

PART

I

MARKET ORIENTATION

*Marketing isn't somebody's responsibility;
marketing is everybody's responsibility.*

—JACK WELCH, CEO 1981–2001
General Electric Co.

A market-based business has a strong market orientation that cuts across the functions and employees of an organization. While those in marketing have the primary responsibility to lead marketing excellence, in a market-based business, all members of the organization have a strong market orientation. This means all members of the organization are sensitive to customers' needs, aware of competitors' moves, and work well across organizational boundaries toward a timely market-based customer solution. The payoff—market-based businesses with a strong market orientation are more profitable.

The purpose of part I is to make explicit the connectivity between market orientation, customer satisfaction, market-based management, and profitability. In chapter 1, we examine the fundamental components of market orientation and how each is related to customer satisfaction and retention. From this perspective, we will demonstrate the profit impact of a lifetime customer as well as the high cost of customer dissatisfaction. While a strong market orientation enhances a business's chances for long-run survival, short-run profits can also be increased with marketing efforts to increase customer satisfaction and retention.

A strong market orientation does not occur by mere proclamation. To attain a strong market orientation, a business needs to adopt a market-based management philosophy. This means implementing a process for tracking market performance and restructuring an organization around markets rather than products or factories and creating an employee culture that is responsive to customers and changing market conditions. Market-based management also requires businesses to measure profits at the market level and to track external, market-based performance metrics. These topics, and their relation to marketing strategies and profitable growth, are discussed in chapter 2.

MARKET ORIENTATION AND PERFORMANCE

In today's globally competitive world, customers expect more, have more choices, and are less brand-loyal. Businesses such as IBM, Sears, and General Motors at one time seemed invincible in terms of their market domination. However, in each case, these companies have had to restructure (reengineer) their organizations to address changing customer needs and emerging competitive forces. In the long run, every business is at risk for survival. Although companies such as Dell Computer, Microsoft, and Wal-Mart were business heroes of the nineties, there is no guarantee that these same companies will continue to dominate over the next decade. The only thing that is constant. . . is *change*.

- Customers will continue to *change* in needs, demographics, lifestyle, and consumption behavior.
- Competitors will *change* as new technologies emerge and barriers to foreign competition shift.
- The environment in which businesses operate will continue to *change* as economic, political, social, and technological forces shift.

The companies that *survive* and *grow* will be the ones that *understand change* and are out in front leading, often creating, change. Others, slow to comprehend change, will follow with reactive strategies, while still others will disappear, not knowing that change has even occurred.

LONG-RUN AND SHORT-RUN BENEFITS

A sports reporter once asked Wayne Gretzky what made him a great hockey player. Gretzky's response was, "I skate to where the puck is going, not to where it is." In other words, Wayne Gretzky has a tremendous instinct for change. He is able to position himself as change is occurring in such a way that he can either score a goal or assist in scoring a goal. Businesses that can sense the direction of change, and position themselves to lead in the change, prosper and grow. Those that wait to read about it in the *Wall Street Journal* are hopelessly behind the play of the game and, at best, can only skate to catch up.

Businesses that are able to skate to where the puck is going have a strong (external) market orientation. They are constantly in tune with customers' needs, competitors' strategies, changing environmental conditions, and emerging technologies, and they seek ways to continuously improve the solution they bring to target customers. This process enables them to move with—and often lead—change.

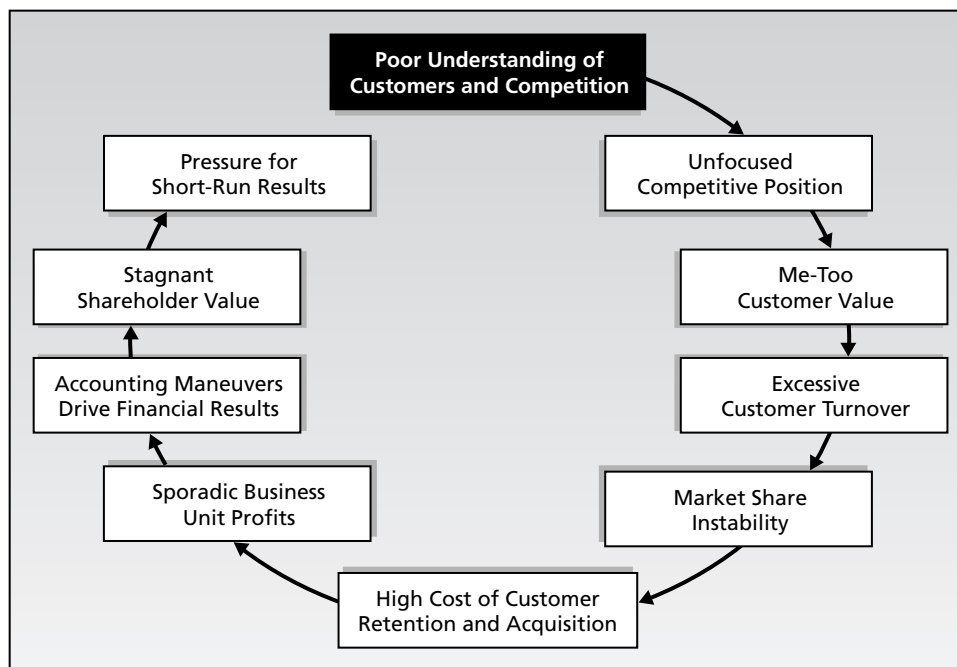
One of the benefits of a strong market orientation is long-run survival. Western cultures have long been criticized for being extremely short-term in perspective. Consequently, long-run survival of a business may not be a strong management motive in developing a strong market orientation. Managers are often judged on the last quarter's results and not on what they are doing to ensure the long-run survival of the business. Likewise, shareholders can be more interested in immediate earnings than in the long-run survival of a business.

Although the long-run benefits of a strong market orientation are crucial to business survival and the economic health of a nation, the purpose of this chapter is to demonstrate the *short-run* benefits of a strong market orientation. Businesses with a strong market orientation not only outperform their competition in delivering higher levels of customer satisfaction, they also deliver higher profits in the short run. Businesses driven by a strong market orientation create greater customer value and, ultimately, greater shareholder value. But perhaps the best way to understand the marketing logic that links market orientation to customer and shareholder value is to examine the sequence of events that evolves when a business has little or no market orientation.

How to Underwhelm Customers and Shareholders

Businesses with a weak market orientation underwhelm both customers and shareholders. A business with a weak market orientation has only a superficial or poor understanding of customer needs and competition. Moving clockwise from the top in Figure 1-1, this poor understanding translates into an unfocused competitive position and a “me-too” customer value.¹ Customers are easily attracted to competitors who offer equal or greater customer value, which leads to high levels of customer turnover

FIGURE 1-1 How to Underwhelm Customers and Shareholders



and market share instability. Efforts to hold off customer switching are expensive, as is the cost of acquiring new customers to replace lost customers.

The combination of market share instability and higher marketing costs results in sporadic business profits. In response, short-term sales tactics and accounting maneuvers are used to achieve short-run financial results. However, investors and Wall Street analysts are able to see through this facade, and shareholder value generally stagnates. Perhaps even worse, as shown in the scenario described in Figure 1-1, management is now under even greater pressure to produce short-run results. This means that there is not the time, the inclination, or the motivation to understand customer needs and to unravel competitors' strategies, and the circular performance displayed in Figure 1-1 continues.

Market Orientation and Customer Satisfaction

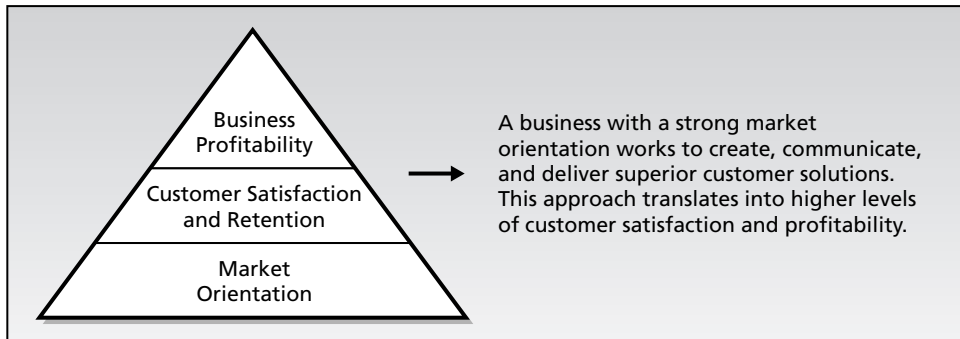
Contrary to the scenario presented in Figure 1-1, a market-oriented business has three management characteristics that make it unique:²

- **Customer Focus:** An obsession with understanding customer needs and delivering customer satisfaction.
- **Competitor Orientation:** Continuous recognition of competitors' sources of advantage, competitive position, and marketing strategies.
- **Team Approach:** Cross-functional teams dedicated to developing and delivering customer solutions.

A strong *customer focus* enables a business to stay in close contact with customer needs and satisfaction. Marketing strategies in these businesses are built around customer needs and other sources of customer satisfaction. The strength of a business's market orientation also relies on how well it *understands key competitors* and evolving competitive forces. This aspect of market orientation enables a business to track its relative competitiveness in such areas as pricing, product quality and availability, service quality, and customer satisfaction. Businesses with a strong market orientation also work well as a team *across functions*, thereby leveraging cross-functional skills and business activities that affect customer response and satisfaction.

The real benefit of a strong market orientation and higher levels of customer satisfaction is a higher level of customer retention.³ Keeping good customers should be the *first priority* of market-based management. As shown in Figure 1-2, a business with a strong market orientation is in the best position to develop and implement strategies

FIGURE 1-2 Market Orientation, Customer Satisfaction, and Profitability



that deliver high levels of customer satisfaction and retention. In turn, customer satisfaction and retention drive customer revenue and the cost of doing business. Ultimately, they are key forces in shaping the profitability of a business.

Customer Satisfaction: A Key Market Performance Metric

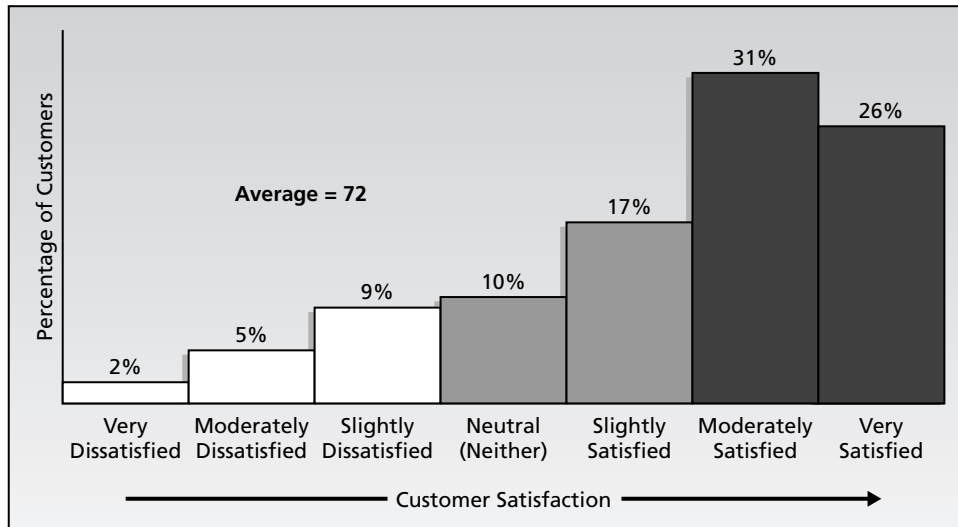
While a market-based business will have several external metrics to track market performance, an essential performance metric is customer satisfaction. There are many marketing strategies that can be developed to attract customers, but it is the business that completely satisfies customers that gets to keep them. This viewpoint may sound philanthropic to those who do not accept the whole concept of market orientation and market-based management. We will demonstrate in this chapter the tremendous leverage a business can create in growing profits from a base of very satisfied customers and proactive management of dissatisfied customers.

There are many ways to measure customer satisfaction. However, one common measure of customer satisfaction can be derived from customers' ratings of their overall satisfaction on a seven-point scale that ranges from 0 (very dissatisfied) to 6 (very satisfied), as shown below.

<u>0</u>	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>
Very Dissatisfied	Moderately Dissatisfied	Slightly Dissatisfied	Neutral (Neither)	Slightly Satisfied	Moderately Satisfied	Very Satisfied

When this method of measuring customer satisfaction is applied to a sample of customers, we can compute an overall measure of customer satisfaction. Assume, for example, that an interview with 100 Xerox copier customers produced an average score of 4.32. An overall average of 4.32 does not tell us much and is not likely to get management's attention. To increase the sensitivity of this measure, we need to index it in a more meaningful way. By dividing the average score by the maximum score of 6 (very satisfied) and multiplying by 100, we can create an index that varies from 0 to 100. When this index is used, the overall average of 4.32 translates to a score of 72, where 100 would be the maximum. Management can quickly discern that the business has achieved a 72 level of customer satisfaction, whereas a 100 would be equivalent to 100 percent very satisfied customers.

Is an overall customer satisfaction score of 72 a good level of performance? That depends on what the business's overall score was in earlier measurements, its target objective, and the overall score given to a leading competitor. Let's assume that an overall score of 72 is an improvement over earlier average scores and that the average score of a leading competitor is 62. Those numbers would lead many businesses to feel pretty good about their level of performance and perhaps become complacent in their pursuit of customer satisfaction. Also, efforts to increase customer satisfaction cost time and money, and many managers may argue that the incremental benefit is not sufficient to justify the cost. That argument would *not* apply at Xerox, where customer satisfaction is a top corporate performance metric and priority.⁴ To really understand customer satisfaction and to leverage its profit potential, we need to expand our view of customer satisfaction.

FIGURE 1-3 Customer Satisfaction: A Wide-Angle View

A Wide-Angle View of Customer Satisfaction

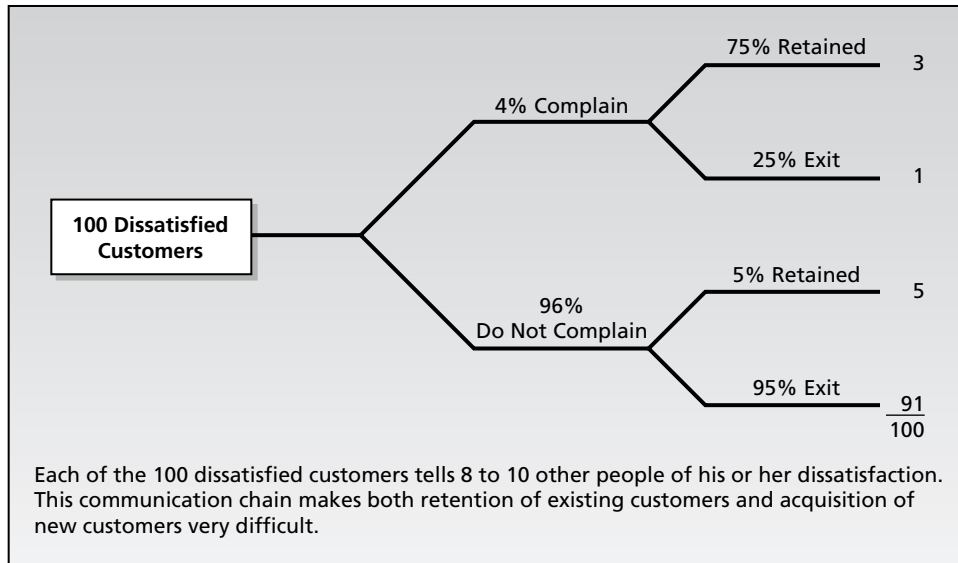
An average customer satisfaction score of 72 (where 100 is the maximum) may be viewed as acceptable, and even very good. However, *managing to the average* masks our understanding of customer satisfaction and opportunities for increased profits.⁵

If we expand our view of customer satisfaction by reporting the percentage for each category on our customer satisfaction scale, a more meaningful set of insights emerges. The average customer satisfaction score of 72 was derived from 74 percent who reported varying degrees of satisfaction, 10 percent who were indifferent or neutral, and 16 percent who reported varying degrees of dissatisfaction, as illustrated in Figure 1-3. The 10 percent who were neutral in their customer satisfaction are certainly vulnerable to competitor moves, but it is the 16 percent categorized as dissatisfied who are very serious candidates to exit as customers. Thus, our immediate concern should be our dissatisfied customers.

Customer Dissatisfaction and Customer Exit

Dissatisfied customers often do not complain to a manufacturer, but they do walk and they *do* talk.⁶ Well-documented studies show that out of 100 dissatisfied customers, only 4 will complain to a business.⁷ Of the 96 dissatisfied customers who do not complain, 91 will exit as customers, as shown in Figure 1-4. While market position is quietly eroded by exiting customers, attracting new customers is made more difficult because each dissatisfied customer will tell 8 to 10 other people of his or her dissatisfaction.

The market impact is enormous. For example, assume that a business has captured 10 percent of a 2-million-customer market, or 200,000 customers. If 15 percent of those 200,000 customers were dissatisfied, this business would have 30,000 dissatisfied customers. The statistics presented in Figure 1-4 would indicate that the business would lose 92 percent of those dissatisfied customers—27,600 customers—each year. This

FIGURE 1-4 Customer Dissatisfaction and Customer Exit

percentage translates to a 1.4 point reduction in market share. To hold a 10 percent share of the market (customers), the business would have to attract 27,600 new customers. This, of course, is a very expensive way to hold market share.

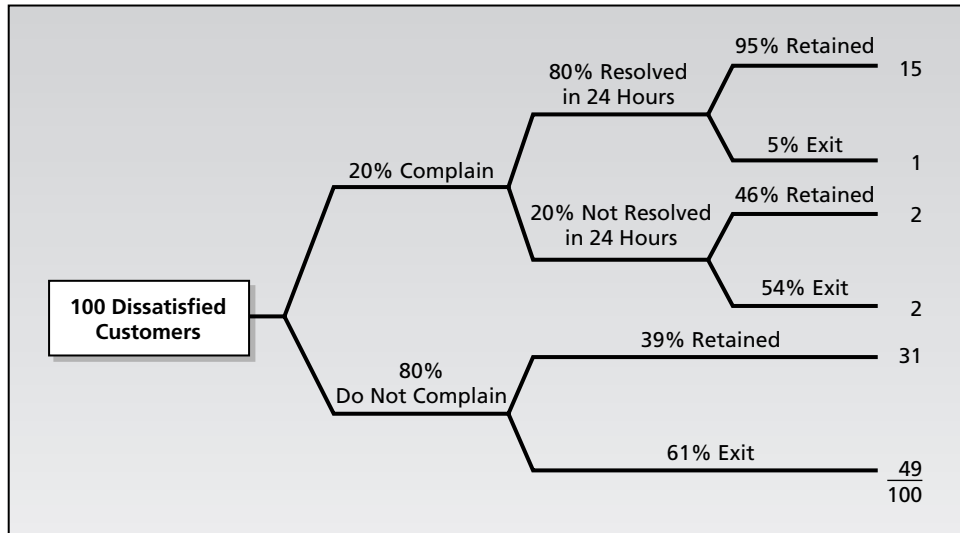
But the situation is much worse.⁸ Many dissatisfied customers become “terrorists;” they vent their dissatisfaction by telling others about it. Recall that each dissatisfied customer tells 8 to 10 other people. This means that the 30,000 dissatisfied customers will communicate their dissatisfaction to approximately a quarter of a million other individuals. These may not all be potential customers, but this level of negative word-of-mouth communication makes new customer attraction much more difficult and more expensive.⁹

This kind of market behavior has led some businesses to develop programs to encourage dissatisfied customers to complain. For example, Domino’s Pizza instituted a program in which their strategy was simply to encourage dissatisfied customers to complain rather than just leave.¹⁰ Figure 1-5 illustrates that their efforts succeeded in getting 20 percent of their dissatisfied customers to complain. For those who complain, Domino’s can resolve 80 percent of the problems in twenty-four hours. When complaints can be resolved quickly, 95 percent of those customers can be retained. When complaints cannot be resolved within twenty-four hours, the customer retention rate falls to 46 percent.

Not surprisingly, if customers do not complain, the odds of retention drop below 40 percent. Thus, while it may seem odd at first, one of the jobs of market-based management is not only to track customer satisfaction but also to *encourage dissatisfied customers to complain*. Only with the specific details of a customer complaint and the source of dissatisfaction can a business take corrective action.¹¹

Companies such as AT&T proactively address potential customer dissatisfaction by encouraging customer complaints through full-page ads with toll-free telephone numbers. Their proactive marketing efforts have two important effects. First, their

FIGURE 1-5 Efforts to Encourage Customer Complaints and Manage Customer Dissatisfaction



proactive services address problems as they occur, greatly reducing potential customer dissatisfaction and exit. Second, communicating their proactive services reinforces customer satisfaction by communicating the importance of their efforts to provide maximum customer satisfaction.¹²

Customer Satisfaction and Profitability

Customer satisfaction is an excellent market-based performance metric and barometer of future revenues and profits, as stated below.

Customer satisfaction is a forward-looking indicator of business success that measures how well customers will respond to the company in the future.

Other measures of market performance, such as sales and market share, are backward-looking measures of success. They tell how well the firm has done in the past, not how well it will do in the future.¹³

Thus, customer satisfaction is a good leading indicator of future operating performance. A business may have produced excellent financial results while underwhelming and disappointing a growing number of its customers. Because customers cannot always immediately switch to alternative solutions, customer dissatisfaction often precedes customer exit and reductions in sales and profitability. Thus, for many businesses, quarterly measures of customer satisfaction provide an excellent leading indicator of future performance. If customer satisfaction is on the decline, an early warning signal is given, providing the opportunity to correct a problem before real damage is done. Of course, if a business does not track customer satisfaction, it forgoes the opportunity to correct problems before declines in sales and profits result.

For example, a dissatisfied FedEx customer can move quickly to an alternative provider of overnight mail. That fact has led FedEx to develop a service quality index for every transaction in order to spot problems as they occur and to avoid the potential loss of customers. In the long run, it is more profitable to keep existing customers than to continually have to work to attract and develop new customers to replace exiting ones. FedEx has demonstrated that gains in customer satisfaction, driven by improvements in service quality, provide gains in revenue and lower cost.

Profit Impact of Customer Dissatisfaction

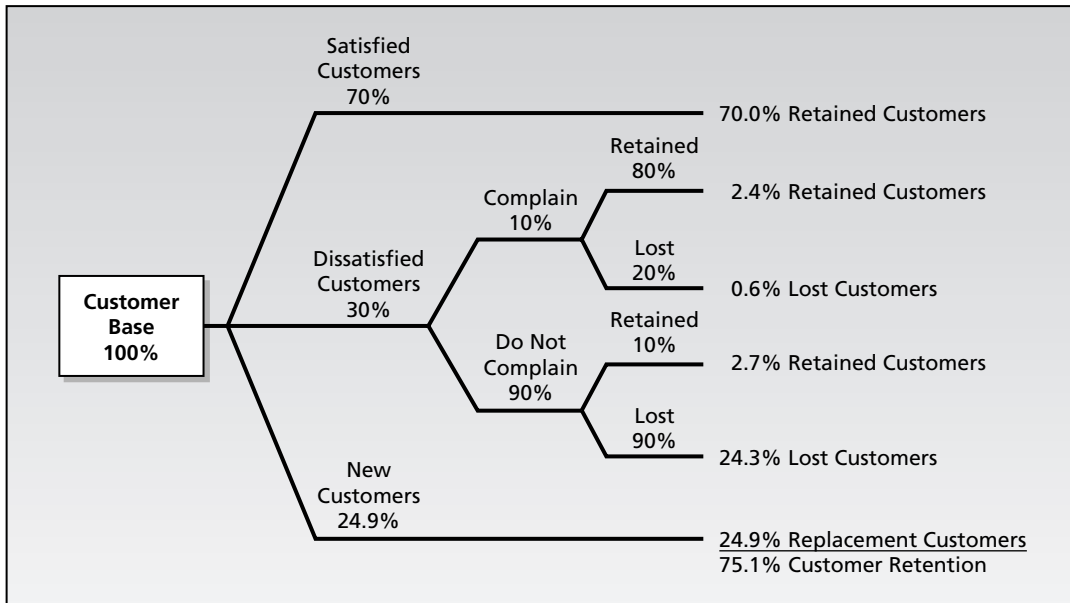
MBNA America is a Delaware-based credit card company that, in the early 1990s, became frustrated with customer dissatisfaction and defection. All 300 employees were brought together in an effort to understand and develop methods of delivering greater levels of customer satisfaction with the intent of keeping each and every customer. At the time, MBNA America had a 90 percent customer retention rate. After several years of dedicating themselves to improved customer satisfaction and retention, they raised customer retention to 95 percent. That may seem like a small difference, but the impact on their profits was a *sixteen-fold* increase, and their industry ranking went from 38th to 4th.¹⁴ Thus, their marketing efforts to satisfy and retain customers paid off in higher levels of profitability.

As demonstrated, most dissatisfied customers do not complain; they just walk away. To hold market share in a mature market, a business must replace those lost customers. Let's examine a business that is in a mature market with 200,000 customers and has a 75 percent rate of customer retention. Each year this business loses 50,000 customers and, to hold a customer base of 200,000, must replace those customers with 50,000 new customers. However, before we look at the profit impact of this level of customer satisfaction and retention, let's look at how this business got to a level of 75 percent customer retention. A closer look at customer satisfaction, complaint behavior, and customer retention enables us to build the *Customer Retention Tree* in Figure 1-6. As shown, the business is operating at a 70 percent level of customer satisfaction. Of the 30 percent who are dissatisfied, 24.9 percent are lost. Furthermore, the majority of dissatisfied customers who are lost do not complain to the business about the source of their dissatisfaction.

The customer profitability profile shown in Figure 1-7 reflects the information presented in Figure 1-6. It shows the average annual revenue, margin, and marketing expense per customer for retained customers, lost customers, and new customers. As shown, retained customers are the profit driver of this business, producing 80 percent of the sales revenue and 89 percent of the total contribution.

Lost customers are generally dissatisfied or neutral customers. Because they are not with the business for the whole year or are in the process of reducing their purchases from the business, the annual revenue per customer is much lower. However, retaining dissatisfied customers is also expensive because they require the business to expend extra resources in an attempt to keep them. These extra efforts often mean extra work for the sales force, price concessions, adjustments to inventory or terms of sale, and more customer service. The net result of losing dissatisfied customers in this example is a negative *net marketing contribution* of \$2.5 million per year. The net marketing contribution shown in Figure 1-7 is the total revenue received from customers less variable

FIGURE 1-6 Customer Retention Tree



costs of producing those revenues less direct marketing expenses needed to serve this level of customer volume. This concept will be discussed in detail in chapter 2.

New customers are also less profitable. Advertising and sales promotion dollars have to be spent to generate sales leads and produce trial purchases. This raises the marketing expenses associated with attracting, qualifying, and serving new customers. New customers also generally buy less because they are in the evaluation stage and

FIGURE 1-7 Profit Impact of 75 Percent Customer Retention

<i>Customer Performance</i>	<i>Retained Customers</i>	<i>Lost Customers</i>	<i>New Customers</i>	<i>Overall Performance</i>
Number of Customers	150,000	50,000	50,000	250,000
Revenue per Customer	\$800	\$200	\$400	
Sales Revenue (millions)	\$120.0	\$ 10.0	\$ 20.0	\$150.0
Variable Cost per Customer	\$400	\$150	\$300	
Margin per Customer	\$400	\$ 50	\$100	
Total Contribution (millions)	\$ 60.0	\$ 2.5	\$ 5.0	\$ 67.5
Marketing Expense per Customer	\$ 60	\$100	\$300	
Total Marketing Expense (millions)	\$ 9.0	\$ 5.0	\$ 15.0	\$ 29.0
Net Marketing Contribution (millions)	\$ 51.0	-\$ 2.5	-\$ 10.0	\$ 38.5
Operating Expenses (millions)				\$ 30.0
Net Profit before Taxes (millions)				\$ 8.5
Return on Sales				5.67%

have not yet fully committed themselves to the business or its products. This lowers both the annual revenue and margin produced by each new customer. The net result in this example is that the business actually loses \$10 million in net marketing contribution each year in its efforts to replace lost customers.

Profit Impact of Customer Retention

For the business situation presented in Figure 1-7, overall sales revenues of \$150 million produce a net profit of \$8.5 million, a 5.67 percent return on sales. But what would be the profit impact of improved customer satisfaction? Let's assume that \$1 million were dedicated to reducing the number of dissatisfied customers so that 80 percent of the business's customers could be retained each year. The marketing logic and profit impact of this strategy can be summarized as follows:

If the business can retain 80 percent of its customers each year instead of 75 percent, the business will reduce the cost associated with customer dissatisfaction and exit and will not have to spend as much on marketing efforts to attract new customers. Also, because retained customers produce a higher annual revenue and margin per customer than do lost or new customers, the total profits of the business should increase.

This effort would produce only a slight increase in sales revenues, as shown in Figure 1-8. However, there would be a tremendous improvement in marketing efficiency and profitability. Because retained customers are more profitable than new customers, the overall total contribution derived from retained customers would increase from \$60 million to \$64 million. The overall marketing expenses would go up because of the \$1 million that were added to the business's marketing budget to achieve an 80 percent customer retention. The net result would be a \$3 million improvement in net marketing contribution derived from retained customers.

FIGURE 1-8 Profit Impact of 5 Percent Improvement in Customer Retention

<i>Customer Performance</i>	<i>Retained Customers</i>	<i>Lost Customers</i>	<i>New Customers</i>	<i>Overall Performance</i>
Number of Customers	160,000	40,000	40,000	240,000
Revenue per Customer	\$800	\$200	\$400	
Sales Revenue (millions)	\$128.0	\$ 8.0	\$ 16.0	\$152.0
Variable Cost per Customer	\$400	\$150	\$300	
Margin per Customer	\$400	\$ 50	\$100	
Total Contribution (millions)	\$ 64.0	\$ 2.0	\$ 4.0	\$ 70.0
Marketing Expense per Customer	\$ 62.5	\$100	\$300	
Total Marketing Expense (millions)	\$ 10.0	\$ 4.0	\$ 12.0	\$ 26.0
Net Marketing Contribution (millions)	\$ 54.0	-\$ 2.0	-\$ 8.0	\$ 44.0
Operating Expenses (millions)				\$ 30.0
Net Profit before Taxes (millions)				\$ 14.0
Return on Sales				9.2%

More important, the net loss of managing dissatisfied customers who exit and the net loss associated with attracting new customers would be reduced by a total of \$2.5 million in this example. The cumulative impact of increased customer satisfaction and retention is an increase of net profits from \$8.5 to \$14 million. This incremental gain in net profits is derived from a larger number of retained customers, the reduced cost of serving dissatisfied customers, and reduced expenses associated with acquiring new customers to maintain the same customer base. This is a 64 percent increase in net profits with essentially *no change in market share or sales revenue*.

One can readily see the enormous potential for increased profits and cash flow that centers around customer satisfaction and retention. For each additional customer that is retained, net profits increase. Inefficient costs associated with serving dissatisfied customers and the cost of acquiring new customers to replace them are reduced. Thus, there is tremendous financial leverage in satisfying and retaining customers.

Customer Satisfaction and Customer Retention

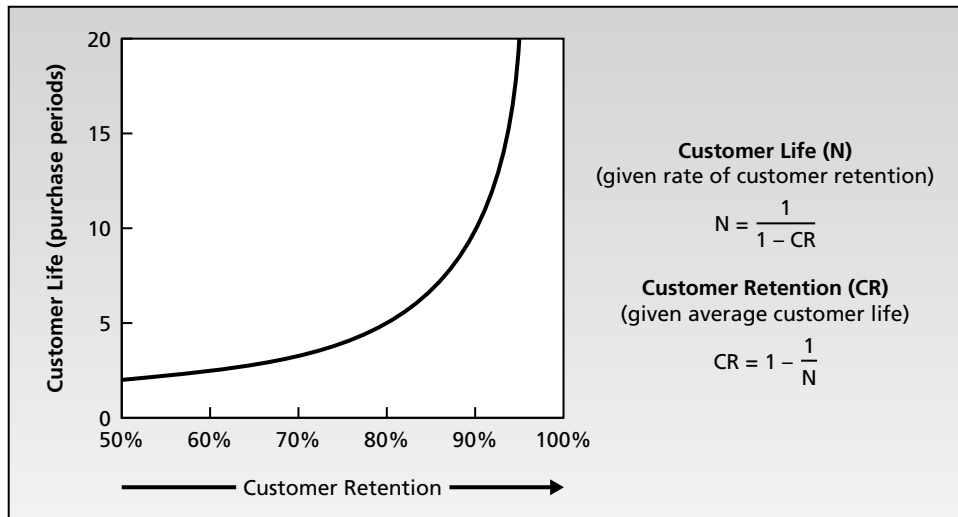
The relationship between customer satisfaction and customer retention is intuitively easy to discern. However, different competitive conditions modify this relationship.¹⁵ For example, in less competitive markets, customers are more easily retained even with poor levels of customer satisfaction because there are few substitutes or switching costs are high. In markets where there are relatively few choices, such as phone service, water companies, or hospitals, customers may stay even when dissatisfied. In these types of markets, where choice is limited or switching costs are very high, higher levels of customer retention are achievable at relatively lower levels of customer satisfaction.

However, in highly competitive markets with many choices and low customer switching costs, even relatively high levels of customer satisfaction may not insure against customer defection. Grocery store, restaurant, and bank customers can switch quickly if not completely satisfied. While the time between purchase events is longer, personal computer, automobile, and consumer electronics customers can also easily move to another brand if not completely satisfied. In these markets, customer retention is much more difficult. And, as a result, it takes higher levels of customer satisfaction to retain customers from one purchase to the next.

Customer Retention and Customer Life Expectancy

Customer satisfaction and retention are important linkages to a market-based strategy and profitability. The ultimate objective of any given marketing strategy should be to attract, satisfy, and retain target customers. If a business can accomplish this objective with a competitive advantage in attractive markets, the business will produce above-average profits.

The customer is a critical component in the profitability equation but is completely overlooked in any financial analysis or annual reports. Customers are a *marketing asset* that businesses have yet to quantify in their accounting systems. Yet, the business that can attract, satisfy, and keep customers over their lifetime of purchases is in a powerful position to deliver superior levels of profitability. Businesses that lack a market orientation look at customers as *individual purchase transactions*. A market-based business looks at customers as *lifetime partners*. The *New York Times* tracks its customer retention and the retention rates of competing newspapers by length of subscription.¹⁶

FIGURE 1-9 Customer Life Expectancy and Customer Retention

Among *Mature Subscribers*, those who have had subscriptions longer than twenty-four months, the *New York Times* has a retention rate of 94 percent. Their closest competitor has an 80 percent retention rate.

The higher the rate of customer retention, the greater the profit impact for a given business. In the short run, we showed this to be true on the basis of increased profits from retained customers, reduced losses from lost customers, and a lower cost of attracting new customers in order to maintain a certain customer base. However, there is also a longer-term profit impact of higher levels of customer retention because a higher rate of retention lengthens the life of a customer relationship.

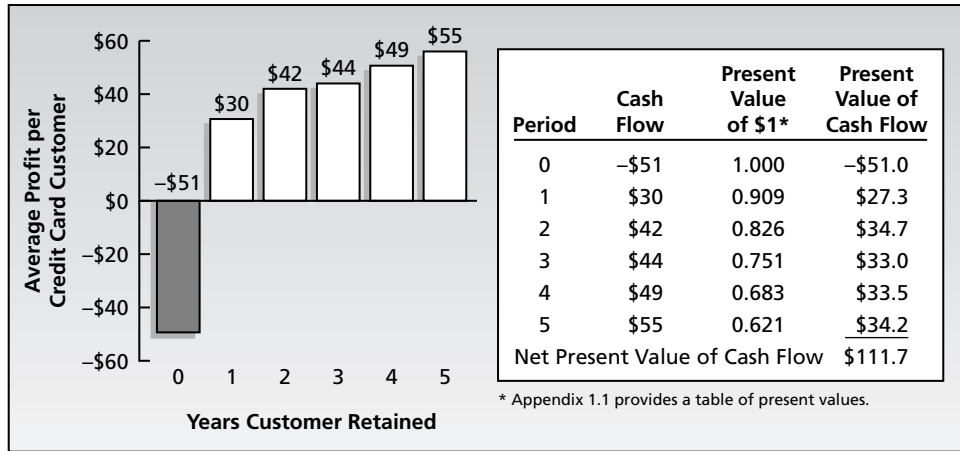
A business that has a 50 percent rate of customer retention has a fifty-fifty chance of retaining a customer from one year to the next. This fact translates into an average customer life of two years, as shown in Figure 1-9. The average life expectancy of a customer is equal to one divided by one minus the rate of customer retention. Therefore, as customer retention increases, the customer's life expectancy increases. But, more important, customer life expectancy increases exponentially with customer retention, as illustrated in Figure 1-9.

For example, the average level of customer retention among health care providers is 80 percent.¹⁷ This translates into an average customer life of five years. If a health care provider could manage to increase its customer retention to 90 percent, that increase would produce an average customer life of 10 years. Thus, the life expectancy of a customer grows exponentially as a business moves to higher levels of customer retention.

The Lifetime Value of a Customer

The Cadillac division of General Motors estimates that a Cadillac customer will spend approximately \$350,000 over a lifetime on automotive purchases and maintenance. If Cadillac loses that customer early in this customer life cycle, it forgoes hundreds of thousands of dollars in future cash flow. And, to replace that lost customer, Cadillac has

FIGURE 1-10 Customer Lifetime Value



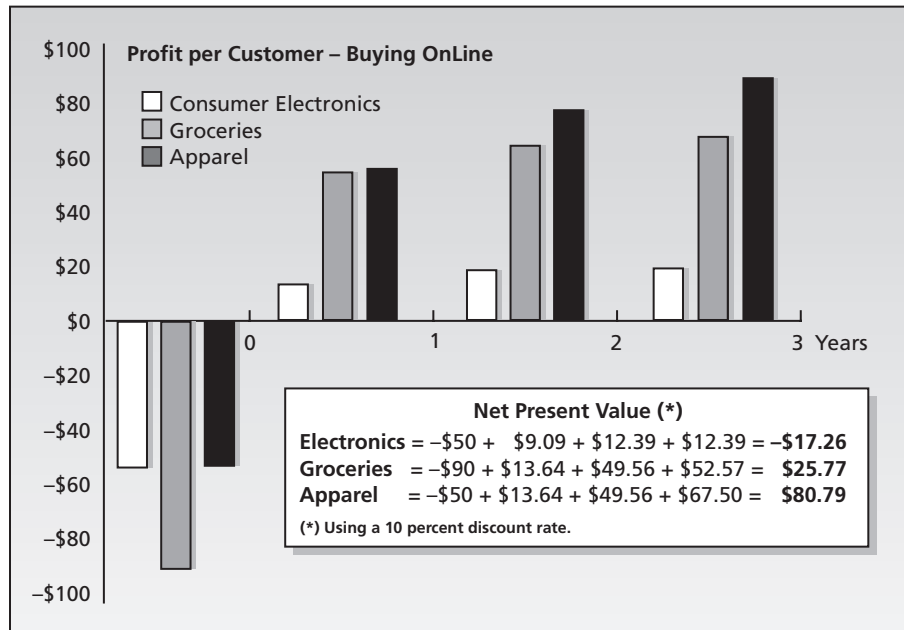
to attract and develop a new customer, which is an expensive process. Thus, the cost of marketing efforts to ensure customer satisfaction is small in comparison with both the current and future benefits of customer purchases, as well as the cost of replacing customers if they become dissatisfied and leave. In general, it costs five times more to replace a customer than it costs to keep a customer.

Figure 1-10 illustrates the average profit per credit card customer generated over a five-year period. Acquiring and setting up accounts for new credit card customers nets an annual loss of \$51 per customer. Newly acquired credit card customers are also slow to use their new cards; they produce an average profit of \$30 the first year, \$42 the second year, and \$44 the third year. By year five, the average profit obtained from a credit card customer is \$55. Thus, the lifetime value of a credit card customer continues to grow. Of course, if a credit card company loses a customer after year four because of customer dissatisfaction, the process of replacing him or her is expensive. This cost in the first year following customer exit is \$106 (\$55 in lost profit from the exiting customer and the \$51 loss associated with attracting a new customer to replace that customer).

In this example, the average customer life is five years. Working backward, we can estimate the customer retention to be 80 percent, as shown below.

$$\text{Customer Retention} = 1 - \frac{1}{N} = 1 - \frac{1}{5} = 0.80 \text{ (or 80\%)}$$

To estimate the lifetime value of a customer at this rate of customer retention, we need to compute the *net present value* of the customer cash flow shown in Figure 1-10. The initial \$51 that it cost to acquire this customer is gone immediately. However, it takes a year to achieve the first year’s revenue of \$30. The present value of \$30 received a year in the future is less than \$30 received immediately. In this example, the business has a discount rate of 10 percent. Therefore, the present value of \$1 received after one year is \$0.909 (the rate at which \$1 is discounted for one year at 10 percent). Thus, \$30 to be received one year later is \$27.27 (\$30 × 0.909). This discounting is performed for each year’s receipts, and the values are totaled to arrive at the net present

FIGURE 1-11 Net Present Value of Online Customers

value of this cash flow. When each year's cash flow is properly discounted, the net present value of the sum of these cash flows is equal to \$111.70. This is what this customer is worth in today's dollars. If customer life expectancy were only three years, the customer value (net present value) would be considerably smaller. The longer the rate of customer retention the longer the average customer life expectancy and the greater the customer value.

To better understand this concept let's look at the customer value (net present value) over a three-year period for online shoppers for consumer electronics, groceries, and apparel¹⁸ as illustrated in Figure 1-11. The cost of acquiring a grocery customer is almost twice the cost of acquiring a consumer-electronics customer. After three years, the online consumer-electronics customer has a negative net present value of -\$17.26. The average online grocery customer produces a net present value of \$25.77 in three years. The average online apparel customer is even more profitable, producing a net present value of \$80.79 in three years.

CUSTOMER RELATIONSHIP MANAGEMENT

While we have shown customer satisfaction and retention to have a positive impact on profitability, a business can have customers it *wants to keep* as well as customers it should *strive to abandon*.¹⁹ Likewise, with the acquisition of new customers there are customers the business *should pursue* and customers the business *should avoid*. This is part of a process called *Customer Relationship Management (CRM)* which is addressed in greater detail in Chapter 5.

Managing Customer Retention

To manage customer relationships effectively with regard to retention, it is useful to classify customers on the basis of customer loyalty and profitability.²⁰ Not all customers are the same. Some may be loyal and profitable, others profitable but not loyal, some loyal but not profitable, and others neither loyal nor profitable. The job of *Customer Relationship Management* is to manage these differences in an effort to obtain higher levels of loyalty and profitability.

The most profitable customers are *Core Customers*.²¹ They make up the majority of a business's profits and are loyal customers as presented below. The primary objective of Customer Relationship Management is to understand the needs of these customers and strive to build programs that deliver superior levels of customer satisfaction.

- **Core Customers** (Profitable and Loyal) – These customers are the key source of a business's profits.
- **At-Risk Customers** (Profitable but Not Loyal) – These are profitable customers who could leave the business due to declining customer satisfaction or weakening customer value.
- **Non-profit Customers** (Not Profitable but Loyal) – These customers are satisfied and retained but can not be served profitably by the business.
- **Spinners** (Not Profitable and Not Loyal) – These are price shoppers who are acquired and exit quickly.

At-Risk Customers are profitable but not loyal. These customers are vulnerable to competitors' efforts to lure them away. An effort to build loyalty among these customers is important to retain them and the profits they produce. Managing customer retention also requires management of *Non-profit Customers*. These customers are satisfied and loyal customers but do not produce positive net present value.²² Often these customers buy infrequently or in amounts that do not cover the cost of serving them. These customers need to be managed to produce an acceptable net present value.

Spinners are “revolving door” customers who enter, purchase and exit. Often these customers are attracted by sales promotions. It is best to avoid these customers altogether when possible. AT&T found that it had 1.7 million customers who were *spinners*, customers who switched telephone carriers an average of three times per year.²³ Even worse, one telephone carrier estimated that 3 percent of its customers sign up, use the company's services, and move on without paying their bills.

Managing New Customer Acquisition

Charles Lillis, former CEO of MediaOne, once said “*I will know when our businesses have done a good job of market segmentation when they can tell me who we should not sell to.*”

Acquiring customers is a tricky process that requires careful Customer Relationship Management. It is common to think of every new customer as beneficial to the business. When the phone rings and someone wants to buy, it takes a rare individual to say “no.” However, the acquisition of new customers can result in *Non-profit Customers* who are loyal but not profitable, or *Spinners* who buy once and exit. This results in an even higher loss given the cost of customer acquisition with little or no

offsetting income. Thus, it is important to understand the differences between target customers and non-target customers as described below.

- **Target Customers** (Good Profit Potential) – These are customers who match the *Core Customer* profile based on customer needs and buying behavior.
- **Non-Target Customers** (Poor Profit Potential) – These are customers who match the profile of *Non-profit Customers* or *Spinners*.

A customer profile of who is *not* a good target customer is just as valuable as a profile of who *is* a good target customer. A new customer acquisition process that can identify *Non-profit Customers* or *Spinners* and avoid them can lower the total cost of acquisition and raise customer retention rates. To the degree a business can attract *Target Customers* and avoid *Non-target Customers*, the business can reduce the overall cost of new customer acquisition and contribute to higher rates of customer retention.

Managing New Customers

Every new customer has the potential to develop into a highly profitable *Core Customer*. *First Time Customers* need to be managed differently. They lack any experience with the business and need above-average service to acclimate them to the business' products and services as described below. How they are managed greatly influences their level of profitability and loyalty.

New customers may also be *Win-back Customers*. These are customers who switched to a competing alternative because they were “mismanaged.” These *Win-back Customers* need special attention that addresses the dissatisfaction that caused them to leave in the first place. If the customer relationship management program is working effectively, both types of new customers can evolve to the level of a *Core Customer*.

- **First-Time Customers** (Good Profit Potential) – These customers have no prior purchase experience but match the *Core Customer* target customer profile.
- **Win-Back Customers** (Good Profit Potential) – These previous customers were profitable but were lured away to a competing product and have been won back by the business.

Managing Customer Exit

Every business loses customers at one time or another. However, customers are lost for different reasons. Some are *Core Customers* that a business would like to win back. These were *Mismanaged Customers* who left the business due to dissatisfaction and/or low loyalty as described below. Lost customers can also include *Abandoned Customers* who were unprofitable and successfully abandoned.

- **Mismanaged Customers** (Profitable but Left) – These are *At-risk Customers* who were once *Core Customers* the business lost but would like to gain back.
- **Abandoned Customers** (Not Profitable and Left) – These customers never should have been customers due to a poor fit with the business and poor profitability (i.e. *Spinners* and *Non-profit Customers*).

Customer Relationship Management is an important aspect of managing customer retention and profitability.²⁴ Careful management of all customer relationships starts with identifying target customers to retain and acquire, as well as how to manage new

customers and abandon unprofitable customers. Each customer relationship has an impact on overall retention levels and profitability. Successful CRM involves managing all customers' relationships to avoid *Spinners* and *Non-profit Customers* while minimizing the loss of *At-risk Customers* and retaining the profitable, loyal *Core Customers*.

BUILDING A MARKET ORIENTATION

Businesses with a strong market orientation are in the best position to develop responsive marketing strategies that deliver high levels of customer satisfaction and retention. But how does a business build a strong market orientation? Why do some businesses have a strong market orientation while others cannot seem to develop one? There are three fundamental forces that drive the degree to which a business has a market orientation:

- **Marketing Knowledge:** The degree to which managers and employees have been educated and trained in the area of marketing directly affects the market orientation of a business.
- **Marketing Leadership:** The market orientation of a business starts at the top. If the senior management and key marketing managers of a business do not have a strong market orientation, it is difficult for a business to establish any level of marketing excellence.
- **Employee Satisfaction:** If employees are unhappy in their jobs and uninformed as to how they affect customers, the business's market orientation will never achieve even minimal effectiveness regardless of senior management speeches and market-based statements of mission and philosophy.

Market Orientation and Marketing Knowledge

The extent to which a manager has a strong market orientation is directly related to their level of marketing knowledge:²⁴ the higher one's level of marketing knowledge, the stronger that individual's marketing orientation as shown in Figure 1-12. This

FIGURE 1-12 Marketing Knowledge and Market Orientation

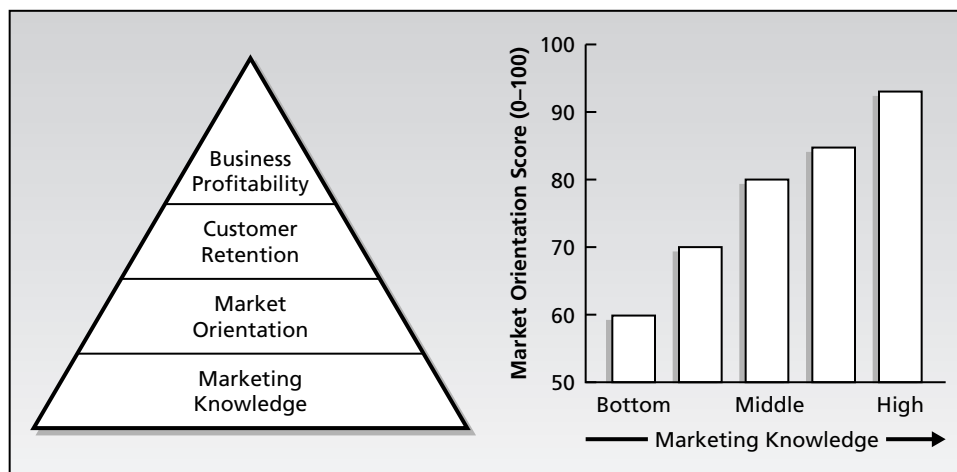
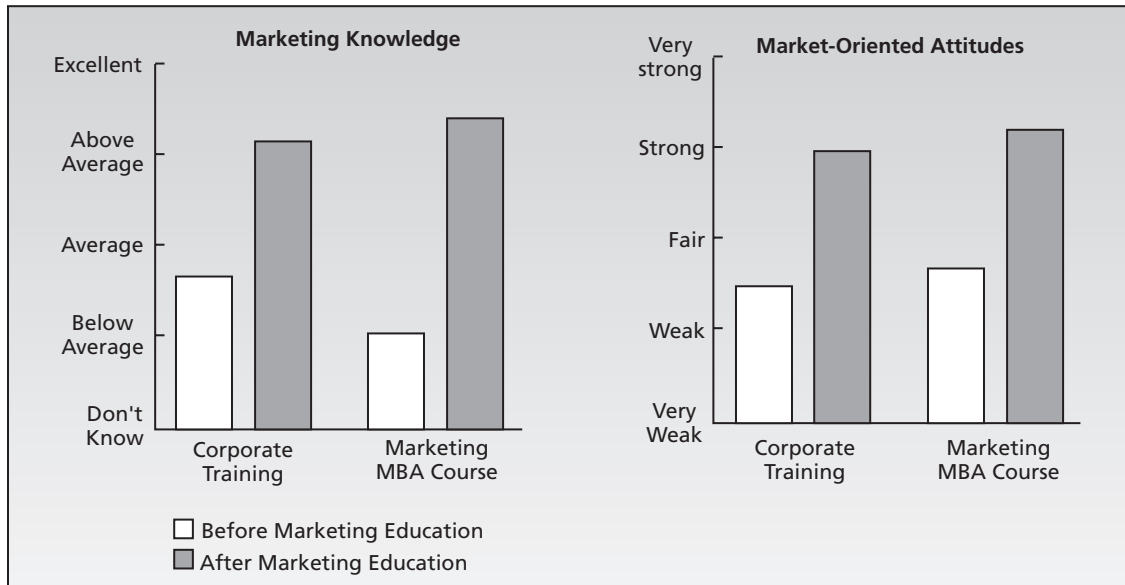


FIGURE 1-13 Effects of Marketing Education on Marketing Knowledge and Marketing Attitudes

graphic was built from a database of 15,000 managers from over sixty countries.²⁵ Further analysis of these data also found that marketing knowledge and market orientation are strongly correlated to marketing education, marketing experience, and participation in marketing training programs. Businesses that build a strong market orientation also have higher levels of customer retention and profitability.

Marketing excellence requires more than words. Businesses seeking to build a strong marketing orientation need to invest in building marketing knowledge. Measures of marketing knowledge and marketing attitudes *before and after* corporate marketing education programs demonstrate that meaningful improvements in marketing knowledge can be obtained as illustrated in Figure 1-13. This has training implications for businesses wanting to build their marketing knowledge in pursuit of marketing excellence.

MBA marketing education can also make a difference. Measures of marketing knowledge and marketing attitudes before and after a first year MBA marketing course for over 1,000 MBAs at Northwestern University, Penn State University, and the University of Oregon demonstrated a significant gain in marketing knowledge and attitudes. This has obvious recruiting and hiring implications for companies interested in building marketing excellence.

While formal marketing education and training are absolutely essential for those in marketing and higher-level positions of leadership, market orientation is also fundamental to every employee of the organization. For example, Disney spends four days training personnel who clean their theme parks.²⁶ They train what they call the “popcorn people” to be information guides because they are the first to be asked where something is located. These “popcorn people” are also trained to treat customers as

guests and to consider themselves on stage. Naturally, the individual marketing orientation of these employees plays a key role in creating a Disney company market orientation that delivers high levels of customer satisfaction.

Market Orientation and Marketing Leadership

A marketing orientation audit of a mid-sized high-tech company involved assessing marketing attitudes and practices at several layers of the business's management hierarchy. The following comments were given in response to the question "How often do you see customers?"

Company CEO: I really don't have too much time for that. I have many financial issues, administrative tasks, and many meetings. So I leave it to my vice president of marketing.

Vice President of Marketing: Well, I have a rather considerable staff and many responsibilities with regard to marketing plans and day-to-day decisions regarding our sales force and advertising. So I really don't have the time. But we have a very highly trained sales force, and they are talking to customers all the time.

Sales Force: Sure, we are in continuous contact with our customers and we bring back new ideas all the time. But nobody in management has the time to listen.

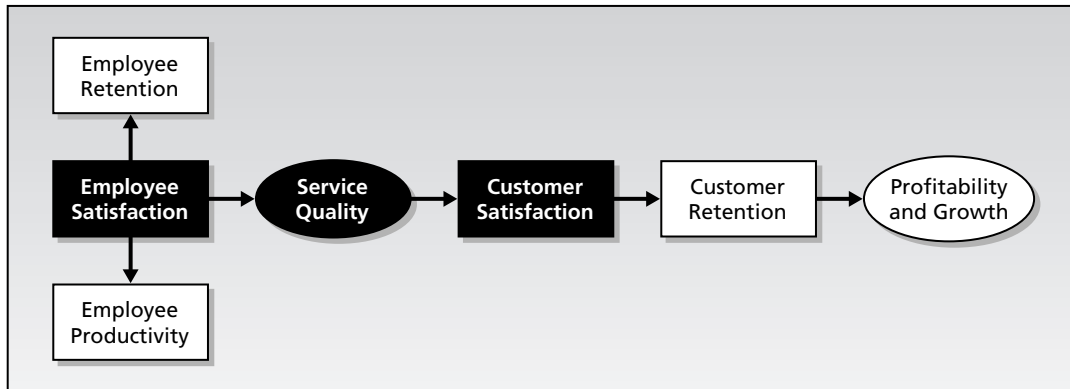
Obviously, this business lacks marketing leadership at the top. To build a strong market orientation, all levels of management, and senior management in particular, need to have a strong customer focus. Market orientation and marketing leadership start at the top.

For example, IBM's top 470 executives are personally responsible for more than 1,300 customer accounts.²⁷ In addition, IBM gives frontline employees the authority, without prior management approval, to spend up to \$5,000 per complaint to solve problems for a customer on the spot. Nordstrom has created a market-based culture in which every customer interaction is an opportunity to build customer satisfaction.²⁸ This initiative is led from the top and permeates all levels of the Nordstrom management hierarchy. Starbucks senior management believes that the first four hours of new employee training are the most important in shaping an employee's market orientation. To the degree that management fails to communicate its customer orientation during this training, it will have failed to shape Starbucks' market orientation.

Every marketing decision implicitly or explicitly sends a message to employees relative to management's commitment to a market orientation. The actions and words of senior and middle management set the tone of a business's market orientation. Their market orientation and leadership are essential in building a market-based business culture. A top management decision to unjustifiably raise customer prices in order to meet short-term profit objectives sends a clear signal of the business's lack of commitment to a market orientation. Thus, consistent market-based leadership is a requirement for building a market-oriented business culture.

Market Orientation and Employee Satisfaction

Think about calling a business with a complaint and interacting with a person who hates their job and the company they work for. What kind of reception do you think you will get? Employee satisfaction is a key factor in delivering customer satisfaction.²⁹ As shown

FIGURE 1-14 Employee Satisfaction is a Key Driver of Service Quality and Customer Satisfaction

in Figure 1-14, employee satisfaction affects customer service, which in turn influences customer satisfaction and retention. And, as we have already shown, higher levels of customer satisfaction contribute to higher levels of customer retention and profitability.

Sears found that in all of its many stores, there was a high correlation between customer satisfaction, employee satisfaction, and store profitability.³⁰ NCR found that, among 12 manufacturing operations, higher levels of employee job satisfaction corresponded with higher levels of customer satisfaction.³¹ Thus, building a strong market orientation requires a healthy business environment in which employees enjoy their jobs and working for the organization.

Summary

The strength of a business's market orientation is directly related to its ability to develop market-based strategies that deliver high levels of customer satisfaction. For years, many observers would have considered that statement to be a nice academic philosophy that had little to do with a company that was in business to make a profit. Today, however, there is considerable evidence that businesses that operate with higher levels of customer satisfaction are more profitable. They are more profitable because they are able to retain a high percentage of customers, have less rework as a result of poor product or service quality, and need to spend less time and money attracting new customers to replace lost customers.

Thus, businesses with a strong market orientation are able to deliver higher levels of both customer satisfaction and profitability.

As is true of most concepts, the words come much more easily than the results. There are three critical components to achieving a strong market orientation:

- A business must have strong individual market orientation among all its managers and employees. A business's market orientation is only as strong as the collective sum of all the individual market orientations of its managers and employees.
- Market-oriented businesses have a strong customer commitment and Customer Relationship Management

- Program. Not all retained, new or lost customers are the same in profitability and loyalty. Customer differences need to be managed effectively in order to achieve high levels of customer retention and profitability.
- The ultimate goal of a strong market orientation is to develop and implement marketing strategies that attract, satisfy, and retain target market customers. Formal measures of customer satisfaction, dissatisfaction, and retention play an important role in achieving a strong market orientation.

A business with a strong market focus is in a position to develop marketing strategies

that are responsive to customer needs and competitive forces. By delivering higher levels of customer satisfaction and value, these businesses are able to retain a higher proportion of their customers. Having higher customer satisfaction and retention lowers the cost of serving customers and acquiring new ones. Perhaps more important, it creates the opportunity to keep customers throughout their customer life cycle. Keeping customers contributes to both current and future profits, enabling a business to invest in other market opportunities. In the end, a strong market orientation rewards customers, employees, and shareholders.

Market-Based Logic and Strategic Thinking

1. What is a market orientation? How would a business with a strong market orientation differ from one with a weak market orientation?
2. How are a strong market orientation and commitment to understanding customer needs related to shareholder value?
3. Why are customer satisfaction and customer retention important drivers of profitability?
4. Why are average measures of customer satisfaction misleading indicators of market-based performance?
5. How does the mix of customers who are satisfied, neutral, and dissatisfied affect a business's net profits?
6. Using the Customer Retention Tree in Figure 1-6, determine how customer retention would change if the business increased its percentage of satisfied customers from 70 to 80 percent.
7. Why do high levels of customer dissatisfaction make attracting new customers more difficult?
8. How do high levels of customer dissatisfaction increase the cost of marketing and hence lower net profits?
9. Why are satisfied customers crucial to a business's net profits?
10. If the average customer life of a credit card (see Figure 1-10) were extended one year, what would be the level of customer retention required? Also, if the profit obtained in the sixth year is the same as that in the fifth year, what is the net gain in customer value (net present value)?
11. How does customer selection affect customer retention?
12. Why is marketing education an important element in building a strong market orientation?
13. What role does employee training play in building market orientation? Why is a market orientation important at all levels of an organization?
14. What role does marketing leadership play in building the market orientation of a business?
15. How can the senior management of an organization destroy a business's market orientation?
16. How does employee satisfaction impact customer satisfaction? Why is it difficult to build customer satisfaction when employee satisfaction is low?

APPLICATION PROBLEM: AIRCOMM

AirComm is a wireless communication service with five million customers and annual sales of \$1.9 billion. Though profitable, AirComm has never measured its customer satisfaction. To better understand customer satisfaction, usage, and what customers do when they are dissatisfied, AirComm conducted a comprehensive study of 1,000 customers, the key results of which are outlined below.

CUSTOMER SATISFACTION

- Sixty-seven percent of AirComm's customers are satisfied and 33 percent are dissatisfied.
- Satisfied customers produce an average revenue of \$400 per year and an average margin of \$250.
- Dissatisfied customers who are retained produce an average revenue of \$300 per year and an average margin of \$150.
- Dissatisfied customers who discontinue their service produce an average \$200 in revenue per year and an average margin of \$100.

CUSTOMER COMPLAINT BEHAVIOR

- Only 5 percent of AirComm's dissatisfied customers complain to AirComm about dissatisfaction. Of these, 90 percent are retained and 10 percent discontinue their service.
- Ninety-five percent of AirComm's dissatisfied customers do not complain. Of these, 20 percent are retained as customers and 80 percent discontinue their service.

NEW CUSTOMERS

- New customers generate an average revenue of \$150 and an average margin of \$50 the first year.

- AirComm actively seeks new customers to maintain its customer base of five million in an increasingly competitive market.

MARKETING COSTS

- The average marketing cost for retaining a satisfied customer is \$50.
- The average marketing cost of managing a dissatisfied customer is \$100.
- The average marketing cost to attract a new customer is \$250.

Questions

For access to interactive software to answer the questions below, go to www.RogerJBest.com or www.prenhall.com/Best.

1. How does customer retention, sales revenues, and marketing profits change if customer satisfaction is improved to 75 percent?
2. How would revenues, margins, and marketing expenses change if the percentage of dissatisfied customers who complained increased from 5 percent to 25 percent (assume the customer satisfaction stayed at 67 percent)?
3. What level of customer satisfaction would be needed to achieve an 90 percent customer retention assuming all other customer characteristics stayed the same? How would profits change if this level of customer satisfaction were obtained?
4. What would be the value of a customer if the customer life improved from 4 to 5 years?

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Appendix 1.1

PRESENT VALUE TABLE

<i>Period</i> (N)	<i>DR=8%</i>	<i>DR=9%</i>	<i>DR=10%</i>	<i>DR=11%</i>	<i>DR=12%</i>	<i>DR=13%</i>	<i>DR=14%</i>	<i>DR=15%</i>
0	1.000	1.000	1.000	1.000	1.000	1.000	1.000	1.000
1	0.926	0.917	0.909	0.901	0.893	0.885	0.887	0.870
2	0.857	0.842	0.826	0.812	0.797	0.783	0.769	0.756
3	0.794	0.772	0.751	0.731	0.712	0.693	0.675	0.658
4	0.735	0.708	0.683	0.659	0.636	0.613	0.592	0.572
5	0.681	0.650	0.621	0.593	0.567	0.543	0.519	0.497
6	0.630	0.596	0.564	0.535	0.507	0.480	0.456	0.432
7	0.583	0.547	0.513	0.482	0.452	0.425	0.400	0.376
8	0.540	0.502	0.467	0.434	0.404	0.376	0.351	0.327
9	0.500	0.460	0.424	0.391	0.361	0.333	0.308	0.284
10	0.463	0.422	0.386	0.352	0.322	0.295	0.270	0.247
11	0.429	0.388	0.350	0.317	0.287	0.261	0.237	0.215
12	0.397	0.356	0.319	0.286	0.257	0.231	0.208	0.187
13	0.368	0.326	0.290	0.258	0.229	0.204	0.182	0.163
14	0.340	0.299	0.263	0.232	0.205	0.181	0.160	0.141
15	0.315	0.275	0.239	0.209	0.183	0.160	0.140	0.123
16	0.292	0.252	0.218	0.188	0.163	0.141	0.123	0.107
17	0.270	0.231	0.198	0.170	0.146	0.125	0.108	0.093
18	0.250	0.212	0.180	0.153	0.130	0.111	0.095	0.081
19	0.232	0.194	0.164	0.138	0.116	0.098	0.083	0.070
20	0.215	0.178	0.149	0.124	0.104	0.087	0.073	0.061

Present Value Formula

$$PV = \frac{1}{(1 + DR)^N}$$

PV = Present Value of \$1.00

N = Number of periods before the \$1.00 will be received

DR = Discount Rate (cost of borrowing or desired rate of return)

Example I: N = 5 periods and Discount Rate (DR) = 10%

$$PV = \frac{1}{(1 + 0.10)^5} = \frac{1}{1.611} = 0.621 \text{ (\$1.00 received in 5 years is worth \$0.621 today)}$$

Example II: N = 2.33 periods and Discount Rate (DR) = 10%

$$PV = \frac{1}{(1 + 0.10)^{2.33}} = \frac{1}{1.249} = 0.801 \text{ (\$1.00 received in 2.33 years is worth \$0.801 today)}$$