Loyalty — What can it really tell you?

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Abstract Loyalty schemes are the most effective method for retailers to find out who a large proportion of their customers are, to understand their buying habits, to capture extra information on them and then to model those findings across the whole customer base. With this in mind, this paper starts by looking at what loyalty schemes are designed to achieve and what the different types of loyalty model are, it then moves on to describe the key points of best practice when analysing the information that comes out of those loyalty schemes. In particular, it examines how such customer database analysis can reveal which customers deliver the bulk of revenue and/or profit, which value groups customers fall into, how to measure their increase/decrease in value and the kinds of initiatives that firms have put in place to encourage profitable customer behaviour.

INTRODUCTION

Most companies are aware that their marketing and finance departments conduct analyses of the customer database. But what can such analysis really reveal? What are these 'customer insights' that roll off the marketer's tongue? And how do they help to take the business forward 'strategically'? Drawing specifically on experiences in the retail sector, this paper reveals how powerful even the most basic insights are. The paper takes the retail sector as its basis for discussion because it faces the most challenging task of all, in that its customers must first be identified before any further action can be taken. This contrasts with sectors such as banking or insurance, which know from the very

start who their customers are and where they live.

Loyalty schemes are the most effective method for retailers to find out who a large proportion of their customers are, to understand their buying habits, to capture extra information on them and then to model those findings across the whole customer base. Just after the turn of the millennium, many pundits started claiming that loyalty schemes might be falling out of fashion. Safeway cancelled its scheme and Sainsbury decided to join a coalition scheme rather than run its own. However, the gloomsters and doomsters were denied satisfaction. There are now more loyalty schemes in operation in all sectors (but especially retail) and numbers continue to grow.

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Nevertheless, doubts still remain, with Vodafone and Barclaycard recently leaving the Nectar consortium loyalty scheme in quick succession.

It is therefore necessary to ask: what do loyalty schemes deliver? Is the outcome actually 'loyalty', or something that uses the word 'loyalty' simply as a convenient label? It is now accepted that loyalty schemes are more about identifying who the customer is, understanding their tastes and preferences, understanding who is valuable and how that value is changing and providing the customer with obvious value and relevance to encourage them to stay with — and spend more with — the retailer.

THE DIFFERENT LOYALTY MODELS

In the retail context, a loyalty scheme is the essential first step to obtaining the data-basis of database marketing; the following sections therefore review the main recognised loyalty models to show how they work and what data they require.

The Dirichlet model¹

This measures repeat buying and makes some simple assumptions, eg that consumers tend to have split loyalties to each of several brands. The application of this model is associated closely with the work of Professor A. S. C. Ehrenberg from South Bank University, London, UK.

The Dirichlet model is useful for predicting future sales performance, analysing the degree of cannibalisation of line extensions, possible success factors for new brands and analysing loyalty programmes (eg the levers: penetration of category, average frequency of buying category, average number of brands bought and market share). However, it

uses quantitative predictions and can be difficult to apply to a database of 1 million customers without modelling the data back, which has limitations of its own.

The Hofmeyr Conversion Model²

The understanding of the psychology of consumer attitudes is an area in which relatively few models exist. The Conversion Model, originally developed by Dr J Hofmeyr, is one approach to trying to rationalise the inconsistency between customers' expressed satisfaction levels and actual repeat purchase behaviour. The model is useful in that it attempts to identify the commitment of the consumer and is therefore a predictor of 'positive preference loyalty', as opposed to inertia or limited choice loyalty. For instance, analysis of brand position and competitors (brand equity) analyses the conversion potential of users and non-users (demographic and psychological differentiators). Again, it can be difficult to apply to a database of 1 million customers without modelling the data back, as it uses attitudinal, not actual, behavioural data.

The RED Matrix model³

This was developed by London-based consultancy, the RED Partnership, and is designed to measure an organisation's commitment and performance in ten major loyalty factors:

- 1 Commitment by management
- 2 Organisation and structure,
- 3 Knowledge and understanding of customer behaviour
- 4 Management of customer expectations
- 5 Integrated strategy
- 6 Relationship marketing practices
- 7 Customer service practices

- 8 Relationship marketing training
- 9 Performance tracking and continuous improvement
- 10 Relationship with other companies

This is very effective for a company examining itself, its commercial practices and how it views customer loyalty, but does not do much for measuring customer loyalty.

The Enis-Paul Index model⁴

The formula used to create the Enis-Paul Index is designed to calculate consumer inclination to patronise a given store during a specified period. In this approach, which defines absolute loyalty as 100 per cent and total promiscuity as zero per cent, a loyal customer would have to patronise few stores, spend a high proportion of his/her available budget in a preferred store and not exhibit switching behaviour.

It is expressed as:

$$L_i = (1/3) [b_i - s_i x(n + 1)/(k + n) - p_i/m]$$

Where:

- L_i = the loyalty of the (i)th consumer towards the store;
- b_i = the fraction of the budget for the product class allocated to the store during the survey period by the (i)th consumer;
- s_i = the number of switches from the store to other stores during the survey period by the (i)th consumer;
- p_i = the number of stores patronised by the (i)th consumer during the survey period;
- m = the total number of store visits during the survey period;
- $k = m - 1$ = the number of opportunities to switch stores; and

n = the number of stores available to the consumer to purchase product category goods during the survey period.

This is a technically impressive approach and makes great logical sense. The problem is (not surprisingly) putting such a range of metrics practically and consistently in place. In practical terms, the benefit gained is likely to be disproportionate to the effort and cost invested — not a concern for academic enquiry, but of the greatest concern for practical application.

Reichheld Loyalty Effect model⁵

This approach was made famous when published by Bain & Co as a review of company profitability related to customer retention rates. The analysis was based on companies in the service sector and the model identified six factors that would allow companies to form a clear view of a customer's life-time value:

- Cost of customer acquisition
- Base profit
- Increased profit from additional sales
- Reduced operating costs of a loyal customer base
- Profits from loyal customer referrals
- Price premiums charged to loyal customers who are less price sensitive

This is a seemingly straightforward model — and a favourite of the author's. It is clean, anyone should be able to understand its thrust. The only problem with it is finding accurate information to plug into the equations, in particular the:

- profits from loyal customer referrals and
- price premiums charge to loyal customers who are less price sensitive.

This is because most systems are not set up to consider this and it is very tricky to get this information after the fact. This is a great model if all of the data is available; however, it most likely isn't, and other measures have to be taken.

The retention rate model⁶

This approach is a simple but effective model for calculating customer retention rates. The significance of this approach is that loyalty is referenced against repeat purchase behaviour with a supplier and not the absolute level of the supplier customer base. The model is based upon:

- The number of customers at the start of the year (s)
- The number of those retained at the end of the year (r)
- The number of customers lost during the year (s-r)
- The number of customers acquired during the year (a)

The retention rate is then expressed as a percentage: $(r/s) \times 100\%$.

Experience shows that this is the most practically useful model of all those described. Unlike the more complex theoretical approaches it is essentially grounded in basic transactional data (which every retail organisation can obtain) and is enhanced by the addition of third party data to enrich the predictivity of the model and the ability to apply it to refined subsegments revealed by the initial transaction-based segmentation. However, it does require further additions and enhancement, which will be described later in this paper.

WHAT IS EFFECTIVE BEST PRACTICE?

In this author's opinion, too many

people get tied up with measuring of loyalty and end up measuring the wrong things, or just measuring for the sake of it. The principles of all of the models above are generally sound, but have also led to the misrepresentation of loyalty. They are aimed to give a company tools to benchmark and judge just how it is doing. In other words, know the customers, judge how valuable they are and make relevant business decisions based on this information.

For example the idea of managing share of wallet is maybe conceptually sound. Yet, in practice, it is found that people are all to some degree promiscuous, and their loyalty is earned by getting product, service, price, experience and brand values right. If this basic value proposition is well crafted, then informed data-based marketing can lock in customers' spend and defend against unexpected surprises. If the basic proposition is not sound, then a loyalty programme is going to provide negligible return. Even if the core proposition is well put together, a 'loyal' shopper will still try competitors. In the author's experience, this should not be regarded as a problem; contrast with less effective competitors provides a useful and confirmatory benchmark for the customer.

Moreover, the idea of getting loyal customers to pay a premium is frankly a joke (as per the Reicheld model). If the 'customer is king', then loyal customers must be treated like gods! Loyal customers cannot be expected to pay more for the same product than a non-loyal customer. Loyal customers will give a supplier more leeway when it makes mistakes, and will come back despite this, and they will spend more. This should be regarded as the price premium that loyal customers pay.

The principles of 'loyalty', then, are

exactly the same as those of an effective database marketing or customer relationship management (CRM) initiative:

- more new customers;
- getting existing customers to spend more often; or
- getting them to spend more; and
- minimise attrition.

This paper now moves on to explore practical illustrations of the key database analyses that should form the fundamentals of any customer development activity. The examples are based on life, although the companies remain unnamed for reasons of client confidentiality.

MEASURING CUSTOMER LOYALTY

The first point to make is that snapshots of customer value are useless in building effective and appropriate customer development strategies. One must look at how value changes over time. For example, if a customer is spending £300 per annum, then what is important is defending this and increasing it if possible. HOW he spends his extra £100 to return £400 at the strategic level is unimportant. The task is to manage customer revenue and profitability, no more or less. Therefore, it is necessary to find out the:

- acquisition cost per customer segment
- marketing communications cost per customer segment
- customer service/marketing administration/overhead costs per customer segment (some segments will have different costs than others, do not just keep it at the top level)
- other business administration and overhead costs per customer
- credit scoring

- time from first purchase to final purchase (ie how long are they kept)
- attrition score (likelihood of decreasing revenue/lost customer)
- annual revenue trend per individual customer (not averaged but tracked to A N Other specifically) and per customer segment
- return on investment (ROI) from each mailing from each customer
- revenue trend from non-loyalty club members (if relevant).

Unlike some of the loyalty metrics criticised earlier in this paper, all these metrics are easily obtainable from basic transactional and campaign data. With all this information in hand, profitability can be calculated over a 2/3/4-year period and strategies developed concerning which customers to defend, to grow or not bother too much about.

At this point, the commonly-held myth that businesses can afford to 'fire' certain categories of customer should be dispelled. This is palpable nonsense. For players in the business-to-consumer (B2C) market, even low value customers are still producing revenue. A company has to consider whether its overheads would fall by 10 per cent if it 'fired' the bottom 50 per cent of its customers (who appear to contribute 10 per cent of revenue). To the author's knowledge, the answer is always negative. The result would be that costs stay as they are, revenue goes down, the profitable customers have to pay for more overheads than they otherwise would do and overall margins suffer.

What firms *should* do is change their operating costs to suit each segment. If low value customers are the ones using the helplines more than most, then find out why and establish if they can be given some level of service but more efficiently. Send them lower cost mailing

packs than the top segments. Any alternative should be considered that still allows a company to communicate with low value customers while reducing expenditure — freeing it up to invest in the more valuable segments.

Two examples

Two specific examples, one B2C, one business-to-business (B2B), follow to illustrate the points made thus far.

B2C example

Consider a restaurant that has a typical loyalty card, which captures:

- the customers
- when then visit
- what meals they have
- the time they visit
- the number in the party
- how frequently they visit.

From this, an eight segment concept is created that combines value and loyalty:

- High value/high loyalty
- High value/low loyalty
- Low value/high loyalty
- Low value/low loyalty
- High value ‘special anniversary only’ eaters
- Low value ‘special anniversary only’ eaters
- Non-spenders
- New customers.

This is reviewed quarterly and the movement between the segments determines what should be done with each segment (all 64 of them — 8×8). If you add in profitability/ROI by segment, this gives you an overview — in truth a very dynamic view — of customers. Economists use the phrase ‘velocity of money’; here this is modified

to ‘velocity of customers’. This is the movement within these 64 segments and how large the movement swings are between the segments. As revenue can be attributed to each customer, it is possible to start to create ROI by customer and customer segment.

How the customer is managed within each of these segments depends on what the customers are actually doing.

For example, for direct marketing promotions, be it mail, telephone, SMS, or e-marketing, the execution technology exists to personalise any communication almost in any way one sees fit. This normally means personalised offers, but can also mean personalised spend targets. If the reward is dependent on the amount of incremental spend the customer is being asked to achieve, the permutations are staggering: 64 segments with ten different offers with ten different targets gives you 6,400 different permutations — and this is relatively basic. Now imagine that, on the fly, the image in the mailing pack can be changed according to each segment (which is possible, even with print nowadays); the permutations and opportunities escalate still further — and this is before targeted mailings that use response models based around the segments are introduced.

If a company knew that a customer visited once a month for eight months with his wife, then suddenly stopped, it would be sensible to make the effort to win him back; or to get him to increase visits from three times a quarter to four; or to buy a bottle of wine, if he didn’t normally ... or give a free bunch of flowers to his wife if they were there on their anniversary — which the company knows, because it bothered to collect that information through its loyalty scheme.

Retailers can also look at merchandising. This is probably the most difficult piece of analysis to do, but one

Table 1: Annual value bands

Revenue band (£000)	Sites	% of sites	Annual revenue	% revenue	Mean monthly revenue
<1	24,109	63.03	£8,887,924	6.87	£51
1–10	12,303	32.17	£36,351,172	28.10	£425
10–25	1,156	3.02	£17,565,229	13.58	£2,477
25–50	368	0.96	£12,778,002	9.88	\$5,347
50–100	173	0.45	£12,192,760	9.43	£10,410
100–500	126	0.33	£25,065,951	19.38	£25,638
500+	14	0.04	£16,505,204	12.76	£171,249
Grand total	38,249	100.00	£123,934,262	100.00	£490

Table 2: Trends in value over one year

Discription	Data Sites	% of sites	Annual revenue	% revenue	Mean monthly revenue
Lost customers	2,206	5.77	£818,940	0.63	£93
Decrease >50%	1,647	4.31	£4,441,880	3.43	£496
Decrease 10–50%	5,853	15.30	£17,904,471	13.84	£393
No change	9,020	23.58	£23,684,086	18.31	£302
Increase <100%	9,180	24.00	£40,530,115	31.33	£399
Increase >100%	3,193	8.35	£27,365,287	21.16	£1,245
New customers	7,150	18.69	£14,602,484	11.29	£706
Grand total	38,249	100.00	£129,347,262	100.00	£490

can identify what product clusters are bought by which type of customer. This gives insights beyond the loyalty programme *per se* and starts to impact stock holding, purchasing and logistics as well as product display positioning and associated timings (even down to different times in a single day, as the age profile of customers will often vary between morning, lunchtime, afternoon and evening).

B2B example

In this example the company is a stationary products supplier with both retail and mail order businesses. The same type of segmentation used for the B2C example is used here, starting with value (see Table 1).

Table 2 shows that if this can be combined with the trend in revenue, one can start to create a unique approach that is, frankly, currently performed by few UK organisations.

Most UK organisations cannot answer some or all of the following questions:

- Do you know your key customers? (Specifically, which 2 per cent provide 60 per cent of revenue?)
- Do you know if they are increasing or decreasing and by how much and *why*?
- Do you know which products they have bought in the past six months? And what products they have stopped buying in the past six months?
- Can you do all of this in less than one hour (let alone one day/week)

In a B2B context, this information is critical to guiding and managing the salesforce's efforts. It is used to target direct marketing in a more relevant manner (customers declining by 50 per cent or more really want to be managed differently than customers who are increasing).

Consider the approach illustrated in

Figure 1: Possible communications

Comm Freq, communications frequency; Quar, quarterly; Ann, annually; Mont, monthly; 6 Mon, 6-monthly

Figure 1, which allows for different dynamics to be taken into consideration.

This conceptual approach allows for communications, messages, channels, offers and timings to be tailored dependent on what is known about the customer and what the company wants to do with them.

CONCLUSION

In conclusion, it can be seen that the distinction drawn between loyalty marketing and database marketing is a false one. Loyalty schemes are a method of gathering information on customers, which then allows appropriate strategies to be applied to different customer

segments — specifically according to how their value is changing over time. Results derived from the most basic of analyses deliver insights that are critical to guiding the short-term and the strategic future of the company. It is the author's assertion that only the minority of companies can yet perform these analyses, however. Static snapshots of customer value are of little use, it is trends in value that provide the real basis for strategy development. Finally, although data is usually gathered and analyses performed for direct marketing purposes, the usefulness of these insights are applicable to many other, broader, marketing functions; from just-in-time stock management to store location.

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