Fundamentals of Customer Value

To create successful customer relationships, companies must understand what their customers care about and what value proposition appeals to them.

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Successful customer relationships are built on the bedrock of superior customer value. To attract and retain your most important customers, you must understand what they care about and what value propositions will appeal to them. While "value" is an overused buzzword, we rarely pause to reflect if we really understand what value is.

It is a natural human failing to question the concepts that we think we know well. As Marshall McLuhan said, "We don't know who it was that discovered water, but we're pretty sure it wasn't a fish." In my decade-long career as a teacher, researcher, and author, I have written extensively about different aspects of creating, delivering, and capturing customer value. But this is my first attempt to distill my understanding of customer value into seven fundamental lessons. I hope these lessons help you in your quest for profitable customer relationships.

What Value Is

The dictionary defines value as: "Worth in usefulness or importance to the possessor." As this definition suggests, value is the assessment of "all that you get in return for all that you give" in an exchange. More formally, I define customer value as "the perceived worth of the set of benefits received by a customer in exchange for the total cost of an offering, taking into consideration available competitive offerings and prices."

Consider an example. When a customer buys a new BMW automobile, she gets a certain level of performance, comfort, safety, and entertainment benefits from the car. She also gets service benefits like financing, warranty, repair, scheduled maintenance, and roadside assistance. And she gets the social status of belonging to an exclusive club of BMW owners. In return, the customer invests money, time, and effort in searching for the right car and dealer, negotiating the deal, arranging for financing, and maintaining the car over its lifetime. The customer will assess the BMW's value based on how these benefits, weighted in proportion to the importance that she places on the benefits, compare with the total costs of buying and owning the car. The customer's assessment of value is also influenced by other new cars she may have considered, the car she currently owns, as well as the alternative of taking public transportation instead of owning a car.

This definition embodies seven fundamental lessons on customer value:

1. Value Is Customer-Defined

You don't define value. Your customers do. As Peter Drucker, the patriarch of management theory, notes, "What the business thinks it produces is not of first importance. ... What the customer thinks he is buying, what he considers value, is decisive. And what the customer buys and considers value is never a product. It is always utility, that is, what a product does for him."

So the first lesson on value is that what you sell (products and services) is not what your customers buy (utility and value). As Ted Levitt pointed out so eloquently in his classic article "Marketing Myopia," you may grossly misunderstand what business you are in if you see your business through the product lens. It is a myth that "if you build a better mousetrap, the world will beat a path to your door." Customers don't want mousetraps. They want to get rid of mice. While you may be busy building a better mousetrap, the customers may simply get themselves a good house cat!

To understand how customers define value, you must focus on the outcomes that customers want when they buy and use your products. This will help you understand what your real business is. Lorenzo Zambrano, the CEO of CEMEX, the world's most innovative cement company, notes that "at CEMEX, we understand that our real business is helping our customers complete their construction projects. At the end of the day, no one wants to buy cement; they want to build a house or a bridge or a road." The same idea was echoed by Charles Revson, the founder of Revlon, when he famously observed, "In the factories, we make cosmetics. In the department stores, we sell hope." This thinking has led CEMEX to provide community micro-loans to finance construction projects and to create a service for Mexican immigrants in the United States to repatriate funds directly to contractors selected by CEMEX to build houses in Mexico.

2. Value Is Opaque

If value is defined by customers, you need to get inside the hearts and minds of customers to really understand value. Needless to say, this is

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a very difficult task. As Drucker notes, "What is value for the customer … is anything but obvious." Quantifying value is difficult because we don't understand customers, customers don't understand themselves, and we don't speak the same language that customers speak.

The first hurdle in quantifying value is that we don't understand customers as well as we should. Consider how Mattel failed to understand the Japanese market for its Barbie dolls. Mattel was at a loss to understand why its world-famous doll wasn't an instant hit in Japan. After much qualitative research, Mattel discovered that Barbie's legs were too long, and her chest too large – physical attributes young Japanese girls couldn't relate to. To appeal to Japanese sense of beauty and aesthetics, Mattel changed Barbie's dimensions and made the doll's eyes brown instead of blue.

The second barrier in quantifying value is that customers don't always understand their own motives and cannot always articulate their needs. Consider the inexplicable popularity of sport utility vehicles (SUVs). Customers claim that they prefer SUVs over cars because SUVs are safer and handle better in difficult conditions. But Dr. Clotaire Rapaille, a psychologist who studies motives of auto buyers for a living, believes that customers are merely offering an alibi to defend their irrational behavior. He questions why any rational consumer would buy a vehicle that gets less than 10 miles per gallon, doesn't fit into a garage, and is prone to rolling over. But at a deeper "reptilian level," he contends that consumers buy SUVs because of their survival instinct – the bigger and taller you are, the better your chance of survival in the urban jungle, where everyone is trying to bump into you or run you over. Unless you plumb deep-seated customer motives and emotions, you run the risk of misunderstanding what drives their perceptions of value.

A third challenge in quantifying value is that marketers don't speak the customers' language. A few years ago, my colleagues and I were conducting research on the attributes that customers would consider important as they evaluated high-definition television (HDTV). One of the attributes we included in our analysis was the "aspect ratio," a term we used to describe the fact that HDTV screens are more rectangular than regular TV screens, with a length-to-width ratio of 16:9 instead of 4:3 for regular TV. To our surprise, customers did not think this attribute was too important, until we realized that we were using techno-speak. When we reworded our description of the attribute to "cinema-like wide screen," we got very different results.

To make value transparent, you must first realize that you are not the customer. As I tell my students – the first principle of customer research is: "I have met the customer, and she is not me!" Then, you must develop empathy with customers by walking in their shoes and feeling their pain. It is a good idea to spend a few days in the life of your customers to understand their hopes, fears, problems, and ambitions. Consider the example of Intuit, a famously customer-centric software company. One of my ex-students is a product manager for Intuit charged with developing a specialized version of the popular QuickBooks financial software package for nonprofits. She has "adopted" a few customers and spends her weekends keeping financial books for a nonprofit organization. What better way to understand customer problems than to become one with the customer?

As the Intuit example suggests, you must observe customers in their native surroundings the way anthropologists do, not in the artificial setting of focus groups and surveys. Often, direct observation offers insights that conventional research techniques will miss, because customers are often unaware of their unmet needs and their unspoken problems. Of course, this observational research must be followed by quantitative research to validate the insights. Validation requires you to build quantitative customer value models and calibrate these models with data collected from customers.

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3. Value Is Contextual

Value, like beauty, lies in the eyes (and in the minds and hearts) of the beholder. So it is irrelevant to talk about the value of a product without knowing the context within which the product will be evaluated, bought, and used. Context has three important dimensions: the end user, the end-use situation, and the environment. Customer assessments of value will be a function of who they are, what they want to do, and the environment that they live and work within.

Value is customer-specific because customers differ in who they are, what outcomes they seek, and therefore what value they place on different benefits of an offering. For example, a mother choosing a digital camera to take pictures of her children may value ease of use and convenience in a camera, while a professional photographer may emphasize image quality, resolution, and advanced controls. Hence the expression "different strokes for different folks." This is the essence of customer segmentation – identifying groups of customers who have similar needs and priorities, who therefore will tend to respond similarly to your offerings.

Value is also application-specific. The application context defines the outcomes that customers seek, a concept that business marketers call "value-in-use". For example, a salesperson who travels frequently and needs to communicate constantly with the home office will place great value on portability and broadband wireless connectivity and will prefer a laptop computer to a desktop. On the other hand, a design engineer in the same company who uses his computer for computer-aided design and works out of the same office every day would strongly prefer a powerful desktop workstation.

Value assessments are impacted by the social and environmental context that surrounds customers. For instance, in movies and fashion, peer pressure and reference groups play an important role in determining what products consumers identify with. And in business markets, the culture of a company influences the types of products or vendors that the company prefers. For instance, the IT organization in a company with a conservative risk-attitude would tend to do business with well-known vendors like IBM, even if their products are not best-of-breed.

4. Value Is Multidimensional

A common myth in marketing is that customers choose products purely based on superior features and functions. While functional value – the value of a product's features and functions – is important, it is only one of three dimensions of value. Besides functional value, customers also consider emotional value, the psychological benefits that they get from buying, using, and owning products. And customers evaluate the economic value, what the product benefits are worth in terms of time and money. To think holistically about customer value, you must think in all three dimensions: functional, economic, and emotional.

Consider the value proposition of HP's iPAQ, a pocket PC-based PDA. According to HP, the benefits of the iPAQ are its powerful processor, bright screen, expandability, and flexibility – clearly a statement of functional value. But to close a sale, HP must also demonstrate economic value of the iPAQ – quantified estimates of improved productivity for end users as well as application developers. And HP must convince customers of the emotional benefits of choosing a device platform that is backed by reputable and financially solid companies like HP and Microsoft. Functional value is an important starting point, but you need to translate functional value into economic value. And you need to get beyond the "arms race" of functional differentiation by developing emotional appeals that are far more sustainable. After all, how do you compete against IBM's famous proposition: "Nobody got fired for buying IBM"?

5. Value Is a Trade-Off

Value is defined as the perceived worth of something in relation to the total cost that customers pay for it. This definition underscores the fact that value is a trade-off between the total benefits that customers get against the total costs they incur. So there are two ways of increasing customer value: increase the benefits you offer or reduce the customer's costs. It is important to understand that the purchase cost of a product is only one element of the customer's total costs. Consider Linux, the open-source software offering. While the Linux server software may be free, customers need to deploy the software, develop applications on the server, integrate existing applications, support the software, and maintain the software. All these are elements of the total cost of ownership (TCO). And some of these cost elements are nonmonetary costs. There is a cost of learning, a cost of switching, a cost of training, a cost of searching, and many other elements of cost.

Sometimes, customers themselves may not be aware of the hidden costs of using products. I remember a conversation between the CEO of a midsize pharmaceutical manufacturer and a supplier of plastics who was trying to get the pharmaceutical company to switch to plastic bottles instead of glass. Naturally, the conversation began with the pharmaceutical CEO asking if plastic bottles were cheaper. Being a good marketer, the plastics manufacturer pointed out that the price of the bottle should not be the sole focus of attention. First of all, he said, plastic weighs less than glass, so the transportation costs for the drug company would be lower. Second, plastic is not as fragile, so the breakage loss would be lower. Third, plastic bottles would save on labeling cost because labels could be imprinted directly. Fourth, being a local supplier, the plastics manufacturer would deliver more frequently in smaller batches, resulting in reduced inventory holding cost. Finally, the production line could be run faster with plastic, because plastic is not subject to breakage when moved at high speed on an assembly line. As this example suggests, there were several hidden costs in using glass bottles the pharmaceutical company wasn't even aware of, including breakage costs, inventory carrying costs, labeling costs, and costs of lower production-line efficiencies. To make an accurate value trade-off, you must make sure that customers are seeing the full picture on benefits as well as costs.

6. Value Is Relative

Customers always evaluate value relative to available alternatives, particularly the next-best alternative. I call this alternative the customer's "best available substitute or equivalent" (BASE). The BASE is the solution that customers will choose if they decide not to buy from you. Customers always have a BASE, even if you don't think you have viable competitors. If you don't know your BASE, you cannot know the frame of reference customers use to make buying decisions. And you may be selling against the wrong competitor.

Customers can use a variety of BASEs to evaluate your product against. A BASE can be a competitor's offering – customers may choose to do business with a competitor instead of you. The BASE can be your own offering if you are trying to sell upgrades or new versions of your products. For instance, Microsoft enjoys a dominant market position in desktop productivity software, where its Office suite of products commands over 90 percent market share. Having largely saturated the market, Microsoft now needs to convince existing Office users to upgrade to its newer versions. In doing so, it is competing against the previous versions of its own products. Status quo can be a BASE, too. Customers may simply decide to stay with the existing way of doing things. Doing nothing is always an option. And it is often a fairly attractive option because it entails less risk. At the Kellogg School of Management, the biggest competitor for M.B.A. students who have been accepted into our program is the applicant's current job, not a competing business school.

So whenever you think about value, you need to understand who or what you are up against, because this is the frame of reference that your customers use to evaluate your value proposition. By understanding competing alternatives, you will also be able to focus on points of differentiation relative to competing alternatives and ignore points of parity that clutter and dilute your value proposition.

Fundamentals of Customer Value

Dimension	Product Mindset	Customer Value Mindset
Strategic Focus	Product leadership – winning by launching innovative products and adding features to products.	Customer value – winning by *creating and delivering superior value* to customers.
Growth Driver	Primary demand – sell *broadly* to new customers.	Selective demand – sell *deeply* to existing customers.
Offerings	Horizontal products with limited customization. Delegate solutions design and delivery to partners.	Customized vertical solutions. Collaborate with partners to design and deliver solutions.
Pricing Strategy	Perpetual license pricing to maximize revenue from transactions.	Value-based pricing to align value creation for customers with value capture for the firm through subscription-pricing and gain-sharing arrangements.
Sales Organization	Product-centric organization with multiple faces to a customer.	Customer-centric organization organized around key customer segments or customer accounts, with a single face to a customer.
Marketing Operations	Emphasis on product launches and breadth campaigns to increase reach and influence customer perceptions.	Emphasis on ongoing customer engagement and customer value assessment/tracking.
Success Metrics	Product revenues and product profitability. Declare success at *product sale.*	Customer satisfaction, profitability, and growth. Declare success when *customers experience success.*
Monitoring and Tracking	Periodic surveys of customer satisfaction with products.	Ongoing tracking and continuous improvement of the total customer experience.

Figure 1 Contrasting the Product Mindset With the Customer Value Mindset

7. Value Is a Mindset

Value-based management is much more than a set of models or processes. It is a mindset. It begins with the belief that the sole purpose of a firm is to create value for its customers and to be compensated equitably for its efforts. Therefore, everything the firm says and does should revolve around its customers, not its products. This is a radical shift in perspective that few firms truly embrace, despite their claims of being customer-focused. True customer-centricity demands that you believe and act on the basis that customer value is the *raison d'être* for the firm. You cannot offer value to customers without changing your firm's values, because what the firm believes determines how it thinks and acts, and its actions and behaviors, in turn, manifest themselves in the firm's offerings.

Firms that adopt the value mindset think differently about the customers whom they focus on, the value propositions they create for their customers, the growth strategy they employ, the way they organize their marketing and sales organization, and the way they measure and reward success. Figure 1 contrasts the traditional product mindset with the customer value mindset on a number of important dimensions of the business.

In stormy economic seas, value can serve as an anchor by reminding you that every initiative you engage in should be grounded in a clearly articulated customer value proposition. If you focus relentlessly on defining value as customers do, designing your offerings based on what customers value, and measuring your performance in terms of the value that customers experience, you will be well on your way to creating successful customer relationships. ■

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