MAINTAINING BALANCE

THE PERILS OF POPULARITY

The iPhone's worldwide success would seem to be an unqualified win-win for Apple and the mobile operators that sell it. Not so, as ***Marco Bertini*** *and* ***Ricardo Cabornero*** *explain, mobile operators must maintain a delicate balance between winning new customers and retaining existing ones. This task is made more difficult when their own brands can actually be diminished by selling the iPhone.*

As they grow, companies face a common tension between acquiring new customers and retaining the customers who have enabled them to grow in the first place. Acquisition and retention have a troubled relationship. In many cases, the marketing tools that most effectively address acquisition may put retention in danger. This is an unhappy impact, made worse because the customer retained is generally more profitable than the customer gained.

In the mobile phone market the acquisition and retention battle is writ large. On the surface, the iPhone would seem to be a perfect tool to win the battle. Market-changing and sexy, it can lure new customers and please existing ones. A mobile operator that sells other firms' products or services (otherwise known as a retailer, reseller or intermediary) can use the iPhone as part of a strategy to gain market share. The trouble is that it is not simply a matter of selling the iPhone; a mobile operator (to be successful) must balance the acquisition of new customers with the retention of those they already serve.

In the mobile phone sector, another tension is added. Mobile operators commonly must sell products and services that have their own strong brands. They are, effectively, both intermediaries selling handsets created by other manufacturers, and direct manufacturers selling service packages.

The downside of success

Think of the pull of the iPhone brand. It has come to dominate the smartphone market, but is sold by mobile operators, such as Vodafone. They are the retailers in this market. Unusually, this dynamic threatens to make the mobile operator's brand less valuable. The mobile operator is relegated to a logistic role, simply ensuring that the iPhone arrives with the customer on time. In this situation, differentiation from competing mobile operators soon disappears.

There is more troubling news for mobile operators. The challenge actually begins with how a mobile operator deals with Apple in order to obtain the privilege of selling the iPhone. Apple's bargaining power in all matters iPhone, gained through the device's smash-hit sales, has driven high subsidies that have made it an expensive device to market. The subsidies not only apply to the handsets but to marketing campaigns. This means that mobile operators have to underwrite the marketing and sales of the iPhone.

According to Informa Telecoms & Media, the incremental cost per customer of the iPhone, relative to other smartphones, is not offset by a strong uplift from average revenue per user. Consequently, mobile operators have actually found that their own sales of iPhones (which contribute to increased market penetration for Apple) can, in fact, become unprofitable for the mobile operator. Their outlets and websites are thronged with buyers, but the profits are delivered to Apple rather than the mobile operator.

What to do

So, mobile operators can attract new customers — typically by offering them better prices than the competition or having low enough prices to lure them to purchase in the smartphone category for the first time. Alternatively, they can try to squeeze

CHANGING THE MARKET

To better understand the iPhone market, think of three basic customer segments.

01

The first segment is made up of iPhone lovers or switchers. These are high-value customers who will stay with the operator that provides them with the best iPhone offer.

02

The second segment is made up of smartphone lovers. They are iPhone deal seekers or non-switchers who are only interested in an iPhone if they can get it at a discounted price.

03

The third segment can be described as iPhone indifferents, customers with no interest — past, present or future — in owning or using an iPhone.

The good news for mobile operators is that there is a proven strong correlation between high value customers and iPhone adoption. Similarly, numerous analyses have demonstrated the high value of early iPhone adopters. With this in mind, switchers should be at the top of a value-based segmentation. They are followed by non-switchers in the mid range. If prices are high, only switchers will adopt the iPhone; if operators lower prices, non-switchers will start to take advantage of good deals.

more out of their existing customers. This is usually achieved by raising prices for existing products or getting them to buy more expensive products.

Some choose to attract new customers and squeeze more out of existing customers.

These three routes to growth leave mobile operators with a clear conflict: they often need to lower prices to new customers and raise them to existing ones.

This creates another dilemma: how do you figure out the optimum allocation of marketing spend? How big a slice of the marketing pie do you give to acquisition and how much to retention?

This dilemma is what makes such factors as switching costs important to growth. Say a mobile phone operator wants to boost its market share by attracting customers from other operators. To prompt the addition of new customers, many will decide to allocate more funds to cover the costs of acquisition; for example, by way of price discrimination that gives new customers a better deal. Such a pricing decision makes sense, a mobile operator will argue, because the perceived hassles of switching mobile phone companies raises a hurdle for existing customers that most of them won't bother to jump.

Of course, mobile operators will inevitably offer multiple discount plans. This can cause problems all around as operators' brand equity and differentiation will suffer as existing customers are increasingly aware of other operators' aggressive acquisition offers and/or that their current operator is doing little or nothing to enhance the perception that all customers are receiving maximum value. What too often occurs is that mobile operators expend enormous time, energy and other marketing resources to attract new customers. Meanwhile, existing customers either come to feel that they are being underserved (if not underappreciated) or they believe they can more profitably switch from operator to operator, taking advantage of acquisition offers.

When loyal customers are aware, they react: In 2011 Vodafone Spain put in place an aggressive programme to proactively apply discounts to its customers, after heavy losses of switchers to alternative operators (Yoigo-Telia Sonera and MVNOs). To stem these losses, Vodafone lowered prices by 25 per cent to four million customers. This illustrates perfectly the tension that all retailers must face when they decide to attract new customers without paying due diligence to the important task of reinforcing the loyalty of existing customers. Moreover, when the value of the brand of part of a product line eclipses the value of the overall brand of the retailer, the story usually does not end well.

And the winner is…

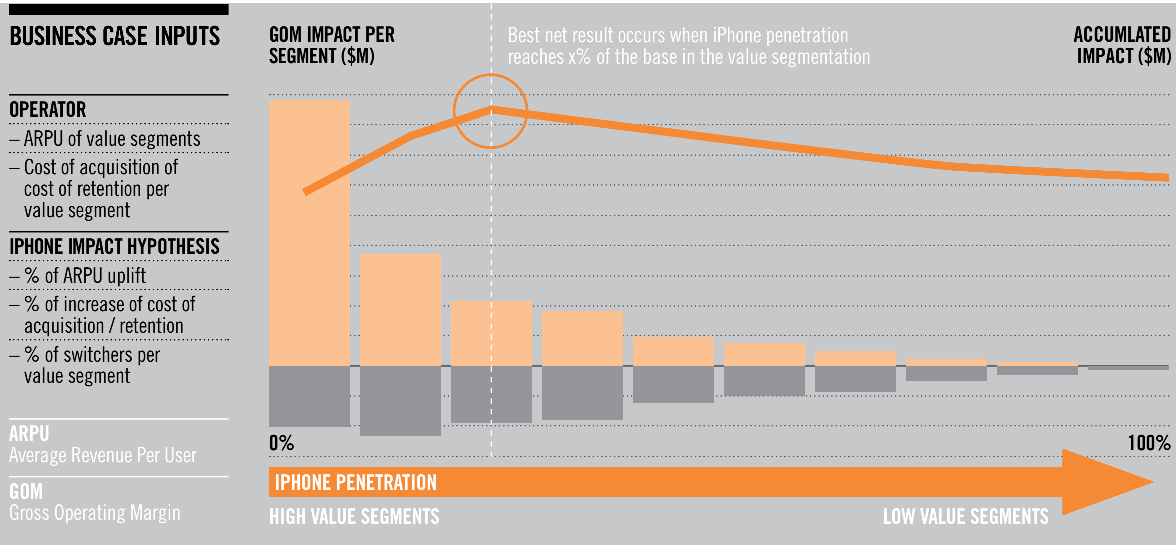
Who, then, is the real winner when it comes to mobile operators selling iPhones? Apple, for sure, wins. Apple seldom loses an iPhone user; in fact, a September 2011 survey by UBS revealed that 89 per cent of iPhone users report that they will purchase another iPhone. No other manufacturer topped a 40 per cent retention rate.

Customers who love the iPhone for itself (or for the price tag on the combined package of the iPhone accompanied by discounted service costs) also seem to be clear winners. But the deleterious impact of the iPhone on the very operators that sell it is suggested by adverts in which, for 29 of their 30 seconds in length, never mention the mobile operator — even though the ads are co-paid by Apple and the operator.

As if finding that it's not difficult enough to determine the ideal pricing strategy for attracting switchers while not suffering significantly from the margin dilution of non-switchers, another threat to maximising profitability is introduced by what we call 'the vicious circle'. Much like the UBS survey, a 2010 analysis by the Yankee Group revealed that once customers have adopted the iPhone, they will very likely choose another iPhone as their next device. It implies that most customers who buy a first iPhone, including non-switchers, will choose iPhones as their subsequent devices. In other words, non-switchers ultimately become switchers. We refer to this effect as a 'one-way trip' because non-switchers become switchers and very infrequently, if at all, revert to their former non-switcher status.

What problem does this pose to operators? Switchers can only be retained by iPhone offers that are more attractive than competing

NET RESULT PER VALUE SEGMENT OF INTRODUCING THE IPHONE – 2011



> The best way, in any relationship, to deal with these unresolvable arguments in the longer term is if both parties implicitly agree never to discuss the topic.

operators' offers. A non-switching customer who could formerly have been counted on as highly likely to be retained is now a switching customer who may jump at any iPhone offer perceived as less costly.

France Telecom's key brand, Orange, suffered the impact of one-way trips following the 2010 launch of the iPhone 4. Orange pursued an intensive retention plan the company found necessary so that it could cope with its under-contract iPhone 3G customers — they were at risk to switch, so Orange made sure its customers could immediately upgrade to the best iPhone 4 package they could find. We believe it's reasonable to expect that Orange incurred high loyalty costs attached to its switchers, a healthy share of whom would once have been low-cost non-switchers.

Margin dilution

What have we learned from the iPhone dilemma? Based on the three segments of iPhone customers (see Box on previous page), operators should focus their iPhone promotion only on switchers (given that the iPhone is a market-share driver for this high value segment) and avoid price wars on the non-switchers segment. This could be achieved, for example, by designing promotions carefully so they appeal to this segment — perhaps by tying the promotion to loyalty, providing the promotion when someone calls to switch, or providing the promotion to non-customers as an incentive to switch.

As a result, it is critical that a mobile phone operator weigh the costs and benefits of each market segment and what, ideally, is the correct proportion of customers in order to generate a healthy bottom-line profit. The optimal iPhone market-share penetration is the point at which the value created from retained/gained switchers doesn't offset the margin dilution on non-switchers.

Diminishing curve

The graphic at the top of the page simulates the dynamics of a European operator experiencing customer switching from other smartphones to iPhones. The aggregated impact appears as a diminishing curve as a result of combining two drivers:

– Upside: Value created from retained/gained switchers. It decreases very quickly as the number of switchers goes down.

– Downside: Diluted margin as extra subsidy required to market iPhones for customers (non-switchers) who did not need such extra customer investment.

The diminishing curve shows that as an operator experiences increased iPhone market penetration, we can assume that the cause is a gradual lowering of iPhone subsidies; in other words, decreasing margin realised as new customers are acquired.

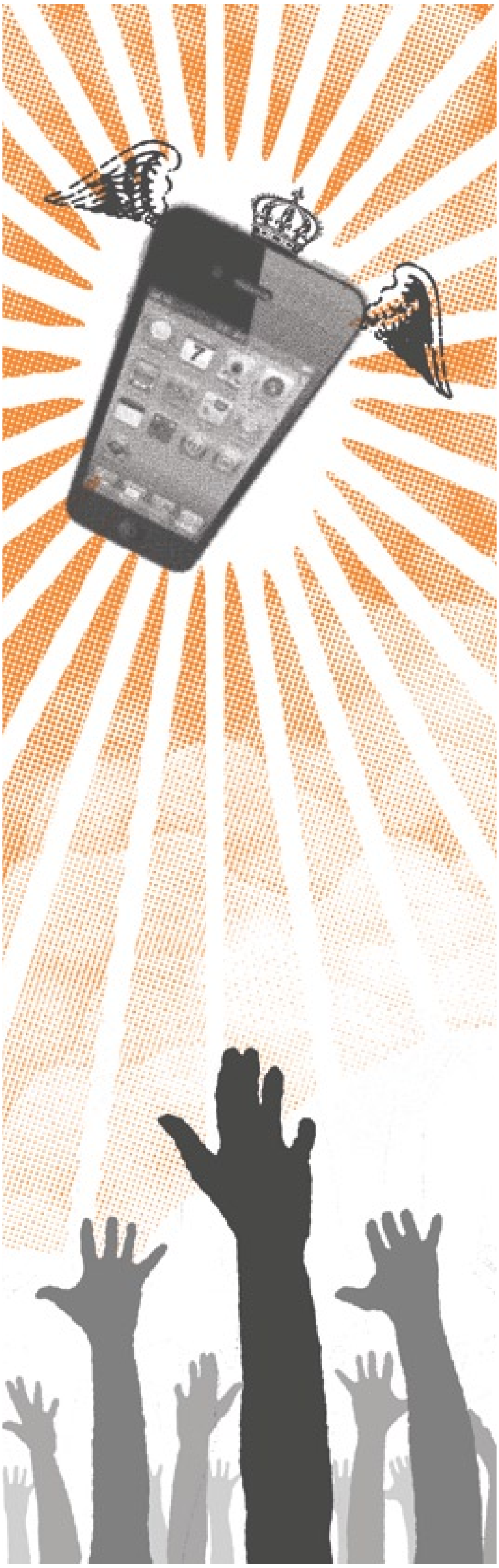
The diminishing curve counterbalances the dynamic we saw earlier, where operators are better off in the short term with aggressive acquisition strategies, given that iPhone is profitable only when it addresses iPhone switchers. Therefore, retention may be more appropriate as an iPhone strategy — to the extent that it facilitates the identification of iPhone switchers applying price discrimination.

For example, Telefonica, in Spain, has been pursuing a relatively conservative iPhone strategy that is aligned with its role as market leader, promoting an aggressive retention strategy aimed at retaining high-value customers. But a different strategy would be more appropriate for an operator occupying a different position in its market, as seen in the UK with O2 employing the iPhone as a strong acquisition lever to grow at a time when the firm was striving to consolidate the leading position in their market.

An optimum mix

By examining the dynamics of the iPhone market and, in particular, the interactions of operators and their customers related to the introduction and sale of the iPhone, we have made the case for very carefully assessing the trade-offs related to the strategies employed by intermediaries to find an optimum mix of offers aimed at customer acquisition and offers aimed at customer retention.

Actions aimed at customer acquisition can adversely affect customer retention. This dynamic is unavoidable; but, with recognition of its existence and a careful formulation of marketing strategies, it can be minimised — and thus better ensure that a mobile operator enjoys sustainable profitability.



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