GOING THE DISTANCE WITH TELECOM CUSTOMERS

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Carriers can increase their profits — by getting more value from existing customers and being more selective about new ones.

Telecom service providers in the United States face a sea of troubles. In wireless, the days of double-digit market growth are over, leaving competitors to fight for one another's customers. In wireline, real revenues for local and long-distance calls are falling while competition from new entrants is taking market share from incumbents. Cable operators are suffering from weak balance sheets, tough competition from direct-broadcast-satellite services, and sharply rising programming costs. Not surprisingly, share prices in the sector have tumbled from their highs in 2000, but even today's depressed prices are hard to justify without much-improved margins.

Unfortunately, most industry CEOs are focusing on margin-improving techniques that are either hard to pull off (such as consolidation and truly differentiated products) or difficult to convert into a sustainable advantage (such as cost reductions). But the service providers have so far underappreciated an alternative: maximizing their new and existing customers' lifetime value.

The value of this approach, known as customer lifetime management (CLM), has been proved by several leading financial-services players.[1] CLM involves capturing and analyzing data about customers for the purpose of marketing to and serving them on the basis of the value they are expected to create during their "lifetime" with the company. Leading practitioners annually develop and test thousands of new offers targeted at narrowly defined customer segments and rapidly scale up only the most successful ones. Telecom carriers can secure a competitive advantage by using similar techniques to extract more value and profit from their customer base.

Although some telecom carriers have started down this path, none have embraced CLM as a core institutional capability in the way leading financial-services providers have. Until recently, most telcos were busier expanding their customer base than increasing their existing customers' value. Now that times have changed, many carriers are intuitively striving to increase it, but they tend to tackle discrete opportunities one at a time, without fully appreciating the complexity of CLM or the careful execution required. Some, for example, have tried to reduce churn by offering discount plans and other incentives — but ended up retaining customers they would have been better off losing and making formerly marginal customers unprofitable. Others have tried to contain the surge in unpaid bills by tightening credit limits on new applicants but are now turning away many customers who would have been profitable.

Companies that implement CLM have to eschew this piecemeal approach and follow a set of basic principles. First, they must tailor the way they view and treat the customer. Second, they must follow a rigorously quantitative approach to determine each customer's value and to test initiatives that might increase it. Third, they must embrace CLM as a core institutional capability requiring a new mind-set and new incentives, processes, and tools. In return, companies will find that a single well-planned CLM program can replace the myriad unrelated projects currently overwhelming management's agenda.

Adopting CLM is undoubtedly a challenge, requiring nothing less than a transformation in the way carriers think about and approach consumers. The carriers must balance their efforts to acquire new customers with efforts to maximize the value of existing ones. They must replace "gut-feel" decision making with decisions based on quantitative facts. And throughout the organization, they must develop the skills and mentality required to treat customers by value.

But the potential payoff from CLM should put it at the top of any senior-management group's agenda. This technique's advanced practitioners, such as Capital One Financial and USAA, have built a vital competitive edge, and the first telecom carriers to move beyond today's early CLM efforts should enjoy the same advantage. Our analysis of best-in-class practitioners of CLM suggests that a typical wireless-service provider implementing it effectively would generate a 4 to 5 percent margin increase in earnings before interest, taxes, depreciation, and amortization (EBITDA) in 18 to 24 months — roughly on par with margin increases from industry consolidation and product differentiation. CLM's advantage over them is that it is very much under the senior-management team's control and, done well, likely to provide a sustainable edge.

CLM's potential isn't limited to telecom service providers, cable operators, and ISPs in developed markets; it applies equally well to telecom companies in emerging markets and to businesses in other industries, including express parcel companies, software providers, and health care payers. We illustrate the following discussion mostly with examples from US wireless carriers, but similar CLM programs could be crafted for other kinds of companies anywhere in the world.

THE WIRELESS CONUNDRUM

The outlook for US wireless carriers is challenging. They can no longer grow by acquiring new customers; in fact, their new customers are increasingly likely to have migrated from other carriers, and that will be especially true with the coming of portable telephone numbers.[2] Indeed, churning will account for as much as 80 percent of new customers in 2005. But trying to retain people through better service or innovative new offers will add costs when carriers are anxious to rein them in. At the same time, the carriers' average revenue per user (ARPU) is falling because customers have been slow to adopt new data services, competition is driving down prices for voice calls, and new customers spend less money than existing ones.

Across the industry, measurements and projections of customer lifetime value — the present value of all future revenues and costs associated with the average customer — reflect this tough environment. Subscriber growth rates and average customer lifetime values are falling. Few carriers have offset this decline, or can expect to, by increasing their market share. As a result, the value of their aggregate customer base (the product of the average customer's lifetime value and the number of subscribers) has been flat or falling.

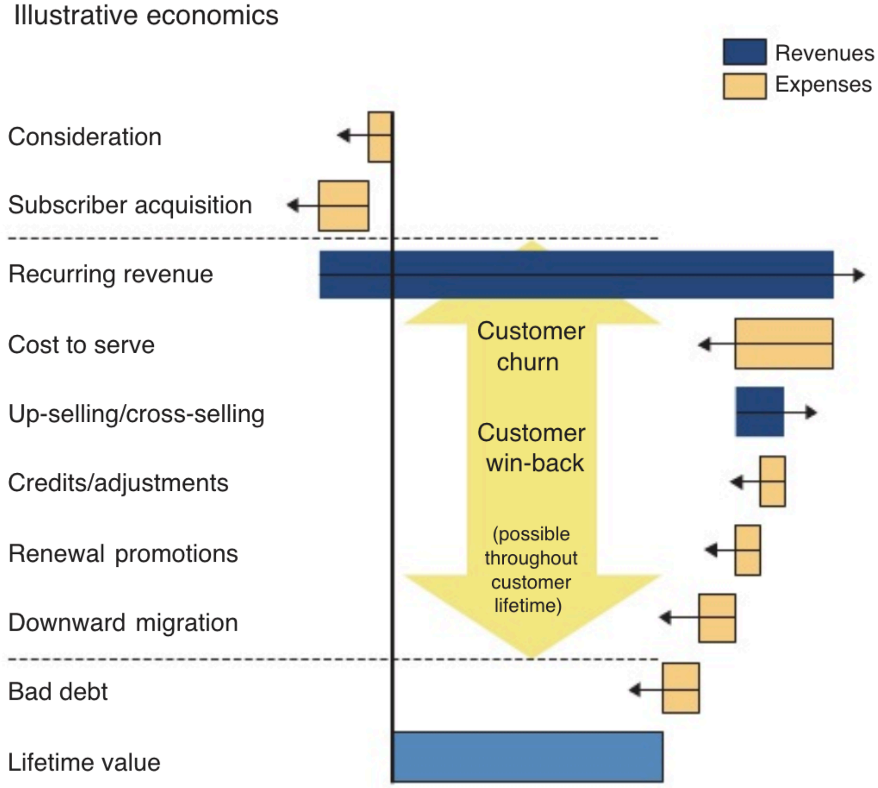
All this means that wireless carriers will have difficulty meeting the expectations of their shareholders as implied by their current stock prices. To justify these prices, the typical carrier will need, by 2008, to have simultaneously limited its ARPU erosion to 1 percent a year and reduced its churn by 9 percent, its acquisition costs by 20 percent, and its service costs by 9 percent. Without fundamental change, meeting all four targets at once presents a spectacular challenge, and it is therefore more reasonable to assume that share prices will probably languish for a considerable time.

There is, however, a ray of hope. Average-customer-lifetime-value figures hide sharp variations among customers — variations caused, for example, by differences in their usage, their reliance on customer care, and their propensity to roam off the network. All customers generate costs and revenues in different ways during their lifetime with a company. Some are recurring and predictable, others one-offs. To reverse the decline in aggregate customer lifetime value, carriers need to tailor the way they serve customers in order to reflect these variations.

In the wireless industry, 11 drivers of costs and revenues determine the lifetime value of customers. Before they sign up, a company invests in efforts to attract them. Over their lifetime with it, all of them generate recurring monthly revenues by paying for their basic plan and generate costs by using the network and the facilities for customer care. However, at any moment, customers may give a one-off boost to a company's revenues by upgrading their services or purchasing additional products — or shrink its revenues by downgrading their services or quitting altogether. Similarly, the company can incur one-off costs by offering benefits to persuade customers to renew their subscriptions, to stop them from churning to competitors, or to win them back when they have. CLM requires companies to move away from a "one-size-fits-all" approach by developing the institutional ability to optimize all drivers of customer value and the relationships between them.

Exhibit 1: Customer Value Drivers

Illustrative economics



A RECIPE FOR CLM

To implement CLM, a company must segment its customer base by value and calculate the lifetime value of each of its existing customers. At one wireless carrier, this initial analysis revealed that 15 to 20 percent of them were actually destroying value. A carrier must next quantify the potential impact of improving all of the lifetime-value drivers and analyze how they are interrelated. In this way, it can anticipate the effect of improving downstream drivers (such as churn and bad debt) on related upstream drivers (such as acquisitions). It will then be able to test new policies and offers aimed at increasing the value of any specific segment and to roll out the most successful of them across the organization.

KNOW YOUR CUSTOMER'S WORTH

The first step in launching a CLM program is to build a model that calculates the lifetime value of individual customers. Data can be drawn from a number of sources: the billing system, the network usage database, and customer service records. For a wireless carrier, the data must include, by customer, expected direct recurring revenues, interconnection and roaming revenues and costs, recorded network usage, the use of customer service, payment behavior, and forecasts (based on the propensity to churn) of the customer's lifetime with the company. Cost and revenue data need to be disaggregated. While a few carriers have done so, many are still averaging too many costs (for instance, customer service, bad debt, and off-network usage) over the entire customer base — an approach that can lead to profoundly mistaken conclusions about the profitability of customers.

Using this model, the carrier must then test the relationships between upstream and downstream drivers to answer questions such as “How much does our low credit hurdle on new customers push up bad-debt levels later?” and “How much does above-average use of customer service diminish a high-revenue customer's value?” Once the carrier understands linkages of this kind, it can calculate the direct and indirect effects of potential marketing and other operational initiatives on all related drivers and thereby avoid unintended consequences.

Consider, for example, an initiative to reduce churn. With the help of prediction models, many wireless carriers proactively get in touch with customers they consider likely to leave them. Usually, however, only a small proportion of the target customers are truly thinking about quitting the carrier, and the cost per customer saved often exceeds $1,000. Some carriers have learned from these expensive campaigns to wait for customers to call in and threaten to quit. (Wireline carriers don't always enjoy this luxury, since customers can often simply sign up with a new provider.)

Customers can bluff about their intentions in order to get incentives such as new handsets. Yet many of these customers may already be economically unattractive, and the carrier could be better off without them. Unless it can identify the worth of each of the customers threatening to quit and treat them accordingly, even a conceptually robust retention program typically fails to capture considerable value — and on occasion destroys value. CLM is about instilling, throughout the organization, the rigor needed to avoid such errors.

A WAY OF LIFE, NOT A ONE-OFF PROGRAM

Once a carrier thoroughly grasps the potential of these drivers and how they are interrelated, it will better understand how to respond to particular problems, such as a spike in churn or a slowdown in cross-selling or upselling.

Consider bad debt, a growing problem for most carriers as they attract younger and less creditworthy customers. The root cause may lie less with the collections department than with the company's acquisitions practices. A certain carrier, hungry for customers, set low credit hurdles for new ones and saw its bad debt increase from 3.9 percent of revenue to more than 6 percent during 2002. At the other extreme, some carriers screen for credit stringently at acquisitions and thus have very little bad debt but forgo a good deal of value. (A number of carriers currently turn away, on credit grounds, 35 to 45 percent of their applicants, many of whom could have been value contributors if managed properly.) Other companies screen for credit more sensitively, but their customer-care agents and retailers have incentives to bypass the credit checks and to sign up undesirable customers who ultimately saddle them with bad debt.

Building CLM capabilities will also allow a carrier to examine the usage, characteristics, and behavior patterns of its subscriber base systematically and to identify ways of boosting the value of particular segments. By capturing the inbound and outbound calling profile of each customer, for instance, the carrier can identify how and when he or she uses the phone and can then tailor offers to stimulate new usage patterns and to boost retention. If a customer, say, never calls between the hours of 10 AM and 11 AM, offers providing free on-network calls during this period have been shown to stimulate additional usage not only for that hour but also throughout the day. Further, these customers' perception that they are receiving increased value reduces their chances of churning, and the shift in network usage away from the peak-usage hours helps limit capital expenditures.

This is a more nuanced way of serving customers than a majority of wireless carriers (and telecom companies in general) currently follow. Most of them target the segments that have the highest average revenues per user; for example, they offer business users nationwide plans with a large number of "anytime" minutes. But the lifetime value of even high-ARPU customers can be sharply different when a company takes into account the costs of serving them throughout the life cycle — such as when they take the idea of "unlimited nights and weekends" literally.

Practicing CLM effectively is an open-ended endeavor, not a one-off blitz of marketing or customer service initiatives lasting six months. The operator must constantly and routinely test, track, quantify, and roll out new initiatives that target specific customer segments across each value driver. Indeed, the financial institutions that first developed CLM as a core institutional capability run thousands of marketing tests each year.

In addition, CLM provides the foundation for efforts to identify and capture broader opportunities in functional areas such as branding, pricing, and channel strategy. Understanding the value of customers who come through different channels can, for instance, allow management to make smarter decisions about which types of retail stores would be the best partners.

GETTING IT RIGHT

Many CEOs may be justifiably wary of what appears at first blush to be an IT-intensive solution. They might have invested quite heavily in customer-relationship-management applications that provided a limited return on investment (ROI) — and still have in the queue a number of CRM-oriented IT projects. The failure of most CRM investments to deliver satisfactory returns has many causes, but chief among them is the failure of companies to appreciate the need to build a detailed understanding of customer economics, to adopt a test-and-learn mind-set, and to reward cooperation across functions and business areas. In effect, the companies viewed IT systems as the answer, not as a tool.

The silver lining is that many telecom service providers now have much of the IT infrastructure they need to embrace customer lifetime management. CLM requires two critical IT capabilities. The first is analytics: a carrier must be able to aggregate data about customers from numerous internal sources (including the network, call centers, and retail stores) and from external sources such as credit agencies. An analytic-services group must then be able to extrapolate the useful metrics, in particular the current lifetime value of customers, their propensity to churn, and an accurate ROI for any new marketing initiative affecting them. This is challenging work and requires a team that possesses strong data-management, statistical, and financial-analysis skills.

In the past, mining customer records for value had an uncertain outcome. But because CLM works backward from a business objective — maximizing the aggregate lifetime value of customers — to the data required to fulfill it, the job of the analysts is much clearer and their efforts are more likely to generate practical, quantifiable strategies. Many data-warehousing projects, in stark contrast, are characterized by heavy IT investments based on poorly defined and quantified business benefits.

The second essential IT capability for CLM is operational. The carrier must capture and deliver customer information quickly to customer-facing channels, such as retail stores and call centers, so staff members know what treatments applied to which customers will add the most value. In addition, call centers need technology that can help them provide differentiated service to their customers — for example, a well-designed interactive voice-response system that makes it possible to navigate through touch-tone menus and provides simple information quickly but doesn't prevent high-value customers from reaching live agents or eliminate opportunities to cross-sell goods and services to likely buyers. Carriers don't need to develop all these IT capabilities at once: successful CLM pioneers built their technology systems step by step, and a majority of carriers already have enough of the required infrastructure from past CRM investments.

If the IT challenges of implementing CLM are easier than they appear, the channel and organizational challenges are frequently underestimated. Well-intentioned CLM initiatives can fail if they ignore the practical complexity of driving systematic change across channels. The necessary changes aren't limited to deploying the latest voice-response units in call centers or Web-based technologies. The ability to test offers quickly and continually requires unprecedented flexibility and coordination within and between channels; agents manning inbound call centers, for instance, must be prepared for questions about a new offer in retail stores. Sales representatives must accept the idea of tailoring different treatments to different customers and trying out new pilot programs whose results are then communicated back to marketing. Changing the way customer-facing employees act, though difficult to do, can generate immediate financial returns.

The “softer” cultural changes needed for success will be a particular challenge for telcos. The whole organization must shift some attention from acquiring new customers to maximizing the lifetime value of those already on board. Leaders must relinquish experience and intuitive decisions and adopt the more data-based CLM approach. The front line must be equipped — and willing — to treat customers with a different value differently. And everyone, from marketing to the customer service organization, must overcome the instinct to develop initiatives in organizational “silos” and instead work together on common priorities.

McKinsey’s experience with transformation programs shows that four conditions must be met before people will change their behavior.[3] A first but often overlooked step is simply to communicate clearly to all employees the logic and importance of CLM. Senior management must actively and consistently model the desired new behavior. Carriers will need to create performance metrics and incentives such as the balanced scorecard to reinforce CLM practices. Many may have to restructure their marketing organizations to strike the right balance between acquiring new customers and boosting the value of existing ones. Finally, carriers must ensure that their people have the skills and knowledge to be successful. This may entail augmenting staff skills, especially in analytics and customer-facing roles, through a combination of training, formal and informal coaching, and hiring.

Leading-edge CLM practitioners in financial services have the “analyze, test, roll out” mentality of CLM ingrained throughout the organization. Telecom carriers won’t succeed in implanting this mind-set merely by mandating it. But carriers — whether they compete in the US wireless, the European wireline, or the Asian cable industry — will develop a matchless competitive advantage if they choose to build the organizational, channel, and IT capabilities needed to identify and capture opportunities to raise their customers’ lifetime value.

NOTES

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1 CLM differs in several important respects from the more familiar customer relationship management (CRM) as it is commonly deployed. CRM is typically an enterprise-software-focused solution that helps companies both to undertake analytics of customer behavior along one or more dimensions, such as estimating a customer’s propensity to churn, and to manage customer sales and service interactions.

2 The US Federal Communications Commission is scheduled to require US carriers to implement portability at the end of 2003.

3 See Emily Lawson and Colin Price, “The psychology of change management,” *The McKinsey Quarterly*, 2003 special edition: The value in organization, pp. 30–41; and Jennifer A. LaClair and Ravi P. Rao, Helping employees embrace change, *The McKinsey Quarterly*, 2002 Number 4, pp. 17–20.

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