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Winning in Service Markets Series: Vol. 10

Managing Customer Relationships and Building Loyalty

Jochen Wirtz

Winning in Service Markets is a highly practical book. I love the comprehensive coverage of services marketing and the rigor. Also, it is easy to read and full of interesting, best practice examples. I recommend this book to everyone working in a service organization.

Jan Swartz
President, Princess Cruises

Winning in Service Markets provides a set of useful frameworks and prescriptions rooted in both practice and research. As such, it represents a refreshing alternative to the prevailing literature available to managers who are looking for insights rooted in sound theory. A must read for any practicing manager in the service economy.

Leonard A. Schlesinger
Baker Foundation Professor, Harvard Business School

Targeting, acquiring, and retaining the "right" customers is at the core of many successful service firms. The objective is to build the relationships and develop loyal customers who will contribute to a growing volume of business with the firm in the future. *Managing Customer Relationships and Building Loyalty* emphasizes the importance of desirable, loyal customers within the chosen segments, and the painstaking process to build and maintain their loyalty through well-conceived relationship marketing strategies. This book is the tenth book in the Winning in Service Markets series by services marketing expert Jochen Wirtz to cover the key aspects of services marketing and management based on sound academic evidence and knowledge.

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Winning in Service Markets Series

Series Editor: Jochen Wirtz *(National University of Singapore, Singapore)*

The Winning in Service Markets Series covers the key aspects of services marketing and management based on sound academic evidence and knowledge. The books in this series is written by services marketing expert Jochen Wirtz, author of globally leading textbook for Services Marketing. Each book in the series covers different themes in the study of services marketing and management, is accessible, practical and presented in an easy-to-read format for busy practitioners and eMBA students.

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Vol. 9 Managing People for Service Advantage
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Vol. 10 Managing Customer Relationships and Building Loyalty
by Jochen Wirtz

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Winning in Service Markets Series: Vol. 10

Managing Customer Relationships and Building Loyalty

Jochen Wirtz

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Winning in Service Markets Series — Vol. 10
MANAGING CUSTOMER RELATIONSHIPS AND BUILDING LOYALTY

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Dedication

To my past and future EMBA and Executive Program participants.

I have been teaching EMBA and Executive Programs for over 20 years. This Winning in Service Markets Series is dedicated to you, the participants from these programs. You brought so much knowledge and experience to the classroom, and this series synthesizes this learning for future EMBA candidates and managers who want to know how to bring their service organizations to the next level.

Preface

The main objective of this series is to cover the key aspects of services marketing and management, and that is based on sound academic research. Therefore, I used the globally leading text book I co-authored with Professor Christopher Lovelock (Title: *Services Marketing: People, Technology, Strategy*, 8th edition) as a base for this series, and adapted and rewrote it for managers. This is a unique approach.

This series aims to aims to bridge the all-too-frequent gap between cutting edge academic research and theory, and management practice. That is, it provides a strongly managerial perspective, yet is rooted in solid academic research, complemented by memorable frameworks.

In particular, creating and marketing value in today's increasingly service and knowledge-intensive economy requires an understanding of the powerful design and packaging of intangible benefits and products, high-quality service operations and customer information management processes, a pool of motivated and competent front-line employees, building and maintaining a loyal and profitable customer base, and the development and implementation of a coherent service strategy to transform these assets into improved business performance. This series aims to provide the knowledge required to deliver these.

Winning in Service Markets comprises of the following volume:

Vol 1: Understanding Service Consumers
Vol 2: Positioning Services in Competitive Markets
Vol 3: Developing Service Products and Brands
Vol 4: Pricing Services and Revenue Management
Vol 5: Service Marketing Communications
Vol 6: Designing Customer Service Processes
Vol 7: Balancing Capacity and Demand in Service Operations
Vol 8: Crafting the Service Environment
Vol 9: Managing People for Service Advantage
Vol 10: Managing Customer Relationships and Building Loyalty
Vol 11: Designing Complaint Handling and Service Recovery Strategies
Vol 12: Service Quality and Productivity Management
Vol 13: Building A World-Class Service Organization

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Introduction

Targeting, acquiring, and retaining the "right" customers is at the core of many successful service firms. The objective is to build the relationships and develop loyal customers who will contribute to a growing volume of business with the firm in the future. *Managing Customer Relationships and Building Loyalty* emphasizes the importance of desirable, loyal customers within the chosen segments, and the painstaking process to build and maintain their loyalty through well-conceived relationship marketing strategies. This book is the tenth book in the Winning in Service Markets series by services marketing expert Jochen Wirtz to cover the key aspects of services marketing and management based on sound academic evidence and knowledge.

Master Class Video:

Building Customer Loyalty

By: Professor Jochen Wirtz
Vice Dean MBA Programmes
NUS Business School
National University of Singapore

To watch the video go to the YouTube channel of Professor Jochen Wirtz or scan QR Code:

VOLUME 10

Managing Customer Relationships and Building Loyalty

The first step in managing a loyalty-based business system is finding and acquiring the right customers.

Frederick F. Reichheld
Author, strategist, and fellow of Bain & Company

Strategy first, then CRM.

Steven S. Ramsey
Former senior partner with Accenture,
current executive vice president with IRi

THE SEARCH FOR CUSTOMER LOYALTY

Targeting, acquiring, and retaining the "right" customers is at the core of many successful service firms. Segmentation and positioning were discussed in Volume 2, while this volume emphasizes the importance of desirable, loyal customers within the chosen segments, and the painstaking process to build and maintain their loyalty through well-

conceived relationship marketing strategies. The objective is to build the relationships and develop loyal customers who will contribute to a growing volume of business with the firm in the future.

Loyalty is an old-fashioned word traditionally used to describe fidelity and enthusiastic devotion to a country, a cause, or an individual. However, in a business context, loyalty describes a customer's willingness to continue patronizing a firm over a long period of time, preferably on an exclusive basis, and recommending the firm's products to friends and associates. Customer loyalty extends beyond purchasing behavior, and includes preference, liking, and future intentions (Figure 1).

"Defector" was a nasty word during wartime. It describes disloyal people who sell out, betray their own side, and join the enemy. Even when they defected toward "our" side, rather than away from it, they were still a suspect. In a marketing context, the term defection is used to describe customers who drop off a company's radar and transfer their purchases to another supplier. Not only does a rising defection rate indicates that something is wrong with quality (or that competitors offer better value), it may also be signaling a fall in profits. Big customers do not necessarily disappear overnight; they often may signal their mounting dissatisfaction by steadily reducing their purchases and shifting part of their business elsewhere.

Why is Customer Loyalty so Important to a Firm's Profitability?

"Few companies think of customers as annuities", says Frederick Reichheld, author of *The Loyalty Effect*, and a major researcher in this field,[1] and that is what a loyal customer can mean to a firm — a consistent source of revenue over a period of many years. How much is a loyal customer then worth in terms of profits? In a classic study, Reichheld and Sasser analyzed the profit per customer in different service businesses categorized by the number of years that a customer had been with the firm. They found that the longer customers remained with a firm in each of these industries, the more profitable they became. Annual profits increases per customer, indexed over a five-year period for easier comparison, are summarized in Figure 2 for a few sample industries. The industries studied (with average profits from a first-year customer shown in parentheses) were: credit cards ($30), industrial laundry ($144), industrial distribution ($45), and automobile servicing ($25).

Figure 1: Organizing framework for managing relationships and building loyalty

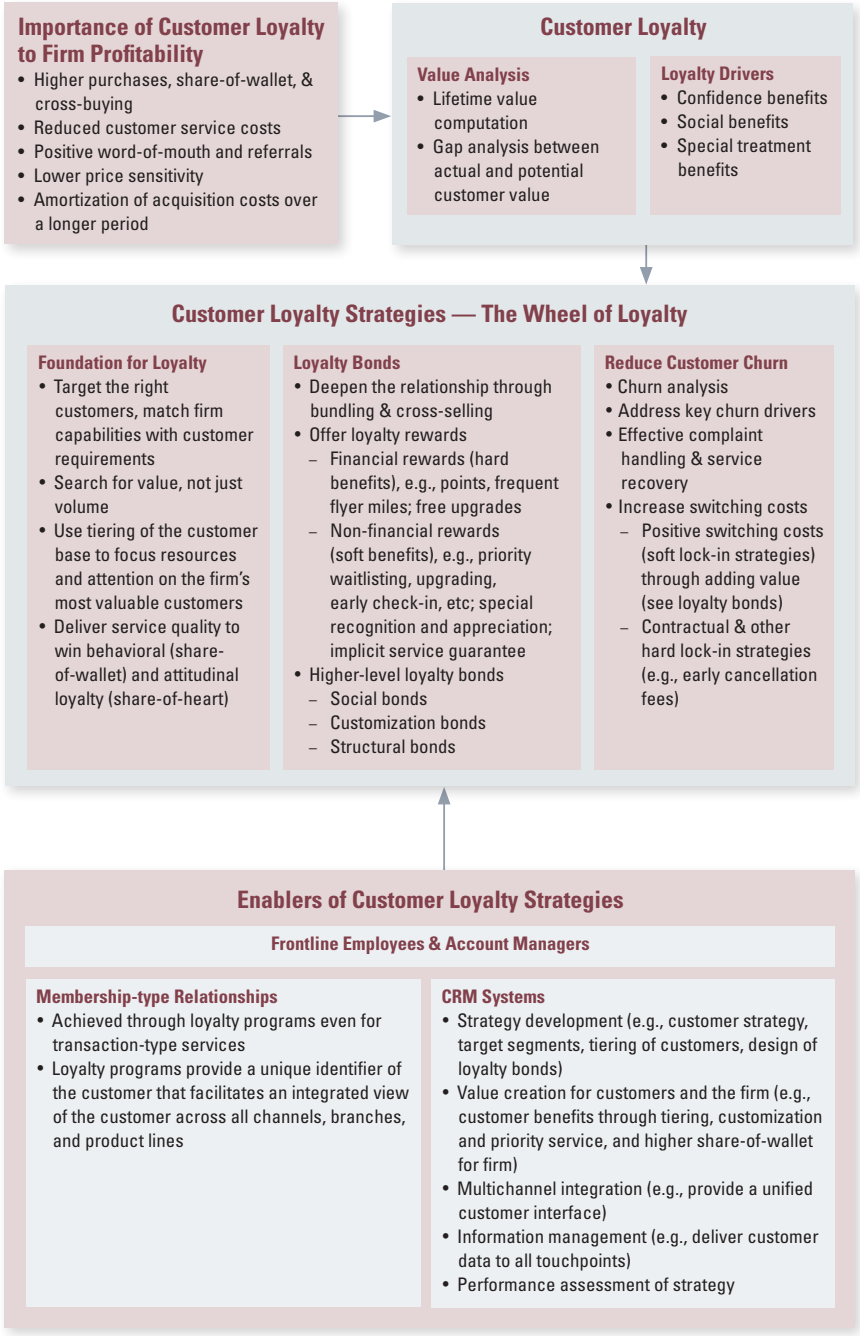
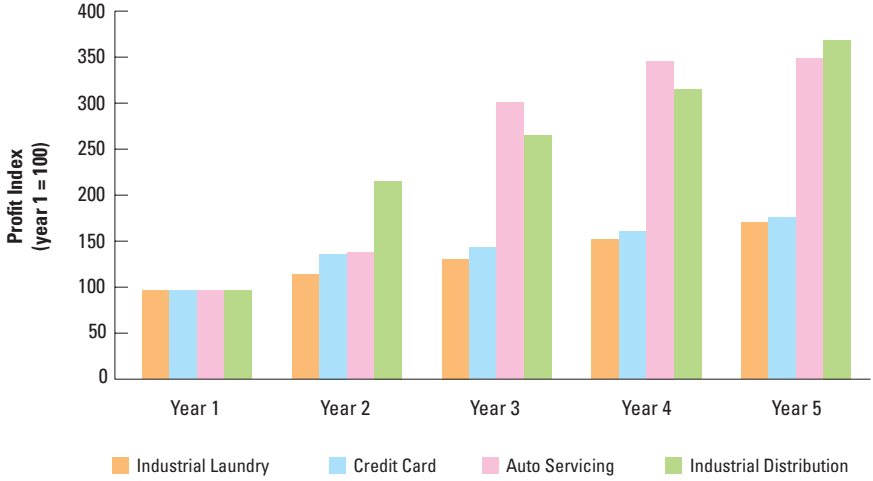


Figure 2: How much profit a customer generates over time.



Source: Adapted from Frederick J. Reichheld and W. Earl Sasser Jr. (1990), "Zero Defections: Quality Comes to Services," *Harvard Business Review,* Vol. 73, Sept–Oct, p. 108.

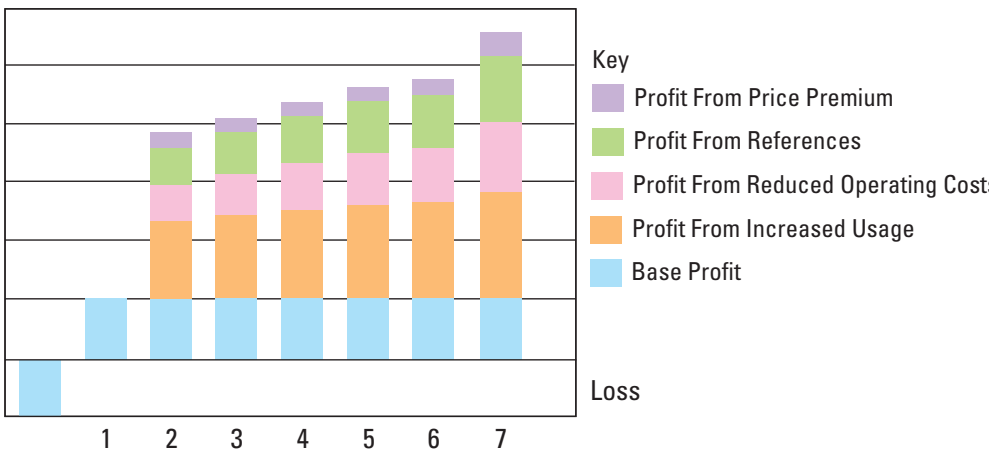
Underlying this profit growth are a number of factors that work to supplier's advantage to create incremental profits. In the order of magnitude at the end of seven years, these factors are:[2]

1. *Profit derived from increased purchases (or, in a credit card and banking environment, higher account balances).* Over time, business customers often grow larger and thus, need to purchase in greater quantities. Individual customers may also purchase more as their families grow, or as they become more affluent. Both types of customers may be willing to consolidate their purchases with a single supplier who provides high quality service, resulting in what we call a high share-of-wallet.
2. *Profit from reduced customer service costs.* As customers become more experienced, they make fewer demands on the supplier (for instance, they have less need for information and assistance, and make use of self-service options more). They may also make fewer mistakes when involved in operational processes, thus contributing to greater productivity.
3. *Profit from referrals to other customers.* Positive word-of-mouth recommendations are like free sales and advertising, saving the firm from having to invest much in these areas.

4. *Profit from lower price sensitivity that allow a price premium.* New customers often benefit from introductory promotional discounts, whereas long-term customers are more likely to pay regular prices, and when they are highly satisfied they tend to be less price sensitive.[3] Moreover, customers who trust a supplier may be more willing to pay higher prices at peak periods or for express work.
5. *Acquisition costs can be amortized over a longer period.* The upfront costs of attracting new buyers can be amortized over many years. These costs can be substantial and can include sales commissions, advertising and promotions costs, administrative costs of setting up an account, and sending out welcome packages and sign-up gifts.

Figure 3 shows the relative contribution of each of these different factors over a seven-year period, based on an analysis of 19 different product categories (both goods and services). Reichheld argues that the economic benefits of customer loyalty noted above often explain why one firm is more profitable than a competitor. As a response, Reichheld and Sasser popularized the term *zero defections*, which they describe as keeping every customer the company can serve profitably.[4]

Figure 3: Why customers are more profitable over time.



Source: Adapted from Frederick J. Reichheld and W. Earl Sasser Jr. (1990), "Zero Defections: Quality Comes to Services," *Harvard Business Review*, Vol. 73, September–October, p. 108.

Assessing the Value of a Loyal Customer

One of the challenges faced by professionals is to determine the costs and revenues associated with serving customers to different market segments at different points in their customer lifecycles, and to predict future profitability. For insights on how to calculate customer value, see "Worksheet for Calculating Customer Lifetime Value".[5]

Recent studies have shown that the profit impact of a customer may vary dramatically depending on the stage of the service product lifecycle. For instance, referrals by satisfied customers and negative word-of-mouth from "defected" customers have a much greater effect on profit in the early stages of a service product's lifecycle — when the name of the game is acquisition of new customers — than in later stages, where the focus is more on generating cash flow from the existing customer base.[6]

Finally, it is erroneous to assume that loyal customers are always more profitable than those who make one-time transactions.[7] On the cost side, not all types of services incur heavy promotional expenditures to attract a new customer. Sometimes, it is more important to invest in a good retail location that will attract walk-in traffic. Unlike banks, insurance companies, and other "membership" organizations that incur costs for review of applications and account setup, many service firms face no such costs when a new customer seeks to make a purchase for the first time.

On the revenue side, loyal customers may not spend more than one-time buyers, and in some instances, they may even expect price discounts. Finally, profits do not necessarily increase with time for all types of customers.[8] In most mass market business-to-customer (B2C) services — such as banking, mobile phone services, or hospitality — customers cannot negotiate prices. However, in many B2B contexts, large customers have a lot of bargaining power and therefore will nearly always try to negotiate lower prices when contracts come up for renewal. This forces suppliers to share the cost savings resulting from doing business with a large, loyal customer. DHL has found that although each of its major accounts generates significant business, they yield below average margins. In contrast, DHL's smaller, less powerful accounts provide significantly higher profitability.[9]

Worksheet for Calculating Customer Lifetime Value

Calculating customer value is an inexact science that is subject to a variety of assumptions. You may want to try varying these assumptions to see how it affects the final figures. Generally speaking, revenues per customer are easier to track on an individualized basis than are the associated costs of serving a customer, unless (1) no individual records are kept and/or (2) the accounts served are very large and all account-related costs are individually documented and assigned.

Acquisition Revenues Less Costs

If individual account records are kept, the initial application fee paid and initial purchase (if relevant) should be found in these records. Costs, by contrast, may have to be based on average data. For instance, the marketing cost of acquiring a new client can be calculated by dividing the total marketing costs (advertising, promotions, selling, etc.) devoted toward acquiring new customers by the total number of new customers acquired during the same period. If each acquisition takes place over an extended period of time, you may want to build in a lagged effect between when marketing expenditures are incurred and when new customers come on board. The cost of credit checks—where relevant—must be divided by the number of new customers, not the total number of applicants, because some applicants will probably fail this hurdle. Account set-up costs will also be an average figure in most organizations.

Annual Revenues and Costs

If annual sales, account fees, and service fees are documented on an individual-account basis, account revenue streams (except referrals) can be easily identified. The first priority is to segment your customer base by the length of its relationship with your firm. Depending on the sophistication and precision of your firm's records, annual costs in each category may be directly assigned to an individual account holder or averaged for all account holders in that age category.

Value of Referrals

Computing the value of referrals requires a variety of assumptions. To get started, you may need to conduct surveys to determine (1) what percentage of new customers claim that they were influenced by a recommendation from another customer and (2) what other marketing activities also drew the firm to that individual's attention. From these two items, estimates can be made of what percentage of the credit for all new customers should be assigned to referrals.

Net Present Value

Calculating net present value (NPV) from a future profit stream will require choice of an appropriate annual discount figure. (This could reflect estimates of future inflation rates.) It also requires assessment of how long the average relationship lasts. The NPV of a customer, then, is the sum of the anticipated annual profit on each customer for the projected relationship lifetime, suitably discounted each year into the future.

Acquisition			Year 1	Year 2	Year 3	Year *n*
Initial Revenue		*Annual Revenues*				
Application fee[a]		Annual account fee[a]				
Initial purchase[a]		Sales				
		Service fees[a]				
		Value of referrals[b]				
Total Revenues						
Initial Costs		*Annual Costs*				
Marketing		Account management				
Credit check[a]		Cost of sales				
Account setup[a]		Write-offs (e.g., bad debts)				
Less total costs						
Net Profit (Loss)						

a If applicable.

b Anticipated profits from each new customer referred (could be limited to the first year or expressed as the net present value of the estimated future stream of profits through year *n*); this value could be negative if an unhappy customer starts to spread negative word-of-mouth that causes existing customers to defect.

The Gap between Actual and Potential Customer Value

For profit-seeking firms, the potential profitability of a customer should be a key driver in marketing strategy. As Alan Grant and Leonard Schlesinger said, "Achieving the full profit potential of each customer relationship should be the fundamental goal of every business… Even using conservative estimates, the gap between most companies' current and full potential performance is enormous".[10] They suggest an analysis of the following gaps between the actual and potential value of customers:

- What is the current purchasing behavior of customers in each target segment? What would be the impact on sales and profits if they exhibited the ideal behavior profile of (1) buying all services offered by the firm, (2) using these to the exclusion of any purchases from competitors, and (3) paying full price?
- On an average, how long do customers remain with the firm? What impact would it have if the association is life long?

As discussed earlier, the profitability of a customer often increases over time. Management's task is to design and implement marketing programs that increase loyalty — including share-of-wallet, upselling and cross-selling — and identify the reasons why customers defect and take corrective action. The active management of the customer-base and customer loyalty is also referred to as customer *asset* management.[11]

Why Are Customers Loyal?

Customers are not automatically loyal to any one firm. We rather need to give our customers a reason to consolidate their buying with us and then stay with us. We need to create value for them to become and remain loyal.

Relationships can create value for individual consumers through factors such as inspiring greater confidence, offering social benefits, and providing special treatment (*Service Insights 1*). The next section discusses how to systematically think about creating value propositions for the customers to become loyal using the Wheel of Loyalty.

SERVICE INSIGHTS 1

How Customers See Relational Benefits in Service Industries

What benefits do customers see themselves receiving from an extended relationship with a service firm? Researchers seeking answers to this question conducted two studies. The first consisted of in-depth interviews with 21 respondents from a broad cross-section of backgrounds. Respondents were asked to identify service providers that they used on a regular basis, and then were invited to identify and discuss any benefits they received as a result of being a regular customer. Among the comments were:

- "I like him [hair stylist]… He's really funny and always has lots of good jokes. He's kind of like a friend now".
- "I know what I'm getting — I know that if I go to a restaurant that I regularly go to, rather than taking a chance on all of the new restaurants, the food will be good".
- "I often get price breaks. The little bakery that I go to in the morning, every once in a while, they'll give me a free muffin and say, 'You're a good customer, it's on us today.'"
- "You can get better service than drop-in customers… We continue to go to the same automobile repair shop because we have gotten to know the owner on a kind of personal basis, and he…can always work us in."
- "Once people feel comfortable, they don't want to switch to another dentist. They don't want to train or break a new dentist in".

After evaluating and grouping the comments, the researchers designed a second study in which they collected 299 survey questionnaires. The respondents were told to select a specific service provider with whom they had a strong, established relationship. Then they were asked to assess the extent to which they received each of the 21 benefits (derived from an analysis of the first study) as a result of their relationship with the specific provider they had

identified. Finally, they were asked to assess the importance of these benefits for them. A factor analysis of the results showed that most of the benefits that customers derived from relationships could be grouped into three categories. The first and most important group involved what the researchers labeled confidence benefits, followed by social benefits, and lastly, special treatment.

Confidence benefits included feelings by customers that in an established relationship, there was less risk of something going wrong, greater confidence in correct performance, and the ability to trust the provider. Customers experienced lower anxiety when purchasing because they knew what to expect, and they typically received the firm's highest level of service.

Social benefits embraced mutual recognition between customers and employees, being known by name, having a friendship with the service provider, and enjoyment of certain social aspects of the relationship.

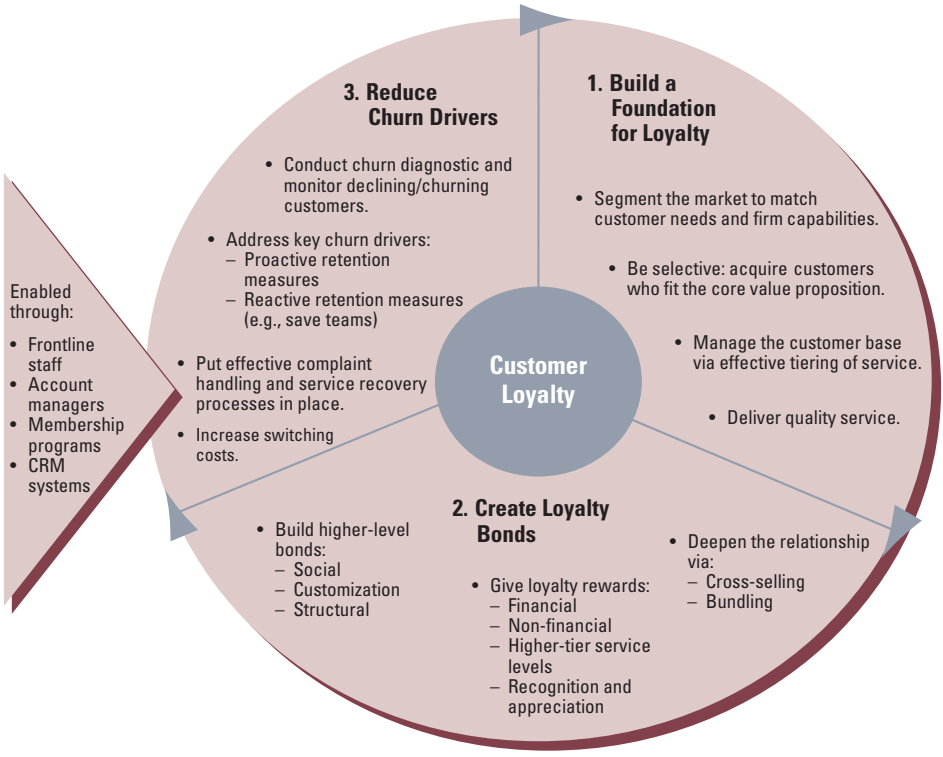
Special treatment benefits included better prices, discounts on special deals that were unavailable to most customers, extra services, higher priority when there was a wait, and faster service than most customers.

Source: Kevin P. Gwinner, Dwayne D. Gremler, and Mary Jo Bitner, "Relational Benefits in Services Industries: The Customer's Perspective," *Journal of the Academy of Marketing Science,* Vol. 26, No. 2, 1998, pp. 101–114.

THE WHEEL OF LOYALTY

Building customer loyalty is difficult. There are very few service firms any customer can count for being loyal to. Most people cannot think of more than perhaps a handful of firms they truly like (i.e., give a high share-of-heart) and to whom they are committed to going back (i.e., give a high share-of-wallet). This shows that although firms put enormous amounts of money and effort into loyalty initiatives, they often are not successful in building true customer loyalty. The Wheel of Loyalty shown in Figure 4 is used as an organizing framework to discuss how to build customer loyalty as discussed in the following sections.

Figure 4: The Wheel of Loyalty



BUILDING A FOUNDATION FOR LOYALTY

Many elements are involved in creating long-term customer relationships and loyalty. In Volume 2, we discussed segmentation and positioning. In this section, the importance of focusing on serving several desirable customer segments, and then taking the pains to build and maintain their loyalty through carefully thought-out relationship marketing strategies is emphasized.

Target the Right Customers

Loyalty management starts with segmenting the market to match customer needs and firm capabilities. "Who should we be serving?" is a question that every service business needs to ask periodically. Not all customers offer a good fit with the organization's capabilities, delivery technologies, and strategic direction. Companies need to be selective

about the segments they target if they want to build successful customer relationships. Managers must think carefully about how customer needs relate to operational elements such as speed and quality, and the physical features and appearance of service facilities. They also need to consider how well their service personnel can meet the expectations of specific types of customers, in terms of both personal style and technical competence.[12]

Leaders are picky about acquiring only the right customers, which are those for whom their firms have been designed to deliver truly special value. Acquiring the right customers often brings long-term revenues and continued growth from referrals. It can also enhance employees' satisfaction, whose daily jobs are improved when they can deal with appreciative customers. Attracting the wrong customers typically results in costly churn, a diminished company reputation, and disillusioned employees.

The result of carefully targeting customers by matching the company capabilities and strengths with customer needs should be a superior service offering in the eyes of those customers who value what the firm has to offer. As Reichheld said, "The result should be a win-win situation, where profits are earned through the success and satisfaction of customers, and not at their expense".[13] Building customer loyalty starts with identifying and targeting the right customers.

Search for Value, Not Just Volume

Too many service firms continue to focus on the *number* of customers they serve without giving sufficient attention to the *value* of each customer.[14] For example, Starwood Hotels & Resorts found that their top 2% of guests generated a whopping 30% of its profits![15] Generally speaking, heavy users who buy more frequently and in larger volumes are more profitable than occasional users. Roger Hallowell makes this point nicely in a banking context:

> *A bank's population of customers undoubtedly contains individuals who either cannot be satisfied, given the service levels and pricing the bank is capable of offering, or will never be profitable, given their banking activity (their use of resources relative to the revenue they supply). Any bank would be wise to target and serve only those*

> *customers whose needs it can meet better than its competitors in a profitable manner. These are the customers who are most likely to remain with that bank for long periods, who will purchase multiple products and services, who will recommend that bank to their friends and relations, and who may be the source of superior returns to the bank's shareholders.*[16]

Ironically, it is often the firms that are highly focused and selective in their customer acquisition — rather than those that focus on unbridled acquisition — that are growing fast over long periods. *Service Insights 2* shows how Vanguard Group, a leader in the mutual funds industry, designed its products and pricing to attract and retain the right customers for its business model.

Also, relationship customers are by definition not buying commodity services. Service customers who buy strictly based on lowest price (a minority in most markets) are not good target customers for relationship marketing in the first place. They are deal-prone, continuously seeking the lowest price on offer, and switch brands easily.

SERVICE INSIGHTS 2

Vanguard Discourages the Acquisition of 'Wrong' Customers[17]

The Vanguard Group is a growth leader in the mutual fund industry that built its $3 trillion in managed assets by 2015 by painstakingly targeting the right customers for its business model. Its share of new sales, which was around 25%, reflected its share of assets or

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market share. However, it had a far lower share of redemptions (customer defections in the fund context), which gave it a market share of net cash flows of 55% (new sales minus redemptions), and this made it the fastest growing mutual fund in its industry.

How did Vanguard achieve such low redemption rates? The secret was in its careful acquisition, and its product and pricing strategies, which encouraged the acquisition of the 'right' customers.

John Bogle, Vanguard's founder, believed in the superiority of index funds and that their lower management fees would lead to higher returns over the long run. He offered Vanguard's clients unparalleled low management fees through a policy of not trading (its index funds hold the market they are designed to track), not having a sales force, and only spending a fraction of what its competitors did on advertising. Another important part of keeping its costs low was its aim to discourage the acquisition of customers who were not long-term index holders.

Bogle attributes the high customer loyalty Vanguard has achieved to a great deal of focus on customer redemptions. "I watched them like a hawk", he explained, and he analyzed them more carefully than new sales to ensure that Vanguard's customer acquisition strategy was on course. Low redemption rates meant that the firm was attracting the right kind of loyal, long-term investors. The inherent stability of its loyal customer base has been key to Vanguard's cost advantage. Bogle's pickiness became legendary. He scrutinized individual redemptions with a fine-tooth comb to see who let the wrong kind of customers on board. When an institutional investor redeemed $25 million from an index fund bought only nine months earlier, he regarded the acquisition of this customer as a failure of the system. He explained, "We don't want short-term investors. They muck up the game at the expense of the long-term investor". At the end of his chairman's letter to the Vanguard Index Trust, Bogle repeated, "We urge them [short-term investors] to look elsewhere for their investment opportunities".

This care and attention to acquiring the right customers is

famous. For example, Vanguard once turned away an institutional investor who wanted to invest $40 million because the firm suspected that the customer would churn the investment within the next few weeks, creating extra costs for existing customers. The potential customer complained to Vanguard's CEO, who in turn not only supported the decision, but also used it as an opportunity to reinforce to his teams why they needed to be selective about the customers they accept.

Furthermore, Vanguard introduced a number of changes to industry practices that discouraged active traders from buying its funds. For example, Vanguard did not allow telephone transfers for index funds, redemption fees were added to some funds, and the standard practice of subsidizing new accounts at the expense of existing customers was rejected because the practice was considered as disloyal to its core investor base. These product and pricing policies in effect turned away heavy traders, but made the fund extremely attractive for long-term investors.

Finally, Vanguard's pricing was set up to reward loyal customers. For many of its funds, investors pay a one-time fee upfront, which goes into the funds themselves (and not to Vanguard) to make up to all current investors for the administrative costs of selling new units. In essence, this fee subsidizes long-term investors, and penalizes short-term investors. Another novel pricing approach was the creation of its Admiral shares for loyal investors, which carried a lower expense fee than ordinary shares (0.15% instead of 0.18% per year).

Different segments offer different value for a service firm. Like investments, some types of customers may be more profitable than others in the short-term, but others may have greater potential for long-term growth. Similarly, the spending patterns of some customers may be stable over time, while others may be more cyclical, e.g., spending heavily in boom times but cutting back sharply in recessions. A wise marketer seeks a mix of segments in order to reduce the risks associated with volatility in demand.[18]

In many cases, David Maister emphasizes, marketing is about getting *better* business, not just *more* business.[19] For instance, the caliber of a professional firm is measured by the type of clients it serves and the nature of tasks on which it works. Volume alone is no measure of excellence, sustainability or profitability. In professional services such as consulting firms or legal partnerships, the mix of attracted business may play an important role in both defining the firm and providing a suitable mix of assignments for staff members at different levels in the organization.

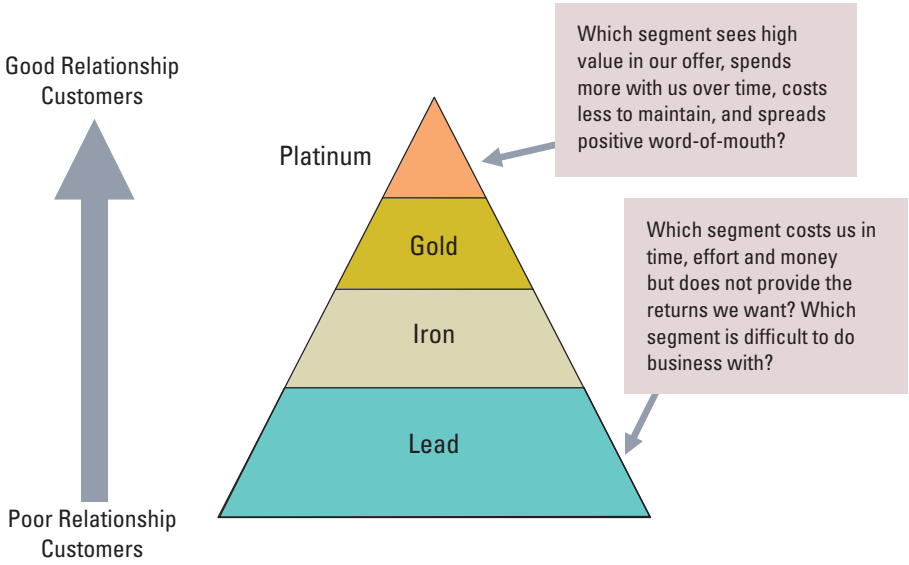
Finally, managers should not assume that the "right customers" are always big spenders. Depending on the service business model, the right customers may come from a large group of people that no other supplier is doing a good job of serving. Many firms have built successful strategies on serving customer segments that had been neglected by established players, which did not see them as being "valuable" enough. Examples include Enterprise Rent-A-Car, which targets customers who need a temporary replacement car. It avoided the more traditional segment of business travelers targeted by its principal competitors. Similarly, Charles Schwab focused on retail stock buyers, and Paychex provides small businesses with payroll and human resource services.[20]

Manage the Customer Base through Effective Tiering of Service

Marketers should adopt a strategic approach to retain, upgrade, and even end relationships with customers. Customer retention involves developing long-term, cost-effective links with customers for the mutual benefit of both parties, but these efforts need not necessarily target all the customers of a firm with the same level of intensity. Research has confirmed that customer profitability and return on sales can be increased by focusing a firm's resources on top-tier customers.[21] Furthermore, different customer tiers often have quite different service expectations and needs. According to Valarie Zeithaml, Roland Rust and Katharine Lemon, it is critical for service firms to understand the needs of customers within different profitability tiers and adjust their service levels accordingly.[22]

Just as service product categories can be tiered to reflect the level of value included (e.g., first, business and economy class in air travel; see Volume 3), so can groups of customers. In the latter instance, service tiers can be developed around the levels of profit contribution of different

Figure 5: The customer pyramid.



Source: Adapted from Valerie A. Zeithaml, Roland T. Rust, and Katherine N. Lemon (2001), "The Customer Pyramid: Creating and Serving Profitable Customers," *California Management Review*, Vol. 43, No. 4, Summer, Figure 1, pp. 118–142.

groups of customers and their needs (including sensitivities to variables such as price, comfort, and speed), and identifiable personal profiles such as demographics. Zeithaml, Rust and Lemon illustrate this principle through a four-level pyramid (Figure 5).

- *Platinum.* These customers form a very small percentage of a firm's customer base, but are heavy users, and tend to contribute a large share of the profits. This segment is usually less price-sensitive, but expects higher service levels in return, and it is likely to be willing to invest in and try new services.
- *Gold.* The gold tier includes a larger percentage of customers than the platinum, but individual customers contribute less profit than platinum customers. They tend to be slightly more price sensitive and less committed to the firm.
- *Iron.* These customers provide the bulk of the customer base. Their numbers give the firm economies of scale. Hence, they are important so that a firm can build and maintain a certain capacity level and infrastructure, which is often needed for serving gold and platinum customers well. However, iron customers on their own may only be

marginally profitable. Their level of business is not enough to justify special treatment.

- *Lead.* Customers in this tier tend to generate low revenues for a firm, but often still require the same level of service as iron customers, which turns them into a loss-making segment from a firm's perspective.

The precise characteristics of customer tiers vary, of course, from one type of business to another, and even from one firm to another. *Service Insights 3* provides an illustration from the marketing research industry.

SERVICE INSIGHTS 3

Tiering the Customers of a Market Research Agency

Tiering its clients helped a leading US market research agency understand its customers better. The agency defined *platinum clients* as large accounts that were not only willing to plan a certain amount of research work during the year, but were also able to commit to the timing, scope, and nature of their projects, which made capacity management and project planning much easier for the research firm. The acquisition costs for projects sold to these clients were only 2%–5% of project values (as compared to as much as 25% for clients who required extensive proposal work and project-by-project bidding). Platinum accounts were also more willing to try new services, and buy a wider range of services from their preferred provider. These customers were generally very satisfied with the research agency's work and were willing to act as references for potential new clients.

Gold accounts had a similar profile to platinum clients, except that they were more price sensitive, and more inclined to spread their budgets across several firms. Although these accounts had been clients for many years, they were not willing to commit their research work for a year in advance even though the research firm would have been able to offer them better quality and priority in capacity allocation.

Iron accounts spent moderate amounts on research, and commissioned work on a project basis. Selling costs were high, as these firms tended to send out requests-for-proposals (RFPs) to a number of firms for all their projects. They sought the lowest price, and often did not allow sufficient time for the research firm to perform a good quality job.

Lead accounts sought only isolated, low-cost projects which tended to be 'quick and dirty' in nature, with little opportunity for the research firm to add value or apply its skillsets appropriately. Sales costs were high as the client typically invited several firms to quote. Furthermore, as these firms were inexperienced in conducting research and in working with research agencies, selling a project often took several meetings and required multiple revisions to the proposal. Lead accounts also tended to be high maintenance because they did not understand research work well; they often changed project parameters, scope, and deliverables midstream and then expected the research agency to absorb the cost of any rework, thus further reducing the profitability of the engagement.

Source: Adapted Valarie A Zeithaml, Roland T Rust & Katharine N Lemon, "The Customer Pyramid: Creating and serving profitable customers," *California Management Review; Berkeley* 43, no. 4 (Summer 2001), pp. 127–128.

Customer tiers are typically based on profitability and their service needs. Rather than providing the same level of service to all customers, each segment receives a service level that is customized based on its requirements and value to the firm. For example, the platinum tier is provided some exclusive benefits that are not available to other segments. The benefit features for platinum and gold customers should be designed to encourage them to remain loyal because these customers are the very ones competitors would like to steal most.

Marketing efforts can be used to encourage an increased volume of purchases, upgrading the type of service used, or cross-selling additional services to any of the four tiers. However, these efforts have different thrusts for the different tiers, as their needs, usage behaviors, and spending patterns are usually very different. Among the segments for

which the firm already has a high share-of-wallet, the focus should be on nurturing, defending, and retaining these customers, possibly by use of loyalty programs.[23]

In contrast, among lead-tier customers at the bottom of the pyramid, the options are either to move them to the iron segment (e.g., through increasing sales, increasing prices and/or cutting servicing costs) or end the relationship with them. Migration can be achieved through a combination of strategies, including upselling, cross-selling, and setting base fees and price increases. For example, imposing a minimum fee that is waived when a certain level of revenue is generated may encourage customers who use several suppliers to consolidate their buying with a single firm instead. Another way to move customers from the lead-tier to the iron-tier is to encourage them to use low-cost service delivery channels. For instance, lead-tier customers may be charged a fee for face-to-face interactions but the fee is waived when such customers use electronic channels. In the cellular telephone industry for example, low-use mobile users can be encouraged to use pre-paid packages that do not require the firm to send out bills and collect payment, which also eliminates the risk of bad debts on such accounts.

Divesting or terminating customers comes as a logical consequence of the realization that not all existing customer relationships are worth keeping.[24] Some relationships may no longer be profitable for the firm because they cost more to maintain than the contributions they generate. Some customers no longer fit the firm's strategy, either because that strategy has changed, or because the customers' behavior and needs have changed.

Occasionally customers are "fired" outright (although the concern for due process is still important). Captial One 360 is the fast-food model of consumer banking — it is about as no-frills as it gets. It only has a handful of basic products, and it lures low-maintenance customers with no minimum balance nor fees, and slightly higher interest rates for its savings accounts and lower interests on its home loans. To offset that generosity, its business model pushes its customers toward online transactions, and the bank routinely fires customers who do not fit its business model. When a customer calls too often (the average customer phone call costs the bank $5.25 to handle), or wants too many exceptions to the rule, the bank's sales associates will say, "Look, this doesn't fit you.

You need to go back to your community bank and get the kind of contact you're comfortable with". As a result, its cost per account are much lower than industry average.[25]

Other examples where customers get fired include students who are caught cheating in examinations, or country club members who consistently abuse the facilities or people. In some instances, termination may be less confrontational. Banks wishing to divest themselves of certain types of accounts that no longer fit their corporate priorities have been known to sell them to other banks (one example is credit card holders who receive a letter in the mail telling them that their account has been transferred to another card issuer).

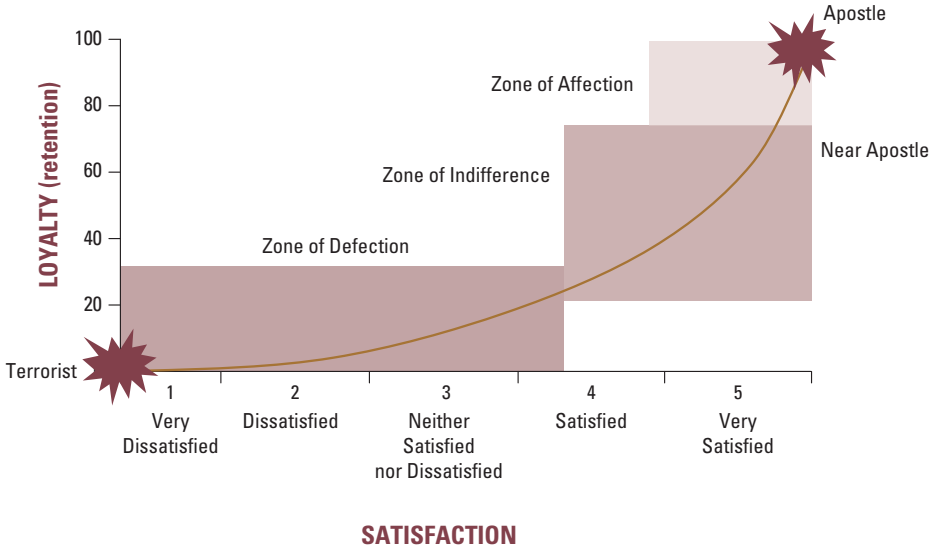
Just as investors need to dispose of poor investments and banks may have to write off bad loans, each service firm needs to examine its customer portfolio regularly and consider ending unsuccessful relationships. Of course, legal and ethical considerations will determine how to take such actions. For example, a bank may introduce a minimum monthly fee for accounts with a low balance (e.g., below $1,000), but for social responsibility considerations, waive this fee for customers on social security.

Customer Satisfaction and Service Quality are Prerequisites for Loyalty

The foundation for building true loyalty lies in customer satisfaction. Highly satisfied or even delighted customers are more likely to consolidate their buying with one supplier, spread positive word-of-mouth, and become loyal apostles of a firm.[26] In contrast, dissatisfaction drives customers away and is a key factor in switching behavior.

The satisfaction-loyalty relationship can be divided into three main zones: defection, indifference, and affection (Figure 6). The *zone of defection* occurs at low satisfaction levels. Customers will switch unless switching costs are high or there are no viable or convenient alternatives. Extremely dissatisfied customers can turn into 'terrorists' providing an abundance of negative word-of-mouth for the service provider.[27] The *zone of indifference* is found at moderate satisfaction levels. Here, customers are willing to switch if they find a better alternative. Finally, the *zone of affection* is located at very high satisfaction levels, where customers have

Figure 6: The customer satisfaction-loyalty relationship.



Source: Adapted from Thomas O. Jones and W. Earl Sasser, Jr. (1995), "Why Satisfied Customers Defect," *Harvard Business Review*, November–December, p. 91.

such high attitudinal loyalty that they do not look for alternative service providers. Customers who praise the firm in public and refer others to the firm are described as 'apostles'.

True loyalty is often defined as combining both behavioral and attitudinal loyalty, also referred to as share-of-wallet and share-of-heart. Behavioral loyalty includes behaviors such as buying again, a high share-of-wallet, providing positive word-of-mouth, and attitudinal loyalty refers to a true liking and emotional attachment of the firm, service and brand.

It is important to note though that satisfaction can be seen as a necessary, but not sufficient, driver of true customer loyalty. Satisfaction alone does not explain a large amount of variance in loyalty behaviors, and has to be seen in combination with other factors such as switching costs and customer knowledge (e.g., knowledgeable customers feel more confident in switching and have lower risk perceptions),[28] how the firm compares to competitors (e.g., if a firm is seen as offering the best value proposition compared to that of the next best alternative provider,[29] switching makes little sense and customers keep buying), and the loyalty bonds as discussed in the next section.

STRATEGIES FOR DEVELOPING LOYALTY BONDS WITH CUSTOMERS

Having the right portfolio of customer segments, attracting the right customers, tiering the service, and delivering high levels of satisfaction builds a solid foundation for creating customer loyalty as shown in the Wheel of Loyalty in Figure 4. However, firms can do more to 'bond' more closely with their customers using a variety of strategies, including (1) deepening the relationship through cross-selling and bundling, (2) creating loyalty rewards, and (3) building higher level bonds such as social, customization, and structural bonds.[30] Each of these three strategies are discussed in the next sections.

Deepen the Relationship

To build closer ties with its customers, firms can deepen the relationship through bundling and/or cross-selling services. For example, banks like to sell as many financial products to an account or household as possible. Once a family has a checking, credit card or savings account, safe deposit box, car loan, mortgage, and so on with the same bank, the relationship is so deep that switching becomes a major exercise and is unlikely, unless customers are extremely dissatisfied with the bank.

In addition to raising switching costs, there is often value for the customer when buying all particular services from a single provider. One-stop shopping typically is more convenient than buying individual services from different providers. When having many services with the same firm, the customer may achieve a higher service tier and receive better services, and sometimes service bundles do come with price discounts.

Encourage Loyalty through Financial and Non-financial Rewards

Few customers buy only from a single supplier. This is especially true in situations where service delivery involves separate transactions (such as a car rental) instead of being continuous in nature (as with insurance coverage). In many instances, consumers are loyal to several brands (sometimes described as "polygamous loyalty") but avoid others. In such instances, the marketing goal is to strengthen the customer's preference for one brand over others, and to gain a greater share of the customer's spending in that service category. Once acquired, it tends to be the

Figure 7: American Airlines uses its AAdvantage program to promote customer loyalty.

© American Airlines, Inc. 2016.

reward-based bonds (often offered through a loyalty program) that entice customers to spend more money and increase a firm's share-of-wallet.[31] Incentives that offer rewards based on the frequency of purchase, value of purchase, or a combination of both, represent a basic level of customer bonding. These rewards can be financial and non-financial in nature.

Financial Rewards. Financial rewards are customer incentives that have a financial value (also called "hard benefits"). These include discounts on purchases, loyalty program rewards such as frequent flier miles (Figure 7), and the cash-back programs provided by some credit card issuers.

Besides airlines and hotels, an increasing number of service firms ranging from retailers (such as department stores, supermarkets,[32] book shops, and petrol stations), telecommunications providers, café

chains, to courier services, and cinema chains have launched similar reward programs in response to the increasing competitiveness of their markets. Although some provide their own rewards — such as free merchandise, vehicle upgrades, or free hotel rooms at vacation resorts — many firms denominate their awards in miles that can be credited to a selected frequent-flyer program. In fact, air miles have become a form of promotional currency in the service sector.[33]

Research in the credit card industry suggests that financial rewards-based loyalty programs strengthen the customers' perception of the value proposition, and lead to increased revenues due to higher usage levels and fewer defections.[34] To assess the potential of a loyalty program to alter normal patterns of behavior, Grahame Dowling and Mark Uncles argue that marketers need to examine three psychological effects[35]:

- *Brand loyalty versus deal loyalty.* To what extent are customers loyal to the core service (or brand) rather than to the loyalty program itself? Marketers should focus on loyalty programs that directly support the value proposition and positioning of the product in question. For example, free upgrades, value-added services, or other core service-related benefits that enhance the overall service experience are directly linked to the core service, but air miles are not.
- *How buyers value rewards.* Several elements determine a loyalty program's value to customers: (1) the cash value of the redemption rewards (if customers had to purchase them); (2) the range of choice among rewards — for instance, a selection of benefits rather than just a single benefit; (3) the aspirational value of the rewards — something exotic that the consumer would not normally purchase may have greater appeal than a cash-back offer; (4) whether the amount of usage required to obtain a reward places it within the realm of possibility for any given consumer; (5) the ease of using the program and making redemptions; and (6) the psychological benefits of belonging to the program and accumulating points.
- *Timing.* How soon can benefits from participating in the rewards program be obtained by customers? Deferred gratification tends to weaken the appeal of a loyalty program. One solution is to send customers periodic statements of their account status, indicating

progress toward reaching a particular milestone, and promoting the rewards that might be forthcoming when that point is reached.

Interestingly, if a firm has loyalty program partners, (e.g., an airline may partner credit card companies, hotels, car rental firms, where loyalty program points can also be earned with these companies), satisfaction with the core service can have a positive impact on buying from program partners. In the same way, satisfaction with the service of program partners can have a positive impact on the buying of the core service.[36] It is therefore important for firms to be selective in choosing loyalty program partners.

Even well-designed rewards programs by themselves are not enough to keep a firm's most desirable customers. If the customers are dissatisfied with the quality of service, or believe they can get better value from another provider, they may quickly become disloyal. No service business that has instituted a rewards program for frequent users can ever afford to lose sight of its broader goals of offering high service quality and good value relative to the price and other costs incurred by customers.[37] Sometimes, what the customer wants is just for the firm to deliver the basic service well, meet their needs, and solve their problems quickly and easily, and they will be loyal.[38] One of the risks associated with a focus on strengthening relationships with high-value customers is that a firm may allow service to other customers to deteriorate.

Finally, customers can even get frustrated especially with financial rewards-based programs, so rather than creating loyalty and goodwill, they breed dissatisfaction! This can happen when customers feel they are excluded from a reward program because of low balances or volume of business, if the rewards are seen as having little or no value, if they cannot redeem their loyalty points because of black-out dates during high demand periods, and if redemption processes are too troublesome and time-consuming.[39] And some customers already have so many loyalty cards in their wallet that they are simply not interested in adding to that pile, especially if customers see them as only of marginable value.

Non-financial Rewards. Non-financial rewards (also called "soft benefits") provide benefits that cannot be translated directly into monetary

terms. Examples include giving priority to loyalty program members on reservation waitlists and virtual queues in call centers. Some airlines provide benefits such as higher baggage allowances, priority upgrading, access to airport lounges, and the likes, to its frequent flyers even when they are only flying in economy class.

Important intangible rewards include special recognition and appreciation. Customers tend to value the extra attention given to their needs and appreciate the efforts to meet their occasional special requests. High-tier loyalty program members also tend to enjoy an implicit service guarantee. When things go wrong, front-line employees will pay extra attention to their most valuable customers and see that the service is recovered to their satisfaction.

Many loyalty programs also provide important status benefits to customers in the top-tiers who feel part of an elite group (e.g., the Seven Stars card holders with Caesars in our opening vignette) and enjoy their special treatment.[40] Tiered loyalty programs in particular can provide powerful incentives and motivation for customers to achieve the next higher level of membership which often leads to a higher share-of-wallet for the preferred provider.

Non-financial rewards, especially if linked to high-tier service levels, are typically more powerful than financial ones as the former can create tremendous value for customers. Unlike financial rewards, nonfinancial rewards directly relate to the firm's core service and improve customers' experience and value perception. In the context of a hotel, for example, redeeming loyalty points for free gifts does nothing to enhance the guest experience. However, getting priority for reservations, early check-in, late check-out, upgrades, and receiving special attention and appreciation will make your stay more pleasant, leave you with the fuzzy warm feeling that this firm appreciates your business, and makes you want to come back.[41]

Service Insights 4 describes how British Airways has designed its Executive Club, effectively combining financial and non-financial loyalty rewards.

Small businesses often do not run formal loyalty programs but can still employ effective bonds. For example, they can use informal loyalty rewards which may take the form of giving regular customers a small treat periodically as a way of thanking them, reserving their favorite table in a restaurant, paying them special attention, and the likes.

SERVICE INSIGHTS 4

Rewarding Value of Use, Not Just Frequency, at British Airways

Unlike some frequent-flyer programs, in which customer usage is measured simply in miles, British Airways' (BA) Executive Club members receive both *air miles* toward redemption of air travel rewards and *points* towards silver- or gold-tier status for travel on BA. With the creation of OneWorld alliance with American Airlines, Qantas, Cathay Pacific, and other airlines, Executive Club members have been able to earn miles (and sometimes points) by flying these partner airlines, too.

As shown in Table 1, silver and gold cardholders are entitled to special benefits such as priority reservations and a superior level of on-the-ground service. For instance, even if a gold cardholder is only traveling in economy class, he or she will be entitled to first-class standards of treatment at check-in, in the airport lounges and boarding. Miles will not expire as long as the frequent-flyer account has at least one transaction in every 36 months (after which they expire), but tier status is valid for only 12 months beyond the membership year in which it was earned. This means that the right to special privileges must be re-earned each year. The objective of awarding tier status is to encourage passengers who have a choice of airlines to concentrate their travel on BA, rather than to join several frequent-flyer programs and collect mileage awards from all of them. Few passengers travel with such frequency that they will be able to obtain the benefits of gold-tier status (or its equivalent) on more than one airline.

Points given also vary according to the class of service. Longer trips earn more points than shorter ones. However, tickets at deeply discounted prices may earn fewer miles and no points at all. To reward purchase of high-priced tickets, passengers earn points at up to 2.5 times the economy rate if they travel in club (business class), and up to triple the rate in first class.

Although the airline makes no promises about complimentary upgrades, members of BA's Executive Club are more likely to

Table 1: Selected Benefits Offered by British Airways to its Most Valued Passengers

Benefit	Bronze-Tier Members	Gold-Tier Members
Reservations		Dedicated gold phone line
Reservation assurance		If flight is full, a guaranteed seat in economy when booking full fare ticket at least 24 hours in advance and checking in at least one hour in advance
Priority waitlist and standby	Higher priority	Highest priority
Check-in desk	According to class of travel	First (regardless of travel class)
Lounge access	According to class of travel	First class departure lounge for passenger and one guest, regardless of travel class; use of arrival lounges; lounge access anytime, allowing use of lounges even when not flying BA intercontinental flights
Special services assistance		Dedicated direct line to customer support staff; problem solving beyond that accorded to other BA travelers
Bonus air miles	+25%	+100%
Upgrade for two		Free upgrade to next cabin for member and companion after earning 2,500 tier points in one year; another upgrade for two after 3,500 points in same year
Partner cards		Upon reaching 5,000 points, the member will receive two Executive Club Silver cards and one Gold Partner so that the benefits can be shared with loved ones
Special privilege		Concorde Room access at Heathrow Terminal 5 and New York JFK Terminal 7 after earning 5,000 points
Lifetime membership		Upon earning 35,000 points, Gold membership status will be awarded for life

receive such invitations than other passengers. Tier status is an important consideration when employees decide whom to upgrade on an overbooked flight. Unlike many airlines, BA tends to limit upgrades to situations in which a lower-class cabin is overbooked. They do not want frequent travelers to believe that they can plan on buying a less expensive ticket and then automatically receive an upgrade.

BA has even created a Household Account that allows for up to six family members who live at the same address to pool their miles and allow them to make full use of the collective balance.

Source: British Airways Executive Club benefits, https://www.britishairways.com/en-gb/executive-club/tiers-and-benefits/compare-the-tiers accessed 1 July, 2016.

Build Higher-Level Bonds

One objective of loyalty rewards is to motivate customers to combine their purchases with one provider, or at least make it the preferred provider. However, reward-based loyalty programs are quite easy for other suppliers to copy, and they rarely provide a sustained competitive advantage. In contrast, high-level bonds tend to offer a more sustained competitive advantage. Next section discusses the three main types of high-level bonds, which are: (1) social, (2) customization, and (3) structural bonds.

Social Bonds. It is interesting to notice how a hairdresser addresses her customer by name who came for a haircut, or how she asks why she has not seen her for a long time, and hopes everything went well when the said customer was away on a long business trip. Social bonds and related personalization of services are usually based on personal relationships between providers and customers. Social bonds are more difficult to build than financial bonds and may take longer to achieve, but they are also harder for other suppliers to replicate for that same customer. A firm that has created social bonds with its customers has a better chance of retaining them for the long term because of the trust the customers place in the staff. [42] When social bonds include shared relationships or experiences between customers, such as in country clubs or educational settings, they can be a major loyalty driver for the organization.[43]

Customization Bonds. These bonds are built when the service provider succeeds in providing customized service to its loyal customers. For example, Starbucks' employees are encouraged to learn their regular customers' preferences and customize their services accordingly. Many large hotel chains capture the preferences of their customers through their loyalty program databases. Firms offering customized service are likely to have more loyalty customers, so that, when customers arrive at their hotel for example, they find their individual needs have already been anticipated, from the preferred room type (e.g., smoking vs. non-smoking) and bed type (e.g., twins or king size), to the kind of pillow they like, and the newspaper they want to read in the morning. Among many other benefits, Fairmont Hotels & Resorts' loyalty program provides its members with jogging shoes and apparel of the right size, and yoga mats and stretch bands waiting in the guests' rooms at their arrival.[44] When a customer becomes used to this special service level, he or she may find it difficult to adjust to another service provider who is not able to customize the service (or at least immediately, as it takes time for the new provider to learn about someone's needs and preferences).[45]

Structural Bonds. Structural bonds are frequently seen in B2B settings. They are created by getting customers to align their way of doing things with the supplier's own processes, thus linking the customer to the firm. This situation makes it more difficult for competitors to draw them away. Examples include joint investments in projects and sharing of information, processes, and equipment.

Structural bonds can be created in a B2C environment too. For instance, some car rental companies offer travelers the opportunity to create a customized account on the firm's website and mobile app, where they can retrieve details of past trips, including pick-up and return locations, types of cars, insurance coverage, billing address, credit card details, and so forth. This simplifies the task of making new bookings. Once customers have integrated their way of doing things with the firm's processes, structural bonds are created, linking the customer to the firm and making it more difficult for the competition to draw them away.

While all these bonds tie a customer closer to the firm, they also deliver the confidence, social, and special treatment benefits that customers desire (refer to *Service Insights 1*). In general, bonds will not work well in the long term unless they generate value for the customer!

STRATEGIES FOR REDUCING CUSTOMER DEFECTIONS

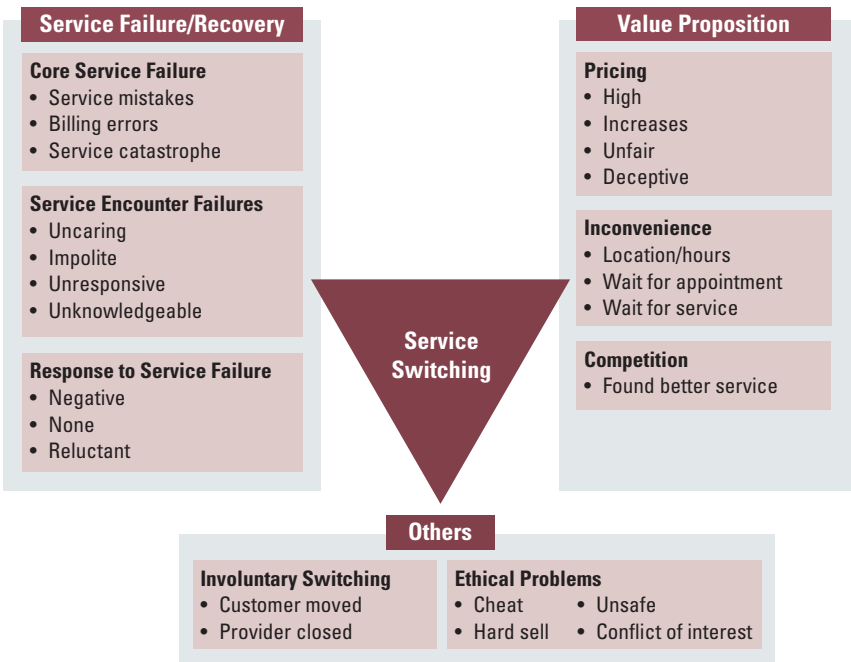
A complementary approach is to understand the drivers of customer defections, also called customer churn, and work on eliminating or at least reducing those drivers.

Analyze Customer Defections and Monitor Declining Accounts

A first step is to understand the reasons for customer switching. Susan Keveaney conducted a large-scale study across a range of services and found several key reasons why customers switch to another provider (Figure 8).[46] These were:

- Core service failures (44% of respondents)
- Dissatisfactory service encounters (34%)
- High, deceptive, or unfair pricing (30%)
- Inconvenience in terms of time, location, or delays (21%)
- Poor response to service failure (17%)

Figure 8: What drives customers to switch away from a service firm?



Source: Adapted from Susan M. Keaveney (1995), "Customer Switching Behavior in Service Industries: An Exploratory Study," *Journal of Marketing*, Vol. 59, April, pp. 71–82.

Many respondents decided to switch after a series of related incidents, such as a service failure followed by an unsatisfactory service recovery. Other important factors that drive switching include overall dissatisfaction with the current service provider and the perception that it has an inferior performance on important attributes compared to the best alternative provider.[47]

Progressive service firms regularly conduct what is called *churn diagnostics* to gain a better understanding of why customers defect. This includes the analysis of data from churned and declining customers, exit interviews (call-center staff often have a short set of questions they ask when a customer cancels an account), and in-depth interviews of former customers by a third-party research agency, which typically yield a more detailed understanding of churn drivers.[48]

Some firms even try to predict churn of individual accounts. For example, cell phone service providers use churn alert systems, which monitor the activity in individual customer accounts with the objective of predicting impending customer switching. Important accounts at risk are flagged and efforts are made to keep the customer, such as sending a voucher and/or having a customer service representative call the customer to check on the health of the customer relationship and initiate corrective action if needed.

Address Key Churn Drivers

Keaveney's findings underscore the importance of addressing some general churn drivers by delivering quality service (see Volume 12), minimizing inconvenience and other nonmonetary costs, and having fair and transparent pricing (Volume 4). In addition to these generic drivers, there are often industry-specific churn drivers as well. For example, handset replacement is a common reason for cellular phone service subscribers to discontinue an existing relationship, as new subscription plans usually come with heavily subsidized brand-new handsets. To prevent handset-related churn, many providers now offer proactive handset replacement programs, where their current subscribers are offered to buy heavily discounted handsets at regular intervals. Some providers even offer handsets for free to high-value customers or against the redemption of loyalty points.

In addition to such proactive retention measures, many firms also use reactive measures. These include specially trained call-center staff called *save teams*, who deal with customers who intend to cancel their accounts. The main job of save team employees is to listen to customer needs and issues, and try to address them with the key focus of retaining the customer. However, you need to be careful on how to reward save teams (see *Service Insights 5*).

SERVICE INSIGHTS 5

Churn Management Gone Wrong

America Online (AOL) found itself on the wrong end of churn management when about 300 of its subscribers filed complaints with the New York state attorney general's office, saying that AOL had ignored their demands to cancel the service and stop billing them. After an investigation by the State of New York, AOL eventually agreed to pay $1.25 million in penalties and costs, and to change some of its customer service practices to settle the case.

What went wrong? AOL had been rewarding its call-center employees for 'saving' customers who called in to cancel their service. Employees could earn high bonuses if they were able to persuade half or more of such customers to stay with the firm. As claimed by the attorney general's office, this may have led AOL's employees to make it difficult to cancel service. As a response, AOL agreed in a settlement to have service cancellations requests recorded and verified by a third-party monitor, and to provide up to four months' worth of refunds to all New York subscribers who claim that their cancellations had been ignored (AOL did not admit to any wrongdoing in that settlement). The New York's Attorney General at the time said, "This agreement helps to ensure that AOL will strive to keep its customers through quality service, not stealth retention programs".

Source: The Associated Press, "AOL to Pay $1.25 M to Settle Spitzer Probe," *USA Today,* 25.08.2005, p. 5B.

Implement Effective Complaint Handling and Service Recovery Procedures

Effective complaint handling and excellent service recovery are crucial for keeping unhappy customers from switching providers. Well-managed firms make it easy for customers to voice their problems and respond with suitable service-recovery strategies. In that way, customers will remain satisfied, and this will reduce the intention to switch[49] (see Volume 11 for more details).

Increase Switching Costs

Another way to reduce churn is to increase switching costs.[50] Many services have natural switching barriers. For example, it is a lot of work for customers to change their primary banking account, especially when many direct debits, credits, and other related banking services are tied to that account, plus many customers are reluctant to learn about the products and processes of a new provider.[51] Firms can increase these switching costs further by focusing on providing added value to customers through increased convenience, customization, and priority (collectively called "positive switching costs" or "soft lock-in strategies") to tie a customer closer to the firm and make switching more costly. Such strategies have been shown to be more effective in generating both attitudinal and behavioral loyalty than the "hard lock-in strategies" discussed next.[52]

Hard lock-in strategies refer to switching costs created by having contractual penalties for switching, such as transfer fees payable to some brokerage firms for moving shares and bonds to another financial institution. Cellular phone service providers often impose contractual penalties if a contract is cancelled during a lock-in period. However, firms need to be careful so that they are not seen as holding their customers hostage. A firm with high switching barriers and poor service quality is likely to generate negative attitudes and bad word-of-mouth. At some point, the last straw is reached and a customer will have had enough and continue to switch service providers even with significant switching costs, or at the first opportune moment, for example, when a contract expires.[53]

ENABLERS OF CUSTOMER LOYALTY STRATEGIES

Most strategies discussed in the Wheel of Loyalty require an in-depth understanding of its customers to actively improve their loyalty. Enablers of customer loyalty strategies provide this understanding and include the creation of "membership-type" of relationships such as through loyalty programs and CRM systems, account managers, and frontline employees. Before discussing these enablers, the fundamental difference between strategies intended to produce a single transaction (i.e., transaction marketing) and those designed to create extended relationships with customers (relationship marketing) will be discussed.

Customer Loyalty in a Transactional Marketing Context

A *transaction* is an event during which an exchange of value takes place between two parties. One transaction or even a series of transactions do not necessarily constitute a relationship, which requires mutual recognition and knowledge between the parties. When each transaction between customer and supplier is essentially discrete and anonymous, with no long-term record kept of customer's purchasing history, and little or no mutual recognition between the customer and employees, then no meaningful marketing relationship can be said to exist. This is true for many services, ranging from passenger transport to food service, or visits to a movie theater, in which each purchase and use is a separate event.

Customer loyalty strategies in a transactional marketing context have to focus mostly on the foundation strategies of the Wheel of Loyalty, such as segmenting the market and matching customer needs with firm capabilities, and delivering high service quality. However, most other strategies require a good understanding of a firm's customer behavior. For example, unless a firm knows the consumption behavior of individual customers, it cannot apply tiering of service, loyalty rewards, customization, personalization, churn management and the like. For all those strategies, a firm has to have individual customer data, which is the case in relationship marketing.

Relationship Marketing

The term *relationship marketing* has been widely used to describe the type of marketing activity designed to create extended relationships with customers. Ideally, both the firm and the customer have an interest in a deeper engagement and higher value-added exchange. A firm may have

transactions with some customers who have neither the desire nor the need to make future purchases, while working hard to move others up the loyalty ladder.[54] Evert Gummesson identified no fewer than 30 types of relationships. He advocates *total relationship marketing*, describing it as:

> *…marketing based on relationships, networks, and interaction, recognizing that marketing is embedded in the total management of the networks of the selling organization, the market, and society. It is directed to long-term, win-win relationships with individual customers, and value is jointly created between the parties involved.*[55]

Relationship marketing requires a membership-type relationship. The next section shows that some service industries naturally have a membership-type relationship, whereas others have to work hard to create them.

Creating "Membership-type" Relationships as Enablers for Loyalty Strategies

The nature of the current relationship with customers can be analyzed by asking first: does the supplier enter into a formal "membership"

Table 2: Relationships with Customers

Nature of Service Delivery	Type of Relationship Between the Service Organization and Its Customers	
	Membership Relationship	No Formal Relationship
Continuous delivery of service	• Insurance • Cable TV subscription • College enrollment • Banking	• Radio station • Police protection • Lighthouse • Public highway
Discrete transactions	• Long-distance calls from subscriber phone • Theater series subscription • Travel on commuter ticket • Repair under warranty • Health treatment for HMO member	• Mail service • Toll highway • Movie theater • Public transportation • Restaurant

relationship with customers, as with telephone subscriptions, banking, and the family doctor? Or is there no defined relationship? Second, is the service delivered on a continuous basis, as in insurance, broadcasting and police protection? Or is each transaction recorded and charged separately? Table 2 shows the matrix resulting from this categorization, with examples in each category. A *membership relationship* is a formalized relationship between the firm and an identifiable customer, which often provides special benefits to both parties.

Discrete transactions in which every use involves a payment to the service supplier by an essentially "anonymous" consumer, are typical of services such as transport, restaurants, cinemas and shoe repairs. The problem for marketers of such services is that they tend to be less informed about who their customers are and what use each customer makes of the service than their counterparts in membership-type organizations. Managers in businesses that sell discrete transactions have to work a little harder to establish relationships.

In small businesses such as hair salons, frequent customers are (or should be) welcomed as "regulars" whose needs and preferences are remembered. Keeping formal records of customers' needs, preferences and purchasing behavior is useful even for small firms, as it helps employees to avoid asking the same questions on each service occasion, allowing them to personalize the service given to each customer, and also enables the firm to anticipate future needs. In addition, selling the service in bulk (for instance, a theater series subscription or a commuter ticket on public transport) can also transform discrete transactions into membership relationships, but do not necessarily allow for more customer insight and deployment of more sophisticated loyalty strategies.

In large companies with substantial customer bases, transactions can still be transformed into relationships by offering extra benefits to customers who choose to register with the firm (loyalty programs for hotels, airlines, car rental firms, and mobile apps for café chains fall into this category). Having a loyalty program in place enables a firm to know who its current customers are, to capture their service transactions and preferences. This is valuable information for service delivery, allowing customization and personalization, and for segmentation and tiering of service purposes. For transaction-type businesses, loyalty reward programs, in combination with CRM systems, become a necessary

enabler for implementing the strategies discussed in the Wheel of Loyalty.

Novices often equate loyalty points with loyalty programs. However, the most valuable aspect of loyalty programs for both the customer and the firm are often all the other benefits a firm's loyalty strategy brings with it. As discussed in the Wheel of Loyalty, it is often the benefits of the loyalty program that enhance the core service (from priority to customization) and have the highest value. One might ask, why then do firms do away with the points and focus on these other benefits? The answer has to do with consumer psychology; we all need a little incentive to sign up, install an app, provide information and carry a loyalty card. For a firm to gain a system-wide view across outlets (and often, across countries), channels, and services, the only unique identifier that is reliable is typically a loyalty card (or membership card number) or a mobile app connected to a cell phone number. All other unique identifiers such as name, passport numbers, and address have been shown to be problematic, as names and addresses can be misspelled and passport numbers change. Therefore, it is often good to view the points (or air miles) of a loyalty program as a little incentive for customers to sign up and identify themselves at reservations, check-ins, and purchases, through their loyalty program membership number, card, or mobile app. The real customer (and firm) benefits are then delivered through the other bonds as described in the Wheel of Loyalty.

The loyalty program and loyalty strategies undoubtedly have to be delivered, and that typically happens through CRM systems that capture, analyze and deliver the relevant information to front-line employees and account managers (in B2B contexts, or top-tier consumer segments). Front-line employees were discussed in Volume 9, and the role of CRM systems in delivering loyalty strategies are discussed in the next section.

CRM: CUSTOMER RELATIONSHIP MANAGEMENT

Service marketers have understood for some time the power of customer relationship management, and certain industries have applied it for decades. Examples include the corner grocery store, the neighborhood car repair shop, and providers of banking services to high net-worth clients. Mention CRM and immediately, costly and complex IT systems and infrastructure come to mind. However, CRM actually signifies the whole

process by which relations with the customers are built and maintained.[56] It should be seen as an enabler of the successful implementation of the Wheel of Loyalty. The CRM system will be discussed next, before moving on to a more strategic perspective.

Common Objectives of CRM Systems

Many firms have large numbers of customers (sometimes millions), many different touch points (for instance, tellers, call-center staff, self-service machines, apps, and websites), and at multiple geographic locations. At a single large facility, it is unlikely that a customer will be served by the same front-line staff on two consecutive visits. In such situations, managers historically lacked the tools to practice relationship marketing. Today, CRM systems allow customer information to be captured and delivered to the various touch points. From a customer perspective, well-implemented CRM systems can offer a unified customer interface that delivers customization and personalization. This means that at each transaction, the relevant account details, knowledge of customer preferences and past transactions, or history of a service problem are at the fingertips of the person serving the customer. This can result in a vast service improvement and increased customer value.

From a company's perspective, CRM systems allow the company to better understand, segment, and tier its customer base, better target promotions and cross-selling, and even implement churn alert systems that signal if a customer is in danger of defecting.[57] *Service Insights 6* highlights some common CRM applications.

SERVICE INSIGHTS 6
Common CRM Applications

- *Data collection.* The system captures customer data such as contact details, demographics, purchasing history, service preferences, and the like.
- *Data analysis.* The data captured is analyzed and grouped by the system according to the criteria set by the firm. This is used to tier the customer base and tailor service delivery accordingly.

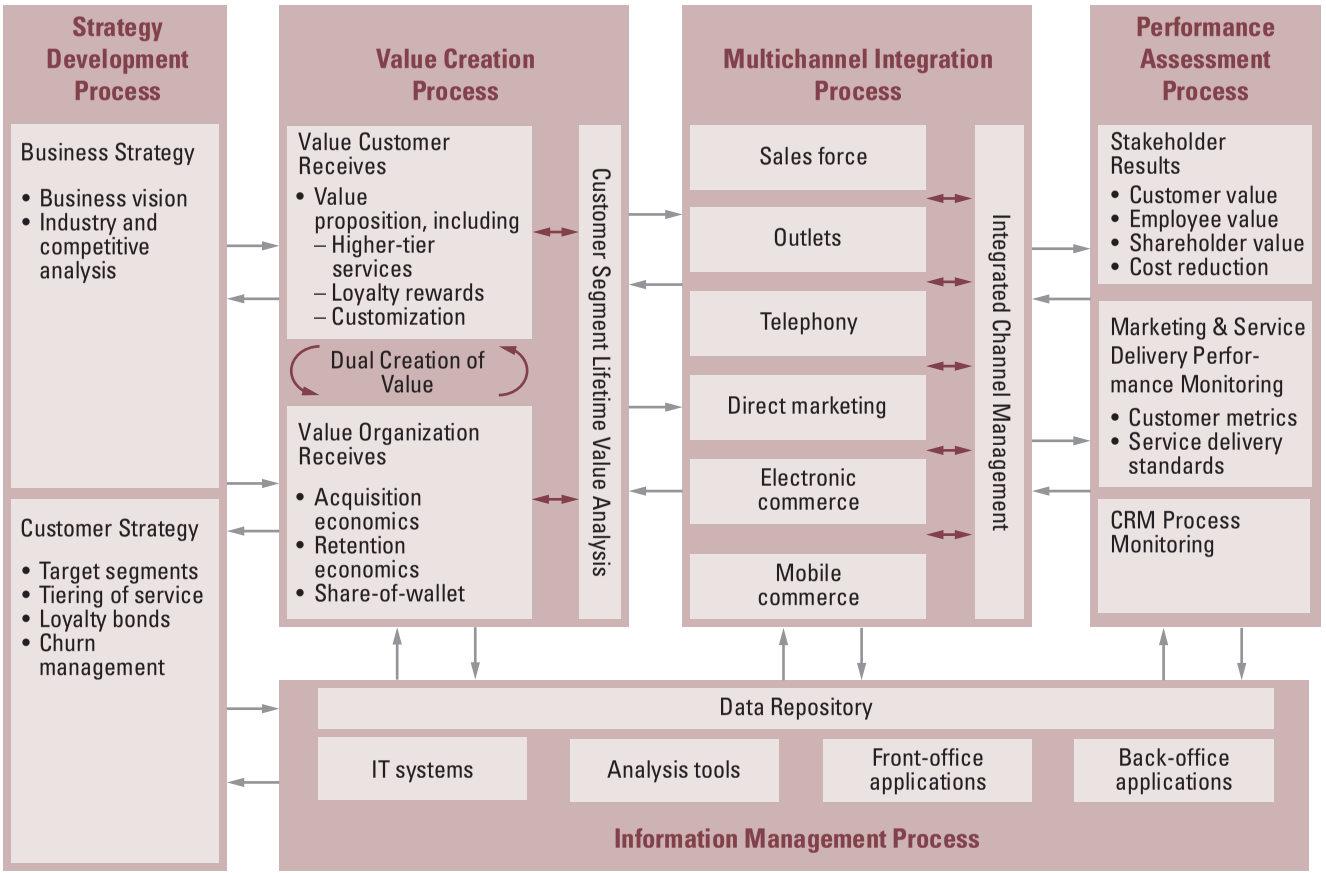
- *Sales force automation.* Sales leads, cross-sell and upsell opportunities can be effectively identified and processed, and the entire sales cycle from lead generation to the closing of sales, and provision of after-sales services can be tracked and facilitated through the CRM system.
- *Marketing automation.* Mining of customer data allows the firm to target its market. A good CRM system enables the firm to achieve one-to-one marketing and cost savings, often in the context of loyalty and retention programs. This results in increasing the ROI on its marketing expenditure. CRM systems also allow firms to assess the effectiveness of marketing campaigns through the analysis of responses.
- *Call center automation.* Call-center staff have customer information at their fingertips and can improve their service levels to all customers. Caller ID and account numbers also allow call centers to identify the customer tier the caller belongs to, and to tailor the service accordingly. For example, platinum callers get priority in waiting loops.

What does a Comprehensive CRM Strategy Include?[58]

Rather than viewing CRM as a technology, we subscribe to a more strategic view of CRM that focuses on the profitable development and management of customer relationships. Figure 9 provides an integrated framework of five key processes involved in a CRM strategy.

1. *Strategy development* involves the assessment of business strategy, including articulation of the company's vision, industry trends, and competition. The business strategy is typically the responsibility of top management. For customer relationship management to have a positive impact on a firm's performance, the firm's strategy is key.[59] Therefore, business strategy should guide the development of customer strategy, including the choice of target segments, customer-base tiering, design of loyalty bonds, and churn management as discussed in the Wheel of Loyalty.

Figure 9: An integrated framework for CRM strategy.



Source: Adapted from Adrian Payne and Pennie Frow (2005), "A Strategic Framework for Customer Relationship Management," *Journal of Marketing*, Vol. 69, October, pp. 167–176.

2. *Value creation* translates business and customer strategies into specific value propositions for customers and firm. The value created for customers includes all the benefits delivered through priority tiered services, loyalty rewards, customization, and personalization. The value created for the firm includes reduced customer acquisition and retention costs, increased share-of-wallet, and reduced customer serving costs. Customers need to participate in CRM (e.g., through volunteering their personal information) for them to benefit from the firm's CRM strategy. For instance, only if your driver's license, billing address, credit card details, and car and insurance preferences are stored in a car rental's CRM system, then you benefit from the increased convenience of not having to provide those data for each reservation. Firms can even create value through the information drawn from one customer for others (e.g., Amazon's analysis of which other books customers with a profile similar to yours have bought, and customers' ratings of books). CRM seems most successful when there is a win-win situation for the firm and its customers.[60]
3. *Multi-channel integration.* Most service firms interact with their customers through a multitude of channels. Thus, it has become a challenge to serve customers well across these many potential interfaces, while offering a unified customer interface that delivers customization and personalization. CRM's channel integration addresses this challenge.
4. *Information management.* Service delivery across many channels depends on the firm's ability to collect customer information from all channels, integrate it with other relevant information, and make the relevant information available to the front-line (or to the customer in a self-service context) at the various touch points. The information management process includes:
   (i) The data repository which contains all the customer data
   (ii) IT systems including IT hardware and software
   (iii) analytical tools such as data mining packages
   (iv) specific application packages such as campaign management analysis, credit assessment, customer

profiling, churn alert systems, and even customer fraud detection and management

(v) front office applications which support activities that involve direct customer contact, including sales force automation and call center management applications

(vi) back office applications which support internal customer-related processes, including, logistics, procurement, and financial processing

5. *Performance assessment* must address three critical questions:

(i) Is the CRM strategy creating value for its key stakeholders (i.e., customers, employees, and shareholders)?

(ii) Are the marketing objectives (ranging from customer acquisition, share-of-wallet, retention to customer satisfaction) and service delivery performance objectives (e.g., call-center service standards such as call-waiting time, abortion, and first-time resolution rates) being achieved?

(iii) Is the CRM process itself performing up to expectations? Are the relevant strategies being set, is customer and firm value being created, is the information management process working effectively, and is integration across customer service channels being achieved effectively? The performance assessment process should drive the continuous improvement of the CRM strategy itself.

Common Failures in CRM Implementation[61]

Unfortunately, majority of CRM implementations have failed in the past. According to the Gartner Group, the CRM implementation failure rate is 55%, and Accenture claims it to be as high as 60%. A key reason for this high failure rate is that firms often equate installing CRM systems with having a customer relationship strategy. They forget that the system is just a tool to enhance the firm's customer servicing capabilities, and is not the strategy in itself.

Furthermore, CRM cuts across many departments and functions (e.g., from customer contact centers and online services, to branch

operations, employee training, and IT departments), programs (ranging from sales and loyalty programs to launching of new services, and cross-selling initiatives), and processes (e.g., from credit-line authorization to complaint handling and service recovery). The wide-ranging scope of CRM implementation and the unfortunate reality that it is often the weakest link that determines the success of an implementation, shows the challenge of getting it right. Common reasons for CRM failures include:

- *Viewing CRM as a technology initiative.* It is easy to let the focus shift towards technology and its features, whereby the IT department takes the lead in devising the CRM strategy rather than top management or marketing. This often results in a lack of strategic direction, understanding of customers and markets during implementation.
- *Lack of customer focus.* Many firms implement CRM without the ultimate goal of enhancing the service value and enabling consistent service delivery for valued customers across all customer service processes and delivery channels.
- *Insufficient appreciation of customer lifetime value (LTV).* The marketing of many firms is not sufficiently structured around the vastly different profitability of different customers. Furthermore, servicing costs for different customer segments are often not well captured (e.g., by using activity-based costing as discussed in Volume 4).
- *Inadequate support from top management.* Without ownership and active involvement from top management, the CRM strategic intent will not survive the implementation intact.
- *Failing to re-engineer business processes.* It is nearly impossible to implement CRM successfully without redesigning customer service and back-office processes. Many implementations fail because CRM is fitted into existing processes, rather than redesigning the processes to fit a customer-centric CRM implementation. Redesigning also requires change management, employee involvement and support, which are often lacking.
- *Underestimating the challenges in data integration.* Firms frequently fail to integrate customer data that are usually scattered all over the organization. A key to unlocking the full potential of CRM is to

make customer knowledge available in real time to all employees who need it.

Finally, firms might put their CRM strategies at substantial risk if customers believe that CRM is used in a way that is harmful to them.[62] Examples include feeling that they are not being treated fairly (for example, not being offered attractive promotions that are offered to new accounts but not to existing customers), and potential privacy concerns. Being aware of and actively avoiding these pitfalls is a first step towards a successful CRM implementation.

How to Get CRM Implementation Right

Despite the many horror stories of millions of dollars sunk into unsuccessful CRM projects, more firms are getting it right. "No longer a black hole, CRM is becoming a basic building block of corporate success", argue Darrell Rigby and Dianne Ledingham.[63] Seasoned McKinsey consultants believe that even CRM systems that have been implemented but have not yet shown results can still be turned around. They recommend taking a step back and focusing on how to build customer loyalty, rather than focusing on the technology itself.[64] Rather than using CRM to transform entire businesses through the wholesale implementation of the CRM model shown in Figure 9, service firms should focus on clearly defined problems within their customer relationship cycle. These narrow CRM strategies often reveal additional opportunities for further improvements which, when taken together, can evolve into broad CRM implementation extending across the entire company.[65] Likewise, Rigby, Reichheld and Schefter recommend focusing on the customer strategy and not the technology, posing the question:

> *If your best customers knew that you planned to invest $130 million to increase their loyalty…, how would they tell you to spend it? Would they want you to create a loyalty card or would they ask you to open more cash registers and keep enough milk in stock. The answer depends on the kind of company you are and the kinds of relationships you and your customers want to have with one another.*[66]

Among the key issues managers should debate when defining their customer relationship strategy for a potential CRM system implementation are:

1. How should our value proposition change to increase customer loyalty?
2. How much customization or one-to-one marketing and service delivery is appropriate and profitable?
3. What is the incremental profit potential of increasing the share-of-wallet with our current customers? How much does this vary by customer tier and/or segment?
4. How much time and resources can we allocate to CRM right now?
5. If we believe in customer relationship management, why have we not taken more steps in that direction in the past? What can we do today to develop customer relationships without spending a lot on technology?[67]

Answering these questions may lead to the conclusion that a CRM system may currently not be the best investment or the highest priority, or that a scaled-down version may suffice to deliver the intended customer strategy. In any case, the system is merely a tool to drive the strategy, and thus must be tailored to deliver that strategy.

CONCLUSION

Many elements are involved in gaining market share, increasing share-of-wallet, and cross-selling other products and services to existing customers, and creating long-term loyalty. The Wheel of Loyalty is used as an organizing framework, which starts with a solid foundation that includes targeting the right portfolio of customer segments, attracting the right customers, tiering the service, and delivering high levels of satisfaction. Second, to truly build loyalty, a firm needs to develop close bonds with its customers that ideally deepen the relationship through cross-selling and bundling, and add value to the customer through loyalty rewards and higher-level bonds including social, customization, and structural bonds. Finally, a firm needs to identify and reduce the factors that result

in "churn" — the loss of existing customers and the need to replace them with new ones.

Marketers need to pay special attention to those customers who offer the firm the greatest value, as they purchase its products with the greatest frequency and spend the most on premium services. Customer relationship management is a key enabler for the strategies discussed in the Wheel of Loyalty and is often integrated with loyalty programs. Loyalty programs help to create membership-type relationships with customers even in transaction-type businesses which, together with effective CRM systems, enable marketers to track the behavior of high-value customers in terms of where and when they use the service, what service classes or types of products they buy, and how much they spend. With the relevant knowledge delivered at key service touch points, frontline employees, account managers, and systems (e.g., ATMs, websites, and mobile apps) can deliver the high value-add benefits inherent in many of the loyalty bonds as discussed in this volume. From a customer perspective, customer relationship management can result in vast service improvements and increased customer value such as through customization and increased convenience.

SUMMARY

1. Customer Loyalty

Customer loyalty is an important driver of a service firm's profitability. The profits derived from loyal customers come from

- increased purchases
- reduced operation costs
- referral of new customers, and
- price premiums.

Also, customer acquisition costs can be amortized over a longer period of time.

2. Calculating the LTV of Customers

To understand the profit impact of the customers, firms need to learn how to calculate the LTV of their customers. LTV calculations need to include

- acquisition costs
- revenue streams
- account-specific servicing costs
- expected number of years the customer will stay with the firm, and
- discount rate for future cash flows.

Also note that it is not true that loyal customers are always more profitable as they may expect price discounts and higher service levels, both of which can reduce customer profitability.

3. Customers are Loyal to Enjoy Benefits

Customers are only loyal if there is a benefit for them to be so. Common benefits customers see in being loyal include:

- Confidence benefits such as feeling there is less risk of something going wrong and the ability to trust the provider.
- Social benefits such as being known by name, friendship with the service provider, and enjoyment of certain social aspects of the relationship.
- Special treatment benefits such as better prices, extra services, and higher priority.

4. The Wheel of Loyalty

It is not easy to build customer loyalty. The Wheel of Loyalty offers a systematic framework that guides firms on how to do so. The framework has three components that follow a sequence.

- First, firms need to build a foundation for loyalty without which loyalty cannot be achieved. The foundation delivers confidence benefits to its loyal customers.
- Once the foundation is laid, firms can then create loyalty bonds to strengthen the relationship. Loyalty benefits deliver social and special treatment benefits.
- Finally, besides focusing on loyalty, firms have to work on reducing customer churn.

5. Building the Foundation for Loyalty

To build the foundation for loyalty, firms need to:

- Segment the market and target the "right" customers
- Choose their target segments carefully and match them to what the firm can do best, and
- Focus on customer value and fit, instead of just going for customer volume.

6. Service Tiering

Manage the customer base through service tiering, which divides the customer base into different value tiers (e.g., platinum, gold, iron, and lead). It helps to tailor strategies to the different service tiers. The higher tiers offer higher values for the firm, but also expect higher service levels. For the lower tiers, the focus should be on increasing profitability through building volume, increasing prices, cutting servicing costs, and as a last resort, even ending unprofitable relationships.

7. Customer Satisfaction

Understand that the foundation for loyalty lies in customer satisfaction. The satisfaction loyalty relationship can be divided into three main zones: defection, indifference, and affection. Only highly satisfied or delighted customers who are in the zone of affection will be truly loyal. True loyalty

covers both behavioral loyalty (share-of-wallet and referral behavior) and attitudinal loyalty (share-of-heart). Loyalty bonds are used to build relationships with customers.

8. Cross-selling and Bundling

Deepening the relationship bonds can be achieved through cross-selling and bundling that deepen the relationships and make switching more difficult, and often increase convenience through one-stop shopping.

9. Loyalty Reward-based Programs

Loyalty reward-based programs aim at building share-of-wallet through financial rewards (e.g., loyalty points) and non-financial rewards (e.g., higher-tier service levels, priority service, recognition, and appreciation).

10. Higher-Level Relationship Bonds

Higher-level bonds include social, customization, and structural bonds. These bonds tend to be more difficult than reward-based bonds to be copied by competitors

11. Churn Drivers

The final step in the Wheel of Loyalty is to understand what causes customers to leave, and then systematically reduce these churn drivers.

- Common causes for customers to switch include core service failures and dissatisfaction, perceptions that pricing is deceptive and unfair, inconvenience, poor response to service failures, and the overall perception that the provider has an inferior performance on key attributes compared to the best alternative provider.
- To prevent customers from switching, firms should analyze and address key reasons why their customers leave them, have good complaint handling and service recovery processes in place, and increase "positive" customer switching costs.

12. Understanding Customers

Most strategies discussed in the Wheel of Loyalty require an in-depth understanding of customers to actively improve loyalty. For example,

unless a firm knows the consumption behavior of individual customers, it cannot apply tiering of service, customization, personalization, and churn management. Here, the "membership-type" relationships needed can be created even for transaction-type services through loyalty programs and CRM systems.

13. Customer Relationship Management (CRM)

Finally, customer relationship management (CRM) systems should be seen as enabling the successful implementation of the Wheel of Loyalty. CRM systems are particularly useful when firms have to serve large numbers of customers across many service delivery channels. An effective CRM strategy includes five key processes:

- Strategy development such as the choice of target segments, tiering of service, and design of loyalty rewards.
- Value creation such as delivering benefits to customers through tiered services and loyalty programs (e.g., priority wait listing and upgrades).
- Multi-channel integration to provide a unified customer interface across many different service delivery channels (e.g., from the website to the branch office).
- Information management, which includes the data repository, analytical tools (e.g., campaign management analysis and churn alert systems), and front- and back-office applications.
- Performance assessment, which has to address these three questions: (1) Is the CRM creating value for customers and the firm? (2) Are its marketing objectives being achieved? (3) Is the CRM system itself performing according to expectations?
- Performance assessment should lead to continuous improvement of the CRM strategy and system.

ENDNOTES

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2 The first four factors were proposed by Frederick F. Reichheld and W. Earl Sasser, Jr., "Zero Defections: Quality Comes to Services," *Harvard Business Revie*w, (October 1990): 105–111. The fifth factor was added by the authors of this book.

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4 Frederick F. Reichheld and W. Earl Sasser, Jr., "Zero Defections: Quality Comes to Services," *Harvard Business Revie*w, (October 1990): 105–111.

5 For a discussion on how to evaluate the customer base of a firm, see Sunil Gupta, Donald R. Lehmann, and Jennifer Ames Stuart, "Valuing Customers," *Journal of Marketing Research,* 41, No.1 (2004): 7–18.

An excellent overview of the metric of CLV and related concept such as RFM (i.e., recency, frequency, and monetary spent), PCV (i.e., past customer value, also called customer profitability analysis or CPA), and share-of-wallet is provided in: V. Kumar (2007), "Customer Lifetime Value — The Path to Profitability", *Foundations and Trends in Marketing*, Vol. 2, No. 1, pp. 1–96.

A review of when to use and how to measure CLV (a prospective perspective on customer life time value which attempts to predict future customer behaviors and discounts derived future cash flows) and customer profitability analysis (CPA, with deploys a retrospective profitability analysis that measures the costs and revenues per customer in the past) is provided in: Morten Holm, V. Kumar, and Carsten Rohde (2012), "Measuring Customer Profitability in Complex Environments: An Interdisciplinary Contingency Framework", *Journal of the Academy of Marketing Science*, Vol. 30, No. 3, pp. 387–401.

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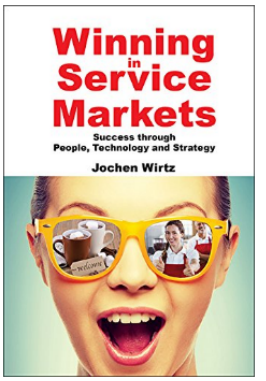

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