CHAPTER ONE

Customer Loyalty

The Way to Many Happy Returns

I'm often asked, "Does customer loyalty still exist?" Many think it has forever vanished and that lowest price is the only thing that keeps a customer returning. But, take heart. Customer loyalty is alive and well. Look no further than computer systems manufacturer Dell Computer, affinity credit card issuer MBNA, or home improvement retailer Home Depot and you'll find companies that are consistently earning customer loyalty while their competitors struggle. But each of these companies would also tell you that in today's unforgiving marketplace, creating and maintaining customer loyalty is more complex than ever. Here's why.

Two dovetailing events have dramatically expanded *how* companies pursue customer loyalty. First, widespread use of the Internet has changed how customers expect relationship-building to work. No longer is marketing and sales information simply pushed toward the customer. Now, a company must also allow customers to pull the marketing information they want, when they want it, and complete the purchase process on their terms.

Second, technology breakthroughs, particularly in the area of knowledge management, offer new and innovative ways to nurture customer relationships. Now a company's ability to thrive depends on capturing appropriate customer data from multiple points of customer contact: a Website click stream, e-mail, telephone, fax, a call center, a kiosk or store, a reseller, or a direct sales force. When used correctly, this data enables the company to individualize its response to each customer interaction in what's often referred to as "mass customization."

These two dovetailing advances have created customers of a new breed, with one distinguishing quality: they want to buy the way they want to buy. Yet most companies have not caught up with this newly empowered customer, and the customer experience has suffered. Consequently, the customer feels underwhelmed, overpromised, and underdelivered. Little wonder, then, that the level of customer loyalty is so low!

In a period of unprecedented marketing innovation like what we've experienced since the mid-1990s, it's tempting to dismiss many of the true principles for building customer loyalty and instead rely solely on a perceived panacea or silver bullet. We've seen plenty. From loyalty card schemes and point programs to CRM (customer relationship management) software to massive data warehousing efforts, firms have plowed millions of dollars into such areas in search of a quick fix. But not surprisingly, many firms report disappointing results. Headlines such as "The Truth about CRM: What You Need to Fight the Hype"[1] and "Delusions of Loyalty: Where Loyalty Programs Go Wrong"[2] are increasingly appearing in industry publications, reflecting confusion, concern, and an urgent search for a better way.

Your best insurance for building a strong loyalty strategy in the new millennium is to make sure your programs are built around the tried-and-true principles of loyalty. Without a doubt, more and more breakthrough technologies will evolve. The best way to leverage these exciting new tools is to ensure that they are applied to plans and programs that embrace strong loyalty principles. Otherwise, your probability of real success is limited. As Willie Nelson croons, "It's time to get back to the basics of life"; that's what this book is all about. Let's get started.

THE WAY TO MANY HAPPY RETURNS

Although customer satisfaction is necessary to any successful business, we are learning that satisfaction alone is not enough to build a loyal customer base. In the 1980s and 1990s, customer satisfaction was the watchword for business. Everyone was rushing around to find a way to make customers happy by meeting and even exceeding their expectations. The theory was that if customers are satisfied, they buy more and do so more often. Books, articles, and seminars touted such buzzwords as *customer service, service quality,* and *service excellence.* Behind all this was the belief that customer satisfaction produces positive financial results, especially in repeat purchase. Yet the latest research findings suggest otherwise: a high level of customer satisfaction does not necessarily translate into repeat purchases and increased sales. Consider these findings:

- Forum Corporation reports that up to 40 percent of the customers in its study who claimed to be satisfied switched suppliers without hesitation.[3]

- *Harvard Business Review* reports that between 65 and 85 percent of customers who chose a new supplier say they were satisfied or very satisfied with the former one.[4]
- Peter ZanDan, whose company Intelliquest conducts market research studies for computer manufacturers worldwide, reports that in more than thirty thousand interviews, his company has never found a high level of customer satisfaction to be a reliable predictor of repeat purchase.
- Research conducted by the Juran Institute reveals that in excess of 90 percent of top managers from more than two hundred of America's largest companies agree with the statement "maximizing customer satisfaction will maximize profitability and market share." Yet, fewer than 2 percent of the two-hundred-plus respondents were able to measure a bottom-line improvement from a documented increase in the level of customer satisfaction.[5]

Most managers assume that a positive correlation exists between customer satisfaction scores and customer buying behavior. The general belief is that increasingly higher satisfaction scores from a customer are followed by an increase in the customer's share of spending, rate of referral, and willingness to pay a premium price. Yet, as the findings I've cited illustrate, this correlation is unreliable. Satisfaction level does not necessarily translate into higher sales and profits.

What accounts for this disparity? Why would customers indicate one thing, yet do another? A number of factors contribute to the problem. At the time customers are queried about their satisfaction, they are unaware of future decisions and actions. For example, a software company analyzed the satisfaction ratings of a group of customers taken a short time before they defected to a competitor and found the ratings virtually identical to those of an equally large group of customers who remained with the company. Yet these reportedly satisfied customers went to a competitor once they became aware of greater value.

Another reason satisfaction scores are unreliable is that people often use these surveys as a way to communicate desires beyond the norm of sufficiency. This is often the case with price. The Juran Institute reported that for more than 70 percent of businesses studied, price scored first or second as the feature with which customers were least satisfied. Even so, when nearly all of the customers who had shifted spending to competing suppliers were interviewed, in no case were more than 10 percent of the lost customers motivated to switch because of price. In addition, a representative sample of customers who had exhibited the most loyalty in terms of buying behavior were as likely to report the same level of dissatisfaction with price as the lost customers.[6]

Perhaps the biggest reason for the disparity between satisfaction rating and repeat purchase is the measurement of satisfaction itself. Recent studies confirm that current satisfaction measurement systems are not a reliable predictor of repeat purchase. Some of the most convincing evidence is found in the research of Professor Robert Peterson of the University of Texas, who found that in most surveys of customer satisfaction, a substantial 85 percent of an organization's customers claim to be "satisfied" but still show willingness to wander away to another provider.[7]

This lack of correlation between customer satisfaction and repeat purchase may be partly due to the difficulty of accurately and reliably measuring customer satisfaction. Satisfaction measures are largely self-reported, which means that a customer answers a series of questions, usually in the form of a written survey. A number of factors can inflate a self-reported satisfaction rating[8]:

- *Question formation.* A question posed in positive terms ("How satisfied are you?" versus "How dissatisfied are you?") gets a more favorable response. The majority of satisfaction survey questions are posed in positive terms.
- *Measurement timing.* Measurements taken immediately after purchase are likely to yield more favorable responses than measurements taken later.
- *Mood of respondent.* A respondent's overall mood at the time of the survey can affect response.

An additional factor contributing to an overstated customer satisfaction rating is customer reluctance to admit having made a bad purchase. They feel a low satisfaction rating reflects badly on their purchase behavior or judgment. Therefore, they compensate by distorting their satisfaction with a higher-than-deserved rating.

Given the many problems with satisfaction measurement, it is little wonder that many companies are failing to find a strong relationship between customer satisfaction measures and economic performance. For example, the CEO of a manufacturing company that produces industrial equipment was feeling intense frustration with the lack of results from his firm's satisfaction program when he remarked, "It gives me a warm feeling to know that the customer satisfaction score is up again for the fourth straight year. Now, can someone tell me why profitability and market share are down again?"[9]

From the customer's inclination to overstate satisfaction to questionable extrapolation of data into sales and profit projections, one thing is certain: current satisfaction measurement systems cannot be used as a reliable predictor of repeat purchase.

THE TRUE MEASUREMENT: CUSTOMER LOYALTY

If customer satisfaction is unreliable, then what measurement is tied to repeat purchase? The measurement is *customer loyalty.* In the past, efforts to gain customer satisfaction have attempted to influence the attitude of the customer. The concept of customer loyalty is geared more to *behavior* than to attitude. When a customer is loyal, she exhibits purchase behavior defined as nonrandom purchase expressed over time by some decision-making unit. The term *nonrandom* is the key. A loyal customer has a specific bias about what to buy and from whom. Her purchase is not a random event. In addition, *loyalty* connotes a condition of some duration and requires that the act of purchase occur no less than twice. Finally, *decision-making unit* indicates that the decision to purchase may be made by more than one person. In such a case, a purchase decision can represent a compromise by an individual in the unit and can explain why he is sometimes not loyal to his most preferred product or service.

Two important conditions associated with loyalty are customer retention and total share of customer. *Customer retention* describes the length of relationship with a customer. A customer retention rate is the percentage of customers who have met a specified number of repurchases over a finite period of time. Many companies operate under the false impression that a "retained" customer is automatically a loyal customer. For example, the CEO of a burgeoning computer hardware company boasted, "We haven't got a loyalty problem; we've retained virtually every customer we've ever sold to." But on closer inspection, the executive discovered that at least 50 percent of retained customers (those who made a minimum of one purchase annually after the initial sale) were buying add-on systems and services from competitive vendors.[10] Retention was not the problem, but share of customer was.

A firm's *share of customer* denotes the percentage of a customer's budget spent with the firm. For example, a firm captures 100 percent, or total, share of a customer if the customer spends the entire budget for the firm's products or services with that firm. Whenever a firm's competitor captures a percentage of the customer's budget, then the firm has lost that portion, or share, of the customer.

Ideally, both customer retention and total share of customer are essential to loyalty. There are, however, some situations (government accounts, for instance) where the customer is restricted from purchasing from just one vendor. In such a case, earning a 50 percent share of the customer may be the most a firm can accomplish. Likewise, in many packaged goods categories, the buyer can be and frequently is multibrand-loyal. For example, a customer may be equally loyal to two beers, Michelob and Amstel, buying one this week and the other the next. In such circumstances, market conditions and product usage can dictate the limits of loyalty.

If customer retention and total share of customer are essential for loyalty, how are these buying behaviors achieved? An important first step is to notice how a number of well-established business strategies actually work against developing customer loyalty. The most frequently used of these strategies is market share.

WHY A MARKET STRATEGY CAN LIMIT LOYALTY

Since the 1970s, American companies have waged a fierce battle to win market share. In short, building market share by attracting new customers was considered *the* way to maximize profits. The belief was so popular that over the last two decades most leading U.S. firms pursued a market share strategy with the expectation that it was the surest way to the greatest profit. Pursuing market share has made many companies more concerned with finding new customers than with holding on to old ones. Statistics show that on average, American businesses spend seven times more money attracting new customers than trying to keep existing ones. Says Bain and Co. consultant Frederick F. Reichheld, "Ask a bank manager how many new accounts he signed up last month and he will probably know off the top of his head. Ask the same person how many accounts he has lost in the past month, and you will most likely draw a blank stare."

Table 1.1 compares the strategy of building market share with that of building loyalty. Note that although both strategies are used under the same market conditions (low-growth, saturated market), this is where the similarity ends. Success and failure in a market share strategy are evaluated in regard to competitors, while success and failure in a loyalty strategy are evaluated in terms of retention and share of customer.

ATTRACTING PRICE SHOPPERS, NOT LOYALTY SEEKERS

Because more effort is required to create customer switching than to maintain the status quo, costs are generally higher for the market share strategy than for the loyalty strategy. For example, in the market share strategy, a company often

Table 1.1. Increasing Market Share Versus Building Loyalty.

	Market Share Strategy	Loyalty Strategy
Goal	Buyer switching	Buyer loyalty
Market condition	Low-growth or saturated markets	Low-growth or saturated markets
Focal point	Competition	Customers
Measures of success	Share of market relative to competition	Share of customer; customer retention rate

uses a host of short-term marketing tools (a coupon, sales promotion, discounted price, and so forth) to woo the customer from a competitor. Though often creating a short-term boost in sales, these actions alone rarely create lasting value for customers, many of whom eventually leave for a competitor.

Consider the outcome of the "coffee wars." In the 1980s, three major brands—Folgers, Maxwell House, and Hills Brothers—dominated the ground coffee market. Each had roughly a third of the market and equally loyal consumer franchises. At one of the companies, a decision was made to implement an aggressive promotional plan to stimulate trial purchase among drinkers of competitive brands. The plan included heavy use of coupons to stimulate switching. The strategy worked so well that the other brands initiated similar programs. As a result, a massive war over market share began and heavy promotional activity became the industry standard. The results were disastrous for coffee manufacturers. By the early 1990s, brand loyalty had been severely eroded and many buyers had come to view coffee as a commodity rather than a preferred brand.

In the never-ending quest to build market share, these coffee manufacturers traded their brand-loyal customers for those who were price-sensitive and eroded their profits in the process.

But the damage didn't stop there. By turning the industry into a commodity market, the manufacturers unwittingly created a nearly perfect environment in which a little-known Seattle coffee retailer named Starbucks could develop a coffee bar empire. Under the leadership of CEO Howard Schultz, Starbucks looked closely at what was missing for coffee enthusiasts and created a unique way to address those wants. The company stopped thinking about coffee as simply a product that was bagged and sent home with the groceries and instead started selling coffee by the cup through Starbucks coffee bars.

Modeled after coffee houses in Italy, the Starbucks coffee bar was carefully designed to appeal to a coffee lover's five senses. The store's rich coffee aroma, married with flavorful coffee (at a premium price), browser-friendly product displays, beautiful music, and relaxing tables and chairs, were an instant hit with consumers who soon made a visit to Starbucks part of their daily routine. Today, the average Starbucks customer visits eighteen times a month and spends an average of $3.50 a visit. With close to three thousand stores and still growing, the company experienced 50 percent sales and profit growth through much of the 1990s. Starbucks is proof positive that real value, not price promotion, wins customer loyalty.

As the coffee industry illustrates, misused sales promotion can turn a loyal customer into a price-sensitive buyer. Research shows that such short-term marketing tools can increase the price sensitivity of all consumers. As a result, a company finds itself in a dilemma whereby it has little choice but to offer coupons and discounted prices because of continuous competitive promotion and strong customer conditioning. In this market, customers feel cheated when they don't have a coupon, rather than feeling rewarded when they do.

Home delivery pizza is another industry that has created a situation in which the customer is always searching for the lowest price. Customers who respond only to price cutting may churn orders, but they seldom become loyal customers. They buy from whichever vendor offers the lowest price.

WHEN HETEROGENEOUS CUSTOMERS MEET HOMOGENEOUS PRODUCTS

The problems with a market share strategy go even further. Pursuing market share can actually work against developing loyalty. Why? Because a substantial gain in market share can increase the diversity of the company's customer base. As a result, the company is forced to serve an increasingly heterogeneous base of customers with a homogeneous set of products and services. This disparity can create a dangerous dynamic within the company: the service and attention once available to high-potential customers are undercut and diluted to cater to an increasing assortment of less-promising customers. To make matters worse, the high-potential customers are undoubtedly receiving exceptional care and service from other companies in other industries. This positive experience with other companies makes them increasingly sensitive to and often intolerant of a company delivering anything less. It also makes them ripe for a competitor that can offer a more specialized product or service tailored specifically for the customer's particular needs.

Serving heterogeneous customers with homogeneous products has been the downfall of innumerable retailers, from department stores and variety stores to supermarkets, drugstores, and hardware stores. Caught in the middle and challenged on either side by specialty stores and volume discounters, many of these "all things to all people" stores have been forced to close their doors.

Those retailers that have successfully remained in the middle have changed their operations drastically. They have centralized management and downsized departments where they are unable to offer the customer a clear advantage. Many have remodeled their stores to resemble a series of specialty stores under one roof. In fact, such stores as Nordstrom and Lord and Taylor are no longer considered department stores but rather departmentalized specialty stores. Relationship building with customers is a priority. In many of these stores, a computer program linked to the cash register records the customer's address as well as purchase. The store uses the data to alert shoppers of sales and new merchandise shipments that match their buying profiles.

Today's companies must manage a strange paradox: in the race to win market share and its promise of profit, a company risks (and often loses) the highestmargin customers and in doing so worsens profitability rather than improving it. A company interested in building a solid, loyal customer base uses an approach different from that of a company interested in simply building market share. Loyalty building requires the company to emphasize the value of its products or services and to show that it is interested in building a relationship with the customer. The company recognizes that its business is to build a stable customer base rather than make a single sale. This shift in emphasis is sometimes subtle, but it is necessary to create loyalty among customers and an understanding of the importance of loyal customers to the company.

When Leslie Otten purchased Sunday River Skiway in Bethel, Maine, in 1980, he had a plan.[11] He intended to use all the well-established marketing techniques he'd learned to grab a share of the market for the largely unknown resort. By offering lower prices, longer hours, and more services, Otten expected to win his new customers by wooing them away from neighboring ski resorts. He knew that his resort was comfortable, attractive, and well managed, so there would be no reason for these new customers to be dissatisfied.

To Otten's dismay, he discovered that after five years of hard work, price cutting, creating customer incentives, sales, discounts, coupons, bonuses—doing whatever it took to get skiers to patronize his Skiway—results were less than satisfying. Sure, people came to his resort, just as they did to others in the area, but profits were not growing and his marketing tactics were not paying off.

This was when Otten sat down and took a long hard look at what he'd been doing. What he found when he examined his five-year company history surprised him. With the major emphasis on tracking sales and profits from new customers, old customers were going unappreciated and dropping by the wayside. Otten found that his staff was taking existing customers for granted. The staff assumed that Skiway didn't need to worry about losing those customers to the competition.

It was clear to Otten that he had to make a new plan to develop economic security for his business. The strategy he adopted flew in the face of standard procedures. Rather than striving for market share, engaging in a competitive discounting war, or luring new customers through short-term incentives, he decided to launch a campaign of "growing" customers.

The new plan paid off big. Instead of focusing only on increased services, price breaks, or longer hours, he and his staff began doing everything possible to turn first-time skiers—those who have never been "on the boards" before—into loyal customers. Otten's plan included making first-time visitors enjoy skiing at his resort so much that they would want to repeat the experience again and again.

Before Otten started courting first-time customers back in the winter of 1984–85, only 40 percent of the people who visited Sunday River ever returned. But thanks to Otten's retention programs, more than 75 percent now returned for more ski adventures. Those repeat enthusiasts were a major reason gross revenues increased from $6 million to $18.3 million. Pretax income climbed almost fourfold, to $4 million a year.

Otten explained his strategy: "If I can turn a first-time customer into someone who skis five times a year, that's $165 in revenue. Given that, I want to make the experience—especially the first experience—of dealing with us as pleasant as possible."[12]

For people just learning to ski, the process can be particularly frightening. Otten set out to minimize their anxiety. As visitors approached the resort, signs instructed them to turn their radios to Sunday River's low-power transmitter. A friendly, soothing voice welcomed them and explained where various slopes and services could be found. To make the transition to a snowy world even more pleasant, Often stationed helpers at every step along the way. His most experienced instructors were assigned to new skiers. Staff members helped new skiers select clothing, boots, skis, and accessories.

Unlike many business people who try to make their profit the first time the customer comes through the door, Otten barely broke even on skiers new to his resort. Instead, he offered incentives for customers to come back—again and again and again. On their first visit, novices paid for their first lesson, but equipment (skis, poles, and boots) and lift ticket were all free. The student was also given the chance to sign up for two additional lessons, which included the freebies. If students completed all three lessons, they were given a coupon for a fourth day of free skiing. Furthermore, Otten sold student poles, skis, boots, and bindings at cost.

The result of all this "nonprofit" activity was surprising. By the time skiers had finished the three lessons and free day at Sunday River Skiway, they were more than likely to become loyal customers. They were familiar with the resort, the ski areas, the equipment, and the service. Not only were customers satisfied; they were virtually sold on the resort as the place to ski. Return skiers guaranteed increasing profit and a stable growth rate.

It's been more than twenty years since Otten purchased Sunday River. A lot has changed. He's grown the company from a single small ski area in Maine into American Skiing, one of the country's leading operators with nine world-class ski resorts in both the eastern and western United States. Maintaining a keen eye on customer loyalty, the company resorts are increasingly embracing the Internet to help stay close to customers. As Skip King, vice president of communications, reports, "Our research shows that skiers and snow boarders, as a group, are strong users of the Web. Because they are well educated and affluent, they have early adopter tendencies, which makes the Internet and e-mail effective vehicles for communicating with them."

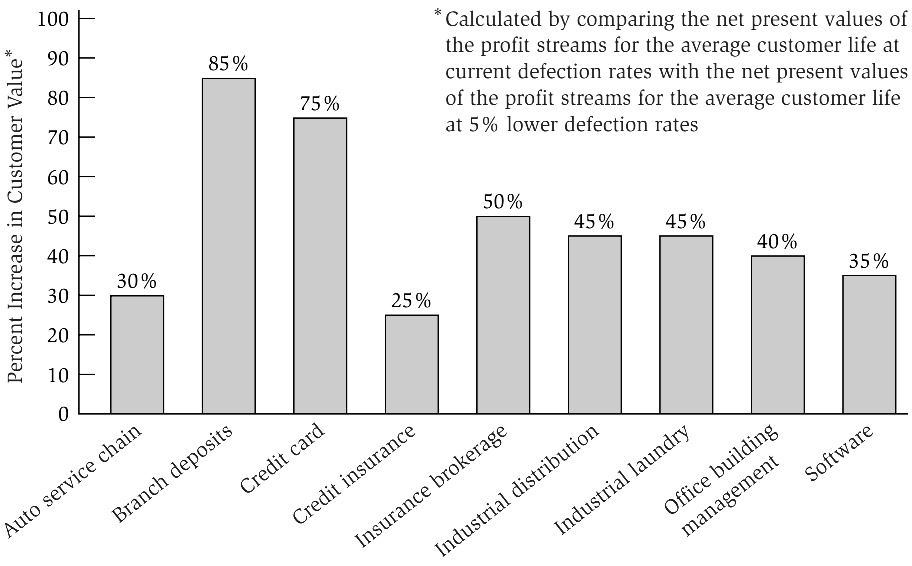
From e-mailing real-time trail condition maps to offering ticket sales online, and monitoring chat rooms and bulletin boards for ideas on better ways to serve customers, American Skiing recognizes the potential of online customer communication and is working hard to put these technologies to good use. King says that "for example, we're seeing significant year-to-year increases in online ticket sales, which is one indicator that we're moving in the right direction."[13]

The average American company loses 20–40 percent of its customers each year. Recognizing this pattern and its severe impact on corporate competitiveness and profitability, a business must move away from the long-accepted market share strategy to a radically different, more long-term approach to business: building customer loyalty. This reorientation produces significant results. Through increasing the rate of customer retention by as little as a few percentage points, banks, retailers, insurance brokers, distributors, health care providers, and software manufacturers can increase their profits by 25–100 percent.

THE LONGER THE LOYALTY, THE BIGGER THE REWARDS

The rewards of loyalty are long-term and cumulative. The longer a customer remains loyal, the more profit a business can reap from this single customer. Research shows that over a cross-section of industries (credit cards, industrial

Figure 1.1. Reducing Defections 5 Percent Boosts Profits 25–85 Percent.



Source: Reichheld, F. F., and Sasser, W. E., Jr. "Zero Defections: Quality Comes to Services." *Harvard Business Review,* Sept.–Oct. 1990, p. 110.

laundry, auto servicing, industrial distribution), the longer a company retains a loyal customer, the more profit that customer generates. For example, the expected profits from a fourth-year customer of an auto service company are more than triple those generated by the same customer in the first year. A company can boost profits 25–85 percent through increasing retention by as little as 5 percent[14] (see Figure 1.1).

If you find these profitability improvements too good to be true, consider a couple of factors. Increased loyalty can bring cost savings to a company in at least six areas: (1) reduced marketing costs (customer acquisition costs require more dollars); (2) lower transaction costs, such as contract negotiation and order processing; (3) reduced customer turnover expenses (fewer lost customers to replace); (4) increased cross-selling success, leading to larger share of customer; (5) more positive word of mouth; and, assuming loyal customers are also satisfied, (6) reduced failure costs (reduction in rework, warranty claims, and so forth).[15]

But the benefits of loyalty and its effect on profitability go well beyond cost savings. As usage increases, so does profit margin. For example, credit card companies spend an average of $51 to recruit a new customer. The person uses the card slowly at first, and the profit ratio is minimal. But a second-year customer is a different matter. Provided he has encountered no major problems with the company, he begins to use the card regularly and more often. The balance, and therefore the profit, grows. In the following years, he purchases even more and profits rise again. In comparison to acquisition spending, there is less expense involved in keeping this customer, and so the original $51 investment really begins to pay off.

This trend is true across industries. For one industrial distributor, profits grew steadily the longer a customer remained with the company. At some point, profits level off, but even after eighteen years with one customer the distributor found that profits from that customer were still going up. Otten, of American Skiing, said the motivating factor for his pursuit of lifetime customers was "greed"; he offered five reasons for wooing a first-time customer into becoming a lifetime buyer:

1. Sales go up because the customer is buying more from you.
2. You strengthen your position in the marketplace when customers are buying from you instead of your competition.
3. Marketing costs go down when you don't have to spend money to attract a repeat customer, since you already have her. In addition, as a satisfied customer she tells her friends, thereby decreasing your need to advertise.
4. You're better insulated from price competition because a loyal customer is less likely to be lured away by a discount of a few dollars.

5. Finally, a happy customer is likely to sample your other product lines, thus helping you achieve a larger share of customer.[16]

Regarding other product lines, Otten sells and rents lodging at his resort. Once he started building a loyal customer base, real estate income went up 52 percent, to $5.8 million, with pretax earning up 440 percent, to $1.3 million.

In addition to these five factors, one other element also supports retention. When a company is spending less on acquiring new customers, it can also spend money to continuously improve its product or service. This in turn can also help make customers more loyal.

THE LOYAL-CUSTOMER, LOYAL-EMPLOYEE CONNECTION

When a company is spending less to acquire new customers, it can afford to pay employees better. Better pay prompts a chain reaction, with a host of benefits. Describing this chain reaction, Frederick Reichheld says, "Increased pay helps boost employee morale and commitment; as employees stay longer, their productivity rises and training costs fall; employees' overall job satisfaction, combined with knowledge and experience, leads to better service to customers; customers are then more inclined to stay loyal to the company; and as the best customers and employees become part of the loyalty-based system, competitors are inevitably left to survive with less desirable customers and less talented employees."[17]

As a rule, customers are apt to become loyal if they develop a personal relationship with salespeople. A customer who regularly buys from the same person comes to rely on that person's help in making the next purchasing decision. Salespeople also find it easier to deal with the same customer again and again rather than having to establish a new relationship. This symbiotic relationship is beneficial both to the business and to the customer. In general, a repeat customer is likely to be satisfied, and an employee who is dealing with content customers is likely to enjoy the job more, do a better job, and remain with the company. A national automotive service chain implemented a customer retention program. Within a year, the company increased its retention rate by seven percentage points and reduced mechanic turnover to a fraction of the former level.

All businesspeople recognize that training a new employee costs both time and money, and that during the training period and for a time following, the employee is not functioning at maximum efficiency. If a company is able to retain good employees, loyalty both inside and outside the company improves.

THE COST OF LOSING A CUSTOMER

Just as customer retention has a positive impact on profitability, customer defection can have a negative impact. The very reasons a loyal customer is so profitable are the same reasons a lost customer is so detrimental. Simply stated, it costs less to sell and service a loyal customer. New customers are more costly. Therefore, defection by a long-term customer can cause a dramatic loss and affect the bottom line much more quickly than defection by a new customer does. It is difficult for a business to realize how expensive it is to lose a customer. (I analyze those losses in detail in Chapter Nine.) Today's accounting systems are designed to show short-term gains and losses and do not help track the benefits of maintaining a relationship with a customer over a long period of time. Expected cash flows over a loyal customer's lifetime cannot be evaluated using current systems. Yet it is clear that a satisfied, loyal customer can contribute a great deal to the financial bottom line of any company.

Consider the experience of Charles Cawley, president of MBNA America, a Delaware-based credit card company. Cawley recognized that customer defection could be an indicator of areas where the company needed improvement. In 1982, Cawley called a meeting of all three hundred MBNA employees and reported that he had had many letters from unhappy customers. He declared that from this point on, the company was going to work hard to keep these people happy and retain them as customers. To accomplish the goal, the company began asking questions of customers who were defecting: Why were they leaving? What were their problems? What did they want in a credit card company? Once the information was gathered, the company put together a plan of action and went to work. Products and processes were regularly adjusted to reflect the changing needs of the customer base.

As a result, fewer customers left the company. Eight years later, MBNA enjoyed one of the lowest customer defection rates in the industry. Some 5 percent of its customers left every year—half the rate for the remainder of the industry. Although the difference between 5 and 10 percent may seem insignificant, it reflected a huge difference in profitability. Without any acquisitions, MBNA's industry ranking moved from thirty-eight to number four. Profit soared sixteenfold.[18]

The company's loyalty legacy continues. Today, MBNA retains 97 percent of its profitable customers. In fact, the company is so committed to customer loyalty that it's the only credit card company reporting loyalty statistics in its annual report. This phenomenal customer loyalty rate drives the company's profitability. MBNA enjoys the best five-year annualized return of any bank in the S&P 500. In 2001, the company earned its fourth consecutive best-in-industry rank and inclusion in the Business Week 50, an annual ranking of America's best-performing companies.[19] MBNA is proof positive that customer loyalty drives company profits and long-term success.

The best alternative to expensive, short-term marketing tactics is a strategy that encourages customer loyalty. To begin this strategy formulation, let's take a close look at the dynamics of loyalty, covered in Chapter Two.

SUMMARY

- Contrary to popular opinion, you *can* earn loyalty from today's demanding customers.
- The Internet and other technological advancements offer new and innovative ways to nurture the customer relationship. But to be successful, these new strategies must be built around tried-and-true principles of loyalty.
- A high level of customer satisfaction does not necessarily translate into repeat purchases and increased sales.
- Question formation, measurement timing, and mood of respondent inflate a customer satisfaction rating and make it a poor predictor of purchase behavior.
- Unlike customer satisfaction, which is geared more toward attitude, customer loyalty is behavior-based; it is defined as nonrandom purchase expressed over time by some decision-making unit.
- Two important conditions associated with loyalty are customer retention and total share of customer. In the ideal, a loyal customer's purchase behavior reflects both of these conditions. The quest for market share can erode a firm's profitability and draw the focus away from its most profitable customers. Loyalty is the result of paying attention to what it takes to keep a customer and then constantly providing it. Increased customer loyalty leads to higher profitability, higher employee retention, and a more stable financial base.

GETTING STARTED

- At your next staff meeting, put this question to everyone: "Think about a company you most enjoy buying from. What is it about the experience that makes it pleasurable and keeps you coming back?" Compare those findings with your own company. What are some ways you can improve your company's customer experience?
- Look for ways to make customer loyalty an integral part of the company culture. For example, review the company's mission statement and the like, and insert the word *loyalty* in place of *satisfaction.* If customer loyalty is not part of the mission statement, consider adding it.

- Start immediately to educate employees about the reasons loyalty, not satisfaction, is the company's true goal. Use staff meetings, the employee newsletter, the employee Website, and so on, to get the message out.
- To better appreciate the financial rewards of customer loyalty, analyze two customers, a longtime one and a relatively new one. Create a side-by side comparison of marketing costs, transaction costs, cross-selling success, word of mouth, incidence of returns, and so forth between these two customers. The contrasts are likely to surprise you.