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# What Drives Customer Equity

A company's current customers provide the most reliable source of future revenues and profits.

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**Consider the issues** facing a typical brand manager, product manager, or marketing-oriented CEO: How do I manage the brand? How will my customers react to changes in the product or service offering? Should I raise price? What is the best way to enhance the relationships with my current customers? Where should I focus my efforts?

Business executives can answer such questions by focusing on customer equity—the total of the discounted lifetime values of all the firm's customers. A strategy based on customer equity allows firms to trade off between customer value, brand equity, and customer relationship management. We have developed a new strategic framework, the Customer Equity Diagnostic, that reveals the key drivers increasing the firm's customer equity. This new framework will enable managers to determine what is most important to the customer and to begin to identify the firm's critical strengths and hidden vulnerabilities. Customer equity is a new approach to marketing and corporate strategy that finally puts the customer and, more important, strategies that grow the value of the customer, at the heart of the organization.

For most firms, customer equity is certain to be the most important determinant of the long-term value of the firm. While customer equity will not be responsible for the entire value of the firm (e.g., physical assets, intellectual property, and research and development competencies), its current customers provide the most reliable source of future revenues and profits. This then should be a focal point for marketing strategy.

Although it may seem obvious that customer equity is key to long-term success, understanding how to grow and manage customer equity is more complex. How to grow it is of utmost importance, and doing it well can create a significant competitive advantage. There are three drivers of customer equity—value equity, brand equity, and relationship equity (also known as retention equity). These drivers work independently and together. Within each of these drivers are specific, incisive actions,

or levers, the firm can take to enhance its overall customer equity.

## Value Equity

Value is the keystone of the customer's relationship with the firm. If the firm's products and services do not meet the customer's needs and expectations, the best brand strategy and the strongest retention and relationship marketing strategies will be insufficient. Value equity is defined as the customer's objective assessment of the utility of a brand, based on perceptions of what is given up for what is received. Three key levers influence value equity: quality, price, and convenience.

## EXECUTIVE briefing

Customer equity is critical to a firm's long-term success. We developed a strategic marketing framework that puts the customer and growth in the value of the customer at the heart of the organization. Using a new approach based on customer equity—the total of the discounted lifetime values of all the firm's customers—we describe the key drivers of firm growth: value equity, brand equity, and relationship equity. Understanding these drivers will help increase customer equity and, ultimately, the value of the firm.

Quality can be thought of as encompassing the objective physical and nonphysical aspects of the product and service offering under the firm's control. Think of the power FedEx holds in the marketplace, thanks, in no small part, to its maintenance of high quality standards. Price represents the aspects of "what is given up by the customer" that the firm can influence. New e-world entrants that enable customers to find the best price (e.g., [www.mysimon.com](http://www.mysimon.com)) have revolutionized the power of

price as a marketing tool. Convenience relates to actions that help reduce the customer's time costs, search costs, and efforts to do business with the firm. Consider Fidelity Investments' new strategy of providing Palm devices to its best customers to enable anytime, anywhere trading and updates—clearly capitalizing on the importance of convenience to busy consumers.

## **Brand Equity**

Where value equity is driven by perceptions of objective aspects of a firm's offerings, brand equity is built through image and meaning. The brand serves three vital roles. First, it acts as a magnet to attract new customers to the firm. Second, it can serve as a reminder to customers about the firm's products and services. Finally, it can become the customer's emotional tie to the firm. Brand equity has often been defined very broadly to include an extensive set of attributes that influence consumer choice. However, in our effort to separate the specific drivers of customer equity, we define brand equity more narrowly as the customer's subjective and intangible assessment of the brand, above and beyond its objectively perceived value.

The key actionable levers of brand equity are brand awareness, attitude toward the brand, and corporate ethics. The first, brand awareness, encompasses the tools under the firm's control that can influence and enhance brand awareness, particularly marketing communications. The new focus on media advertising by pharmaceutical companies (e.g., Zyban, Viagra, Claritin) is designed to build brand awareness and encourage patients to ask for these drugs by name.

Second, attitude toward the brand encompasses the extent to which the firm is able to create close connections or emotional ties with the consumer. This is most often influenced through the specific nature of the media campaigns and may be more directly influenced by direct marketing. Kraft's strength in consumer food products exemplifies the importance of brand attitude—developing strong consumer attitudes toward key brands such as Kraft Macaroni and Cheese or Philadelphia Cream Cheese. The third lever, corporate ethics, includes specific actions that can influence customer perceptions of the organization (e.g., community sponsorships or donations, firm privacy policy, and employee relations). Home Depot enhanced its brand equity by becoming a strong supporter of community events and by encouraging its employees to get involved.

## **Relationship Equity**

Consider a firm with a great brand and a great product. The company may be able to attract new customers to its product with its strong brand and keep customers by meeting their expectations consistently. But is this enough? Given the significant shifts in the new economy—from goods to services, from transactions to

relationships—the answer is no. Great brand equity and value equity may not be enough to hold the customer. What's needed is a way to glue the customers to the firm, enhancing the stickiness of the relationship. Relationship equity represents this glue. Specifically, relationship equity is defined as the tendency of the customer to stick with the brand, above and beyond the customer's objective and subjective assessments of the brand.

The key levers, under the firm's control, that may enhance relationship equity are loyalty programs, special recognition and treatment, affinity programs, community-building programs, and knowledge-building programs. Loyalty programs include actions that reward customers for specific behaviors with tangible benefits. From airlines to liquor stores, from Citigroup to Diet Coke, the loyalty program has become a staple of many firms' marketing strategy. Special recognition and treatment refers to actions that recognize customers for specific behavior with intangible benefits. For example, US Airways' "Chairman Preferred" status customers receive complimentary membership in the US Airways' Club.

Affinity programs seek to create strong emotional connections with customers, linking the customer's relationship with the firm to other important aspects of the customer's life. Consider the wide array of affinity Visa and MasterCard choices offered by First USA to encourage increased use and higher retention. Community-building programs seek to cement the customer-firm relationship by linking the customer to a larger community of like customers. In the United Kingdom, for example, soft drink manufacturer Tango has created a Web site that has built a virtual community with its key segment, the nation's youth.

Finally, knowledge-building programs increase relationship equity by creating structural bonds between the customer and the firm, making the customer less willing to recreate a relationship with an alternative provider. The most often cited example of this is amazon.com, but learning relationships are not limited to cyberspace. Firms such as British Airways have developed programs to track customer food and drink preferences, thereby creating bonds with the customer while simultaneously reducing costs.

## **Determining the Key Drivers**

Think back to the set of questions posed earlier. How should a marketing executive decide where to focus his or her efforts: Building the brand? Improving the product or service? Deepening the relationships with current customers? Determining what is the most important driver of customer equity will often depend on characteristics of the industry and the market, such as market maturity or consumer decision processes. But determining the critical driver for your firm is the first step in building the truly customer-focused marketing organization.

## **When Value Equity Matters Most**

Value equity matters to most customers most of the time, but it will be most important under specific circumstances. First, value equity will be most critical when discernible differences exist between competing products. In commodity markets, where products and competitors are often fungible, value equity is difficult to build. However, when there are differences between competing products, a firm can grow value equity by influencing customer perceptions of value. Consider IBM's ThinkPad brand of notebook computers. Long recognized for innovation and advanced design, IBM has been able to build an advantage in the area of value equity by building faster, thinner, lighter computers with advanced capabilities.

Second, value equity will be central for purchases with complex decision processes. Here customers carefully weigh their decisions and often examine the trade-offs of costs and benefits associated with various alternatives. Therefore, any company that either increases the customer benefits or reduces costs for its customers will be able to increase its value equity. Consider consumers contemplating the conversion to DSL technology for Internet access. This is often a complex, time-consuming decision. DSL companies that can reduce the time and effort involved in this conversion will have the value equity advantage.

Third, value equity will be important for most business-to-business purchases. In addition to being complex decisions, B2B purchases often involve a long-term commitment or partnership between the two parties (and large sums of money). Therefore, customers in these purchase situations often consider their decisions more carefully than individual consumers do.

Fourth, a firm has the opportunity to grow value equity when it offers innovative products and services. When considering the purchase of a "really new" product or service, customers must carefully examine the components of the product because the key attributes often may be difficult to discern. In many cases, consumers make one-to-one comparisons across products, trying to decide whether the new product offers sufficient benefits to risk the purchase. New MP3-type devices that provide consumers with online access to music are examples of such innovative products and services. Consumers will seek out substantial information (e.g., from the Web, friends, and advertisements) to determine the costs and benefits of new products. Firms that can signal quality and low risk can grow value equity in such new markets.

Finally, value equity will be key for firms attempting to revitalize mature products. In the maturity stage of the product life cycle, most customers observe product parity, sales level off, and, to avoid commoditization, firms often focus on the role of the brand. But value equity also may grow customer equity. By introducing new benefits for a current product or service, or by adding new features to the current offering, firms can recycle their products and services and grow value equity in the process. Consider the

new Colgate "bendable" toothbrush. It seeks to revitalize the mature toothbrush market with a new answer to an age-old problem. The success of this new innovation increases Colgate's value equity.

Clearly then, the importance of value equity will depend on the industry, the maturity of the firm, and the customer decisionmaking process. To understand the role of value equity within your organization, ask several key customers and key executives to assess your company using the set of questions provided in the Customer Equity Diagnostic on the following page.

## **When Brand Equity Matters Most**

While brand equity is generally a concern, it is critical in certain situations. First, brand equity will be most important for low-involvement purchases with simple decision processes. For many products, including frequently purchased consumer packaged goods, purchase decisions are often routinized and require little customer attention or involvement. In this case, the role of the brand and the customer's emotional connection to the brand will be crucial. In contrast, when product and service purchase decisions require high levels of customer involvement, brand equity may be less critical than value or relationship equity. Coca-Cola, for example, has been extremely successful making purchases a routine aspect of consumer's shopping trips by developing extremely strong connections between the consumer and the brand.

Second, brand equity is essential when the customer's use of the product is highly visible to others. Consider Abercrombie & Fitch, the home of in-style gear for the "Net Generation." For A&F aficionados, the brand becomes an extension of the individual, a "badge" or statement the individual can make to the world about himself or herself. These high-visibility brands have a special opportunity to build brand equity by strengthening the brand image and brand meanings that consumers associate with the brand.

Third, brand equity will be vital when experiences associated with the product can be passed from one individual or generation to another. To the extent that a firm's products or services lend themselves to communal or joint experiences (e.g., a father teaching his son to shave, shared experiences of a special wine), the firm can build brand equity. The Vail ski resort knows the value of this intergenerational brand value well. The resort encourages family experiences by promoting multigenerational visits.

Fourth, the role of the brand will be critical for credence goods, when it is difficult to evaluate quality prior to consumption. For many products and services, it is possible to "try before you buy" or to easily evaluate the quality of specific attributes prior to purchase. However, for others, consumers must use different cues for quality. This aspect of brand equity is especially key for law firms, investment banking firms, and advertising agencies, which are beginning to recognize the value of strong brand identities as a key tool for attracting new clients.

## Customer Equity Diagnostic

### How much do your customers care about value equity?

- Do customers perceive discernible differences between brands? Do they focus on the objective aspects of the brand?
- Do you primarily market in a B2B environment?
- Is the purchase decision process complex in your industry?
- Is innovation a key to continued success in your industry?
- Do you revitalize mature products with new features and benefits?

### How are you doing?

- Are you the industry leader in overall quality? Do you have initiatives in place to continuously improve quality?
- Do your customers perceive that the quality they receive is worth the price they paid?
- Do you consistently have the lowest prices in your industry?
- Do you lead the industry in distribution of your products and services?
- Do you make it most convenient for your customers to do business with you?

### How important is brand equity?

- Are the emotional and experiential aspects of the purchase important? Is consumption of your product highly visible to others?
- Are most of your products frequently purchased consumer goods?
- Is the purchase decision process relatively simple?
- Is it difficult to evaluate the quality of your products or services prior to consumption or use?
- Is advertising the primary form of communication to your customers?

### How are you doing?

- Are you the industry leader in brand awareness?
- Do customers pay attention to and remember your advertising and the information you send them?
- Are you known as a good corporate citizen? Active in community events?
- Do you lead your industry in the development and maintenance of ethical standards?
- Do customers feel a strong emotional connection to the brand?

### How does relationship equity weigh in?

- Are loyalty programs a necessity in your industry?
- Do customers feel like "members" in your community?
- Do your customers talk about their commitment to your brand?
- Is it possible to learn about your customers over time and customize your interactions with them? Do your customers perceive high switching costs?
- Are continuing relationships with customers important?

### How are you doing?

- Do customers perceive that you have the best loyalty program in your industry?
- Do you lead the industry in programs to provide special benefits and services for your best customers?
- To what extent do your customers know and understand how to do business with you?
- Do customers perceive you as the leader in providing a sense of community?
- Do you encourage dialogue with your customers?

Therefore, brand equity will be more important in some industries and companies than others. The role of brand equity will depend on the level of customer involvement, the nature of the customer experience, and the ease with which customers can evaluate the quality of the product or service before buying it. Answering the questions in the Customer Equity Diagnostic will help determine how important brand equity is for your organization.

## When Relationship Equity Matters Most

In certain situations, relationship equity will be the most important influence on customer equity. First, relationship equity will be critical when the benefits the customer associates with the firm's loyalty program are significantly greater than the actual "cash value" of the benefits received. This "aspirational value" of a loyalty program presents a solid opportunity for firms to strengthen relationship equity by creating a strong incentive for the customer to return to the firm for future purchases. The success of the world's frequent flyer programs lies, to some extent, in the difference between the "true" value of a frequent flyer mile (about three cents) and the aspirational value—the customer's perception of the value of a frequent flyer mile ("I'm that much closer to my free trip to Hawaii!").

Second, relationship equity will be key when the community associated with the product or service is as important as the product or service itself. Certain products and services have the added benefit of building a strong community of enthusiasts. Customers will often continue to purchase from the firm to maintain "membership" in the community. Just ask an active member of a HOG (Harley-Davidson Owners Group) to switch to a Honda Gold Wing; or ask a committed health club member to switch to an alternate health club. Individuals who have become committed to brand communities tend to be fiercely loyal.

Third, relationship equity will be vital when firms have the opportunity to create learning relationships with customers. Often, the relationship created between the firm and the customer, in which the firm comes to appreciate the customer's preferences and buying habits, can become as important to the customer as the provision of the product or service. Database technology has made such "learning" possible for any company or organization willing to invest the time and resources in collecting, tracking, and utilizing the information customers reveal. For example, Dell has created learning relationships with its key business customers through Dell's Premier Pages—customized Web sites that allow customers to manage their firm's purchases of Dell computers. The benefit: It becomes more difficult for customers to receive the same personal attention from an alternative provider without "training" that new provider.

Finally, relationship equity becomes crucial in situations where customer action is required to discontinue the service. For many services (and some product continuity programs), customers must actively decide to stop consuming or receiving the product or service (e.g., book clubs, insurance, Internet service providers, negative-option services). For such products and services, inertia helps solidify the relationship. Firms providing these types of products and services have a unique opportunity to grow relationship equity by strengthening the bond with the customer.

As with value and brand equity, the importance of relationship equity will vary across industries. The extent to which relationship equity will drive your business will depend on the importance of loyalty programs to your customers, the role of the customer community, the ability of your organization to establish learning relationships with your customers, and your customer's perceived switching costs. Answer the questions in the Customer Equity Diagnostic framework to see how important relationship equity is to your customers.

## A New Strategic Approach

We have now seen how it is possible to gain insight into the key drivers of customer equity for an individual industry or for an individual firm within an industry. Once a firm understands the critical drivers of customer equity for its industry and for its key customers, the firm can respond to its customers and the marketplace with strategies that maximize its performance on elements that matter.

Taken down to its most fundamental level, customers choose to do business with a firm because (a) it offers better value, (b) it has a stronger brand, or (c) switching away from it is too costly. Customer equity provides the diagnostic tools to enable the marketing executive to understand which of these three motivators is most critical to the firm's customers and will be most

effective in getting the customer to stay with the firm, and to buy more. Based on this understanding, the firm can identify key opportunities for growth and illuminate unforeseen vulnerabilities. In short, customer equity offers a powerful new approach to marketing strategy, replacing product-based strategy with a competitive strategy approach based on growing the long-term value of the firm.

## Additional Reading

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