

Loyalty

Loyal 1: Unswerving in allegiance: as **a:** Faithful in allegiance to one's lawful sovereign or government. **b:** Faithful to a private person to whom fidelity is due. **c:** Faithful to a cause, ideal, custom, institution, or product.¹

Retention programs, often called loyalty programs, are all around us. Consider the following commonplace examples:

- An apparel retailer has a “Preferred Customer” card program. Customers can apply for the card by filling out a simple application form, and this entitles them to discounts in the store as well as other service benefits. Likewise, petrol pumps, fast food outlets, department stores, and even coffee shops use card-based programs.
- Most airlines offer frequent flyer programs. Travelers accumulate miles by taking flights, and can then “spend” the miles in exchange for free flights, upgrades to higher classes of service or access to airport lounges. Travelers who have accumulated a certain number of miles are accorded additional privileges like priority boarding, dedicated seating, and separate lounge areas.
- Many of the airline programs have evolved away from being pure “airline” programs, and have now grown to include other products

¹ Loyal. Def. 1. *Merriam-Webster Online Dictionary*, 2009.

and services. For instance, Cathay Pacific's Asia Miles program allows a member to earn miles at hotels, car rental firms and other retailers, and to similarly redeem these miles at various member locations.²

- A sandwich shop offers patrons a stamp card. Every sandwich purchased on the card earns a stamp, and a card with 10 stamps on it can be exchanged for a free sandwich. Similarly, a music retailer in India offers stickers for each purchase that can be exchanged for free merchandise.
- Third-party loyalty programs like Air Miles, and credit card-based points programs allow the cardholder to collect points at a number of different locations, and to redeem them at either the same — or any other participating location.³
- Membership-based retailers like Costco and Sam's Club require customers to pay an annual membership fee in exchange for the privilege of shopping at their locations at low prices.⁴ These memberships are annual. In a slightly different example, an Asian grocery supermarket rewards customers with free gifts and special promotions as a function of their cumulative spending over the calendar year.
- A department store in Canada — Canadian Tire — issues points in the form of “Canadian Tire money,” which is designed to look like dollar bills as a reward for making purchases in the store.⁵ The Canadian Tire money can be used as cash for making purchases at a later date.

² About Asia miles, *Asia Miles*, 17 January 2009, <<http://www.asiamiles.com/am/en/about>>.

³ About us, *Airmiles.ca*, 17 January 2009, <<https://www.airmiles.ca/arrow/AboutUsAmrp?referrerUrl=AboutUsHome>>.

⁴ Costco, *Canadaloyalty.com*, 17 January 2009, <<http://www.canadaloyalty.com/Programs/costco.html>>; Sam's Club, *Canadaloyalty.com*, 17 January 2009, <http://www.canadaloyalty.com/Programs/sams_club.html>.

⁵ Canadian tire money, *Canadaloyalty.com*, 17 January 2009, <http://www.canadaloyalty.com/Programs/canadian_tire_money.html>.

The fundamental goal in each of these examples is the same — to get a customer who is presently a purchaser of the firm to make yet another purchase with the firm. At the barest bones, that is what a loyalty program is all about.

Recall that we divided all marketing interventions into two different groups. In the language of the retail metaphor, interventions that get a customer to visit a store are acquisition activities and those that happen from the time that the customer is first in the store onwards can be called retention or loyalty activities. Therefore, loyalty activities can be decomposed into a large number of specific behaviours. These may include:

- A repeat visit to the store
- Increasing the basket size of purchases, through cross-selling and up-selling
- Increasing the frequency of store visits and therefore purchases
- Movement to higher margin products and services
- Referring the store to friends and family members

We will refer to the collection of activities that allow a manager to encourage these behaviours as a loyalty program. In this chapter, we address the following issues:

- (1) What are the different types of loyalty programs and when should they be used?
- (2) What are the underlying goals of a loyalty program?
- (3) How can I design a loyalty program to explicitly reward the desired behaviours?
- (4) How should I go about setting up a loyalty program?

In the next chapter, we will look at data-driven marketing and ask the question: How can I best couple my loyalty program with a data-driven marketing system to truly generate value for the firm?

I. The Different Flavours of Loyalty Programs

In each of the examples above, the firm is targeting a current purchaser of the product by using some form of a mechanism designed to incentivize that customer to purchase the same product — or all other products from the same firm — again. That said, there are a number of specific differences across the loyalty programs. In some, customers earn the incentive at the end of a single purchase while in others; they have to wait for a number of purchases. In some programs, the benefit is in the form of lower prices, in others it is in the form of gifts and other forms of recognition. Some programs buy loyalty (i.e., they require the customer to commit upfront to a purchase, say a membership or apply for a card before they can start earning rewards) while others reward loyalty (i.e., they offer the customer a reward contingent on the number of purchases). And these programs differ in terms of the time horizon over which loyalty is rewarded. The sandwich card offers a reward at the end of every 10 purchases; the Asian supermarket offers a reward for purchases made over a calendar year.

But perhaps the two biggest variables that differentiate loyalty programs are (a) they use historical data in triggering promotions and (b) use of third-party vendor. In the case of the third-party vendors, the program can either be operated by the selling firm, where transactions to the program are only between the customer and the firm (an “in house” loyalty program); or is operated by a third-party firm that operates the programs, but signs on a number of different vendors who transact with the customer through the program (a “third-party” or “consortium” program). Figure 6.1 shows a few examples of loyalty programs as a function of these two dimensions.

Let us first focus on the ability of the program to track and exploit historic transaction data. As we will discuss later in the chapter, the ability of a program to build a good database of customer intelligence is perhaps one of the biggest values of a loyalty program. Therefore, we believe that any program that does not have

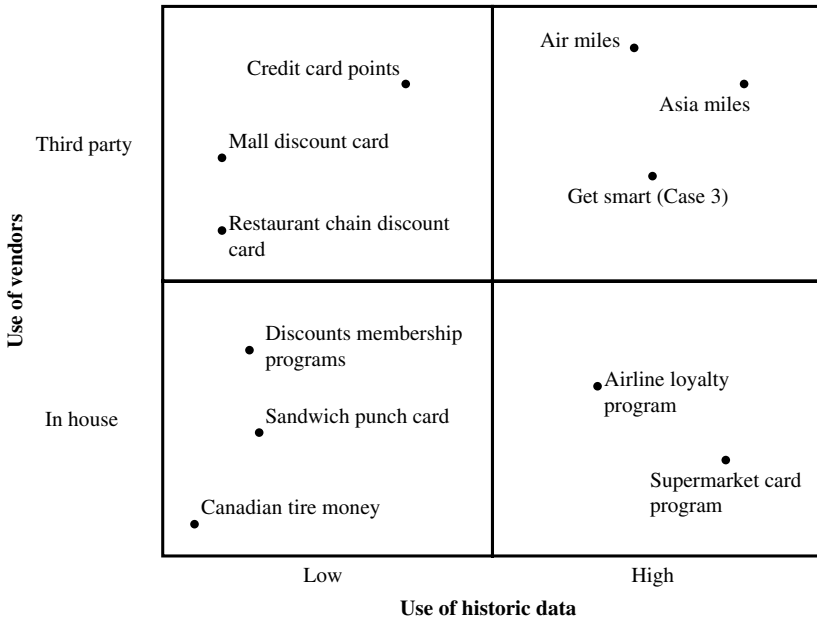


Figure 6.1 A typology of loyalty programs.

the ability to harness historic data is incomplete at best. In essence, many of the programs that have no memory are structurally similar to price discounts applied over a number of purchases. That said, we can certainly identify with the point that such programs do have a role to play in some conditions, especially to generate relatively quick repeat purchase rates, or perhaps even to accelerate the consumption of the product by impatient customers who are eager to get their free unit, or other gift.⁶ Also, such memory-less programs could be used as part of a larger basket of loyalty offerings.

Perhaps the one question that has received the least amount of research effort by both academics and practitioners relates to the relative benefits for a firm of having its own, in-house loyalty

⁶ X. Li, M. Shi, and D. Soman, 2007, Multi media rewards programs, *Rotman School of Management Working Paper*, University of Toronto, Toronto.

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Third-party loyalty programs are offered by external providers. Vendors subscribe to the program, and customers can earn and redeem points across all participating vendors. They are cheaper than in-house loyalty programs, and particularly beneficial to small and growing firms seeking to establish a reputation.

program, versus being a member in what are often called third-party (or, sometimes, consortium) loyalty programs. The third case study in this book is about a third-party loyalty program called “Get Smart,” and it illustrates some of the issues that managers deal with in making this decision.

We conducted a series of interviews with a number of managers in customer-facing roles in four different verticals: restaurants, retail, leisure and transportation, and entertainment and asked them for the relative pros and cons of in house versus third-party programs. The following emerged as key issues:

(1) *The Richness of Data*

This point raises an interesting paradox. Given that a third-party program allows customers to collect and redeem points at an assortment of vendors, it has the capacity to generate a rich dataset that can be used to paint comprehensive behavioural profiles of customers. For example, the American Express or Airmiles database might be able to generate a richer set of customer insights and segments based on travel patterns, hotel preferences, spending levels at restaurants and wine bars, and even patterns of retail shopping. On the other hand, a bookstore loyalty card can only inform the firm about book-buying behaviour. Herein lies the paradox. While an in store program gives more impoverished data, the firm has more control on the data; indeed the data sit on their computers. In the case of a third-party program, the data are owned by the firm running the program. In some legal frameworks, it might be illegal for this firm to sell the comprehensive dataset to its vendors, although

it might be possible for them to provide customer intelligence consulting services.

(2) *The Brand*

Small and relatively new brands can benefit from the established network of a third-party program to drive traffic to their stores. Large established brands get no such benefits.

(3) *The Size of the Establishment*

Smaller establishments like coffee shops and neighbourhood stores have neither the volume nor the financial wherewithal to support a loyalty program of their own. The larger the establishment, the more likely is it to be able to support its own loyalty program.

(4) *The Goal of the Program*

For small-to-medium-sized establishments, most of our respondents favour third-party programs if the primary goal of the firm is acquisition in early stages of growth. However, as the relationships of customers with the firms lengthened, and the goal moved towards retention and value creation at the higher levels of the value chain, in-house programs are seen as being more valuable. This conclusion makes perfect sense — at the early stages of the value chain, a firm will indeed benefit by creating incentives for customers of other firms. As the length of relationship increases, the focus should shift away from what the customer buys elsewhere to how value can be added once the customer is “in house.”

(5) *The Nature of the Product*

There are some products that customers buy infrequently; there are others that are consumed more frequently. Third-party programs make more sense for the former, in-house programs are

more valuable for frequently consumed items, or frequently visited establishments.

From these responses, we conclude that as a new and small firm enters the marketplace in quest of customers, it might want to consider enrolling itself in a third-party program. However, as it evolves and starts building a reliable core of customers, it could consider starting an in-house program of its own. An alternate approach is to be involved in both a third-party program and an in-house program simultaneously.

II. The Motivation

In our framework, a loyalty program refers to any collection of marketing activities that allows a firm to build value from existing customers. When defined in this manner, the question of why a loyalty program is needed is rather tautological.

That said, the concept of a good loyalty program fits perfectly with our “one stage at a time” approach to managing customer value. Keeping in mind the principle that different customers are at different stages of the value chain, and that the activities and behavioural outcomes that the firm needs to achieve to grow their value is therefore different, we claim that good loyalty programs should do the following:

(1) *Create Differentiation*

Specifically, they should allow the firm to treat different customers differently.

(2) *Enable Marketing Interventions to be Targeted*

In particular, the program should identify which customers would grow in value as a result of a given intervention, and target that intervention only to those customers.

(3) *Deliver Marketing Interventions That Elicit Specific Behaviour*

Rather than the vague goal of increasing sales or profits, interventions should be designed to elicit specific behaviours like increasing basket size, increasing frequency of store visitations, etc.

Why is it important for the firm to be able to differentiate, and to be able to be targeted and specific? Think about a simple business model, say an ice cream parlour that sells flavours of ice cream that vary on margin. Any customer consumes just once a day, but could choose a small (one scoop), medium (two scoops), or large size (three scoops). The more frequently they make a purchase, the more they will consume in a given interval of time. In this simple, stylized world, there are three drivers of the value of the customer — the specific flavour they purchase, the frequency of visitation and the size of purchase.

First, let us assume that the parlour does not have a loyalty program. The vendor sells ice cream as the demand arises, but does not have the ability to identify specific customers and to pull out their purchasing histories. The owner, though, is savvy and recognizes that he can increase value by encouraging people to buy high margin flavours, by increasing the frequency of visitation and by encouraging referrals. He might influence these behaviours by spending money on (a) redesigning the displays and offering a coupon for a high margin ice-cream sample, (b) offering a frequent buyers discount through — say, a stamp card which is punched for every visit, and (c) offering an explicit incentive like a volume discount for increasing consumption per occasion. After pushing the numbers on costs and increases in value (using analyses like the ones shown in Chapter 5), the owner decides that the activity with the highest yield is the one that increases margin through flavour choice, followed by the one that increases frequency, and finally the one that increases volume.

Suppose he decides on a coupon-based sampling program to influence flavour choice and a stamp card to increase frequency.

These interventions might work well; but there is one big downside — there may already be a number of customers who purchase high margin flavours and/or who purchase very frequently, and who do not need to be incentivized to do so. The owner should not have to spend on these customers because he would get no additional benefit. So while the goal of the marketing intervention is specific, the owner may end up spending money on behaviour that already happens. This is a common problem with many types of businesses, say retailers or business-to-business services. No matter what marketing intervention is used, there will already be a number of customers already displaying the desired behaviour, and hence a portion of the marketing spends will be wasted.

Assume for a moment that the ice cream parlour had the ability to track and identify all of their customers through a loyalty program. Customers get a card that can be swiped at the cash register, so that all of their purchases (flavours and quantity) and the date and time of purchases could be recorded. To get the card, the customer needs to fill a short form asking for their name, and basic contact information. The customer could also choose whether or not they would like to receive any marketing offers in the mail or electronically. At any point in time, the owner has the ability to generate a framework like the one shown in Figure 6.2.

This framework will allow the owner to segment the customer base as a function of behaviour. For instance, we have identified three groups of customers on the figure, the entry-level group (Group 1), the frequency-opportunity group (Group 2) and the

Volume-opportunity group (Group 3). The first group (Group 1) represents customers who are new and have just signed up for the loyalty card. The owner could increase value from them by encouraging any of the three behaviours,

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<p>Identify the drivers of customer value (VOC), and then identify the appropriate value chain that you would like your customers to traverse. This value chain provides the guiding rails for your loyalty program.</p>