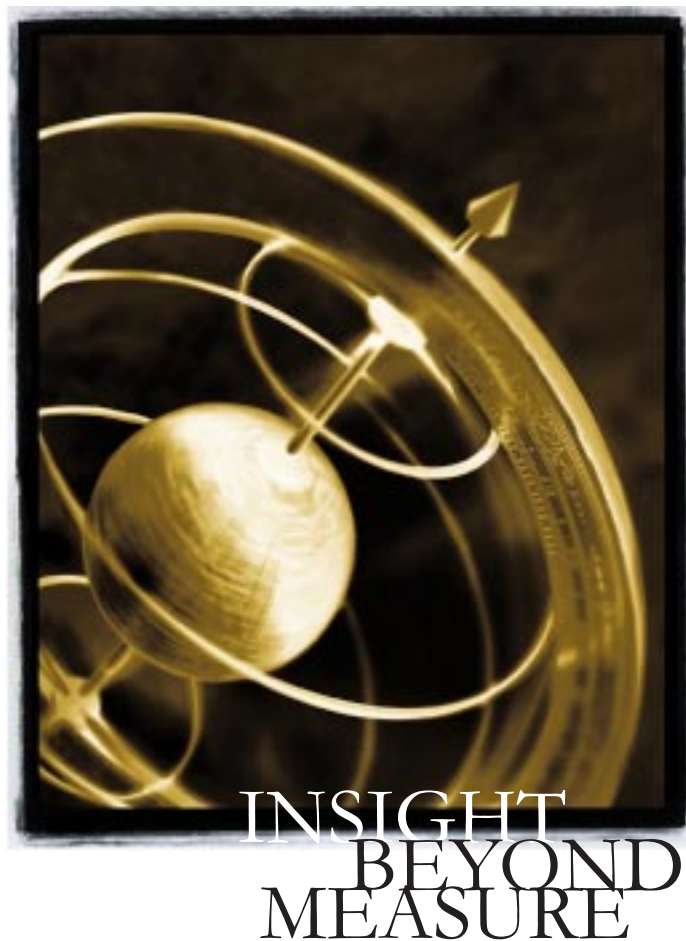


EXECUTIVE INSIGHTSSM

Driving Business Performance: Customer First A Framework for Loyalty and Its Measurement



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INTRODUCTION

The *sine qua non* for business success today is performance measured in economic terms. **Shareholder value** is often the top item on the minds of senior executives. While Wall Street demands quarterly financial performance, senior executives need to balance security analyst requirements with creating a successful long-term business strategy. Those who succeed in meeting both short- and long-term goals will be tomorrow's heroes.

Myriad tools and programs have been designed in the past two decades to assist senior managers in the pursuit of the optimally functioning organization. "Total quality management," the "balanced scorecard," and "re-engineering" are among the host of offerings. Few will argue that the contribution of some of these concepts has been enormous. However, often lost in the zeal of implementing these techniques is the importance of the customer. Few organizations truly understand the behaviors, motivations and needs of their customers. While a re-engineered company can generate a greater ROE -- assuming the exercise is real and not a cloak for a cost-cutting effort -- even the most efficient organization cannot be profitable without customers.

Investment in programs "to put the customer first" is huge and includes human resource costs, fees paid to consultants and the costs of measuring or monitoring the customers' "state-of-being." The critical questions any CEO or CFO usually asks before an investment is made is "What is the ROI?" and "What is the pay-back period?" Yet these questions are rarely asked of customer-focused programs because there is an implicit assumption that these programs work.

Why? It seems only logical that businesses with happy customers are more profitable and, as a result, produce a greater return for shareholders. However, the majority of customer-focused programs have failed, in part because they have not demonstrated a positive impact on the bottom line. At ORC International, we believe it is possible to create financial metrics that can provide the justification for these programs as well as follow a number of basic tenets necessary for success.

PRINCIPLES OF SUCCESS

ORC International has developed customer satisfaction programs since the late 1950's, building a deep knowledge base about what works best. Today, we focus on understanding how to measure and monitor the loyalty process. The knowledge we have acquired has enabled us to develop six key principles which we believe must form the foundation of any customer-focused program.

Customer-Focused Programs: Principles of Success

- Principle 1: The mandate must come from the top but the vision must be shared by all.
- Principle 2: Focus on those customers who will make the biggest difference to your bottom line.
- Principle 3: Business and financial impact of the process must be demonstrated.
- Principle 4: Customer impact must be measured using a framework that is valid and replicable.
- Principle 5: Programs must be developed to help the organization use the knowledge created.
- Principle 6: Employees are critical to the success of any

Principle 1: The Mandate Must Come From the Top but the Vision Must be Shared by All

No customer-focused program will be successful without the support of top management. Top-down direction and the power to remove obstacles and resolve disputes are imperative to support a customer-driven strategy which may be counter to short-term business initiatives. It is only those organizations whose senior management fully believe in the value of being customer-focused that are willing to make the necessary decisions to support such a program.

The vision of being truly customer-focused must be shared with all employees. "Going the extra mile" for a customer is often the result of knowing such actions will be acknowledged, rewarded and, in fact, expected by senior management. Rather than allow corporate bureaucracy and inertia to bog down the best programs, senior executives must foster the enthusiasm of all employees in order to support a customer-focused mentality.

Principle 2:**Focus on Those Customers Who Will Make the Biggest Difference to Your Bottom Line**

Our research has shown that the greatest gains occur when companies convert customers who like them into customers who love them. This should be obvious. In our own lives, we prefer to spend more time with those we love than with those we just like. Customers purchase more - and more frequently - from companies with whom they have a relationship. Whatever the measure for customer loyalty or satisfaction, successful companies continue to perform at superior levels. In most instances, customers who are totally loyal are far more profitable than those who are not. As a result, the companies who reap the greatest financial benefits are those who understand that superior performance leads to loyalty and retention. And, loyalty and retention drive not only revenue but, more importantly, profitability.

The key points below provide further clarity on the Customer Loyalty focus:

Success breeds success: Customers already pleased with your performance are likely to be more receptive to messages designed to increase their loyalty to you. They are also more likely to consider you for new products and services you haven't marketed to them before, because of their positive prior experience.

Relationships are key: Our research has shown that a major reason for not being fully loyal to a company is not necessarily due to any flaws in performance, but because the company has not established a meaningful relationship with the customer. Successful loyalty programs identify new opportunities to interact with the customer that will reinforce a positive relationship.

"Preach to the Converted": Customers with low levels of loyalty are tough to move, and will require a lot of effort to convert into loyal fans. In fact, it is questionable whether an economic argument can be made to justify such a conversion process. Although tremendous learning can result from investigating why these customers feel the way they do, your relationship dollars are better spent on those who will be more receptive to your overtures.

**Principle 3:
Business and Financial Impact of the Process Must be Demonstrated**

In order to succeed, a customer-focused program must provide measurable results which can be used to calculate the return on the investment made in the program. Even the most ardent supporters of a customer-focused program must admit that, absent a financial and business impact, there is no reason to implement such a program. Without impact, these programs deduct dollars from the bottom line. Is a happy customer that isn't profitable really worth having? A company with too many such customers runs the risk of going bankrupt.

**Principle 4:
Customer Impact Must be Measured Using a Framework that is Valid and Replicable**

Investment in a top-caliber measurement system is an essential component of the total cost of any customer-focused effort. Without a valid and replicable measurement of the business and financial impact of the program, you may not know if your program is driving the performance of your business up or the profits of your business down.

**Principle 5:
Programs Must be Developed to Help the Organization Use the Knowledge Created**

Successful ongoing customer-focused programs live in continuous learning organizations. Managers and employees are, of course, critical to the success of any customer-focused program, and they must be able to understand the information provided to them by the program. Without adequate and continuous training, it is unlikely that most managers and employees will be able to leverage the knowledge that is being provided to them.

**Principle 6:
Employees Are Critical to the Success of Any Customer-Focused Process**

The linkage between customer loyalty and employee loyalty should be intuitive and has been demonstrated statistically, using customer and employee satisfaction data. We have seen the linkage across a number of industries. Employees are often the critical link to customers. If they do not "feel good" about their employer and their ability to deliver to the customer, the customer will know it. Happy employees make loyal customers and loyal customers spend more money. It is essential to monitor employees with the same tenacity as you monitor customers. Employees are one of any company's most important assets.

Case Study: Komatsu America

To bring a successful customer loyalty program to life, let us highlight a brief case study. Our client, Komatsu America, a leading manufacturer of heavy equipment, is using a software system developed by ORC International that allows its dealers to monitor the performance of its products and services on a one-on-one basis. Jenkins Davis, the founder and ongoing director of Komatsu's PULSE PROGRAM™ has successfully implemented a vision that is at the cutting edge of customer retention programs. As we will discuss, the program illustrates a number of key points.

The program:

- Is based on key time periods in a relationship cycle that begins with the purchase of the equipment.
- Is survey based and is replicable and reliable from a measurement standpoint.
- Provides a dealer with comparative data for his/her region and across all other Komatsu dealers, providing the dealer with quick benchmarks for performance.
- Includes an alert mechanism which provides a dealer with information about a problem a customer is having and allows the dealer to take action within 24 hours of the problem identification.
- Includes software which allows a dealer to "drill down" to the individual customer level and see ratings on specific aspects of the dealer's performance. Verbal comments of customers can be heard verbatim to by the dealers, thereby bringing customer experiences and opinions to life.

With this level of information, the dealer can easily tailor actions to fit individual customer needs.

Dealers using the program can also analyze the information at many different levels. This analysis can then be used by the dealers to determine where to focus their efforts. To the surprise of many dealers, customers provide ORC International's interviewers with feedback they are reluctant to give directly to the dealer—even when the customer/dealer relationship has existed for many years. Komatsu America, in turn, can analyze the information across dealers, identifying ways it can better support its dealer network.

The next phase of this program will be a globalization of this effort that initiated in the United States. Additionally, the research results will be linked to financial metrics to calculate an ROI in order to demonstrate the financial impact of the program.

The PULSE PROGRAM™ represents leading-edge thinking and we are certain it represents the future of successful loyalty programs.

DEFINING LOYALTY

Defining loyalty and creating a process to enhance loyalty among customers is a significant venture, and should only be undertaken by those willing to dedicate the necessary resources to make it successful. A half-hearted attempt can lead to frustration and failure. It is better not to start a program than to have raised - and dashed - expectations.

Before turning to the specifics of developing customer loyalty programs, it is important to know what we mean by "loyalty". ORC International defines loyalty as:

...a state of mind which occurs in a customer when a company fully delivers and often exceeds on its promise to the customer.

We believe, based on our experience, that:

Loyalty results in a disproportionate share of business and a fundamental belief among customers that a firm can meet tomorrow's needs as well as today's.

Loyalty is a 'reward' for good performance and will result in sustained profitability.

True loyalty cannot be manufactured in the marketing department or won solely by incentives. Loyalty must be won through consistent experience.

Customer loyalty undeniably results in the business impact all companies seek - greater profitability and a greater share of the customer's business.

How does one go about setting up a loyalty program? There are no "shrink-wrapped" solutions, as each company - and customer - is unique. However, we have found that successful programs often follow a similar path.

The first challenge in setting up a customer loyalty program is arriving at a definition of loyalty for your company. This may sound straightforward, but our experience has shown that it is not, as few executives and managers have actually spent time thinking about the characteristics of a loyal customer.

We have found that a two-stage facilitated workshop can generate lively discussion which eventually sheds light on what makes a customer loyal to your company. The workshop typically has four objectives:

- 1) **Identifying case examples of loyal customers**
- 2) **Determining metrics that reflect loyalty based on the cases cited**
- 3) **Identifying which metrics your company currently captures in its records**
- 4) **Evaluating meaningful units of comparison – by sales region performance, market segments, business lines, production plants, and so on**

Many companies already use these or similar comparisons in their business and financial reviews. As the Komatsu America case study illustrated, these comparisons when used in a customer loyalty program can readily provide benchmarks for performance.

The first stage of the workshop is conducted among front-line employees, those who interact with customers on a regular basis, or with relationship managers who are responsible for nurturing customer relationships. The second stage involves bringing the comments of front-line employees to senior managers. This format challenges senior management's understanding of how relationships are built with the customer, and the outcomes can be interesting.

Identifying loyal customers often proves to be a lively discussion. Is it simply the length of time the customer has been with the company? Often, the answer is no. Many companies can point to at least one customer who has been with the company "forever," but who has never generated profit - only seemingly endless and time-consuming problems.

Considerable time should be spent in discussing what makes a client loyal. A full and spirited debate will yield important insights. The discussion may become deeply personal and political. One manager may argue over a customer's loyalty because of personal relationships or the manager's own sphere of influence. The discussion may become bogged down because no one really knows about a customer's current – or future – status. Hard data – share of account, length of time with the company, number of referrals to prospective customers, and so forth – should be used to the extent possible to keep the discussion focused on the task at hand.

At the end of the workshop, "loyalty measures" that include both "hard" and "soft" metrics which can be identified and tracked over time will have been established, as illustrated below. Clearly, some of this data can only be obtained from customer surveys. Other loyalty measures such as customer tenure, change in business, or profitability may already reside in internal databases or accounting files.

KEY METRICS IN DETERMINING CUSTOMER LOYALTY

Hard Metrics:

- Share of customer's total purchases
- Breadth/depth of products/services purchased
- Tenure
- Profitability
- Increase/decrease in business with customer in last 12 months
- Number of referrals to prospective customers in last 12 months

Soft Metrics:

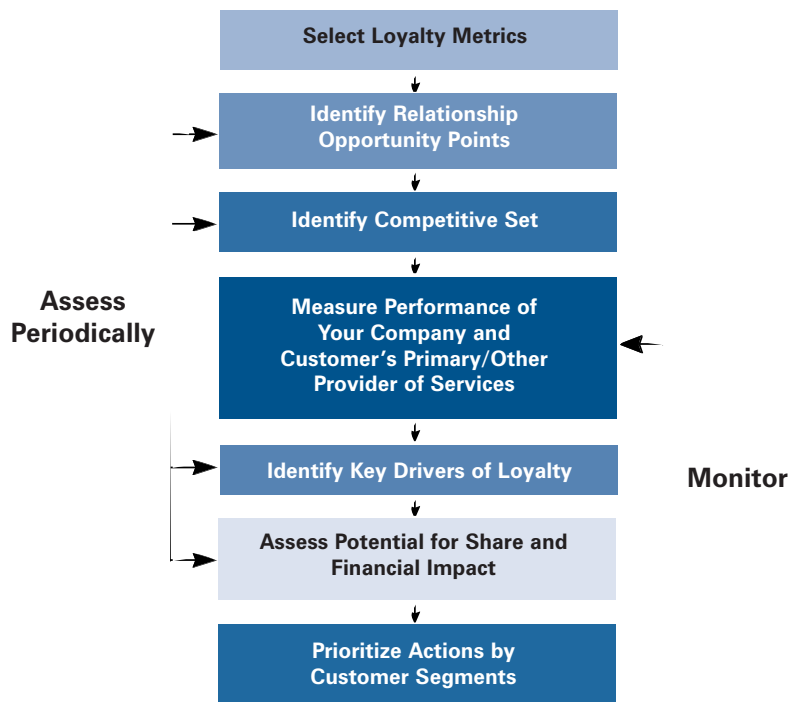
- Willingness to repurchase/continue the relationship with your company
- Satisfaction with your products/services
- Satisfaction with the overall relationship with your company
- Willingness to recommend your company's products/services in the future
- Willingness to buy new products/services from your company
- Comparative value of your products/services vis-a-vis your competitors
- Likelihood to consider a competitive offer at the same price as the current product/service purchased from you
- Recent establishment of new relationships with competitors

You will note that customer satisfaction is only one of several elements on the list. While we do advocate measuring customer satisfaction, we do not believe it is the sole measure of loyalty. The American automotive industry is an often cited example of why this is so. While most car buyers are satisfied or very satisfied when they leave the car dealer's parking lot, fewer than half of them buy the same car the next time.

CREATING LOYALTY PROGRAMS THAT DRIVE BUSINESS PERFORMANCE

Eight steps are required to provide senior management with the knowledge necessary to create loyalty programs that drive business performance. Once these steps are in place, training programs to transfer knowledge throughout the organization must be held so that the full impact of the program is realized.

The Process for Driving Loyalty and Business Performance



1. Selecting the 'Right' Loyalty Metrics

The process for driving loyalty and, as a result, business performance, begins with the selection of the loyalty metric. Our preference is to use share of business a customer gives you as the metric. This is often referred to as **share of wallet** or **account share**. We believe, as do others, that this is the only true measure of a customer's loyalty. The more business a customer gives you, the more loyal they are to you as their primary supplier of a specific product or service. Experience has shown us that many customers, if asked, will say whether you are their primary supplier and even what share of their business you have. They may not reveal which of your competitors receives how much of their business, but they will disclose the size of the slice of the pie your company receives when the request is framed properly.

What if this information cannot be obtained? There are alternatives. Historically, many firms used satisfaction as the measure of 'happiness'; based on the theory that satisfaction translates into more business. As we have identified in earlier work, unless you are at the pinnacle of satisfaction, it has little impact on repurchase intent. An example to which many of us can relate concerns our various financial dealings. We can be very satisfied with the financial institution where we have our primary checking account, yet we often turn to other sources for investments, mortgages, loans, etc. that we need throughout our lives.

In the absence of being able to measure share, we would argue that the next best measure is **value**. Our research has shown that providing value is a much more stringent measure of the potential to capture share than is satisfaction. Brad Gale's discussion of his well known approach to market perceived value, through a Customer Value Analysis (CVA)¹ clearly demonstrates the concept of value as a function of price and quality. The higher your products and services are on the value curve, the more likely you are to be top-of-mind for the purchase of these products and services today, and, potentially, new products and services tomorrow.

¹ Gale, Bradley T. Managing Customer Value. New York: The Free Press, 1994

2. Identifying Relationship Opportunity Points

Once the loyalty metric is agreed upon -- share of wallet/account or value -- the next challenge is to identify points in the customer relationship where one can impact loyalty. Traditional approaches to customer satisfaction have focused on identifying the processes involved in the delivery of the product or service. A customer's satisfaction with these processes is then measured. This approach does provide management with information about where change needs to occur, but it can be limited in its scope. A customer-loyalty approach requires a broader understanding of the many relationship points at which a customer can potentially interact with your company and its employees. Identifying these points leads to a better understanding of the opportunities to impact the customer relationship. **Each point of contact is an opportunity to enhance customer loyalty.**

Another example can be drawn from the automobile industry, where a dealer has numerous opportunities to build loyalty with the buyer.

These include when the buyer:

- Begins to shop
- Makes the purchase decision
- Obtains financing
- First begins to experience the new car
- Falls into a routine with the car that is no longer so new
- Services the car
- Starts thinking about the next vehicle

Some of these relationship points are obvious, but there are also points in the relationship we might not have thought of as marketers of products and services. For example, purchasing an automobile is one of the most significant financial outlays an individual will make. It is quite likely that two or three days after the purchase a consumer says to

him/herself "What have I done?" Herein lies the opportunity for the dealer to call the customer, check on their experience with the car thus far and reinforce the value of the automobile purchased and the fact that it was a very 'smart' decision on the buyer's part. While this might seem like pandering, "buyer's remorse" is a common occurrence, and reinforcement, at the right time, can provide a very positive and loyalty-building experience.

Once identified, the points of the customer relationship can be broken down into discrete events and actions. Focus groups with customers and front-line employees, interviews with managers, and 'assisted shopping,' can all yield important information. 'Assisted shopping,' involves accompanying a customer during the buying process (or different customers at different points in the buying process) to see how they view different elements and experiences during the relationship cycle. An initial review, testing and validation of the specific events in the relationship cycle will result in a finite set of events which are measured as part of the customer monitoring process to be more fully discussed later.

3. Identifying the Competitive Set/Measurement Considerations

Identifying the competitive set is the next significant task in the process. Two key questions must be answered:

Are we looking at the competition accurately? Are there new and emerging competitors we haven't encountered before?

Who do our customers tell us our competitors are?

Measuring your company's performance among your customers in the absence of measuring the performance of your primary competitors may provide you with misleading information. If your share of your customers' business is increasing, you might be very happy with the job you are doing. However, if the share of business your customers are giving to your competitors is increasing faster, you have a problem that will become increasingly apparent and urgent. **Assessing the performance of competitors is critical.**

Competitive measurement has historically been conducted among a number of competitors. While this provides useful information and is important to do periodically, it is far less meaningful in an environment of a one-to-one relationship with your customer. Far more meaningful is the measurement of your company's performance against the competitor 'nipping at your heels' (if you are number one) or the competitor whose position you would like to capture (if you are number two or three). Furthermore, building on the work of Srinivasan², a consultant at KPMG, we agree that the most critical measure is not a comparison of absolute performance (percent rating each company a '5' for example), but rather the gap in performance between your company and the competitor of focus. If you trail the competitor, you want to close the gap as much as possible. Conversely, if you are ahead, you want to widen the gap as much as possible.

Our example uses a five-point rating scale and references our earlier example of a heavy equipment manufacturer. The academic literature is full of discussion concerning whether a five-, seven- or ten-point scale should be used to measure satisfaction and loyalty. While we maintain a viewpoint on this topic, it is supplanted by the simple fact that **it is not the scale that makes the difference in customer loyalty; it is how you use the information which comes out of it.**

² Srinivasan, Madhav. New Insights Into Switching Behavior. Marketing Research, Fall 1996.

This example demonstrates the type of information that should be gathered about your performance as well as the competitor's. A quick look at the gaps in performance allows you to understand your strengths and weaknesses at a very detailed level.

FOCUS ON COMPETITIVE GAPS

Illustrative Example – Heavy Equipment Manufacturer
% Rating "Very Satisfied"

Attribute	Your Company	Competitive Company	Gap
Action is taken based on feedback provided through Pulse Program™	60	42	18
Salesperson thoroughly reviewed maintenance schedule	65	53	12
Calls back within two hours	50	40	10
Had opportunity to try variety of equipment at customer days event	34	32	2
Regularly attending quarterly maintenance seminars	15	15	0
Salesperson provided introductions to head of parts and service	40	43	(3)
Salesperson fully explained follow-up service quality program	25	30	(5)
Salesperson thoroughly reviewed owners manual	40	46	(6)
Repair crew stays on-site to ensure all repairs are 100% functional	23	30	(7)
Available 24 hours/day	42	50	(8)
Has mobile field force for on-site emergency repairs	30	40	(10)

As an aside, even more important than the scale used is whether bias is introduced into the measurement process through the information collection effort. A personal anecdote seems relevant here. I recently stayed in a hotel run by a large, international and very well-known chain. On the desk in the room I found a simple memo which stated that sometime after my stay I would be mailed a survey asking for my comments on the stay. The memo provided directions for completing the survey and stated "we want you to realize that a rating of an 8, 9 or 10 means that we met your expectations and a rating of 7 or below, means we did not." In essence, this hotel chain had truncated a ten-point scale to two points – 'we met your expectations or we did not.' Any information gleaned by attempting to use the scale as a ten-point scale is thus, inaccurate.

4. Identifying the Key Drivers of Loyalty

Sophisticated statistical analysis at both the individual and relationship concept level is needed to provide an understanding of both what is driving customer loyalty and what actions can be taken to influence those drivers.

Relationship concepts are identified using a data reduction technique, such as factor analysis, to develop a picture of how customers view the world. Like most of us, customers tend to think in broad terms about their relationships, not as a combination of discrete actions which may or may not occur.

An example from our work with a heavy equipment manufacturer illustrates this point. Five major relationship areas were identified as drivers of customer loyalty to the company: responsiveness to emergency situations; knowledge and helpfulness of the parts and services staff; thoroughness of pre-delivery explanations; experience with the product; and relationship-building experiences. Factor analysis enabled us to understand the relative importance of each of these relationship factors, thus giving management a road map for allocating resources to those programs that have the greatest customer impact.

The example outlined on the following page enables us to look at the three relationship concepts in greater detail. Additionally, we are able to understand, through the use of advanced analysis such as regression techniques, the contribution of the relationship concept as well as the contribution of each detailed aspect. The level of contribution helps us ultimately prioritize our actions and initiatives for improvement.

RELATIONSHIP CONCEPT STRUCTURE

Illustrative Example – Heavy Equipment Manufacturer
(Factor Structure Results)

Relationship Concept	Contribution of Concept to Loyalty	Concept Components	Contribution of Attribute to Concept
Responsiveness to Emergencies	.45	Has mobile field force for on-site emergency repairs	.80
		Available 24 hours/day	.75
		Calls back within two hours	.48
		Repair crew stays on site to ensure all repairs are 100% functional	.45
Pre-Delivery Explanation	.40	Salesperson thoroughly reviewed owners manual	.79
		Salesperson thoroughly reviewed maintenance schedule	.78
		Salesperson fully explained follow-up service quality program	.60
		Salesperson provided introductions to head of parts and service	.65
Relationship Building	.15	Regularly attend quarterly maintenance seminars	.80
		Action is taken based on feedback provided through Pulse Program™	.75
		Had opportunity to try variety of equipment at customer days event	.50

What emerges from this discussion is the importance of selecting the correct relationship attributes to measure. This was discussed in a prior section in regard to defining customer loyalty. The old adage of "garbage in, garbage out" certainly applies here. The greater the effort expended upfront to gain the correct understanding of what determines customer loyalty, the greater the chance of success. If the attributes are off-target, no amount of analysis will make them right, and no program designed from the information gathered will succeed.

5. Assessing Potential Share and Financial Impact

The next and final analytic stage is to determine the potential for impacting market share and financial results. At the outset, it is essential to understand that the result of this analysis is indicative, but NOT definitive. Market share is impacted by much more than just quality of service or being able to deliver on the drivers of loyalty. Distribution opportunity, the number of competitors, marketing and advertising, and the general economic climate for the industry at that time all affect market share. The corresponding revenue calculations are subject to the same influences. As a result, the information presented here is most likely to be the upper bound of any such outcomes. That said, the measurement process described thus far provides all the necessary components determine the impact of share and financial results. As we've discussed, our methodology proposes that the following information be collected:

Share of business/account with you and your key competitor

Dollar amount of business your customer conducts with you each year

Importance of the major relationship concepts to driving loyalty

Performance gaps between you and your key competitors on the major relationship concepts

In addition, internal account information may be useful to the process. The most important of them is a profitability measure by account. If this is not available, results will be based on the revenue impact of the drivers of loyalty instead of an estimation of the contribution to the bottom line.

Turning once again to our heavy equipment manufacturer, we can calculate the impact that a service change has on the share of business a given customer provides. For the purposes of this paper, the mathematics have been simplified. For example, the impact of time, an important element, has been left out. The time delay between improvements in drivers of loyalty and changes in revenue differs across customer segments and industries and must be taken into account. In a real implementation for a client, we include this information as well as the extended benefits and costs of improvements into the future. These issues are discussed more fully in Step 7.

FINANCIAL IMPACT ASSESSMENT

Illustrative Example – Heavy Equipment Manufacturer

Relationship Concept	Impact of Concept on Loyalty	Potential Share of Business/Account Impact*
Responsiveness to Emergencies	.45	2.01 %
Pre-Delivery Explanation	.40	1.79 %
Relationship Building	.15	0.63 %

* Impact per one unit improvement in performance on concept

Extensive statistical modeling is used to estimate the unknown parameters and the relationships between the parameters. When possible, this modeling occurs at the level of the individual customer. Results are then aggregated across all customers to provide company level measures. While the mathematics can get complicated, all of the measures that we have discussed are taken into consideration.

To further expand upon this example, we know the following from our survey analysis:

- Ms. Smith, a customer, spends \$470,000 with our client.
- Our client receives 43% of Ms. Smith’s business.
- This means that Ms. Smith spends \$1,093,023 annually.
- \$623,023 of those expenditures are spent with a competitor which could be potential business for our client.
- Each percentage point of her share of account is worth approximately \$10,930.
- We know from the results of the loyalty driver analysis that the ‘Responsiveness to Emergencies’ relationship concept is the most important aspect driving loyalty.
- We also know from the analysis that a one unit improvement in the relationship concept of ‘Responsiveness to Emergencies’ will lead to a 2% increase in the share of the account.
- A more common improvement goal is five units which means that for the Smith account, a five unit increase in the service quality provided in the area of ‘Responsiveness to Emergencies’ will lead to minimal incremental revenue of \$109,300.

Calculating the Potential Economic Impact of Loyalty

Example: Heavy Equipment Manufacturer

a.	Total \$ spent	\$1,093,023
b.	Total \$ spent with client (43%)	\$470,000
c.	Total \$ of potential business client does not have (57%)	\$623,023
d.	\$ value of each share point of client $\$470,000/43$	\$10,930
e.	2% share increase in improvement (as a result of a 1 unit improvement on “responsiveness to emergencies”)	\$21,860
f.	Minimum incremental revenue from customer due to 5 unit improvement in service quality of emergency responses (5 x item)	\$109,300

Now taking this approach and applying it across all of the customer accounts we learn the following:

- The total potential incremental revenue from the entire customer segment, based on an improvement in service quality as described in the former example with the Smith account, is \$2,543,000.
- The cost of delivering this level of service quality in the area of ‘Responsiveness to Emergencies’ is \$1,750,000. This recognizes that the current level of performance for this relationship concept is inferior to the competition.
- However, weighing the cost of service quality improvement against the potential incremental revenue from the entire customer segment yields a *profit of \$793,000*.

Calculating the Potential Economic Impact of Loyalty

Example: Heavy Equipment Manufacturer

Now, summing across all customers...

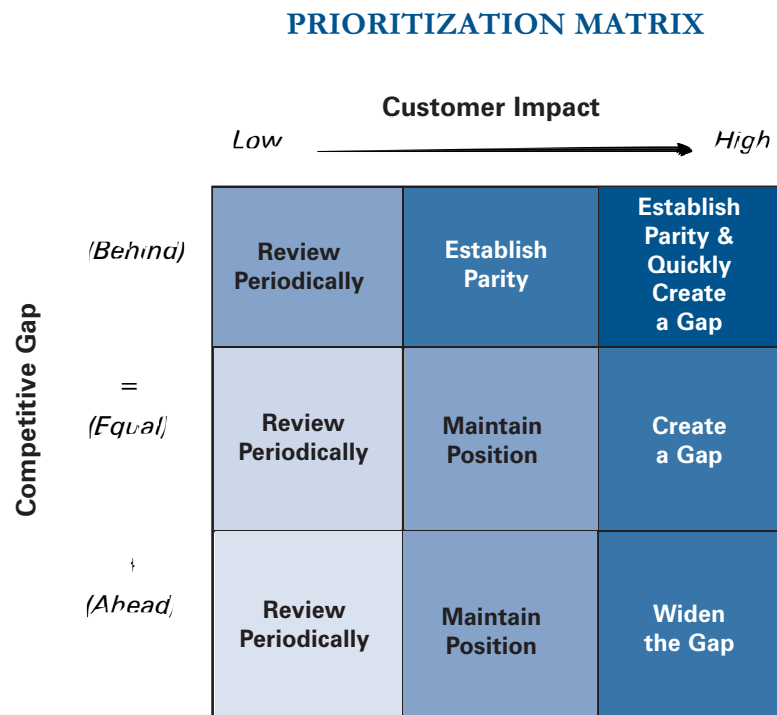
a.	Potential incremental revenue from entire customer segment	\$2,543,000
b.	Cost of service quality improvement	\$1,750,000
c.	Potential Profit	\$793,000

By arraying the relationship concepts from the highest to lowest impact, we get a sense for where attention should be focused and an estimate of what will be gained by our actions. Further discussion on these concepts is provided in the following section.

6. Prioritize Actions by Customer Segment

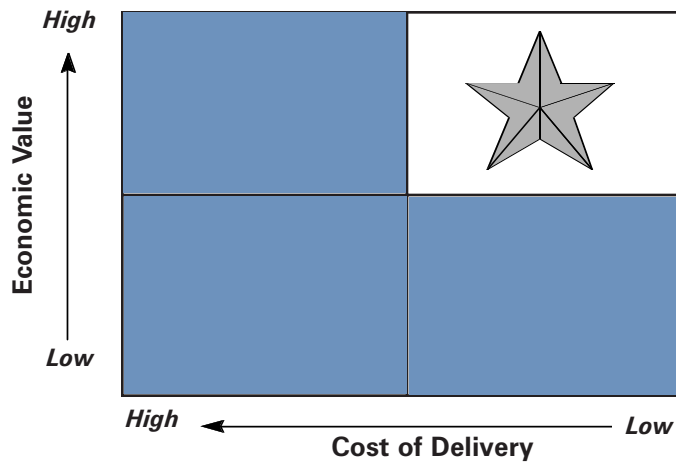
The potential economic impact is again predicated on what is important to customers. By our definition, drivers of loyalty are those elements which have the greatest impact on market share. Determining on which relationship concepts to focus first is dependent not only on the potential financial impact but also on your position relative to your competitors on each concept. At this point it is helpful to refer to relationship concepts as loyalty program elements. From a tactical standpoint, these concepts will be translated into programs that will impact the loyalty of your customers.

The **Prioritization Matrix** is a useful tool in understanding where to focus first.



However, unless money is no object, the cost of delivering on loyalty-related programs must be considered. As a result, a second prioritization must occur which is depicted in the **Resource Allocation Matrix**. As can be seen in this matrix, the prioritization can be adjusted based on the cost of program implementation.

RESOURCE ALLOCATION MATRIX



Not to complicate matters, there is an underlying consideration that crosses both aspects of prioritization. As we indicated in an earlier section of this document, one of the principles for impacting the bottom line is focusing on those customers who make a financial difference. Whether the method by which you look at your customers is a statistically-based segmentation or an a-priori segmentation based on demographics, lines of business or other factors, it is essential to evaluate the financial value of each segment to your organization. It can be argued that this is the first prioritization which should occur. There is a strong business argument to carry out the prioritization schemes discussed above for the customer segments with the highest financial potential for the organization.

7. Determining A Customer Segment's Financial Potential

This is a difficult task and one that could be the topic of its own paper. For the purposes of this discussion, we will present a conceptual framework for determining a segment's financial impact and will gladly provide details of the calculation to anyone interested in discussing it further.

A number of factors need to be considered to determine the long-term value of a customer, including:

Size of the customer segment

Net Present Value (NPV) of the customer segment based on current activities with your company and the NPV of business currently given to competitors which you would like to have

Half-life of the customer segment

Strategic importance of the segment

The first of these, size of the customer segment may seem logical but is often overlooked. There is a balance between pursuing smaller but highly profitable segments and larger but less profitable segments. What is often overlooked is what we refer to as the "*Law of Volume*," which states that the sum of the profitability across a large number of moderately profitable individuals can be far greater than that of a smaller but highly profitable group. A prime example are retail banks which often ignore the profitability of the "masses" based on fee-revenue they can generate in favor of the more lucrative, but far smaller affluent segments. A good deal of the proprietary research we have conducted for our clients shows that the affluent segment is more fee sensitive because they expect services for free in exchange for the amount of business they give the bank. Conversely, an individual who maintains only a moderate or small balance (but is a good risk) is more accepting of fees linked to returned checks, financial planning activities or other services a bank provides. Less affluent individuals are also more accepting of services provided through remote channels such as telephone banking, etc. Do not confuse the word "accepting" with the word "like." These people do not like the evolving financial services world any more than their more affluent counterparts. The difference is that they realize the size of the business they can give the bank does not warrant "special breaks".

Net Present Value, or NPV, is a well established concept that is perhaps the most useful tool available for determining the long-term value of a customer. Simply stated, NPV is the long-term value of a customer in *today's* dollars. It is typically calculated by determining the profits that a customer will yield over a defined period of time. Profits are calculated based on a profile of current customers' use of products/services at the point of the average customer life with the company minus the cost of delivering the products and services.

We use a number of modifications in our NPV calculations:

- We agree with Reichheld³ that a more robust metric is customer half-life and not average customer tenure. The average customer life in many industries can be long, and the accuracy of NPV calculations projected over long periods of time is questionable. Developing a customer tenure statistical model which takes into account the variation in the distribution of customer tenure based on the characteristics of the customers is a refinement that yields better results. However, it is a more involved process.
- A second refinement we suggest to the typical NPV model is to look at a customer's long-term value based on their potential value. We define potential value as the business that customers are doing with you today plus the business they are doing with your competitors. If, as we believe, the objective of a customer loyalty program is to increase the share of account your company receives from your customers, then potential business must be included in the NPV calculation. Assuming our model for measuring loyalty is followed, this information will be available from a sufficient proportion of customers to include estimates of competitive spending in the NPV calculations.
- Finally, another overlooked, but terribly important consideration, in the prioritization is whether you have the "right customers." Again, we reference Reichheld in his book The Loyalty Effect where he discusses the need to have the "right" customers. If a customer segment does not fit within the strategic direction of your company, then why design strategies to improve its loyalty? This will mean that you have to develop products and services which do not benefit your company in the long-term, and will distract your employees from focusing on the "right" customers.

³ Reichheld, Frederick F. The Loyalty Effect. Massachusetts: Harvard Business School Press, 1996

With the financial framework outlined, it is possible to view loyalty and retention related programs within a classic financial analysis framework. Terms like ROI and pay-back period now have relevance in the context of these programs. This, we believe, is the true benchmark for success of any program. Loyalty and retention programs must be viewed just as any other capital investment. To date, however, few companies have set up the infrastructure to do so. Our experience is that without this information, these programs are seen by executives as overhead costs. This makes any loyalty or retention program vulnerable to the accountant's ax when financial resources become scarce or a company's profits are insufficient to satisfy its shareholders.

8. Monitoring Performance

Monitoring performance is more than engaging in standard tracking research. **Monitoring without the ability to take action at the individual customer level produces statistics and some nice graphs but often little else.** In a business-to-business environment, loss of even a single account can impact the bottom line. In both the business-to-business and consumer environments, even more damaging than losing an account is maintaining accounts that are inactive or declining in value to the company. The costs of maintaining the accounts can exceed the profit the accounts contribute. This is a common problem in the financial services industry.

Two questions are often asked: "What do we monitor?" and "How often should we monitor?" The answer to the first question is you should monitor performance on the drivers of loyalty and retention. The program's success depends on your ability to deliver on those elements in the relationship cycle that enhance the share of account you receive. The prioritization matrices presented are the tools to help you determine where to focus first. Historically, the difficulty has been in producing this information in a way that allows relationship managers or other staff who have direct contact with the customer to take action. As our Komatsu example shows, technology is quickly addressing this issue. The answer to the second question is—it depends. You have to consider the frequency of the relationship cycle or elements within the relationship cycle, the momentum of the industry (pace of change in the industry) and the value of the customers being monitored, (i.e., spend more time and money monitoring your most valuable customers) to arrive at a satisfactory timetable for your group program.

SUMMARY

This paper has attempted to provide a framework for the development of loyalty and retention programs and the measurement of these two critical customer-focused areas. In summary, we offer a short review of the key themes addressed in this paper:

- The mandate must come from the top. Without support from executive management, success is questionable at best.
- Recognize that all customers cannot be treated equally. Customer segmentation is required to understand which customers should get a disproportionate share of the resources devoted to loyalty and retention programs.
- Loyalty and retention programs should be viewed as investments with an expected return. The development of a framework to provide this information is essential.
- Loyalty is best measured using a "share of account" metric.
- Statistical analysis is necessary to understand the "drivers" of loyalty.
- Actions should be prioritized based on value to the company and must balance the importance of a loyalty driver with the cost of program delivery.
- Programs must enable action at the customer level. Loyalty is a one-to-one proposition.
- Employees are an integral part of the picture.
- Training will be required to make it all happen.

The rewards of focusing on these principles are clear—delivery on commitments to shareholders, market leadership, and a closer, stronger and more profitable relationship with your customers.

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