



CUSTOMER CHURN MANAGEMENT:
RETAINING HIGH-MARGIN CUSTOMERS
WITH CUSTOMER RELATIONSHIP
MANAGEMENT TECHNIQUES

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CUSTOMER CHURN IN THE COMMUNICATIONS INDUSTRY

As communications companies battle to thrive and survive amid constant industry change, deregulation, and a general economic downturn, management must shift its focus from rapid revenue and market share growth to maintaining and enhancing margins. Margin enhancement consists of effective revenue enhancement and cost management, leading ultimately to increased profitability and margins.

A persistent challenge on both the cost and revenue sides is *customer churn*, the movement of customers from provider to provider in search of better and cheaper products and services. As markets become saturated and competition intensifies, customers have more choices and are eager to flex their purchasing power. Churn rates have escalated with increased competition and deregulation.

For providers, increased customer churn has resulted in rising customer acquisition costs and lower average monthly billings. It also has translated into a renewed interest in customer satisfaction and retention, since it costs much more for a communications company to acquire a new customer than to retain an existing one.

While the fundamentals of pricing, choice, customer service, service quality, and marketing play an ongoing role in keeping customers happy, carriers need to proactively identify high-value customers who are thinking of jumping ship—for whatever reason—and find a way to keep them on board. Carriers also should be able to identify customers that generate unreasonably low margins and develop strategies to increase margins or divest of such customers. To meet these challenges, communications companies are employing sophisticated customer relationship management (CRM) and churn management techniques.

CUSTOMER CHURN: CAUSES AND ISSUES

WHAT IS CHURN?

Specifically, churn is the gross rate of customer loss during a given period. Churn can be shown as follows:

$$\text{Monthly Churn} = (C_0 + A_1 - C_1) / C_0$$

Where:

C_0 = Number of customers at the start of the month

C_1 = Number of customers at the end of the month

A_1 = Gross new customers during the month

As an example, suppose a carrier has 100 customers at the start of the month, acquires 20 new customers during the month, and has 110 customers at the end of the month. It must have lost 10 customers during the month, 10 percent of the customers it had at the start of the month.

According to the formula:

$$\text{Monthly Churn} = (100 + 20 - 110) / 100 = 10\%$$

Churn can be broken down into *involuntary* churn, where the carrier cuts off service, oftentimes due to repeated nonpayment of invoices, and *voluntary* churn, where the customer chooses to disconnect service.

While eliminating unprofitable customers is an important goal for carriers, this paper focuses on voluntary churn and how it can be more effectively managed.

COSTS OF CUSTOMER CHURN

According to a March 2001 study by Telephia, annual U.S. wireless churn rates now hover at around 27 percent. And this is not just a wireless issue. Other industry segments that are competitive are experiencing significant churn rates as well.

CUSTOMER CHURN: CAUSES AND ISSUES

Local carriers are not immune to this trend and are likely to experience increased churn in the future. Wherever stiff competition generates incentives—from wireline carriers, wireless services, and Internet service providers to utilities, credit card issuers, and insurance companies—customers are switching service providers. According to data published by the Federal Communications Commission in January 2002, competitive local exchange carriers' (CLECs') share of total U.S. local service revenue has increased from 5.5 percent in 1999 to 8.6 percent in 2000 and approximately 10 percent year-to-date through September 2001. U.S. CLECs are expected to control more than 17 percent by 2004. This will happen only with significant churn of the incumbents' core local telephone service customers, particularly high-volume, high-margin business customers.

In addition to lost revenue, customer churn means increased activation and deactivation costs. In the global wireless industry, these amount to \$10 billion per year, according to an August 2001 study by International Data Corporation.

A high churn rate also puts pressure on companies to win new customers. According to a J.D. Power & Associates U.S. wireless industries services study released in September 2001, the cost of acquiring each new customer ranges from \$350 to \$475. And providers need to retain these new customers for more than four years to break even. Replacing old customers with new ones carries other burdens. In addition to marketing and advertising, companies incur costs associated with provisioning new customers, as well as increased risks associated with billing issues and other revenue assurance matters.

To illustrate how the cost of churn affects an individual wireless carrier, suppose the carrier has three million subscribers at the start of a year and an annual churn rate of 27 percent, amounting to a loss of about 810,000 subscribers in that year. Assuming an equal distribution of customer churn throughout the calendar year and an average revenue-per-user of \$45.27 a month (according to the Cellular Telecommunications Industry Association as of the end of 2000), the total revenue loss per

year is approximately \$220 million. Further, assuming the cost of acquisition to be \$350 per customer, the total cost to replace that revenue is \$284 million.

Customer churn also generates soft costs: loss of brand value when dissatisfied customers tell others about their experiences, lost opportunities for cross-selling of complementary products and services, and a potential domino effect with respect to the carrier's remaining customer base. Further, the deactivation and disconnection of customers brings inherent risk of revenue and margin deterioration, particularly when multiple service providers are involved. Finally, the potential impacts on profitability that come from inactive, underutilized, and otherwise unprofitable network facilities must be considered.

CAUSES OF CHURN

In an intensely competitive environment, customers receive numerous incentives to switch and encounter numerous disincentives to stay.

- *Price.* Particularly in the wireless and long-distance markets, carriers often offer pricing promotions, such as relatively low monthly fees, high-volume offerings (fixed number of minutes at a reasonable fee per month), and low rates per-minute. These price incentives can provide residential customers, in particular, with powerful incentives to change carriers.
- *Service quality.* Lack of connection capabilities or quality in places where the customer requires service can cause customers to abandon their current carrier in favor of one with broader reach or a more robust network.
- *Fraud.* Customers may attempt to "game the system" by generating high usage volumes and avoiding payment by constantly churning to the next competitor.
- *Lack of carrier responsiveness.* Slow or no response to customer complaints is a sure path to a customer relations disaster. Broken promises, long hold times when the customer reports problems, and multiple complaints related to the same issue are sure to lead to customer churn.

CUSTOMER CHURN: CAUSES AND ISSUES

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- *Brand disloyalty* (or loyalty to another). Brand issues may arise due to service or other issues experienced over time, mergers or acquisitions involving the incumbent carrier, or entry into the market of another carrier with strong brand recognition and reputation. Marginal brand loyalty can often be overcome by competitors' incentives.
- *Privacy concerns*. Consumers have an increasing awareness that companies they deal with have a lot of information about them, including their spending habits, personal financial information, health information, and the like. Breaking of privacy promises, publicized privacy problems, telemarketing, and other issues are causing many customers to consider their personal privacy as an asset and they are holding their service providers responsible for keeping privacy promises.
- *Lack of features*. Customers may switch carriers for features not provided by their current carrier. This might include the inability of a particular carrier to be the "one-stop shop" for all the customer's communications needs.
- *New technology or product introduced by competitors*. New technologies—such as high-speed data or bundled high-value service offerings—create significant opportunities for carriers to entice competitors' customers to switch.
- *New competitors enter the market*. The mere existence of viable competitors to the incumbent carrier may cause certain disloyal customers to churn. Further, as competitors enter new markets, they often offer short- or long-term incentives to new subscribers to build market share.
- *Billing or service disputes*. Billing errors, incorrectly applied payments, and disputes about service disruptions can cause customers to switch carriers. Depending on the situations, such churn may be avoidable.

In a customer-centric marketplace, price, product, and even customer service are fluid by necessity. The carrier's ability to offer choice and respond to—or better yet, anticipate—needs of individual customers has become a major competitive advantage. For this reason, managing customer churn is largely a customer relationship management issue. Through effective customer relationship building and management, loyalty can be gained and many causes of churn mitigated.

The main problem with churn is that customers don't announce their intentions in advance. It's up to the carrier to uncover evidence of potential churn, ideally even before the customer solidifies feelings or intentions. Ten years ago this would have been a nearly insurmountable challenge. Today, effective business processes enabled by technology can help reveal customer behavior patterns and aid in assessing the profitability of various customer segments, what is important to them, and how the carrier can build loyalty within the most valued customer sets.

What's more, communications companies are sitting on perhaps the richest proprietary customer databases of any industry. Communications usage patterns and service histories reflect personal buying habits, and communications data is relatively easy to capture, store, retrieve, and analyze. To retain customers, carriers need to unlock the value hidden in these massive databases.

To conduct such analyses, marketing professionals need a model that can help them identify individual customers and customer segments with a high churn risk. Such a model evaluates weighted factors that associate given characteristics—a customer profile—with a prescribed customer behavior, in this case a propensity to churn. The weights are estimated using data on a large number of individuals. The model can then be applied to an individual to determine his or her propensity for churning, essentially developing a churning "score."

CUSTOMER RELATIONSHIP MANAGEMENT

Ideally, customer knowledge of this type can be integrated into an enterprisewide process for targeting marketing campaigns and customer service activities, taking into account the revenue potential associated with each customer. A number of carriers have created Web-based portals to centralize customer support services and provide a unified view of each customer. This customer knowledge can be used to actively monitor usage patterns to highlight those customers most likely to migrate to another carrier.

Such efforts can be even more successful when carriers focus on customers with the highest lifetime value—the total amount a customer is expected to spend over time—which can vary depending on cross-selling and up-selling opportunities, balanced against the costs of attracting and retaining that customer. So important is this fact that companies such as Orange and Vodafone make claims to market leadership based on “numbers of *active* customers” and ARPU (average revenue per user), rather than the size of their respective customer bases. (BBC News, January 29, 2002)

The tools for performing such analyses of customers include *data warehousing*, *data mining*, and *data visualization*. While all carriers have proprietary customer information databases (albeit with varying degrees of accuracy, maintenance, and productive use), the warehousing and mining of the data can either be performed in-house with the requisite technology platform or outsourced to a telecom-focused CRM adviser. In fact, advances in CRM technology give carriers a choice among a wide range of software packages and customized solutions. In any case, ongoing analyses of real-time data enable a carrier to intervene with a range of *customer retention options*.

Data Warehousing, Mining, and Visualization

Data warehousing creates a central repository that consolidates all pertinent data from relevant systems and external sources in a consistent format to facilitate user access and modeling. By having all such data available simultaneously and uniformly, analysts can

uncover relationships between customer characteristics, customer value, and churn likelihood. Data warehousing provides the platform for data mining and data visualization.

Data mining is the process of searching huge volumes of customer data to uncover patterns, relationships, and trends in customer activity. Data mining can help develop customer profiles and detect historical associations between certain profiles and the propensity to churn.

Data mining tools are used to analyze many profile-related variables, including those related to demographics, seasonality, service periods, competing offers, and usage patterns including feature usage. Leading indicators of churn potential include late payments, numerous customer service calls, and declining use of services.

In data mining, one can choose a high or low degree of granularity in defining variables. By grouping variables to characterize different types of customers, the analyst can define a customer segment. A particular variable may show up in more than one segment.

It is essential that data mining results extend beyond obvious information. Off-the-shelf data mining solutions may provide little “new” information and thus serve merely to predict the obvious (e.g., predicting churn for a subscriber who hasn’t paid his or her bills in over three months). Tailored data mining solutions can provide far more useful information to the carrier.

Data visualization software enables analysts to view graphically the relationships between churn and customer profiles or profile-related variables. By enabling human perception to detect associations that are difficult to detect mathematically, visualization provides a cognitive complement to statistical techniques. It can be used to add or remove variables from data mining results as a way to measure the impact of those variables. Data visualization is also an efficient way to examine graphically the strengths of the relationships detected by data mining.

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A WORD ABOUT PRIVACY

By their very nature, customer analysis tools such as data warehousing, data mining, and customer relationship management depend on information about current and potential customers for commercial marketing purposes. But privacy-conscious consumers are becoming increasingly concerned about *how* companies are using their personal information for commercial purposes. As a result, many countries are developing privacy laws to protect consumers' personal information from unauthorized use. In fact, U.S. regulators are considering, and in some cases enacting, privacy-related laws at both the federal and state levels.

The definition of "privacy" for our purposes includes the processes for protecting the collection, processing, storage, dissemination, and destruction of personal information. Faced with consumer demands for greater protection of personal information, some leading organizations are increasingly viewing privacy protection as a way to enhance stakeholder trust as well as a means to avoid costs, mitigate risks, and improve customer satisfaction.

Companies involved in customer relationship management need to recognize privacy as a strategic issue and to implement a privacy program that customers can easily understand. A comprehensive privacy program can include the following basic components:

- Notice (inform customers of privacy policies to protect their information)
- Choice (provide customers with the opportunity to choose how their information can be used)
- Access (provide customers with the ability to see and correct information about themselves)
- Security (maintain information in a secure and confidential manner)
- Control (confirm that privacy policies and procedures are in place and functioning as intended)

Customer Retention Options

The outcome of applying data warehousing, mining, and visualization tools is a set of models that supports predictions of those customers most likely to churn and, possibly, when and why. These models help identify intervention strategies that can reduce churn among particular customer segments. They may also provide insight into ways to solve more fundamental root causes of churn, such as pricing, poor customer service, or service quality. When coupled with predictions of lifetime value by customer segment, these models can support very focused retention efforts. Moreover, they can be used to estimate the return on investment (ROI) of each retention effort as a basis for selecting among competing efforts.

The CRM approach helps the service provider to reduce customer churn by anticipating and addressing customer issues and increasing customer satisfaction. Much of the value of this approach stems from its *real-time nature*. By frequently and rapidly collecting and analyzing data, it enables the provider to make the right offer to the right customer at the right time.

In a fully functional churn management environment, data miners work with sales, marketing, and customer care to reduce churn exposures. Customer service representatives receive flagged customer profiles throughout the day, enabling them to recommend customer- or segment-specific actions, including the following:

- *Price/volume adjustments*. The carrier can allow the customer to fine-tune trade-offs between price and volume. For example, if research reveals pricing to be an issue, the carrier can, at the "right" moment, make an offer of a lower price or volume discount, or suggest ways to avoid surcharges.
- *Geographic discounts*. Analysis of calling patterns can identify frequently called destinations and lead to rate reductions and volume discounts to such locations to better accommodate the customer's needs.
- *"One-rate"* plans for local and long-distance calling can create loyalty by benefiting the customer from a cost standpoint as well as simplifying billing.

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CONCLUSION

- *Bundled solutions*—including local and long-distance wireline and wireless services; high-speed data, Internet, and calling features; and other services offered via a discounted pricing plan—can provide incentives for customers to stay with their current carrier.
- *Promotional giveaways*, such as cash-back, airline frequent flier miles, free night and weekend minutes, free installation/first month of service for new services or features, free calling card minutes, and similar promotions, can induce customers to stay on board.

Timeliness is crucial in reducing *involuntary* churn as well. Providers can help prevent nonpayment deactivation by monitoring at-risk clients, notifying them when their minutes are nearly depleted, intervening before debt levels become unmanageable, providing prepaid calling card or other prepaid services, and instituting risk-scoring, credit checks, and customer deposits.

In short, the synergistic combination of data warehousing's data management capabilities, data mining's predictive capabilities, and data visualization's explanatory capabilities paves the way for informed marketing strategies and real-time customer-retention strategies—from promotions and mailings to direct customer contact and new service plans.

CHURN MANAGEMENT CASE STUDY

A major U.S. long-distance carrier maintained data on more than 20 million customers in multiple legacy systems, making data analysis difficult and time-consuming. By linking and enhancing its systems, the carrier integrated data across all strategic business units, thereby supporting customer retention functions as well as cross-selling, acquisition, and forecasting. Company analysts now perform their own research by accessing a multidimensional database over the corporate intranet. As a result of this effort, the carrier has reduced its churn rate by two thirds and estimates that its system upgrade will pay for itself within two years.

Churn is a significant global business issue communications companies must effectively manage to be viable, long-term industry players. Wireless carriers have had to deal with churn from their inception, while incumbent wireline carriers have to pay close attention to churn and find ways to retain customers as markets deregulate and competition intensifies. In a weakened economy, carriers must go further—and find creative ways to retain the most profitable customers.

Fortunately for carriers, they're in a perfect position to better manage their relationships with customers because of their vast and dynamic databases. Using CRM technologies, they can identify potential "churners" and take preventive actions to retain them. Using the same methods, they can further refine their effort to target the most profitable segments with appropriate loyalty-enhancing incentives.

Customer churn management is inherently cross-functional. Data mining alone will not help a carrier retain customers any more than shotgun promotions will. Churn reduction, particularly with an emphasis on long-term profitability, requires the integration of technology and technical analysis with sales and marketing and customer-facing initiatives. Sales and marketing, finance, and operational functions must collaborate effectively to identify and deliver solutions that provide value to the customer and hence enhanced margins for the company.

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