customer equity represents more than just an extension of any single research stream. Instead, it represents an integrated approach to marketing that can form the basis for more effective marketing strategies.

Direct Marketing/ Database Marketing

The direct marketing literature and applications in practice have made several contributions to our understanding of customer equity. Direct marketers were the first to capture purchase information in individual customer information files. They also pioneered the use of statistical techniques for predicting customer response to marketing communications and for the development of increasingly fine-grained behavior-based segmentation techniques such as chi-square automatic interaction detection (CHAID) (Hughes 2000; Newell 1997). Finally, direct marketers were the first to use customer lifetime value assessments as a basis for marketing strategy. Using customer behavior to understand the value of the customer to the firm is a significant contribution of direct marketing to customer asset management.

However, this research stream has some limitations that prevent it from forming the basis for the new marketing paradigm. The focus of direct marketing has always been on the operational level and has not addressed broader issues such as competitive positioning, risk, changing customer preferences, or a broader view of customer-based strategy. In addition, direct marketing has typically focused on communications and response and has not addressed other operational issues such as pricing, product quality, or customer service. Finally, despite the introduction of the customer lifetime value concept, the discipline (and practice of direct marketing) is still heavily focused on optimizing responses to individual transactions, rather than on maximizing the value of the relationship as a whole.

Service Quality Literature

The research on customer satisfaction and service quality has made a substantial contribution to our understanding of the relationship between service quality and customer profitability (Anderson, Fornell, and Lehmann 1994; Heskett et al. 1994; Rust, Zahorik, and Keiningham 1995). In addition, this research stream has identified causal linkages between antecedents of service quality and components of customer lifetime value such as retention. Thus, a major contribution of the service quality literature has been to explore how the many dimensions of a key marketing function, customer service, can contribute to the value of a customer and hence, to shareholder value. However, the relatively narrow focus on service quality has largely failed to account for the role of other aspects of marketing mix such as the tangible product, communications, or channel issues in customer equity management. Some research has investigated the influence of price on the customer's relationship with the firm. Woodruff (1997) and Zeithaml (1988) have examined price, quality, and value perceptions. Recent work such as Bolton and Lemon (1999); Bolton (1998); and Verhoef, Franses, and Hoekstra (2001) has examined the effects of price and payment equity on retention, usage, and cross-buying. The service quality literature has made substantial progress toward understanding the link between customer satisfaction and various elements of customer profitability such as retention. However, what is needed is a broader understanding of the linkage between the entire marketing mix and customer profitability.

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Relationship Marketing

The relationship marketing literature, particularly in the business-to-business arena, was among the first to focus on customer relationships as strategic assets of the firm (Håkansson 1982; Hunt and Morgan 1995; (Jackson 1985; Srivastava, Shervani, and Fahey 1998). Research in this area also has delineated processes of relationship development and identified key elements for developing and sustaining long-term relationships. In a few cases (e.g., Gummeson 1999; Håkansson 1982; Storbacka 1994; Storbacka, Sivula, and Kaario 1999), this research has begun to move beyond the interpersonal model (and such focal constructs as trust, commitment, or shared values) to connect these variables to profitability and shareholder value. A good review of these initial steps is given in Brodie, Glynn, and Van Durme (2002).

In addition, this research stream often makes the assumption that all relationships should eventually lead to long-term commitment, not recognizing the possibility that from the firm's standpoint, not all relationships should be pursued. Similarly, reliance on models of interpersonal relationships may not be appropriate in more economically focused relationships because not all customers want a committed relationship. What is needed is a model that optimizes the firm's strategy by balancing the customer's desired level of relationship against the profitability of doing so.

Brand Equity

The brand equity literature (especially that on customer-based brand equity, e.g., Keller 1998) has also substantially contributed to the customer equity approach. By examining the antecedents and consequences (including the financial consequences) of brand equity, this research stream has provided substantial insights into the process by which consumers develop relationships with firms. In addition, the brand equity researchers have been moderately successful in gaining recognition for brand equity as a measurable asset that should be included on the firm's financial statements. However, as Ambler et al. (2002) note in this special issue, the brand equity literature has traditionally been organized around products and therefore underrepresents the financial contribution of the customer, especially for multibrand firms.

Models of Customer Equity

The term *customer equity* was proposed by Blattberg and Deighton (1996), who defined it as the total of the discounted lifetime values summed over all of the firm's customers. The initial Blattberg and Deighton (1996) model showed the importance of understanding the value of a firm's customer base and using this understanding to begin to determine optimal investments in customer acquisition and retention. Much of the later research into customer equity models has focused on the identification of antecedent variables and how to link them to customer profitability. Rust, Zeithaml, and Lemon (2000) developed a conceptual model of the antecedents of customer equity and a decision support system (Rust, Lemon, Zeithaml 2001) to allow firms to focus their marketing strategy and determine the financial impact of strategic investments on the firm's (and competitors') customer equity. In addition, Blattberg, Getz, and Thomas (2001) have developed a model that enables a firm to understand the extent to which acquisition, retention, and customer add-on selling contribute to the firm's overall customer equity that provides insights into how firms can manage investments in each.

Additional research has begun to examine the underlying financial models used to value customer assets. For example, Hogan and Hibbard (2001) proposed a real options-based customer value model that specifically accounts for growth and abandonment options that are embedded in the customer relationship. Their work suggests that conventional, discounted cash flow–based customer equity models may significantly undervalue customer assets. Other researchers have begun to validate the assumptions of customer equity models to better understand the underlying processes of relationship development and its contribution to customer equity (Bolton, Lemon, and Verhoef 2001; Hogan, Lemon, and Libai 2002a, 2002b; Reinartz and Thomas 2001; Thomas 2001). This growing stream of research suggests that by understanding the value of the customer asset to the firm and by actively managing the customer as a strategic asset, firms can increase the overall value of the firm and, ultimately, shareholder value (Gupta, Lehmann, and Stuart 2001).

A CONCEPTUAL FRAMEWORK OF CUSTOMER EQUITY MANAGEMENT

The customer equity approach to marketing, although still in its infancy, is evolving rapidly as researchers continue to develop new models and test relationships between key constructs. As an overview and as an attempt to integrate the current approaches to managing customers as strategic assets, we offer a conceptual model of how the firm can employ its stock of physical, intellectual, and customer-based assets to maximize the value of its customer equity and achieve above-industry-average profits (see Figure 1). The model is grounded in the resource view of competition (Barney 1991; Conner 1991; Hunt and Morgan 1995) that suggests firms can develop strategic as-

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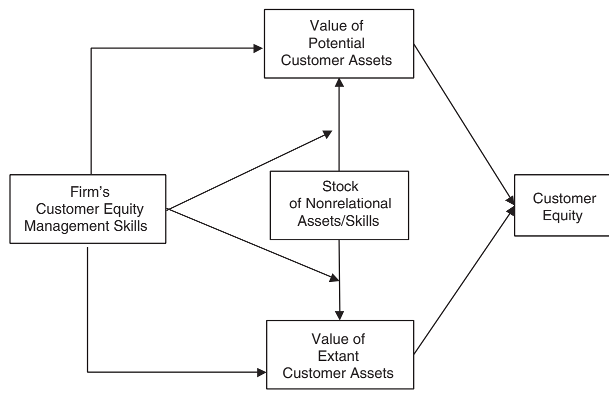
FIGURE 1
Conceptual Model of Customer Equity Management



sets that can become a source of sustainable competitive advantage. Unlike previous applications of the resource-based view to marketing that did not differentiate between the effects of various strategic assets (e.g., Srivastava, Shervani, and Fahey 1998), we argue that there is hierarchy among firm assets. The firm's tangible assets (e.g., plant and equipment) and intangible assets (e.g., brands, channel relationships) are valuable only to the extent to which they enhance the combined value of the firm's customer assets or customer equity. Customer equity is a combination of the value of a firm's current customer assets (those customers who currently buy from them) and the value of the firm's potential customer assets (those customers who currently do not buy from them because they buy from a competitor or because they are not yet in the market). The contribution of these assets to customer equity is moderated by the firm's customer equity management skills. In other words, the value of the firm's plant, equipment, brands, and the like are determined in large part by the firm's ability to deploy them in a way that increases customer equity.

There are several implications of the customer equity management framework for the firm. First, the framework focuses attention on two critical assets of the firm: its stock of current and potential customer relationships and its collective knowledge concerning how to select, initiate, develop, and maintain economic relationships with those customers. Second, the framework explicitly focuses on the collective value of customer assets (i.e., customer equity) as the guiding metric for the marketing activities of the firm. The firm's relationship with current and potential customers can be viewed as a type of "superasset" whose value is derived from the way the firm chooses to combine its other resources and apply them to the market. Finally, the framework suggests a new role for marketing as the organizing force behind the deployment of nonrelational assets to maximize the value of customer assets. This approach suggests an expanded role for marketing organization in the firm, as the firm seeks to integrate all activities to grow the value of its customer assets.

A focal point of the model is the abilities that a firm must possess to compete successfully in today's dynamic markets. In the conceptual model, these abilities are labeled the *customer equity management skills*, which include all of the skills needed to identify, initiate, develop, and maintain profitable customer relationships. It is beyond the scope of this article to describe the myriad skills needed to accomplish this task. Therefore, we focus on modeling and measurement skills as two of the most important skills needed to manager customer assets. These skills relate directly to the value creation process in which firms attempt to assess the potential value of a strategy, execute that strategy, and then measure the results to improve the modeling effort going forward.

In terms of modeling, the firm must be able to develop applicable models of the customer-firm interaction that clearly link marketing actions to shareholder value. Historically, applications of financial models to marketing strategies (e.g., product portfolio models) have often proven ineffective because the underlying assumptions of finance are frequently too restrictive for marketing (Devinney and Stewart 1988; Wernerfelt 1985). More recently, models have focused on net present value approaches to link marketing strategies to shareholder value, and indications are that these models are more appropriate than their predecessors (e.g., Dwyer 1997; Srivastava, Shervani, and Fahey 1998). In the future, firms must develop expertise in modeling customer equity to develop more effective strategies. Moreover, the required knowledge will be increasingly cross-functional in nature as the models incorporate more sophisticated measurement approaches and more sophisticated valuation methodologies.

The ability to collect and analyze market information to answer management questions and guide strategy has long been a core competency of the marketing function. In recent years, these measurement skills have been viewed in a new light as firms recognize that the ability to acquire, distribute, interpret, and store market information can be a source of competitive advantage (Sinkula 1994). The challenge for marketers has been to determine what data should be captured and how those data should be transformed into usable information. Answers to these questions become clearer for firms using customer equity models to guide strategy. The models require that specific inputs be captured to estimate customer equity. The models not only provide direction about what information

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should be captured; they also provide explicit guidance on how that information should be processed. One of the reasons that so many firms are overwhelmed with customer data is because they have invested millions of dollars in CRM systems without any clear sense of how to process the information. The result is a lower return on investment (ROI) on their information technology (IT) investments and a less coherent and less well executed marketing strategy.

The framework highlights the relationship among the array of assets held by the firm by proposing that nonrelational assets are only valuable to the extent they increase the value of the customer asset. Let us consider a few examples of how these assets work to grow the customer superasset as noted in Figure 1. Consider the role of typical capital assets in the firm such as plant and equipment, for example. Such assets provide value to the firm in at least two ways. First, they may be sold for some price and, therefore, represent potential cash value for the firm. But second, and more important, they support the firm in its attempt to create potential products and services that improve firm cash flows when purchased by customers. Therefore, physical assets become a tool in growing the overall customer asset by providing the means through which the firm provides value to the customer and, therefore, the customer chooses to do business with the firm.

Some nonrelational assets may enable the firm to improve the value of the customer asset by enabling it to be more responsive to customer needs. For example, a technology that enables the firm to customize products, services, or communications to a customer has the potential to influence the value of extant customer assets considerably. Similarly, innovative or efficient supply chains or new product development processes may enable the firm to react quickly to market developments and changing customer requirements, thereby insulating the firm from potential decreases in the value of extant customer assets or creating new opportunities to turn potential customers into real customers.[1]

Employees and firm knowledge (or potential knowledge, through research and development) represent additional nonrelational assets that can be leveraged by the firm. These human assets, in somewhat similar ways to the physical assets noted above, give the firm the potential to effect changes in the value of the customer asset. By successfully serving customers, by creating new products and services that are valuable to current and potential customers, the firm can use these assets to grow the customer asset.

1. We thank an anonymous reviewer for this insight.

REDEFINING MARKETING'S ROLE IN THE FIRM

In recent years there has been growing concern about the evolving, and according to some, declining, role of marketing within the firm. Much of this concern stems from the fact that virtually all functional areas have adopted a more market-oriented stance resulting in a diminished role for the marketing "function" in many firms (Workman 1993). Marketing strategies are often developed by a "strategy group." Channel decisions (e.g., supply chain management, logistics) are often made in operations or purchasing. Customer service and after-the-sale service are often handled by operations as well. New product development decisions often do not involve marketing at all. What remains? Often, marketing is relegated to creating the message and setting the price (unless price is set by finance)—in a firm that now speaks proudly about being customer oriented.

Given the current business environment, the challenge facing the firm is to develop a coherent approach to strategy that is more closely linked to shareholder value. Given marketing's expertise in managing customer interactions, the role of marketing should be to employ its modeling and measurement skills to answer critical questions pertaining to customer management at all levels of the firm (Moorman and Rust 1999; Webster 1992). If the firm's goal is to grow customer equity (as a means of growing shareholder value), marketing's role should be to manage the firm's customer assets in such a way as to *facilitate* the growth of customer equity. That marketing should participate in the strategy dialogue at all levels of the firm is hardly a new perspective. What is different under a customer equity approach is the nature and focus of that participation.

At the organizational level, marketing must draw on its modeling skills to help the firm match its knowledge and strategic assets to the markets that have the greatest potential for maximizing customer equity. Recent customer equity models (e.g., Blattberg, Getz, and Thomas 2001; Rust, Lemon, and Zeithaml 2001) can contribute substantially to this effort. However, there is a need to extend these models and validate them across a variety of market contexts to fulfill their potential to support corporate strategy. Customer equity models can also advance the firm's market orientation by providing metrics for assessing how various organizational activities contribute to the customer equity of the firm. Firms frequently use financial metrics such as cost savings per share of outstanding stock to help employees understand the linkage between their actions and the financial health of the firm. But such metrics tend to focus on cost reduction strategies and may lead employees to miss opportunities to increase shareholder value by im-

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proving other customer equity drivers. Finally, marketing can provide guidance to the organization about which strategic partnerships will make the best contribution to the firm's ability to maximize customer equity. As firms increasingly rely on partners to share the risk associated with new ventures, it is essential that they be vetted in terms of their contribution to customer equity.

At the strategic business unit (SBU) level, the primary role for marketing is to draw on its models and measurement systems to identify the optimal marketing mix to maximize customer equity in real time. This is an especially challenging goal in today's dynamic markets characterized by rapid product and process innovation due to intense competition. However, extant customer equity models suggest that this is an achievable objective. Another contribution of customer equity management is to develop more effective value-based segmentation approaches. Recent research used a Markov switching matrix approach and has demonstrated how firms can assess the value of various segments and develop marketing programs to influence consumers to switch to more profitable segments (Libai, Naryandas, and Humby 2002 [this issue]). Developments such as this suggest that customer equity management can make several contributions to strategy at the SBU level.

At the operational level, the role of marketing will often be to develop the systems necessary to deliver the marketing mix to *individual* customers. Too often, decisions on customer relationship management are driven by advances in technology rather than customer needs. This technology-driven approach to marketing operations contributed to the poor performance of Internet start-ups in the late 1990s. In the new millennium, the role of marketing will be to guide the design of the customer interface so that it can support the efficient flow of information to and from the customer. Customer information must not only be captured at the operational level; it must also be translated into usable intelligence to support new dynamic decision models. This can occur only in an organization in which the learning processes necessary to fuel strategy are grounded in a customer equity-driven approach to management.

What is required to implement a customer equity management approach? Implementation of the customer equity management approach will require a greater attention to marketing operations and will demand thorough cross-functional cooperation with virtually all areas of the company. The days when marketing can remain isolated from the front lines of the customer interface are long gone. In addition to the need for development of new models and metrics, implementation of this approach will also require a significant realignment of the organization. The most significant change will be in realigning the organization around the goal of growing customer equity, which will require a realignment of many aspects of the firm, including, for example, planning processes, performance requirements, budgets, and incentive and reward systems.

A RESEARCH AGENDA

Current models of customer equity and customer equity management have provided an excellent beginning to this new approach to marketing and management. Specifically, Rust, Lemon, and Zeithaml (2001) have developed a Markov-based approach to customer equity measurement that provides a richer understanding of the nature of customer retention and acquisition. In addition, Blattberg, Getz, and Thomas (2001) have provided an approach to measuring and managing customer equity that focuses on acquisition, retention, and cross-selling of customers. Significant research in this area is currently in process, and new models will continue to be developed. In the spirit of encouraging future research in this area, we offer the following broad research agenda.

Strengthen the Financial Underpinnings of the Customer Equity Model

As one of the articles in this special issue points out, current valuation models make a large number of restrictive assumptions that raise questions about their validity as currently applied (Hogan et al. 2002). For example, the discounted cash flow model that is the basis for current customer equity models assumes that all customers are equally risky, risk is time invariant, and firms adopt a static management approach to managing the customer base, among others. Clearly, these and other implicit assumptions are inconsistent with the circumstance of most firms. The full potential of customer equity management will never be achieved without a critical examination of the underlying financial models and an exploration of alternative models with less restrictive assumptions. Fortunately, there are a number of promising valuation approaches ranging from dynamic asset pricing models to options-based models that hold the potential to dynamic and flexible customer equity models in the future.

Explore the Strategic Implications of Customer Equity Management

It is all well and good to speak of the customer as a strategic asset of the firm. However, to fully implement this approach, it is important to understand how far the analogy of "customer as asset" can really be taken. In this area, fu-

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ture research should examine the resource-based view hypotheses that the firm's relational skills and abilities are associated with differential profits. Figure 1 provides hypothesized routes through which these profits might be generated, yet the relationships in the model along with other resource-based view hypotheses require empirical examination. In addition, research is needed to more fully explicate the skills and abilities needed to identify, select, initiate, and maintain the most profitable customer relationships. Research is also needed to explicate the role of value-based segmentation. Currently, the tools to accomplish this are in their infancy, with most firms relying on relatively simplistic distinctions between "gold," "silver," "iron," and "lead" customers (e.g., Zeithaml, Rust, and Lemon 2001). Finally, research is needed to refine our current understanding of a firm's market orientation. It is our belief that this approach can add additional focus to the nature of market orientation, as marketing's role expands at the organizational level of the firm (see Bell et al. 2002 [this issue] for a more detailed discussion of future research in this area).

Develop a Truly Dynamic Individual Customer Profitability Model

Although customer equity models purport to assess the value of a customer, most of the models in the literature assess the "average" value of a customer (e.g., Blattberg and Deighton 1996; Blattberg, Getz, and Thomas 2001). Average valuation models are unable to support the marketing decision making that increasingly occurs at the individual level. Individual-level models are just beginning to emerge (e.g., Rust, Lemon, and Zeithaml 2001). However, even this model, which does capture some aspects of customer value at the individual level, is a static representation of the firm's (and the industry's) customer base and relies on the average customer values for some inputs. There is also a need to develop models that capture the dynamic nature of markets as competitors and customers interact with one another over time. Rust, Lemon, and Zeithaml (2001) have incorporated the competitive element, but more work needs to be done on the dynamic nature of customer relationships and customer value. Some initial research investigating the dynamic nature of the customer base is now emerging (e.g., duration and usage: Bolton 1998; Bolton and Lemon 1999; word of mouth: Hogan, Lemon, and Libai 2002a, 2002b; customer lifetime value: Libai, Narayandas, and Humby 2002 [this issue]), but more work needs to be done. Specifically, models of the dynamic nature of customer relationships and their value to the firm could be developed using analytic models, game theory, and other techniques such as simulations.

Explore the Relationship of Brand Equity and Customer Equity

Existing brands also represent assets to the firm that are tied in very interesting ways to the customer asset (see Ambler et al. 2002 [this issue]). The brand provides a strong tie between the customer and the firm, strengthening the value of the customer asset. However, in addition, the brand offers two key opportunities to grow the value of the customer asset. First, brands provide an opportunity for the firm to get a greater share of wallet from an existing customer through additional purchases of current brands and products or through purchases of new brands or brand extension products. Second, brands provide the opportunity to attract new customers through the strength of the overall perception of the brand in the marketplace or through the development of new brands or brand extensions that attract new customers, thereby growing the value of the customer asset. Understanding how brand equity and customer equity are related and how investments in brands and customers are related to the value of the firm is critical for future research.

Identify Intermediate Metrics to Creating Customer Equity

The routes to creating customer equity are numerous and include many intermediate constructs. There is a need to identify which metrics are most appropriate. For example, Bolton, Lemon, and Verhoef's (2001) Customer Asset Management in Service Industries (CUSAMS) model represents an initial attempt to examine the effects of intermediate metrics on the value of the customer asset. The authors model the differential effects of marketing mix elements (e.g., price, loyalty programs) on customer behaviors that affect customer equity: retention, usage, cross-buying, and word of mouth. However, additional research is necessary across several industries and contexts to determine the mechanisms by which marketing mix affects the customer asset and such intermediate measures such as customer satisfaction. These issues and directions for future research in this area are discussed more fully in Berger et al. (2002 [this issue]).

Pedagogical Research

In addition to theoretical research and models, new tools are needed for the classroom as well. Given the explosive investment in CRM technologies in recent years, students need to be trained in new customer asset management tools—at both the strategic and tactical level. We see

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an urgent need for case studies, simulations, and applied tools in the classroom at the undergraduate, MBA, and executive levels (such as the Hilton Honors case, as noted in Bell et al. 2002 [this issue]). Such new approaches will make marketing more relevant in the classroom and provide the acid test to other research developments.

CONCLUSION

There are marked changes under way in the manner in which marketing is understood, performed, and taught. These changes are leading to an increased focus on profitability and a renewed expansion of marketing's contribution to the firm. Customer equity management provides a compelling, integrated framework in which marketing's new role can be understood. More important, it addresses critical management needs at all levels of the organization. Already, leading firms are moving to implement customer equity management as a prelude to reengineering marketing processes. Ultimately, their success in these efforts will depend on continued academic research in this exciting arena. It is our hope that the articles contained in this special issue of the *Journal of Service Research* will encourage additional research leading to improved models and management systems.

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