

# RETHINKING CUSTOMER ACQUISITION BEFORE TALKING RETENTION

BY RODRIGO S. GRION

While marketers can positively affect customer retention in a number of different ways, improving retention is more expensive and difficult than originally thought. Rodrigo Grion believes that without selective customer acquisition programs, additional investments in retention will have little effect.

## INTRODUCTION

Customer retention has gained popularity during the last few years. The concept's simplicity, coupled with the promise of high financial returns, has made retention a high priority at many corporations. However, because little is known about the role of communications in improving retention, the answer to this marketing puzzle has traditionally taken the form of increased marketing spending, improvements in customer service and incremental incentives. While these solutions have the potential to improve customer longevity, many original retention proponents have ignored the fact that customers are not as responsive as they had predicted. And when retention rates stall despite increased spending, marketers take the blame for poorly designed programs. So why is improving retention so challenging?

This article uses the concepts of nature (customers' intrinsic retention potential) and nurture (marketers' ability to boost customer longevity through communications) to discuss current difficulties in improving retention, and to propose alternative ways of approaching the retention challenge.

## THE NATURE VERSUS NURTURE FRAMEWORK

The nature versus nurture question has been around for a long time. All newborns have the potential to grow to a certain height, defined by their genes. This potential is often referred to as nature. Nurture, on the other hand, relates to outside influences that can affect a baby's height, such as proper nourishment, exercise and environmental conditions. The more babies are nurtured, the taller they may become, but they will always be bound by their natural height potential. From a marketing perspective, the nature v. nurture concept becomes a very useful framework. It allows us to analyze how marketers have traditionally tackled retention challenges, and understand why so many of their efforts have failed.

## THE TRADITIONAL WAY

The first "modern" retention studies confirmed what many had suspected — financially successful companies excel at retaining customers (Reichheld, 1996). Much like inexperienced parents shopping for *Everything You Need to Know about Babies*, marketers and practitioners rushed to learn as much as possible about the best practices in customer retention. They wanted to learn how to nurture their customers. In this context, a wide range of competing theories emerged with several adaptations to specific industries and backgrounds. Most of them fall into one of the following categories: branding and preference, customer relationship management (CRM), and loyalty rewards.

**MANY CUSTOMERS DO NOT HAVE THE "NATURAL" CHARACTERISTICS NECESSARY FOR COMPANIES TO BUILD SUSTAINED RELATIONSHIPS AND INCREASE RETENTION.**

However, for many years, marketers have ignored the nature aspect of their customers. Despite parental aspirations, not every child will have the natural ability to become a doctor. Likewise, many customers do not have the natural characteristics a company needs to build a sustained relationship and increase retention. Since marketers have traditionally focused on nurturing customers, let's first examine the current challenges of fostering loyalty among an existing customer base.

## THE CHALLENGES OF NURTURING CUSTOMERS

Although much disagreement exists regarding the basis for retention, most marketers agree on two things: Increasing retention is

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more important than ever before and improving retention is much more difficult than once thought. The mantra of "it costs five times more to acquire a new customer than to retain an existing one" can still be heard almost everywhere. However, for those responsible for improving retention, such an assertion has long lost its appeal. The hype about the astronomical financial results of retention marketing is slowly fading and the reasons are easy to understand.

First, the availability of low-cost opportunities to affect retention is limited. Sending a thank you letter to a new car owner or changing the color of a credit card might positively affect customers' perceptions of a company. But what other options exist? While there are still a number of ways marketers can positively affect retention, most require substantial investments. Building a new call center, defining the next blockbuster advertising campaign, revamping a distribution network and training poorly compensated front-line staff are by no means trivial projects. A Big Three auto manufacturer, for example,

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**BY TRULY UNDERSTANDING THE NATURE OF THEIR CUSTOMERS, MARKETERS CAN RETHINK THEIR ACQUISITION STRATEGIES AND REPLACE LOW-POTENTIAL CUSTOMERS WITH THOSE WHO HAVE AN INHERENT PREDISPOSITION TO ESTABLISH LONGER-TERM RELATIONSHIPS.**

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has reportedly spent in excess of \$100 million on a new customer relationship management system. From a financial standpoint, implementation is just the tip of the iceberg. Companies must also consider employee training necessary to run the system and ongoing maintenance when evaluating the effectiveness of this investment in retaining customers. While such an investment may prove to be financially justifiable, it is reasonable to assume that the return must not be as good as having a goose that lays golden eggs. Second, virtually all retention theories erroneously assume that consumers want to be molded into more loyal customers. The child example is once again helpful. From birth to pre-school, parents place a child in a controlled environment, which, to a certain extent, allows them to mold their infant's behavior to what they consider appropriate. However, when the child starts school he encounters a variety of new influences. The immediate exposure to new choices and concepts gives him reason to challenge some of his parents' assumptions. This change of environment is analogous to comparing the old, controlled marketplace to the unregulated, information-rich world of today. As

Schultz pointed out in this very publication, the availability of information at the click of a button has shifted most of the power from marketers to the consumers (Schultz, 1999). It is now estimated that only one out of ten visitors to information-heavy sites such as Amazon.com and Expedia.com eventually becomes a customer; the rest simply gather information.

Finally, and perhaps most importantly, Reichheld contends that each person has a retention propensity, or what he describes as a loyalty coefficient (Reichheld, 1996). Thus, at one end of the retention spectrum, we have individuals who will not abandon their supplier, despite the supplier's mediocrity. At the opposite end of the spectrum, however, exist customers who will not hesitate to defect, no matter how hard marketers try. The implications of this disparity are serious. For one thing, a company without a sophisticated targeting mechanism will often invest in keeping its most loyal customers, only to discover that those individuals have reached their retention potential. Implementing a new rewards program to the most loyal customers may do little to increase retention, but will certainly cost money. Conversely, a substantial portion of the marketing budget will be aimed at retaining customers who have either no affinity with the company's products and values or who have a high propensity to switch brands or vendors. As we might expect, these investments also generate less than spectacular returns.

#### **CUSTOMERS' NATURE**

As previously discussed, one of the common pitfalls of retention marketing is the assumption that customers want to be molded. But if customers don't change as rapidly as marketers expected, then marketers are the ones who should adapt to the new market reality. In other words, when thinking about retention, they must accept and understand customers' nature — their predisposition to be retained. Unfortunately, very little research exists on the nature side of the retention equation (a notable exception is Reichheld, 1996).

Most people agree that customers differ and some have an inherent or natural low retention potential. Unfortunately, the causes of such low potential are complex and as difficult to explain as the congenital factors that cause an individual to become tall. In the case of customers, Reichheld proposes that they arise from a "natural" divergence of values between a customer and a firm, and are due to each customer's natural propensity to switch across all brands and categories (Reichheld, 1996).

From a nurturing perspective, it is important to understand why customers have a naturally low retention potential. However, from a financial perspective, it is even more important to understand what proportion of a firm's customers commands a low retention potential. After all, the higher the proportion of such customers in the customer base, the more dif-

difficult and expensive it will be to achieve incremental retention. In some cases, it may prove to be nearly impossible to improve retention, as the customers may have attained their naturally low retention limit, obviating the need for additional nurturing efforts. Thus, it is no surprise that many of today's retention challenges can be attributed to the acquisition of "less-than-ideal" customers in the past. We all have heard tales about banks where one-third of the customers are unprofitable. Why were those customers acquired in the first place?

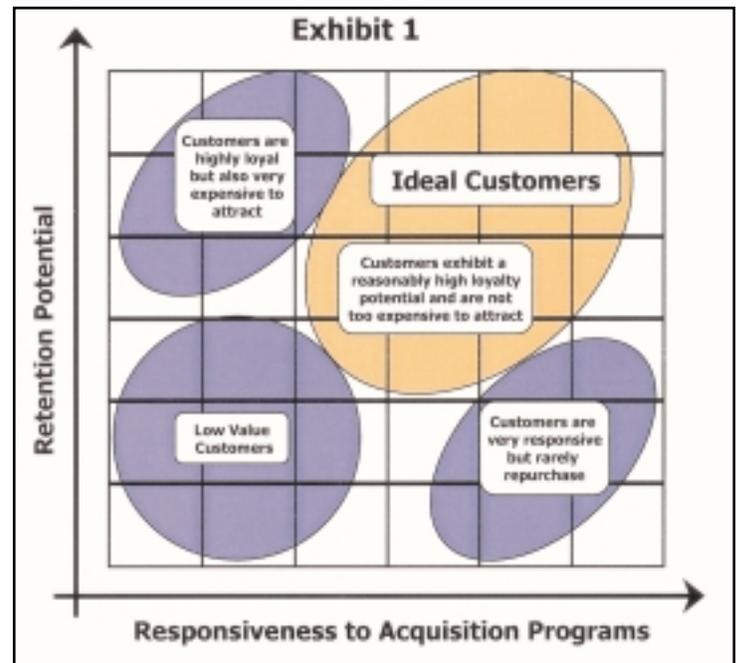
## RETHINKING ACQUISITION

Fortunately, imperfect retention works in marketers' favor. Take a company with a retention rate of 65 percent a year, a rate by no means uncommon in several industries. Assuming that this company desires to maintain the size of its customer base, it has to replenish the 35 percent of its customers who leave every year through new acquisition programs. Looking at the numbers from a different angle, one can assert that at any given time, the company acquired about one-third of its customers less than a year ago. Such high customer turnover offers a tremendous opportunity for enhanced acquisition programs to bring in more qualified customers. This is true because as the proportion of loyal customers increases in the mix, so does the company's overall retention rate.

Less intuitive, however, is that typically the "ideal" prospects will be neither the easiest to attract nor the prospects with the highest loyalty potential. Prospects with a naturally high loyalty potential are most certainly someone else's very loyal customers. In this case, attracting them becomes a matter of affordability. In contrast, overly eager prospects will usually become the least loyal customers. This phenomenon is most apparent with credit cards. Prospects with no or poor credit history are four to six times more responsive to credit card solicitations than their counterparts with better credit. These same individuals become customers that are almost equally as hard to retain, serve and extend credit. Therefore, finding the right customers boils down to balancing responsiveness (how easy and affordable is it to attract them) and potential (how easy will it be to keep and profit from them) (Exhibit 1).

Retention, however, is only one dimension of customer potential. In many industries, customer spending, the amount of customer service required and several other characteristics are equally important in defining customer profitability. Thus, sophisticated marketers will weigh several characteristics to define their "ideal" customers — those who bring the most profit to a company over their tenure. In other words, the ideal customers are those who generate the highest return on investment (ROI). This concept of customer potential is usually known as customer long-term value (LTV).

But identifying the "ideal" customers is only the first step. The challenge lies in acquiring more of those customers. Luckily, history generally repeats itself. Using historical retention information, a com-



pany can break down a customer base by several different attributes and evaluate where today's most loyal customers came from. Often, such analysis will point to weak areas that can be eliminated or reduced from future acquisition programs.

Alternatively, companies can reallocate the acquisition budget from areas attracting low performers to areas attracting greater proportions of loyal customers. Therefore, at a very minimum, companies should collect some level of information that allows them to divide the retention problem into smaller pockets. For example, customer acquisition source proved to be the problem for the magazine publisher discussed in the case study below. In a second example, an online merchant found that certain geographic locations traditionally produced non-loyal customers. In other instances, the channel or marketing medium — or even the type of promotions used to attract new customers — may prove to be the weak links. It is not uncommon, for example, to find that online customers have a lower retention potential than their mail-order counterparts. The following cases illustrate this point.

## CASE STUDY FROM THE PUBLISHING INDUSTRY

After detailed studies, a magazine publisher found that its acquisition source was the main driver of poor quality subscribers. Magazines have traditionally recruited new subscribers through two main sources: direct marketing and agents. Agents recruit new subscribers for publishers, charging a flat fee per subscription. On the surface, using agents appears to be a good deal, since in many instances this fee is lower than the costs of direct marketing. In addi-

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tion, by using agents, publishers avoid the costs and risks of maintaining a full in-house circulation group.

However, this publisher found that after five years, only 15 percent of the subscribers acquired through agents remained active, yet approximately 30 percent of the customers acquired at the same time through direct mail remained loyal. Since every subscriber receives the same magazine, such differences in loyalty can be almost exclusively attributed to customers' natural retention potential.

Agent-recruited customers have also proven to be unresponsive to the publisher's renewal efforts and have tended to renew through agents. In this instance, the publisher had to pay the agency's annual flat fee to reacquire the same subscribers. After carefully reviewing its alternatives, the company is progressively shifting its acquisition budget allocations from agents to direct marketing. While this decision may increase its upfront customer acquisition costs, this publisher also understands that such a shift will pay off handsomely through customers with a better retention potential.

### **ONLINE MERCHANT CASE STUDY**

One online merchant relied almost solely on advertising and public relations to attract new customers to its web site. It tracked acquisition and retention success using zip codes. This data allowed the company to develop demographic profiles using Census data to identify those areas producing a high number of new customers and those areas producing the most loyal customers.

This geo-demographic study resulted in very interesting findings. The company found that it could accurately predict each new customer's two-year retention rate potential by looking at the demographics of the customers' residential areas. In areas with high natural potential, about 60 percent of the acquired customers continued to purchase after two years, compared to 30 percent in the low potential areas. The outcome of this study represented a radical change in the company's goal, allowing a shift in focus from acquiring as many customers as possible to acquiring more customers from "desirable" zip codes and geographical areas.

### **WHO'S TO BLAME FOR POOR-QUALITY CUSTOMERS?**

As retention gained corporate acceptance in the marketplace, many companies reorganized their functions to allow for the improvement of customer care. In many instances, this has led to the separation of customer acquisition and retention functions. From an organizational perspective, the idea of separate planning seems to make sense. The acquisition department concentrates on identifying and converting as many prospects as possible, while a second department focuses on becoming intimately familiar with customers and increasing retention. From a performance evaluation standpoint, the structure is also sound. The first department is compensated for minimizing the acquisition costs (i.e. con-

verting as many prospects to customers as possible with a given budget), while the second department strives to increase customer longevity. Unfortunately, this logic also points to a conflict of interest.

First, in many industries, an inverse correlation exists between prospects' responsiveness to communications and prospects' quality. The credit card industry is a prime example. Insurance companies know that individuals voluntarily contacting them tend to be their worst customers (Reichheld, 1996). Cataloguers usually find that the easiest-to-find prospects are not the ones who will eventually spend the most. However, if compensation is linked to the number of customers acquired, then acquisition managers have a disincentive to be selective. They will always go for the sure target — the most responsive, and typically least loyal prospects.

Second, the more upfront incentives offered to prospects, the lower the quality of the customers attracted. Rebates, coupons and discounts lure and convert prospects who are "deal-seekers," those who are not as interested in a company's products or in maintaining a long-term relationship as in getting a good deal. An example is the widespread zero percent APR campaigns used last year by car manufacturers. From a customer acquisition perspective, the results were phenomenal. However, it is reasonable to assume that the car companies lured a significant number of new customers purely interested in a good deal. It should not come as a surprise that retention rates will drop as these customers seek the next deal when replacing their cars. Once again, acquisition marketers with no incentives to be selective will make indiscriminate use of upfront incentives to improve their numbers at the expense of future retention.

The disparities above describe two forces acting in opposite directions. Without coordination between acquisition and retention, companies will continue to experience stalled retention rates despite incremental investments. It is often the case that companies grow too fast by acquiring easy-to-find customers who have no

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## **VIRTUALLY ALL RETENTION THEORIES ERRONEOUSLY ASSUME THAT CONSUMERS WANT TO BE MOLDED INTO MORE LOYAL CUSTOMERS.**

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intrinsic loyalty potential. Not surprisingly, in many instances these companies are forced to scale down their operations when customers and profits dwindle. Companies must remember that retention starts with the selective recruitment of the appropriate customers, and therefore the planning of such efforts needs to consider prospects' long-term potential.

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## CONCLUSION

Traditionally, the challenge of retaining customers has been approached from a nurture perspective. In other words, marketers have improved customer service, increased marketing expenditures and provided customers with more financial incentives in exchange for customer loyalty. While such strategies pointed in the right direction, little has been done to deal with the root of many retention problems — the indiscriminant acquisition of "easiest-to-find" new customers. Such customers usually do not have the same values as the company and are simply interested in pursuing the next good deal. It should come as no surprise that efforts to increase retention do not produce results under these circumstances.

However, by truly understanding the nature of their customers, marketers can rethink their acquisition strategies and replace low potential customers with those who have an inherent predisposition to establish longer-term relationships. Only then will customer-nurturing programs achieve their full potential to significantly increase retention.

## THANKS

I thank my Kestnbaum Consulting colleagues for their contribution.

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