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HOW FIRM'S PROFITABILITY IS ANALYZED IN RELATIONSHIP MARKETING

ABSTRACT

While relationship marketing is viewed as an important driver in the development of the firm's profitability, the condition of this profitability seldom receives much attention. In this study, we employ a dynamic exchange model between firm and customer to explore the conditions affecting the firm's profitability from a relationship perspective. The application of this model reveals explicitly that relationship marketing is not always profitable. The firm-customer relationship profitability depends on the customer life value (margin and retention rate), the duration of the firm-customer relationship, and the marketing budget to retain the customer and the customer acquisition cost.

Key Words: firm's profitability, relationship marketing theory, customer lifetime value, firm value

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INTRODUCTION

Managing a portfolio of customers in relationship marketing has attracted many scholars (e.g., Corsaro et al. 2013; Ritter and Andersen 2014; Terho and Halinen 2012). This attraction has increased because of the numerous challenges that are facing the competition such as global competition, high customers' expectations, and new industry revolution (e.g., Industry 4.0). The objective of the portfolio of customer management is to optimize efforts and investment towards customers in order to maximize firm's profitability (Ritter and Andersen 2014). These latter called this type of relationship as the "me perspective" because it is oriented toward the firm's satisfaction and interest. Ritter and Andersen (2014) also distinguished two other alternatives relationship perspectives - the "you perspective" and the "us perspective". The former perspective focused on the customer needs and is interested in customer segmentation (Ritter and Andersen 2014). The "us perspective" emphasized the properties of the customer-supplier relationships (Ritter and Andersen 2014).

These two new perspectives are important for at least two reasons. First, Grant and Schlesinger (1995) stated, "Achieving the full profit potential of each customer relationship should be the fundamental goal of every business. Profits from customer relationships are the lifeblood of all business" (p. 59). Second, if a firm does not invest in the appropriate customer, the consequence can be destructive. In this regard, Reichheld (1996) indicated that "a customer who will provide steady cash flows and a profitable return on the firm's investment for years to come, a customer whose loyalty can be won and kept" (p. 63).

Customer profitability refers to the contribution of a customer to a supplier's profits (Ritter and Andersen 2014) during the total expected supplier-customer relation. Although several scholars study the profitability of customers in relationship marketing in the "us perspective," the result is still equivocal. Indeed, for some scholars (e.g., Grönroos 2000; Grönroos 2004; Gupta and Zeithaml 2006; Ravald and Grönroos 1996; Wirtz and Zeithaml 2018; Zhang, Dixit, and Friedmannet 2010), this relationship is profitable for the firms. The main premise of these authors is a positive cause and effect relationship between customer profitability and some antecedent as customer satisfaction and customer loyalty (Helgesen 2006). Other scholars (e.g., Colgate and Danaher 2000; Reinartz and Kumar 2000; Palmatier 2008, Musalem and Joshi 2009) indicated that this relationship is not automatically profitable. For example, in analysing firms' decisions to invest in customer relationship management in competitive setting, Musalem and Joshi (2009) showed that decision does not always lead

to greater firm profitability. Likewise, Umashankar, Bhagwat, and Kumar (2016) showed that firm's relationship with behaviorally loyal customers is not continually profitable because these customers spend less and are more price sensitive.

The way in which customer profitability is measured has a great impact on the customer's choice. Therefore, this choice can significantly influence a firm's profitability in relationship marketing. In the literature, scholars (Gupta, Lehmann, and Stuart 2004; Pfeifer, Haskkins, and Conroy 2004; Reinartz and Kumar 2003) used different methods to measure the customer profitability such as calculating the customer lifetime value. However, none of these explicitly solved the problem of why the results of the customer's profitability are equivocal. In studying the sales force profitability in the relationship marketing, Echchakoui (2014) showed that a salesperson profitability depends on customer value, salesperson compensation, and the salesperson-customer relationship duration.

Drawing on this latter research, our objective in this research is to try to give answers to the questions above. Specifically, based on an exchange model between firm and customer, as well on the customer life value concept, we identify three zones that characterize the dynamic firm's profitability in his/her relationship with a customer. We show that only one zone can be profitable to the firm. This result is important, because it can solve the equivocal positions taken by scholars in regard to the success or to the failure of relationship marketing. This study also specifies the critical retention rate, the critical duration time, and the critical retention investment in which the firm begins to be profitable in his/her relationship with a customer. That information can help the sales managers to manage and select profitable customers in relationship marketing. It can also be used by the sales manager to effectively design the sales force compensation implementation or control.

In the next section, we introduce a brief review of customer profitability analysis. Next, a model is developed to evaluate firm's financial value when a salesperson is recruited. The conditions of a firm's profitability are then presented. Followed by a discussion including some managerial implications, the conclusion presents the limitations and the opportunities for further research.

CUSTOMER PROFITABILITY ANALYSIS

In the literature, scholars use diverse terms to label customer profitability such as: 1) productivity which focuses on the output/input ratio (e.g., Anderson, Fornell, and Rust 1997; Wirtz and Zeithaml 2018); 2) customer accounting emphasizing on the difference between the revenue and the cost over a certain historical period of time (Lind and

Stromsen 2006); and 3) customer life profitability which calculates the customer profitability over its lifetime (e.g., Däs et al. 2017; Echchakoui 2014; Pfeifer et al. 2004; Reinartz and Kumar 2003). In this study, we consider the customer life profitability for two reasons. First, customer accounting focus on historical data, so this method is not suitable for a firm that is deciding its first steps for customer relationship if it is better or not to invest in this relationship. Second, many research (e.g., Reinartz and Kumar 2000) showed that, for some customers, the relationship becomes profitable after some periods of times. In addition, as highlighted by Reichheld (1996), accounting system consider customer costs acquisition as current expense, whereas the customers life profitability takes the expenses over the firm-customer life relationship in consideration.

Therefore, drawing on Ritter and Andersen (2014), we define customer profitability as the contribution of the customer to the firm's profits during the total expected relationship. Specifically, drawing on some authors (e.g., Calciu and Salerno 2002; Echchakoui 2014; Gupta et al. 2004; Pfeifer et al. 2004; Reinartz and Kumar 2003), we use the customer life value (CLV) to measure the customer profitability in relationship marketing. The main reason for this choice is that the CLV is one of the famous customer assessment models (Däs et al. 2017). In this paper, CLV refers to the sum of a customer discounted present and expected future cash flows (Berger and Nasr 1998).

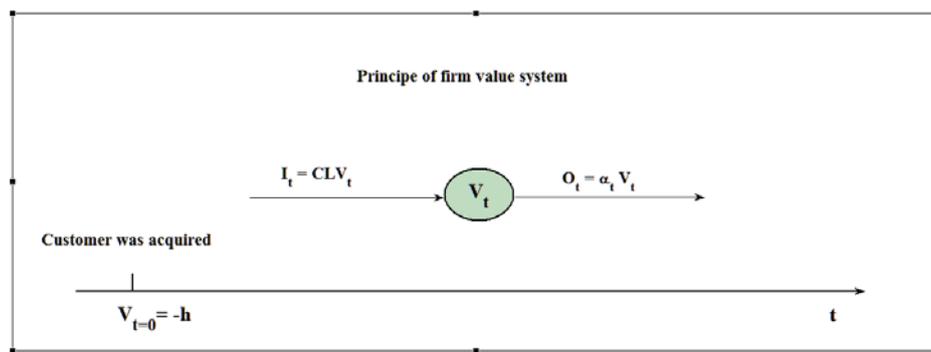
There has not been any marketing research that used a dynamic model to study the marketing relationship profitability. The previous studies in this field (e.g., Managing a portfolio of customers in relationship marketing) has attracted many scholars (e.g., Colgate and Danaher 2000; Helgesen 2006; Musalem and Joshi 2009; Palmatier 2008; Reinartz and Kumar 2000; Umashankar et al. 2016) were descriptive. Only Echchakoui (2014) used a dynamic model to explore the conditions when the recruitment of salespeople to manage customers in relationship marketing is profitable.

Echchakoui (2014) identified three zones that characterize the dynamic salesperson profitability, and only one zone was profitable to the firm. This study is important, but it not analyzes the firm's profitability in relationship marketing in general context (e.g., without salespeople). Indeed, firms can use different tools as direct marketing strategy to attract and develop their relationship with a portfolio of customers. In this study, we consider the investment's budget of its relationship strategy and the Echchakoui (2014) methodology to study the firm's profitability in relationship marketing.

MODEL DESIGN

Firm value encompasses tangible economic value as well as intangible elements such as social value. For the purposes of this article, we are concerned only with the financial. Drawing on Echchakoui's (2014) methodology to assess the firm's profitability in a relationship, we consider the firm relationship exchange with each customer after it was acquired. The firm's cost «h» for attracting this customer represent the firm's financial value at time $t = 0$ (time when the customer was acquired).

Figure 1. Firm-customer Exchange System



If we consider the closed "firm-customer" system, we observe that through the firm's offer and effort, it transforms customer value into financial value. A part of this value will be attributed to marketing cost (e.g., adverting budget, salesperson salary) in order to maintain customer alive. By analogy with the principle of conservation of energy or mass in physics, the fundamental principle for calculating the firm's value as a function of time is based on the transformation of its value. The principle of conservation generally postulates that at a specified time, the rate of change within the system is equal to the rate of creation in the system, less the rate of destruction.

Therefore:

$$(\text{Variation in the system}) = (\text{Rate of input}) - (\text{Rate of output})$$

If we consider the creation of the value of a firm to be a closed system, referred here to as the "firm value" system, the variation of the firm value at time t (V_t) is equal to the rate of input of value received by the firm (I_t) at time t minus the rate of output of value

given or lost by the firm (O_t) at time t . This principle of value transformation is represented schematically in Figure 1 and algebraically as follows:

$$\frac{\partial V_t}{\partial t} = I_t - O_t \quad (1)$$

The input rate of the “firm value” system is simply the CLV at time t which is due to the effort expended by the firm. Several formulas are available for calculating (CLV_t) at time t , but the formula proposed by Calciu and Salerno (2002) is the most common.

The continuous formula of (CLV_t) proposed by Gupta et al. (2004) is:

$$CLV_t = \int_{k=0}^t M_k \exp\left(-\frac{1+d-r_k}{r_k} k\right) dk \quad (2)$$

- d: Discount rate appropriate for marketing investment.
- r_t : Retention rate for customer or being live at period t .
- k : Auxiliary variable indicating that time varies from 0 to t .
- M_k : Firm’s gross margin resulting from a customer.

Therefore, the rate of input of the "firm value" system may be expressed as a ratio of CLV_t when its discount rate is zero ($d = 0$) as follows:

$$I_t = \int_{k=0}^t M_k \exp(-\beta_k k) dk \quad (3)$$

β : is the index of defections. Conversely, Gupta et al. (2004) used the index of retention, $1/\beta=r/(1-r)$. β is positive ($\beta \geq 0$) because $r \leq 1$.

The output of the “firm value” system includes the amount of marketing budget attributed to manage the customer. In order to calculate the rate of output (O_t), we express this marketing budget as a ratio of V_t ($O_t = \alpha_t V_t$).

- α_t : Rate of marketing budget at time t .

As a result, the equation 1 becomes:

$$\frac{\partial V_t}{\partial t} = -\alpha_t V_t + \int_{k=0}^t M_k \exp(-\beta_k k) dk \quad (4)$$

The values of M_t , β_t , and α_t are dependent upon several factors that may vary as a function of time, such as the firm's production costs, the intensity of the competition, and the effectiveness of the distribution network, all of which render the solution to equation 4 complex. For this reason, we examined the solution of the equation over one relationship period (e.g., year), and we consider M , β (i.e. r), and α as the respective means of M_t , β_t (i.e. r_t), and α_t over this period. Therefore, equation 4 becomes:

$$\frac{\partial V_t}{\partial t} = -\alpha V_t + \int_{k=0}^t M \exp(-\beta k) dk \quad (5)$$

$$V_0 = -h \quad (6)$$

Equation 5 is a nonlinear first-order differential equation, with equation 6 as an initial condition. Its solution is as follows:

$$V_t = -h + \left(\frac{M}{\alpha(\alpha-\beta)} \right) e^{-\alpha t} - \frac{M}{\beta(\alpha-\beta)} e^{-\beta t} + \frac{M}{\alpha\beta} \quad (7)$$

The firm's financial value (V_t) at time t for the customer depends upon parameters M , h , t , α , β . This function exists if and only if: $\alpha - \beta \neq 0$, that is: $r \neq 1/(1+\alpha)$. This hypothesis will be assumed in the remainder of this article.

From equation 7 we can deduce that: $\lim_{t \rightarrow \infty} V_t = -h + \frac{M}{\beta\alpha}$. This result allows us to deduce that the customer acquisition cost, the margin, the customer retention rate, and the cost retention ratio have a major influence on the magnitude of the firm's profitability. More specifically, in a relationship perspective, the firm's financial value cannot be positive if the retention r does not exceed the critical value r_c ($r_c = \frac{h\alpha}{M+h\alpha}$). This critical value increases with the margin (M) and decreases with both the acquisition cost (h) and the marketing budget ratio (α).

CONDITIONS OF FIRM'S PROFITABILITY

By conducting an in-depth examination of the firm's profitability in a customer relationship orientation, we can consider the variation in financial value over time when the customer was acquired. The firm's financial value will be deduced from the partial derivative of V_t with respect to time (t):

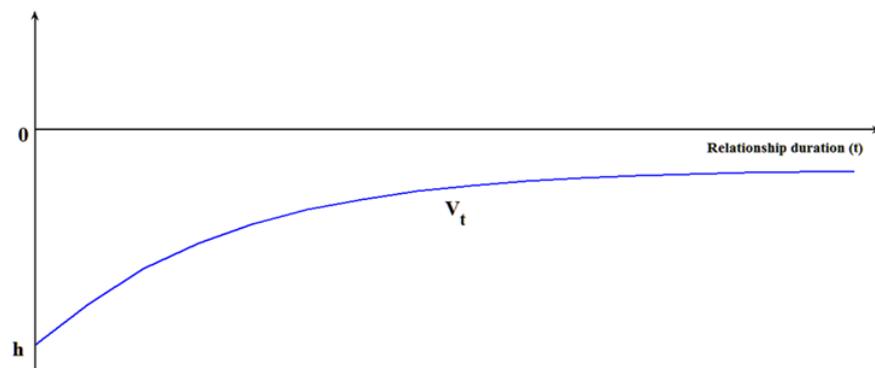
$$\frac{\partial V}{\partial t} = \frac{M(-e^{-\alpha t} + e^{-\beta t})}{\alpha - \beta} \tag{8}$$

We deduce from equation 8 that the variation of the firm's financial value always positive for all value of the margin generated by the firm (M), the retention rate r (i.e., $1/(1+\beta)$) and the marketing budget ratio (α).

More specifically, three cases can occur:

1. If $r \leq r_c$, then for all relationship duration with customers, the firm's financial value V_t is always negative or equal to 0. Therefore, in this case (refer to Figure 2), the customer won't be profitable.

Figure 2. Firm profitability: Case $r \leq r_c$

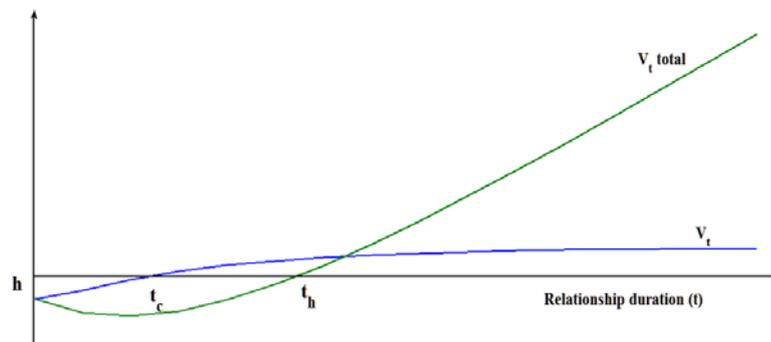


2. If $r_c < r$ V_t changes sign at critical time $t = t_c$. This indicates that function V_t begins to be positive at t_c . However, the firm will be profitable if and only if the cumulative firm's

financial value ($\sum_{t=0}^n V_t$) becomes positive ($\sum_{t=0}^n V_t > 0$). This latter occurs if the relationship between firm and customer exceeds a critical time t_h . t_h is the time in which the cumulative firm's financial value is equal to 0 (see Figure 3). So, two cases can occur:

Figure 3. Firm Profitability: Case $r > r_c$

(a) $t \leq t_h$, then $\sum_{t=0}^n V_t \leq 0$.



So, in this case (see Figure 3), the firm relationship with the customer is not profitable.

(b) $t > t_h$, then $\sum_{t=0}^n V_t > 0$.

Therefore, in this case (see Figure 3), the firm relationship with the customer will be profitable. We can deduce from the above that, given the acquisition cost (h), the margin (M), and the marketing budget ratio (α), the firm's profitability in a relationship orientation with a customer depends on two parameters: 1) the position of the retention probability with respect to the critical coefficient r_c , and 2) the duration of the firm-customer relationship with respect to the critical duration t_h . More specifically, two cases arise: 1) the retention probability (r) is less or equal to r_c ($r \leq r_c$), in this case (see Figure 2), the firm-customer relationship is not profitable; 2) the retention probability (r) exceeds the retention rate r_c ($r_c < r$), in this case (see Figure 3), the firm's financial value begins to be positive since the duration of the relationship firm-customer exceeds a critical time t_c , however, the firm becomes profitable if the duration time exceeds the critical time t_h (see Figure 3).

To illustrate those conditions, let us consider a numerical example in which we suppose that the firm wanted to develop a relationship with a customer A. The acquisition cost was \$500, and the margin was \$800 each period. In order to maintain the relationship with this customer, the sales manager estimated that it was necessary to allow the marketing budget ratio equal to 0.5. Given this information, sales manager can estimate the critical retention rate r_c ($r_c = (h \alpha)/(M+h \alpha)$). In our case: $M= \$800$ and $\alpha = 0.5$, so $r_c = 0.24$. Therefore, the firm's financial will be negative if the firm-customer relationship cannot exceed 0.27.

Table 1. Firm's Financial Value and Total Value with Respect to Different Retention Rates and Time

t	r = 0.3		r = 0.5		r = 0.7	
	V_t	$\sum_{t=0}^n V_t$	V_t	$\sum_{t=0}^n V_t$	V_t	$\sum_{t=0}^n V_t$
0.0	-\$500.00	-\$500.00	-\$500.00	-\$500.00	-\$500.00	-\$500.00
1.0	-\$325.49	-\$825.49	-\$252.29	-\$752.29	-\$204.65	-\$704.65
1.5	-\$220.89	-\$1 046.37	-\$54.56	-\$806.86	\$73.75	-\$630.90
2.0	-\$133.59	-\$1 179.96	\$139.32	-\$667.53	\$383.56	-\$247.35
2.5	-\$63.78	-\$1 243.74	\$314.52	-\$353.01	\$699.88	\$452.53
3.0	-\$8.85	-\$1 252.58	\$465.64	\$112.63	\$1 006.81	\$1 459.34
3.5	\$34.11	-\$1 218.47	\$592.24	\$704.87	\$1 294.73	\$2 754.08
4.0	\$67.62	-\$1 150.85	\$696.23	\$1 401.10	\$1 558.43	\$4 312.51
4.5	\$93.73	-\$1 057.12	\$780.50	\$2 181.60	\$1 795.65	\$6 108.16
5.0	\$114.08	-\$943.04	\$848.11	\$3 029.71	\$2 006.10	\$8 114.25
5.5	\$129.92	-\$813.12	\$901.97	\$3 931.68	\$2 190.74	\$10 304.99
6.0	\$142.26	-\$670.85	\$944.65	\$4 876.32	\$2 351.29	\$12 656.28
6.5	\$151.88	-\$518.98	\$978.33	\$5 854.65	\$2 489.84	\$15 146.13
7.0	\$159.36	-\$359.62	\$1 004.83	\$6 859.48	\$2 608.65	\$17 754.78
7.5	\$165.19	-\$194.43	\$1 025.63	\$7 885.11	\$2 709.99	\$20 464.77
8.0	\$169.73	-\$24.70	\$1 041.93	\$8 927.03	\$2 796.01	\$23 260.78
8.5	\$173.27	\$148.57	\$1 054.68	\$9 981.71	\$2 868.75	\$26 129.53
9.0	\$176.02	\$324.59	\$1 064.65	\$11 046.36	\$2 930.02	\$29 059.55
9.5	\$178.16	\$502.75	\$1 072.43	\$12 118.80	\$2 981.48	\$32 041.03
10.0	\$179.83	\$682.58	\$1 078.51	\$13 197.31	\$3 024.57	\$35 065.60

Note: r: retention rate; V: firm's financial value; t: time.

We suppose that the sales manager estimated the customer retention rate (r) equal to 0.5 ($r = 0.5$), which is greater than r_c ($r_c = 0.24$). To calculate t_c time, we used Newton's method. For our example, t_c was equal to 1.63 periods (196 days if the period is equal to a quarter per year) which means that the firm's financial value begins to be positive after 1.63 periods. We also used Newton's method to calculate t_h value in which the cumulative value of the firm's financial value is equal to 0 ($\sum_{t=0}^n V_t = 0$).

In our example, t_h was equal to 2.31 periods, which means that the firm begins to be profitable in his relationship with this customer after 2.31 periods (277 days if a period is equal to a quarter per year). Table 1 illustrates the firm's financial value and the cumulative financial value for our example. We can notice from Table 1 that both the firm's financial value (V_t) and the total value ($\sum_{t=0}^n V_t$) increase with the growth of the retention rate. This logical result confirms existent literature that retaining loyal customers can lead to greater revenues (e.g., Reichheld 1996).

Table 2. t_c and t_h Value with Respect to Different Retention Rates and Marketing Budget Ratio

r	β	$\alpha = 0.3$		$\alpha = 0.5$		$\alpha = 0.7$	
		t_c	t_h	t_h	t_c	t_c	t_h
.10	9.00	NE	NE*	NE	NE	NE	NE
.30	2.33	2.37	3.97	3.08	6.29	NE	NE
.50	1.00	1.51	2.05	1.63	2.31	1.79	2.67
.70	0.43	1.3	1.63	1.37	1.76	1.45	1.92

r: retention rate; α : marketing budget ratios; β : index of defection; t_c , t_h : critical times.

*Note: NE: Not exist.

In Table 2, we have also calculated the critical value t_c and t_h for different retention rates and marketing budget ratios (α). This table shows that both t_c and t_h decrease with the retention rate (r), in contrast they increase with the marketing budget ratio (α).

DISCUSSION

The optimistic vision of relationship marketing is not shared by the entire scientific community. Some authors reported that this approach was highly beneficial for the firm. For example, Gupta and Zeithaml (2006) reported that customer retention was one of the key drivers of CLV and firm profitability. Likewise, Reichheld and Sasser (1990) showed that a 5% improvement in customer retention for a variety of service companies could enhance their overall profitability by anywhere from 25% to 85%. Some other scholars (e.g., Colgate and Danaher 2000) indicated that the results of the implementation of this approach were negative for some managers. Finally, few scholars (e.g., Reinartz 2000; Palmatier 2008) maintained that the success of relationship marketing is not automatic for all customers. To solve those equivocal statements, the model developed in this study at the level of the "firm-customer" system has allowed us to assess dynamic firm profitability in a

relationship approach. Specifically, this model links the firm's financial value and the CLV in a relationship exchange.

The solution of this model has given rise to some significant results. Indeed, our study demonstrated that the effectiveness of a firm's strategy to develop a customer relationship is not automatic: it depends on the customer value, the cost retention allowed to this customer and the duration time. This result is not only consistent with Palmatier's (2008) results, but further expanded on it. Our research has specifically illustrated that firm profitability is a function of the retention rate, the acquisition cost, the margin, the retention's cost, and the duration time of the relationship. In addition, our study has determined the critical retention rate and the critical duration of the firm-customer relationship with the firm's profitability in a relationship perspective.

Specifically, the results of our study indicate three cases. First, under a critical rate r_c ($r_c = (h \alpha) / (M + h \alpha)$), the firm's financial value was negative. So, the relationship between firm and a customer cannot be profitable. This critical retention decreases with the margin (M) and increases with both the customer acquisition costs (h) and the marketing budget ratio (α). Second, the firm's financial value begins to be positive if the customer retention (r) exceeds r_c , and the duration time of the relationship exceeds the critical value t_c . However, the firm's total financial value remains negative even though the duration time exceeds another critical time t_h . Finally, the firm-customer relationship will be profitable if the customer retention (r) exceeds r_c , and the duration time of the relationship exceeds the critical value t_h . Both t_c and t_h decrease with the margin and the retention rate (r), but they increase with the value of acquisition cost (h) and the value of marketing budget ratio (α).

Based on these findings, a number of theoretical and managerial implications can be drawn. From a theoretical perspective, this research integrates and expands on several ideas. First, the relationship marketing is not automatic, but it depends on some conditions. Second, our result can explain why some researchers have found that the result of the customer relationship was negative for some managers. Based on our result, we can argue that the retention probably did not exceed the critical rate r_c or the duration time did not exceed the critical time t_h . Third, to our knowledge, this research is the first to specify both the critical retention rate and the critical duration time for a profitable relationship marketing. It is also the first to employ the exchange model to assess the firm's profitability with their customers.

From a managerial perspective, this research has at least three implications for managers who wish to focus on long-term relationships with customers. First, our results indicated that the firm's return on investment in relationship marketing is not guaranteed, but is dependent on certain parameters— customer value, marketing budget to retain customers and the duration of the relationship. Second, the results of our study will incite managers to adopt different strategies when it comes to recruiting sales force, depending on the nature of the customer portfolio. Specifically, they can integrate retention rates in salespeople commission rate attribution. Sales managers can also choose the appropriate type of salesperson and determine his/her compensation as a function of the various relationship stages with customers. Third, an effective relationship orientation requires the tailoring of services to the level of each potential customer. Consequently, the success of such an action requires the customized marketing budget, and the acquisition cost based on each customer's value (margin and retention rate), as well the estimated duration with each customer.

CONCLUSION

To resolve why researcher disagree about the benefit of the relationship marketing, this study employed a dynamic exchange model between firm and customer to explore the conditions that affect firm profitability. The application of this model reveals explicitly that relationship marketing is not always profitable. The firm-customer relationship profitability depends on the customer life value, the duration of the firm-customer relationship, the marketing budget to retain customers, and the customer acquisition cost.

This paper opens for several interesting future researches like the following four. First, scholars can integrate the firms' characteristics (e.g., expertise, communication skills) that are essential for successfully developing and maintaining relationships with customers to extend our model. Second, a researcher can use to incorporate a dynamic product portfolio sold by the firm instead. This issue is important, because it can integrate the influence of the new products on the firm's profitability in relationship marketing. Third, the Echchakoui's (2017) study showed the influence of the variability of both margin and customer retention on the salesperson commission in relationship perspective. Drawing on this study or others, the future research can take both margin and customer retention as stochastic variables to build a more extended model. Finally, other research avenues may be considered, such as the calculation of optimal marketing budget rate and the optimal margin in a relationship orientation.

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