CUSTOMER EQUITY MODEL FROM CUSTOMER AND ORGANIZATION PERSPECTIVE

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Abstract

The purpose of this paper is to develop a theoretical framework for customer equity from customer and organization perspective. Scientific literature of customer equity concept was analyzed, different customer equity models were compared and customer equity drivers identified as well as a theoretical framework for customer equity proposed. The model will help organizations to project purposefully marketing actions, allowing managing customer equity. Two major limitations are associated with this research, i.e.: (1) customer equity drivers were identified on the basis of theoretical researches and (2) the effect of competitors marketing efforts put on customer attraction and retention as well as on market life cycle impact were not taken into consideration. Further empirical research should be carried out assessing the comparative significance of customer equity drivers in industry.

Keywords: customer equity, customer life-time value.

Introduction

Organizations, in order to attract new customers and retain the existing ones, suffer significant costs. The efforts to retain retail customers while offering them new products, more attractive service conditions, involving these customers into loyalty programs not always stands up, because customer loyalty not always can be identified as a customer value to organization (Dowling & Uncles, 1997; Uncles et al., 2003; Kumar & Rajan, 2009). It is important that marketing investments to foster and retain customer loyalty would not become greater than customer value to organization, which should be measured using customer life-time value and customer equity concept (Lemon et al., 2001; Reinartz & Kumar, 2000; Epstein et al., 2009).

When estimating customer equity as discounted total of customer life-time value, marketing costs and cash flows created by customers must be calculated (Venkatesan & Kumar, 2004). Researchers suggest the usage of customer equity for optimal planning and allocation of marketing budget, understanding the connection between marketing investment, marketing metrics and financial performance of organization, and increasing of return on marketing investments (Lemon et al., 2001; Blattberg et al., 2001; Villanueva & Hanssens, 2007). Organization, while embracing customer equity view, should efficiently manage customer attraction, customer retention and add-on selling processes (Blattberg et al., 2001; Rust et al., 2004; Villanueva & Hanssens, 2007). However, an organization having focused all its efforts on customer attraction and retention, may decrease customer life-time value in a short-term, if the costs, allocated for this purpose, will be higher than the cash flows created by customers (Hanssens et al., 2008). Therefore, it is necessary to identify, which marketing efforts and marketing mix play a key role in the process of value equity, brand equity and relationship equity creation, while attracting new and retaining the existing customers (Rust et al., 2004; Villanueva & Hanssens, 2007; Hanssens et al., 2008).

The purpose of this paper is therefore: (1) to review the academic literature of customer equity and (2) to develop a theoretical framework for customer equity from customer and organization perspective.

Methodology. The major research method is literature review. Different customer equity models were compared and critically assessed and customer equity drivers identified as well as a theoretical framework for customer equity proposed.

Findings and limitations. Customer equity model, suggested in the article, will help organizations to project purposefully marketing actions, allowing managing customer equity. The limitation of this research is that customer equity drivers were identified on the basis of theoretical researches. Therefore, further empirical research, assessing the comparative significance of customer equity drivers in industry, should be carried out. Another limitation of the suggested model is that the effect of competitor marketing efforts put on customer attraction and retention as well as market life cycle impact on customer equity have not been taken into consideration.

This paper is structured as follows. First, the literature on key issues involving customer equity concept were reviewed. Second, customer equity models are presented in the article and key limitations of
the models are described. Further, a theoretical customer equity model, which should be tested empirically, is presented.

Customer equity concept

According to Lemon et al. (2001), customer equity is described as discounted sum of life-time value of existing and potential customers of an organization.

Customer equity concept encourages organizations to consider their customers as the major source of the current and future cash flows of organization and put forward the increase of customer life-time value as the key goals of marketing strategy (Villanueva & Hanssens, 2007; Bruhn et al., 2006; Lemon et al., 2001). Customer equity is considered to be a significant advantage of organizations’ competitiveness and a major marketing goal in many industries. Organizations are encouraged to ensure profit growth and long-term success while managing customer life-time value and customer equity (Pitt et al., 2000; Flint et al., 2002; Slater et al., 2009).

According to a number of researchers, three intercorrelated drivers – customer attraction, customer retention and add-on selling – are equally important in customer equity creation (Blattberg et al., 2001; Hansotia, 2004; Rust et al., 2004; Malthouse & Blattberg, 2005; Villanueva & Hanssens, 2007; Kumar & Rajan, 2009).

According to Sharma (2006), in the process of transfer from product-centered thinking to customer-centered thinking (Sheth et al., 2000), customer equity is more and more often presented as the basis for marketing strategy. It is emphasized that organizations should focus their marketing efforts on the value equity, brand equity and relationship equity improvement and in each stage of customer relationship development process choose the most relevant customer equity drivers (Rust et al., 2004).

As each of the customer equity drivers has different significance level in a certain market or at different market life cycle, organization should identify the factors that have the highest effect on customer preferences (i.e. strong brand, product quality and price, long-term valuable relationship) and drive its marketing efforts in the right direction (Rust et al., 2001; Lemon et al., 2001).

However, the most problematic task for marketers is to identify, which marketing mix components play a key role in improving value equity, brand equity and relationship equity, while attracting new customers and retaining the existing ones (Lemon et al., 2001; Rust et al., 2001; Hanssens et al., 2008).

Customer equity models

Customer equity view recognizes customers as source of cash flows and the majority of customer equity measurement models are not incidentally based on net present value calculation method, used to measure customer life-time value (Roemer, 2007; Villanueva & Hanssens, 2007). Despite to the simplicity of this method and its frequent application, Roemer (2007) emphasizes the main weaknesses of net present value calculation method, used to measure customer equity.

The net present value calculation method does not enable assessing of fluctuations in demand, technological change, changing prices and production costs, customer relationship and understanding of changing customer needs (Roemer, 2007).

According to Helm (2004), in order to choose properly between the potentially high and less profitable customers, organization must perform its valuation of customer relationship, whereas not sufficient consideration is shown in the customer equity models for the so called “soft” measures (e.g. organization image consideration, intention to recommend product, etc.). It is important to notice that the customer equity patterns that are based only on financial value aspect measurement do not reflect customer relationship value (Helm, 2004).

In order to schedule properly the marketing strategy, organization must understand the factors of customer perception and behavior that have effect on the value created by customer to organization and how this effect should be measured. A number of authors carried out researches on customer equity drivers that have crucial effect on customer equity (Lemon et al., 2001; Rust et al., 2000; 2001; 2004; Holehonnr et al., 2007; Bush et al., 2007; Vogel et al., 2008).

In the table 1 the comparison of customer equity models is provided. The models, which include customer behavior and (or) perception constituents, not pure financial customer equity, have been chosen for the analysis.
### Table 1. Selected Articles of Previous Studies on Customer Equity Drivers

<table>
<thead>
<tr>
<th>Reference</th>
<th>Findings</th>
<th>Drivers</th>
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<tbody>
<tr>
<td>Lemon <em>et al.</em> (2001)</td>
<td>Deterministic model. The impact of organization marketing efforts on customer preference change and brand selection influence, thus increasing customer life-time value and customer equity has been analyzed.</td>
<td>Value equity, brand equity, relationship equity.</td>
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<td>Rust <em>et al.</em> (2000; 2001)</td>
<td>Deterministic model. Purposeful marketing budget allocation for main investment categories - value equity, brand equity and relationship equity – has been analyzed.</td>
<td>Brand equity (drivers – customer attitude towards brand and brand awareness); value equity (drivers – perception of quality, price and convenience) and relationship equity (frequent buyer programs, loyalty programs, channel relationship). Customer satisfaction determines customer decision for switching (i.e. refusing a certain brand) and thus effects customer equity.</td>
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<td>Rust <em>et al.</em> (2004)</td>
<td>Stochastic (Markov) model. Suggested marketing effort measurement method using financial outcomes, which are calculated as customer equity alteration.</td>
<td>Customer equity is determined by the frequency of purchasing certain product category and by average quantity of purchased products. Advertising awareness, perception of service quality, price and convenience, loyalty programs influence customer decisions and the level of expenditure.</td>
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<td>Holehonur <em>et al.</em> (2007)</td>
<td>Empirical research. Proved that product quality perceived by customer is a driver that has a direct effect on value equity. Customer attitude towards brand has a direct impact on brand equity, what makes customer repurchase intentions to grow.</td>
<td>A number of drivers (perceived quality of the product, perceived a price-prestige relationship of the product, perceived convenience of purchasing, positive attitude toward the brand, positive attitude toward the organization, brand awareness) determine value equity and brand equity and thus – customer’s purchase intentions.</td>
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<td>Bolton <em>et al.</em> (2004)</td>
<td>Conceptual model. A research on how the marketing instruments (direct mailing, different customer programs) used by organization influence customer behavior within the relationship, thereby influencing the value of the customer.</td>
<td>Loyalty, length, depth and breadth of a relationship between customer and organization, and therefore longer customer lifetimes are associated with a greater degree of cross-buying, a more significant level of transactions and thus – customer value, created for organization.</td>
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<td>Bush <em>et al.</em> (2007)</td>
<td>Conceptual model. The effect of relationship marketing efforts put by organization on customer equity and organization financial value has been analyzed. One of the key weaknesses of customer equity models has been pointed out – financial accounting method is only backward focused, whereas having discovered the proper methods of forecasting customer behavior could be both complex and more accurate.</td>
<td>Customer responses (such as satisfaction, trust, commitment and loyalty) to organization marketing efforts impact customer intentions to use product and to recommend it and thus - customer equity.</td>
</tr>
<tr>
<td>Vogel <em>et al.</em> (2008)</td>
<td>Conceptual model. Correlations between customer attitude and customer perception while measuring organization marketing actions and organization future cash flows were analyzed. The model includes customer behavior history as well.</td>
<td>Value, perceived by customer, attitude towards brand and relationship appreciation is the drivers for loyalty initiatives. Loyalty intentions and past sales directly influence future sales and customer equity. Value equity and brand equity are the primary drivers for future sales, while relationship equity influences the customer intentions to be loyal.</td>
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Source: developed by the authors

Although the majority of organizations understand that customer value to organization can be best assessed while measuring customer equity and customer life-time value, the efforts of practical implementation of customer equity in business have not yet shown the desired outcomes (Hansotia, 2004;
Kumar & Rajan, 2009; Epstein et al., 2009). In order to properly manage customer equity, marketers must answer the following three key questions: (1) how to choose, attract and retain the existing and potential customer segments that are worth investment; (2) how to define, which of the existing and potential customer segments will not create a sufficient value for the organization and purposefully reduce investments in such segments; (3) how to balance correctly the resources for customer attraction and retention (Kumar & Rajan, 2009). Hence, marketers should consistently carry out the following stages of customer equity management: customer segmentation, determining of potential value created for organizations by certain segments, measurement of costs and revenue from customer segment and customer life-time calculation.

Despite the fact that proper measurement and management of customer life-time value would contribute to organization in the process of profitable customer attraction and retention (Kumar & Rajan, 2009), customer life-time value measurement model reliability is still one of the key subjects of the researchers discussions. According to Bruhn et al. (2006), research on customer equity is focused mainly on measuring customer value to organization, while there is an insufficient attitude to the concepts for customer equity management. In our opinion, the model suggested in this article, may complement quantitative customer equity patterns that are based on financial value aspect and help organizations better understand the complexity of value created by customer.

**Customer equity model development**

Jain and Singh (2002) grouped customer life-time and customer equity patterns into the following three types:

- models to measure customer life-time value and customer equity. The models incorporate revenue streams from customers as well as marketing cost, dedicated for customer acquisition and retention. Some of these models extended so that on the basis of these patterns optimal resources for customer equity increase could be allocated;
- “customer base analysis” models, where, in order to compute properly future cash flows and purchase probability, customer information analysis and behavior history were considered. In the latter models, the stochastic purchase behavior per individual customer has been assessed and the likelihood of future purchases has been simulated;
- normative customer equity models, suitable for customer equity management, i.e. for policy making.

The normative model, suggested in the article (see Fig. 1) could supplement the existing policy making models and correct the defined gaps in such patterns. In the suggested model, taking into consideration the major stages of customer equity process, organization’s and customer’s perspective was analyzed.

![Customer Equity Model from Customer and Organization Perspective](source: developed by the authors)
In the process of customer attraction, organization analyses target segments, in order to identify, which of these segments will create the potentially highest value for organization. The characteristics of the analyzed attractive segment are identified (personal, demographic characteristics, purchasing habits, relationship length, etc.) and response likelihood is measured (Villanueva & Hanssens, 2007, Epstein et al., 2009; Kumar & Rajan, 2009).

To ensure the value for customer, organization must recognize the needs and expectations of target segment customers, analyze competitor’s offers and formulate its own value offer, which must include product/service quality, attractiveness, convenience level and price. Thus, an assumption can be made that in the process of customer attraction, a significant effect on customer equity improvement has the constituent of value equity, and that organizations should focus their marketing efforts on the communication of value equity. Brand equity plays also a very important role in customer attraction process: customers, realizing perceived value (the desired and received value at purchase), analyze competitor’s offers and switching costs, thus organization brand image and its position in the context of competitors’ brands will play a significant role in customer decision making. It should be noted that the customers that will be successfully attracted by organization while offering a low price, most likely will have no long-term relationship and the customer’s value to organization will be not very high, therefore the improve of only value equity constituent solely may, in a long-term, be loss-making for organization (Gupta & Zeithaml, 2006).

Thus, organizations, in order to attract retail customers, should develop their superiority through value equity and brand equity. According to Rust et al. (2001), organizations should assess the conventional marketing 4 P’s on the basis of customer equity constituents. Consequently, to encourage marketing efforts, in the period of customer attraction, the formation of attitude towards brand, increase of brand awareness and communication of services quality, price and convenience should take place.

In the process of customer attraction, organization can analyze only unobservable metrics (Gupta & Zeithaml, 2006) of potential customer, such as product/service quality perception, customer perceived value, intentions to use product, trust in brand. According to Holehonnr et al. (2007), customer decision to purchase and customer behavior is determined by a number of tangible and intangible factors, therefore, when analyzing the customer value to organization, it is important to choose those constituents, which have the greatest effect on customer equity. Though a number of researchers highly focused on the survey of different perceptual measures, i.e. unobservable metrics, customer perceptual measures are intercorrelated; therefore, while carrying out surveys, the analyzed constructs should be selected carefully (Gupta & Zeithaml, 2006).

It has been defined that product quality and price, perceived by customer, as well as consideration of the relationship between organization and customer as exclusive, improves brand equity and value equity, what results in increased customer tendency to purchase and hence, in customer equity growth (Holehonnr et al., 2007). Lundstrom and Dixit (2008) substantiated the importance of trust in brand equity and relationship equity growth and emphasized the importance of loyalty, caring, fulfillment of needs, wants and desires as well as two-way communication in brand equity and relationship equity development.

In the process of customer attraction, organization makes decision on the methods of proper selection of communication channels. To obtain this, it is necessary to estimate the efficiency of each channel and allocate the budget among the channels so that optimal effect could be achieved (Venkatesan & Kumar, 2004; Reimartz et al., 2005; Villanueva & Hanssens, 2007). Marketers in the customer attraction process mostly use such customer attraction channels as advertisement and promotion, direct marketing and sales force (sales agent) activity. It has been defined that communication via different marketing channels directly stimulates purchase frequency and thus has indirect effect on customer life-time value (Venkatesan & Kumar, 2004). Though organizations often use several ad channels at the same time, yet the data allowing substantiating their synergistic effect or liaison is not sufficient. It is believed that in the future the effect of word-of-mouth, the Internet hidden ads and public relations on retail customer attraction will continuously grow (Villanueva ir Hanssens, 2007; Hanssens et al., 2008), therefore the organizations for their advertising and promotion should most likely choose these channels.

Organization, using personal interactive communication methods (e.g. personal sales visits) for customer attraction, in a long-term perspective can expect higher value of the customer, whereas in the process of customer retention, less cost and less discomfort to customer causing communication methods, such as Internet channel, telephone sales, may be efficient (Reimartz et al., 2005).
In the process of customer retention as customer equity management stage, organization puts efforts to ensure long-term customer relations and achieve extra sales while performing up-selling and cross-selling to its customer. Customer and organization relationship length, as one of the fundamental prerequisites of customer life-time value increase, has always been in the focus of researchers (Payne & Holt, 2001). Reinartz and Kumar (2003), when providing a conceptual pattern of long-term profitable customer and organization relationship, has stated that the quantity of purchased products, cross-buying, purchase frequency, focus-of-buying, quantity and frequency of returned goods, loyalty instruments used by customer and customer demographic characteristics are the key factors that have effect on customer long-term profitability and hence on value of the customer.

To measure the likely length of customer relationship, organization must analyze customer behavior as well as customer perceptual measures, in particular customer satisfaction, intentions to recommend product, trust and commitment. According to the data of a number of surveys, customer satisfaction has a direct positive effect on relationship length and the customer’s value for organization. The data that substantiate the correlation among the customer satisfaction, intention to repurchase and repeated purchasing exists (Villanueva & Hanssens, 2007). Though Gupta and Zeithaml (2006) have noted that customer satisfaction and commitment constructs are the alternatives to each other, the researchers focused their attention on identifying how commitment can have effect on customer initiative to continue relationship with organization. According to Villanueva and Hanssens (2007), customer future intentions, i.e. the intention to purchase and to recommend products to others must be measured in customer equity patterns. The aim of customer behavior researchers was to understand how organization marketing efforts effected customer decisions on “what, when, how much and where to purchase” (Gupta & Zeithaml, 2006); and in customer equity surveys, the role of marketing efforts and costs factors in increasing customer retention likelihood, should be measured (Villanueva & Hanssens, 2007).

Although value equity constituent with no doubt is a particularly important factor in every stage of customer equity management pattern process, in industries, where the quality of service and products becomes very similar, the importance of value equity in customer retention process becomes less significant. We believe that in customer retention process marketing efforts should be focused on relationship equity, especially taking into consideration the fact that customers constantly estimate competitor’s offers and customer value perception continuously changes (Flint et al., 2002).

Limitations and conclusions

Customer equity concept enables considering the customers as the primary source of current and future cash flows. It can be used for optimal marketing budget allocation planning and increase of return on marketing investments (Lemon et al., 2001; Blattberg et al., 2001; Malthouse & Blattberg, 2005; Rust et al., 2004; Villanueva & Hanssens, 2007).

According to the majority of authors the value of the customer can be best assessed while measuring customer equity and customer life-time value. The efforts of practical implementation of customer equity concept in business have not yet shown the desired outcomes (Hansotia, 2004; Kumar & Rajan, 2009; Epstein et al., 2009). Perhaps, the complexity and insufficient completion of customer equity measurement patterns has influence on the above concept. A significant number of customer life-time value measurement patterns are based on quantitative and financial data, whereas organization and customer relationship measurement has not yet been studied in detail. Integration of customer behavior and perception measures would make the patterns more versatile and increase their validity and relevance for application (Helm, 2004; Jain et al., 2002).

The model, suggested in this article, allows organization to measure its marketing efforts and costs based of customer equity management. The authors view the principal benefit of the model that it may complement quantitative customer equity measurement models that are based on financial equity measurement aspect and at the same time can help organizations better understand the value, created by customer. The primary limitation of this model is that the model has been developed on the basis of the data obtained during theoretical researches and literature analysis. Another limitation of the suggested model is that the effect of competitor organizations marketing efforts put on customer attraction and retention as well as market life cycle impact on customer equity have not been taken into consideration.
References


