

Customer Retention Chapter 18

Ted Mitchell

Consider Customer Loss Rates as Depletion or Depreciation Rates

As a Point of Interest

- If your current set of customers is considered an asset.
- You tend to lose customers over time.
- Customer Loss Rate is like a straight line depreciation rate.

Where

$$\text{Customer Loss Rate} = 1 / \text{Customer Life}$$

Customers as Assets

- You have 220 customers. The average customer stays loyal for five years.
- What is the rate of customer loss?
- How many customers will you have after 2 years?

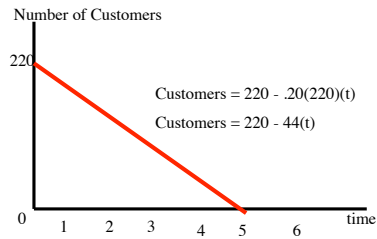
Customers as Assets

- You have 220 customers. The average customer stays loyal for five years.
 - What is the rate of customer loss or asset depletion rate?
- Depletion rate = $1/\text{customer life} = 1/5 = 20\%$
Or Retention rate = 80%

Customers as Assets

- You have 220 customers. The average customer stays loyal for five years.
- How many customers will you have after 2 years?
- Asset value in two years = $220 - 2(.2)220$
- Asset value in two years = $220 - 88 = 132$

Example 1



Increase Value of Firm

- Decrease the rate at which assets depreciate.
- Increase the life of the asset.
- Increase the customer retention rate

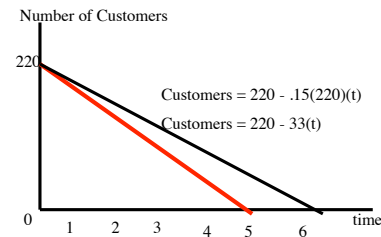
Customers as Assets

- You have 220 customers. Giving more service has increased your customer retention rate to 85%
- What is the rate of customer loss or asset depletion rate and new expected life of the customer.

Customers as Assets

- You have 220 customers. Giving more service has increased your customer retention rate to 85%
- What is the rate of customer loss or asset depletion rate and new expected life of the customer.
- Depletion rate = $1 - 85\% = 15\%$
- Customer life = $1/\text{Depletion rate} = 1/.15 = 6.7$ years
- An increase of 1.7 years

Example 1



What is a year worth?

- Average customer buys 100 dollars a year that has a contribution (markup) of 40%.
- What is the customer's net cash contribution each year?

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- Average customer buys 100 dollars a year that has a contribution (markup) of 40%.
- What is the customer's net cash contribution each year?
- $M = Mp(R) = .4(\$100) = \40 a year
- 1.7 years is worth $1.7(40) = \$68$

Need The Time Value of \$

- \$68 dollars received 6.7 years from now is not worth 68 of today's dollars.
- Future cash contributions must be discounted into today's dollars

Value of Loyal Customer

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Value of Future Revenues

- No Business will pay \$1000 for \$700 in revenues.
- The net cash flow in future periods is the key
 - Cash in period 1 = \$300
 - Cash in period 2 = \$400
- **BUT It Is Not Worth \$700**

Present Value, PV, of Future Dollars

- $PV = (\text{Future cash in period } t)(1+k)^{-t}$
- $PV = \frac{(\text{Future cash in period } t)}{(1+k)^t}$
- Where k = cost of capital or discount rate
 t = time period

Value of Future Revenues

- Assume 10% discount rate and average customer retention rate of 50%
- Value at the end of period 1 =
 - $\$300 / (1+0.1)^1 = \272.7
- Value at the end of period 2 =
 - $\$400 / (1+0.1)^2 = \330.4
- Value for sum of the two years average life = \$603.1

Net Present Value

- Present Value for sum of the two years average life = \$603.1
- If you paid \$700 for the customer then, Net Present Value is negative at -\$96.9

Present Value with discount rate of r

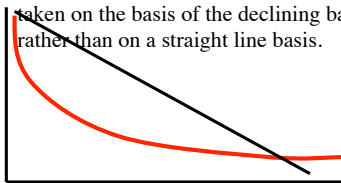
$$\begin{aligned} \text{Present Value} = & (\text{Cash in period 1})/(1+r)^1 \\ & + (\text{Cash in period 2})/(1+r)^2 \\ & + (\text{Cash in period 3})/(1+r)^3 \\ & + (\text{Cash in period n})/(1+r)^n \end{aligned}$$

Future Value of a Customer

- Present Value of the future cash flows
- Plus
- Non-tangible elements
 - Good word of mouth - opinion leader
 - Using product in public
 - Learns how to service it
 - Probability of Creating First Sale

Profit Advantage of Retention

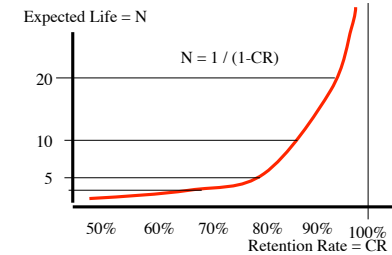
- Gets Better when the customer loss rate is taken on the basis of the declining balance rather than on a straight line basis.

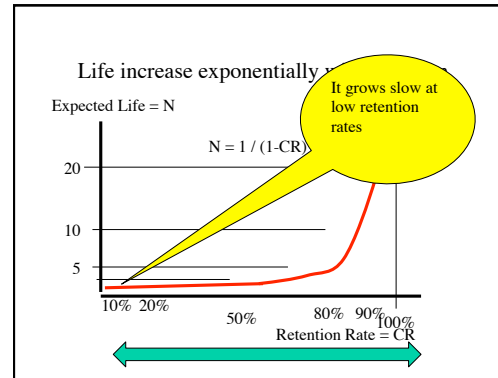
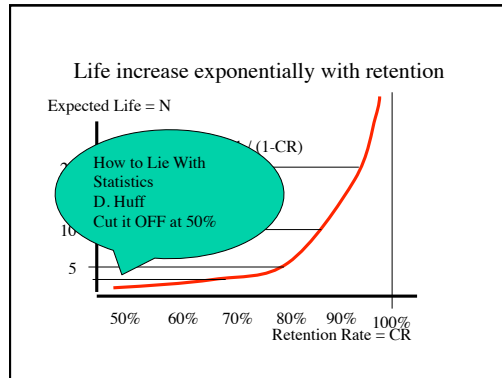


Declining balance vs Straight Line

- | | |
|------------------------------|------------------------------|
| • Straight line 20% | • Declining balance 20% |
| • Start = 220 customers | • start = 220 customers |
| • Year 1 = lose 44, 176 left | • Year 1 = lose 44, 176 left |
| • Year 2 = lose 44, 132 left | • Year 2 = lose 35, 141 left |
| • Year 3 = lose 44, 88 left | • Year 3 = lose 28, 113 left |
| • Year 4 = lose 44, 44 left | • Year 4 = lose 23, 90 left |
| • Year 5 = lose 44, 0 left | • Year 5 = lose 18, 72 left |

Life increase exponentially with retention





- If you have high retention rates, (high loyalty) then any change is crucial!!!
- If you have low retention rates, (low loyalty) then changes in the loss rates are relatively unimportant to the change in average account life!!

- Any questions on the lifetime value of an account based on Loss-Retention Rate?