Richard Ivey School of Business
The University of Western Ontario

908A01

CONROY'S ACURA: CUSTOMER LIFETIME VALUE AND RETURN ON MARKETING

Mike Moffat wrote this case under the supervision of Professor Kyle B. Murray solely to provide material for class discussion. The authors do not intend to illustrate either effective or ineffective handling of a managerial situation. The authors may have disguised certain names and other identifying information to protect confidentiality.

In the fall of 2006, Terrence Conroy, president of Conroy's Acura, was poring over the company's quarterly sales. Despite a healthy economy, sales at his dealership were stagnant. If the dealership were to remain profitable, Conroy needed to find a cost-effective way to increase sales. His vice-president of sales, Rachel De Lima, was continually coming up with new marketing schemes to boost sales. But Conroy had difficulty determining how successful past marketing efforts had been in increasing profitability. He needed a way to put the numbers into context.

HISTORY OF THE DEALERSHIP

Conroy's Acura was founded in November 1986 by Ross Conroy, a veteran of the car industry who also owned a General Motors dealership and an American Motors (AMC) dealership. Conroy's Acura was the first Acura dealership to open in Toronto and one of the first in North America. Located in downtown Toronto, Conroy's Acura sold both new and pre-owned vehicles, and its service department was dedicated to Acura products.

In 1999, Ross's son, Terrence Conroy, became president of Conroy's Acura. Along with Terrence Conroy and De Lima, the dealership had a staff of nine salespeople, two administrative assistants/receptionists and six technicians who worked in the service department.

Conroy's Acura was an independently owned dealership that held a franchise agreement with Honda, Acura's parent company. Conroy's Acura purchased its inventory directly from Honda's Canadian distributor and sold the cars at a markup. Conroy's Acura also sold pre-owned automobiles, the majority of which were obtained through trade-ins from consumers.

THE MARKETPLACE

Conroy's Acura had a number of competitors in the marketplace, the most obvious were the dozen or so other Acura dealerships within a 30-kilometre radius. Conroy's Acura competed directly with dealerships that sold cars comparable to Acura's offerings, such as Saab, Volkswagen and, most notably, Honda. Conroy believed the four biggest competitors in the Toronto market were BMW, Mercedes-Benz, Lexus and Infiniti. BMW and Mercedes-Benz, two German brands, tended to price their cars higher than Acura. Lexus, the luxury brand of Toyota, and Infiniti, the luxury brand of Nissan, tended to price their cars in the same range as Acura.

Competition had grown fierce over the past few years, because of the advent of the Internet, which made it much easier for consumers to comparison shop.

THE CARS

Conroy's Acura sold six models of new cars:

Acura CSX — average sales price: $31,860
The Acura CSX was an entry-level luxury car, similar to the Honda Civic. It competed against cars such as the Volkswagen Jetta and the Nissan Sentra.

Acura RSX — average sales price: $35,100
A small sporty sedan, the Acura RSX competed with cars such as the Mitsubishi Eclipse and the Volkswagen Golf GTI.

Acura TSX — average sales price: $42,984
The Acura TSX competed in the entry-level luxury market with the BMW 3 series, the Mercedez-Benz C-Class, the Audi A4 and the Lexus IS.

Acura TL — average sales price: $49,680
The Acura TL was a mid-sized luxury car with many competitors, including the Infiniti G35, the Lexus ES, the Saab 9-3, the Mercedes-Benz E-Class and the Volvo S60. The Acura TL was far and away Conroy's Acura's highest selling car.

Acura MDX — average sales price: $61,776
The Acura MDX was a sport utility vehicle (SUV), which had an SUV appearance but a unibody construction typically seen in cars. Other mid-sized crossover SUVs included the Lexus RX, the BMW X5, the Infiniti RX and the Volvo XC90

Acura RL — average sales price: $79,812
The oldest model of the six sold by Conroy's Acura, the Acura RL, competed with the Audi A6, the Lexus GS and the Volvo S80 in the luxury sedan market.

SALES AND EXISTING MARKETING EFFORTS

The firm was currently spending $120,000 on marketing to new clients each year, split between billboards, direct mail, radio and television spots, and newspaper and community magazine advertisements. Conroy's Acura sold approximately 650 cars each year, spread over six car classes. On each model, the firm's gross markup was approximately eight per cent of the dealer cost. After fixed expenses, such as staff salaries, rent and taxes, net profit was typically two per cent of sales revenue.

The firm also spent $10 a year to maintain each of its existing customers. The bulk of this expense came from quarterly postcards reminding drivers to change their oil and the occasional letter promoting new models and specials offered by Conroy's Acura.

The dealership typically judged the success of its marketing efforts by comparing the cost of the marketing effort to the number of extra cars sold. De Lima believed this method understated the true value of her efforts, because it did not take into account that 25 per cent of customers who bought a car today would also buy their next car from the dealership. To get an accurate gauge of the dealership's marketing efforts, this statistic needed to be taken into account.

Conroy was also very concerned with quantifying the return on marketing. He had seen more than his share of creative marketing ideas that did not produce a tangible financial return. Although brand building and general recognition were important to him, his dealership was now well-known in the community and, at the end of the day, he wanted new marketing initiatives to provide a compelling return on his marketing investment.

Sales could be broken down into two types: sales to new customers and sales to previous customers. Conroy's Acura used a two-pronged marketing approach to gain sales from each group, but spillovers occurred; a billboard designed to gain new customers could also help the dealership to retain its existing customers.

INCREASING THE NUMBER OF NEW CUSTOMERS

Most of De Lima's ideas to increase the number of new customers were simply to do more of what they were already doing: more direct-mail postcards, more billboards, and more advertisements on television, on radio and in newspapers.

The sales staff, however, had a different suggestion. They believed the eight per cent markup on cars was too high, given how easy it was for consumers to comparison shop. The salespeople believed that by lowering the margin they could more than make up for it in increased sales. Conroy, though, was skeptical that sales could be increased enough to make a price reduction worthwhile.

INCREASING THE CUSTOMER RETENTION RATE

Conroy's Acura spent approximately $30,000 a year on customer retention, or approximately $10 to $12 a year for each customer that had purchased in the past four years. This expense was largely spent on postcard mailings to customers to remind them to change their oil or to notify them of upcoming promotions from the service department (for example, 10 per cent off tire rotation). Because it was less expensive to retain an existing client than to acquire a new customer, De Lima believed increasing the customer retention rate should be the primary focus of the dealership's efforts. After a brainstorming session with her sales force, they came up with the following ideas:

- Providing free oil changes or car washes with purchase of a new car
- Customer reward programs along the lines of frequent flyer miles offered by airlines. But the sales force had difficulties coming up with details. For example, who would run the program? What would the rewards be? How could consumers collect points other than buying a new car?
- Increased contact with customers (through postcard or letter mailings, phone calls and e-mails).
- Surveys of existing customers to ask what would influence them to purchase from Conroy's Acura in the future.

Conroy was intrigued by the ideas, but needed a way to compare the costs to the benefits. How much would their retention rate need to increase if the marketing budget for existing clients were doubled?

THE DATA KEPT BY CONROY'S ACURA

The dealership kept simple records of their sales and marketing efforts, including the following:

- The $120,000 spent on advertising.
- The number of sales of each car class, including the sales to first-time clients and the sales to previous Conroy's Acura customers.
- The dealer cost per car class, the average price and the markup for the firm, which historically was eight per cent per car class.
- The length of time a customer kept a car before purchasing a new one. Historically, for the Acura brand, the average was four years for each class of car.
- The historic retention rate, which was the percentage of customers who purchased their next car from the dealership. Since 1999, when Terrence Conroy became president of Conroy's Acura, the retention rate had been stable at 25 per cent.
- The yearly maintenance cost, or the cost of maintaining the customer relationship. Currently the firm spent $10 per year per current customer (those that had purchased in the past four years).

From these data, the firm could calculate the cost of acquiring a new consumer (the acquisition cost), the customer lifetime value and the return on marketing of increasing the marketing efforts (see Exhibit 1).

Acquisition Cost

The acquisition cost compared the amount of money spent on marketing to the general public to the number of cars sold to first-time clients. This cost is expressed by the equation:

Fixed Marketing Cost / Total Sales to New Clients

The firm's marketing budget was currently set at $120,000, and it expected to sell 497 cars to first-time clients this year, leading to an acquisition cost of $241 per client ($120,000/497 = $241).

Customer Lifetime Value (CLV)

The customer lifetime value related the amount the firm expected the average customer to spend over a lifetime. This amount varied from car class to car class. To calculate the customer lifetime value, the following data were needed:

- *d*: The discount rate, which represents the time value of money, the fact that a dollar today is worth more than a dollar next year. The higher the number, the more the future is discounted relative to today. Conroy's Acura used a discount rate of five per cent.
- *y*: The length of time a customer keeps a car before purchasing a new one.
- *r*: The retention rate, the percentage of consumers who return to the dealership to purchase their next car.
- *m*: The yearly maintenance cost of maintaining the customer relationship.
- *p*: The sales price of the car.
- *c*: The dealer cost of the car.

The customer lifetime value (CLV) is calculated as follows:

$$CLV = ((1 - d)^y \times ((p - c - (m \times y))/(1 - r)))$$

The customer lifetime value increases as the price *p* and the retention rate *r* increase, but decreases as the discount rate *d*, the dealer cost *c*, the yearly maintenance cost *m* and length of time between purchases *y* increases.

Return on Marketing

In order to estimate the effect of a change in marketing efforts, the new marketing efforts needed to be compared to a base case in which nothing had changed. To calculate the expected return on marketing of the marketing change, the following calculation is used:

ROM = Increased Profits in New Scenario / Increased Costs

To be worthwhile, the return on marketing should be at least as high as the returns Conroy's Acura could have achieved by investing in the stock market.

THE DECISION

Terrence Conroy felt that the dealership should be able to do something to increase the bottom line. Although, he was glad that they had some numbers to work with, he knew that a great deal of uncertainty always surrounded any projections. Conroy wondered, "What should I be doing differently to increase customer lifetime value, return on marketing, sales and profits? What steps do I need to take to make this happen?"

Exhibit 1

EXCEL SHEET DEFINITIONS

The Excel sheet (see Ivey product # 7B08A001) contains two scenarios: a base case in columns H through N and a modified scenario in rows A through G. When changes are made to the modified scenario, the Excel sheet will calculate the differences between the modified and the base scenario. The cells on the sheet are color-coded as follows:

Cyan cells: The user enters a figure into these cells.
Blue cells: These parameters or figures are calculated automatically. The user does not need to alter anything in a blue cell.
Yellow cells: The numbers in the yellow cells are chosen from a set of options in a drop-down box.
Green cells: These cells show the final results of the sheet, indicating the profitability and return on marketing (ROM) of any changes made.

Row 2 – Fixed Costs: The costs of any marketing efforts not captured by the acquisition cost and the yearly maintenance costs box. If an additional $2,500 is spent on a billboard, then this number should be increased by $2,500.
Row 4 – Car: The model of the car.
Row 5 – Total Sales: The total sales in a year for that particular model.
Row 6 – New Sales: The total sales in a year for that particular model to *first-time customers*.
Row 7 – Return Sales: Sales made to returning customers. This figure is calculated automatically as the difference between Row 5 and Row 6.
Row 8 – Avg. Markup: The price markup for that particular model.
Row 9 – Return (Yrs): The average length of time a customer keeps a car before purchasing a new one.
Row 10 – Retain Rate: The percentage of customers who will return to purchase their next car from Conroy's Acura.
Row 11 – Yr. Main Cst: The yearly maintenance cost of keeping an existing client. This cost includes expenses such as mailings and postcards sent to existing clients, free oil changes and other promotions given to existing clients.
Row 12 – Disc. Rate: The discount rate represents the time value of money, the fact that a dollar today is worth more than a dollar next year. The higher the number, the more the future is discounted relative to today.
Row 14 – Acq. Cost: The per-consumer acquisition cost, calculated using the fixed costs from Row 2 and the yearly sales to first-time customers (Row 6).
Row 15 – Dealer Cost: The dealer cost for each type of car.
Row 16 – Avg. Price: The average price of the car. This price is calculated by Dealer Cost × (1 + Markup)
Row 17 – T Life Maint: The total lifetime maintenance for all the cars sold of a particular class, taking into account the length of time the average customer keeps a car (Row 9) and the discount rate (Row 12).
Row 18 – Tot. Acq: The total acquisition cost, calculated by multiplying the acquisition cost of Row 14 by the number of sales to first-time customers (Row 6).
Row 19 – Unit Gross: The per-unit gross profitability of the car. This figure is the average price minus the dealer cost.
Row 20 – T Gr Lifetime: The total gross lifetime profit from the car class. This figure includes maintenance costs but does not include acquisition costs.
Row 21 – T Gr Net of Acq: Similar to Row 20, but excluding acquisition costs.