

Feature Story

How Can You Measure Loyalty?

Are these customers “loyal”?

- You’re DuPont, and one of your customers is a chemical engineer buying polymers from you under a master purchasing agreement. He receives a volume-pricing discount. This customer represents a lot of revenue and repeat business for you, but is he loyal?
- Pfizer relies on physicians to prescribe its pharmaceuticals. One doctor admits that, all other things being equal, she specifies Pfizer drugs because she appreciates the educational seminars the company provides each spring in Florida. How loyal is she?
- A business traveler can buy coffee anywhere but seeks out Starbucks in whichever city she finds herself because she knows she can relax there. Can Starbucks assume it has created a loyal customer?
- An office manager gives Staples high customer-satisfaction scores for breadth of merchandise, good pricing, and friendly service. He also carries one of Staples’ *Business Rewards* cards. Can we assume he’s loyal?
- Nike has strong repurchase rates among amateur athletes who find Nike shoes a better fit for wide feet. Are these buyers loyal to the Nike brand?

Each of these scenarios describes a loyal customer. “Loyalty” comes in many forms. But should it be defined as

a feeling? An attitude? Or is behavior the only thing that counts?

The key to loyalty measurement is having a very clear picture of the economic value you are trying to create. If there is no expectation of superior economic value in either the short or long term, then initiatives intended to inspire customer loyalty can’t possibly pass the basic business-case test.

The Business Case for Loyalty

For most businesses, the promise of customer loyalty implies potential economic value creation with some combination of the following five dimensions.

First, many companies invest disproportionately in *customer acquisition* at the beginning of the relationship, placing themselves in a negative economic position. The hope (a.k.a. “the plan”) is to pay off the initial investment many times over through retaining customers and capturing the lion’s share of their spending in the category year after year.

Second, loyal customers may be inclined to buy more types and more volume of products and services from you, thereby generating an *enhanced return* over the life of the relationship. Estimate how much these customer spend with you over their lifetimes, and arrive at the financial benefit.

Third, loyalty can be a *strategy for reducing ongoing expense*. A company that is retaining customers is one that can, in theory, reduce its investment in customer replacement. By closing the proverbial hole in the bottom of the bucket through which customers leak out, the company can improve profitability substantially. This was amply demonstrated by Frederick Reichheld in his breakthrough 1996 study, *The Loyalty Effect*. It analyzed the bottom-line value of an additional five percentage points in retention rate, across a variety of industries. [For an exclusive interview with Reichheld on his current thinking, please see page 10.]

If you hear a lot of companies talking about the importance of customer retention, it’s because they have good reason. Competition in most industries is brutal. Customers are promiscuous. Couple these trends with the old-but-true saw that it costs more to acquire a customer than it does to retain one, and focusing your marketing efforts on existing customers makes sound business sense. The more attractive and relevant your value proposition remains to your customers, the less likely they are to defect to the competition.

Fourth, customer loyalty can be associated with *lower price elasticity* and willingness on behalf of the customer to pay more for the privilege of doing business with you. Higher margins almost always drop to the bottom line.

And finally, loyalty can be equated with the mother of all profitability engines — *referrals*. If loyal customers are happy customers, then it's likely they are unpaid ambassadors for your company, spreading the word on how wonderful it is to do business with you. That saves you real money in reduced customer acquisition costs.

Four Types of Loyalty

There are four essential types of loyalty, each with its own benefits, risks, and measurement approach. You may be able to distill your market into categories that align with these four loyalty types.

1. **CONTRACTUAL LOYALTY.** When a customer purchases from you through a formal agreement, you have contractual loyalty. This is very common in business-to-business situations. The DuPont example falls into the contractual loyalty category. Contractual loyalty also applies to consumer situations like subscriptions for newspapers and magazines, or for cable, telephone, or broadband services.

Contractual loyalty can be very profitable when looked at on the basis of the net present value of the contract. But it is often less profitable as contracts come up for renegotiation and competitors use aggressive promotional tactics to steal your customers. Contractual loyalty also can instigate dissatisfaction. Customers may feel trapped in a business arrangement. Dell uses its key account service program, Premier.Dell.com, to add value to the traditional contractual



relationship by allowing corporate buyers to place their orders online 24-7, buying under the terms defined in their contracts. However, the computers still have to match the needs of the customers.

2. **TRANSACTIONAL LOYALTY.** Repeat purchasing without any contractual obligation can be called transactional loyalty: The customer is in the market for widgets, and you sell widgets. Loyalty is based on factors such as price, value perception, and convenience. The customer may find a better deal at any time, and if so, will switch without hesitation.

The doctor giving her prescription-writing business to Pfizer is an example of transactional loyalty. She writes one prescription at a time. Because the doctor's loyalty is affected by her value assessment — the product costs her nothing,

and she gets a free trip to Florida each year — the economic relationship is vulnerable to a better deal. If some other pharmaceutical manufacturer develops a better educational curriculum in a more attractive warm weather location, it is likely the physician will prescribe equivalent products from the new company.

Transactional loyalty is easy to stimulate with promotions or rewards programs. But to the degree non-core components are used, "loyalty" can be difficult to sustain at an acceptable profit level. It's also important to note that transactional loyalty can be achieved solely due to customers' perception of the switching cost associated with moving their business. With financial services, consumers may perceive a hassle in switching banks for marginally superior value propositions.

3. **FUNCTIONAL LOYALTY.** To the functionally loyal customer, the product's very attributes are perceived as superior, thus preferable. One wireless phone company may provide better reception near the customer's home, making for functional loyalty. The Nike example also falls into this category; if you have wide feet, you develop a very functional loyalty to shoes that fit.

Functional loyalty is often the first hope of efforts to differentiate. To the degree that you can offer customers something tangibly, palpably different yet relevant to the category purchase, you

can lock up the portion of the market that prioritizes your advantaged function.

- 4. EMOTIONAL LOYALTY.** This is the “feeling” part of loyalty, in which a customer develops preferences for products or services based on their appeal to the individual’s values, ego, sensibilities, or other intangibles. Customers identify with the brand, like the traveler searching for a Starbucks, because they seek some nonfunctional benefit from the association or experience. Emotional loyalty is the Holy Grail for many marketers — most often sought and least often attained.

One of the primary pluses of emotional loyalty is its ability to withstand challenge to the economic or service relationship: Emotionally loyal customers will forgive minor errors in their experience and maintain the relationship. Also, emotional loyalty often is associated with price premiums in powerful brands that have no discernable differences in form, function, value, or convenience.

Loyalty and Satisfaction

Over the years, most companies have acknowledged that happy customers are more likely to be repeat customers than unhappy ones. Owing to the difficulty of defining “happy,” loyalty indicators predominantly have been linked to satisfaction measurement. Some have even gone further, setting their sights on nothing less than “delighting” customers or eliciting the rare reaction of “wow.”

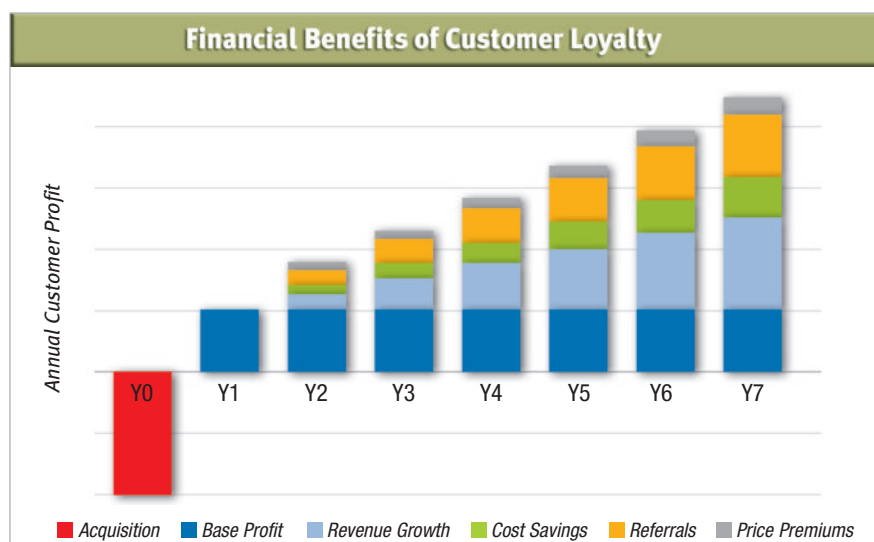
Yet none of these descriptors has proven sufficiently objective to span business units, channels, or customer touchpoints so as to create a consistent standard for managers to achieve. Nor has any been more than loosely correlated to incremental profitability because few attributes are so distinct that they exceed the matching efforts of competitors. Nevertheless, the majority of mid-sized to large companies today have some sort of measurement system for customer satisfaction, if for no other reason than to ensure continued performance at or above their category’s competitive standard.

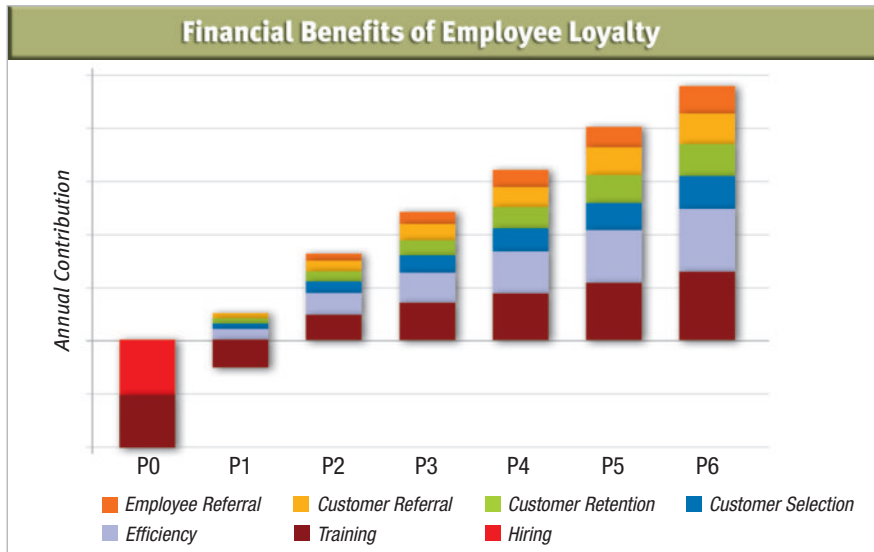
Satisfaction = Loyalty?

Satisfaction, though necessary, is an insufficient solo condition for loyalty. You can achieve high levels of satisfaction yet not inspire any real loyalty. For an example, look no further than your local car dealer. Automotive companies have been fast — and thorough — in their willingness to embrace satisfaction metrics. But anyone who has bought a car knows

how sales reps manipulate the satisfaction scoring system. In a quiet moment during the new car delivery process, when one might reasonably expect the customer to be at the very peak of happiness, salespeople blithely inform their customers of the impending arrival of a J.D. Power satisfaction survey. Even if dealerships play it straight and work hard to meet customers’ needs, the manufacturers they represent have no better insight into customer loyalty.

That’s because functional satisfaction doesn’t necessarily ensure that either behavioral or emotional loyalty will follow. Satisfaction rates among U.S. auto buyers are often reported in the upper 80th percentile range — this past summer Toyota Motor Corp. topped the University of Michigan’s American Consumer Satisfaction Index with an 87 — but actual manufacturer repurchase rates hover in the 30th to 40th percentile range. Dealer loyalty is even worse, with only about 20% of customers returning to the same dealer to purchase their next car. This





suggests that even though customers may want different car experiences every three to five years, no one auto manufacturer is meeting their needs. Loyalty is low in the category, regardless of what satisfaction scores say.

To reinforce the point, a number of academic studies in recent years have shown that satisfied customers don't necessarily buy more or more often, in any category. Satisfaction as a proxy for loyalty is relative to each brand's position in the market at any given time. If we accept that the perception of value most heavily influences

comparative purchase decisions at any point in time, and past satisfaction is but an element of that perception, then if company B offers me greater value, all my satisfaction with company A likely will not prevent my switching for greater relative value.

So if you cannot rely on satisfaction metrics to measure loyalty, what is the solution?

How to Measure Loyalty

The overwhelming evidence today points to the power of triangulation — evidence of emotional loyalty coupled with one or more elements of functional, transactional, or contractual loyalty. Emotional loyalty overcomes problems, sustains the brand relationship, and drives a desire to repurchase.

When paired with a strong rationale of a functional, contractual, or transactional nature, the combination works to erect barriers to competition and decrease price elasticity.

We know that the drivers of loyalty are complex, and may be based on different — but equally important — factors like experiences, beliefs, preferences, or fit with one's self image. But if we are investing in improving our products, services, or processes, we need to link those investments to specific economic value creation. And because after-the-fact measurement approaches may come far too late to eliminate bad investments or course-correct those with minor flaws, we need methods for forecasting the creation of economic value based on changes we see early in the market response cycle.

All this suggests that to successfully measure loyalty, we need first to define it in very specific terms that apply to the desired business outcome. For example, a gasoline retailer might define loyalty as a high share of customer, measured in gallons purchased annually. Because it has no idea of total consumption for each individual, the retailer estimates share of customer by looking at total household consumption of gasoline across the country and breaking it down into purchase deciles. The marketer assumes, by studying aggregate driving behaviors in miles per year and average fuel economy, that the purchase patterns of drivers in the 7th decile represent the practical maximum annual purchase volume for most households. (Customers in deciles 8, 9, and 10 may be viewed as abnormally

	Citi	American Express	Wells Fargo	Capital One	Bank of America	Chase	Discover
Citi	42	6	14	16	2	4	5
American Express	8	65	6	11	1	4	8
Wells Fargo	11	4	38	3	7	9	4
Capital One	14	10	5	37	3	3	8
Bank of America	4	4	10	2	55	1	10
Chase	6	14	4	6	7	45	2
Discover	3	4	3	5	9	6	20

After 3 years, 42% of Citi customers remain loyal; 6% switch to American Express; 14% switch to Wells Fargo, and so forth. Numbers do not equal 100% due to options not shown.

high-mileage/low-economy drivers). Consequently, a customer purchasing 100% of the decile 7 consumption level is believed to be directing a high percentage of overall category business to the company and thereby judged to be very loyal (without indication of an emotional connection to the marketer as yet).

The retailer then collects self-reported survey data from customers in deciles 4, 5, 6, and 7 about their perceptions of the brand and its quality, convenience, value, etc. With this information, the retailer can build predictive models to estimate emotional factors' impact on purchase behaviors and thereby evaluate the potential return on spending more to drive emotional brand loyalty vs. investing in credit promotions, station lighting, or premium item giveaways.

Some marketers measure loyalty by engagement. They monitor the correlations between customers' actual purchase behaviors and the use of the brand Web site, interactions with customer service channels, responses to price increases or discounts, etc. Engagement actions, taken by the customer between purchase events, are generally good leading indicators of the customers' likeliness to repurchase or purchase complementary products or services. This is the basis of the bundling model being pursued so vigorously by telecommunications and cable companies today as they fight to get their hooks into customers by building high levels of engagement in the "stickiest" of services like broadband access or digital entertainment. A customer who orders three pay-per-view movies per month is far more likely to stick around than one who orders only sporadically.



So the measure of true loyalty doesn't rely on any single indicator but rather several, all pointing in a common direction. Here are a few we've compiled.

Indicators of Loyalty

Each kind of loyalty — contractual, transactional, emotional, and functional — is open to its own set of metrics.

Because *contractually loyal* customers are buying under a purchase agreement, the agreement and its status need to be measured. Ways to do this include:

- Share of market under contract
- Frequency distribution of contract profitability
- Frequency distribution of customer share of wallet
- Contract renewal rates (perhaps by inception date cohorts)
- Incidence of contract expansion into new product lines or business units
- Customer referral frequency
- Effective price changes at renewal

Transactionally loyal customers are characterized by patterns that can be teased out by data analytics, such as:

- Changes in recency-frequency-monetary value by customer segment or cohort group
- Velocity of change in segment mobility
- Cross-category purchase behavior and trends
- Latency (gaps between transactions)
- Frequency distribution of transaction value

With the *functionally loyal* buyer, the key is to closely monitor the basis of the functional preference. Measurement approaches include:

- Top-of-mind awareness on key functional dimensions
- Changes in perceptions of key functional attributes vs. those of competitors
- Willingness to recommend
- Price elasticity

- Attitudinal surveys on key attributes
 - “like me”
 - “a brand I can trust”
 - “the right brand for the times”
- Competitive brand preference
- Price insensitivity
- Problem tolerance
- Resistance to competitive offers
- Overall brand preference

Timing Is Everything

While marketers and managers place high value on loyalty measurement, it’s important to not only select the

metrics carefully but time them right, too. With perceptual metrics such as those collected in surveys, experience has shown how the timing of the question can influence the result. Too soon after the transaction the response reflects the “honeymoon” when the consumer wants psychological reinforcement of his or her spending behavior. But too long after the transaction, many of the discriminating details can be lost, resulting in mid-range scoring patterns. The goal is to pick a time when the customer’s perspective will be fresh, but reflect consideration of the experience vs. expectation.

With those guidelines, it is critically important to continuously measure loyalty. Too many companies are still fielding monthly or quarterly surveys, then reading the results several weeks after the data is aggregated. This makes it difficult to gauge the impact of any single or series of loyalty initiatives precisely: Too many variables may be present to tease out causality. Instead, the more effective approach is to sample customers every day or at least every week and continuously read moving averages (of sufficient sample size). With time, you’ll be able to isolate the exact time when customers’ perceptions or beliefs changed and correlate that to both behavior changes *and* the presence of the loyalty stimulus.

A Simple Loyalty Segmentation

Recognizing that satisfaction is NOT a predictor of economically profitable behavior (although dissatisfaction has been found to be highly predictive of negative economic behaviors), many companies look to factors such as “likelihood to recommend,” “likelihood to continue as a customer,” and “good value for the money” to triangulate on a customer’s loyalty.

Using 1-to-5-point scales for each, with 1 being very low and 5 being extremely high, customers who rate the company as a 4 or 5 on each of the three dimensions are considered “loyal.” Those who rate the company high on any two dimensions but low on the third are assumed to be “vulnerable.” And customers rating the company low or neutral on two or more dimensions are assumed to be “neutral” — neither loyal nor disloyal.

On a scale of 1 to 5, with 1 being the lowest and 5 being the highest, please rate us on each of the following:			
	“Loyal”	“Vulnerable”	“Neutral”
Likelihood to refer a friend to us	4	2	2
Likelihood to purchase from us again soon	5	4	3
Value you get for the money you spend with us	5	4	4

The simplicity of this approach can also be its downfall. Be careful to validate that these are the right questions for your business and that the results correlate to actual customer spending patterns with respect to longevity, frequency, or share of customer.

The Bottom Line Is the Bottom Line

Ultimately, the objective of a loyalty measurement process is to forecast changes in customer profitability. Loyalty, properly measured, is a leading indicator of future purchase behavior, and thereby profitability. It’s not about satisfaction, transaction frequency, or favorable imagery. The relationships between them drive shareholder value. There are many ways to measure loyalty. The key is to measure more, do it faster, and connect your measurements to the economic outcomes of the organization. With a focused approach on the key drivers of loyalty in your business — contractual, transactional, emotional, or functional — and a set of metrics against each, you will manage customer loyalty in an efficient and actionable way. 