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Whitepaper

Project CRM:
Customer Response, Retention and Valuation Concepts (RFM Model)

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Have you ever heard somebody refer to his or her customer list as a "file"? If you have, you were probably listening to someone who has been around the catalog block a few times. Before computers, catalog companies used to keep all their customer information on 3 x 5 cards.

They'd rifle through this deck of cards to select customers for each mailing, and when a customer placed an order, they would write it on the customer's card. These file cards as a group became known as "the customer file", and even after everything became computerized, the name stuck. There was an exchange-taking place, and the data was speaking. What the data said to them, what they heard, were 3 things:

1. Customers who purchased recently were more likely to buy again versus customers who had not purchased in a while

2. Customers who purchased frequently were more likely to buy again versus customers who had made just one or two purchases

3. Customers who had spent the most money in total were more likely to buy again. The most valuable customers tended to continue to become even more valuable.

So the catalog folks tested this concept, the idea past purchase behavior could predict future results. First, they ranked all their customers on these 3 attributes, sorting their customer records so that customers who had bought most Recently, most Frequently, and had spent the most Money were at the top. These customers were labeled "best". Customers who had not purchased for a while, had made few purchases, and had spent little money were at the bottom of the list, and these were labeled "worst".

Then they mailed their catalogs to all the customers, just like they usually do, and tracked how the group of people who ranked highest in the 3 categories above (best) responded to their mailings, and compared this response to the group of people who ranked lowest (worst). They found a huge difference in response and sales between best and worst customers. Repeating this test over and over, they found it worked every time!

The group who ranked "best" in the 3 categories above always had higher response rates than the group who ranked "worst". It worked so well they cut back on mailing to people who ranked worst, and spent the money saved on mailing more often to the group who ranked best. And their sales exploded, while their costs remained the same or went down. They were increasing their marketing efficiency and effectiveness by targeting to the most responsive, highest value customers.

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The Recency, Frequency, Monetary value (RFM) model works everywhere, in virtually every high activity business. And it works for just about any kind of "action-oriented" behavior you are trying to get a customer to repeat, whether it's purchases, visits, sign-ups, surveys, games or anything else.

How is RFM implemented? Customers are ranked based on their R, F, and M characteristics, and assigned a "score" representing this rank. Assuming the behavior being ranked (purchase, visit) using RFM has economic value, the higher the RFM score, the more profitable the customer is to the business now and in the future. High RFM customers are most likely to continue to purchase and visit, AND they are most likely to respond to marketing promotions. The opposite is true for low RFM score customers; they are the least likely to purchase or visit again AND the least likely to respond to marketing promotions.

For these reasons, RFM is closely related to another customer marketing concept: Life time value (LTV). LTV is the expected net profit a customer will contribute to your business over the Life cycle the period of time a customer remains a customer. Because of the linkage to LTV and the LifeCycle, RFM techniques can be used as a proxy for the future profitability of a business.

High RFM customers represent future business potential, because the customers are willing and interested in doing business with you, and have high LTV. Low RFM customers represent dwindling business opportunity, low LTV, and are a flag something needs to be done with those customers to increase their value.

Once you have scored customers using RFM, you will be able to:

- Decide who to promote to and predict the response rate

- Optimize marketing to acquire and retain the most valuable customers and avoid spending on poorly performing ones

- Determine which parts of the site or activities attract high value customers and focus on them to increase customer loyalty and profitability

The approach used and the methods described have roots in the original RFM theory, but have been updated and modified based on my experience using RFM for interactive environments, and simplify customer analysis by emphasizing the visual display of customer behavior for use in decision making.

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