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Customer Centricity in the Telecommunications Industry

Transformation from Product-Centric to Customer-Centric and Creating Competitive Advantage Along the Way

WHITE PAPER:
COMMUNICATIONS

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ABSTRACT

EXECUTIVE LEADERS ACROSS ALL INDUSTRIES CONTINUE TO FACE THE MOST DISRUPTIVE MARKET CONDITIONS IN DECADES.

INCREASED COMPETITION HAS ONLY ACCELERATED. LARGE RIVALS CONTINUE TO COMPETE AGGRESSIVELY BUYING MARKET SHARE, NEW ENTRANTS ARE MORE NIMBLE AND SUBSTITUTE PRODUCTS SEEM TO POP UP ALMOST AT EVERY TURN.

THESE COMPETITIVE FORCES PARTICULARLY APPLY TO THE TELECOMMUNICATIONS INDUSTRY. WITHIN THE TELECOMMUNICATIONS CATEGORY, COMPETITORS CONTINUE TO SLUG IT OUT FOR INCREASINGLY DEMANDING CUSTOMERS WHO TREAT PRODUCTS AND SERVICES AS COMMODITIES AND WHERE PRICE UNFORTUNATELY BECOMES THE ONLY DIFFERENTIATOR. FACED BY ERODING PRICING POWER, TELECOMMUNICATIONS EXECUTIVES FIND THEMSELVES IN A DOWNWARD SPIRAL OF PRICE DEFLATION AND PROFIT PRESSURE.

THIS WHITE PAPER PROVIDES THE LATEST INFORMATION ON HOW PROVIDERS CAN BECOME MORE CUSTOMER CENTRIC WHILE BUILDING GREATER COMPETITIVE ADVANTAGE.

SOME CUSTOMERS AND SEGMENTS ARE THE ENGINE THAT DRIVES NET INCOME, WHILE OTHERS ARE DESTROYING IT.

Executive Summary

Executive leaders across all industries continue to face the most disruptive market conditions in decades. Increased competition has only accelerated; large rivals continue to compete aggressively buying market share, new entrants are more nimble and substitute products seem to pop up almost at every turn. These competitive forces particularly apply to the telecommunications industry. Within the telecommunications category; competitors continue to slug it out for increasingly demanding customers who treat products and services as commodities and where price unfortunately becomes the only differentiator. Faced by eroding pricing power, telecommunication executives find themselves in a downward spiral of price deflation and profit pressure.¹

The telecommunication industry consists of telephone companies, cable TV companies, wireless companies and satellite TV companies. For many years, these providers and operators played the incumbent role within their own service area without much thought to competition. The introduction of the Internet changed the playing field forever.

Since then, there has been overlap of services and blending into new categories. Both cable TV and phone companies began offering broadband access to the Internet in direct competition to each other. Cable TV began to offer telephone service. Wireless began to steal landline phone customers. Satellite TV steals customers from Cable operators. The blurring of traditional lines, operators offering new products, and crossing over into new categories created a highly competitive industry. A result of this change is significantly higher customer churn as providers and operators “exchange” subscribers on a monthly basis. As one executive stated, “my customer today is your acquisition target tomorrow and vice versa.” The chief executive officer and senior executives are left wondering how they can break out from flat to moderate growth and begin to once again deliver shareholder value in a now highly competitive industry with no end in sight.

That customers are important assets of a company is not necessarily a new idea. Senior executives readily agree that customers are critical to the survival of the organization, however, their strategy, business model, organizational alignment and execution does not match their rhetoric. For example, a Fortune 500 company claimed in 2001 to have just “three strategic imperatives,” one of which was “creating a customer-centric culture to better satisfy and serve our customers.” A Wall Street analyst reported at the time that one of the firm’s executives stated, “We have a heightened sense of urgency and a clear focus on the customer, and we are working as one unified team to make retail history.” The company was Kmart. A year later it filed for the largest bankruptcy petition of any retailer.²

Let’s look at the telecom industry closer. Most telecommunication providers have an organizational design that can be best described as an “inside-out” structure that puts products at the center of the organization, not customers. The various functional areas across sales, marketing, service, operations and finance use different tools and methodology to measure performance, however, most organizational metrics are product-oriented, such as revenue across cable TV, landline phone and high-speed Internet access. Furthermore, there is little, if any, alignment across the functions on how to measure true value—and are these product-oriented measures the right ones in the first place? Our hope is not only to show a link between customer value and organization value, but identify the critical levers that drive shareholder value. The intent is to provide a framework that will bridge the functional areas (including marketing and finance) by providing a common language and specific metrics that can be leveraged across the functions. And at the same time, our goal is to highlight customer-centric strategies that are proven to create differentiation in an ever-increasingly commoditized market.

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Angel Customers and Demon Customers

The functional areas are often measured differently and perhaps have differing priorities. For example, marketing is perhaps focused on average revenue per unit (ARPU), sales is focused on new customer acquisition, and service is reducing churn and increasing retention. These are certainly all key activities, but does the organization have a line of sight into customer performance and profitability to make the strategic decision on customer investment, resource allocation and cross-channel treatment? A company consists of both profitable and unprofitable customers; perhaps we call them “angels” and “demons.” Some customers and customer segments are the engine that drives net income, while others are destroying it.²

Let’s put some rigor to the definition and define unprofitability as failing to earn the cost of capital. It is common for senior executives to confidently say they “do not have unprofitable customers,” even though the business is failing to earn its cost of capital. Analyzing customer profitability proves more times than not that they are mislead. In fact, some of the customers are deeply unprofitable; meaning that doing business with them on the current terms is reducing the firm’s market capitalization by hundreds of thousands of dollars per customer! Studies have shown that the bottom 20 percent of customers by profitability can generate losses equal to more than 100 percent of total company profits.³ (superscript) Some telecommunication providers certainly have detailed reports on product performance and revenue such as ARPU, but lack the line of sight into customer segment performance and profitability, and lack the strategy, collaboration and execution capability across the functions and channels to optimize investment and treatment.

All too often, companies over-invest in low value/low potential customers and under-invest in high value/high potential ones. This misuse of capital alone is wreaking havoc on organizational performance. Most companies frankly don’t know the difference between their angels and demons or have the strategy or execution capability to differentiate investment and treatment. Your market capitalization depends entirely on the future profitability of your existing customers and your ability to attract and retain profitable new customers in the future. How would you rate your organization’s ability to execute against customer profitability?

Let’s look at an example. A mid-tier cable operator was acquiring approximately 3,000 new residential cable TV subscribers per month. The sales leader and general manager were pleased as they continued to achieve their monthly acquisition quota. Marketing was spending dollars on mass advertising (TV, radio, print and billboards) to create awareness and drive leads into the channels. Everything is A-okay right? Not necessarily. After conducting further analysis, we discovered that the cable operator was acquiring exactly the wrong type of customers—demons—and didn’t even know it. Across the three major product offerings, cable TV is by far the least profitable due to the associated fixed costs, including programming, labor, set-up, truck-roll and hardware. Analyzing the acquisition results produced a startling fact; the majority of churners are cable TV buyers! Turns out, this one product only subscriber had a tendency to buy on promotion and terminated just prior to annual renewal by switching to a lower cost competitor. The cost of acquisition (CPGA) was approximately \$400 and thus, these demons were not only not breaking even, but destroying shareholder value. Although the sales manager and the GM were “hitting their numbers” the nature of the acquisition efforts were bringing on exactly the wrong type of customer—demons.

THERE IS NO BETTER EXAMPLE OF VALUE DESTRUCTION THAN CUSTOMER INTERACTION AT THE CALL CENTER.

There is no better example of value destruction than the interaction with a customer at the call center. It is an example of how firms aligned around products, not customers, leave money on the table. Just recently, spending time at a CARE center highlighted the issue and challenge facing most telecoms. The call service representative (CSR) relies on numerous applications at the desktop to manage customer interactions. Most telecoms pump data from the internal billing system into the CSR desktop application. In this particular example, the CSR received a call from a current subscriber who wanted to terminate the relationship with this particular telecom. The CSR dutifully asked why and the customer replied that he had received a "better offer" from a large tier national provider. The CSR had only seconds to make a decision on how best to handle the situation and develop a save strategy.

The information pumped into the CARE application consists mostly of transactional information; customer name, address, phone, monthly revenue contribution, product history, trouble ticket history and renewal date. The CSR fairly quickly navigated a few pop up screens and began to "match" the same offer to the subscriber that the national carrier had provided. What was striking about this and many other similar interactions is that the CSR lacked true insight into the value of that particular customer, including profitability. The entire CARE organization operates day in and day out with no idea which inbound customers are angels versus which ones are demons. Afterwards the EVP of the CARE organization sighed, saying that almost each interaction resulted in a "race to the floor," especially when the large tier national competitors were entering into their footprint.

Lifetime Value and Customer Centricity Framework

Strategies, operating models and measurements designed around products, not customers, are key contributors to organizational under-performance. We have developed a framework that bridges the gap between the various functions (including marketing and finance) that provides a common language, so the functions collectively can align on strategy and make more effective decisions regarding investment and treatment. Let's take an example.

There is a pretty big divide between marketing and finance executives. Marketing managers are proud of the improvements in awareness, brand image and customer satisfaction as a result of marketing spend, however, they are less confident in the relationship between these metrics and overall value of the firm. It is difficult, if not impossible, for marketing managers to say how much an extra point of customer satisfaction is worth. Should the organization push forward and spend \$500,000 to improve customer satisfaction for a marginal improvement rating? How about spending an additional \$1.5 million in a mass advertising campaign to create awareness across the prospect universe? With such large expenditures at stake, executives demand tangible results. The fact is many of the benefits from these marketing initiatives tend to be long-term in nature. Measurement is harder and the debate between marketing and finance grows louder. At the same time, while marketing may be too focused on sales growth, the finance organization may be too myopic in not treating customers as assets and marketing expenditures as long-run investments.

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Customers are indeed assets that generate profits over the long run, so marketing expenditures to acquire and retain these customers should be treated as investments, not expenses. Rather than using traditional metrics such as product revenue (ARPU or RGU's), the fundamental building block for the approach is the value of a customer, called the lifetime value (LTV) of a customer. LTV is defined as the present value of all future profits generated from a customer. This LTV framework combines several key components; the importance of not only current but also future profits, the time value of money (\$100 of profits today is worth more than \$100 of profits tomorrow), and the possibility that customers may not do business with a firm forever. To build the LTV model, we need two key pieces of information: customer profit patterns and their churn rate.⁶

Transformational step #1: Use a lifetime value model that measures customer performance and profitability to begin the organizational shift from product-focus to customer-focus

In its simplest form, customer lifetime value is the present value of a customer based on future cash flows attributed to the relationship. Essentially, the figure represents how much a company can spend acquiring and keeping your customers. This produces a net value of increasing your retention rate (or decreasing churn) and the value of increasing ARPU.

Lifetime value can be calculated across the entire customer base, but to make the metric truly valuable; it should be calculated on a segment-by-segment basis. Later, we will look at a specific example for calculating customer lifetime value for a telecommunications provider that offers television, phone and high-speed Internet. Before we enter into an example, there are several required pieces of input that drive the LTV output:

- **Churn Rate**—Percentage of customers who end their relationship over a specified time period. For the example below, we will use an annual figure. To determine retention rate, simply take 1-churn rate.
- **Discount Rate**—Cost of capital used to discount future revenue from a customer.
- **ARPU**—Average revenue per unit; remember that this should be calculated for the particular segment if you are working on a segment-by-segment basis.
- **Cost per Gross Ad**—Cost of adding a new customer within this segment. So remember, for a triple play customer, you should have the total cost to add that customer for all three products.
- **Cash Cost per Unit**—Cost to service a customer at the same period you calculate ARPU. For example, if ARPU is a monthly number, CCPC should also be a monthly number.
- **Total Marketing Cost**—How much you currently spend on marketing.

Got the metrics? Good, now let's start to build out the calculations for your lifetime value. Let's start with year-one calculations.

LIFETIME VALUE OF A TRIPLE PLAY CUSTOMER

LTV Calculator	Year 1 Value	Explanation
Customers	500,000	Total customers on file (within segment)
Churn Rate	12%	Annual Churn of Customers
Retention Rate	88%	(1.00-Churn Rate)
ARPU	\$141	Total Annual Revenue per Customer
Total Revenue	\$846,000,000	Total Customers*ARPU
Costs		
CPGA	\$800,000,000	Total Customers*CPGA
Landline CCPU	\$156,000,000	Total Customers *Landline CCPU
Broadband CCPU	\$120,000,000	Total Customers *Broadband CCPU
TV CCPU	\$210,000,000	Total Customers *TV CCPU
Marketing Expenditure	\$5,000,000	Total Expenditure on Marketing
Total Cost	\$1,091,550,000	SUM(All Expenses)
Gross Profit	(\$245,550,000)	Total Revenue – Total Cost
Discount Rate	1.00	In Year 1, this is always 1.00 as it is the present value
Net Present Value Profit	(\$245,550,000)	Gross Profit/NPV
Cumulative NPV Profit	(\$245,550,000)	Cumulative NPV
Lifetime Value	(\$122.78)	Cumulative Gross Profit/Total Customers

LIFETIME VALUE IS DEFINED AS THE PRESENT VALUE OF ALL FUTURE PROFITS GENERATED FROM A CUSTOMER.

We now have our baseline year-one calculation. Often, you will find that year-one customers will cost you money to service. This is due to fixed and variable costs associated with new customer acquisition. Do not dismay, because this is not the number that is most important. What becomes interesting here is when we take a look at years two and three in the LTV calculation.

So far, we have assumed our fictitious telecom provider was executing a status quo strategy relying on the internal billing system for reporting, analysis and marketing programs. Let's now assume for our purposes here that the telecom provider began to shift its thinking beyond product performance and focused on customer performance. Let's assume they upgraded their capability to include a marketing database that integrated and consolidated internal with external data sources to provide a holistic view of customers and prospects. Secondly, they acquired analytic capability to predict customer churn and propensity to buy "best next product" offerings. And they developed customer segments based on profitability and modeled best customers for more effective acquisition targeting. And so on.

FULL THREE-YEAR LTV CALCULATION

		Acquisition Year 1	Year 2	Year 3
Lifetime Value Framework				
Customers		500,000	440,000	387,200
Churn Rate		1.0%	0.98%	0.95%
Retention Rate		88%	89%	89%
ARPU		\$141	\$151	\$161
Revenue		\$846,000,000	\$797,280,000	\$748,070,400
CPGA	\$1,200	\$600,000,000		
Landline CCPU	\$26.00	\$156,000,000	\$137,280,000	\$120,806,400
Broadband CCPU	\$20.00	\$120,000,000	\$105,600,000	\$92,928,000
TV CCPU	\$35.00	\$210,000,000	\$184,800,000	\$162,624,000
Database Marketing	\$1.10	\$550,000	\$484,000	\$425,920
Total Marketing	\$10.00	\$5,000,000	\$4,400,000	\$3,872,000
Total Cost		\$1,091,550,000	\$482,564,000	\$380,656,320
Gross Profit		(\$245,550,000)	\$364,716,000	\$367,414,080
Discount Rate		1.0	1.16	1.35
Net Present Value		(\$245,550,000)	\$314,430,345	\$272,158,578
Cumulative NPV		(\$245,550,000)	\$68,860,345	\$341,018,923
Lifetime Value		(\$122.78)	\$34.43	\$170.51

A few changes were made, including a marginal increase in marketing investment, however, look closely at the business outcomes:

- Churn was reduced by a small amount
- ARPU was increased by \$10 per month

The punch line is...a small reduction in churn and marginal improvement in ARPU led to a major increase in lifetime value! The lifetime value framework is a highly quantitative tool grounded in the finance domain that bridges the divide between the functional areas (marketing and finance in particular), gaining alignment on a methodology to develop a common language between the functions to chart a customer strategy framework that will drive investment, resource allocation and cross-channel treatment.⁴

Transformational step #2: Manage the customer segments to optimize shareholder value

A firm provides value to a customer in terms of products and services, and a customer provides value to a firm in terms of a stream of profits over time. Investment in a customer today may provide benefits to the firm in the future. In that sense, customers are assets in which a firm needs to invest. At the same time, with any investment, the firm needs to assess the potential return. Since some customer segments drive profits and others do not, investment in customers should vary by their profit contribution and potential.

Many executives boast how "customer-focused" their organization is, however, let's put these claims to the test:

1. Who in your company "owns" the customer?

Which one, specific, identifiable person is responsible for understanding a designated customer segment thoroughly, for designing and executing value propositions that are better than your competitor, while staying aligned with their value contribution, ultimately driving shareholder value? The truth is, at most telecoms the answer is no, or, as one executive recently said "lots of people own the customer." When everyone owns the customer, no one does.

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2. Who is accountable for the profitability of customer segments?

Most telecoms assign managers to products and measure performance at the product level (landline phone, wireless voice, high speed internet or cable TV). In fact, most organizations lack insight into customer profitability to identify the angels and demons within their customer portfolio. It is not intellectually honest to claim your company has “put the customer first” if your firm does not know which customer segments are driving shareholder value and which ones are destroying it—and no one executive is responsible for segment performance.

3. How significantly does your firm differentiate its interactions with different customers?

Companies that put customers at the center of their organization don't invest and treat customers the same. On the contrary, the customer-centric leaders understand the importance of a mutually beneficial value exchange and treat customer segments differently based on their respective value contribution.²

Customer profitability is influenced by three factors: customer acquisition, customer margin and customer retention. These three factors are the critical drivers of the firm's growth and overall profitability. Let's dive deeper into each and flesh out how the customer-centric leaders manage customer segments differently based on value contribution.³

Customer Acquisition: The cost to acquire a new customer can be significant. It makes economic sense to spend, say, \$350 to acquire a customer only if the value of customer to the company over the lifecycle is more than \$350. Pretty simple? Most firms do not have a good handle into the true cost of acquisition (cost per gross add) and continue down a “blanket” mass advertising approach.

Telecoms typically rely on a mass advertising approach, including TV ads, radio, billboards, promotional events and web activity (banner ads). Additionally, many buy lists of prospect names from data vendors and pump direct mail into the mail stream. This type of acquisition strategy results in high customer churn and ultimately destroys shareholder value. As stated earlier, a cable operator had used various marketing media vehicles (mass advertising and direct mail) without knowing its own customer profitability in the first place. Not knowing the characteristics of their angel customers, how can they expect to develop highly targeted acquisition programs to find the next angel or look-alike? That's precisely the reason why many new subscribers don't hit their break-even point nor ever become profitable. The majority of the cable operator's churn turned out to be cable TV-only buyers that bought on promotion, were never interested in a triple play offering and were likely to churn prior to the year-one renewal.

Customer Margin: While customer acquisition focuses on growing the numbers of customers, increasing customer margin focuses on growing the profit from each existing customer. Most telecom firms use average revenue per unit (ARPU) or revenue generating unit (RGU) as a measurement stick; however, most firms leave money on the table in this critical area. Telecoms execute fairly simplistic up-sell and cross-sell programs based on simple math; if customer has product A and B not but C, offer C. These firms do not deploy rigorous analytics and propensity to buy modeling to identify growth opportunities across the segments and lack the marketing delivery capability to execute on targeted offers. As an example, during an engagement with a mid-tier telecom provider, we conducted deep analytics across customer purchase behavior and from that insight developed highly targeted cross-sell and up-sell programs. For example, the average video on demand (VOD) purchase price is \$4 per buy; increasing the purchase rate by 1.0 per customer per month resulted in \$15 million per year pure profit.

SMALL REDUCTIONS IN CHURN AND MARGINAL IMPROVEMENTS IN APRU LEAD TO MAJOR INCREASES IN LIFETIME VALUE.

Customer Retention: Analyzing the telecom industry shows that the cost of acquisition is generally much higher than the cost of retaining existing customers. Therefore, it seems obvious that a firm should focus on retaining its existing customers. It is also fair to say that most telecoms have a general idea of their attrition rate; however, they are essentially helpless in predicting and intercepting churn. It is not as if these firms don't spend marketing dollars to retain customers—they do. The biggest issue is they lack a line of sight into which segments are angels and demons. Let's flesh out an example. Too many telecoms rely on simplistic analysis in an attempt to predict attrition based on a few indicators, such as renewal date, trouble ticket and competition. An executive of a cable operator described his retention efforts as "simple spreadsheet really based on gut that produces hunches and worse yet, nothing that is actionable." In this particular case, lacking a line of sight into churn led to spending scarce marketing dollars across the entire customer base to find the 2 to 3 percent real churners. Each domain across sales, marketing and services conducted some type of analysis around churn, however, the analyses were all conducted in silo's, producing sub-optimal results. And the bottom line proved it.³

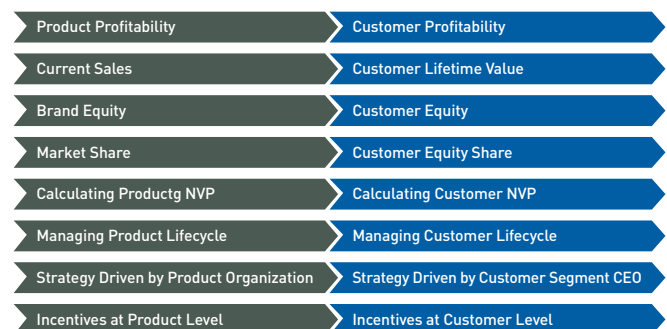
Transformational step #3: Organize around customers and executive competitive value propositions that align with customer value creation

By this point, it would be a fair question to ask "who are the companies that execute customer centricity?" In fact, there are a few well-documented examples of organizations that have shifted their strategy, operating model and execution from products to customers and have harvested the results ever since. Some of these leaders include Best Buy, Harrah's Entertainment, Apple, American Express, Cisco, Four Seasons, Royal Bank of Canada, and Southwest Airlines. These leaders manage their customer segments extraordinarily well and that's the primary reason they continue to deliver shareholder value quarter after quarter.²

Most telecoms are structured and aligned around products, not customers. For example, they have vice president-level managers responsible for specific products, including wireless, high speed internet or VoIP. These managers are measured and incented on top line revenue generation by product and thus build and execute strategy to achieve their yearly quota objective. These product-oriented strategies barely take into consideration the mutually beneficial relationship between customer and firm. One telephone company recently described a situation where it's common for a customer to receive four to six promotions within a thirty-day time period, all originating from different product managers at the organization. Contrast that to an organization that is customer-focused, with designated customer segment managers who are measured and incented on mutual value creation between the firm and customers.

Over the past ten years, companies built around an "inside-out" mind set—pushing out products to the marketplace based on a customer view that looks at them only through the narrow lens of products. That view has made them less competitive than those organizations that have transformed to an "outside-in" mindset that puts the customer at the center of the organization and looks to deliver competitive value propositions. Outside-in orientation, strategy, operating model and execution maximizes customer lifetime value and ultimately creates differentiation between you and your competitors.

Customer-Centric Metrics



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An important factor in the customer-centric leaders named above has been their recognition that information from across functions must be integrated for a more valuable view of the business. With this framework, customer information and insight is placed in a holistic context, and then turned into action, which in turn necessitates an enterprise-wide effort across relevant domains ranging from marketing, service, sales, operations and finance. With alignment on customer lifetime value, functions can more effectively and efficiently drive collaboration, drive differentiation and create shareholder value.

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