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The dynamic effect of customer equity across firm growth: The case of small and medium-sized online retailers☆

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ABSTRACT

Although several causal studies investigate the relationships between customer equity and firm performance, some debate about whether their positive relationship is valid over long time horizons and across firm/industry environments does exist. This study investigates the dynamic effect of customer equity on firm performance. Using individual-level purchase data for an online retailer, the results show a weak relationship between customer equity and firm profitability, which is not consistent with previous assumptions and beliefs. Additional analysis to resolve this gap shows that in the early stage when a firm's growth rate is relatively high the firm is required to manage many newly enrolled customers. In contrast, in the mature stage when a firm's growth rate is stable and low the firm should retain its customers. Thus, marketing managers need to leverage the drivers of acquisition and retention to continue to grow overall customer equity and firm performance.

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1. Introduction

Acquiring customers and retaining them are two of the most important aspects of marketing, especially from the practical perspective. Companies thus put tremendous effort into effectively managing customers and many researchers have studied this issue. Concurrently, studies on customer relationship management (CRM), customer lifetime value (CLV), and customer equity (CE) have become important topics. With the growing importance of customer value, marketing scholars have suggested that CE, which is the sum of CLV of the firm's customers, can be the alternative measure of firm performance (Bejou & Gopalkrishnan, 2014; Mark, Lemon, Vandenbo, Bulla, & Maruotti, 2013; Song, Kim, & Kim, 2013; Srinivasan & Hanssens, 2009; Wiesel, Skiera, & Villanueva, 2008). Because of the rapid development of information technology, research results of such topics are increasingly being used in areas such as customer-value-based segmentation, optimal resource allocation, and company value evaluation (Jai & Tung, 2015).

With the growing interest in CE, several causal studies have investigated the relationships between CE and firm performance (Gupta, Lehmann & Stuart, 2004; Gupta & Zeithaml, 2006; Kumar & Shah, 2009). Most of them provide substantial and widespread conceptual and empirical evidences of the positive link between CE and firm performance either directly or through improved customer outcomes (Blattberg, Malthouse, & Neslin, 2009; Chae, Ko, & Han, 2015; Gupta & Zeithaml, 2006; Hogan, Lehmann, Merino, & Verhoef, 2002; Kim, 2015; Kim, Ko, Lee, Mattila, & Kim, 2014; Kumar & Shah, 2009; Rust, Lemon, & Zeithaml, 2004; Schulze, Skiera, & Wiesel, 2012; Silveira, Rovedder de Oliveira, & Luce, 2012; Sun, Kim, & Kim, 2014; Vogel, Evanschitzky, & Ramaseshan, 2008; Wiesel et al., 2008). However, apart from these cross-sectional studies, increasing demand for research investigating the relationship between CE and firm performance over time still exists. Recently, Ryals (2005) and Kumar and Shah (2009) have shown some initial evidence of how CLV is related to changes in firm performance over time. Kumar and Shah (2009) emphasize the business environment, which can be changed over time; therefore, this study will address this issue in relation to firms' internal factors (e.g., the firm's growth rate), as shown in Reinartz, Thomas, and Kumar (2005). Some researchers have raised the possibility of a negative short-term outcome of CRM strategies depending on the lifecycle stage. For example, because of the large investment, adaptation to new strategies, and strong focus on technology required, the short-term consequences of CRM may be negative (Verhoef et al., 2010).

Russo and Fouts (1997) find that environmental factors like growth rate can affect firm performance in different ways. Kumar and Shah (2009) argue that a positive relationship between CE and firm performance may not be valid for longer time horizons, in which firms in general may eventually experience a slowdown in business due to the increasing difficulty of acquiring profitable customers, which leads to

Abbreviations: CE, Customer equity; RCE, Retained customer equity; NCE, Newly acquired customer equity; CRM, Customer relationship management; CRV, Customer lifetime value.

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diminishing contribution margins over time. The purpose of this research is, first, to investigate the long-term effects of customer equity (CE) on profitability across firms' environmental factors. Although the high correlation between firm performance and CE seems to be undoubtedly because the concept of customer lifetime value (CLV) is based on the profitability of an individual customer, their relationship is not straightforward because of the following conceptual differences between CE and CLV. First, CE considers the CLV of all users (including the growth in the number of customers) rather than that of each individual user. Drèze and Bonfrer (2009) show that the transition from CLV to CE is more complicated. Second, the estimated future profit is not directly related to immediate and short-term profit, because most CLV estimation models employ the entire history of the previous buying behaviors rather than only that of the immediate buying behavior, covering the long-term income stream (Gupta et al., 2004). Rather, in this study, we anticipate a significant difference among these correlations over longer time horizons due to the long-run characteristics of CLV and CE. As shown by the results of the current analysis, a few cases that show the obvious relationship between CE and profit (only 6 among 30 cases exhibit a significant relationship between CE and profit) support this argument. Thus, verifying the direct and dynamic relationship between CE and firm profitability with empirical data is a significant research topic. The other purpose of this study is to examine the dynamic effects of CE on firm performance and compare these effects to firms' environmental factors such as firm growth rate.

2. Theoretical background and hypotheses

2.1. Customer equity and firm growth rate

The previous literature shows high correlation between CE and firm financial performance. Previous researchers have argued that CLV and CE can be good indicators of a firm's market value. For example, Gupta et al. (2004) empirically study this issue by estimating the CE (or future customer value) of each of four online firms and one offline firm and explain the relationships between the estimated CE and the firms' stock prices. Recently, using the marketing dynamics perspective, researchers have aimed to model the different effects of marketing actions and policies on firm performance. More importantly, the dynamic effect of marketing efforts has received much attention from marketing practitioners and academics (Leeflang, Bijmolt, van Doorna, Hanssens, van Heerdec, Verhoef & Wieringaa, 2009; Song, 2014; Song, Kim, & Ko, 2014).

Russo and Fouts (1997) find that environmental factors such as firm's resources have different effects on firm profitability. Firm profitability can be influenced by customer type, and this effect is also influenced by internal firm factors such as firm size, reputation, and growth rate (Kumar & Shah, 2009; Reinartz et al., 2005; Venkatesan & Kumar, 2004). Kumar and Shah (2009) contend that their results may not hold true for firms from industries that do not anticipate continuous growth. Therefore, the moderating role of growth rate on the relationship between CE and firm profitability should be demonstrated. Inclusion of a firm's growth rate factor can help explain why the firm may not experience a positive relationship between CE and profitability during all stages of the lifecycle.

Although some research has examined the static relationship between CE and performance with the time-series data (e.g., Schulze et al., 2012), little research has investigated the dynamic impact of CE on performance depending on the environmental changes. As strategic resource allocation is no doubt critical for firms, this study empirically demonstrates that customer management strategies can be applied differently and that the subsequent outcomes may hold true across a firm's lifecycle. Because the current modeling framework and dataset facilitate the computation of the lifetime value of each customer of a firm, firms can deploy different marketing tactics and strategies for each period for each customer segment.

2.2. Classifying customer equity

Researchers have proposed many approaches for classifying customers to efficiently allocate marketing resources. Homburg, Droll, and Totzek (2008) argue that customer classification refers to the ways in which customers are targeted with different marketing instruments according to their importance to the firm (the top tier - most important customers vs. bottom tier - least important customers). Reinartz et al. (2005) propose that customers should be categorized according to their profitability across three stages of the customer relationship: initiation, maintenance, and termination. Buzzell (1966) and Best (2000) segment customers into two groups: old and new. Some studies have contributed to the understanding of relationship management by developing a typology of relationship exchange mechanisms (Heine & Berghaus, 2014; Hogan et al., 2002; Johnson & Slenes, 2004; Maloney, Lee, Jackson, & Miller-Spillman, 2014; Wu & Chalip, 2014).

However, as Hanssens (2003, p. 16) note, the more challenging task is to assess long-run marketing effectiveness and allocate the overall marketing budget across the key activities that generate CE; thus, the issues related to establishing the customer-profitability-based decision model of the marketing resource allocation problem are important and challenging. Here, this study uses Hogan et al.'s (2002) customer portfolio management depending on the relationship strength and classify the CE based on the length of the relationship. Furthermore, Song, Kim, and Lee (2009) show the differential effects of CE of new customers and existing customers on firm profitability.

In the same manner, this research classifies CE based on the two relationship types. NCE_t refers to the summation of CLV for customers acquired at time t. RCE_t refers to the summation of CLV for customers that were existing or acquired before time t. With this classification, the current study contributes to the limited literature on customer classification by framing the pursuit of CE as a resource allocation for the guiding ideals of CRM business processes. This research also responds to the need for a better understanding of how firms can improve their performance using different CE by differentiating the effects of a customer-focused structure.

2.3. Hypothesis

Srivastava, Fahey, and Christensen (2001) have described how a company should take advantage of its resources to get customer value from the perspective of resource-based theory. Recently, Sirmon, Hitt, Ireland, and Gilbert (2011) suggest the need of research that captures the dynamics pertaining to firms in and between lifecycle stages since it could elucidate firms' operating and governance structures that in turn affect firm performance. They emphasize the importance of resource orchestration efforts across the lifecycle of a firm (Ndofor, Sirmon, & He, 2011). Petersen et al. (2009) note that research needs to continue to focus on the two components of marketing, namely customer acquisition and customer retention; therefore, this research considers the marketing resource allocation problem in terms of determining how much to spend on customer acquisition and retention efforts.

Previous research has addressed the issue of how much to spend on customer acquisition and customer retention (Blattberg et al., 2009). For example, Blattberg, Getz, and Thomas (2001) include acquisition, retention, and cross-buying in a model of CLV and CE but do not consider the specific impact of marketing expenditure on customer profitability. Thomas (2001) examines the link between customer acquisition and customer duration. Reinartz and Kumar (2000) examine the link between customer duration and customer profitability. Rust et al. (2004) address both acquisition and retention aspects, but their model does not provide for separate or distinct investments in the acquisition of new customers and the retention of existing customers. Reinartz et al. (2005) suggest that in a fixed marketing budget, firms must make a resource allocation decision between acquisition and retention efforts;

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