Valuing a Target Using Net Promoter® Score (NPS)

By Lumeric Consulting LLC

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## Contents – Net Promoter® Score

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Net Promoter® Score (NPS) is a very effective tool in assessing the competitiveness and revenue potential of a prospective acquisition in commercial due diligence

Snapshot of article

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| **What is Net Promoter® Score (NPS)?** | - NPS is a relatively new measure designed to provide a simple but accurate metric for assessing customer loyalty, which can be used to align an organization toward delivering above-average growth  
- NPS is built around a single question asked of customers – “How likely would you be to recommend company X to a colleague or friend?”  
- Based on the answer, customers who are intensely loyal – called Promoters – and customers who are moderately-to-intensely disloyal – called Detractors – are identified  
- If there are more Promoters than Detractors, the company is positioned to create value; however, if there are more Detractors than Promoters, the company is positioned to destroy value  
- Bain and Satmetrix® conducted extensive research which validated the premise of NPS for most industries |
| **How can NPS be used in commercial due diligence?** | - Accurately forecast net customer turnover and the likelihood of a target being a net creator or destructor of value  
- Effectively evaluate competitive positioning and potential to capture or lose share  
- Identify and comprehensively assess the opportunities for improving performance, which could add significant value to a target after acquisition  
- Accurately forecast revenue growth potential under current and improved operating scenarios |
| **What will I learn from this thought piece?** | - Why NPS was developed, including the rigor of the process used to develop it  
- How NPS is calculated  
- How several organizations have successfully used NPS  
- How NPS can be used to improve the quality and accuracy of commercial due diligence  
- Insights into how NPS is practically applied in commercial due diligence via a case study |
NPS is the most accurate metric for predicting customer loyalty and forecasting long-term sustainable growth

Definition and development history of Net Promoter® Score (NPS)

Definition

Customer rating scale: how likely are you to recommend to a colleague or friend?

- **Promoters** (9-10): Extremely loyal with the highest rates of repurchase, referral and revenue growth
- **Passives** (7-8): Satisfied but indifferent to maintaining a relationship and at moderate risk of switching. Unlikely to refer new business
- **Detractors** (0-6): Are disappointed and at moderate to high risk of switching. Spread negative views encouraging potential customers to go elsewhere

Details of customer type by rating/score

<table>
<thead>
<tr>
<th>Customer Type</th>
<th>Score</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Promoter</td>
<td>9-10</td>
<td>Extremely loyal with the highest rates of repurchase, referral and revenue growth</td>
</tr>
<tr>
<td>Passive</td>
<td>7-8</td>
<td>Satisfied but indifferent to maintaining a relationship and at moderate risk of switching. Unlikely to refer new business</td>
</tr>
<tr>
<td>Detractor</td>
<td>0-6</td>
<td>Are disappointed and at moderate to high risk of switching. Spread negative views encouraging potential customers to go elsewhere</td>
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Development History of Net Promoter® Score (NPS)

- NPS was developed with the intent of identifying a simple metric to accurately predict customer loyalty which could easily be imbedded across an organization to focus customer-facing personnel on behaviors that improve performance
- The metric was created through research conducted by Bain Consulting and Satmetrix® which found that a customer’s willingness to refer a supplier to a friend or colleague is by far the most accurate predictor of the sustainability of customer relationships
- Over 10,000 customers were surveyed across 400 companies in more than a dozen industries
- A 10-point scale was used to assess the likelihood of a customer to make a referral. The responses clustered into three distinct groups:
  - Promoters, with ratings of 9-10, were most likely to continue purchasing, increase their purchases and make referrals
  - Passives, with ratings of 7-8, were satisfied but unlikely to make a referral, offered limited growth and a modest threat of switching
  - Detractors, with ratings of 0-6, were unsatisfied, could spread negative views hampering business development and likely to switch or reduce purchases
- The researchers then subtracted the % of detractors from the % of promoters to come up with an NPS for each company and tied the NPS to three years of growth for each firm
- The conclusions of this analysis showed that for most industries:
  - NPS can be directly correlated to rates of growth
  - Companies with the highest NPS in their sector experienced more rapid growth and share capture than their peers
  - A company must have more promoters than detractors to experience long-term sustainable growth

On average, NPS leaders in an industry grow 2.5 times faster than competitors and a 12-point increase in NPS leads to a doubling in growth.

NPS airline industry example and success stories from other industries:

NPS correlated to 5-year growth rate of US airlines 1999-2004

<table>
<thead>
<tr>
<th>5 Year Growth Rate</th>
<th>5%</th>
<th>10%</th>
<th>15%</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Promoter® Score</td>
<td>-20</td>
<td>-15</td>
<td>-10</td>
</tr>
<tr>
<td>Net value destroyer</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Value Creator</td>
<td></td>
<td></td>
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NPS implementation success stories:

- “When we started with NPS, our score was -20% due to some poor management decisions which led to a significant increase in customer turnover. Adopting NPS allowed us to quickly identify and address the issues driving turnover. Our staff found NPS straightforward to understand, making it easy for us to realign their behaviors to better service and support customers. Our NPS is now over 40% and customer retention is way up. The score is 5 times higher than the nearest competitor and revenue growth is averaging 10% a year.” – Director, Product Mgmt., Financial Services

- “NPS is a key metric we use to measure customer satisfaction. We have tied performance assessments and compensation directly to satisfaction. This has everyone thinking of what they can do to improve customer relationships and we are spending much more time discussing and addressing their feedback. This has led to greater retention, growth in wallet share and a broadening of products/services an account will purchase from us.” – Sr. Director of Strategy, B2B Software

- “Since adopting NPS in 2005, our scores have gone up substantially and there is a direct tie-in to the growth we have experienced over the same timeframe. We collect NPS, along with underlying performance information, for us and our competitors. We have used this data to develop themes by segment which have improved the quality of our performance with customers and prospects. This has led to a higher conversion rate for new customers and to growth in business with current customers.” – CMO, B2B lender
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An NPS approach was used to assess customer loyalty, competitive positioning, revenue forecasts and the upside potential of a B2B services target

Case study overview – using NPS in commercial due diligence

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| **Target background** | • A provider of outsourced maintenance and repair services for specialized industrial equipment and machinery, with annual revenue of ~$40m  
• Youngest player in the market, having entered 15 years previously  
• Holds second-largest market share at 27%  
• Successfully built differentiated position by providing service technicians who offer 'best-in-class' on-site service, which is the most important buying factor for a majority of customers |
| **Client’s key commercial due diligence questions related to NPS** | • What percentage of business is at risk of turnover and how easy/hard is it to take steps to prevent this turnover?  
• How does the Target benchmark against competitors based on NPS and is the company positioned to gain or lose share?  
• What does the five-year revenue forecast look like if operations continue on as-is basis?  
• What are the drivers of NPS and where are the gaps in the target’s performance?  
• If the gaps in performance were addressed, what would be the impact on revenue? |
| **Outline of NPS evaluation approach** | • Determine Target’s NPS and likelihood of revenue growth/decline  
• Assess Target’s competitive position vs. key competitors using NPS  
• Forecast revenue, broken down by NPS customer type, assuming operations remain static  
• Identify and analyze drivers of NPS scores and gaps in performance  
• Develop case revenue forecasts to capture potential benefits to Target if gaps in performance are addressed after acquisition |
The target’s NPS of 15 suggests the firm’s revenue streams are stable, with some upside growth potential

Target NPS as of Oct ’10 and overview of buying intentions for each customer type

### Target’s NPS Oct ’10

<table>
<thead>
<tr>
<th>Promoters</th>
<th>Passives</th>
<th>Detractors</th>
</tr>
</thead>
<tbody>
<tr>
<td>39%</td>
<td>37%</td>
<td>24%</td>
</tr>
</tbody>
</table>

**Net Promoter® Score (NPS):**

15 = 39 - 24

### Customer Type Analysis

**Promoters**
- Almost all intend to renew their service and support agreements with Target. Many would consider consolidating their purchases with the firm if they expanded into additional areas
  - "We have used the <target> for over ten years. The service technicians really know their stuff and usually have us back up and running quickly when we have a problem. It would be hard to find someone better … if they opened up near our other facilities, we would use them there as well.” – VP, Mfg.
  - “The service guy was very helpful with a recent change we made in our production work flow. He made some suggestions based on what he’d seen in other facilities which made the results a lot more workable … it’s this type of service which keep us coming back to the <Target>.” – Ops. Engineer

**Passives**
- Are generally satisfied in their relationship with the Target and are at low risk of switching. However, many believe the service is average for the premium they pay
  - "The service we get is fine. The job gets done with little stress for us, but I think they could be more proactive in recommending better ways for us to work together to save money. We will put the contract out to bid next time just to keep them honest.” – Director of Purchasing

**Detractors**
- The majority view their interactions with the Target as needing improvement. Many have had poor experiences that have not been adequately resolved. The switching risk is medium-high
  - "The tech is OK but our customer service rep is not very good. She rarely returns messages and schedules maintenance visits at times we have repeatedly said do not work.” – Plant Mgr.
  - "One of the machines they support broke and shut our line down for three days. They promise us 4-hour turnaround on emergencies like this, but the tech did not show up for two days. The cost was huge and we are looking for other suppliers.” – CEO

**Sources:** Interviews and analysis
The Target has a strong, defensible competitive position in relation to key competitors, primarily due to the superior expertise of their service techs

Target NPS and overview of competitive positioning

### Target’s NPS in relation to key competitors – Oct ’10

<table>
<thead>
<tr>
<th>Firm</th>
<th>Position</th>
<th>Market Share</th>
<th>Competitive Analysis</th>
</tr>
</thead>
</table>
| A      | Market Leader | 37%          | • Built through acquisition of local/regional players in past 10 years  
• Now focused on reducing turnover and capturing share via aggressive, continuous improvement program  
• Customers value the improvements rewarding firm with greater wallet share |
| Target | Challenger  | 24%          | •Entered market 15 years ago, aggressively building share by focusing on professionalism and expertise of service techs  
• Charges premium, attracting and (for the most part) retaining customers that will pay for excellent service  
• Techs are recognized as best-in-class, supporting market position |
| B      | Niche Player | 7%           | • Solely focused on supporting food & beverage sector  
• This expertise is a strong competitive differentiator, allowing the firm to effectively fend off competitive threats |
| C      | Follower    | 15%          | • Low-cost provider attracting a large share of price-sensitive customers  
• Service can be inconsistent and unreliable, but many customers are willing to accept for costs saved |
| D      | Follower – Historic Market Leader | 17% | • Has lost share by not adjusting to just-in-time service expectations  
• Primarily maintains relationships with long-term customers who do not see a large-enough benefit to change |

Sources: Interviews and analysis
Under the current approach, the target will grow by \(~3.5\%\)/yr through ‘15. High passive-detractor turnover is more than offset by promoter growth and new accts.

Target incremental revenue growth forecast by customer type, 2010-2015; static model

### Incremental revenue forecast ‘10 – ‘15

<table>
<thead>
<tr>
<th>Year</th>
<th>Promoters</th>
<th>Passives</th>
<th>Detractors</th>
<th>New Accts</th>
</tr>
</thead>
<tbody>
<tr>
<td>2010</td>
<td>39.5</td>
<td>3.1</td>
<td>3.1</td>
<td>5.1</td>
</tr>
<tr>
<td>2015</td>
<td>46</td>
<td>18.6</td>
<td>-18.6</td>
<td>46</td>
</tr>
</tbody>
</table>

CAGR = 3.5%

### Sources: Interviews and analysis
The target can measurably improve customer retention and new customer captures by reducing emergency response time and improving customer service.

Root causes of poor NPS performance: target and weak competitors

**Target - weak competitor performance against key buying criteria – (passives & detractors only) (1)**

<table>
<thead>
<tr>
<th>Rating (4=Poor - 10=Excellent)</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
</tr>
</tbody>
</table>

= opportunities

**Current customers—positive impact of addressing opportunistic issues on NPS**

<table>
<thead>
<tr>
<th>Issue</th>
<th>Impact on NPS</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Emergency Response</td>
<td>+8%</td>
<td>- Improving operations to ensure the 4-hour promised response time is consistently met</td>
</tr>
<tr>
<td>Customer Service</td>
<td>+5%</td>
<td>- Ensuring that reps respond to inquiries in a timely manner and are effective in resolving issues</td>
</tr>
</tbody>
</table>

Total +13%

**Prospective customers from Competitors C&D—positive impact of addressing opportunistic issues**

<table>
<thead>
<tr>
<th>Issue</th>
<th>Conversion Rate</th>
<th>Analysis</th>
</tr>
</thead>
<tbody>
<tr>
<td>Emergency Response</td>
<td>+4%</td>
<td>- A large issue for disgruntled customers, which could drive them to switch to and stay with Target if there is a proven record to support effectiveness in this area</td>
</tr>
<tr>
<td>Customer Service</td>
<td>+2%</td>
<td>- The quality of service can make a large difference in attracting a select set of prospects that have perpetually suffered from the poor service their supplier has been unable to improve</td>
</tr>
</tbody>
</table>

Total +6%

Source: Interviews and analysis

Notes: (1) Only passives and detractors are included because these are the customers that will be motivated to stay with or switch to the target if performance improves
Addressing the emergency response and customer service issues would boost the NPS score by 80% and almost double the forecast average annual revenue growth.

Target forecast growth scenarios based on NPS improvements:

**Case** | **NPS** | **CAGR** | **Analysis**
--- | --- | --- | ---
Base 15 | 3.5% | Do not address opportunities to improve NPS
• “The relationship with the service tech is what keeps us with ‘Target’. If I made my decision based on customer service, I would be looking to move.” – Passive
Base +1 23 | 5.5% | Address emergency response opportunity
• “I was planning on bidding out the contract this year with a good chance we would settle on someone else. If they could get their act together on emergency response, I might change my mind.” – Detractor
Base +2 27 | 6.25% | Address emergency response and customer services opportunities
• “Our customer service guy is awful. He rarely responds to calls or emails and messes up the service schedule half the time. Everything else is OK with them <Target>. If this does not get fixed, we will eventually leave.” – Detractor

**Forecast annual growth rates based on NPS score ’10 –’15**

- **Base**
  - Net Promoter® Score: 24%
  - Average Annual Revenue Growth: 3%
- **Base +1**
  - Net Promoter® Score: 45%
  - Average Annual Revenue Growth: 6%
- **Base +2**
  - Net Promoter® Score: 20%
  - Average Annual Revenue Growth: 7%

**Source:** Interviews and analysis
Contact details

Ross Goralnick
CEO
Lumeric Consulting LLC
122 W 27th Street, Floor 10
New York, NY 10001
USA

+1 646-237-6967 (p)
+1 646-253-1258 (f)

info@lumericconsulting.com

www.lumericconsulting.com