KINETIC CONSULTING

Accelerating Business Growth

The Real Financials of CX

CX Economics

The best starting point in understanding the real financial value of customer experience is to have a better appreciation for what a CX program is trying to accomplish. There are many different reasons why an organisation may embark on a plan to improve its customer experience performance. A simplistic approach is to identify any targeted departmentally focused initiatives as tactical in nature and any whole-of-company approach as strategic. Tactical actions taken by an organisation are designed to fix a specific aspect of their business that is generating lower CX results. Tactical initiatives tend yield short-term results that are not sustainable in the longer-term because they often do not address more significant root cause problems that are creating the issue.

Strategic approaches to CX take a holistic approach by addressing all company parts impacting the customer. A strategic approach will comprise several initiatives that aim to improve a wide range of business components such as products, services, people, technology, processes, and culture to improve the customer experience. The ideal strategic approach is when the organisation designs a CX program that is transformative in nature and aims to differentiate the company in the marketplace.

The economics of strategic programs can lead to the most substantial financial benefits. Strategic CX programs aim to create a new positive bias towards the products and services of a company. This increase in favouritism occurs typically throughout the entire customer lifecycle. The reason it usually occurs throughout the whole lifecycle is that an effective CX program builds a stronger emotional bond with customers and the brand. Emotional attachment is the currency that generates the economic outputs of an effective strategic CX program. The stronger the attachment that customers have with the brand the greater the economic benefits a company is likely to receive.

What are the main economic outputs of a strategic CX program? The answer to this question can be truncated into five key financial outputs:

1. Increase in the number of new customers
2. Increase in customer retention from existing customers
3. Increased spending from existing customers
4. Reduction in operating costs
5. Increase in brand value

To design a compelling customer experience program the initiatives need to be measured using one or more of the financial metrics listed. Without these measures the initiatives are unlikely to translate back to the desired economic benefits expected from having a differentiated customer experience in the marketplace. Before we outline the types of financial measures to CX initiatives we will cover one of the often overlooked economic benefits of CX which is brand value.

CX & Brand Value are Inextricably Linked

Brand value is often a dimension that is not considered when putting together the commercial business case for corporate customer experience. However, it plays a significant role. Brand value is typically the largest single asset in any company valuation. For example, Apple's brand value in 2019 was US$205.5B, and the company's overall market value was approximately US$1 trillion. The brand is an intangible asset that has a significant impact on whether customers will pay a premium amount for a company's products and services. Professional brand valuations are completed following an ISO 10668 standard.

There are 6 key ISO requirements that need to be met in a brand valuation:

1) **Transparency**

   Monetary brand valuation processes shall be transparent. This requirement includes disclosure and quantification of valuation inputs, assumptions and risks as well as when appropriate, sensitivity analyses of the brand value to the main parameters used in the valuation models.

2) **Validity**

   The valuation shall be based on valid and relevant inputs and assumptions as of the value date.

3) **Reliability**

   If a valuation is repeated, it shall reliably give a comparable and reconcilable result.

4) **Sufficiency**

   Brand valuations shall be based on sufficient data and analysis to form a reliable conclusion.

5) **Objectivity**

   The appraiser shall conduct the valuation free from any form of biased judgement.

6) Financial, behavioural and legal parameters

When performing a monetary brand valuation, financial, behavioural and legal parameters shall be taken into account, the aforementioned parameters forming part of the overall assessment. The monetary brand valuation shall be conducted on the basis of the findings from the financial, behavioural and legal modules.

A market valuation is the most common method used for brand valuations. Value is in the eye of the beholder, so it is essential to determine whether an asset is to be valued from the perspective of **a typical purchaser**. Big data and small data are analysed to determine:

- Public statements made in the media
- Social media conversations about your brand
- Semantics analysed to determine brand influence in the market
- Frequency of terms used about the brand
- Conversations about competitor brands
- Sales performance of the company
- Legal rights

Brand valuations are therefore **tightly linked to customer experiences** and what customers are saying about your brand. When brands grow the trust with customers, so does the value of the brand increase. The converse occurs when trust is lost. Loss of brand value due to a drop in trust was clearly demonstrated this year with Facebook. The Cambridge Analytica data scandal led to a large number of Facebook customers losing confidence in how Facebook was managing and using their data. The breach in trust between Facebook and their customers saw the brand value drop by 6.1% on the previous year which equated to a US$5.33 billion loss in brand value alone for Facebook in 2019.

Brand value is not only a real financial asset, but it can be easily measured using a financially accepted standard. A strategic CX strategy should factor in the uplift in brand value based on the successful execution of the plan leading to increased trust and loyalty from customers. Even a conservative estimate of 0.5% increase in brand value could easily justify the costs of implementing a strategic CX program by providing a three-dimensional view of the potential ROI offered by an effective CX program.

5 Metrics to Measure CX Value

The metrics covered in this section are designed to provide organisations with a tangible way of determining the real financial impact their CX initiatives are having on the organisation. Unlike other measures such as NPS, that doesn't reveal the direct economic implications, some other measures should be monitored, and targets set, to reveal if the CX strategy is achieving the set financial objectives.

In the earlier section, we provided an outline of the critical financial outputs from strategic CX programs. These economic outputs can be translated into practical initiative based objectives such as:

- Reduce the cost of customer acquisition.
- Increase the number of customer acquisitions.
- Reduce customer churn rate.
- Increase the frequency and spend of each transaction.
- Increase customer lifetime.
- Reduce the cost of support and retention.

There are five key metrics that can be applied to measure these objectives:

1) **Current cost to acquire a new customer** (CAC) CAC is defined as follows:
    - *CAC = sum of all sales & marketing expenses/number of new customers added*

Simply applied, a company that is spending $1 million annually in marketing expenses and is able to acquire 500 new customers would have a CAC of $2,000.

2) **Customer lifetime** can be calculated using the following formula**:**
    - *CL = 1/ customer churn rate*

CL is how long you can keep a customer before he or she leaves your organisation. To understand a customer's value to the organisation, you need to know the length of time the individual interacts with you as a customer. CL can be gleaned from your annual or monthly churn rate.

Some organisations, particularly those that see themselves as a single sale business, may find this seemingly simple task quite difficult. However, every organisation does have a CL, even if it has not thought about its customers in that way. For example, a government entity providing power to customers may be a monopoly, but it also has customers continually connecting and disconnecting power, and thus a CL is associated with its customers. A cohort of its customers over a period of time would reveal an average churn rate.

Using the formula, and hypothetically applying an annual churn rate of 10 per cent to the company's customer base, the CL would be ten years. So on average, the company would be billing the same customer for ten years.

3) Customer Lifetime Value (CLV)

CLV is how much a customer will spend with the company during his or her CL. Four key inputs are required in order to arrive at this metric, generated using historical figures or future dates based on predictions. Often organisations should calculate both historical and predictive CLV because the current pace of change in the marketplace means historical CLV is unlikely to provide a reliable metric when formulating business decisions for the future. There are numerous ways to calculate CLV; two common methods are outlined here.

1. Historical CLV

Using historical data to determine the CLV has limitations: It reveals only what the customer was worth to your organisation in the past, not what the customer will be worth in the future. However, you must calculate historical CLV to ensure that any predictive calculations using forecasts are as accurate as possible.

When you know what the customer is spending over a period of time, you can calculate historical CLV as follows:

- *historical CLV = (sum of all transactions made) x gross profit margin*

So if a customer spends $21,000 in sales over seven years at a gross margin of 30 per cent, then the historical CLV for the customer is $6,300.

2. Predictive CLV

In this calculation, you are seeking to predict the future value of each customer to the organisation. Predictive CLV is complex and requires a number of factors to calculate it, including

- the lifetime of a customer in months (MCL),
- the average gross margin on the products or services the customer buys (AGM),
- the number of repeat purchases on a monthly basis (MRP), and
- the average expenditure per transaction (AET).

When you know these figures, you can calculate predictive CLV using this formula:

- *predictive CLV = ((MRP x AET) x AGM%) x MCL*

For example, assume the following about customers of a telecom company on a contracted plan:

- MCL = 120 (ten years) AGM = 30% (assumed)
- MRP = 1 (the customer is billed only once a month) AET = $300 (assumed monthly plan cost)

In this case, application of the formula would be as follows: CLV = ((1 x 300) x 30%) x 120
The predictive CLV for the company is, therefore, $10,800 per customer.

This simple application of the formula depicts the basic aspects you must consider when calculating CLV.

4) Customer Retention Cost calculated as follows:

CRC = total retention expenditure /total customers retained

During the customer lifetime, there may be additional costs related to customer retention that are not captured as separate items in the company's profit and loss statement. These costs affect the company's profitability and overall bottom line and should be taken into consideration using If the total customers retained in twelve months equal 200,000 and the total retention costs are $5 million annually, then the cost to retain a single customer is $25 per year. If this were a fixed cost, then using a CLV of 10 years, the cost of retention over the ten year lifetime would be $250. Subtracting this amount from the CLV calculation would offer a better sense of the value of the customer.

5) Average Margin Per User (customer) – AMPU

The formula to use is as follows:

AMPU = Operating revenue – operating expenses/average number of customers for the reporting period

Tracking the gross profit of each customer segment and your overall customers will provide a good indication of which customer segments are profitable and if your cost of servicing them is where it needs to be.

These five metrics can provide the organisation with a measurable and tangible way to track the economic impact the CX program is having on the bottom-line financials of the company. Simply put, if your CX initiatives are not making a positive change in these numbers, then it would be challenging to claim the CX strategy is working.

Enterprise Value: The Hidden CX Metric

Every organisation, based on the type of industry sector and the maturity level of the marketplace, has different potential to attract and retain customers. We will use a conservative hypothetical example to illustrate the economic benefits of a strategic customer experience program. Any commercial organisation (other than a start-up) is valued in the marketplace based on either its free cash flow, multiples of its earnings, or multiples of its revenues. For this exercise we will use one of the most common valuation methods: multiple of earnings. More specifically, the valuation is a multiple of earnings before interest tax depreciation and amortisation (EBITDA). If we assume a company is making $40 million in EBITDA, and the marketplace estimates it is worth ten times that amount, then the valuation of the company is $400 million.

Despite ample studies on the commercial benefits obtained from companies able to deliver differentiated experiences for their customers, we will adopt a conservative approach in our example. So, assuming we can make only a positive 2 per cent increase in the EBITDA of the company from the CX program, the value to the organisation would be as follows:

- New EBITDA: $40.8 million
- New enterprise value: $408 million

So, in this example, the 2 per cent increase in EBITDA has had a positive commercial benefit equivalent:

- $800,000 increase in profitability
- $8 million increase in enterprise value

The total commercial benefit to the organisation is $8.8 million. This amount will determine what investment should be made when implementing customer experience initiatives.

The uplift potential in enterprise value from an effective customer experience program is one of the less mentioned metrics when discussing the ROI opportunities of an effective CX strategy. However, the potential financial impact on increasing the overall value of the enterprise is both real and compelling. When considering the total enterprise value equation, you need to incorporate the brand value component also. The enterprise value includes the brand value component but building the value of the brand through customer experience differentiates the organisation from its competitors and therefore makes it more attractive for investors. The appeal of a leading organisation in its respective sector demands a higher market valuation than its peers simply because its products and services are favoured by customers over similar competitor offerings.

Designing the Business Case for a CX Program

Getting started on a strategic CX program requires proper detailed analysis of existing customer and operational metrics as well as competitor dynamics. Kinetic has developed a methodology to take any size business through a design process that yields practical and measurable initiatives designed to achieve tangible results. The CX plans we create articulate the real financial outputs of each initiative to ensure senior executives can effectively sponsor and provide the necessary support required to achieve CX market differentiation.

Correct citation of paper: The Real Financials of CX, Kinetic Consulting, Tawfik, Joe, https://www.kineticconsulting.com.au 2019

Contact us at:

E: help@kineticconsulting.com.au

AUS: www.kineticconsulting.com.au

UAE: www.kineticcs.com

Phone AUS: 1300 780 556

Phone UAE: +971 44558410