Libey-Concordia Economic Outlook

and

Secrets of the Catalog Master

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Donald R. Libey, Editor

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Philadelphia, Pennsylvania
Cherry Hill, New Jersey
www.libey.com

Lifetime Value

Donald R. Libey

Recently, I have completed forensic audits on three multi-channel direct marketing companies for their owner, investment group or parent corporation. In all three instances, neither the CEO nor any of the senior managers knew the lifetime value of their customer. This is not surprising. Many people have come to the direct marketing world in recent years from other endeavors and simply have not been exposed to the precise formulaic measurements that support our world. Additionally, the present focus on measurements related to the online channel has made such an old-fashioned concept as lifetime value seem obsolete. Au contraire! Lifetime value retains its position as the **Prime Measurement.**

Preliminary Definitions

The first thing I want to stress is that lifetime value cannot be understood until the cost to acquire a customer is understood. Measuring the cost to acquire a customer is a complex calculation dependent upon the direct marketing methodology. A one-step acquisition, as with a list rental or a space advertisement requires one method of calculation. A two-step involving lead generation and conversion of inquiries requires a second calculation. The cost to acquire a customer is one of the Mother Measurements in multi-channel direct marketing.

The term 'lifetime value' is often associated with several other 'lifetime' terms that should be mentioned. Lifetime *spend* is the total amount a customer will spend with you over their life, also called *sales*. It should not be confused with value, which is a derivative of sales. Lifetime *profit* is a confusing term that should be further qualified by either *gross profit*, *profit contribution* or *net profit*. Gross profit is sales less cost of goods. Profit contribution is sales less cost of goods, cost of advertising and fulfillment. Net profit is sales less cost of goods, advertising, fulfillment and overhead. Lifetime value—correctly—is profit contribution multiplied by the time value of money discount factor, which produces the net present value, or the value today of profits to be gained in the future.

The second thing I want to stress is the definition of 'life.' Most direct marketers have customers that have been buying from them for years. The owners believe *all* of their customers are similarly loyal. They're not. Best case, life is a measured and known average length of time that a customer is active. Worst case, life is a time-limited amount of time that can be justified, such as three years. In the first instance, the company *actually* knows the life span of their customer. In the second, the company does not actually know but makes a logical *assumption* based on experience. In a business where fractions of a percentage point can product huge gains or losses, it isn't too difficult to figure out why actually knowing the exact life is preferred to assuming.

The third thing I want to stress is that lifetime value is different depending on the channel. The life of a catalog customer may be different from the life of an online customer. But, while they are likely different and require calculations by channel, the *overall* life of a customer is inclusive of all channels. At some point, we have to get to one number in order to be relevant. To get to one number representing life, however, we have to know *all* life numbers by channel. And, to get *there*, you *have* to be able to attribute a source for all customer acquisition and for all orders by channel.

The fourth thing I want to stress is that there is no acceptable 'normal' cost for the cost to acquire a customer, customer life or lifetime value. They all depend on variables such as industry, gross margin, acceptable return on investment, whims of the owners, and so forth. One company will pay more to get a customer because they expect to have that customer longer, or because the gross profit is 72 percent, or because the average order value is $4,200. *The point: These are individual calculations for individual situations.*

Finally, while knowing lifetime value today is critical, knowing lifetime value next year and two years from now is genius. The only way to predict that is to be able to track lifetime value over time and 'see' the trend. The visual trend is only understood on a classic *x* and *y axis* chart. The minimum amount of tracking time to accurately understand and see the lifetime value trend is twenty rolling quarters or five years of history. Rolling quarters describes a period of the last five years always moving through time; the oldest quarter drops off when the newest quarter is added to the chart.

Lifetime Value

Lifetime value is the value today of the profits to be gained in the future from a specific group of customers. Another way of looking at this is lifetime value is what the customers are worth today for their expected performance over time. A third, somewhat crude, way of stating lifetime value is, "What's in it for me? If I spend money to get a customer, how much do I get back along with some interest for using my money?" Right away, you can see that the lifetime value process excites a direct marketer and the lifetime value number either excites or turns off an investor. Lifetime value is, therefore, an operating measurement and an investment measurement.

Begin with a group of customers either from one source or channel or from a variety of sources or channels. That selected group of customers will be tracked through the three years, or all customers can be tracked through the three years. By determining a selected group for lifetime value analysis, you can choose to track, for instance, all catalog customers, all online customers, all DRTV customers, all space ad customers, and so on. Similarly, you may choose to track all customers from response lists, or from compiled lists, or from co-op lists, or subscriber lists, or email lists. Some may want to do zip code lifetime value, or geographic lifetime value, or who knows—customers attracted on phases of the moon, or Tuesdays—whatever. Most of us, however, tend to need: 1) an overall customer lifetime value; 2) an overall channel lifetime value; and 3) an overall source lifetime value. For the advanced multi-channel direct marketer, lifetime value by recency, frequency and monetary value (RFM) segmentation is essential. Some business-to-business marketers also require lifetime value by Standard Industrial Classification (SIC). *The point: There are many lifetime values and you will benefit from a variety of views; however, until you can accurately do one overall lifetime value, don't get weird.*

Lifetime value offers the CEO of any multi-channel direct organization a multi-variate tool with which to begin the process of financial optimization. For some, lifetime value is *the* calculation that precedes all others. A focus on sales reveals response and retention; a focus on costs reveals operational and channel/media efficiencies; a focus on profits reveals the relative effectiveness of the entire business above the overhead line, which is the dynamic portion of the company. Whatever factors are right or wrong about a multi-channel direct marketing company, I can almost always get to the heart of the matter via the lifetime value calculation. For me, it's the Mother Calculation, the Béchamel Sauce from which all other sauces emanate.

The following chart provides a synopsis of the lifetime value calculation. The percentages and values are hypothetical, but reasonable for direct marketing organizations. Gross profit, advertising and fulfillment costs will vary from company to company. While both advertising and fulfillment are important, the critical variables in lifetime value are retention and gross profit. If retention can be improved only slightly, or if gross profit can be increased only slightly, the lifetime value is improved dramatically. In the future, the impact of online technologies and costs will have a much more significant effect on both advertising and fulfillment costs, particularly as automated processes replace labor-intensive systems.

Please note that this is *not* a full discussion of the complete suite of value calculations, which include: 1) lifetime value; 2) net present value; 3) internal rate of return; and 4) payback. These four are used by boards of directors as the minimal calculations necessary to evaluate the potential of an investment. In this example, the time value of money discount factor is 20 percent, a common rate for the direct marketing industry; however, the rate can be higher or lower depending on numerous variables.

Lifetime Value Calculation	First Year	Second Year	Third Year
Sales			
Customer Group	1000	500	300
Customer Group Retention Percentage	50%	60%	70%
Sales per Customer	$400	$400	$400
Total Sales	$400,000	$200,000	$120,000
Costs			
Gross Profit	50%	50%	50%
Cost of Goods Sold	$200,000	$100,000	$60,000
Fulfillment Percentage	12%	12%	12%
Fulfillment Cost	$48,000	$24,000	$14,400
Advertising Percentage	25%	25%	25%
Advertising Cost	$100,000	$50,000	$30,000
Profits			
Contribution to Overhead	$52,000	$26,000	$15,600
Time Value of Money Discount	20%	20%	20%
Net Present Value	$43,333	$18,056	$9,028
Customer Lifetime Value ($ ÷ 1,000)	$43.33	$18.06	$9.03
Cumulative Customer Lifetime Value	$43.33	$61.39	$70.42

A primary use for lifetime value is to establish how much a direct marketing company is willing to spend to acquire a new customer, or the level of *investment prospecting*. Logic tells us that if the cost to acquire a customer in the first year is $70.42, this idea isn't going to work out well. And don't forget, the above is only calculated to the contribution to overhead line. Knowing the cost to acquire a customer at the source level is essential. Source includes not only lists, but also search engine sourcing, including organic, pay-per-click, pay-per-sale, affiliate, and all other forms of online new customer acquisition. Each of these sources is examined, first for cost to acquire and second for lifetime value. A hierarchical comparison is made for cost to acquire and lifetime value, and a subsequent correlation produces the optimized source + cost to acquire + lifetime value ranking.

Responsibility for Lifetime Value

Everyone in the company has a stake in customer lifetime value, but there are two positions that have the responsibility for accuracy and application of lifetime value to management: the CEO and the CFO. Lifetime value is a 'rudder' analysis; it keeps the ship on course and it takes a long time to swing the bow a few degrees to port or starboard. The CEO has to give the orders; the CFO has to execute those orders. Everything concerning lifetime value is determined by response rates, cost of goods, advertising costs, fulfillment costs, and the proper determination of the time value of money and the risk associated with the investment.

The Second Quarter 2005 Regional Economic Outlook

While the majority of business-to-business direct marketers and most consumer direct marketers report the year continues to look positive, there is a bit of softness entering the picture in late April. There have been weather distractions and almost a month of concentration on the changes at the Vatican, but there is also some softening in the leading economic indicators, such as housing starts, employment growth, retail sales, and manufacturing production. Additionally, higher interest rates and the record energy costs have caused some slowing and the market response to inflationary fears is palpable.

We continue to believe that marketers should pursue prospecting and customer contacts reasonably aggressively, even in the coming summer months. We remain positive for the second quarter 2005 outcome and neutral on July and August 2005 until further energy price activity emerges. All regions continue to benefit, albeit at a slightly reduced rate of growth than we saw in the first quarter of 2005.

Signs of Improvement

Region One (CT, ME, MA, NH, RI, VT)
Region Two (NY, NJ, CT, PR, VI)
Region Three (PA, NJ, DE)
Region Four (OH, KY, PA, WV)
Region Five (KY, MD, TN, VA, NC, SC)
Region Six (GA, AL, FL, LA, MS, TN)
Region Seven (IL, IN, MI, WI, IA)
Region Eight (MO, IL, IN, KY, TN, LA, AR)
Region Nine (MN, WI, ND, SD, MT, MI)
Region Ten (KS, CO, MO, NE, NM, OK, WY)
Region Eleven (TX, LA, NM)
Region Twelve (CA, UT, AZ, NM, OR, WA)

Mixed to Slower

None

The Second Quarter 2005 Circulation Outlook and Recommendation

Synopsis

The short-term economic outlook for the catalog industry continues to be reasonably positive through the first half of 2005. There are some signs of slowing emerging, especially in leading indicators, which may be signaling moderation in the late summer and third quarter. The intermediate-term outlook is positive for the balance of 2005, and the long-term outlook through 2007 remains positive.

Keep Prospecting

Once again, perspective is essential. If you will think back over the years and recognize how many companies have regretted their short-term decisions to pull back in either economic downturns or periods of threat, you will once again conclude that reducing prospecting and house mailings *at any time* is always a strategy for slowing the growth and profitability of the business longer-term. The savings of a few thousand dollars in times of pressure can result in the loss of many more thousands of dollars in future profits and business valuations. Multi-channel marketers are having good results. This is because we are so far advanced over other forms of commerce. You have invested in advanced online marketing *and* you have wisely continued to support, grow and invest in your catalog businesses because you know that those catalogs are driving substantial number of online orders. If the media and the politicians create doubt, it's about power. Our jobs are about focus and consistency. Those are the qualities that deliver increased corporate valuation. *The point: Prospecting isn't an optional strategy; it is a <u>constant</u> strategy that produces profits.*

Nation at a Glance

The detailed economic conditions for each state have been integrated into the following recommendations. **Changes to circulation recommendations through the Second Quarter 2005 and summer are highlighted in bold italics.** A number changes are recommended for the balance of the second quarter, all from Increased to Normal mailing.

State	Mailings
Alabama	Normal
Alaska	Normal
Arizona	Increase
Arkansas	***Normal***
California	Increase
Colorado	Increase
Connecticut	***Normal***
Connecticut-Fairfield	Increase
Delaware	Increase
District of Columbia	Increase
Florida	Increase
Georgia	Increase
Hawaii	Normal
Idaho	Normal
Illinois—North	***Normal***
Illinois—South	***Normal***
Indiana—North	***Normal***
Indiana—South	***Normal***
Iowa	Increase
Kansas	Increase
Kentucky—East	Normal
Kentucky—West	Normal
Louisiana—North	Normal
Louisiana—South	Normal
Maine	Normal
Maryland	Increase
Massachusetts	***Normal***
Michigan	Normal
Michigan—Up. Pen.	Normal
Minnesota	Increase
Mississippi—North	Normal
Mississippi—South	Normal
Missouri—North	Normal
Missouri—South	Normal
Montana	Normal
Nebraska	Normal
Nevada	Normal
New Hampshire	Normal
New Jersey—North	Increase
New Jersey-South	Increase
New Mexico—East	Normal
New Mexico—West	Normal
New York	Increase
North Carolina	***Normal***
North Dakota	Increase
Ohio	Increase
Oklahoma	Normal
Oregon	Increase
Pennsylvania—East	Increase
Pennsylvania—West	Increase
Puerto Rico	Normal
Rhode Island	Normal
South Carolina	***Normal***
South Dakota	Increase
Tennessee—East	Normal
Tennessee—West	Normal

Texas	Increase	West Virginia—East	Normal
Utah	Normal	West Virginia—West	Normal
Vermont	Normal	Wisconsin—North	Increase
Virgin Islands	Normal	Wisconsin—South	Increase
Virginia	Increase	Wyoming	Increase
Washington	Increase		

New Services

Libey Incorporated, our advisory practice, has begun three new services for multi-channel direct marketing CEOs and companies. They are: *BoardroomAdvisor; ResearchAdvisor;* and *WebsiteAdvisor*. Descriptions can be found on our website www.libey.com.

BoardroomAdvisor is a unique service providing CEOs with access to strategic evaluation and advisory services on a flexible and very affordable subscription basis. It gives CEOs access to Don Libey for extensive strategic consultation without the expense of travel.

ResearchAdvisor is a custom direct marketing research service also on a flexible, affordable, subscription basis. It fills the need for practical 'hands-on-find-answers' research for direct marketers *by* direct marketers.

WebsiteAdvisor is a one-of-a-kind service. *WebsiteAdvisor* uses a proprietary protocol to evaluate your direct marketing website on a low-cost basis. It delivers practical, useful and common sense information that you can immediately use to improve your customers' perceptions about your online business. *WebsiteAdvisor* is a qualitative review focused on your website's credibility and aesthetics.

For many direct marketers, business-to-business or consumer, the last thing you need are more usability studies or quantitative analyses of the website technical elements; these can be obtained by many web analytic vendors. *WebsiteAdvisor* looks at the *really* important credibility and aesthetic elements of your website. Our researchers have reviewed thousands of websites and have found over 50 unique *credibility elements* that *must* be included for you to generate buyer trust. *WebsiteAdvisor* also examines practical elements of your website, from the 'mildly irritating' to the outright 'turn offs' of the structure, format and aesthetics of the presentation.

WebsiteAdvisor is not 'click analysis' or unique visitor analysis; it is a comprehensive and candid evaluation of what is good, what is bad, what is ugly, what is missing, and what there is too much or too little of to be effective. *WebsiteAdvisor* is unlike any other review available to the multi-channel direct marketing company relying on their website for a significant portion of sales.

As an introductory offer, the thorough review covering the all-important credibility and practical elements of your website is only $500, paid in advance, until September 1, 2005 (possibly the best and least amount of money you will ever spend on your website). Consider the benefits of the *WebsiteAdvisor* review. Visit our website and contact Andrea Stewart to assist you with a valuable review of your website today. Her email is: stewart@libey.com. Of course, MeritDirect and Amtower & Co. clients receive courtesy fee reductions on these and other advisory services of Libey Incorporated.

Secrets of the Catalog Master

Perceptions

Websites and catalogs create perceptions in the minds of prospects and customers. These perceived qualities occur because of the opaqueness of the channel. When a browser looks at a catalog or a website, the company is ‘created’ in the mind. Unlimited inventory is conjured up; great spans of warehousing are envisioned; legions of customer representatives are seen in the mind’s eye. A new direct marketing company operating out of 1,000 square feet in a tiny industrial park can appear to be a venerable, large business entering its seventh generation and sitting atop all of its competition through the magic of catalog and website design perception. I do not mean fabrication of the facts; rather, the use of the customers’ natural perception to create the necessary quality of credibility.

For some companies, operating from unimpressive facilities, it may be better *not* to show pictures of the warehouse. Let the perception create the picture in the mind. Direct marketing companies that are starting out are best advised to spend the money on a catalog and website that inspire confidence. So many small companies go through the ‘cute’ phase or the ‘we’re really small and we give great personal attention’ phase. Often, this is rejected by the prospect or customer because it is *not* what they want to perceive.

A second perception where direct marketers have an advantage over retailers and forms of commerce is *satisfaction guaranteed*. The perception of satisfaction is conveyed by customer testimonials and other customer feedback. These are almost *never* found in the retail world. Retailers don’t post signs saying, “Bring anything back and we’ll refund your money.” Returns are discouraged in many stores, although ultimately being accepted.

A third perception that the prospect or customer carries in the mind is one of abundance. They all believe that all products in the catalog and on the website are stocked in abundance and are waiting to be bought. The mind of the customer cannot conceive ‘not available’ or ‘out of stock.’ The kiss of death in a retail store or an office products store is the clerk’s pathetic phrase, “We’re out of that, but we can get it for you by next Thursday.” I recently purchased a bird-watching spotting scope. This is a $300 item. One website offered it within 2-3 *weeks* drop-shipped from the factory plus a hefty shipping charge. Another offered it *same-day* with free shipping. Guess who got the order. I went with the perception of abundance. *The point: Catalog masters use perceptions to gain very real advantage over competitors*.

Merchandising

Is merchandising a lost art in multi-channel direct marketing?

What is merchandising, anyway?

The post-online era of direct marketing uses the terminologies *merchant*, *merchandiser*, and *merchandising* in ways that are unusual to traditional direct businesses. When I audit a company, often the CEO asks about the adequacy of the company's merchandising. In most instances, the company's are combining merchandising and marketing functions. But the surprising finding is that many CEOs don't have a clear distinction between those two functions.

First, there are really three types of merchandising. One is concerned with markets, another is concerned with products, and the third is concerned with analytics.

A market merchandiser is expert at understanding the needs of a target universe of a multi-channel direct marketing company *and* the positioning of that company within the universe (high-price leader, mid-price follower, low-price leader; quality; speed; channel; access). Market merchandisers are also experts on the company's products, but they have an additional skill in understanding the market requirements, trends, and other influencing factors on a macro basis. The market analysts are also skilled in conducting research dealing with markets, customer behavior, and products.

The second type of merchandiser is a product merchandiser. This is the individual who goes to sleep and wakes up with five new products under the pillow. They are expert at doing competitive analyses of products and product groups to develop perspectives on pricing, lines, extensions, depth and breadth, applications, features and benefits, categories and positioning. From there, product merchandisers skillfully choose the products that make up the lines, based on the competitive findings in each product component area. The development portion of their responsibilities include creating product specifications, writing product descriptions, describing product applications, forming the written description of the features and benefits, sourcing and negotiating manufacturing, purchasing or drop-shipping terms and conditions, preparing contracts, establishing pricing and quantity discounts (if any), and participating in the development of catalog and website creative.

The third type of merchandiser is the product analyst. These unique people have responsibility for all product analysis including RFM and product overlays, square-inch analyses, mark-up catalogs, price analyses, category analyses, product lifecycle analyses, and any other product or product category-related analytics. Additionally, they are instrumental in the analyses of supply chain logistics, inventory turns, cubing, and other supply management analyses.

Both market merchandisers and product merchandisers share the product development and sourcing through a variety of outside activities, including trade shows, import buying trips, vendor sales presentations, customer focus groups, review of trade publications and competitive purchases. The magic occurs when the market merchandisers and the product merchandisers see things from different perspectives, but come together in harmony on finding great products for great markets. Among most multi-channel merchandisers, the top sources for new products are ranked (first to last) as trade shows, manufacturers, internal development, competitors, and trade publications.

Merchandisers have a daunting job. To create a 32-page catalog and web site from scratch, sufficient products are needed for a page density of, say, five products per page. That is about 150 products, allowing for editorial space. To find 150 product winners to make it to the catalog and website, about 750 products will have to be evaluated. The ratio can be as high as 5 evaluated products to 1 selected product for inclusion. Established direct marketers require a minimum 35 percent new products annually to as high as 100 percent new products *seasonally*. The unrelenting demand for new products by prospects and multi-buyers places a significant amount of pressure on merchandisers. It is illogical to expect a combination marketer/merchandiser to be able to meet the demands of today's dynamic, multi-channel marketplace. In most of my performance audits, I find severe understaffing—or total lack of staffing—in the merchandising discipline. And wherever it is a function combined with marketing—which is circulation and contact strategy and creative—the results are universally below par.

The additional post-online era recognition that should be conclusive for strong merchandising skill and experience is that each channel has its own merchandising quirks and behavior. One size may not fit all.

Libey-Concordia
Advisors and Investment Bankers to the Catalog Industry

Philadelphia, Pennsylvania Offices
(Offices of Kenneth W. Evans, Jr., Geoffrey C. Walker)

1601 Market Street 16th Floor
Philadelphia Pennsylvania 19103
Tel: 215-561-4454 Fax: 215-561-4455

Cherry Hill, New Jersey
(Office of Donald R. Libey)

811 Church Road Suite 105
Cherry Hill, New Jersey 08002
Tel: 877-903-9448 Fax: 866-221-8346

E-mail: libey@libey.com
www.libey.com