Calculating Customer Lifetime Value (Basic Formula)

Introduction to CLV

Customer lifetime value (CLV) is an important marketing metric, particularly within the service industries. It basically provides a profit measure, on a per customer basis, of a customer over the lifetime that they deal with the firm.

There are three elements to the calculation in its simplest form (please note that other calculations can be more complex, but this is an introduction to the topic). The three elements are:

1. customer acquisition costs,
2. customer retention rate, and
3. customer profit per year.

Customer acquisition costs refer to promotional, selling, and other “setup” costs associated with gaining the customer in the first year.

Customer retention rate is the percentage of customers who remain loyal each year – that is, will buy from the company/brand in the following year.

And customer profit per year is the net amount (that is, after all relevant costs) of profit on a per customer basis.

Your Task

Your task in this exercise is to determine the customer lifetime value for various scenarios using the following formula:

Customer lifetime value = 1/(1 - customer retention rate) X annual customer profit less customer acquisition cost.

As an example, if:

- the acquisition cost was $500,
- the retention rate was 80%,
- and the annual profit was $250

Then the customer lifetime value would be calculated as:

- 1/(1-80%) X $250 - $500
- 1/20% X $250 - $500
- 5 X $250 - $500
- $1,250 - $500 = $750 CLV

Student Discussion Questions

1. Calculate the customer lifetime value for the following three scenarios:
   - Acquisition cost = $1,000, retention rate = 60%, annual profit = $500
   - Acquisition cost = $10,000, retention rate = 75%, annual profit = $2,500
   - Acquisition cost = $100, retention rate = 50%, annual profit = $100
2. Which scenario generates the most customer lifetime value? Which is the least profitable scenario?
3. What elements appear to be the most significant in the calculation – that is, if you were a marketer facing these scenarios, which elements would you focus upon?
4. This is the simple calculation for customer lifetime value. What other information you think needs to be incorporated?