

Customer File Dynamics in a Multi-Channel World

Kevin Hillstrom

During the past fifteen years, catalogers have transformed themselves from print-based merchandisers to multi-channel retailers. This revolution gave our customers tremendous power. In 1990, a customer received a catalog, viewed several hundred pages of merchandise, and read copy that detailed the benefits of purchasing this product. The customer kept copies of catalogs from numerous companies. She compared products and price, and then made a decision to buy something. She filled out her order form, wrote a check for the purchase amount, and mailed her envelope to the cataloger. Two weeks later, merchandise arrived at her home. Alternately, she phoned in her order via a 1-800 number, used her credit card, and received merchandise in about a week.

Today, a similarly-aged woman accesses the internet to gain information about a potential purchase. She visits any search engine or price comparison website, compares merchandise, price, shipping and handling across an array of companies. Based on price, value, trust, and delivery options, the customer chooses a company to purchase the item from. She visits the website of this company. The customer chooses whether to buy that item online, or to use the web to have the item shipped to a retail store, where she can pick it up on the way home from work. If she has the item shipped to her home, she expects it to be shipped in just a few days, and she expects to be able to return the item directly to a store.

Catalog, online and retail executives have responded to changes in consumer expectations, changes largely fueled by advances in technology. The purchase behavior of consumers today is different than the controlled environment catalogers enjoyed in 1990. Executives responded to these changes by creating a multi-channel environment that begins to address the needs of the consumer.

Business leaders are keenly aware of the difficulty in implementing a multi-channel strategy that is appropriate for any given brand. Vendors and business leaders are trying hard to implement strategies that meet customer needs. Consequently, multi-channel marketing discussions focus on aligning merchandise, systems, marketing and operational systems across the entire enterprise.

When deciding how to align all elements of a multi-channel strategy, it is important to have metrics available that thoroughly understand how actual customers behave. Multi-channel discussions frequently consider how customers interact across channels (telephone, online, retail), or how the customer responds to advertising. Executives should thoroughly understand the inter-related behavior of customers, channels, product classifications and advertising. Multi-channel strategies are highly dependent upon technology and systems infrastructure. Fortunately, an understanding of how customers, channels, product classifications and advertising inter-relate is available today, using techniques that have been around for the past ten to twenty years, or more. Fully understanding customer behavior drives the multi-channel strategies retailers will employ in the future.

What Are The Repurchase Rates Of Your Customers Across All Products And Channels?

Executives should routinely monitor reporting that indicates the percentage of customers who purchased within each product classification and channel last year, and repurchased in the same product classification or channel again this year. This metric is called the ‘repurchase rate’, or ‘rebuy rate’.

For most business models, measuring repurchase rates on an annual basis is appropriate. Count the number of customers who purchased during a calendar year. Next, count how many of these customers purchased again during the next calendar year. Divide this year’s customers by last year’s customers, and you have calculated the repurchase rate.

For example, assume that 1,000 customers purchased from your company in 2004. In 2005, only 375 of the 1,000 customers purchased again. The repurchase rate is $375/1000 = 37.5\%$. This metric should be calculated for your business, in total. Next, the metric should be calculated for each channel. Within each channel, the metric should be calculated for each product classification you have.

Once these measurements have been taken, it is important to classify each metric within one of three categories. These categories are:

Acquisition Mode:	Repurchase rates between zero and forty percent.
Balanced Mode:	Repurchase rates between forty and sixty percent.
Retention Mode:	Repurchase rates between sixty and one-hundred percent.

Why is it important to measure and categorize repurchase rates? Because your marketing strategy is highly dependent upon which category your business, channel or product classifications fall into. It is very difficult to manage an effective marketing strategy without fully understanding how customers interact with your brand.

Acquisition Mode implies that it is essential to continually find new customers for your business, channel, or product classification. When fewer than forty percent of last year’s buyers purchase again this year, growth happens if the customers who are lost are replaced with at least as many new customers. The executive must make it a priority to find new customers at an acceptable cost, in order to grow. Regardless of efforts to increase average transaction size, or purchase frequency, the business simply won’t grow unless customer acquisition is the top priority of the marketing team. Businesses in Acquisition Mode have some loyal customers. More frequently, the customers are purchasing one to three times a year and then move on.

Balanced Mode may be the most enjoyable category for an executive to manage. When the repurchase rate is close to fifty percent, many different levers exist to fuel growth. The business leader must continue to drive customer acquisition activities to replace all the customers that are lost each year. In addition, the business leader has the opportunity to increase repurchase rates, increase annual purchase frequency, or increase the average transaction size. All of these strategies can be managed within Balanced Mode. Success can happen by improving any one metric. Wild success can happen by improving repurchase rates, purchase frequency, average transaction size, and customer acquisition all at the same time. Shortcomings in one area can be offset by improvements in other areas. This is a fun type of business for an executive to run.

Retention Mode occurs when more than sixty percent of last year’s buyers purchase again this year. In this category, the executive will be hard-pressed to increase retention rates, so marketing strategies need to include increasing annual purchase frequency, or increase the

average transaction size. If customers can be acquired at a profitable rate, growth is also achievable. Wal-Mart and McDonalds fit into this category. Each business retains the vast majority of their customers, on an annual basis (or monthly basis). Without opening new stores, these businesses must grow by stealing market share, creatively expanding into new product lines, or by providing services that meet customer expectations.

Classifying each business, channel and product classification into one of these three segments is essential if an executive wishes to identify the appropriate marketing levers to grow the business.

How Do Brands, Channels And Product Classifications Interact With Each Other?

Once the executive understands customer file dynamics surrounding repurchase rate, it becomes essential to measure how brands, channels and product classifications interact with each other. By understanding how customers migrate across business units, the executive has the tools necessary to grow her business in an efficient and profitable manner.

Four dynamics amply explain how customers migrate across businesses, channels and product classifications. Let's explore each dynamic.

Isolation represents a situation where competing brands, channels or merchandise divisions do not interact with each other. For instance, Dell sells computers to both businesses and consumers. It is possible that customers who purchase computers for their business visit Dell for that reason, whereas customers who purchase computers for their home do not have the job responsibility to buy computers for their business. In this situation, the business-to-business and business-to-consumer executives at Dell operate in Isolation Mode. These leaders need to insure that each business unit markets in a manner that benefits the brand. However, they can act in a largely independent manner, because their customers are independent of each business unit. Executives who run business units in the Isolation Mode are largely dependent upon their own strategies for success or failure, since customers from other business units are not likely to cross-shop another business unit.

Equilibrium represents a business model where customers freely shop across brands, channels or product classifications, regardless of past purchase history. Management teams responsible for business models that operate under the Equilibrium Mode are highly dependent upon each other for success. If one business unit, brand, channel or product classification is failing, customers are not being fed to the other businesses. If one leader is struggling, all other leaders may struggle as a result. Conversely, another executive might be doing a great job of driving her business. The other executives benefit by the success of this leader.

Large department stores frequently operate under the Equilibrium Mode. At Target or Wal-Mart, executives in charge of apparel, toiletries, electronics, lawn and garden, automotive, grocery and home furnishings share customers. A customer who purchased toiletries in the past may be equally likely to purchase from any other product classification in the future.

Transfer represents a customer dynamic that must be clearly understood, in order for a business to achieve its potential. Under the Transfer Mode, a brand, channel or product classification transfers its customers to another brand, channel or product classification. For instance, Barnes & Noble is well known for selling books. However, other products are sold at Barnes & Noble. Customers can purchase music, movies, magazines, or even coffee. Books may be the reason why a customer enters the store. Once the customer trusts Barnes & Noble, after

purchasing several books, she may purchase a movie, or enjoy a latte, or purchase a magazine. The book product classification transfers its customers to other product classifications.

In this example, the other product classifications (music, movies, magazines, coffee) may not be responsible for cultivating their own customers. Instead, they are dependent upon customers who purchase books. If the executive who manages books does an excellent job, then the executives responsible for the other product classifications are set up for success. The book executive bears a larger share of responsibility than the other executives, because he must recruit loyal customers who will transfer to other product classifications.

In our multi-channel environment, this is the most important customer dynamic to understand. The interaction between catalog, online and retail channels must be thoroughly understood in order to determine the appropriate marketing strategy. Does the catalog channel operate in Isolation Mode? Does it operate in Equilibrium Mode, or Transfer Mode? The dynamic that the catalog operates under determines its place within a company.

The last customer dynamic is called *oscillation*. Under Oscillation Mode, brands, channels or product classifications transfer customers to each other in a cyclical manner. Consider the automotive industry. A customer purchases a new car. The new car sales division transfers the customer to the service division. Over the next several years, the service division must do a great job of taking care of the customer. At some point, the customer is ready for a new car, so the service division transfers the customer back to the new car sales division. If sales and service do their job well, then the customer oscillates back and forth, between each division.

Integrating Repurchase and Customer Dynamics

In my book, *Hillstrom's Database Marketing* (Direct Academy; Campbell & Lewis Publishers, 2006; www.ForBetterBooks.com), I describe case studies from a fictional company called Buddies. This company markets dog toys, treats and doggie t-shirts through an e-commerce enabled website, and operates one small retail store. Buddies has been in business for three years.

After three years, Buddies retains just over forty percent of the customers who purchased the prior year. This means Buddies operates on an inflection point between Acquisition Mode and Balanced Mode. In order to continue growing, it must acquire as many customers as possible, in a cost-effective manner. By the same token, as the business matures, it will enter Balanced Mode. Increasing purchase frequency and average transaction size will become more and more important as the business matures.

Within each product classification, toys, treats and doggie t-shirts, customers have different repurchase rates. Customers purchasing from all three product classifications have a seventy percent repurchase rate. Customers purchasing from two of the three product classifications have a forty-six percent retention rate. Customers purchasing from just one product classification have a thirty-three percent retention rate.

It is very important to understand how the three product classifications interact with each other. Customer dynamics can be understood by measuring how last year's customers migrate in the next twelve months.

Let's look at customers who only purchased dog toys last year. Among those who repurchased, sixty-five percent purchased only dog toys in the next twelve months. Only three percent purchased only dog-treats. Only two percent only purchased doggie t-shirts. The

remaining thirty percent purchased from multiple product classifications. Dog toys operates in Isolation Mode, because its customers tend to repurchase dog toys again next year.

A different dynamic occurs for doggie treat customers. Twenty-three percent of those who repurchase buy only dog toys next year. Twenty-four percent of the repurchasers buy only doggie treats next year. Twenty-three percent of the repurchasers buy only doggie t-shirts next year. Twenty-eight percent of the repurchasers buy from multiple product classifications next year. Clearly, doggie treats operates under the Balanced Mode. Customers who purchased doggie treats last year are equally likely to shop anywhere next year.

Doggie t-shirts operate under yet another mode. Among those who repurchase, fifty percent purchase only toys. Twenty percent purchase only treats. Twenty percent purchase only doggie t-shirts. Ten percent purchase from multiple product classifications. Clearly, doggie t-shirts operates under Transfer Mode. Customers who purchase from this product classification tend to migrate to toys in the next year, with some migrating to treats.

The executive in charge of each of these product classifications must employ very different strategies, in order to be successful. The leader of the toys division has a very good chance of being successful. She can acquire her own customers, knowing they tend to stay loyal to toys. She knows that treats buyers are likely to cross-over, and buy from her product classification. She knows that doggie t-shirt buyers are most likely to migrate to toys in the next year. This leader could fund customer acquisition activities in the doggie t-shirt division, because those customers will eventually migrate to toys.

The executive in charge of doggie treats has fewer options. His customers tend to shop across all product classifications in the future. Therefore, his strategy must be to constantly acquire new customers. Some doggie t-shirt buyers will purchase treats in the future, so there is some dependence upon the t-shirt executive for success.

The executive in charge of doggie t-shirts has no choice but to acquire a lot of new customers. Toys buyers are unlikely to cross-over, and purchase doggie t-shirts. Treats buyers will cross-over, and buy doggie t-shirts. Most important is the fact that doggie t-shirt buyers do not stay loyal to doggie t-shirts. The buyers transfer to other product classifications. Therefore, the doggie t-shirt executive must constantly recruit new buyers, in order to be successful. She cannot depend upon the other executives to help fuel her business.

Putting It All Together

The analytical tools that support retention metrics and customer dynamics have been used for decades. The concepts of isolation, equilibrium, transfer and oscillation are not new to database marketing. However, these techniques are largely under-utilized in today's multi-channel environment. The tools of the past are directly applicable to today's business challenges.

When coupled with concepts like life-tables, multi-year simulations, lifetime value, experimental design and rolling twelve-month files, database marketing can serve as the foundation for your multi-channel business. Integrating these techniques into multi-year simulations give clarity into where your business is heading. The marketing strategy for each brand, channel and product classification become self-evident when using this framework. Database Marketers have a responsibility to drive business strategy by applying these time-tested these analytical concepts to their specific business problems.

Kevin Hillstrom

Kevin Hillstrom is a database marketing executive with nearly two decades experience in statistical modeling, experimental design, customer segmentation, housefile planning and customer file forecasting, multi-channel customer migration, lifetime value and measurement of complex customer behavior. After earning a Bachelor's Degree in Statistics from the University of Wisconsin, Kevin has worked in the hybrid seed, catalog, specialty apparel, online advertising and retail industries. Kevin and his wife reside in the suburban Seattle area.

Kevin's new book, *Hillstrom's Database Marketing: A Master's Complete Method for Success* is published by Direct Academy, an imprint of Campbell & Lewis Publishers; 206 pages, hardcover, \$95. The book is a complete and comprehensive consultation in database marketing principles for owners, CEOs, marketing executives, database coordinators, and the board of directors.

The publishers believe this is the finest book to be written on database marketing. It is clear. It is simple. It is understandable. It is complete. It is exactly what it promises: a master's complete method for success. And Kevin Hillstrom is a Master of database marketing.

For the CEO, *Hillstrom's Database Marketing* is a model for corporate database development or enhancement.

For the marketer, this book is a proven plan for improved performance, knowledge, profits and strategic wisdom.

For the newcomer to database marketer, this book will hold its own for decades as a primary textbook. It contains the knowledge of a successful Master and he is passing his science and his art to you for your future.

For the online, catalog, retail or wholesale entrepreneur, there is all the foundation 'How To' you need for building a database analytic process that creates success and growth.

For the financial manager, Hillstrom turns 'mumbo jumbo' into logical, clear data that translates to ROI and a higher corporate valuation and multiple.

For the Board of Directors, if your database marketing strategies and capabilities follow Hillstrom's methods, you can check off one less worry.

Hillstrom's Database Marketing is destined to be a database marketing classic. Even better, for those few inside database pros who keep all the secrets to themselves, this book will be a *cult classic*.

Available online at www.ForBetterBooks.com

