Much of the common wisdom about customer retention is bunk. To get strong returns on relationship programs, companies need a clearer understanding of the link between loyalty and profits.

The Mismanagement of Customer Loyalty

by Werner Reinartz and V. Kumar

Included with this full-text Harvard Business Review article:

1 Article Summary
   The Idea in Brief—the core idea
   The Idea in Practice—putting the idea to work

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11 Further Reading
   A list of related materials, with annotations to guide further exploration of the article's ideas and applications

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The Mismanagement of Customer Loyalty

The Idea in Brief

“Loyal customers cost less to serve! They pay more than other customers, and attract new customers through word-of-mouth!” These loud claims prompted one high-tech service provider to launch a $2 million-per-year customer-loyalty program. Five years later, the company made disturbing discoveries: Half of its loyal customers barely generated a profit. And half of its most profitable customers bought high-margin products once—then disappeared.

What happened? As recent research reveals, the loyalty-equals-profitability equation is surprisingly weak—and complicated. Not all loyal customers are profitable, and not all profitable customers loyal.

Managing customers for loyalty doesn’t automatically mean managing them for profits. To strengthen the loyalty-profitability link, you must manage both—simultaneously.

The Idea in Practice

RECONSIDER CUSTOMER-LOYALTY CLAIMS

A study of 16,000 customers at four companies revealed surprising findings:

<table>
<thead>
<tr>
<th>CLAIM</th>
<th>CONTRARY FINDING</th>
</tr>
</thead>
<tbody>
<tr>
<td>Loyal customers cost less to serve.</td>
<td>Loyal, high-volume customers know their value to you—and exploit it to get premium service and discounts.</td>
</tr>
<tr>
<td>Loyal customers pay more than other customers.</td>
<td>Experienced customers believe they deserve lower prices.</td>
</tr>
<tr>
<td>Loyal customers attract more customers through word-of-mouth.</td>
<td>Customers spread the word only if they feel, as well as act, loyal. To spot apostles, measure customers’ attitudes as well as purchasing behavior.</td>
</tr>
</tbody>
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MEASURE LOYALTY—ACCURATELY

If the loyalty-profitability link is so weak, should you abandon loyalty programs? No: The problem isn’t the programs; it’s the crude methods used to measure and predict loyalty. Many tools generate dangerously inaccurate information.

Example:

The RFM method (recency, frequency, and monetary value) ignores pacing—time between purchases—so companies misjudge the likelihood of a customer’s buying again. RFM also bases monetary value on revenue, not profitability. When customers buy only low-margin products, serving them may cost more than the revenue they generate. Results? Companies chase the wrong customers—and neglect the right ones.

Companies need a better measurement system—one based on “event-history” modeling.

Example:

By combining pacing with the average profit customers generate in typical purchase periods, an event-history approach lets marketers design effective loyalty strategies for each customer.

BUILD LOYALTY STRATEGIES

After measuring customers’ profitability and predicting how long they’ll remain loyal, determine in which of these four categories they fit—then tailor your strategies:

<table>
<thead>
<tr>
<th>CATEGORY</th>
<th>PROFITABILITY/LOYALTY</th>
<th>LOYALTY STRATEGY</th>
</tr>
</thead>
<tbody>
<tr>
<td>True Friends</td>
<td>Profitable and loyal; buy regularly but not intensively</td>
<td>Approach softly: Don’t communicate too often, or they’ll ignore everything. Reward their loyalty with exclusive access to special events and high-quality, limited-supply products.</td>
</tr>
<tr>
<td>Butterflies</td>
<td>Profitable but disloyal</td>
<td>For the short time they buy, milk them with short-term, hard-sell offers. After their purchasing drops off, stop investing.</td>
</tr>
<tr>
<td>Barnacles</td>
<td>Unprofitable but very loyal</td>
<td>If you determine they have more money to spend, offer them products related to those they’ve already purchased.</td>
</tr>
<tr>
<td>Strangers</td>
<td>Neither profitable nor loyal</td>
<td>Identify early. Invest nothing.</td>
</tr>
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