

Value

Value 1: A fair return or equivalent in goods, services, or money for something exchanged. **2:** The monetary worth of something. **3:** Relative worth, utility, or importance.¹

The word value has been one of the most used terms in both academic and managerial folklore. There are four common examples of the usage of the term value.

- (1) “It has been argued that the primary goal of business is to create value for customers.”
- (2) “Retailers have claimed that they believe in the principles of value pricing.”
- (3) “A recent surge of academic work in the domain of customer value has put forth the notion of customer lifetime value.”
- (4) “A number of service providers have proposed that the most effective pricing structure is — what they call — value-based pricing.”

Interestingly, while the general idea of value being something that gives utility or worth to an agent is common across the four examples cited above, the more nuanced meaning of the term is different in each of the four examples. In general, there appears to be a lot of conceptual confusion about the definition of the term value.

¹ Value. Def. 1–3. *Merriam-Webster Online Dictionary*, 2009. Merriam-Webster Online. 14 January 2009, <<http://www.merriam-webster.com/dictionary/value>>.

Textbook definitions of the term “value” abound:

Value is the ratio of perceived benefits to price.²

Value can be defined as what the customer gets in exchange for what the customer gives.³

Unfortunately, many of these descriptions share common features to the dictionary definition of the term. They are imprecise (i.e., they are not defined against the backdrop of a specific marketing task), ambiguous (i.e., they mean different things under different contexts), and immeasurable (i.e., they do not lend themselves to developing a model for quantifying the value).

While it may be argued that all of these problems are not unique to the term value, we believe that it is critically important to be nuanced in the definition of value, to understand different drivers of value, to develop a taxonomy for classifying value and finally to develop a method for measuring value. Our approach to the management of customer value is based on the following principles:

(1) *What is value conceptually?*

Managers need to know precisely what it is they are trying to maximize. Are they trying to maximize the value gained by customers, the value gained by the firm, or some other facet of value? Without a nuanced definition of value, there may be a “vocabulary gap,” where multiple managers in a given firm do not complement each others’ efforts because they are working with different objectives.

(2) *How to create value?*

Managers need to understand what they can do to create value. Traditional approaches to marketing and strategy have talked about

² E. N. Berkowitz *et al.*, *Marketing*, 8th ed. (New York: McGraw-Hill/Irwin, 2006).

³ J. P. Peter and J. H. Donnelly, *A Preface to Marketing Management* (New York: McGraw-Hill Professional, 2002).

value creation through new products and services. We would like to go a step further and think about value creation as a function of what the product or service does for the customer. Does it help them save money? Does it make their processes more efficient? Does it make them happy? Does it allow them to do their business more effectively or efficiently? Understanding value at the level of the customer allows a firm to better think about other ways of value creation.

(3) *How much value to create?*

Managers need to be able to quantify value. Our emphasis will be on tools and models that will allow the manager to determine the dollar equivalent of the value they create. Without tools to quantify the value, the manager is at a loss to determine whether their new products, services, or marketing efforts have truly been successful. However, we now have the tools to answer questions like these: What is the average customer worth to me? What is the difference in value between Segment A and Segment B? Therefore, how much should I spend to try and move a customer from one segment to the other? What is the effect of a particular product, service or marketing program on the value of a customer and the value to a customer?

(4) *Which mechanisms should be used to increase value?*

Managers need to be able to influence value with the mechanism that gives the biggest bang for the buck. Chapter 1 introduced the idea of a customer value chain. If the manager could quantify the value of each stage of the value chain, and also determine what it takes to move a customer from one stage to the next one, they are now in a position to make several interesting analyses. Which movement in the value chain yields the highest increase in value? Which ones are the cheapest to influence? What changes yield the highest bang for the buck? Which marketing intervention is the most cost effective in doing this?

In this chapter, we start addressing these building blocks of managing customer value. In particular, we distinguish between value to

a customer and value from a customer. We think about different types and sources of value, and start identifying some simple principles that help quantify the value. In Chapter 5, we will build on some of these principles and illustrate different approaches to the calculation of value, and what utility these value calculations have for the marketing manager.

I. When is Value Created?

In order to develop a more nuanced definition of value, we return to the examples from the introduction. Recall that we gave four examples of the usage of the term value.

(1) *The primary goal of business is to create value for customers.*

When used in this sense, the term “value” suggests that some form of utility is being added to the customer. As we will discuss later, this utility could be in different forms and could manifest itself in different ways.

(2) *Retailers have claimed that they believe in the principles of value pricing.*

We interviewed several retailers to find out what exactly they meant when they spoke of “value pricing.” Our investigations revealed that they used the term primarily to mean prices that were low given the cost structure of the retailer. One retailer said:

“Value pricing is all about giving the lowest possible price that is fair both to the customer and to the store.” This retailer (and indeed many others) was using the term “value pricing” to mean low and fair prices — prices that were driven primarily by the costs of selling.

(3) *A recent surge of academic work in the domain of customer value has put forth the notion of customer lifetime value.*

In their seminar work on customer lifetime value, Gupta and Lehman write, “The lifetime value of a customer is the present value

of all future profits generated from this customer.⁴ Conceptually, this is similar to the present value or discounted cash flow (DCF) approach used in finance to make appropriate investment decisions and to estimate the value of a firm.⁵ A mathematical treatment of the customer lifetime value will be provided later on in this chapter, and in more detail in Chapter 5. However, for now, we recognize the fact that this usage of the “value” term stands for the utility that a particular customer (or groups of customers) brings to the firm. It is the answer to the question — what is this customer (or segment) worth to me? Therefore, how much should I be spending in order to acquire and maintain the business of this customer? As we will see in Chapter 5, while the concept of customer lifetime value was created to understand individual customers, it can also be used to determine a number of important customer-related indices, including the effectiveness of various marketing programs, the marketing return on investment, and marketing spending decisions.

(4) *A number of service providers have proposed that the most effective pricing structure is — what they call — value-based pricing.*

This usage of the term relates very closely to the first usage, and is distinctly different from the second usage. It says that the price that the firm charges a customer should depend on the dollar value that the firm creates for the customer. The greater the value a firm can create, the higher is the price it can charge for its product or service. This is dramatically different from the second usage — the concept of “value pricing” which suggests that pricing is based primarily on costs. As we will see in Chapter 8, the exact same service created with the exact same costs could create a different dollar value for different customers.

⁴ S. Gupta and D. R. Lehman, Customers as assets, *Journal of Interactive Marketing*, 17:1 (2003): 9–24.

⁵ R. Brealey, S. Myers, and F. Allen, *Principles of Corporate Finance 9th Edition* (New York: McGraw-Hill/Irwin, 2007).

A. The Value Grid

Two big ideas emerge from this discussion. The first idea relates to the distinction between the value to the customer and the value of customer to the firm. For simplicity, we will refer to the former as value to the customer (VTC) and the latter as value of the customer (VOC). For now, let us assume that we can somehow quantify both these variables and plot firms on a two-dimensional grid as in Figure 2.1.

The four quadrants in Figure 2.1 represent four stages in a firm's value evolution. Those firms in quadrant 1 neither create value to the customer nor gain value from the customer. These are either recent startups that are in their early days of operations and hence have no proven products and services or firms that have tried but failed to produce winning products. Most (eventually) successful firms are born in this quadrant, but quickly move to quadrant 2. In this area, the firm can deliver value to customers through winning products and services. However, the firm has not yet been able to master the ropes of pricing and is therefore unable to extract value from their customers. This could either be the result of sub-optimal

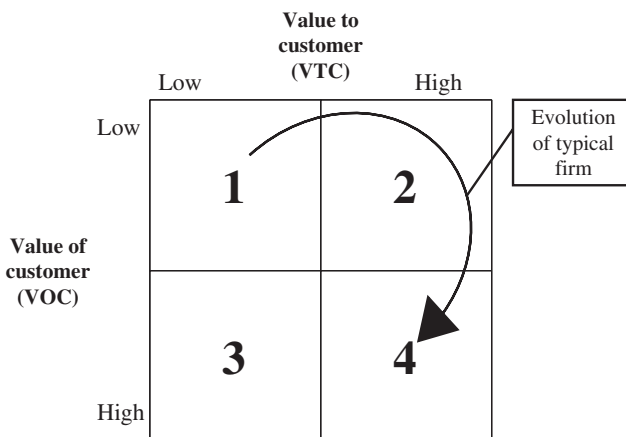


Figure 2.1 The value grid.

pricing and selling policies or the fact that the firm may not yet have a brand name and reputation that allows it to command a higher price. In either case, a startup firm should not remain in this quadrant (2) for too long else they may risk giving away value but not making any money for themselves in the long run. If the firm eventually gets its pricing model right, it should graduate to quadrant 4 — the bliss point in the matrix where the firm creates value for customers and also extracts value in exchange. In this book, we will use quadrant 4 as the goal of all the firm's efforts.

In our parlance, value creation occurs when both:

- (a) the firm has product and services that create utility for the customer, and
- (b) that increased utility is reflected in valuable customers; customers that are valuable to the firm.

In order to understand whether value is created for the customer, we use a simple value heuristic which says:

You create value for the customer when you can do something for them that:

- (a) They — or anyone else — cannot do.
- (b) You can do better than anyone else.
- (c) You can do faster, cheaper or more efficiently than anyone else.
- (d) Somehow allows them to do their business better than they could otherwise do.

Therefore, when you want to create value for your customers, one very simple approach is to understand how the customer does their own business and then ask the question: What is it they do that I can do more

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The VTC, the value of your product to the customer, captures the economic or emotional benefits that your customer gets from using your product rather than what they are currently doing.

effectively for them? Or what can I do that makes their process and products better?

But creating value for the customer is only part of the overall value creation machinery. Put differently, overall value is created if and only if the creation of customer values has a direct and positive effect on cash flows accruing to the firm.

These increased cash flows could arise from:

- (a) A greater willingness to pay for the product;
- (b) Greater frequency of purchase;
- (c) Increased consumption per occasion;
- (d) Greater rates of loyalty; and
- (e) Greater willingness to refer and recommend the product to others.

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It is not enough to merely create value for the customer. Over time, the firm needs to ensure that customers are valuable to them.

In addition, traditional measures of success like market share and volume of sales also have the capacity to increase the cumulative value of the customer to the firm.

Occasionally, some firms (or divisions of firms) may find themselves in quadrant 3 of Figure 2.1. In this quadrant, the firm has a high potential value of the customer, but unfortunately the value to the customer is low. Why does this happen? Sometimes the reputation of the firm, or the hype created through advertising results in a large number of customers who are willing to try a new product or service. If the firm were able to then follow up on its promise and deliver a truly value-added product to its customers, it could potentially land up very quickly in quadrant 4. Sometimes, though, firms fail in this endeavour and find themselves in quadrant 3. In 1992, Crystal Pepsi was marketed as a caffeine-free “clear alternative” to colas, equating clearness with purity and health. Its marketing tagline was “You’ve never seen a taste like this.” However, the taste

was not significantly different from other colas; unlike other colourless soft drinks, which usually have a lemon-lime flavor, Crystal Pepsi tasted much like original drink. Initial sales were good, but quickly fell. Pepsi pulled the drink off the market, and pulled itself out of quadrant 3!⁶

B. Pricing

The second major theme emerging from the discussion in this section is the importance of pricing in creating customer value. For the longest time, pricing has been treated as an ancillary function to the marketing function — a role conducted primarily by economists and the “numbers people.” The centrality of pricing to value cannot be overemphasized. Effective pricing can acquire customers, it can grow value to customers, it can create the right incentives for customers, and eventually it can grow value to the firm. In addition to merely setting a price, the manner in which the price is presented to the customer and the manner in which it evolves over time are critical to the firm’s ability to manage value. We will discuss various aspects of the pricing decision in Chapter 8.

II. Value to the Customer

In order to understand the drivers of customer value, we would like to present examples from a number of hypothetical firms. In the examples that follow, we present a relatively impoverished description of these firms, as well as their operations without

⁶ A. L. Brody and J. B. Lord, *Developing New Food Products for a Changing Marketplace* (Lancaster: Technomic Publishing Co., 2000).

any loss in generality. Put differently, while the descriptions are impoverished, they are sufficient to highlight the underlying principles.

A. *Coal Inc. Case*

The first example is of a firm called Coal Inc. This firm is in the coal distribution business — it transports coal from coal mines and sells it to manufacturers of iron ore. It uses primarily rail links to transport coal. On a fixed schedule (say once every week), a train laden with coal will make a journey from the closest coal mine to one of the customers, Iron Inc. and will deposit the coal on the customers' yard. The customer, in turn, manufactures iron by using a process called smelting in a tall structure called a blast furnace. When the furnace is run, coal and iron ore are fed continuously through the top of the furnace. Chemical reactions ensue, and after a period of time the end products (the molten metal and waste) are taken off from the bottom of the furnace. Iron Inc. runs the blast furnace on a six-day schedule, and on every occasion that the blast furnace is run, it runs a series of conveyor belts from the yard onto which workers manually load the coal so that it could be fed into the top of the furnace. On an average, the coal sits on the yard for about eight days before it is used.

Note that it is highly improbable that one would find a freshly minted marketing MBA student working for Coal Inc. The MBAs would find the product category relatively boring, and their skills difficult to apply. However, suppose an ingenious student of “managing customer value” were to spend some time on the customers' site and to ask themselves, “now what could Coal Inc. do to add value to the customer?” This student could recall the value heuristic, map out Iron Inc.'s process and ask — which part of this process can I improve? One part of the process that should jump up at this student is the eight days of inventory carrying costs. If Coal Inc. could somehow manage to run a train twice a week and reduce the inventory to four days, that would represent a four-day inventory cost