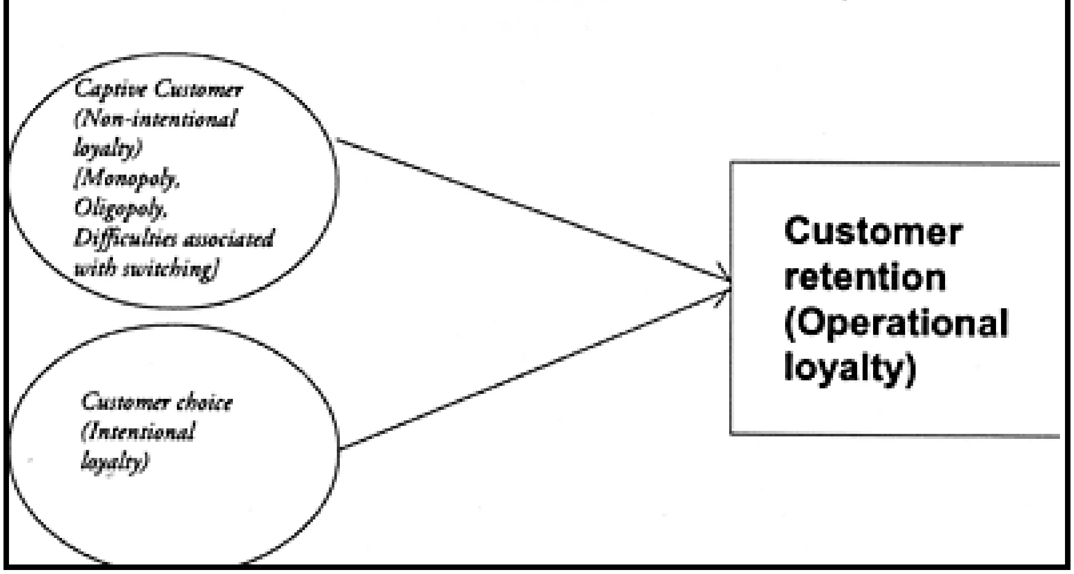
Customer loyalty and customer value - 2
Customer retention curves and the loyalty challenge

Chuck Chakrapani

What is loyalty?
Loyalty can be defined in many ways. For measurement purposes, loyalty can be defined as a customer doing repeat business with us. With this definition, the best measure?ment of customer loyalty is customer retention. The assumption here is that the higher the customer retention, the higher the loyalty. However, this is not an entirely satisfactory definition. For instance, as we shall discuss later, sometimes customers who would rather not deal with a given institution still stay with it. This happens fairly frequently in monopolistic and near monopolistic situations.

So as not to get bogged down in definitions, we will accept the general definition of loyalty as the customer's act of doing (as opposed to willingness to do) repeat business with an institution. Even so, we should be careful not to confuse the operational definition of loyalty with its linguistic definition which implies voluntary willingness to do repeat business with an institution.

Exhibit 1. Sources of customer retention: Captivity vs. Choice



Customer satisfaction vs. customer loyalty
What is the relationship between customer satisfaction and customer loyalty? Given the current emphasis on customer loyalty, can we assume that customer satisfaction is an outmoded concept?

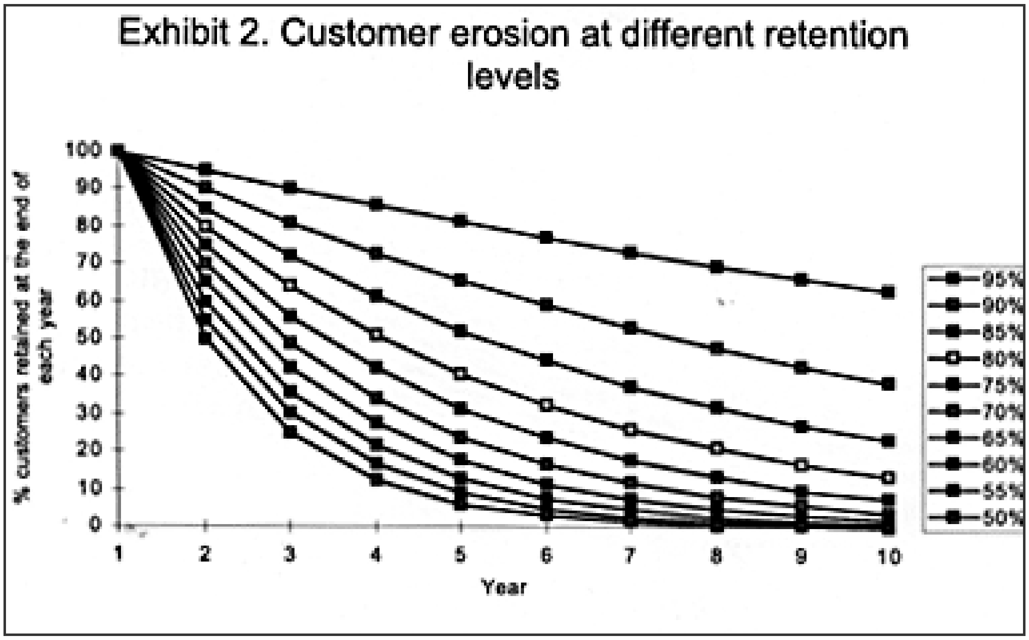
Frederick Reichheld estimates that 65% to 85% of all defectors say that they were satisfied with the firm they left (Loyalty-Based Management, Harvard Business Review, March-April 1993.) This leads us to wonder why we should measure customer satisfaction at all.

The best way to understand the relationship between satisfaction and loyalty is to view customer satisfaction as a necessary but not a sufficient condition of loyalty. If a customer is not satisfied with an organization, he or she is not likely to be loyal to the firm (except in situations where the customer does not have a choice). So customer satisfaction is the first step to customer loyalty.

Our objective then is two-fold: to keep as many customers as satisfied as possible and to retain as may of the satisfied customers as possible.

The customer retention effect
The effect that customer retention (often referred to as loyalty) has on profits is not fully appreciated even by those who use these measures. The main reason for this is that relatively small changes can result in relatively large profits. For instance, a customer retention rate of 95% does not seem to be much higher than a customer retention rate of 90%. But, as we shall see, this difference is by no means small.

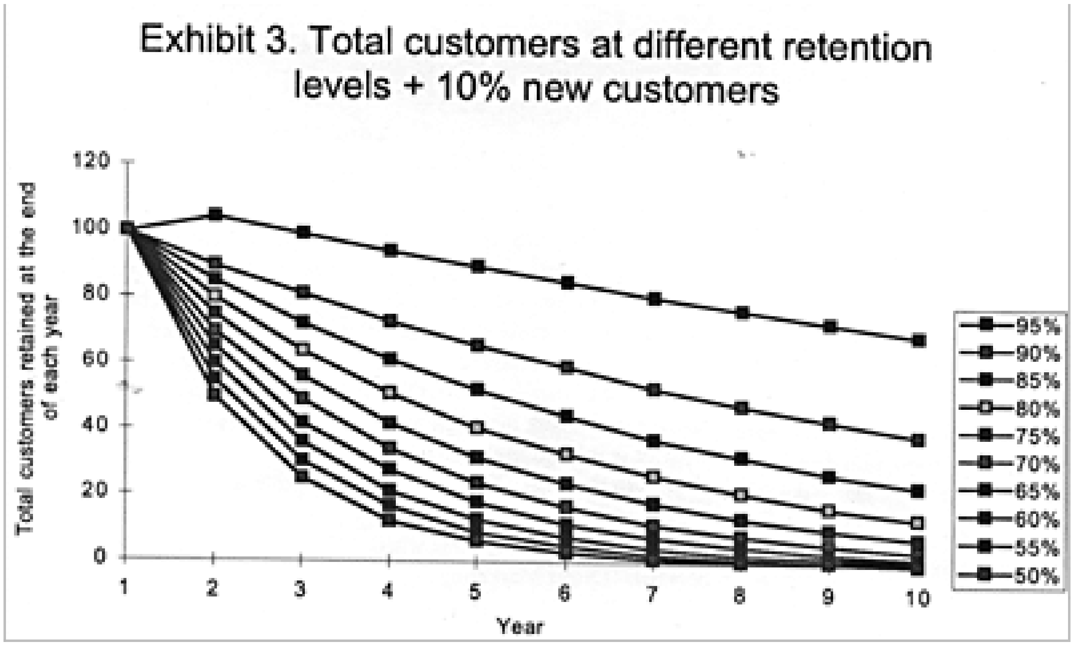
Customer retention curves
Let us consider 10 institutions with different retention rates: 5%,10%, 15%, 20%, 25%, 30%, 35%, 40%, 45%, and 50%. Where would they be in 10 years from now, if they do not replace their lost customers? Exhibit 2 shows the effect of different retention rates assuming that no new customers are gained during the periods under consideration. When the retention rate falls below 90%, 'half-life' of the company or retention of no more than 50% of the customers is reached in six years or less! Even if an institution retains almost 85% of its customers half of its customers will be gone in a little over 5 years. This fact is not intuitively obvious. Customer loss is a more serious problem when we view it in the long term than when we look one year at a time.



Gain-loss analysis
A more realistic scenario would assume that organizations are also engaged in constantly seeking new customers. Let us assume that the ten organizations illustrated in Exhibit 2 also gain customers at the rate of 10% a year. The combined effect of erosion and gaining of customers is shown in Exhibit 3.

The charts clearly show how difficult it is to make up for customer erosion. Exhibit 4 shows the percentage of customers that must be gained to offset different rates of annual loss levels.

Obviously the more new customers we need to gain to make up for lost customers, the tougher our challenge. Practically all research in this field (e.g. studies by TARP) clearly indicates that it is much easier to hold on to our current clients than to acquire new ones.

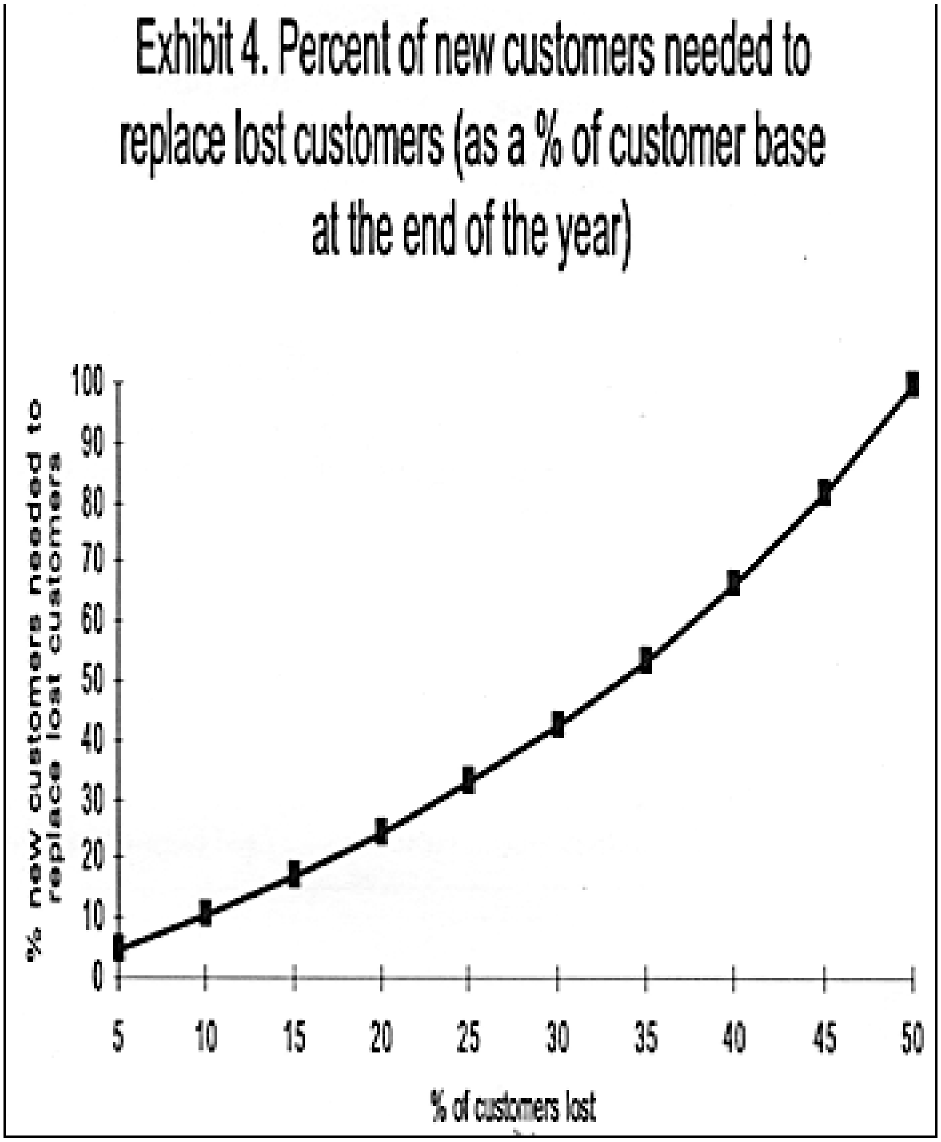


Double jeopardy
The challenge in the forthcoming years is much greater for organizations in a monopolistic or oligopolist situation. This would include most utility companies and many large-scale financial institutions. There are two reasons for this:

1. In a monopolistic or near monopolistic situation, it is hard to isolate captive customers from voluntarily loyal customers. It is reasonable to assume that at least part of client retention could be attributed to lack of real choice. So technology and global competition is a greater threat to monopolistic and near monopolistic org-anizations.

2. If you examine the retention rate curves (Exhibit 2 and 3) you will note that a fall in retention rate (of say 5 percentage points) for organizations with high retention rates is much more detrimental than a similar fall in retention rate for low retention organizations.

As a consequence high retention organizations face a double jeopardy: First, they are much more vulnerable to customer defection than low retention organizations. Second, similar defection rates are more damaging to high retention organizations that to low retention organizations.



Towards zero defections
The cost of acquiring a new customer is currently estimated to be about 500% higher than that of retaining a current one. When we examine the retention curves (Exhibit 2) along with the effort required to replace lost customers (Exhibit 4), it becomes clear that loyalty is top priority for any organization that guards its bottom line profitability. It is unlikely that we will ever achieve zero defections and yet, given what is at stake, it's again worth attempting.

From operational loyalty into intentional loyalty
In measuring and implementing loyalty programmes, many organizations with traditionally high retention rates face the loyalty challenge. It is important for them to know now-more than ever-why they have retained a large proportion of their customers: is it because customers intended to be loyal or is it because they had few choices in the past?

Not every one will agree with Professor David Foot's view when he writes (Direct Marketing News, May 1997) "There is not one organization today that is loyal to me. Not my bank, credit-card company, auto dealership, or grocery store, and certainly not my phone company. There's not one that remotely understands what customer loyalty is really." Yet it is obvious that many organizations, in their attempt to gain customer loyalty, can go a lot further to be loyal to customers.

Dr. Chuck Chakrapani of Standard Research Systems can be reached at (416) 340-1722 or
srsystems@msn.com .