

VIEWPOINT

The importance of valuing customers

Although the famous adages about the value of brands still stand, it is also worth remembering how that value is created so as not to lose sight of another old adage which reminds us that the customer, is king

Customers are the reason for a business' existence, they are behind existing activity and create new business opportunities. An important feature of a powerful brand is the depth of the relationship it has with a company's customers or ultimate consumers. This is one of the key drivers of brand value.

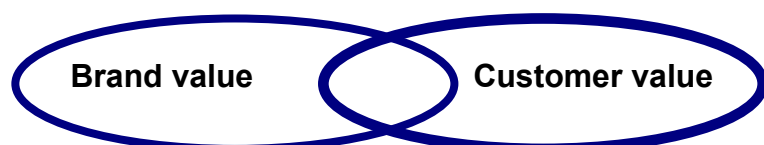
Brands have long been touted as a company's most valuable asset and the one thing companies could not do without. Roberto Goizueta, the late CEO of Coca-Cola said "All our factories and facilities could burn down tomorrow but you'd hardly touch the value of the company; all that actually lies in the goodwill of our brand franchise and the collective knowledge in the company." John Stuart, the ex-Chairman of Quaker famously said "If this company were to split up I would give you the property, plant and equipment and I would take the brands and the trademarks and I would fare far better than you."

The major part of acquisitions is frequently also the value of the brands. Based on a preliminary allocation of assets published by Procter & Gamble in relation to the purchase of Gillette in 2005 for \$57bn, 97% of the value of the acquisition was attributed to the intangibles. And the majority of this value would be for the brands including Gillette, Duracell, Oral B and Braun. When L'Oreal bought The Body Shop in March 2006 for £652.2m, 81% of the purchase price was down to intangibles of which again the majority of which would be the brand.



In many industries, such as FMCG and retail, customer relationships are inherent within the brand which is why brands frequently deserve the high value they are given. Gillette valued its customer relationships together with technology at \$1.5bn which is only 2.6% of the acquisition price and I suspect largely made up of technology not customer relations. In other industries brands are unable to command such an importance and surrender their dominance to customer relationships directly.

Of course brands and customer relations do not operate in isolation, but in conjunction with other tangible and intangible assets. Very often there will be considerable overlap, particularly between brand and customer relations:



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This indicates not only that the value of customer relations overlaps with brand value but that there are other distinct elements of customer relations which can be highly valuable in themselves. Important aspects of such non-brand customer relations include the following:

- relationships between people and groups of people;
- customer loyalty;
- contracts for the supply of goods and services;
- habit or inertia, in that it is easier to stay with the status quo; and
- a desire to avoid the disruption and cost from changing.

Some industries place a much higher value on the non-brand elements of customer value. Several recent acquisitions have highlighted the substantial value companies put on customers, specifically in the telecoms and financial services markets. Both these sectors are heavily branded but it is the customers that appear to be the motivation for acquisition rather than the brands which is so frequently the case. NTL's acquisition of Virgin Mobile, Telefonica's acquisition of O2, Banco Santander's acquisition of Abbey and Aviva's acquisition of RAC are all examples of strongly branded companies for which the main motivation for their acquisition was the customer base, not the brand.

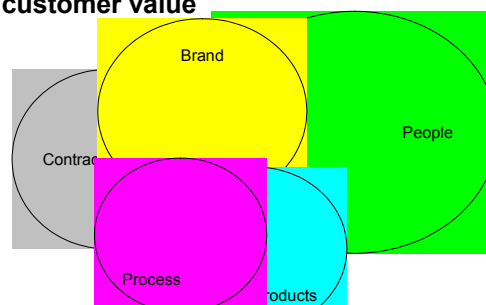
Further consolidation is expected in both the telecoms and financial services industry, placing an even greater emphasis on the value of customers. Eircom is rumoured to be in talks with both Swisscom and Babcock & Brown, Vodafone has been linked to Vivendi's mobile arm SFR which has 17.2 million customers and Lloyds TSB, Alliance & Leicester and Prudential are all perennial targets in the financial services sector. All of these have very large and valuable customer relationships.

Customers, it seems, are becoming an increasingly valuable and sought after commodity. Calculating this value is not as nebulous a concept as sometimes thought. The first step is to recognise just where the customer relationships reside and why and how customers generate value.

Where do the customer relationships reside?

In B2B situations such as consulting firms customer relationships often exist between small numbers of individuals. This means that the customer relationships effectively belong to those individuals. Therefore those individuals can take the customers with them if they leave either to set up on their own or with a competitor. The relative importance of various attributes of customer relations is illustrated below, indicating circumstances where value is held by the people rather than the business:

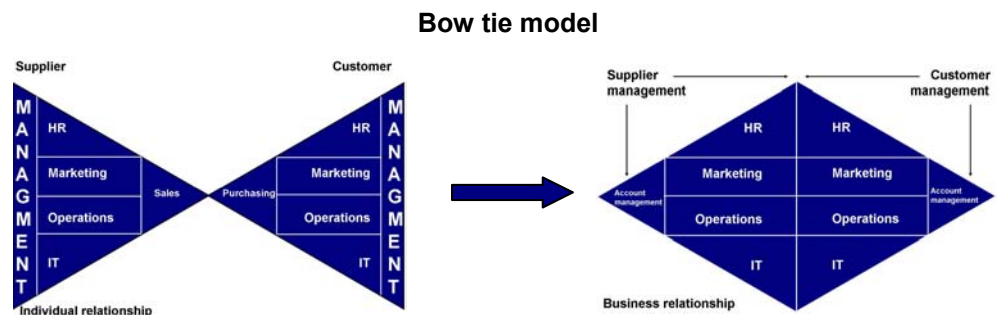
Contributors to customer value



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The more significant and less interdependent the contribution of individual people becomes, the more they have the ability to break away and set up competing businesses, taking customers with them. Given this potential loss of value to the business it would make sense to put in place a strategy to safeguard the dependence of customer value on people. The most effective strategies would involve broadening out customer relationships so that there is less dependence on individuals, strong contractual arrangements, building scale and interdependence with other aspects of the business and strengthening the value of other customer facing activities, including the brand. For example a depth of relationships between business and customer teams will be stronger and less susceptible to loss. This broadening of reliance on customer relationships from the individual is illustrated in the bow tie model.



The stronger the web of inter dependent activities, which the customer values, then there is less chance of customer relationships effectively belonging to individuals.

Why are customers valuable and why are they considered IP?

It sounds obvious but customers are the only source of income for all companies. It is all very well having good products, strong brands and efficient internal processes, but if you have no one to sell to then you do not have a business. And of course some companies have more customers than others. Unilever will view every household in all its markets as potential customers for its Persil products whereas Rolls Royce segments its market into just two small, distinct groups, past and present owners of Rolls Royces and people with an annual income over £750,000.

For both these examples most of the value inherent in the customer relations will be absorbed in the brand as the customers have a much stronger relationship with the brand than with the product. However, the customer list and database, separable from the brand, does have significant value in its own right – Persil by knowing the details and habits of millions of people and Rolls Royce by having details on a select group of high net worth individuals. Both lists would sell for a lot of money and are extremely valuable to their owners because they are able to generate money from them. There are a number of ways to determine just how much value customer lists are able to generate and therefore how much they are worth.



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How to value customers

Valuing customers is rather similar to valuing other intangible assets, such as brands. There are three basic approaches: cost, market and income. There are two aspects to the cost approach. Firstly, historic cost which would be the cumulative cost of acquisition and maintenance of the list, such as advertising and promotional spend, the cost of servicing customers. And secondly, replacement cost which is more directly relevant as building a comparable customer list can be a relevant consideration for a buyer.

The market approach is based on identifying comparable transactions in the market which can then be adjusted for any differences in circumstances. One difference is the synergies that companies are able to derive from an acquisition. For example, Aviva achieved annualised cost savings of £100m in 2006 from its acquisition of RAC, the travel and motoring products and services company, and Procter & Gamble identified between £14bn and \$16bn of cost synergies in its acquisition of Gillette. These cost synergies were likely to have been reflected in the premium the buyers were prepared to pay for their acquisitions and adjustments such as these would generally have to be made in order to be able to compare the transactions.

The objective of the income approach is to identify how much money a database of customers is able to generate for its owner over its expected life. This amount would then be discounted to reach a net present value. Forecasting future revenue streams requires an appreciation of retrospective activity and an understanding of future macro and micro environmental trends. Elements such as the churn rate, loyalty of the customers, their propensity to purchase and profitability by segment are analysed to help forecast revenues.

Generally, a consideration of all three approaches is used when valuing customer relations with the income methodology being the dominant way, supported by the cost and market approaches acting as sense-checks. This can be seen in the analysis of the Virgin Mobile customer list detailed below.

Virgin Mobile



Virgin Mobile was in essence a virtual company made up of just two things, a brand and customers. It did not have a network of its own, in fact all it did have originally was a trusted brand. Virgin Mobile piggy-backed on T-Mobile's spare UK network capacity for which T-Mobile received the usual payments made by the mobile users and a percentage payment from Virgin Mobile for each call.

Virgin Mobile made money by receiving about £4 for each customer it signed up each month from T-Mobile. The Virgin brand soon began attracting customers in record time, 500,000 in its first year and 1 million a year later. It floated in 2004 and by 2006 when it was bought by NTL for £962.4 million in April 2006 it had 4.3 million active customers.



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Importantly, the Virgin brand was not included as part of this deal. Part of the attraction of the acquisition for NTL was no doubt access to the Virgin brand but this was negotiated separately. NTL entered into a 30-year exclusive license agreement with Virgin which guarantees Sir Richard Branson 0.25 per cent of the combined group's revenues from consumer telephone, television and broadband services, in addition to a seat on the board. This is expected to be at least £8.5m a year – in excess of £255m over 30 years. As Virgin Mobile had little infrastructure and the brand was not included as part its acquisition, NTL paid £962.4 million for Virgin Mobile's customer base.

Here we have a good demonstration of all three approaches to valuing customers. A market approach is simply to take the acquisition cost minus Virgin Mobile's assets, divided by the number of customers. This values the customers at £215 each or £901m in total. Virgin Mobile's subscriber acquisition cost is £26 per individual and costs per customer are £2. Adding cost per customer to the customer acquisition cost gives us an answer based on the cost approach which is £28 per customer or £117.6m in total. An income approach forecasts the discounted profit from Virgin Mobile customers based on Virgin Mobile's annual churn rate of 17.5% over a five year period. Costs of 35% are taken off the average revenue per user to arrive at an estimated profit per user. This values each customer at £173 or £529.5m in total. If a ten year period was used instead of five, the cost per customer would increase to £285 per customer or £661m in total.

So here we have three different values for each of Virgin Mobile's customers: what was paid, £215; what it would cost to acquire them, £28; and how much they generate a year, between £173 and £285. Now clearly this is a somewhat simplistic approach, for example, the cost of customer acquisition does not take into account other factors such as use of a brand, and that what NTL paid was a premium to satisfy shareholders, for goodwill, for access to the Virgin brand through a separate deal and for an appreciation of the involvement of the Virgin Mobile brand in acquiring the customers in the first place as well as the synergies NTL was expecting to strip out of Virgin Mobile. But despite the obvious simplicity, this example does demonstrate the three different processes involved in valuing customers and the huge value that customers hold.

Analysis of Virgin Mobile customer value

1. Market approach	
Purchase price	962,400,000
Assets	61,235,000
Number of customers	4,200,000
Cost per customer	215
Total cost	901,165,000

2. Cost approach	
Subscriber acquisition costs	26
Cost per customer	2
Cost per customer	28
Total	117,600,000

3. Income approach	Year	1	2	3	4	5
Number of customers		4,200,000	3,465,000	2,858,625	2,358,366	1,945,652
Discount rate (9%)		0.917431193	0.841679993	0.77218348	0.708425211	0.649931386
Churn		17.5%	17.5%	17.5%	17.5%	17.5%
Average revenue per user (ARPU)		127	127	127	127	127
Operating profit margin relationship		35%	35%	35%	35%	35%
Customer operating cashflows		186,690,000	154,019,250	127,065,881	104,829,352	86,484,215
Annual revenue from all customers		533,400,000	440,055,000	363,045,375	299,512,434	247,097,758
Discounted annual revenues from customers		171,275,229	129,634,921	98,118,174	74,263,756	56,208,806
Discounted annual revenues per customer		41	37	34	31	29
Cost per customer		173				
Total cost		529,500,887				

10 years	
Cost per customer	285
Total cost	661,024,565



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RAC

Another recent example which illustrates all three approaches to valuing customers is the acquisition of RAC. In March 2005, Aviva, the world's sixth-largest insurance group bought RAC, the UK's second largest motor breakdown and associated services company, for £1.113 billion. The intangible assets included in the sale were the brands, RAC and BSM, which were valued at £260m and the contractual customer relationships which were valued at £132 million. With 6.7 million roadside assistance customers, this values each customer at £20. This is the value Aviva placed on the customer relationships in its 2005 annual report so does not necessarily reflect the true or opportunity value of RAC customers. Valuations in Annual Reports have limitations, and need to be treated with caution.

The commercial value Aviva placed on RACs customers could have been more around £186 each. This is arrived at by subtracting the net assets from the total price paid and adding the identified value of the customer relationships and dividing the total by the number of customers. The difference between the market value and the value Aviva placed on the relationships reflects the synergies Aviva anticipated creating through its existing Norwich Union business and the opportunity this would create for generating more revenue, more efficiently from RAC's customer base.

The income approach values RAC customers at £227 each over a five year period and £374 over ten years, £1.266 billion and £1.752 billion respectively. This is arrived at by forecasting the number of customers on an estimated churn rate of 10% a year and linking revenue and profitability per customer to RAC's published 2004 figures.

Aviva's purchase of RAC consequently gives us three examples of customer value. The cost approach values each customer at £20, the market approach values them at £186 each and the income approach values them between £227 and £374 each.

The valuations of RACs customers are not dissimilar to the valuation of Virgin Mobile customers. In fact, the average difference is 0% which demonstrates that valuing customers is not an entirely subjective exercise but can be benchmarked accurately against comparable market transactions and competitor analysis.

Analysis of RAC's customer value

1. Market approach	
Purchase price	1,113,000,000
Net assets	-26,000
Identified value of customers	132,000,000
Number of customers	6,700,000
Cost per customer	186
Total cost	1,245,026,000

2. Income approach	Year	1	2	3	4	5
Number of customers		6,700,000	6,030,000	5,427,000	4,884,300	4,395,870
Discount rate (9%)		0.917431193	0.841679993	0.77218348	0.708425211	0.649931386
Churn		10.0%	10.0%	10.0%	10.0%	10.0%
Average revenue per customer		174	174	174	174	174
Operating profit margin relationship		33%	33%	33%	33%	33%
Customer operating cashflows		390,400,000	351,360,000	316,224,000	284,601,600	256,141,440
Annual revenue from all customers		1,166,700,000	1,050,030,000	945,027,000	850,524,300	765,471,870
Discounted annual revenues from customers		358,165,138	295,732,682	244,182,949	201,618,949	166,474,361
<i>Discounted annual revenue per customer</i>		53	49	45	41	38
Cost per customer		227				
Total cost		1,266,174,079				

10 years	
Cost per customer	374
Total cost	1,752,103,814



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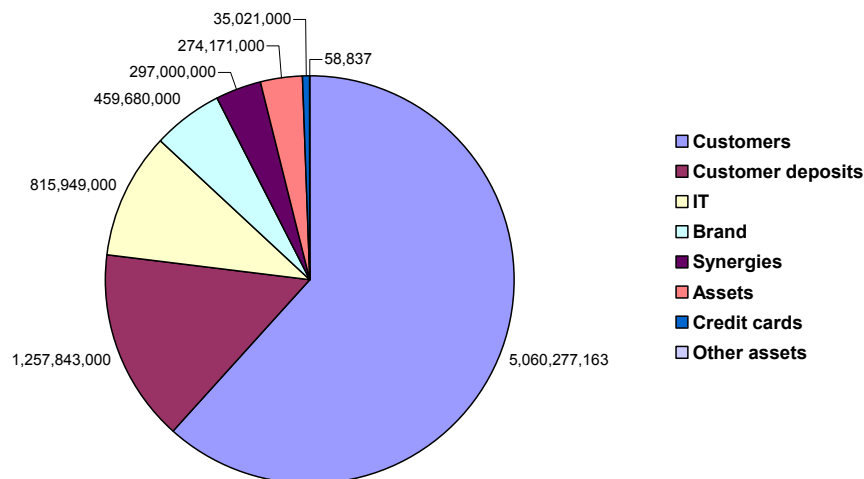
Abbey



Another example of the market approach can be seen in the acquisition of Abbey by Banco de Santander in 2004 for £8.2 billion. Abbey had some valuable assets: customer deposits of £1.3bn, IT infrastructure worth £816m, a brand valued at £460m, credit cards worth £35m and of course other assets such as its 741 branches worth about £274m. Abbey also identified synergies of £297m. The difference between these identified assets and the price Santander paid Abbey was largely the value of Abbey's 18.3 million customers. That's £5.1bn, or £277 a customer.

Santander is also phasing out the Abbey brand in favour of its own Santander brand and hopes to have completed this transition by 2007. It clearly did not want the Abbey brand; it was after its customers. And again, this market valuation is in the same ballpark as the market valuation of Virgin Mobile's and RACs customers except a little higher. This is because bank's profit and revenue per customer is likely to be greater than that of a phone company and a roadside assistance company and also because as we are statistically more likely to get divorced than change our current account, customer loyalty is greater and the lifetime value higher.

Abbey acquisition breakdown



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Brand vs customers

Large companies have the luxury of having a valuable customer list and valuable brands, both of which work hard to generate business. Smaller companies frequently rely solely on customer relationships and transferring this reliance to a brand can be a very long process. In both circumstances there is some overlap between brand and the power balance between customer relationships and the brand is evident in all industries.

The examples given indicate that in some businesses, such as telecoms (Virgin Mobile) roadside assistance (RAC) and banking (Abbey) the non brand customer value is important. Whilst the brand plays a role it is the relationships with customers that really drive value. This value arises for a number of reasons, such as a highly satisfied and loyal customer base or the inertia customers have from making a change. This is clearly worth analyzing, protecting and building up as an important part of IP and business strategy.

In the beer industry, beers such as Stella Artois or Carlsberg secure distribution and therefore volume because of their brands – consumers want them – and therefore all the value is in the brands. Less well known beers, such as Wells Eagle IPA for example, would rely either on direct customer or business relationships with pub landlords or buyers or it would depend on larger brands from Charles Wells' stable such as Red Stripe or Corona to secure distribution. Here the majority of value is likely to be with the customer or business relationships and not the brand.

Determining where the value resides, with the customer relationships or the brand, is an important part of the valuing process.

Conclusion

Amongst the currently increasing levels of M&A activity, especially in the telecoms and financial services sectors, there is sometimes greater value being placed on customers than brands. In other sectors, such as Unilever's impending divestment of Birds Eye, the value is still very much with the brands. Customers and brands are needed together as important business assets to create value, along with many other business assets and activities. Some markets and businesses will put more emphasis on drivers of customer value rather than brand value. In those circumstances it is important to formulate a strategy that recognizes and protects this so that the value of the whole business can be optimized.

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