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Customer equity management as formative second-order construct

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Abstract

Despite intensive discussions about customer equity, little research addresses how to manage customer equity from a firm's perspective. Recent literature proposes various concepts of customer equity management but does not feature an empirical study that identifies and quantifies activities that aim explicitly to maximize customer equity. In the current study, the authors develop a formative measurement instrument for customer equity management as a second-order construct that indicates how intensively firms orient their customer management toward customer value and equity. The study presents a complete process for conceptualizing and operationalizing a formative second-order construct, including a thorough literature review, intensive qualitative research, and a quantitative study with 92 customer equity managers. On the basis of this process, the authors model customer equity management as a function of three formative dimensions – customer equity analysis, customer equity strategy, and customer equity actions – measured by several formative indicators. The resulting formative operationalization satisfies the criteria for evaluating formative indexes.

Keywords: Customer equity; Customer value; Customer equity management; Management implementation; Formative indicators; Second-order construct

1. Introduction

Its ability to assess individual customers and customer segments from a value perspective makes customer equity a significant marketing objective (Rust et al., 2000). Although research and practice first concentrated on measuring customer equity (e.g., Berger and Nasr, 1998; Blattberg and Deighton, 1996; Reinartz and Kumar, 2000), a broader perspective of managing customer equity is rising, as highlighted by the *Journal of Service Research*'s 2002 special issue on systematic customer equity management (CEM) and, specifically, the two conceptual articles about designing CEM (Bell et al., 2002; Berger et al., 2002). *Customer equity* refers to the value of a firm's entire customer base or the aggregation of customers' individual *customer values* (in the sense of customer lifetime value). Consequently, *customer equity management* encompasses all activities that aim explicitly to maximize customer equity (Bell et al., 2002; Hogan et al., 2002). This customer focus challenges traditional marketing practices that often concentrate on services and products instead of customer relationships to define marketing objectives (Berger et al., 2002; Rust et al., 2000). More specifically, CEM views marketing expenditures as investments in customer relationships, not costs or expenses (Blattberg and Deighton, 1996; Blattberg et al., 2001; Rust et al., 2000).

Marketing literature contains an extensive body of work related to models that attempt to measure and forecast customer (lifetime) value (e.g., Bolton, 1998; Schmittlein et al., 1987); analyzing the relationships among different customer value components, such as lifetime and profitability (Reinartz and Kumar, 2003); conducting customer value and equity segmentation (e.g., Marcus, 1998); and using customer value/equity to define marketing activities (e.g., Ness et al., 2001). However, only conceptual works apply to the design of systematic CEM

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(Bell et al., 2002; Berger et al., 2002); a lack of empirical research pertains to CEM activities, and no clear evidence describes which activities relate to successful CEM. Yet developing a measure of CEM would help identify and quantify those individual activities that constitute systematic CEM, as well as overall CEM components that consist of the individual activities. Such a measure further could demonstrate how CEM activities relate to CEM success and therefore existing knowledge about the drivers of successful CEM. In turn, this information could enable companies to quantify the state of their CEM system and identify areas that require action.

Against this background, this research conceptualizes and operationalizes a measure for CEM as companies apply the concept. The authors identify and measure a set of CEM activities that together define CEM. To classify specific CEM activities into superordinate components, this research conceives of CEM as a second-order construct that consists of first-order dimensions, which themselves consist of specific activities. The CEM dimensions contribute to the overall CEM construct. Therefore, as this article shows subsequently, a formative measurement approach is appropriate. Furthermore, in the context of this special issue, this research offers directions regarding how to operationalize second-order constructs using formative indicators.

This research effort follows the generic guidelines for formative index construction provided by Diamantopoulos and Winklhofer (2001), which consist of four steps: content specification, indicator specification, assessment of indicator collinearity, and assessment of external validity. The remaining sections of this article process these steps. The next section contains a theoretical conceptualization of the CEM construct based on literature pertaining to both content and indicator specification. The latter task involves a qualitative study with CEM managers in firms. Next, a quantitative study with CEM managers allows an assessment of indicator collinearity and external validity within the index construction process. Finally, the last section offers some implications for business practice and an outline of further research.

2. Conceptualization of the construct

The first step of index construction requires specifying the construct domain by providing a conceptual definition of the construct (Diamantopoulos and Winklhofer, 2001). According to existing literature, the scope of the CEM construct is the composition of all firm activities that specifically aim to maximize customer equity (Bell et al., 2002; Hogan et al., 2002). Existing literature reveals three different approaches that provide optional compositions of activities as parts of CEM.

The first approach, by Berger et al. (2002), provides a framework for a so-called customer asset management. Their concept centers on information flows pertaining to customer value and consists of four activities: (1) creating a comprehensive, dynamic customer database; (2) segmenting the customer base into homogeneous groups; (3) forecasting customer lifetime value for the various segments, and (4) allocating resources to maximize the customer base's value. This CEM concept is data driven; these authors propose building customer segments to differentiate among existing marketing activities (e.g., which customers should receive better treatment?).

Bell et al. (2002) define a customer asset-based marketing model, with which they differentiate among analysis, action, and control activities at both the aggregate and the individual customer level. On the basis of these considerations, they define five CEM activities: (1) evaluating the customer base (aggregate level); (2) evaluating customer acquisition, retention, and abandonment (segment/individual level); (3) selecting customer-/segment-specific marketing actions (segment/individual level); (4) observing customer-/segment-specific results (segment/individual level); and (5) observing aggregate results (aggregate level). This approach differs from the approach of Berger et al. (2002) mainly in the emphasis on the activity used to define specific actions that may manage customer value (e.g., specific service program for a certain segment). In contrast, Berger et al. use customer value to differentiate already defined marketing actions or select customers for existing actions.

In the third approach, Payne et al. (2001) propose a framework for integrated value management that focuses not only on customer value or equity but also on employee and shareholder value. Furthermore, they suggest a generic process for managing value by means of (1) value determination, (2) value creation, (3) value delivery, and (4) value assessment. They argue that profit chains represent the objectives of each value management area (i.e., customer, employee, and shareholder).

These proposed concepts also suggest that companies should recognize three distinct components when managing customer equity. First, all of them encompass customer equity analysis, though they use different terminology, namely, "create a comprehensive, dynamic customer base" and "forecast customer lifetime values for the customer segments" (Berger et al., 2002); "evaluate the customer base on an aggregate level," "evaluate customer acquisition, retention, and abandonment," and "observe customer segment and aggregate results" (Bell et al., 2002); or "value determination" and "value assessment" (Payne et al., 2001). Second, they recognize customer equity strategies in the form of "segment customer base" and "allocate resources" (Berger et al., 2002) or "value creation" (Payne et al., 2001). Third, the concepts all specify customer equity actions: "marketing actions" (Berger et al., 2002), "select customer-/segment-specific marketing actions" (Bell et al., 2002), and "value delivery" (Payne et al., 2001).

On the basis of the generic CEM scope that this section defines and the CEM that derives from existing literature, CEM represents the composition of CE analysis, strategies, and actions that attempt to maximize customer equity, such that customer equity represents the sum of customer values for the firm. In terms of dimensionality, CEM is a second-order construct that consists of CE analysis, strategy, and actions, each of which represents facets of CEM that could be separate constructs but remain integral parts of CEM at a more abstract level. Therefore, the following sections refer to these parts as first-order dimensions of the second-order CEM construct.

The first dimension, CE analysis, pertains to measuring the customer value/equity of a firm's customers. Extensive research