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Buying the Business – Re-defining "Loyalty"

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I - The Problem With "Loyalty"

There is a definitional problem that underlies the challenges faced by companies involved in "Loyalty" programs. Outside of the narrow world of marketing and promotions, loyalty generally defines an emotional relationship between or among individuals. In our world, the term "loyalty" has morphed into a business process that can best be defined as "schemes that help consumers earn value (points) for transacting with a company, and then redeeming that value for products or services at some point in the future." Additional functionality can be added to a "loyalty" program, such as value added services provided for higher value customers, but the core of the program is nearly always providing a customer with some form of currency in exchange for their continued patronage.

Just to be clear, this is not loyalty; it's incenting (bribing) customers to enable habituation in order to increase customer profitability. Not that there's anything wrong with that, but real loyalty is emotional and it has to do with faithfulness and mutual obligation between two parties. Customers are fiercely loyal to Apple to the point where they will pay whatever it takes to get their products. Apple rewards that faithfulness by their continued delivery of products and services that delight customers and work really really well. That's loyalty. Unfortunately the term has been hijacked by industry to define a business relationship that has very little to do with the emotional connection between a loyal customer and a faithful merchant, and this clouds thinking and creates strategic confusion.

To be fair, it's not anyone's fault that loyalty has morphed into a commoditized points management business. The concept of "do this now, get this later", embedded in traditional loyalty schemes is the result of the technological limitations inherent in processing systems that were prevalent when loyalty programs were developed. Programs had to be supported by batching transactions and recording value over a periodic cycle. There was no way to track points without direct linkage to a processing cycle, and the customer's progress and status was included in a monthly statement. Over time batch became institutionalized as the expected process by which repeat purchase and visit behavior was rewarded. Programs proliferated, moving from airlines where they began, into payment cards and ultimately into all forms of consumption from retail to hospitality. According to Colloquy's 2011 Loyalty Inventory[1], the number of loyalty memberships in the U.S. has more than doubled since 2000, from **973 million to 2.09 billion**. **And the numbers of programs per household rose by more than 50% since 2006, from 12 to 18, but customers are active in only 8 to 9 of those programs.**

If instead of calling it "loyalty" and thinking about it in the traditional "do this now get that later" paradigm that has little to do with real loyalty, think of the business process as "*increasing customer value through the deliberate use of behavioral psychology*", and call it "*customer reward/incentive programs*". This will give us a much clearer view of the landscape and enable more realistic decisions to both improve business performance and increase the value of customer relationships.

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[1] Kelly Hlavinka, Jim Sullivan: "The Billion Member march: The 2011 Colloquy Loyalty Census", Colloquy Talk (04.11)

II – Does "Loyalty" Work?

There's ample data to support the assertion that consumers love these programs and take advantage of them, but what are they doing for the companies that manage and fund them? It's tough to objectively separate response to loyalty programs from all the other behaviors that can motivate a consumer to select a particular business over another, but there are some studies that have been done that raise questions about the value of traditional loyalty programs.

Magi[2] (2003) analyzed the impact of loyalty cards on sales volume and customer share spent at grocery stores. Her analysis found only mixed support for the positive effects of loyalty cards on customer share. At the primary store level, loyalty cards had no impact on share-of-purchase and share-of-visits, while at the chain level there was only a positive impact for card members who only hold the focal chain's card. ***Further, the presence of more than one loyalty card in a given category actually showed a negative impact on purchase habits.*** (Author's italics)

Reinartz and Kumar [3](2002) studied the dynamics of customer loyalty by evaluating more than 16,000 individual and corporate customers of four companies over the course of four years. They, too, found limited support for the claim that loyalty programs incentivize a higher level and more frequent consumer spending. ***In fact, the researchers found no evidence that consumers who make steady, consistent purchases over time are cheaper to serve, less price sensitive, or particularly effective at bringing in new business.*** (Author's Italics)

On a more encouraging note, Liu [4] (2007) found that there was an increase in customer spend and visit frequency in a two year study of a convenience store loyalty program. The increase was differentiated, however in that the most significant lift in consumer behavior was among light and moderate users rather than heavy users, whose spending showed little change. ***Her conclusion was that among heavy users, a loyalty program is more likely a defensive tool, while for light and medium users, the program can help to consolidate spend at the loyalty provider.*** (Author's italics)

Clearly, there have been successes with traditional loyalty programs. Most notably the travel/hospitality and the credit card industries have used the programs to build their businesses over the years. But with a 50 percent increase in the number of programs per household in the last 5 years (Colloquy), and with households only active in about half of those programs (Colloquy), and some fairly solid research that indicates that traditional programs

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[2] Anne Magi: "Share of Wallet in Retailing : The effects of customer satisfaction, loyalty cards and shopper characteristics", Journal of Retailing, 79 (2003): 97-106

[3] Werner Reinartz and V. Kumar: "The Mismanagement of Customer Loyalty", Harvard Business Review, July 2002

[4] Yuping Liu: "The Long-Term Impact of Loyalty Programs on Consumer Purchase Behavior and Loyalty", Journal of Marketing, Vol. 71, (October 2007): 19-35

aren't doing what they're supposed to do, it's safe to say that a lot of money is being left on the table, and it's not clear that **any** traditional "loyalty" program in this environment can deliver sufficient incremental value to business to offset the expense. So what to do? **Change the model.**

III – The Environment – It Ain't Just Points

Beyond the increasingly ineffective structure of traditional loyalty programs, a confluence of external forces is creating an environment where programs require either re-definition or re-creation. Here are a few of the factors that are changing the customer incentive and reward universe:

1) *Deals, deals, deals* – Promotional offers directly connect the incentive with the reward for the customer, a "do this now – get this now" model that has a much more powerful and immediate impact on customer behavior than the "do this now – get that later" model of traditional programs. The promotional environment has exploded with dramatic increases in off-price deals, and new coupon aggregators like Groupon and LivingSocial. Google Offers now has the ability to link promotions to contextual advertising and potentially improve the responsiveness of an offer by targeting the right individuals.

   Promotional marketing is getting saturated however, and the results are less than stellar:

   "In 70 percent of package-goods categories last year (2010), at least 30 percent of merchandise was sold with some kind of promotional support, according to Symphony IRI; that's up from 60 percent of categories four years ago. In all, two-thirds of categories saw increased promotional support last year. But average volume lift per merchandising event declined across more than half — 57 percent — of CPG categories last year, according to the research firm. (Advertising Age, January 2011[5])

   While increasingly inefficient, the sheer volume of noise around deals and offers diminishes the perceived value of traditional reward/incentive programs.

2) *New channels* – Information regarding reward/incentive programs used to be one-way communication delivered from the program provider to the customer via mail in the customer's statement. Two-way communication was only encouraged (or even allowed) for problem resolution with calls directed to a call center or worse, a VRU. With email, instant two-way dialog was enabled, dramatically increasing the customer's ability to

[5] Jack Neff, "Why Promotion May End Up a Bad Deal for Packaged Goods", Advertising Age, January 31, 2011

interact with the program manager. Now, mobile has created the ability for companies and customers to interact and transact in real time, anywhere. For example, PayPal can deliver its payment capabilities anywhere the customer chooses to be, and the customer can talk right back.

All communications can be public and all value can be transparent. Control of communications has been ceded to the customer. The proliferation of channels also enables new ways to engage and interact with customers, before, during or after a transaction, in-store, or at the POS terminal.

3) *New Technology* – Smart phones and tablets offer a new user interface and create new opportunities to communicate with customers. Simultaneously, the ease with which a customer can navigate an environment on a tablet or a smart phone makes traditional point and click searches appear sluggish and “corporate”. More importantly, the device goes with the customer and that means the customer can change the way they do business with the store. Aisle Buyer is a good example of moving the transaction to the customer and changing the way that customers can be incented and rewarded.

4) *New players* – Beyond coupon aggregators, other organizations are entering the space and reinventing it in the process. Merchant Funded Reward Network players such as Affinity Solutions are aggregating merchants to create very low cost or even revenue generating programs for their clients. And, the providers of traditional loyalty programs themselves are disaggregating into a “best of breed” model where companies can pick and choose components from different players.

5) *New customers* – There is a generational divide on consumption of products, services, media and technology. The Baby Boomers and the Millennials are the two largest demographic cohorts in history and they currently reside on either end of the demographic spectrum. No program can effectively deliver an equivalent value proposition to all cohorts with the same messaging, channel or technologies.

Any business currently offering or contemplating the development of a customer reward/incentive program needs to factor all of these variables into the mix, both to make sure that the customer base is being engaged when, where, and how they want but also to make sure that incremental value from the program is optimized.

IV – So, Why Have a Program At All?

There are a lot of ways to spend money in a business and a lot of those don't directly drive sales and profit. If there is one program that should, it should be the program that is in place to reward and incent customer behavior**.**

And there are only three things that any reward and incentive program should expect to accomplish for a business:

1) **Profitably increase average spend per transaction**
2) **Profitably increase frequency of usage/visits**
3) **Increase per customer profitability in a given period**

That's it.

Any other objective, like, say, customer lifetime value, improved perception of the enterprise, or positive perception of the brand are potentially excellent benefits to get from a program but they should not be the primary reasons for doing a customer reward/incentive program. If the above three key criteria are not met, it's likely that the economics won't work so they must be the criteria that determine the need for and value of any customer incentive and reward program.

It could be argued that customer longevity should be included as a criterion but the truth is that without increased spend, frequency, or profitability, longevity has no value to the enterprise beyond the average revenue per customer that the individual generates in any given measurement period**. In fact, if a customer is part of a reward/incentive program and is not changing their behavior to increase their value to the business over time, the carrying cost of that customer is actually increasing and their value is shrinking because the liability cost for the customer increases but the revenue they generate for the enterprise does not.**

So to review;

- Most loyalty programs are working off an antiquated batch processing model
- The number of consumers enrolled in programs has grown exponentially since 2000
- As has the number of programs per customer
- But consumers are active in less than half of the programs they're enrolled
- Research shows questionable economic benefit to companies with existing programs
- Technology has improved so that now there are a lot of different ways to reward and incent customer behavior
- There are only three things that an reward/incentive program can do: profitably increase average spend per transaction, profitably increase visit frequency, and increase per customer profitability in a given period

Why have a customer reward/incentive program? Well, if you have a business where there is a need to generate incremental sales and visits with the same customers over time and you are open to re-thinking the way that a program is delivered and executed, customer reward and incentives can move the needle. And that's what we'll talk about next.

V – Building a program – What to do?

If you're thinking of launching or re-tooling a customer reward/incentive program in the environment described above, what are the questions that you should ask to determine if the program will deliver real value to the enterprise?

Here are the questions that I would be asking myself:

1) **Why do we have a program?** Is it because we now assume that its "table stakes" and we'll lose market share without it? Has it just always been there and we've been focusing on other things, or is it a strategic asset that makes a significant contribution to the value of our enterprise?
2) **Is it making money? What does the program <u>really</u> cost?** Are all the costs being factored into the equation, or are we just looking at program administration, marketing expense and point liability? Are we also looking at consulting fees, redemption management expense, statementing cost, customer service and call center costs, training of front line staff and others in the organization not directly connected with the program, direct and indirect IT cost, and website development and maintenance, among others? What about the opportunity cost of focusing so much resource on the loyalty program instead of working on other ways to improve the value proposition and competitive position of the business? And then there's the cost of business that we would have gotten from the customer anyway even if there wasn't a loyalty program in place.
3) **What can we reasonably expect a program to do for the business?** Aside from improving profitability, should we expect anything else? Is it really creating and retaining profitable customer relationships or is it just habituating them to the program, and is that necessarily the best way to create a "sticky" customer?
4) **What is it actually doing for the business?** Is the program generating incremental revenue and profitability well in excess of the total program costs? Is it creating franchise value for the enterprise and creating shareholder value?
5) **Are there other investments that we could make that would deliver more value to the business?** Do we need to commit to a status quo level of spending against the loyalty

program forever, or could some funding be diverted into other areas that have the potential to do more for the enterprise long term?

6) **Why should our customers choose us over a competitor?** Is it reasonable to assume that a program creates enough differentiable value to attract customers or keep customers from leaving? How much value does the program deliver within our value proposition? Any at all?
7) **How does the program fit in the overall product mix?** Is it one of several different offerings or programs with variable benefits, or is it core to every product or service offering? How does it impact the perceived value of the company's product offering with consumers? Is it creating positive or negative perceptions?
8) **Are we using the data that the program creates?** Is the data being integrated into the broader vision of the customer in the CRM? How does customer behavior in the loyalty program impact other aspects of the customer's relationship with the organization? What can we learn that will help us improve the customer experience and shareholder value? If we're not learning anything from the data that we're collecting, then why are we collecting it?
9) **How does the program affect the customer experience?** Is it positively changing customer's perception of the company, or is it an add-on that effectively complicates things from a product delivery and purchase decision point of view?
10) **What do customers really think of the program?** Do they see it as a valuable component of the product offering or do they see it as a giveaway that they are entitled to because everybody offers a points program? Is the program meeting their needs in terms of rewarding them appropriately when they exhibit the right behavior, or are reward thresholds too high to be meaningful?
11) **If we shut down the program tomorrow, what would happen?** Would any negative economic impact be offset by the expense savings from not having to operate the program? How long would the negative impact last? What would happen to the customer mix, would the customers who deliver the most value to the business be significantly impacted?
12) **What do we mean by loyalty?** Finally, are we actually creating loyal customers, or are we deluding ourselves? Are there other, better ways to create loyalty to the business and "sticky" customers that would have a more beneficial and lasting impact?

VI – Building a program – How to do it

The next obvious step, if you decide that a reward/incentive program is in fact a good idea, is to determine the best approach, and there are a lot of choices.

Program Design Principles

Every business has different paths to nirvana (nirvana = bigger sales and/or more sales and/or more profitability per customer), so each program design must be unique. ***That means that the program that was designed for your competitor is not necessarily the same program that will be effective for you***. While the design for each business may be unique, the core principles that need to be addressed are functionally the same:

Program Design Principle Template

Design Principle	Indicated Actions
Different customer segments will have different responses to the same incentives	Develop a detailed segmentation strategy that can be used to create differentiated incentives/rewards by segment
Customer behavior in response to the program determines program success in achieving objectives	Use the principles of behavioral economics to develop the program
Rewards and incentives can take place before, during and after the desired behavior	View the customer's interactions holistically, and design rewards and incentives to drive the desired behavior
Customers, not the enterprise, decide how, when and where to connect with the enterprise	Design the program to deliver appropriately at every customer touch point
We are never the customer's only choice	Assume every transaction decision made by a customer is made in the context of a competitive choice.

The indicated actions shown above are the core tenets of program design and deserve some more explanation;

- **Develop a detailed segmentation strategy that can be used to create differentiated incentives/rewards by segment –** As was shown in research (LIU), high value customers don't necessarily deliver the level of lift that can be expected from newer or less valuable customers. So, the strategy with the best customers may be retention vs. growth. And because these customers are habituated to points, they become an expected component of their universe and can fail to drive incremental behavior. In that situation, non-monetary value can make a significant difference. For frequent flyers, there is huge value to being able to board the plane first so that they can stow their carry-on baggage before all the space runs out. Each segment needs separate analysis and program design to optimize return.

- **Use the principles of behavioral economics to develop the program –** One of the problems with the traditional points based loyalty model is that it assumes that the same stimulus that generates a response in customer A will have a similar effect on customer B. A discipline has emerged, behavioral economics, which seeks to understand how customer perception and behavior can impact an economic decision. The discipline can be used, along with segmentation to understand and predict customer behavior in certain situations and that can be applied to program design.
- **View the customer's interactions holistically, and design incentives and rewards to drive the desired behavior –** The traditional "do this now, get that later" model is no longer necessary or relevant to many transactions between an enterprise and a customer. Appropriately frequent, relevant interaction with the customer increases responsiveness, and that can take many forms, from sending an email about a sale that is interesting to the customer, to a bounce-back coupon on the customer's phone after they've made a purchase, to a simple "Thank you for the business" at a time when it's not expected.
- **Design the program to deliver appropriately at every possible customer touch point –** Assume that there is no "primary" form of contact with a customer. Instead, assume that the customer will choose to interact with the organization when, where and how they choose and it's your job to be there when they do.
- **Assume every transaction decision made by a customer is made in the context of a competitive choice –** *Who "owns" the customer? No one. The customer "owns" you, if you're lucky*. Every transaction is a micro-decision on your relevance and value to the customer. No matter how entrenched a customer, they nearly always have a choice and in certain circumstances they will exercise that choice. To keep a customer, first "do no harm", and then do a whole bunch of good stuff to make sure that the customer's micro-decisions are generally in your favor and not in the other direction.

What's next?

Execution! Building a customer reward/incentive program that delivers significantly more value than it costs is really hard. It not only takes a clear understanding of the goals and really good, focused thinking, it demands a concerted and sustained effort to build and deliver it to customers. It's a perpetual effort and it's never done. Perhaps one last question to add to the questions asked above would be; "If we build this, are we willing to keep it going forever?" Execution is everything.

The traditional loyalty model is not achieving the kind of results that businesses require in this environment and there's no room for programs that don't pull their own weight. The combination of an obsolete core platform and a rapidly changing environment leaves no room for status quo "loyalty" programs. Re-design, Re-engineer, or Re-create, those are the options. You can profitably improve the value of your customers to the enterprise through rewards and incentives, and the good news is that there have never been better tools available to build a program that delivers value to the enterprise AND to the customer.