RFM Analysis: The Key to Understanding Customer Buying Behavior

Can you identify your best customers?
Do you know who your worst customers are?
Do you know which customers you just lost, and which ones you're about to lose?
Can you identify loyal customers who buy often, but spend very little?
Can you target customers who are willing to spend the most at your store?

If you answered "no," then consider RFM Analysis. RFM stands for Recency, Frequency and Monetary Value. It's a proven database marketing technique that has traditionally been used by catalogers to increase conversion rates and reduce the expensive cost of mailing catalogs. Today, online retailers should use RFM to increase conversion rates, personalization, relevancy and revenue. Sophisticated online shoppers demand personalized shopping experiences, and RFM Analysis is an excellent way to provide highly relevant, personalized campaigns that reflect the preferences of the customers they want to keep. This whitepaper is designed to help you increase your email marketing revenue through use of this powerful strategy.

Proven Results of RFM Analysis

To get started, let's take a moment to understand why RFM Analysis is a powerful tool worth investing the time and effort to master. There are countless case studies from successful retailers available, but we'll examine these three:

Eastwood — repair • restore • revive
Email Marketing Profits ↑ 21%

L'OCCITANE EN PROVENCE
2500% ↑ Revenue Per Email

frederick's OF HOLLYWOOD
6-9% Conversion Rates

Eastwood[i], L'Occitane[ii] and Frederick's of Hollywood[iii] each created significant increases in revenue through RFM Analysis and the use of purchase history to segment customers. These results are impressive, but also attainable due to the simple nature of RFM. Let's get started!

How does it work?

The goal of RFM Analysis is to segment customers based on buying behavior. To do this, we need to understand the historical actions of individual customers for each RFM factor. We then rank customers based on each individual RFM factor, and finally pull all the factors together to create RFM segments for targeted marketing. Now let's define each term in RFM:

Recency – Number of days or months since last purchase

Frequency – Number of purchases made

Monetary Value – Amount spent by a customer

<u>Recency</u> is the number of days since the customer's last purchase. Typically, its value is defined in days. For example, if the customer's order was 42 days ago, then their Recency input is "42."

<u>Frequency</u> is the number of orders placed in a given time period. If a customer has placed seven orders over the course of one year, then their Frequency input is "7."

<u>Monetary Value</u> is the total amount of money spent by the customer over a given time period. If a customer has made 5 orders of $50 each over the course of one year, their Monetary Value input for the year is $250.

There are three basic steps to RFM analysis:

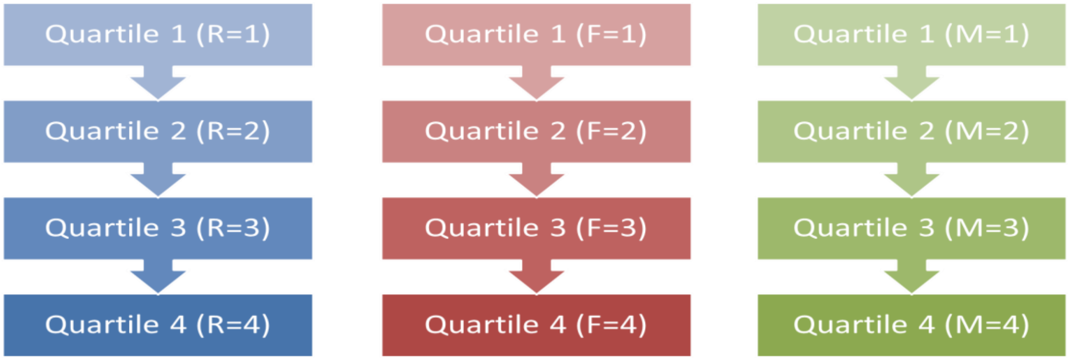
1. Sort all customers in ascending order based on Recency, Frequency and Monetary Value.
2. Split customers into quartiles for each factor.
3. Combine factors to group customers into RFM segments for targeted marketing.

The first goal is to identify and sort customers. To do this, you need to download a spreadsheet with customer purchase history. The file should include the date of the most recent order, the number of orders placed over your selected time period, the total value of all purchases made in that time period, and customer ID. Including the customer's email address will save you time later on, so this should be exported as well.

Now your spreadsheet is ready to be segmented. Sort each column in ascending order based on its RFM factor. For example, select the column for Recency, and sort so that the most recent orders are first, and the oldest orders are last.

The next step is to score your customers. We will use Basic Ranking, as it will serve the needs of most online marketers, but be aware that other approaches exist and might be appropriate for your business. With customers now organized in ascending order, divide them into quartiles, or four equal groups, for each RFM factor. The customers in the top quartile represent your best customers for each factor. For example, the top quartile for Monetary Value will have the 25% of your customers who have spent the most at your store. Each quartile also has a name: the top quartile for Recency is called R-1, the second quartile is called R-2, and so on.

WINDSOR CIRCLE
When Data Moves, Retailers Win



Dividing into quartiles will create 64 RFM segments: 4 Recency groups x 4 Frequency groups x 4 Monetary Value groups. Common RFM Analysis practice is to start by dividing customers into quintiles, which creates 125 RFM segments. While the granularity created by 125 customer segments will help you increase conversion rates, it also reduces the number of customers in each cell. For most online marketers, quartiles will be sufficient.

With customers now in quartiles, it's time to group them into RFM segments. Let's say you have a customer who purchased an item 17 days ago (R=1), bought 7 times in the last year (F=1), and spent $568 total in the past year (M=1). As a result, we place this customer in RFM segment "111." Segment 111 contains your "Best Customers."

Marketing to RFM Segments

Now that all customers are divided into RFM segments, you've identified a number of different groups that warrant very different marketing strategies. Here are a few of the groups you can access using this technique:

Name	Segment	Who They Are
Best Customers	R1, F1, M1	These are the customers that bought recently, buy often and spend a lot. It's likely that they will continue to do so. Since they already like you so much, consider marketing to them without price incentives to preserve your profit margin. Be sure to tell these customers about new products you carry, how to connect on social networks, and any loyalty programs or social media incentives you run.
Loyal Customers	F = 1	Anyone with a high frequency should be considered loyal. This doesn't mean they have necessarily bought recently, or that they spent a lot, though you could define that with your R and M factors.
Big Spenders	M = 1	Big spenders have spent a lot of money over their lifetime as your customer. This might be a few number of big purchases, or many small purchases, but you know they trust you enough to invest a lot in your products. Considering marketing your

		most expensive products and top of the line models to this group.
New Spenders	141	New Spenders are new customers that spent a lot of money on their first order(s). This is the kind of customer you want to convert into a loyal, regular customer that loves your products and brand. Be sure to welcome them and thank them for making a first purchase, and follow it up with unique incentives to come back again. Consider branding the email with a special note from the CEO, and include a survey to ask about their experience.
Loyal Joes	X14	Loyal Joes buy often, but don't spend very much. Because they already like and trust you, your goal should be to increase the share of wallet you have from this customer. Send offers that require them to "Spend $100 to save $20" and "Buy 4, Get 1 Free." These offers create high hurdles that must be cleared to gain the reward, and will increase the amount these loyal customers spend with you.
Lost Customers	411	Lost Customers used to buy frequently from you, and at one point they spent a lot with you, but they've stopped. Now it's time to win them back. They might be lost to a competitor; they might not have need of your products anymore, or they might have had a bad customer service experience with you. Regardless, they were an extremely valuable customer that should be approached differently.
Almost Lost	311	Similar to Lost Customers. It has just been less time since they purchased. These customers might warrant more aggressive discounts so that you can win them back before it's too late. (We all know how much less expensive it is to keep customers compared to winning new ones.)
Splurgers	X41	Splurgers combine a high Monetary Value with a low Frequency, which means they've spent a lot of money in just a few orders. Because they have the wealth and willingness to spend a lot with you, target high priced products with good margins at this group. This group might also correspond with seasonal events or even just the typical buying cycle of your product's wear.
Deadbeats	444	These customers spent very little, bought very few times, and last ordered quite a while ago. They are unlikely to be worth much time, so put them in your general house list and consider a re-opt-in campaign.

There are many other RFM segments that should be targeted, and many times segments can be combined to receive an offer. For example, you may want to combine “Lost Customers” and “Almost Lost” for a win-back campaign.

As a final note, it bears mention that you should include all messaging as part of a broader campaign management strategy. Do not ignore lower value segments as they can still be profitable, and do not over-market to your best customers. “Going silent” or creating “contact fatigue” both have negative consequences and should be managed appropriately.

About Windsor Circle

RFM Analysis requires the ability to access customer purchase history data, analyze it, and upload it to your email marketing platform. If you believe in the power of RFM, but don’t have time for a new revenue generating project, Windsor Circle can help.

Windsor Circle incorporates RFM Analysis as one element of its customer segmentation algorithm. By providing integrations to leading software platforms used by online retailers, Windsor Circle provides marketers with instant access to shopping cart, order management, and eCommerce data so that they can benefit from the same personalization and targeting capabilities that the world’s top online retailers use to drive revenue.

Windsor Circle's Intelligence engine goes beyond reporting and analytics. It provides insights and recommendations that double and triple email marketing revenue, plus there is no software to learn and I.T. barely gets involved. It's software for eCommerce marketers, with a focus on the bottom line. Contact us to learn more.

[i] http://www.retailonlineintegration.com/article/rfm-analysis-strengthens-eastwoods-e-mail-marketing-program-403943/1
[ii] http://www.e-dialog.com/pdf/ED146_L'Occitane_DataMart_Analytics.pdf
[iii] http://www.lyris.com/media/pdf/casestudies/casestudy_fredericks.pdf