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The Effects of Channel Experiences and Direct Marketing on Customer Retention in Multichannel Settings☆

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Abstract

In customer relationship management (CRM), it is critical for managers to understand how and when customers terminate their relationships with the company in order to make more accurate predictions for CLV. However, in many non-contractual settings, customer churn is not easily observed, which presents difficulty for estimating customer retention. In this research, we present a framework for estimating multichannel customer relationship dynamics in a non-contractual setting that flexibly allows for relationship revival and investigates the effects of different channel experiences and marketing communication on retention and profitability. We use a multi-segment, multivariate hidden Markov modeling framework to model three managerially relevant customer behaviors: purchase amount, purchase incidence, and channel choice. Using data from a multichannel clothing retailer, we uncover two latent relationship states that customers migrate to and from — an active state and an inactive state characterized by different levels of purchase frequency, responsiveness to marketing, and profitability. We find that an offline (retail-store) channel can be used to migrate customers from an inactive state to an active state, effectively serving the purpose of "education" or "revival," whereas an online channel is most effective in keeping the existing active customers active, thus serving the purpose of "retention". Using counterfactual analysis, we highlight an opportunity for the multichannel firm to optimize marketing strategies to dynamically manage and increase the retention and hence also the value of its customer base.

Keywords: Customer retention; Multichannel marketing; Hidden Markov model; Customer–firm relationship

Introduction

The multichannel marketing environment is becoming increasingly prevalent in recent years. Firms and their customers can interact via brick-and-mortar stores, catalogs, online stores, emails and in recent years mobile platforms, and multichannel marketing has become an important tool to motivate customers to shop more frequently through increased interaction and to build lasting customer relationships (Hansotia and Rukstales 2002; Rangaswamy and Van Bruggen 2005). In addition, multichannel firms are looking for strategies to increase customer retention and avoid customer churn, as the costs of customer acquisition are much higher than that of retention, and small increases in retention could drive large profit increases (Pfeifer and Farris 2004; Reichheld and Sasser 1990). Specifically, Gupta and Lehmann (2003) assert that an increase in retention of 5% yields a dramatic 22% to 37% increase in customer lifetime value.

Given the prevalence of the multichannel environment and the importance of customer retention, it is crucial for both marketing academics and practitioners to study the link between these two areas in order to answer the question of how to increase customer retention and thus increase customer value in multichannel settings. However, such research is particularly difficult for firms in non-contractual settings (e.g. most retail settings such as Nordstrom, Sephora, L.L. Bean, and the recently opened Amazon stores), because the termination of relationships is difficult to observe, and thus retention rates

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cannot be easily evaluated. Our research framework studies customer retention in multichannel settings, while accounting for issues in non-contractual settings.

Most extant research on customer retention has either focused on highlighting the importance of retention on customer lifetime value (Gupta and Lehmann 2003; Pfeifer and Farris 2004; Reichheld and Sasser 1990) or on attempting to estimate the impacts of various factors on relationship length in contractual settings that require accurate information about the termination of the relationship (Boehm 2008; Schweidel, Fader, and Bradlow 2008). From a channel perspective, some studies have examined the impact of Internet use (specifically, online banking) on service termination (customer retention) (Boehm 2008; Campbell and Frei 2010; Hitt and Frei 2002; Verhoef and Donkers 2005). Those studies are also based on contractual settings.

These issues are hard to resolve in non-contractual settings due to the difficulty in identifying a customer's true relationship with a firm. The extant literature on customer relationships suggests that customers are considered active or inactive based on their purchase activities, which are governed by underlying relationship states. These latent relationship states that govern customer activity could exhibit different levels of awareness or top-of-mind awareness, different levels of trust towards the retailer, or different levels of familiarity (Li, Sun, and Montgomery 2011; Montoya, Horton, and Kirchner 2008; Zhang, Netzer, and Ansari 2014), all of which could change over time via repeated interactions with the firm. Retention efforts in a non-contractual setting should be aimed at preventing active customers from becoming inactive and reviving inactive customers back to an active state. However, in non-contractual settings, customers may seem to have churned when they have not actually terminated the relationship with a firm; customers with longer inter-purchase time might just be in an inactive relationship state and need to be distinguished from customers who have truly terminated the relationship altogether. Previous research that attempts to derive customer retention with a non-contractual firm 1) has treated all purchases the same and has not accounted for the channels through which customers make purchases, ignoring the fact that different channels offer different experiences (i.e. retail stores offer richer experience, online offers convenience) and would impact the relationship differently, and 2) has not considered customer revival. In particular, the Pareto/NBD and BG/NBD models, which explore repeat purchase behavior while accounting for unobserved customer dropout rates in CRM, ignore the possibility that customers who shop through a particular channel may have different retention/churn probabilities than those who shop through alternative channels. These models treat the inactive customer as "dead" and do not allow for the customer to come back to the active relationship state. Overall, the various impacts of multichannel experiences and direct marketing on customer retention in non-contractual settings have not been well explored.

The purpose of this research is to fill such a gap and to investigate the impacts of multichannel experiences and direct marketing on improving customer–firm relationships and customer retention in non-contractual settings. To do so, we simultaneously model three managerially important customer decisions for a multichannel retailer – purchase incidences, channel choices and purchase amounts – and recover the underlying latent relationship states which represent customers' tendencies to stay active or inactive. We apply a multi-segment, multivariate hidden Markov Model (HMM) approach to link the latent relationship states with the three observed customer behaviors (i.e. incidence, channel choice, and amount) and examine how choice preference evolves as a customer–firm relationship changes due to channel experiences and marketing communications. This modeling framework allows us to first identify each customer's latent state of relationship state over time; second, to determine the retention probability affected by channel experience; third, to identify customers who are more likely to churn by the end of the observation period; and finally, to examine the impact of alternative channel experiences and direct marketing on migrating customers towards desirable state, hence improving retention.

We contribute to the CRM and multichannel literature in the following dimensions. Methodologically, our framework investigates the effects of channels and direct marketing on customer behaviors in a non-contractual setting through multiple important customer decisions. It can track each customer's varying retention rates dynamically and flexibly allows for customer relationships to be revived, a framework that is relevant for many multichannel markers. Theoretically, to the best of our knowledge, our paper is among the first to provide empirical evidence for the different purposes of channels in managing customer portfolios in non-contractual settings: offline retail channel can be used to migrate customers from an inactive to an active state, effectively serving an "educational" or "revival" purpose, whereas online channels have the biggest impact of keeping currently active customers active, thus serving a "retention" purpose. These findings are consistent with various prior research that suggests that offline channels are experientially more immersive (Verhoef, Neslin, and Vroomen 2007), which can help get customers excited about the retailer experience and hence is good for learning and relationship building, whereas online channels provide convenience and low transactional cost for those customers who are familiar with the retailer experiences (Lal and Sarvary 1999). The catalog channel's effect is weak compared to both the offline and online channels, which confirms the intuition that it has neither the immersive experience of a retail immersive experience of a retail store nor the convenience of an online channel and serves to explain why the catalog is a "sunset" channel that's losing its appeal. Managerially, our framework allows the firm to identify every customer's latent state every month, which enables the firm to adjust its marketing resources dynamically for each customer. Recent multichannel research has demonstrated that customers can be persuaded through non-financial marketing communication to adopt a particular channel, suggesting right channeling as a marketing strategy that firms could employ (Montaguti, Neslin, and Valentini 2016). Using the counterfactual analyses of both customer activity and profitability, our findings on the roles of channels and marketing provide managerial guidance on how the