

How to Calculate the Life Time Value of a Subscriber

Executive summary

Subscription-based models are on the rise. Understanding the challenges and benefits that are specific to this delivery method are paramount to success. This means culling through mountains of data from both the front and back-ends. Measurement and tracking of specific metrics like lifetime value and customer retention will help optimize campaigns and increase return on investment. Here's what you need to know about what impacts LTV and retention how to increase both and how to create a successful, profitable subscription-based online business.

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Implementing an online subscription-based model requires a deep understanding what has to be measured to help achieve profitability goals. Businesses must be analyzing back-end data as well as front-end marketing results in order to get a clear picture of their efforts and optimize digital marketing channels for this model.

That means thinking beyond just acquiring new customers. It's imperative to measure the lifetime value (LTV) of customers and retention.

Market research firm Gartner Group states that 80% of a company's future revenue will come from just 20% of its existing customers.

And Lee Resource Inc. says attracting new customers will cost your company 5 times more than keeping an existing customer.

Calculating Customer Lifetime Value

One of the key drivers of long-term success is understanding the lifetime customer value. Customer lifetime value is the dollar value of a customer relationship, based on the present value of the projected future revenue from the customer relationship. That's why maximizing the customer lifetime value is a key success factor to a profitable business.

However, not all customers are equal. Knowing the breakeven point on customer relationships enables identification of the source of profits. Segmenting customers into profitable and unprofitable categories quickly identifies drivers of profitability as well as leading causes of churn.

Overall profit is only reached by deducting the cost of:

- **Customer Acquisition:** This comprises all the costs of marketing to attract new customers.

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- **Superior Customer Service:** Creating and implementing customer service requires and investment in people, technology and services. These are costs that must be factored into your equation.
- **Renewals:** The cost of generating a renewal is far less than the cost of initially acquiring a customer.

Understanding what has to be measured will help achieve profitability goals. Businesses must be analyzing back-end data as well as front-end marketing results in order to get a clear picture of their efforts and optimize digital marketing channels.

Businesses should be closely tracking:

- **Impressions:** This will help in determining the reach and branding
- **Clicks:** This is the standard method of measuring traffic
- **Trials :** This data point will help businesses convert leads to customers and what motivates potential customers

There are also standard operational metrics every business must be tracking:

- **Customer Acquisition Ratio (CACR):** Sales and marketing costs associated with signing a new customer as a ratio to revenue gained by converting to a customer.
- **Customer Renewal Cost Ratio (CRCR):** Sales and marketing costs of closing a renewal as a ratio to revenue accrued from renewals.
- **Research and Development Ratio (RD):** Cost to invest in and improve products and services as a ratio to sales revenue.
- **Gross Margins (GM):** Revenue minus the costs associated with having the service and providing customer support.
- **General and Administrative Ratio (GA):** Cost associated with finance, management, and other operational functions as a ratio to revenue generated.
- **Churn Rate (CR):** Percentage of revenue not renewed at the end of a subscription term.
- **Profit Margin (PM):** Percentage of revenue that are profits.

There are various methods to calculate LTV. Several apps and LTV calculators are also available online.

However, one relatively simple way to calculate LTV using the defined operational data is to examine the profitability of a customer relationship as the total lifetime subscription revenue minus the total costs.

The total subscription revenue is the number of subscription terms multiplied by the subscription price, minus any churn. (For example: 3 years times \$100 per year = \$300)

The total cost is the customer acquisition costs, customer retention costs (both are marketing costs), and prorated general and administrative costs, research and development and other operational costs.

Businesses need to spend less on marketing to new customers and renewing existing customers, than LTV to make their efforts profitable.

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To calculate:

Customer Lifetime [CL] X Subscription Price

- Customer Acquisition Cost [CACR]
- Customer Retention Cost [CRCR] X Customer Lifetime
- (1 - Gross Margins) X Customer Lifetime
- General & Administrative Costs [GA] X Customer Lifetime
- Research & Development Costs [RD] X Customer Lifetime
- Churn Rate X Subscription Price (Customer Lifetime - 1)

= Profit

The equation is turned into operational metrics by dividing by subscription price to create ratios of each cost in relation to revenue.

The result is the following equation:

Customer Lifetime

- CACR
- $CRCR - (1 - GM) - GA - RD$ X Customer Lifetime
- CR X (Customer Lifetime - 1)

= Profit Margin

Calculating the average customer lifetime to the breakeven point is accomplished using the following equation:

$$\frac{(PM + CACR - CR)}{\div (1 - CRCR - (1 - GM) - GA - RD - CR)}$$

= Customer Lifetime

At breakeven, profit margin (PM) equals zero, which allows the equation to be solved.

Customer Retention

Once you have converted a lead to a customer, you must keep them from defecting in order to bring their LTV to a profitable level. Renewing customers are the engine that drives successful subscription businesses.

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Measuring Retention Rate (the percentage of the total number of customers retained in context to the customers that approached for cancellation) is crucial. It also has a huge and direct impact on business profitability.

In the book *Human Sigma: Managing the Employee-Customer Encounter*, Gallup researchers John H. Fleming, Ph.D. and Jim Asplund, indicate that engaged customers generate 1.7 times more revenue than normal customers, while having engaged employees and engaged customers returns a revenue gain of 3.4 times the norm.

And, according to the Harvard Business School, increasing customer retention rates by 5 percent increases profits by 25 percent to 95 percent.

But customer retention is about more than simply giving the customer what is expected or has been paid for. The real payoff comes in being able to exceed expectations and turn customers into loyal, repeat users and ultimately advocates for your brand.

There are many ways to maximize retention:

- **Match data through common IDs:** This allows for tracking of customers and a holistic view of all customer activity.
- **Carry customer IDs forever:** Even if customers defect there is an opportunity to get them to return. Saving IDs enables brands to reach out to those that left with special offers. If customers come back, having historical data from their old account lets businesses treat them as a long-term valued customer rather than a newcomer to the brand or service.
- **Link referrals to originating ID:** This method can be used to track traffic and leads. It can also be used as a way to reward loyal customers for their recommendations and can be included as a way to help measure the influence of a customer, which may impact their LTV.
- **Link backend customer ID to front end marketing:** This allows for segmentation and creating unique offers to specific types of customers. It will also be measurable and give marketers an idea of what type of promotions are providing the most activity and conversions.
- **Seek out insights around what drives quality:** Look at data surrounding social media engagement; parse demographics; measure effectiveness of email communications, measure special promotions and offers; etc. All this great data will provide a better view into what motivates customers.

Increasing customer retention can also be aided by leveraging many marketing disciplines and channels of business.

- **Keywords:** Use commonly searched terms related to your brand, product or service to maximize search rankings and increase chances of consumers finding your website through search queries.

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- **Affiliates:** Create an affiliate program whereby this group of publishers can promote your brand and offers. As affiliates push consumers to your site you can see what techniques are work and gain a steady revenue channel.
- **Placements:** Secure paid placements or cross marketing deals with content publishers that have a desirable target audience to drive traffic and leads to your site.
- **Consumer Offers:** Use special offers and deals to promote subscriptions and drive qualified leads.
- **Landing Pages:** Create special landing pages for specific offers. Optimize those landing pages and track relevant data for effectiveness of campaigns.
- **Order Process:** By streamlining the order process, businesses can insure that consumers who are ready to make the subscription purchase will sign up. This could significantly reduce cart abandonment and increase sales conversions.

The bottom line is that focusing on LTV and retention are a must for any business using a subscription-based model. Continued monitoring, measuring and tracking these data points will help business make better decisions and modifications on its marketing spend and ultimately provide growth and achievement of profitability.