CUSTOMER LIFETIME VALUE

PAYBACK PERIOD AND PROFIT

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CUSTOMER LIFETIME VALUE: PAYBACK PERIOD AND PROFIT

What if your new sales are generating negative profit? Is that ok? How long does it take to break even? Once you break even, how much profit do you earn?

Let's analyze your Payback Period and your Contribution Margin (think, "ROI") and then look at solutions for improving your bottom line.

We'll use the scenario proposed in "Customer Acquisition Cost". (*Please read it first! Understanding cost will help you understand profitability much better*.)

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Quick Review

In "Customer Acquisition Cost", we proposed a scenario where an agency buys 100 leads for $500.

They win 10 new P&C customers with average annual premium of $1500.

Average Customer Acquisition Cost (CAC) was $337.50.

Now we'll assume a 10% commission to calculate the payback period and contribution margin.

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Step 1: Calculate the Contribution Margin.

Most income statements (P&L statements) flow roughly like this:

Revenue
\- COGS

Gross Profit
\- Expenses

Net Income

COGS (Cost of Goods Sold) isn't very useful to a company with no inventory or raw materials. As an insurance agent, your Revenue and Gross Profit are probably the same number. So how do you evaluate *profitability*?

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Contribution margin is a more useful way of looking at profit. Basically, you're asking, "How much did it cost to get this business, and how much is left over to pay the bills?" The simple formula is Revenue – CAC.

	Revenue
-	CAC
	Contribution Margin
-	Expenses
	Net Income

Contribution margin is what you use to pay expenses and put money in your own pocket (net income).

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In many cases, Contribution Margin will be a negative number. For example, using our example scenario:

$$
\begin{array}{rl}
 & \$150.00 \text{ (commission)} \\
- & \$337.50 \text{ (CAC)} \\
\hline
 & (\$187.50)
\end{array}
$$

You can compare the contribution margins of various marketing and sales activities, such as internet leads vs. review appointments, to see which are most profitable.

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Important Note

Going forward, when we say, “Profit,” we mean, “Contribution Margin.”

In both cases, we mean, “How much is left after the cost of acquiring business?”

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Step 2: Calculate the Payback Period.

The Payback Period is the amount of time it takes to earn back customer acquisition cost (CAC). It's also the point at which you start making profit.

Payback Period is pretty simple. Divide average CAC by average annual commission:

CAC / annual commission = payback period (in years)

$337.50 / $150 = 2.25

In this case, it will take **2.25 annual commissions** to earn back CAC. (Since agents get their first commission up front, not at the end of the year, it will actually take **1.25 years**.) If your customer leaves before then, you've *lost money* on that sale.

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Payback Period Illustration

			Payback	
	Up-Front	Year 1	Year 2	Year 3
Commission	$ 150.00	$ 150.00	$ 150.00	$ 150.00
- Remaining CAC	$ 337.50	$ 187.50	**$ 37.50**	$ -
Cumulative Profit	$(187.50)	$ (37.50)	$ 112.50	$ 150.00

The up-front commission leaves $187.50 of CAC. Year 1 commission leaves $37.50 of CAC. Year 2 commission pays off remaining $37.50 of CAC and leaves $112.50 of profit. Year 3 is all profit.

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2 Critical Takeaways

Payback Period is why thinking myopically about new sales is risky. Two sales might produce the same revenue, but their profitability may be vastly different depending on CAC. *Profits* fuel growth.

So here are two critical takeaways:

1. Reduce your Payback Period by selling more lines to each customer.

2. Add more years of profit to your bottom line by keeping customers longer. (*Consistently meet with customers and provide them with more products.*)

NEXT STEPS CHECKLIST

- ❑ Try calculating your CAC for various activities: Internet leads, customer appointments, referrals, digital marketing, etc.
- ❑ Review the document about "Contribution Margin and Breakeven" to see how long it takes you to break even and start earning profit on given business development activity.
- ❑ Dig in deep to figure out which levers you can pull to increase return on your CAC:
  - Experiment with leads of varying price/quality. (Lead cost was *only 15% of total costs* in this example. There's room to play.)
  - Call every lead at least 3-4 times to improve reach rate.
  - Discover and meet more of each customer's needs.
  - Close more often.

WANT TO LEARN MORE?

To schedule an in-depth conversation with your study group or large agency about Customer Lifetime Value and Payback Period, contact us at CLV@clientfocuscorp.com.

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