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Capabilities for Forging Customer Relationships

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Customer retention has always been a high priority in business-to-business markets, and it is now at the center of the strategy dialogue in most markets. Customer relationships are seen as among the most valuable and durable of all advantages. Most firms have started, or will start, a major customer relationship management initiative to achieve:

- a continuing dialogue with customers,
- across all their contact and access points,
- with personalized treatment of the most valuable customers,
- to increase customer retention and the effectiveness of marketing initiatives.

However, for many firms, this initiative will be purely defensive, and will not result in advantages. In addition, as firms diffuse best practices, and vendors make relevant software widely available and economical, all competitors will be equally equipped. Most importantly, the organizational capability to provide a personalized experience for each customer is more difficult to achieve than a transactional or product-focused approach. In fact, few firms will master it.

What factors distinguish firms that are more capable than their rivals? How do firms achieve an alignment that enables them to successfully execute customer relationship management? What actions can strengthen the customer-relating capability?

Achieving a Relationship Advantage

In this paper, author Day provides a framework for addressing these issues. He uses a resource-based view that differences in firm performance are attributable to differences in assets and capabilities. Like all capabilities, he suggests, the customer-relating capability is embedded in a web of other capabilities and resources, and exercised through a complex knowledge acquisition, sharing, and application process. These include three closely coupled components:

- Orientation—the standards by which employees set priorities and make decisions about customer retention
- Information—the availability, quality, and depth of relevant customer information

- ❒ Configuration—the structure, systems, and processes that enable the application of the information

Each of these components plays an essential role—but none is a sufficient condition for success. To gain an advantage a firm must be as good or better than the best of the rivals on each component, and there has to be a positive interaction among the components.

Implications for Action

This model of a superior customer-relating capability raises a series of questions for managers:

- ❒ *What are our competitors doing?* How do we compare to the best of the rivals on each of the three components? Are our judgments the same as those of our customers? If not, why not?
- ❒ *Is the entire organization engaged?* No business can prevail if the firm orientation is transactional or unsupportive, if the key implementers don't accept the need to treat different customers differently, or if a silo mentality discourages information sharing and condones the belief that one function "owns the customer."
- ❒ *Are the structures, systems, and incentives aligned?* Each of these elements of the configuration sends a strong signal. Revamping the incentives and organizing around customers have especially high leverage.
- ❒ *Are there new possibilities for relationship building?* Does the collective mindset encourage a continual search for innovative ways to combine market insights and technology advances to tighten customer relationships?
- ❒ *Is learning a priority?* Best of breed companies are never satisfied, and keep learning more about what their best customers value.

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Introduction

Firms are continually seeking new ways to forge close relationships with their most valuable customers. They know that these loyal customers are the source of most of their profits and that any slowing of the rate of defection helps grow the customer base (Reichheld 1996; Zeithaml 2000). There is even more motivation to move closer to customers when the Internet makes price comparisons easier, opens the market to new competitors, and threatens to undermine customer loyalty. Although customer retention has always been a high priority in business-to-business markets, which typically feature a few powerful customers or intermediaries, it has now moved toward the center of the strategy dialogue for firms in all markets.[1]

With recent advances in networking, computing, and database-management technologies, firms have both the motivation and the means for moving closer to their valuable customers. Under the umbrella of customer relationship management (CRM) strategies, firms are being urged to integrate customer data from different departments and channels, use the information to learn which customers have the greatest profit potential, and then tailor their communications and offerings to accommodate these customers.

Firms are finding, however, that customer relationship management is no panacea. Their enthusiasm is tempered by three awkward realities. First, a strategy of building close customer relationships is neither appropriate nor feasible for every market or customer. Customers willingly enter only into relationships that are perceived as beneficial to them, and only a few are likely to be of a close and committed nature (Fournier, Dobscha, and Mick 1998). This constraint applies both to business-to-business markets, where customers typically collaborate with only a few suppliers, and business-to-consumer markets with low-involvement, habitual purchasing processes.

Second, efforts to forge relationships are continually being undercut by pervasive countervailing forces. Network technologies that facilitate interaction have also spawned shopping agents, third-party exchanges (Kaplan and Sawhney 2000), and auctions (Tully 2000). These tools shift the balance of information about prices, product availability, and performance in favor of the customer,[2] and expand the choice set at low marginal cost (Griffith 1999). Online software and search routines come to the aid of the buyer, not the seller. Of course, the loyal and valuable customers of one firm are also attractive prospects to be pursued by rival firms—and vice versa. This competition leads to an unremitting effort to neutralize or leapfrog the advantages that engender loyalty, a process aided by the rapid diffusion of the practices that created the advantages in the first place.[3]

Third, the organizational capability needed to provide a seamless and personalized experience for each customer is much harder to master than a transactional or product-focused approach, where the future of the relationship is not an overriding consideration.[4] The obvious steps of copying best practices, deploying the latest software, assembling a customer database, and proclaiming good intentions are not enough to overcome a weak capability.

This raises the question of what accounts for differences in the ability of competitors to manage customer relationships.[5] Why are some firms more closely connected to their customers, and rewarded with higher rates of loyalty and lower rates of defection? What factors distinguish firms that are more capable than their rivals? How do they achieve an alignment in their organization that enables them to better execute the core CRM process? What actions are most effective at strengthening the customer-relating capability? This paper provides a structured framework for addressing these issues.

For this purpose, we have adopted the resource-based view that differences in firm performance are attributable to heterogeneity in assets and capabilities.[6] According to this theory, a capability is a source of sustainable competitive advantage when it is superior to the capabilities of rivals, valuable in the market, difficult to imitate, and unlikely to be trumped by a different resource (Barney 1991; Collis and Montgomery 1995). The capability itself is a complex bundle of skills and accumulated knowledge, combined with investments in systems and databases. We propose that the distinguishing components of the customer-relating capability are:

- ❒ *Orientation*—comprising relevant values, behaviors, and mindsets
- ❒ *Information*—reflecting the availability, quality, and depth of relevant customer information
- ❒ *Configuration*—including the structure, systems, and processes in which the capability is embedded

A firm has a superior customer-relating capability when each of these components is as good as or better than that of its rivals, and when, together, they are aligned so that there is interaction among them that enhances the overall effect. Whether the customer-relating capability yields a meaningful competitive advantage also depends on differences in the potential for the industry to personalize relationships with tailored offerings and communications. The rest of this paper will dissect the individual components, and then show how they interact to create a competitive advantage and enhance performance.

Perspectives on Customer Relationship Management

We define customer relationship management as a crossfunctional process for achieving:

. . . a continuing dialogue with customers

. . . across all their contact and access points, with

. . . personalized treatment of the most valuable customers,

. . . to increase customer retention and the effectiveness of marketing initiatives.

This definition incorporates the four overlapping perspectives on CRM found in practice and in the literature. These are reciprocal connections, operational entanglements, infrastructure integration, and strategic resource. Each is helpful but gives only a partial picture of what is needed to gain a competitive advantage:

Reciprocal Connections. This perspective emphasizes the reasons that draw a buyer and seller together and keep them connected, including:

- The expectation of *mutual benefits*, which provides the motive for initiating a relationship, and reciprocity to keep it going. A sense of obligation must be felt by both parties—but only in retrospect (Bagozzi 1995).
- *Mutual commitments*, which reflect the extent of shared goals, incentives, and even contractual commitments (Blankenburg, Eriksson, and Johaneson 1999).
- *Trust* that each relationship partner will act in the best interests of the other, and the expectation that the other party will fulfill their (implied) obligations (Rousseau et al. 1998).[7]
- *Connective links*, which range from the sharing of information to the coordination and integration of joint processes.

Although it is helpful to understand why two parties have a relationship, it does not explain what has to be done to initiate or sustain this relationship.

Operational Entanglements. Traditionally, these entanglements were based on relationship-specific assets that created "switching costs" (Dyer and Singh 1998; Williamson 1985), and involved some combination of the following:[8] (1) the location of assets in close proximity, (2) the tailoring of physical assets, and (3) human-asset specificity achieved through cospecialization and shared knowledge.[9] Operational entanglements can be evidenced in the search for "sticky" website designs, which discourage the customer from leaving the site for another because it would require re-creating data already accumulated.

According to this CRM perspective, close relationships are forged via an iterative learning process whereby a firm acquires ever more knowledge about each customer, by remembering the cumulative details of each interaction, and the customer, in turn, values the personalization of the offering and interaction.[10] Firms acquire customer knowledge either through direct means such as site registration or telephone queries, where needs are articulated, or through unobtrusive means such as cookies that log website visits. Personalization may be as limited as tailored communications, or as extensive as customized products and prices, and entail the use of collaborative filtering technologies to anticipate requirements. The intent of all these entangling devices is to make the firm so easy to do business with that the customer has no incentive to switch, and it becomes difficult for a rival to duplicate the level of personalization.

Infrastructure Integration. This perspective seeks to meld information from all customer touch-points—including direct sales, telesales, websites, customer service, resellers, and channel partners—to get a coherent view of the customer. The preferred solution is packaged software that coordinates and automates customer-contact processes. Depending on the size and complexity of the firm, the technology can embrace data warehouses, Web integration, salesforce automation, call-center systems, and customer service and support, and requires integration with enterprise resource planning (ERP) applications. There is a strong technological bias to these integration efforts. Technology constraints often impede the desired integration, given that the process of integration is very time-consuming and organizationally disruptive, while potential advantages may be eroded as suppliers make the software available to all rivals.

Strategic Resource. Here, the firm weighs the economic value of each customer in relation to other customers in order to allocate resources for the retention and growth of its most valuable customers. The value of a customer to the firm is the net present value of all future profits from that customer, considering the margin earned, customer-specific servicing costs, and the profit earned on referrals by that customer (Peppers and Rogers 1997).

Underlying this perspective is the implicit presumption that growth in the aggregate value of the customer base is a key driver of economic profit and shareholder value. Accordingly, the strategic priorities are, first, to reduce the rate of defection and increase the longevity of the relationship,[11] and, second, to devise strategies to enhance the growth potential of valuable customers by expanding “share of wallet” with cross-selling activities or new products and services. Third, it is necessary to deal with low-potential-value customers, who will probably never earn enough profit to justify the expense of serving them, by creating incentives to make them more profitable or encourage them to buy from someone else. Success with this strategy requires an organization that is highly sensitized to differences in customer lifetime value, and is willing and able to treat different customers differently.

A Resource-based Perspective on the Customer-Relating Capability

A distinctive customer-relating capability is based on a superior ability to attract and retain valuable customers. But how, and why, does this capability confer an advantage? Our answer will be grounded in the resource-based view of the firm because (1) our interest is in the resources, assets, and capabilities that are housed within the firm and are difficult to imitate, and (2) the premises that define the logic of this theory can be shown to be consistent with the hypothesized functioning of the customer-relating capability.

Appraising the Resource-based View

Although the resource-based theory may be the best lens for examining differences among firms in their ability to forge close customer relationships, it is often a flawed lens. Despite a stream of persuasive conceptual arguments, most of the empirical support is still based on inductive reasoning and ex-post case studies. The absence of rigorous empirical work contributes to the persistent concern that the identification of capabilities may be a tautological process. As Williamson (1999) puts it, "Show me a success story and I will uncover a distinctive capability." These capabilities are also likely to be difficult to uncover because they are usually embedded in a rich network of other resources.[12]

A fuller appreciation of the strengths and weaknesses of the resource-based view can be gained by examining the three premises that underpin the theory.[13]

Performance Premise. A firm's competitive position and performance relative to competitors is believed to be a function of the strength, expert exploitation, and leveraging of its assets and distinctive capabilities. When these resources are valuable, superior, and durable, they are the basis for a sustainable competitive advantage.

The corollary to this premise is that these capabilities are more fundamental to the prospects for the firm than any particular product or services for which they are used. Therefore, strategies should be designed to "compete on capabilities" (Stalk, Evans, and Shulman 1992) rather than seek a position in an attractive market that can be defended against rivals. This premise is a direct challenge to the competitive forces approach (Porter 1991) and the related entry deterrence approach to strategy. However, the shift in emphasis toward capabilities and assets does not mean that strategy position and market attractiveness are any less important. On the contrary, the choice of which capabilities to nurture and which investment commitments to make must be guided by a shared understanding of the industry structure, the needs of the target-customer segments, the positional advantages being sought, and trends in the environment (Schoemaker and Amit 1997).

The most problematic aspect of the performance premise is the process by which resources are transformed into performance outcomes. Theorists have oscillated between internal and external reference points in the specification of this process (Scarbrough 1998). Some emphasize the learning process within the firm, and link cumulative learning to functional outputs. The implication is that a distinctive capability is what a firm does best. To others, what matters is ability relative to competitors (Collis 1991). Something a firm does well is not a source of competitive advantage if its rivals are as good at it, or better. Adopting an external reference point requires insights into competitive capabilities that may have to be inferred from differences in performance. The tacit knowledge and cumulative learning embedded in the competitor's capabilities will then be obscured from view.

Development Premise. This premise holds that resource and capability development is a selective and path-dependent process. The need for selectivity requires that an organization concentrate attention on a few capabilities that correspond to key success factors in the target market. Indeed, this logic leads to the outsourcing of any activities judged to be noncore because they do not contribute to gaining a competitive advantage that can be protected, or that can be done better by others.

There is a path dependency in choosing which capabilities to develop in the sense that firms build on what they know (Liebowitz and Margolies 1994). Behind immediate choices are histories of prior choice that sensitize firms to certain issues and possibilities, create a knowledge platform on which they can keep building, and constrain or "lock in" the firm to a particular path. This premise has face validity, in view of the considerable inertia behind most strategies and the demonstrable inability of incumbent organizations to respond to challenges from disruptive technological or social change.

This premise is also consistent with what we already know about customer relationship management. It is a selective process in that firms choose whether to make it a central versus supportive element of their strategy. Firms may be deterred from making it a central theme because close relationships are path dependent. They evolve over long periods of time, require the reciprocal development of trust and mutual commitments, and require investments in relationship-specific assets.

Sustainability Premise. If key resources and capabilities are to keep their value, they must be protected from imitation or substitution. Inimitability results from causal ambiguity or other barriers to duplication (Barney 1997).

There is causal ambiguity when it is unclear to competitors how the source of advantage works; thus, the causal connections between the actions of a firm and the observed results cannot be uncovered. The greater the uncertainty over how successful firms realize their results, the more likely it is that potential entrants will be deterred. Causal ambiguity deepens when the distinctive capability is based on a complex pattern of coordination among diverse types of resources. This means that few people have a complete grasp of the entire system, and no single component can be singled out for examination.

Once a potential rival comprehends the sources of advantage—however imperfectly—imitation requires that it acquire or develop the resources necessary to mount a competitive challenge. The sustainability of the advantage in the face of these attacks depends on several barriers to duplication, including:

- *Immobility or scarcity of resources.*
- *Inaccuracy of information* about the value of resources. The established firm will usually have better insight into the productivity of individual assets, whereas rivals face an imperfect market with poor information about how much to pay.
- *Risk.* Even if resources can be acquired, there is a risk that the value may not be realized because of a degradation in their productivity after the transfer.

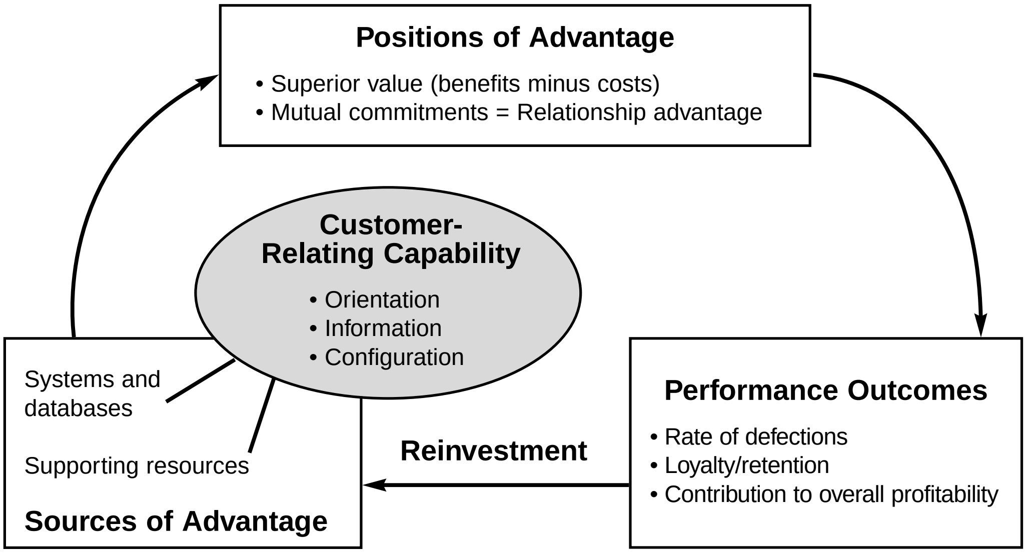
The problem with the sustainability premise is that the advantages derived from a distinctive capability may not be sustained even if the capability cannot be imitated (Collis 1991). First, if there is profound causal ambiguity with a high level of tacit knowledge, the capability will not be well understood by those inside or outside the firm. This could potentially impede the ability of the firm to adapt to new circumstances. Second, even if each of the distinctive capabilities is inimitable, there will always be rivals trying to invalidate these sources of advantage by developing substitute capabilities or new business models that utilize different capabilities. Indeed, capabilities may be especially vulnerable to this threat because there are so many possible variants derived from different combinations of each of the linked activities in a business process. If the new capability becomes a competitive threat, because it delivers superior value, the defender may be handicapped in responding if its deeply embedded and imperfectly understood distinctive capability becomes a core rigidity.

A counterargument is that firms that have sustained their advantages and maintained superior performance have higher-order capabilities for developing new capabilities. These "metacapabilities" might include the flexibility to shift between capabilities more efficiently or faster than rivals, or the ability to carry through major change initiatives or speedily acquire and act on insights into emerging opportunities.

Applying the Resource-based View to Customer Relationship Management

An understanding of the role and functioning of the customer-relating capability requires a distinction between the resources that are the source of the competitive advantage, and the consequent positional advantages and performance outcomes, as shown in Figure 1. Consistent with the findings of Rindova and Fombrun (1999), this is a cyclical process that relies on consistency and alignment of elements to achieve advantage, and continuous reinvestment and learning to sustain that advantage.[14]

Figure 1. Achieving a Relationship Advantage



Sources of Advantage. These are the resources that a firm deploys, comprising assets such as databases and systems that are firm-specific, factors of production that are readily available, and the capabilities that enable these resources to be deployed advantageously.

The diagnosis of an individual capability—such as the customer-relating capability—requires that the scope be disaggregated to a level where the skills and execution of the capability are competitively superior. Broad generalizations like superior consumer-marketing skills will not suffice when the distinctive capability may only be in demand stimulation through image-based advertising, and when other ingredients such as pricing or channel linking may be merely average.

Although disaggregation is necessary, it may also be misleading if two factors are not taken into account: First, each capability is nested within a complex network with many direct and indirect links to other resources (Black and Boal 1994).[15] Second, there are strategic themes and methods that prioritize, orchestrate, and direct the collective resources toward the delivery of superior customer value. Sometimes, the valuable resource is an adroit combination of capabilities, none of which is superior by itself, but when combined, make a better package. Then, competitive superiority is due either to: (1) the weighted average effect—the business does not rank first on any asset or capability but is better on average than any of its rivals, (2) the firm's system-integration capability, which assures that the capabilities are mutually reinforcing, or (3) the superior clarity and focus of the strategic thrust that mobilizes the resources.

Positions of Advantage. What we see in the market—from the vantage point of the customer or competitor—is positional superiority achieved with superior capability. This requires the reliable provision of superior value to customers on the attributes they judge important when making a choice. Whether there is a relational advantage per se depends primarily on the customer's judgment that having a close relationship with a supplier confers benefits that exceed the costs. Typical benefits include time savings, technical assistance, assurance of performance, access to latest developments (in software and technology, for example), superior responsiveness to service requests or problems, and a superior fit to the customers' needs because of personalized solutions. Of course, the customer must feel these benefits outweigh any costs due to loss of flexibility and the restricted ability to play one supplier against another.

The strongest positional advantages are gained when customers are willing to make mutual commitments (Blankenburg, Eriksson, and Johaneson 1999). These can range from information exchanges to cross-firm coordination of interdependent activities such as new product development, to multiple social linkages that engender trust and facilitate sharing of information, and, possibly, to relation-specific investments such as online EDI connections or the adoption of common interface standards. A firm that is better able to forge such close relations with high-value customers in a market has secured a strong positional advantage.

Performance Outcomes. We would expect a firm's relationship advantage to be rewarded with lower rates of defection (churn), greater loyalty and retention, and higher profit margins than its competitors. However, the linkage from positional advantage to performance outcome has proven troublesome to understand because of confounding effects. A relationship advantage is no exception. First, customers buy a complete package of benefits, so it may be difficult to untangle the contribution made by the relationship itself. Second, the construct of loyalty is itself difficult to study. Much attention has focused on proxy measures, such as satisfaction, which have a complex, asymmetric relationship to loyalty (Oliver 1999). Whereas loyal customers are likely to be satisfied, all satisfied customers will not be loyal. Loyalty is gained with a combination of performance superiority that ensures high satisfaction, plus trust and mutual commitments.[16]

The economic rewards of higher loyalty have been demonstrated primarily through studies of the payoff from increasing the retention rate (see, for example, Reichheld 1996). Although these studies are certainly germane, caution is needed in applying their findings. Retention is not the same thing as loyalty because it also captures lock-in effects, switching costs, and inertia. In addition, these studies do not include the cost of developing and maintaining the relationship, and specifically, of operating a loyalty program.

Achieving a Relationship Advantage

Although considerable progress has been made in refining the general concepts of capabilities and resources, the same cannot be said for the identification and dissection of specific capabilities. Because each of these capabilities is embedded within a web of other resources, and much of their knowledge component is tacit, they are obscured from view. One effort to surmount these hurdles was made by Leonard-Barton (1995), who traced the knowledge component of the core technological capability according to the following criteria: (1) *accumulated employee skills*, which are acquired from technical knowledge, training, emulation of proficient people, and long experience; (2) *technical systems*, which comprise the knowledge in linked databases, computer systems, and software; (3) *managerial systems*—especially education, rewards, and incentives—which guide and monitor the accumulation of knowledge; and (4) *values and norms*, which dictate what information is to be collected, what types are most important, who gets access to the information, and how it is used. These values and norms serve to encourage or discourage the accumulation of different kinds of information.

Our concept of the market-relating capability also views it as a knowledge acquisition, sharing, and application process, with three interdependent components—orientation, information, and configuration.[17] *Orientation* provides the guidance mechanism and reveals the organization's commitment to customer retention; retrievable *information* is the raw material; and *configuration* encourages and enables the application of that information. We can delineate additional features of this approach: (1) it incorporates all relevant activities such as solving problems jointly, addressing individual customer requirements, and customizing offerings; (2) each component has a competitive referent that takes into account the possibility that a high level of demonstrated ability may still only be at parity if rivals are equally effective; (3) interaction among the components also matters; thus, the appropriate orientation without the requisite information is of little value in achieving advantage; and (4) there is a contingent relationship between this source of advantage and the ensuing positional advantage. A market-relating capability is of greatest value in markets where there is a high personalization potential.

Orientation toward Relationships

A relationship orientation is embedded within the overall culture, and establishes what is appropriate and inappropriate behavior for the organization. It signals the importance of customer relationships and the willingness of the organization to treat different customers differently. As part of the culture, it includes relevant *values*, which are often deeply embedded as tacit assumptions (McDonald and Gandz 1994). The more accessible outcroppings of the culture are behavioral *norms*, the shared *mental models* that people use to make sense out of complex realities, and the *behaviors* that people exhibit as they make choices about how to spend their time.

The amount of empirical research on the topic of corporate culture is not nearly commensurate with the importance of the topic.[18] When it comes to specific domains of the culture, such as the orientation of the firm to the market,[19] and the allied aspect of the customer-relationship orientation, the work is sparse indeed. To understand better how a relationship orientation is likely to be manifested, we undertook extensive interviews with knowledgeable managers and consultants, perused the voluminous professional literature (e.g., Wiersema 1996; Wayland and Cole 1997; McKenna 1991), and abstracted from detailed case studies. From these, we inductively derived the following indicators of a superior orientation:

- Customer retention is a priority shared throughout the organization.
- There is a willingness to treat different customers differently, and a commitment to act quickly on information from customers (complaints, queries, and changes in requirements).
- All employees exhibit an appreciation of the customer's lifetime value.
- Employees have considerable freedom to take action to satisfy customers without having to take time to get approval. Their judgment as to what action to take is shaped by observation of what other employees have done, stories about initiatives that have been recognized, and training programs that provide role-playing opportunities.

Information about Relationships

An essential ingredient of customer relationship management is trackable and usable information, obtained through an ongoing dialogue with each customer (Pine, Peppers, and Rogers 1995). This element of the customer-relating capability depends on how well the firm elicits and manages the sharing of this information, and then converts it into knowledge that can be used to change how the organization collectively behaves toward the customer.

Competitive advantage in customer-information utilization means outperforming rivals throughout the market-learning process (Day 1994). This learning process entails a series of linked activities, each of which must be done well for the process to function effectively, with extensive systems support to ensure integration of these activities. Relative performance on each of the following steps provides indicators of a firm's capability:

- *Capturing customer information* (the capacity of customer databases to reveal individual customer histories, connections, requirements, expectations, and purchasing activity, as well as the overall rate of customer defection)
- *Collating* (the assembly of all customer touch-points in one location)
- *Retrieving* (the ability to obtain customer information when needed)
- *Utilizing* (the ability to differentiate customers according to their importance, long-term potential, and anticipated needs)

- *Sharing* (the mechanisms for sharing findings throughout the organization)

Mastery of this process is confounded by three factors. First is the sheer scale of most customer databases, and the rapid rate at which information about customers goes out of date and degrades the quality of the database. Even so, most databases are inherently incomplete because they only contain the record of a customer's interactions with one company, and thus cannot provide a full picture of all purchasing activity. Second, these databases are usually part of larger customer-support systems that provide information to customers in response to their queries, complaints, and service requests. Frontline staff need accurate and immediate answers to increasingly complex questions (Davenport and Klahr 1998) while also being able to vary their response to customers in light of their previous interactions. The potential for conflicts among these two requirements is considerable.

Third, at the point where the information is being utilized and shared throughout an organization, it has become partly tacit, highly contextual, and goes beyond the surface-level, explicit contents of the database.[20] As Nonaka and Takeuchi (1995) note, this makes it difficult to communicate and share the information with others. The deeply held knowledge of customer-contact and -service people, acquired through problem solving and trial-and-error learning, is especially difficult for the rest of the organization to access.

Configuration

The configuration provides the distinctive context in which information and knowledge flows are embedded, activated, and given meaning. Noteworthy aspects include organizational design, incentives and controls, activities and processes that enable personalized solutions, and the revealed competitive strategy. This is a narrower conception of configuration than that of Miller (1986 and 1996), but shares the view that organizations are interdependent systems and, accordingly, competitive success requires an orchestrating theme that ensures complementarity among parts.

Useful indicators of a superior configuration of a customer-relating capability include the following:

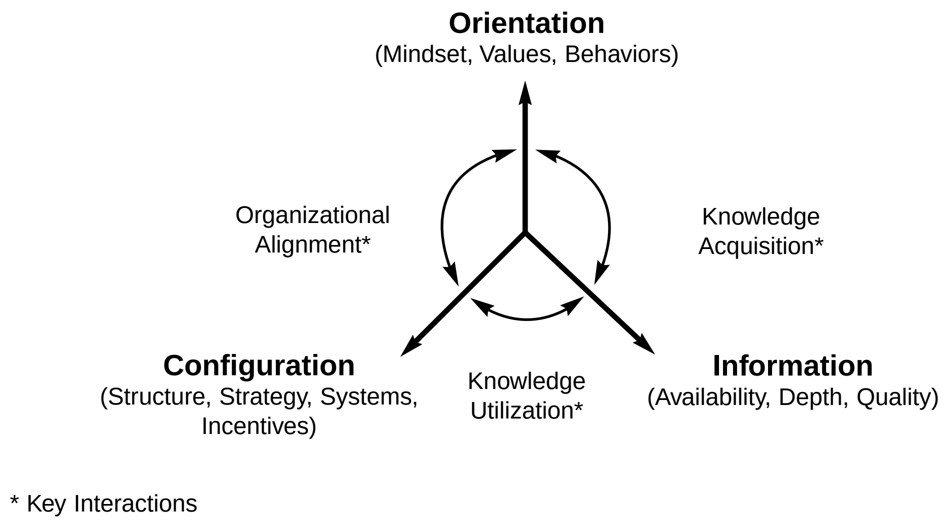
- There is a general consensus about the goal and means of achieving a relationship advantage.
- The organization is designed around customers, rather than products or functions. This design could include structural variants such as customer teams and customer managers to oversee customer portfolios.
- The performance measures, incentives, and coordinating mechanisms emphasize customer retention.
- The aspects of the configuration are aligned with a compelling customer-value proposition that recognizes customer differences and puts customer retention at the center of strategy.

- ❐ Within the resource base there are enabling processes so that the organization is able to personalize or mass-customize communications, products, and services.
- ❐ Resources are allocated to initiatives that give high priority to database development and other activities that support the overall strategic thrust.

Interdependencies

A superior market-relating capability requires that each component reinforce the others by interacting positively. Thus, all the process activities and incentives are aligned, structural impediments are negligible, and knowledge is effectively utilized. When the interactions are dysfunctional, due to poor alignment or conflicts among the elements, the capability is degraded and contributes to a competitive disadvantage. These roles and interactions are illustrated in Figure 2, and described below. Two of these interactions dictate how well the organization acquires and uses information, while the third determines how well the organization is aligned to customer relationships.

Figure 2. Market Relating as a Distinctive Capability



Organizational Alignment. A close and supportive interaction between orientation and configuration is a necessary condition for a superior capability, although it is not sufficient without knowledge to share. The right orientation cannot be sustained or even realized unless it is encouraged with the proper incentives, nurtured with resources and attention that demonstrate the management's commitment, and cleared of structural or system barriers to sharing knowledge across the functions. Orientation also has a strong reciprocal influence in this interaction by encouraging changes in the configuration that enable frontline employees to get closer to customers, and also by overcoming resistance by the rest of the organization to investments in systems and enhancements to strategy.

Knowledge Acquisition. This interaction works primarily through the effect of the orientation on the information element of the capability. It can be quite counter-productive when one function, such as sales, believes it "owns" the customer. In this case, potentially useful information is held closely by one person who knows the customer and his or her history, vulnerabilities, and requirements, and is unlikely to be converted into knowledge that can be shared across teams or functions. Similarly, if customer acquisitions are celebrated through individual initiatives, little energy will be spent on capturing customer information or assembling it all in one place—a goal that will be further subverted if the culture condones or encourages functional rivalries.

When the entire organization is oriented toward customer learning and the creation of customer capital in the common belief that customer relationships are valuable assets, acquiring relevant information then becomes a shared priority. To a lesser degree, the right information can also influence the orientation. For example, if new information reveals that a few valuable customers account for an unexpectedly high share of profits, the belief that all customers should be treated equally would be challenged.

Knowledge Utilization. There are many ways in which a configuration can enhance (or degrade) the ability of an organization to apply information toward the goal of tightening customer relationships.[21] Those that have especially high leverage within this overall interaction include:

❒ Incentives that base rewards on measures of retention or loyalty.

❒ A strategy with a value proposition based on customer selectivity and the personalization of communications and offerings, which can only be achieved through intimate knowledge of individual customers.

❒ A supportive organizational context that facilitates information flows and utilization by eliminating functional barriers (through the use of advances in network technology that make customer information readily accessible).

❒ The ability to integrate business processes and systems in order to build products to order, using modular elements that can be combined and reused in many different ways. Production is based on clues about emerging customer requirements (Haeckel l999).

There is a reciprocal process working within this interaction, in that a change in configuration is enabled by the information that is available, while also creating a need for more timely, relevant, and accessible customer information.

Personalization Potential

Given that there is no theory to distinguish environments of high-versus-low potential to justify and reward personalization and relationship-building strategies, we have again drawn on the practitioner literature to derive the distinguishing attributes.

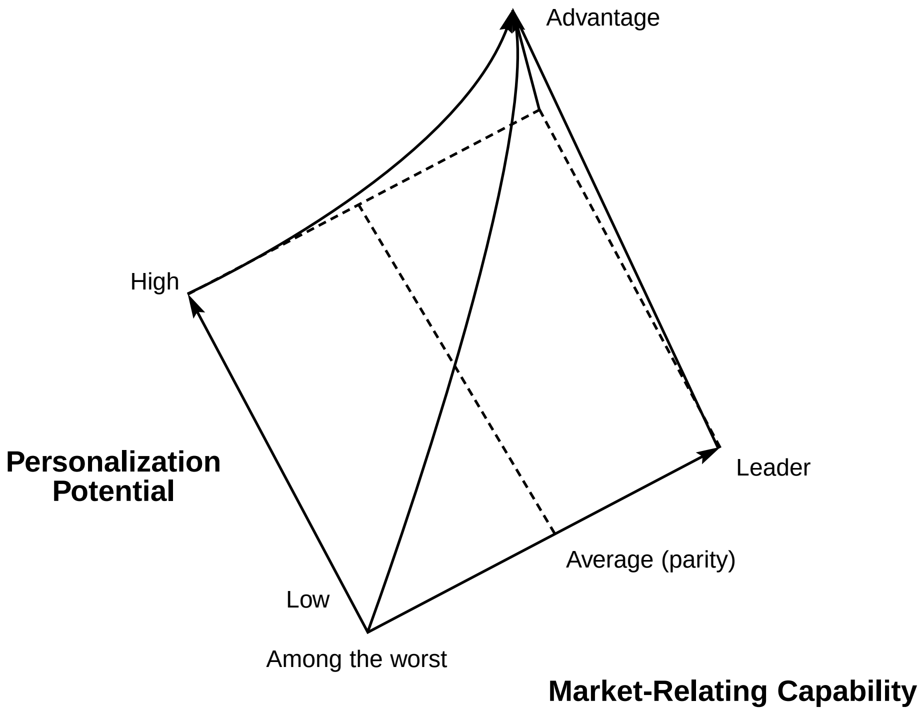
Four of these attributes are necessary conditions. If these cannot be satisfied, there is no potential for personalization. First and foremost, there must be some feasible way of identifying customers and individuals, and of addressing them in ways that reflect their previous purchasing activity. In addition, there must be diversity in customer needs, the product or service must not be a one-time purchase, and the value of individual transactions must be large enough to warrant a personalized effort. Conversely, if customer needs are homogenous, the product has a very low frequency of purchase, and/or the sale value is low, then personalized relationship-building efforts will not be productive.

The remaining features of the market determine the size of the economic incentive to pursue a personalization strategy. The highest payoff comes when the necessary conditions are satisfied and the customer base is highly skewed; that is, the distribution of customer lifetime values is such that a small proportion of the customers have very high values, whereas the rest are break-even or even loss-making.[22] These valuable customers are so profitable that they warrant special treatment to ensure that they do not defect. Further incentives are offered when it is feasible to tailor (mass-customize) the offering or the communications, and there are attractive bundling or cross-selling opportunities to exploit.

Gaining a Position of Advantage

The contribution of the market-relating capability to the firm's position of advantage depends on whether the personalization potential offers an attractive opportunity for a strategy that highlights customer-relationship building, and if so, whether the firm is clearly superior to its rivals in pursuing this strategy and managing the elements of the capability. This is shown in Figure 3.

Figure 3. Opportunities for Relationship Advantage



Because the market-relating capability is deeply nested within the other resources of the firm, the ability to achieve a relationship advantage is dependent on all the processes and systems working together to deliver all elements of the value proposition. A relationship cannot be developed or sustained if the product quality is unacceptable, the technology is out of date, orders cannot be reliably fulfilled, or the product is persistently unavailable. Similarly, the role of personalization potential cannot be abstracted from other forces in the market environment. Thus, the shape of the functions portrayed in Figure 3 will be smoothed or sharpened by the intensity of competition (and especially, the bargaining power of customers), the complexity of the channel system (with particular emphasis on the number of ways in which the customer can bring the product to the market), the maturity of the market, and the characteristic rate of imitation in the market (Williams 1992). These forces will also influence the sustainability of the relationship advantage. If direct rivalry is intense and growth is slow, the incentive to copy and neutralize this advantage is greater. The success of the effort to imitate depends on the workings of the sustainability premise (especially, the size of the barriers to imitation), and the ability of Internet technologies to give rivals a way to manage relationships differently and catch up more quickly.

Earning Performance Rewards

Investments in market-relating capabilities and supporting resources are ultimately justified by an expected improvement in profitability and in intermediate metrics such as rate of defection, customer satisfaction, and market share. We would expect to see firms with superior capabilities gain a relationship advantage and thereby outperform their rivals. Whether investment in these capabilities is warranted may be less obvious. On the one hand, there is the difficulty of identifying the full costs and investments of the initiative; on the other hand, it must be asked, how should the opportunity costs of not pursuing the strategy be treated?

Summary and Implications

The Challenge of Customer Retention

In an era in which management theories and concepts emerge and quickly fade away, the value of forging close customer relationships is one business precept that will remain at the center of the strategy dialogue. Not only are the economics of customer retention compelling, but the relationships themselves are seen as among the most durable and valuable of all assets. Meanwhile, rapid advances in Web-enabled technologies are making it more feasible to learn quickly about each customer, customize offerings, and tighten system linkages.

Now that CRM has become fashionable and there is broad acceptance of the need to organize around customers, treat different customers differently, present a seamless face to these customers, and personalize communications and offerings, most firms will have a major CRM initiative in place within three years. Will they see any payoff from these efforts?

Past history with other management fads and mounting evidence from the field suggests that most firms will fail to gain even a fleeting advantage from their CRM initiatives. Many will be purely defensive, having been initiated to keep up with the leaders or to narrow disadvantages. Meanwhile, firms such as Oracle, Siebel, and the Peppers and Rogers Group are busily diffusing best practices, and hundreds of software vendors are making their latest database, call center, and sales-force automation software widely available and economical to use, thus ensuring that all competitors are equally equipped. Sometimes, CRM initiatives will be misguided and will be applied in inappropriate markets where there is insufficient "personalization potential," by which is meant diversity in customer needs, and a highly shared customer base in which only a small proportion of customers are highly valuable.

The main reason for frustration and disappointment is that a market-relating capability is so difficult to manage that few firms will master it. Our model of this capability reveals the depth and extent of the challenge. Like all capabilities, it is embedded in a web of other capabilities and resources, and exercised through a complex process of knowledge acquisition, sharing, and application. This capability is best nurtured in a market-driven organization (Day 1999) whose external orientation puts a premium on superior market sensing and strategic thinking capabilities to support the market-relating capability, while providing a conducive cultural context and organizational configuration.

This capability has three closely coupled components: The *orientation* reveals the standards by which employees set priorities and make decisions about customer retention; retrievable *information* is the raw material; and the *configuration* enables the application of that information. Each of these components plays an essential role—but none of them alone is a sufficient condition for success. To gain an advantage, a firm must be as good as or better than the best of its rivals on each component, and there must be positive interaction among the components. Rich information without the right enabling conditions in the configuration and orientation will not yield useful knowledge or the commitment to use it to gain advantage.

Implications for Managers

This model of a market-relating capability relays a strong message for managers who think that their firms are ahead of their rivals, or hope to find a way to get ahead by forging closer relationships with their most valuable customers. An action plan must address the following questions:

1. *What are our competitors doing?* This requires a self-critical assessment of the firm's ability to cultivate customer relationships on each of the three components, and the ways in which that ability compares to the best of its rivals. Firms should avoid stopping the process with a mere snapshot of the current situation, but rather, continue to work toward anticipating the moves of rivals by looking at patterns of investment, strategic intentions, new hires, and other clues of a shift in strategy. They should talk to suppliers about new software and systems developments that rivals could adopt. Most importantly, they should validate and challenge all judgments from the point of view of customers: Who do they think is most responsive to their individual needs? Easiest to do business with? Most trusted? Offers the best solution to their problems?

2. *Is the entire organization engaged?* No firm can prevail for long if its values are shallow or unsupportive, if the key implementers fail to understand or accept the need for treating different customers differently, or if a silo mentality discourages information sharing and condones the belief that one function "owns the customer." There must be broad acceptance of the belief that every interaction matters—what Jan Carlson of SAS Airline once called "the million moments of truth that determine success." But strong leadership is paramount; if top management demonstrates only hesitant and intermittent commitment or is unwilling to invest sufficient resources, the rest of the organization will soon get the message.

3. *Are the organization's structures, systems, controls, and incentives aligned?* A capability emerges from the complex interaction of many elements, and will only be as good as the weakest link. Every element must be scrutinized for possible improvement and realignment. Incentives have high leverage, so a commission plan can be designed to encourage salespeople to chase the next easy conquest or, alternatively, to carefully screen prospective customers on the basis of their likelihood of defecting. The structure of the organization also sends a strong signal. Traditionally, firms have organized around functions, products, and/or geographies. By shifting the focus to customers, assigning multifunctional teams the responsibility of overseeing CRM and order-fulfillment processes, while organizing around customers with distinct needs or different channels, the alignment is naturally tightened.

4. *Are there new possibilities for relationship building?* Many managers accept the value of relationship-building activities when there are a few valuable customers buying risky and expensive products, but dismiss it for frequently purchased, low-

cost consumerables. This is a myopic framing that misses the point that some customers are more valuable than others because they buy a lot of Heinz or Nabisco products across divisions, product lines, and time. This points to the real opportunity in these markets which lies in retail, institutional, or distributor relationships.

A well-developed relationship orientation helps open the collective mindset to new strategies for relationship building—especially when combined with deeper insights into the economics of loyalty, and an appreciation for the possibilities of Web-based interaction with key customers. At best, creative combinations of these insights and technologies will spawn new business models that competitors will be hard-pressed to copy.

5. *Is learning a priority?* There are always ways to improve. The best-of-breed companies are never satisfied. Instead, they use pilot tests and hothouse experiments to try out new approaches and learn more about what their best customers really value. This requires continuity of people, since rapid turnovers slow momentum and disrupt relationships.

Notes

1. An extensive literature on the strategic possibilities of close customer relationships covers such aspects as relationship marketing (Wiersema 1996), channel partnering (Buzzell and Ortmeyer 1995), the one-to-one enterprise (Peppers and Rogers 1997), Wayland and Cole 1997), customer collaboration (Prahalad and Ramaswamy 2000), interactive relationships using Web technologies (Seybold 1998), with offshoots into mass customization (Gilmore and Pine 1997). The emphasis has been on the character of the relationship, the changing role of customers, the mechanics of maintaining relationships, and the profit rewards (Reichheld 1996).

2. According to one argument, it is not in the customer's interest to have a close relationship with an Internet retailer. The fewer ties that individuals have, the better able they are to seek the best value in the market (Griffith 1999).

3. Porter (1996) draws the distinction between operational *effectiveness*, which means performing activities better than rivals perform them, and *strategic positioning*, which means either performing different activities, or similar activities in a different way. He argues that operational effectiveness does not lead to sustainable advantage because of the rapid diffusion of best practices.

4. This organizational capability is exercised through the core CRM processes. The core processes are usually considered to be supply-chain or operations management, product development or innovation, and customer relationship management (Hagel and Singer 1999; Srivastava, Shervani, and Fahey 1999). These high-level macroprocesses come in many guises, cut across the organization, and subsume many subprocesses, but are arguably found in all firms. Some authors (notably, Teece, Pisano, and Shuen 1997) separate the frontline activities that enable superior performance with the current business model from growth-enabling or dynamic activities that lead to reconfigurations of resources.

5. This question has seldom been addressed in the marketing or strategy literature. For an interesting exception, see Kay (1993). In contrast, there is a considerable literature on the innovation or new-product-development capability. See, for instance, Leonard-Barton (1992).

6. We follow convention in considering assets to include all the factors of production that are readily available in factor markets (and are easily traded and valued), as well as privileged or firm-specific assets that are hard to obtain and replicate (Amit and Schoemaker 1993). *Capabilities* are the glue that holds these assets together and allows them to be deployed advantageously.

7. These authors show that conceptualizations of trust drawn from diverse disciplines have an “expectancy” component, and a “behavioral” component that focuses on one's action tendencies toward exchange partners.

8. These relation-specific assets were derived from Williamson's (1985) identification of three types of asset specificity: (1) site specificity, (2) physical-asset specificity, and (3) human-asset specificity.

9. For example, GE Plastics (Polymerland) has installed sensors in the storage silos of customers, like injection molders, to signal an automatic reorder when volume gets low. The intent is to make it as easy as possible for customers to stay with them.

10. This view of a relationship that gets smarter with each individual interaction and so becomes increasingly valuable to the customer is found in Peppers and Rogers (1997). For a similar perspective, see Seybold (1998).

11. The assumption that loyal customers are more profitable has been challenged (Dowling and Uncles 1997), and, until recently, empirical support for the assumption has been scant. Exceptional in this regard are the studies of Reichheld (1996) and Reinartz and Kumar (2000). The latter study found that it is revenues that determine customer lifetime value, rather than the duration of the customer's tenure.

12. Leonard-Barton (1995) distinguishes "core" or distinctive capabilities from "supplemental" capabilities, which add value to the core capability but can be imitated, and "enabling" capabilities, which are necessary but not sufficient to distinguish a firm competitively.

13. These premises are adapted from Lengnick-Hall and Wolff (1999), who propose a fourth premise that presumes an evolutionary equilibrium context (which may be a "punctuated" equilibrium), and note that it is at odds with the view that strategy is about fomenting disequilibrium and responding quickly to unpredictable requirements. This premise does not seem necessary to the understanding of the customer-relating capability.

14. The basic framework for distinguishing between the sources, positions, and performance dimensions of competitive advantage was developed by Day and Wensley (1988).

15. Some authors (e.g., Oliver 1997) expand this context to encompass the firm's culture and broader influences such as traditions, network ties, and regulatory pressures.

16. In addition to these factors, Oliver (1999) would include the capacity to be included in a social network as a necessary condition for loyalty.

17. These three components are also represented in the three factors of resources, processes, and values that Christensen and Overdorf (2000) use to define an organization's set of capabilities and how they evolve over time. However, they use resources to encompass information, relationships, brand equity, and so forth, which we treat separately and more narrowly. Our construct of configuration includes their processes but adds the context of strategy and structure. Their notion of values as standards by which employees set priorities is also narrower than the orientation construct.

18. The work on managerial and organizational cognition is a potential exception to this observation. See, for example, Walsh (1995), Eden and Spender (1998), and Meindl, Stubbart, and Porac (1996).

19. For a review of what is known about the cultural component of a market orientation, see Deshpandé (1999). Although this work acknowledges the importance of customer relationships, it does not identify the specific beliefs, behaviors, and mental models needed to sustain these relationships. Instead, the emphasis is on higher level (competing) values.

20. Ironically, as organizations become more committed to managing explicit knowledge, they often find their efforts thwarted by the tacit element, which they tend to downplay, or by ignorance (Fahey and Prusak 1998).

21. For a recent overview of current thinking on this issue, see Cole (1998) and, especially, Brown and Duguid (1998).

22. This condition is subject to the usual caveats about the appropriateness of accounting allocations, and the difficulty of incorporating potential value into the lifetime-value assessment.

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