# AU CONTRAIRE (4)

# Fifty Shades of Loyalty

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**"The gospel of customer loyalty has been repeated so often and so loudly that it seems almost crazy to challenge it."**
— Werner Reinartz and V. Kumar

Customer loyalty is a topic that is steeped in misinformation and wild claims. Anything positive we say about loyalty sounds self-evident and convincing. The highly convincing argument goes like this: If we have loyal customers, we don't need to worry about the stability of the organization or even its growth. We will have low marketing costs, because loyal clients don't need to be marketed to. We don't need to worry too much about acquiring new customers either, because loyal customers will act as our evangelists.

Quite enticing. After all, having lunch with a loyal client is a far more pleasant occupation than making cold calls and writing endless proposals. No wonder companies spend billions of dollars on loyalty programs. Reading loyalty literature and listening to loyalty experts, one would think that loyalty would be easy enough to achieve if we followed their prescriptions. But how much evidence is there for their claims? Let's explore the topic of loyalty in this and subsequent articles.

## The Fantasyland of Zero Defections

The most extreme version of loyalty is the concept of "zero defection." Marketing publications often publish articles with *zero defection* in the title. That is, our consumers will always be 100 per cent loyal to us and will never defect to competition. The most prominent of such articles was by the reigning high priest of loyalty mania, Frederick Reichheld. His article (with Earl Sasser), "Zero Defections: Quality Comes to Services," was published by the venerable *Harvard Business Review* in September 1990.

Zero defections happen in a fantasyland where no consumer ever dies. No consumer has changing needs. No consumer's life conditions change. All consumers are Stepford wives, devoid of curiosity, with no need to experience new or different things. No competitor can possibly make them a better offer, and no new product can possibly entice them.

Where does this strange notion of keeping all profitable customers for life come from? Zero defections is an inappropriate extension of the concept of "zero defects" in manufacturing, where achieving zero defects using quality control procedures is both possible and desirable. Zero defections, on the other hand, is neither achievable nor desirable. It is not possible because – unlike machines, which have no free will – a consumer can do what he or she pleases. It doesn't have to be logical or rational.

So no matter what a marketer does, there is no guarantee consumers will respond in the way that the marketer intended. It is not desirable to hold on to customers whose needs have changed so our products may not be the right fit for them any more. The customers could still be profitable but may not be to the required level. Holding on to customers whose needs are better served by someone else is the recipe for customer dissatisfaction.

## The Mythical Kingdom of Cheap Customer Retention

Retaining a current customer is often considered cheaper than getting a new one. How much cheaper? According to loyalty literature, getting a new customer is five times as expensive as retaining a current one. This claim is attributed to a research study carried out by Technical Assistance Research Programs Inc., or TARP, in the 1980s; since then, it has been quoted widely (including by yours truly) and has reached axiomatic status in loyalty literature. Reichheld and Sasser went a step further and stated that reducing customer defection by 5 per cent would increase a company's profitability by 25 to 85 per cent, fuelling the idea that customer loyalty rather than customer acquisition is the royal road to riches.

**"Here's my number. Call me, maybe?"**
— Carly Rae Jepsen

Time for a reality check. There is no credible evidence to show that customer retention is cheaper than customer acquisition or that reducing defections by 5 per cent will boost profits by as much as 85 per cent. Preferring loyalty over acquisition is not necessarily in the company's interest. Consider a new product: Customer acquisition is vital, and there is no way for a company to grow by just having a few loyal customers. Or consider a product which is on the decline: Customer retention could be as expensive as customer acquisition.

Neither is retaining customers cost-free. The cost of retaining a customer could be giving discounts or providing additional benefits for no additional revenue. It could even be giving discounts and other benefits to customers who didn't seek them, in a proactive attempt to retain those customers. All these incur costs, and they can all add up.

For a product to be 85 per cent more profitable, with 5 per cent reduction in defection, would mean that the 5 per cent who defected accounted for 85 per cent of the profits of the entire brand. It can happen when the break-even point for a company is so high and the marginal cost is so low that it depends on the last 5 per cent of its customers for its profits. Hardly a typical scenario for most brands. The figures simply don't add up. As far as I know, there is no credible research evidence to back up this claim.

## The Fairytale of Loyalty Always Leading to Profit

The loyalty bandwagon runs on three assumptions: one, it costs less to serve loyal customers; two, loyal customers will pay higher prices; and three, loyal customers act as evangelists for our brand. None of these assumptions are systematically tested and proved.

Let us look at a study by Werner Reinartz and V. Kumar ("The Mismanagement of Customer Loyalty," *Harvard Business Review*, July 2002) that examines these assumptions. The authors' analysis uses 16,000 corporate and individual records covering behaviour, revenue and profitability drawn from four diverse companies in three countries over four years: a high tech corporate data provider (U.S.), a mail order company (U.S.), a retail food business (France), and a direct brokerage house (Germany). Here's what they found.

*It does not cost less to serve loyal customers.* In their data, Reinartz and Kumar did not find any evidence to support the assumption that loyal customers cost less to serve. Loyal customers who did business in high volume knew their value to the company and negotiated better deals. The disparity in service cost-to-sales ratios was small, even when the authors examined firms as diverse as a French grocery chain and a German brokerage firm. It may *look* as though it is easier to serve loyal customers, as we already know their expectations, but the cost of serving them is not much different from serving a new customer.

*Loyal customers are not willing to pay a higher price.* For the companies they studied, Reinartz and Kumar found that long-term customers paid lower prices than newer customers – about 5 to 7 per cent lower. Customers expect to be rewarded for their loyalty and resent companies that try to profit from their loyalty. (See also *The Disloyal Company*, by Leger Marketing, 2009.)

*Loyal customers do not necessarily act as evangelists for your brand.* Reinartz and Kumar identified the customers of the French grocery store who recommended it to others (either actively or passively) and linked this information to their *actual* purchase behaviour on record. The relationship between longevity and the propensity to recommend was not strong. Of the customers Reinartz and Kumar analysed, the positive relationship between profitability and loyalty held for approximately 60 to 65 per cent of the customers. The remaining 35 to 40 per cent of customers were either short-term but high-profit or long-term but low-profit customers. In other words, the generally assumed relationship of low loyalty resulting in low profitability and high loyalty leading to high profitability simply did not hold for more than a third of the customers. Many high-profit customers were short-term (low-loyalty), as shown in exhibit 1.

**Exhibit 1. The Four Loyalty Segments – Loyalty Does Not Always Mean Profits**

| | Low loyalty | High Loyalty |
|---|---|---|
| **High profit** | 15-20% [Butterflies] | 30-35% [True-friends] |
| **Low profit** | 30-35% [Strangers] | 15-20% [Barnacles] |

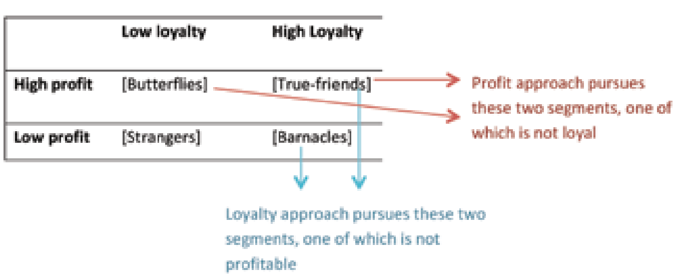
*The purpose of the above table is to illustrate that there is a large proportion of low-loyalty customers who are profitable and a large proportion of high-loyalty customers who are not. (The figures are approximations derived from Reinartz and Kumar and may not be quantitatively generalizable.)*

**"No company should ever take for granted the idea that managing customers for loyalty is the same as managing them for profits."**
— Werner Reinartz and V. Kumar

As summarized by Reinartz and Kumar, "A sizable percentage of long-standing customers … are only marginally profitable, whereas a large percentage of short-term customers are highly profitable." For every high-loyalty but low-profit "barnacle," there is a low-loyalty but high-profit "butterfly." If we pursue only high-loyalty customers, 35 to 40 per cent of the customers we pursue will be customers that do not generate enough profit for the company and even generate loss, while we ignore a corresponding number of customers who are not considered loyal but are profitable.

*Loyalty does not equal profitability.* A third or more of loyal customers could be unprofitable or even drain a company's resources. From a profitability perspective, some loyal customers are not worth pursuing, while some fleeting customers may be. It is worth cultivating a subgroup of loyal customers – those who are loyal and profitable – but

**Exhibit 2. Loyalty Does Not Always Imply Profits, and Profits Do Not Always Imply Loyalty**




not *all* of those who are loyal. In terms of the four segments described in exhibit 1, the loyalty approach would also deploy resources on retaining barnacles, who are not profitable, while ignoring butterflies, who are (see exhibit 2).

## Chimes of Loyalty Leading to Higher Market Shares

> Higher market shares almost always lead to higher loyalty. But higher loyalty does not necessarily lead to higher market shares.

Another common assumption is that our market share will increase as the number of loyal customers increases. This is not supported by facts either. A glaring example of this is the Mac computer. Since it came out in the 1980s, it has had a fiercely loyal following (see for example, *The Cult of Mac*, by Leander Kahney, 2004). Yet it had a near-death experience in the 1990s, saved by a change in management and an infusion of capital from Microsoft. Apple did not become the hugely successful company it is today until it introduced high-penetration products such as iPod, iPhone and iPad.

Higher market shares almost always lead to higher loyalty, as we shall see later. But higher loyalty does not necessarily lead to higher market shares. Since we already have some evidence that loyal customers don't necessarily act as our evangelists, we cannot depend on our loyal customers to bring in new customers. Some proportion of our loyal and fleeting customers will recommend us to others. But an organization cannot leave growth solely in the hands of loyal customers.

Exhibit 3 summarizes what we know about loyalty, based on objective data.

Loyalty that does not take into account profitability is a poor business strategy.

**Exhibit 3. What We Know about Loyalty**

Loyalty is not the same as profitability.

Not all loyal customers are profitable.

Some loyal customers are a drain on the company.

Not all profitable customers are loyal.

Some non-loyal customers are highly profitable.

One hundred per cent loyalty is neither possible nor desirable.

Customer retention is not necessarily inexpensive.

Loyalty does not always lead to higher market share.

## The Strange but True Case of Unearned Loyalty

This may sound strange, but loyalty is not always "earned." Every brand has a baseline loyalty. It is unearned in the sense that baseline loyalty is not dependent on a company's efforts but can be predicted from mathematical models using a brand's and its competitors' market shares. Such predictions hold unusually well when we compare them to actual data.

For example, John Bound (2004) tried to predict how many customers would buy a brand of instant coffee once in a given period and how many would buy it more than five times. The data he used were nothing more than (1) the proportion of customers who bought instant coffee at all, (2) the average number of purchase occasions for those who do buy any instant coffee, (3) the proportion of buyers buying each brand, and (4) the average number of purchases for each brand. The information used to predict did *not* include any other data. Yet Bound was able to predict loyalty (in terms of customers' buying). Exhibit 4 shows how close the predictions were.

**Exhibit 4. Predicting Baseline Loyalty from Market Shares and Average Purchases**

| Brand | % Bought | 5+ times |
|---|---|---|
| | Actual | Predicted |
| Folgers | 18 | 19 |
| Maxwell House | 20 | 19 |
| Taster's Choice | 18 | 18 |
| Nescafe | 12 | 16 |
| Sanka | 19 | 16 |
| Maxim | 23 | 14 |
| High Point | 16 | 14 |
| Brim | 15 | 14 |
| Average | 17 | 16 |

You will note that loyalty (illustrated in exhibit 4 as those who bought more than five times during a given period), which is predicted for each brand by a purely mathematical model, fits extremely well for each brand, with the single exception of Maxim. Such exceptions may actually tell us something about the brand. There could be a reason why the actual loyalty is higher than the model's predicted baseline loyalty for Maxim and, to a certain extent, for Nescafe.

A more recent example is provided by Peter Fader and Jordan Elkind, of the Wharton School, ("Open the Blinds," *Marketing Research*, Summer 2012), who tried to predict share of wallet (a good measure of loyalty) for five online travel firms – Expedia, Orbitz, CheapTickets, Travelocity, and Priceline – using market share as input. Their mean prediction errors (MAD) for share of wallet ranged from an average of 1.5 per cent to 2.2 per cent.

In both the above examples, the loyalty level predicted by the models did not take into account the efforts made by the companies in increasing customer loyalty. The closeness of these predictions (and many such others) clearly shows that a baseline loyalty exists for each firm, irrespective of what the firm does.

## Where Does That Leave Us?

So far, research has established the following:

- Loyalty can lead to profitability, but not necessarily. There are as many unprofitable loyal customers as there are profitable non-loyal customers. It is not optimal use of a company's resources to attempt to keep *all* loyal customers.

- Some level of baseline loyalty exists for all brands, purely based upon a brand's market share vis-*à*-vis its competitors.

If we are interested in our company's profitability, what should our strategy be, since pursuing only loyal clients appears ineffective? If there is a baseline loyalty for every brand, how do we increase it? Can we generate excess loyalty for our brand – loyalty that is in excess of the baseline loyalty? We will consider these issues in the forthcoming articles.

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