Balancing Acquisition and Retention Spending for Firms with Limited Capacity

Have you ever wondered about how firms find the right balance between revenue management and customer relationship management? To date, many industries have seen notable success with revenue management techniques that emphasize maximizing short-term revenue, yet they often ignore the potential negative impact on the firm’s relationship with customers. In contrast to a rudimentary strategy of revenue management (RM), customer relationship management (CRM) focuses on maximizing the value of the firm’s current and future customer relationships, often at the expense of short-term profitability. Even today, the interaction between revenue management (RM) and customer relationship management (CRM) is not well understood.

Researchers Ovchinnikov, Boulu-Reshef and Pfeifer hope to contribute to this literature through their paper. Their research purpose and findings are of particular importance for firms that operate in customer-retention situations with limited capacity, which makes for a unique set of challenges, for example the performing arts, sports and entertainment, et cetera. For this purpose, the researchers contrast a stylized dynamic programming model for selecting acquisition and retention spending with results from a behavioral experiment in which subjects made acquisition and retention decisions for firms with limited or unlimited capacity and with or without explicit information about customer lifetime value (CLV). It was important for the researchers to contrast the modeling solution and laboratory behavior as these decisions are often made by managers rather than computer algorithms.

For the model, the researchers formulate a model of a firm that decides on how much to spend on acquisition and retention. The model is purposefully stylized to capture the general elements of the problem and yet isolate the effect of a capacity restraint from other possible dependencies that could be creating dynamics in spending. This model is comparable to CLV model used by other researchers. Upon creation of the model, the researchers used it to characterize optimal spending and then test it behaviorally.

The goal of the behavioral analysis was to understand how managers of firms in retention situations with limited capacity handle acquisition and retention spending trade-offs. For this purpose, the researchers designed an online simulation platform. Specifically, the simulation asked subjects to decide on retention spending for two types of customers, specifically customers that are easy to retain and customers that are hard to retain. Participants were provided with a number of decision support tools. The four treatments were – with limited or unlimited capacity, and with or without a CLV calculation and graph in the subjects’ instructions.

The modeling part of the paper shows that when capacity is unlimited, VIC (Value of an Incremental Customer) equals CLV, but when capacity is limited, VIC is much smaller and changes dynamically depending on the number of customers and their mix. As a result, the optimal spending is constant and depends on CLV from the firms with unlimited capacity, but changes dynamically and is generally unrelated to CLV when capacity is limited.

In the experimental part, the researchers find that in terms of balancing across customer types, subjects overspent on retention of high-value customers and underspent on low-value customers. In addition, in terms of the role of CLV, CLV information helped subjects when capacity was unlimited, but hurt them when capacity was limited.

This research suggests that managers who are responsible for acquisition and retention trade-offs need to be more wary of the relative costs and benefits (VIC) of each customer, and of the strategic interplay between acquisition and retention activities and interchangeability when firms’ capacity is limited. Managers must realize that the firm can benefit more retaining/acquiring a low-value customer if doing so is inexpensive relative to going out of its way trying to retain a higher-value customer. Overall, managers should consider CLVs only when they have ample available capacity, but when capacity is scarce, they should focus on assessing the marginal profitability of retention and acquisition activities.

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