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• Customer Relationship Management Systems can provide false or bad data in reference to the between profitability and loyalty.
• Pumping money into customers who have no intention of repurchasing can cost companies huge amounts of money.
• Event History Modeling is a much more effective measurement of customer profitability and loyalty.
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The True Cost of Loyalty

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Marketing Metrics: Note for Marketing Managers

The Fallacy of Customer Loyalty

- Traditional theory is that the best customers are loyal customers. They are willing to pay more than other customers and cost less to maintain.
- Upon research we discovered little or no evidence to suggest customers who purchase steadily over time are necessarily cheaper, less price sensitive or particularly effective at bringing in new business.
- According to a case study performed by one US high tech service provider. Which investigated the actual payoff of their $2 million annual investment of customer loyalty program. Found the following.
- About half of the customers that made regular purchases over the past 2 years "loyal customers" barely generated a profit.
- In support of this they found that half of the most profitable customers purchased a high margin of products in a short time.

Is loyalty Profitable ?

- To test this the relationship between customer longevity and customer profits were observed in four different companies.
- The expected results were to fins a positive correlation between customer loyalty and profitability.
- However the correlation coefficient were as follows.
    - French Grocery Store .45
    - Service Provider .30
    - Brokerage Firm .29
    - Mail Order .20
- To test this correlations we investigated the 3 claims of customer loyalty.

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Three Claims of Customer Loyalty

- Claim # 1- It cost less to serve loyal customers.
  - In researching the four individual companies we assessed that even with a difference in spending by a factor of a 100, we noticed that none of the four companies showed that long term customers were consistently cheaper to maintain than short term customers. In fact the only strong correlation found was that long term customers were more costly to maintain.
  - This is strongly supported in the B2B industry where customers purchase high volumes from suppliers and know the value of their account. This leads them to use that leverage to exploit the suppliers in order to get premium service or price discounts.
  - At the very least the link between loyalty and lower cost is industry specific.

- Claim #2- Loyal customers pay higher prices
  - Research has shown that loyal customers actually spend between 5%-7% less on average and as high as 9% on specific categories of products.
  - No evidence to show that loyal customers paid higher prices in consumer businesses.
  - In fact loyal customers are more sensitive to price increases then new customers. For example in the mail order company loyal customers would choose lower cost alternatives vs new customers who are not familiar with the catalog.
  - Surveys have shown customers resent companies who try to profit from loyalty.

- Claim #3- Loyal customers market the company
  - In our experiment with the French grocery chain we asked customers four different questions to measure Attitudinal, and Behavioral loyalty levels.
    - First we inquired how many time they recommended the particular store when asked.
    - Second we asked whether they spontaneously told friend or family about the company.
    - Third we investigated each customers level of loyalty by evaluating their purchase behavior.
    - Lastly we solicited their attitudinal loyalty in telephone surveys were we asked how satisfied they were with the company and asked if they were interested in switching to another company.
    - Our findings showed that customer longevity has little to no relation to the propensity for customers to market by word of mouth.
    - In fact customers who scored high on both loyalty levels were 54% more likely to actively market by word of mouth, and were 33% more likely to passively market by word of mouth.
  - Thus it is important for business to learn and understand when to "fire" a customer.

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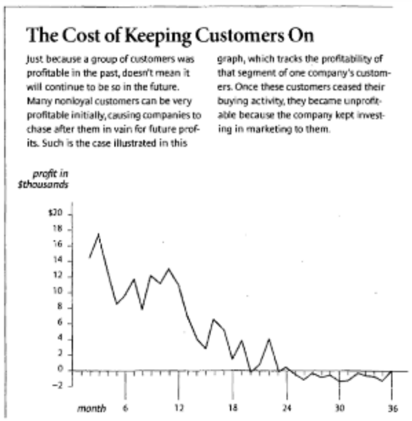
Knowing When to Fire a Customer

- The link between loyalty and are weaker than expected and none of the usual justification for investing in loyalty stands up to examination.
- The most common way to sort customers is to score them according to how often they make purchases and how much they spend. Which has proven to be an over investment in lapse customers.
  - For example lets review two customers that began purchasing during the first month of the year. The two customers purchase at different rates. Customer x purchases at a rate of every 2 months and customer y every 6 months. At first glance you assume that customer x deserves more investment since they purchase more frequently. But an RFM evaluation would fail to take into account if a lapse in purchase happens. In this example customer y is still within his/ her purchase window so in probability the chances that a purchase will be made is higher and will likely be a safe bet for further investments.

  - The equation for probability that a customer will keep on purchasing is t^n where n represents the number of purchases made within a certain time period and t represents the number of months between first and last purchase.


The Cost of Keeping Customers On

Just because a group of customers was profitable in the past, doesn't mean it will continue to be so in the future. Many nonloyal customers can be very profitable initially, causing companies to chase after them in vain for future profits. Such is the case illustrated in this graph, which tracks the profitability of that segment of one company's customers. Once these customers ceased their buying activity, they became unprofitable because the company kept investing in marketing to them.

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From Measurement to Management

- After analyzing your customers profitability and projected duration of their relationship to the organization you can place each of them into four categories. Its also important to know what type of relationship management strategy to apply to each segment.

Which Customers Are Really Profitable?

When customers are sorted according to their profitability and longevity, it becomes clear that the relationship between loyalty and profits is by no means assured. Here, a sizable percentage of long-standing customers in all four companies are only marginally profitable, whereas a large percentage of short-term customers are highly profitable. It is these segments that drive down the overall correlation between loyalty and profitability.

	Short-term customers	*percentage of customers*	Long-term customers	*percentage of customers*
High profitability	corporate service provider	20%	corporate service provider	30%
	grocery retail	15%	grocery retail	36%
	mail-order	19%	mail-order	31%
	direct brokerage	18%	direct brokerage	32%
Low profitability	corporate service provider	29%	corporate service provider	21%
	grocery retail	34%	grocery retail	15%
	mail-order	29%	mail-order	21%
	direct brokerage	33%	direct brokerage	17%

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Choosing a Loyalty Strategy

When profitability and loyalty are considered at the same time, it becomes clear that different customers need to be treated in different ways.

	Short-term customers	Long-term customers
High profitability	**Butterflies** • good fit between company's offerings and customers' needs • high profit potential *Actions:* • aim to achieve transactional satisfaction, not attitudinal loyalty • milk the accounts only as long as they are active • key challenge is to cease investing soon enough	**True Friends** • good fit between company's offerings and customers' needs • highest profit potential *Actions:* • communicate consistently but not too often • build both attitudinal and behavioral loyalty • delight these customers to nurture, defend, and retain them
Low profitability	**Strangers** • little fit between company's offerings and customers' needs • lowest profit potential *Actions:* • make no investment in these relationships • make profit on every transaction	**Barnacles** • limited fit between company's offerings and customers' needs • low profit potential *Actions:* • measure both the size and share of wallet • if share of wallet is low, focus on up- and cross-selling • if size of wallet is small, impose strict cost controls

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Effectively Managing the Four Different Customer Groups

- **Turning True Friends into True Believers (Most Valuable Group)**
  - In managing true friends the biggest trap is overkill. For example increased solicitation is more likely to put them off then keep them aboard as customers.
  - Companies need to tailor their marketing plan towards customers who scored highly on attitudinal and behavioral loyalty measures can greatly increase profits
  - In the case of the French grocery store customers who met these criteria increased profits by over 120%.
  - In the case of commercial industries the same customers increased profits by up to 50%
  - In order to maintain these True Believers it is important to create creative ways of rewarding their loyalty. EX: mailing recipes, exclusive wine tastings, etc.
- **Enjoying Butterflies (Second most Valuable Group)**
  - Customers who are profitable yet transient.
  - Classic mistake with these is to invest in them after the activity drops off, most resources are invariably wasted.
  - In fact most Butterflies conversion rates are 10% or lower in the four companies we studied.
  - In practice this usually means a short term hard sell through promotion and mailing blitzes. Ex: special offers on other or similar products.
  - The most important part is to find the right moment to cease investing in them.
- **Smoothing Barnacles (Third Most Valuable and Most Problematic)**
  - These customers do not generate satisfactory returns on investments made in account maintenance and marketing because the size and volume of transactions are to low.
  - First step is to determine if the problem is a small wallet or a small share of the wallet.
  - Small wallet- customers are not valuable to begin with and are not worth chasing.
  - Small Share- could spend more and should be chased.
  - This is effectively done by looking a POS data on the type and amount of product the individual purchases. EX: Up selling memory upgrades or software to a consumer who purchased a computer.
- **Strangers (The Lost Cause)**
  - Customers who have no Loyalty and bring in few to no profits
  - Most efficient method for dealing with these kinds of customers is to identify quickly and cease investing immediatly.

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