

SERVICES MARKETING

PEOPLE, TECHNOLOGY, STRATEGY

SIXTH EDITION



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Services Marketing

People, Technology, Strategy

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ABOUT THE AUTHORS



As a team, Christopher Lovelock and Jochen Wirtz provide a blend of skills and experience that's ideally suited to writing an authoritative and engaging services marketing text. This book marks their second collaboration on an edition of *Services Marketing*. Since first meeting in 1992, they've worked together on a variety of projects, including cases, articles, conference papers, two Asian adaptations of earlier editions of *Services Marketing*, and *Services Marketing in Asia: A Case Book*. In

2005, both were actively involved in planning the American Marketing Association's biennial Service Research Conference, hosted that year by the National University of Singapore and attended by participants from 22 countries on five continents.

Christopher Lovelock is one of the pioneers of services marketing. Based in Massachusetts, he consults and gives seminars and workshops for managers around the world, with a particular focus on strategic planning in services and managing the customer experience. Since 2001, he has been an adjunct professor at the Yale School of Management, where he teaches an MBA services marketing course.

After obtaining a BCom and an MA in economics from the University of Edinburgh, he worked in advertising with the London office of J. Walter Thompson Co. and then in corporate planning with Canadian Industries Ltd. in Montreal. Later, he obtained an MBA from Harvard and a Ph.D. from Stanford, where he was also a postdoctoral fellow.

Professor Lovelock's distinguished academic career has included 11 years on the faculty of the Harvard Business School and two years as a visiting professor at IMD in Switzerland. He has also held faculty appointments at Berkeley, Stanford, and the Sloan School at MIT, as well as visiting professorships at INSEAD in France and The University of Queensland in Australia.

Author or co-author of over 60 articles, more than 100 teaching cases, and 21 books, Dr. Lovelock has also seen his work translated into 10 languages. He serves on the editorial review boards of the *International Journal of Service Industry Management*, *Journal of Service Research*, *Service Industries Journal*, *Cornell Hotel and Restaurant Administration Quarterly*, and *Marketing Management*, and is also an ad-hoc reviewer for the *Journal of Marketing*.

Widely acknowledged as a thought leader in services, Christopher Lovelock has been honored by the American Marketing Association's prestigious Award for Career Contributions in the Services Discipline. In 2005 his article with Evert Gummesson, "Whither Services Marketing? In Search of a New Paradigm and Fresh Perspectives," won the AMA's Best Services Article Award and was a finalist for the IBM award for the best article in the *Journal of Service Research*. Earlier, he received a best article award from the *Journal of Marketing*. Recognized many times for excellence in case writing, he has twice won top honors in the *BusinessWeek* "European Case of the Year" Award.



Jochen Wirtz has worked in the field of services for more than 18 years, and holds a Ph.D. in services marketing from the London Business School. He is an associate professor at the National University of Singapore (NUS), where he teaches services marketing in executive, MBA, and undergraduate programs and is co-director of the dual-degree UCLA–NUS Executive MBA Program.



Professor Wirtz's research focuses on service management topics, including customer satisfaction, service guarantees, and revenue management. He has published over 60 academic articles, 80 conference papers, and some 50 book chapters, and is co-author of 10 books, including his latest book, *Flying High in a Competitive Industry—Cost-Effective Service Excellence at Singapore Airlines* (Singapore: McGraw-Hill, 2006).

Professor Wirtz has received seven awards for outstanding teaching at the NUS Business School and in 2003 was honored by the prestigious, university-wide "Outstanding Educator Award." His six research awards include the Emerald Literati Club 2003 Award for Excellence for the year's most outstanding article in the *International Journal of Service Industry Management*. He serves on the editorial review boards of seven academic journals, including the *International Journal of Service Industry Management*, *Journal of Service Research*, and *Cornell Hotel and Restaurant Administration Quarterly*, and is also an ad-hoc reviewer for the *Journal of Consumer Research* and *Journal of Marketing*. Professor Wirtz chaired the American Marketing Association's biennial Service Research Conference in 2005, and in 2006 he was the chair for the Services Marketing Track at the Academy of Marketing Science Annual Conference.

Dr. Wirtz has been an active management consultant, working with international consulting firms, including Accenture, Arthur D. Little, and KPMG, and major service firms in the areas of strategy, business development, and customer feedback systems. Originally from Germany, Jochen Wirtz spent seven years in London before moving to Asia.

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Chapter 12

Managing Relationships and Building Loyalty

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

FREDERICK F. REICHELDT

Strategy first, then CRM.

STEVEN S. RAMSEY

Targeting, acquiring, and retaining the “right” customers is at the core of many successful service firms. In Chapter 7 we discussed segmentation and positioning. In this chapter, we emphasize the importance of focusing carefully on desirable, loyal customers within the chosen segments, and then taking pains to strengthen their loyalty through well-conceived relationship marketing strategies. The objective is to build relationships and to develop loyal customers who will do a growing volume of business with the firm in the future.

Building relationships is a challenge, especially when a firm has vast numbers of customers who interact with the firm in many different ways, from email and web sites to call centers and face-to-face interactions. When *customer relationship management* (CRM) systems are implemented well, they provide managers with the tools to understand their customers and tailor their service, cross-selling, and retention efforts, often on a one-on-one basis.

In this chapter, we explore the following questions:

1. Why is customer loyalty an important driver of profitability for service firms?
2. Why is it so important for service firms to target the “right” customers?
3. How can a firm calculate the lifetime value of its customers?

4. What strategies are associated with the concept of relationship marketing and the wheel of loyalty?
5. How can tiering of service, loyalty bonds, and membership programs help in building customer loyalty?
6. What is the role of CRM systems in delivering customized services and building loyalty?

THE SEARCH FOR CUSTOMER LOYALTY

Loyalty is an old-fashioned word that has traditionally been used to describe fidelity and enthusiastic devotion to a country, a cause, or an individual. More recently, it has been used in a business context to describe a customer's willingness to continue patronizing a firm over the long term, preferably on an exclusive basis, and recommending the firm's products to friends and associates. Customer loyalty extends beyond behavior and includes preference, liking, and future intentions. Ask yourself: What service companies are you loyal to? And in what industries are they?

"Few companies think of customers as annuities," says Frederick Reichheld, author of *The Loyalty Effect*, and a major researcher in this field.¹ And yet that is precisely what a loyal customer can mean to a firm—a consistent source of revenue over a period of many years. The active management of the customer base and customer loyalty is also referred to as *customer asset management*.²

"Defector" is a nasty word during wartime. It describes disloyal people who sell out their own side and go over to the enemy. Even when they defect toward "our" side, rather than away from it, they're still suspect. Today, in a marketing context, the term *defection* is used to describe customers who drop off a company's radar screen and transfer their brand loyalty to another supplier. Reichheld and Sasser popularized the term *zero defections*, which they describe as keeping every customer the company can serve profitably.³ Not only does a rising defection rate indicate that something is wrong with quality (or that competitors offer better value), it may also be a leading indicator signaling a fall in profits. Big customers don't necessarily disappear overnight; they often signal their mounting dissatisfaction by reducing their purchases and shifting part of their business elsewhere.

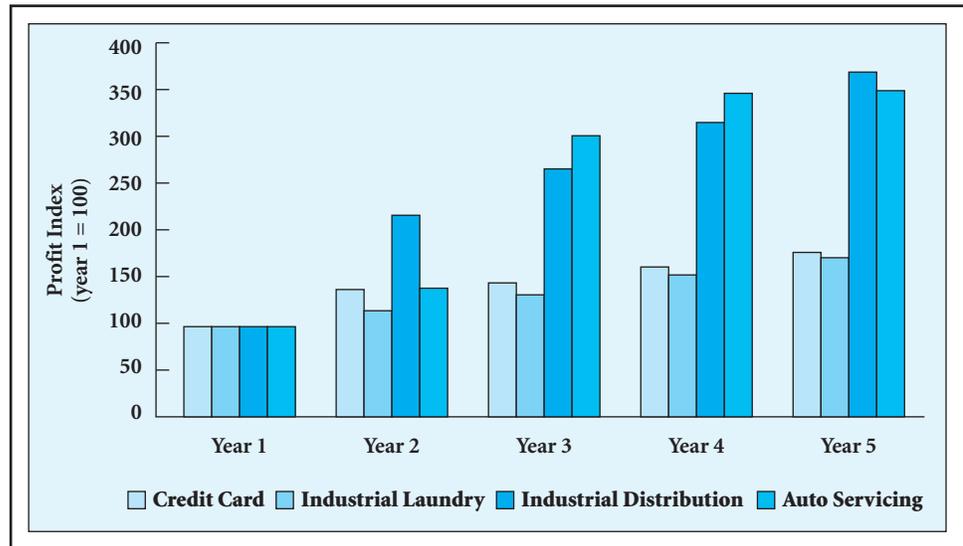
Why Is Customer Loyalty Important to a Firm's Profitability?

How much is a loyal customer worth in terms of profits? In a classic study, Reichheld and Sasser analyzed the profit per customer in various service businesses, as categorized by the number of years that a customer had been with the firm.⁴ They found that customers became more profitable the longer they remained with a firm in each of these industries. Annual profits per customer, which have been indexed over a five-year period for easier comparison, are summarized in Figure 12.1. 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). A study of Internet sales showed similar loyalty effects; typically, it took more than a year to recoup acquisition costs, but profits increased as customers stayed longer with the firm.⁵

Underlying this profit growth, say Reichheld and Sasser, are four factors that work to the supplier's advantage to create incremental profits. In order of magnitude at the end of seven years, these factors are:

1. *Profit derived from increased purchases (or, in a credit card or banking environment, higher account balances).* Over time, business customers often grow larger and so need to purchase in greater quantities. Individuals 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.

Figure 12.1 How Much Profit a Customer Generates over Time

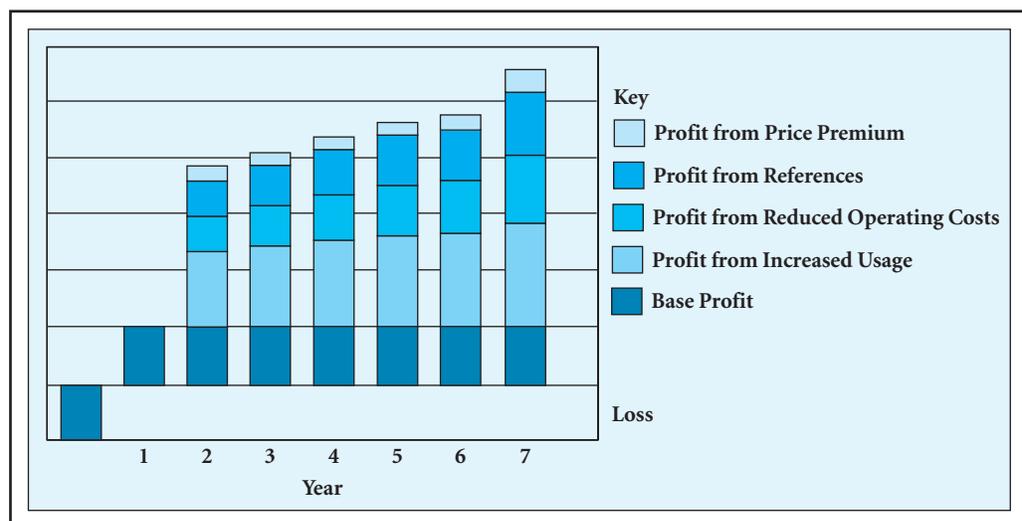


Source: Based on reanalysis of data from Frederick R. Reichheld and W. Earl Sasser, Jr., "Zero Defections: Quality Comes to Services," *Harvard Business Review* 68 (Sep.–Oct. 1990), 105–111.

- 2. Profit from reduced operating costs.** As customers become more experienced, they make fewer demands on the supplier (for instance, they have less need for information and assistance). They may also make fewer mistakes when involved in operational processes, thus contributing to greater productivity.
- 3. Profit from referrals of other customers.** Positive word-of-mouth recommendations are like free selling and advertising, saving the firm from having to invest as much money in these activities.
- 4. Profit from 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 are even willing to pay a price premium.⁶ Moreover, customers who trust a supplier may be more willing to pay higher prices at peak periods or for express work.

Figure 12.2 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

Figure 12.2 Why Customers Are More Profitable over Time



Source: Why Customers Are More Profitable Over Time from Frederick J. Reichheld and W. Earl Sasser Jr. "Zero Defections: Quality Comes to Services," *Harvard Business Review* 73 (Sep.–Oct. 1990): p. 108. Reprinted by permission of Harvard Business School.

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. Furthermore, the up-front costs of attracting these buyers can be amortized over many years.

Assessing the Value of a Loyal Customer

It's a mistake to assume that loyal customers are always more profitable than those who make one-time purchases.⁷ On the cost side, not all types of services incur heavy promotional expenditures to attract new customers. 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 first seeks to make a purchase. On the revenue side, loyal customers may not necessarily spend more than one-time buyers, and in some instances they may even expect price discounts.

Finally, revenue does 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 can't negotiate prices. However, in many business-to-business (B2B) contexts, large customers have significant bargaining power and therefore will nearly always try to negotiate lower prices when contracts come up for renewal, which 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, it yields below-average margins. In contrast, DHL's smaller, less powerful accounts provide significantly higher profitability.⁹

Recent work has also shown that the profit impact of a customer can vary dramatically depending on the stage of the service products life cycle. For instance, referrals by satisfied customers and negative word of mouth by defected customers have a much greater effect on profit in the early stages of the service product's life cycle than in later stages.¹⁰

One of the challenges that you will probably face in your work is to determine the costs and revenues associated with serving customers in different market segments at different points in their customer life cycles, and to predict future profitability. For insights on how to calculate customer value, see the box, "Worksheet for Calculating Customer Lifetime Value."¹¹

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 declare, "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."¹² They suggest 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 effect 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?
- How long, on average, do customers remain with the firm? What effect would it have if they remained customers for life?

As we showed 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, cross-selling, and to identify the reasons why customers defect and then take corrective action.

WORKSHEET 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. Additional research may be needed to clarify whether "older" customers are more likely to be effective recommenders than "younger" ones.

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
<i>Initial Revenue</i>					
Application fee ^a	_____	_____	_____	_____	_____
Initial purchase ^a	_____	_____	_____	_____	_____
<i>Total Revenues</i>	=====	=====	=====	=====	=====
<i>Initial Costs</i>	_____				
Marketing	_____	_____	_____	_____	_____
Credit check ^a	_____	_____	_____	_____	_____
Account setup ^a	_____	_____	_____	_____	_____
Less total costs	_____	_____	_____	_____	_____
Net Profit (Loss)	=====	=====	=====	=====	=====

^aIf applicable.

^bAnticipated 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.

UNDERSTANDING THE CUSTOMER–FIRM RELATIONSHIP

There's a fundamental distinction between strategies intended to produce a single transaction and those designed to create extended relationships with customers. Repeated transactions form the necessary basis for a relationship between customer and supplier, although we shouldn't assume that every customer who uses a service with some frequency seeks an active relationship.

Relationship Marketing

The term *relationship marketing* has been widely used, but until recently it was only loosely defined. Research by Nicole Coviello, Rod Brodie, and Hugh Munro suggest that there are, in fact, four distinct types of marketing: *transactional marketing* and three categories of what they call relational marketing: *database marketing*, *interaction marketing*, and *network marketing*.¹³

Transactional Marketing

A *transaction* is an event during which an exchange of value takes place between two parties. One transaction or even a series of transactions don't necessarily constitute a relationship, which requires mutual recognition and knowledge between the parties. When each transaction between a customer and a supplier is essentially discrete and anonymous, with no long-term record kept of a 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.

Database Marketing

In database marketing the focus is still on the market transaction, but now it includes information exchange. Marketers rely on information technology, usually in the form of a database, to form a relationship with targeted customers and retain their patronage over time. However, the nature of these relationships is often not a close one, with communication being driven and managed by the seller. Technology is used to (1) identify and build a database of current and potential customers, (2) deliver differentiated messages based on consumers' characteristics and preferences, and (3) track each relationship to monitor the cost of acquiring the consumer and the lifetime value of the resulting purchases.¹⁴ Although technology can be used to personalize the relationship, relations remain somewhat distant. Utility services such as electricity, gas, and cable TV are good examples.

Interaction Marketing

A closer relationship often exists in situations where there is face-to-face interaction between customers and representatives of the supplier (or "ear-to-ear" interaction by phone). Although the service itself remains important, value is added by people and social processes. Interactions may include negotiations and sharing of insights in both directions. This type of relationship exists in many local service markets, ranging from community banks to dentistry, in which buyer and seller know and trust each other. It is also commonly found in many B2B services. Both the firm and the customer are prepared to invest resources to develop a mutually beneficial relationship. This investment may include time spent sharing and recording information.

As service companies grow larger and make increasing use of technologies such as interactive web sites and self-service technology, maintaining meaningful relationships with customers becomes a significant marketing challenge. Firms with large customer bases find it increasingly difficult to build and maintain meaningful relationships through call centers, web sites and other mass delivery channels (Figure 12.3).

Figure 12.3
Building and
Maintaining
Relationships
Through Call Centers
Is a Challenge



Network Marketing

We often say that someone is a “good networker” because he or she is able to put individuals in touch with others who have a mutual interest. In a B2B context, marketers work to develop networks of relationships with customers, distributors, suppliers, the media, consultants, trade associations, government agencies, competitors, and even the customers of their customers. Often, a team of individuals within the supplier’s firm collaborates to provide effective service to a parallel team within the customer’s organization.

The four types of marketing described above are not necessarily mutually exclusive. 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.¹⁵ Evert Gummesson identifies 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.¹⁶

Creating “Membership” Relationships

Ideally, we would like to create ongoing relationships with our customers. This is easier when customers receive service on a continuing basis. However, even where the transactions are themselves discrete, there may still be an opportunity to create an ongoing relationship, as we will discuss later in the chapter in the context of loyalty reward programs.

The nature of the current relationship can be analyzed by asking, first: Does the supplier enter into a formal “membership” 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 12.1 shows a matrix resulting from this categorization, with examples in each category.

Table 12.1
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	Car rental Mail service Toll highway Pay phone Movie theater Public transportation Restaurant

A *membership relationship* is a formalized relationship between the firm and an identifiable customer, which may offer special benefits to both parties. Services involving discrete transactions can be transformed into membership relationships either by selling the service in bulk (for instance, a theater series subscription or a commuter ticket on public transport) or by offering extra benefits to customers who choose to register with the firm (loyalty programs for hotels, airlines, and car rental firms fall into this category). The advantage to the service organization of having membership relationships is that it knows who its current customers are and, usually, what use they make of the services offered. This can be valuable information for segmentation purposes if good records are kept and the data are readily accessible for analysis. Knowing the identities and addresses of current customers enables the organization to make effective use of direct mail (including e-mail), telephone selling, and personal sales calls—all highly targeted methods of marketing communication. In turn, members can be given access to special numbers or even designated account managers to facilitate their communications with the firm.

THE WHEEL OF LOYALTY

Building customer loyalty is difficult. Just try and think of all the service firms you yourself are 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. We use the *wheel of loyalty* shown in Figure 12.4 as an organizing framework for thinking about how to build customer loyalty. It comprises three sequential strategies.

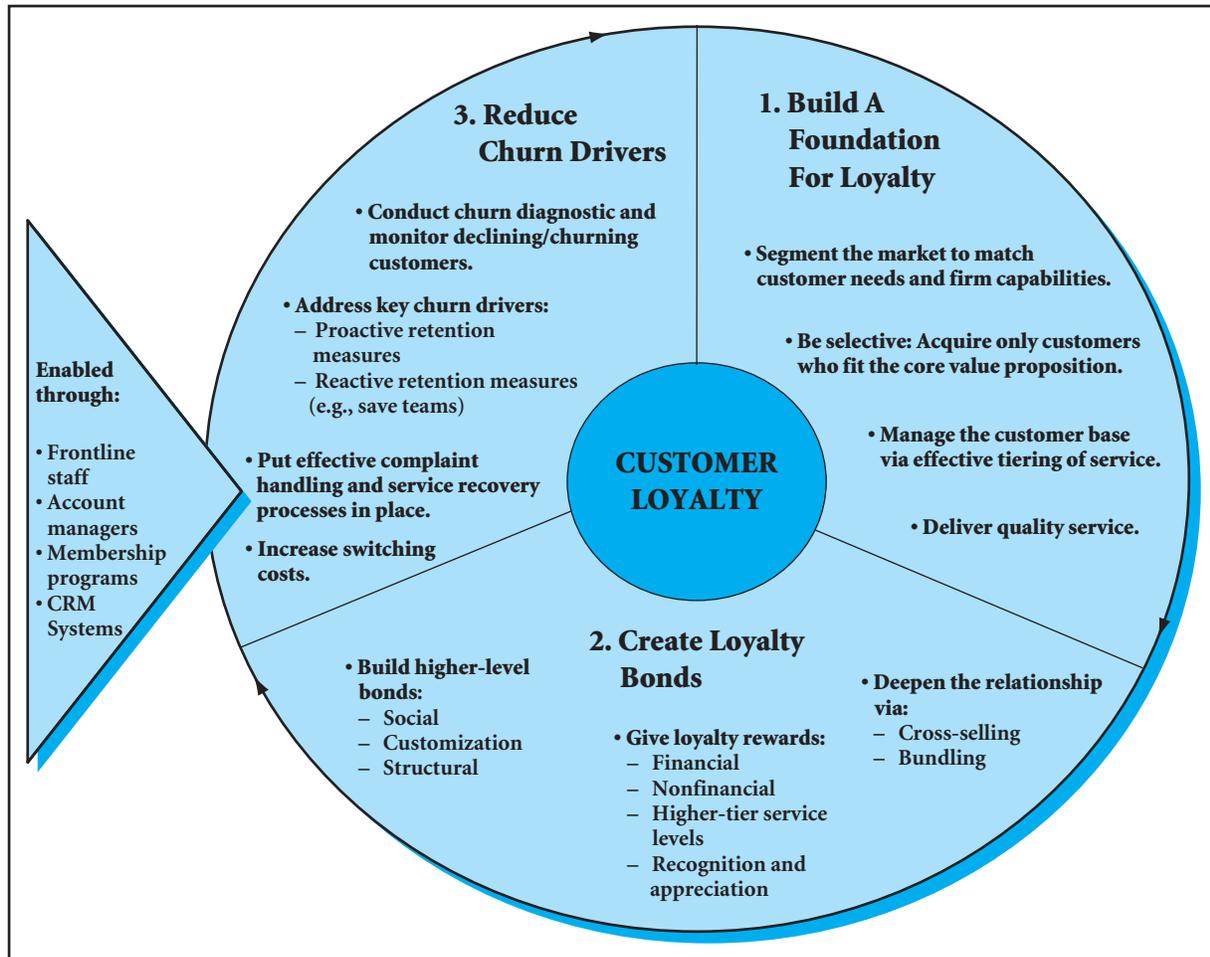
First, the firm needs a solid foundation for creating customer loyalty, which includes having the right portfolio of customer segments, attracting the right customers, tiering the service, and delivering high levels of satisfaction.

Second, to truly build loyalty, a firm needs to develop close bonds with its customers, which either deepen the relationship through cross-selling and bundling, or add value to the customer through loyalty rewards and higher-level bonds.

Third, the firm needs to identify and eliminate factors that result in “churn”—the loss of existing customers and the need to replace them with new ones.

We discuss each of the components of the wheel of loyalty in the following sections.

Figure 12.4 The Wheel of Loyalty



BUILDING A FOUNDATION FOR LOYALTY

Many elements are involved in creating long-term customer relationships and loyalty. In Chapter 7 we discussed segmentation and positioning. In this section, we emphasize the importance of focusing on desirable customers, and then taking pains to build their loyalty through well-conceived relationship marketing strategies, including delivery of quality service.

Good Relationships Start with a Good Fit Between Customer Needs and Company Capabilities

The process starts with identifying and targeting the right customers. “Who should we be serving?” is a question that every service business needs to raise periodically. Customers often differ widely in terms of needs. They also differ in terms of the value that they can contribute to a company. 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. In this section, we emphasize the importance of choosing to serve a portfolio of several carefully chosen target segments and taking pains to build and maintain their loyalty.

Matching customers to the firm’s capabilities is vital. Managers must think carefully about how customer needs relate to such operational elements as speed and

quality, the times when service is available, the firm's capacity to serve many customers simultaneously, 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.¹⁷ Finally, they need to ask themselves whether their company can match or exceed competing services that are directed at the same types of customers.

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 Frederick 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."¹⁸

Searching for Value, Not Just Volume

Too many service firms still focus on the *number* of customers they serve, without giving sufficient attention to the *value* of each customer. 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 discussion of banking:

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.¹⁹

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, and continuously seek the lowest price on offer.

Loyalty 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 can bring in long-term revenues, continued growth from referrals, and enhanced satisfaction from employees 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. Ironically, it is often the firms that are highly focused and selective in their acquisition rather than those that focus on unbridled acquisition that are growing fast over long periods.²⁰ Best Practice in Action 12.1 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.

Managers shouldn't 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 customers segments that had been neglected by established players, which didn't perceive them as being sufficiently "valuable." Examples include Enterprise Rent-A-Car, which targets customers who need a temporary replacement car, avoiding the more traditional segment of business travelers who are pursued by its principal competitors; Charles Schwab, which focuses on retail stock buyers; and Paychex, which provides small businesses with payroll and human resources services.²¹

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

BEST PRACTICE IN ACTION 12.1

Vanguard Discourages the Acquisition of “Wrong” Customers

The Vanguard Group is a growth leader in the mutual fund industry that built its \$850 billion in managed assets by painstakingly targeting the right customers for its business model. Its share of new sales, which was around 25 percent, reflected its share of assets or market share. However, it had a far lower share of redemptions, which gave it a market share of net cash flows of 55 percent (new sales minus redemptions), and made it the fastest-growing mutual fund in its industry.

How did Vanguard achieve such low redemption rates? The secret was its careful acquisitions, 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 spending only 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.

John Bogle attributes the high customer loyalty Vanguard has achieved to a great deal of focus on customer redemptions, which are defections in the fund context. “I watched them like a hawk,” he explained, and 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 was 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 reiterated: “We urge them [short-term investors] to look elsewhere for their investment opportunities.”

This care and attention to acquiring the right customers became legendary. For example, Vanguard turned away an institutional investor who wanted to invest \$40 million because Vanguard 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 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 accepted.

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 disloyal to its core investor base. These product and pricing policies in effect turned away heavy traders, but made the fund unequivocally attractive for the long-term investor.

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 to compensate all current investors for the administrative costs of selling new shares. 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 an expense fee one-third less than that of ordinary shares (0.12 percent per year instead of 0.18 percent).

Source: Adapted from Frederick F. Reichheld, *Loyalty Rules! How Today’s Leaders Build Lasting Relationships*. Boston: Harvard Business School Press, 2001, pp. 24–29, 84–87, 144–145; www.vanguard.com, accessed January 19, 2006.

some customers may be stable over time, while those of others may be more cyclical, 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.²²

In many cases, as David Maister emphasizes, marketing is about getting *better* business, not just *more* business.²³ For instance, the caliber of a professional firm is measured by the type of clients it serves and the nature of the 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 business attracted 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.

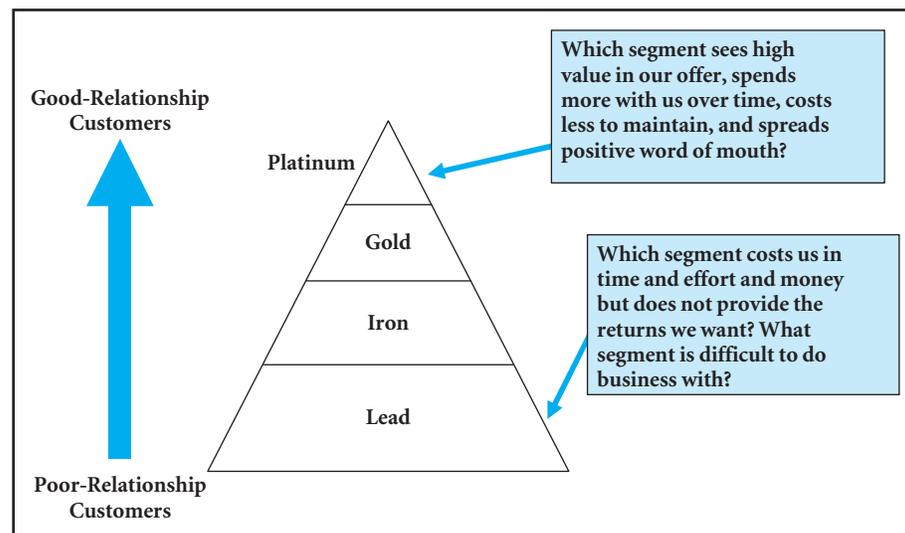
Managing the Customer Base Through Effective Tiering of Services

Marketers should adopt a strategic approach to retaining, upgrading, and even terminating 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 customers with the same level of intensity. Recent research has confirmed that most firms have different tiers of customers in terms of profitability, and these tiers often have quite different service expectations and needs. According to Valarie Zeithaml, Roland Rust, and Katharine Lemon, it's critical for service firms to understand the needs of customers within different profitability tiers and to adjust their service levels accordingly.²⁴

Just as service product categories can be tiered to reflect the level of value included (see Chapter 7, pp. 190–191), so can groups of customers. In the latter instance, customer tiers can be developed around different levels of profit contribution, 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 12.5).

- **Platinum.** These customers constitute a very small percentage of a firm's customer base, but they are heavy users and contribute a large share of the firm's profits. Typically, this segment is less price-sensitive but expects highest service levels, 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 tier, 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 often important so that a firm can build and maintain a certain capacity level and infrastructure, which is often needed to serve gold and platinum customers well. However, iron customers in themselves are often only marginally profitable. Their level of business is not sufficient to warrant special treatment.
- **Lead.** Customers in this tier tend to generate low revenues for a firm, but often require the same level of service as iron customers, which turns them into a loss-making segment from the firm's perspective.

Figure 12.5 The Customer Pyramid



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SERVICE PERSPECTIVES 12.1

Tiering the Customers of a Market Research Agency

Tiering its clients helped a leading U.S. 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 to 5 percent of project values (as compared to as much as 25 percent for clients who required extensive proposal work and project-by-project bidding). Platinum accounts were also more willing to try new services, and to 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 were 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 to apply its skill sets appropriately. Sales costs were high as the client typically invited several firms to quote. Furthermore, because 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 from Valarie A. Zeithaml, Roland T. Rust, and Katharine N. Lemon, "The Customer Pyramid: Creating and Serving Profitable Customers." *California Management Review*, 43, no. 4 (Summer 2001): 127–128.

The precise characteristics of customer tiers vary, of course, from one type of business to another and even from one firm to another. Service Perspective 12.1 provides an illustration from the marketing research industry.

Customer tiers are typically based on profitability and 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 levels for platinum and gold customers are often designed with retention in mind, because these customers are the ones competitors would like to entice to switch.

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 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.²⁵

For lead-tier customers, the options are to either migrate them to the iron segment or to terminate them. Migration can be achieved via a combination of strategies, including base fees and price increases. 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 transactions with a single provider.

There may be opportunities to cut service costs to those customers. Customer behavior can be shaped in ways that reduces the cost of serving them; for instance, transaction charges for electronic channels may be priced lower than for people-intensive channels. Another option is to create an attractively priced, low-cost platform. In the cellular telephone industry, for example, low-use mobile users are directed to prepaid packages that do not require the firm to send out bills and collect payments, which also eliminates the risk of bad debts on such accounts.

Terminating customers comes as a logical consequence of the realization that not all existing customer relationships are worth keeping. Some relationships may no longer be profitable for the firm, because they may cost more to maintain than the revenues 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. Just as investors need to dispose of poor investments and banks may have to write off bad loans, each service firm needs to evaluate its customer portfolio regularly and consider terminating unsuccessful relationships. Legal and ethical considerations, of course, will determine whether it is proper to take such action.

Occasionally, customers are "fired" outright (although concern for due process is still important). ING Direct is the fast-food model of consumer banking: It is about as no-frills as it gets. It has only a handful of basic products, and it lures low-maintenance customers with high interest rates (its Orange savings account paid 3.8 percent in January 2006, which was several times the industry average). To offset that generosity, its business model pushes its customers toward online transactions, and the bank routinely fires customers who don't 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 basically 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, ING Direct's cost per account is only one-third of the industry average.²⁶

Other examples of customers being fired include students who are caught cheating on examinations, or country club members who consistently abuse the facilities or other people. In some instances, termination may be less confrontational. Banks wishing to divest themselves of certain types of accounts that no longer fit with 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).

Customer Satisfaction and Service Quality Are Prerequisites for Loyalty

The foundation for true loyalty lies in customer satisfaction, for which service quality is a key input. Highly satisfied or even delighted customers are more likely to become loyal apostles of a firm,²⁷ consolidate their buying with one supplier, and spread positive word of mouth. Dissatisfaction, in contrast, drives customers away and is a key factor in switching behavior. Recent research has even demonstrated that increases in customer satisfaction lead to increases in stock prices—see Research Insights 12.1.

The satisfaction–loyalty relationship can be divided into three main zones: Defection, indifference, and affection (Figure 12.7). 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.²⁸ The *zone of indifference* is found at intermediate 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 may have 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."

RESEARCH INSIGHTS 12.1

Customer Satisfaction and Wall Street—High Returns and Low Risk

Does a firm's customer satisfaction level have anything to do with its stock price? This was the intriguing research question that Claes Fornell and his colleagues wanted to answer. More specifically, they examined whether investments in customer satisfaction lead to higher stock returns (see Figure 12.6), and if so, whether these returns were associated with higher risks, as would be predicted by finance theory. The researchers built two stock portfolios and then measured the return and risks of the firms in those portfolios compared to the firm's American Customer Satisfaction Index (ACSI) scores.

Their findings are striking for managers and investors alike. Fornell and his colleagues discovered that the ACSI was significantly related to the stock prices of the individual firms. However, simply publishing the latest data on the ACSI did not immediately move share prices, as efficient market theory would have predicted. Rather, share prices seemed to adjust slowly over time as firms published other results (perhaps earnings data or other "hard" facts that may lag customer satisfaction), and excess stock returns were generated as a result. This result repre-

sents a stock market imperfection, but it is consistent with research in marketing, which holds that satisfied customers improve the level and the stability of cash flow.

For marketing managers, this study's findings confirm that investments (or "expenses" if you talk to accountants) into managing customer relationships and the cash flows they produce are fundamental to the firm's, and therefore shareholders', value creation.

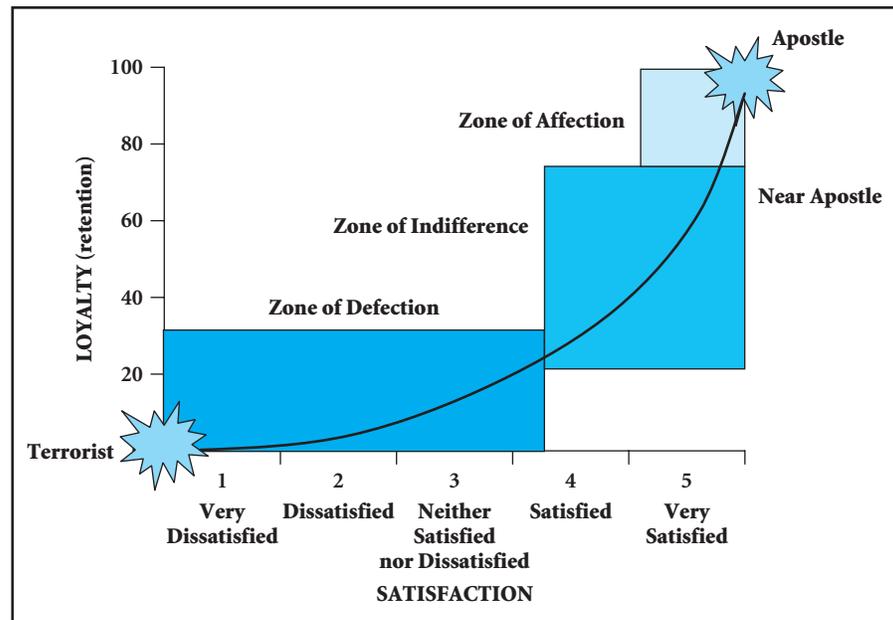
Although the results are convincing, be careful should you want to exploit this apparent market inefficiency and invest in firms that show high increases in customer satisfaction in future ACSI releases—your finance friends will tell you that efficient markets learn fast! You will know this has happened when you see stock prices move as a response to ACSI releases. You can learn more about the ACSI at www.theacsi.org.

Source: Claes Fornell, Sunil Mithas, Forrest V. Morgeson III, and M. S. Krishnan, "Customer Satisfaction and Stock Prices: High Returns, Low Risk." *Journal of Marketing*, 70 (January 2006): 3–14.

Figure 12.6 Can Customer Satisfaction Data Help to Outperform the Market?



Figure 12.7 The Customer Satisfaction/Loyalty Relationship



Source: The Customer Satisfaction-Loyalty Relationship from Thomas O. Jones and W. Earl Sasser, Jr., "Why Satisfied Customers Defect" *Harvard Business Review*, Nov.-Dec. 1995, p. 91. Reprinted by permission of Harvard Business School.

CREATING LOYALTY BONDS

What makes customers loyal to a firm, and how can marketers increase their loyalty? In this section, we first review the common loyalty drivers for customers, and then explore how firms can build or enhance such loyalty drivers.

How Do Customers See Relational Benefits?

Relationships create value for individual consumers through such factors as inspiring greater confidence, offering social benefits, and providing special treatment (see Research Insights 12.2). In a B2B service context, relationships depend largely on the quality of the interactions between individuals at each of the partnering firms, and service firms need to take care to communicate the relevant benefits to the right people in the client organization, because purchasing decisions are often made jointly. As relationships strengthen over time, the service provider's employees often take on the role of an outsourced department and make critical decisions on behalf of their client.²⁹

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 are a solid foundation for creating customer loyalty, as shown in the wheel of loyalty in Figure 12.4. However, firms can do even more to bond more closely with their customers. Specific strategies include deepening the relationship through cross-selling and bundling, and creating loyalty rewards and higher-level bonds such as social, customization, and structural bonds.³⁰

Deepening the Relationship

To tie customers more closely to the firm, deepening the relationship via bundling and/or cross-selling services is an effective strategy. For example, banks like to sell as many financial products to an account holder or household as possible. Once a family has a checking account, credit card, savings account, safe deposit box, car loan, mortgage, and so on, with the same bank, the relationship is so deep that switching

RESEARCH INSIGHTS 12.2

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 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 categorizing 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 the questionnaire asked them to assess the extent to which they received each of 21 benefits (derived from 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 special treatment.

- *Confidence benefits* included feelings by customers that in an established relationship there was less risk of something going wrong, confidence in correct performance, ability to trust the provider, lowered anxiety when purchasing, knowing what to expect, and receipt of the firm’s highest level of service.
- *Social benefits* embraced mutual recognition between customers and employees, being known by name, 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 received.

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*, 26, no. 2 (1998): 101–114.

becomes a major exercise and is unlikely, unless of course, the customer becomes extremely dissatisfied with the bank.

Customers can benefit from consolidating their purchasing of various services from the same provider through the added convenience of one-stop shopping and potentially higher service levels and/or higher service tiers because of the higher volume of business they bring to the firm.

Reward-Based Bonds

Within any competitive product category, managers recognize that few customers consistently buy only one brand, especially when service delivery involves discrete transactions (such as a car rental) rather than being continuous in nature (as with insurance coverage). In many instances, consumers are loyal to several brands while spurning others (sometimes described as “polygamous loyalty”). In such instances, the marketing goal becomes one of strengthening the customer’s preference for one brand over the others, and well-designed loyalty programs can achieve increased loyalty and share-of-wallet.³¹

Incentives that offer rewards based on frequency of purchase, value of purchase, or a combination of both represent a basic level of customer bonding. Reward-based bonds

can be financial or nonfinancial in nature. Financial bonds are built when loyal customers are rewarded with incentives that have a financial value, such as discounts on purchases and loyalty program rewards such as frequent flier miles or the cash-back programs provided by some credit card issuers. Nonfinancial rewards provide customers with benefits or value that cannot be translated directly into monetary terms. Examples include giving priority to loyalty program members for waitlists and queues in call centers, and access to special services. Some airlines provide benefits such as higher baggage allowances, priority upgrading, access to airport lounges, and the like to their frequent flyers, even when they are only flying in economy class. Informal loyalty rewards, sometimes found in small businesses, may take the form of periodically giving regular customers a small treat as a way of thanking them for their custom.

Important intangible rewards include special recognition and appreciation. Customers tend to value the extra attention given to their needs. They also appreciate the implicit service guarantee offered by high-tier memberships, including efforts to meet special requests. One objective of reward-based bonds is to motivate customers to consolidate their purchases with one provider or at least make it the most preferred provider. Tiered loyalty programs often provide direct incentives for customers to achieve the next higher level of membership. However, reward-based loyalty programs are relatively easy for other suppliers to copy and rarely provide a sustained competitive advantage. By contrast, the higher-level bonds that we discuss next tend to be more sustainable.

Social Bonds

Have you ever noticed how your favorite hairdresser addresses you by your name when you go for a haircut or how she asks why she hasn't seen you for a long time and hopes everything went well when you were away on a long business trip? Social bonds are typically based on personal relationships between providers and customers. Alternatively, they may reflect pride or satisfaction in holding membership in an organization. Although social bonds are more difficult to build than financial bonds and may require considerable time to achieve, for that same reason 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. When social bonds extend to shared relationships or experiences between customers, such as in country clubs or educational settings, they can be a major loyalty driver for the organization.³²

Customization Bonds

Customization 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 service accordingly (Figure 12.8). One-to-one marketing is more specialized form of customization in which each individual is treated as a segment of its own.³³ Many large hotel chains capture the preferences of their customers through their loyalty program databases, so that when customers arrives at their hotel, they find that their individual needs have already been anticipated, from preferred drinks and snacks in the minibar to the kind of pillow they like and the newspaper they want to receive in the morning. When a customer becomes used to this special service, he or she may find it difficult to adjust to another service provider who is not able to customize the service (at least immediately, as it takes time for the new provider to learn about the customer's needs).

Structural Bonds

Structural bonds are seen mostly in B2B settings and aim to stimulate loyalty through structural relationships between the provider and the customer. 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 airlines have introduced short message service (SMS) check-in, and SMS email alerts for flight arrival and departure times so that travelers do not have to waste time waiting at the airport in the case of delays. Some car rental companies offer travelers the

Figure 12.8
Starbucks' Employees
Are Encouraged to
Learn Their
Customers'
Preferences



opportunity to create customized pages on the firm's web site, where they can retrieve details of past trips including the types of cars, insurance coverage, and so forth. This simplifies and speeds the task of making new bookings. Once customers have integrated their way of doing things with the firm's processes, structural bonds are created that link the customers to the firm and make it more difficult for competition to draw them away.

Have you noticed that while all these bonds tie a customer closer to the firm, combined they also deliver the confidence, social, and special treatment benefits customers desire (refer back to Research Insights 12.1)? In general, bonds will not work well unless they also generate value for the customer.

Creation of Customer Bonds Through Membership Relationships and Loyalty Programs

Discrete transactions, in which each use involves a payment to the service supplier by an essentially "anonymous" consumer, are typical of services such as transport, restaurants, movie theaters, 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, because it helps employees avoid having to ask the same questions on each service occasion, allows them to personalize the service given to each customer, and also enables the firm to anticipate future needs.

Transforming Discrete Transactions into Membership Relationships

In large companies with substantial customer bases, transactions can still be transformed into relationships by implementing loyalty reward programs, which require customers to apply for membership cards with which transactions can be captured and customers' preferences communicated to the front line. For transaction-type

businesses, loyalty reward programs become a necessary enabler for implementing the strategies discussed in relation to the wheel of loyalty.

Besides airlines and hotels, more and more service firms ranging from retailers (such as department stores, supermarkets, book shops, and gas stations) to telecommunications providers, café chains, courier services and cinema chains have or are also launching 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 short, air miles have become a form of promotional currency in the service sector. Best Practice in Action 12.2 describes how British Airways has designed its Executive Club.

Customers may even get frustrated with a reward programs, so that rather than creating loyalty and goodwill, they actually breed dissatisfaction. Examples include when customers feel they are excluded from a reward program because of low balances or volume of business, if they cannot redeem their loyalty points because of blackout dates during high-demand periods, if the rewards are seen as having little or no value, and if redemption processes are cumbersome and time-consuming.³⁴

Of course, even well-designed rewards programs by themselves will not suffice to retain a firm's most desirable customers. If you and other customers are dissatisfied with the quality of service, or believe that you can obtain better value from a less expensive service, you may quickly become disloyal. No service business that has instituted an awards 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.³⁵

One of the risks associated with a focus on strengthening relationships with high-value customers is that a firm may allow service to its other customers to deteriorate. In the reading, "Why Service Stinks" (pp. 471–477), Diane Brady explores the negative aspects of customer stratification.

How Customers Perceive Loyalty Reward Programs

Recent research in the credit card industry suggests that loyalty programs strengthen the customers' perception of the value proposition, and lead to increased revenues due to fewer defections and higher usage levels.³⁶ 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:³⁷

- **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.
- **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 gifts rather than just a single gift; (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 an award places it within the realm of possibility for any given consumer; (5) the ease of using the program and making claims for redemption; 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.

BEST PRACTICE IN ACTION 12.2

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's) Executive Club members receive both *air miles* toward redemption of air travel awards and *points* toward silver- or gold-tier status for travel on BA. With the creation of the OneWorld airline alliance with American Airlines, Qantas, Cathay Pacific, and other carriers, Executive Club members have been able to earn miles (and sometimes points) by flying these partner airlines, too.

As shown in Table 12.A, 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 traveling in economy class, he or she will be entitled to first-class standards of treatment at check-in and in the airport lounges. However, whereas miles can be accumulated for up to three years (after which they expire), tier status is valid for only 12 months beyond the membership year in which it was earned. In short, the right to special privileges must be re-earned each year. The objective of awarding tier status (which is not unique to BA) is to encourage passengers who have a choice of airlines to concentrate their travel on British Airways, 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. However, one of the rewards of that status may be the ability to use lounges and

other amenities of airlines that belong to the same international alliance (such as OneWorld).

The assignment of points also varies according to the class of service. BA seeks to recognize higher ticket expenditures with proportionately higher awards. Longer trips earn more points than shorter ones (a domestic or short-haul European trip in economy class generates 15 points, a transatlantic trip 60 points, and a trip from the UK to Australia, 100 points.) However, tickets at deeply discounted prices may earn fewer miles and no points at all. To reward purchase of higher-priced tickets, passengers earn points at double the economy rate if they travel in club (business class), and at triple the rate in first class.

To encourage gold and silver cardholders to remain loyal, BA offers incentives for Executive Club members to retain their current tier status (or to move up from silver to gold). Silver cardholders receive a 25 percent bonus on all air miles, regardless of class of service, and gold cardholders receive a 50 percent bonus. In other words, it doesn't pay to spread the miles among several frequent flyer programs.

Although the airline makes no promises about complimentary upgrades, members of BA's Executive Club are more likely to receive such invitations than other passengers, with tier status being an important consideration. Unlike many airlines, BA tends to limit upgrades to situations in which a lower class of cabin is overbooked, rather than letting frequent travelers believe that they can plan on buying a less expensive ticket and then automatically receive an upgraded seat.

Table 12.A Benefits Offered by British Airways to Its Most Valued Passengers

BENEFIT	SILVER-TIER MEMBERS	GOLD-TIER MEMBERS
Reservations	Dedicated silver phone line	Dedicated gold phone line
Reservation assurance	If flight is full, guaranteed seat in economy class when booking full-fare ticket at least 24 hours in advance	If flight is full, guaranteed seat in economy class when booking full-fare ticket at least 24 hours in advance
Priority waitlist and standby	Higher priority	Highest priority
Advance notification of delays over 4 hours from U.S. or Canada	Yes	Yes
Check-in desk	Club (when traveling economy class)	First (when traveling club or economy class)
Lounge access	Club departure lounges for passenger and one guest regardless of class of travel	First-class departure lounge for passenger and one guest, regardless of travel class; use of arrivals lounges if traveling economy class; lounge access anytime, allowing use of lounges even when not flying BA intercontinental flights
Preferred boarding	Board aircraft at leisure	Board aircraft at leisure
Special services assistance		Problem solving beyond that accorded to other BA travelers
Bonus air miles	+25%	+50%
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. Award someone else with a Silver Partner card on reaching 4,500 points within membership year

Source: British Airways Executive Club, www.britishairways.com/travel/ecbenftgold/public/en_us, accessed January 2006.

STRATEGIES FOR REDUCING CUSTOMER DEFECTIONS

So far, we have discussed drivers of loyalty and strategies to tie customers more closely to the firm. A complementary approach is to understand the drivers of customer defections, also called customer churn, and work on eliminating or reducing those drivers.

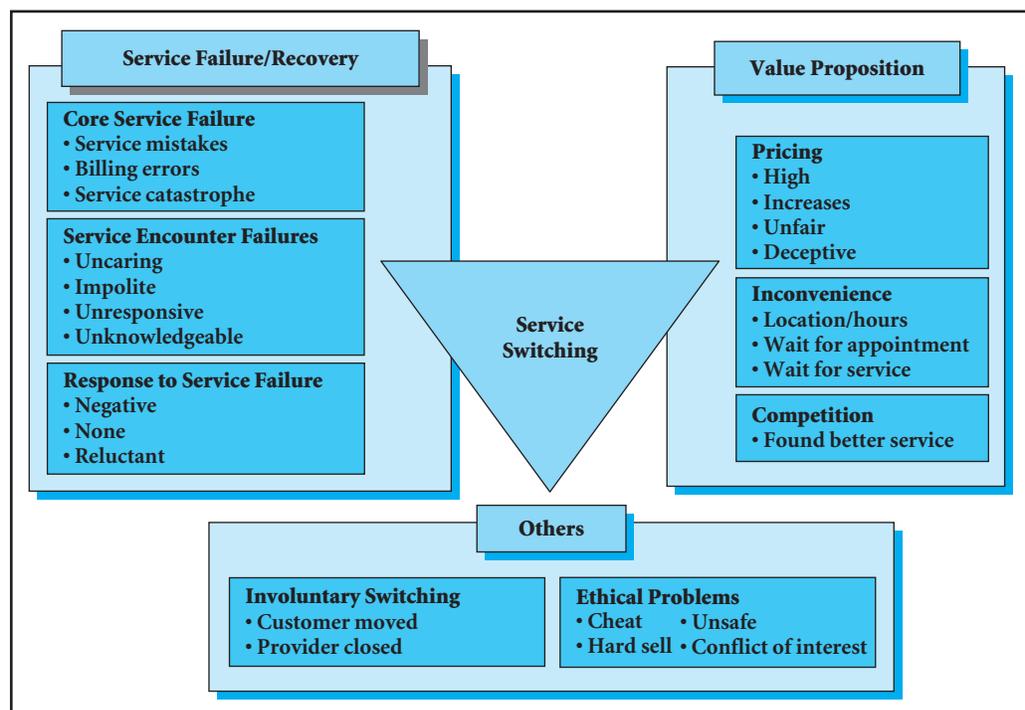
Analyze Customer Defections and Monitor Declining Accounts

The first step is to understand the reasons for customer switching. Susan Keaveney conducted a large-scale study across a range of services and found several key reasons why customers switch to another provider³⁸ (Figure 12.9). Core service failures were mentioned by 44 percent of respondents as a reason for switching; dissatisfactory service encounters by 34 percent; high, deceptive, or unfair pricing by 30 percent; inconvenience in terms of time, location, or delays by 21 percent; and poor response to service failure by 17 percent. Many respondents described a decision to switch as resulting from interrelated incidents, such as a service failure followed by an unsatisfactory service recovery.

In the mobile phone industry, players regularly conduct what is called *churn diagnostics*. This includes the analysis of data on churned and declining customers, exit interviews (call center staff often have a short set of questions they ask when a customer cancels an account, to gain a better understanding of why customers defect), and in-depth interviews of former customers by a third-party research agency, which typically yield a more detailed understanding of churn drivers.³⁹

Many mobile phone service operations use *churn alert systems*, which monitor the activity in individual customer accounts with the objective of predicting impending customer switching. Accounts at risk are flagged and trigger proactive retention efforts 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.

Figure 12.9
What Drives Customers to Switch Away from a Service Firm?



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

SERVICE PERSPECTIVES 12.2

Churn Management Gone Wrong

America Online (AOL) agreed to pay \$1.25 million in penalties and costs, and to change some of its customer service practices, to settle an investigation by the State of New York. In complaints filed with the office of the state attorney general, some 300 subscribers accused AOL of ignoring their demands to cancel the service and stop billing them.

What went wrong? AOL had been rewarding its call center employees for “saving” customers who called to cancel their service. Employees could earn high bonuses if they were able to dissuade 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 record service cancellation requests and have them verified by a third-party monitor, and it agreed to provide up to four months’ worth of refunds to all New York subscribers who claimed that their cancellation requests had been ignored (AOL did not admit to any wrongdoing in the settlement). Attorney General Eliot Spitzer said in a statement: “This agreement helps to ensure that AOL will strive to keep its customers through quality service, not stealth retention programs.”

Source: Adapted from The Associated Press, “AOL to Pay \$1.25M to Settle Spitzer Probe.” *USA Today*, August 25, 2005, p. 5B.

Address Key Churn Drivers

Keaveney’s findings underscore the importance of addressing some generic churn drivers by delivering quality service (see Chapter 14), minimizing inconvenience and other nonmonetary costs, and fair and transparent pricing (Chapter 5). In addition to these generic drivers, there are often industry-specific 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 typically come with heavily subsidized new handsets. To prevent handset-related churn, many providers now offer proactive handset replacement programs, in which their current subscribers are offered heavily discounted new handsets at regular intervals. Some providers even provide handsets free to high-value customers or against redemption of loyalty points.

In addition to such proactive retention measures, many firms use reactive measures as well. These include specially trained call center staff, so-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 about how you reward save teams—see Service Perspective 12.2.

Implement Effective Complaint-Handling and Service Recovery Procedures

Effective complaint handling and excellent service recovery are crucial to keeping unhappy customers from switching providers. That includes making it easy for customers to voice their problems with the firm, and then responding with strong service recovery. We will discuss in depth on how to do that effectively in Chapter 13.

Increase Switching Costs

Another way to reduce churn is to increase switching barriers. Many services have natural switching costs (e.g., 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).⁴⁰

Switching costs can also be created by instituting contractual penalties for switching, such as the transfer fees levied by some brokerage firms for moving shares and bonds to another financial institution. However, firms need to be cautious that they are not perceived 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 previously inert customer will have had enough” and switch the service provider.⁴¹

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 the term *CRM*, however, and costly, complex IT systems and infrastructure, and CRM vendors such as SAP, Siebel Systems (Figure 12.10), and Oracle come immediately to mind. But CRM actually signifies the whole process by which relations with customers are built and maintained. It should be seen as an enabler of the successful implementation of the wheel of loyalty. Let us first look at CRM systems before we move 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, and web sites), at multiple geographic locations. At a single large facility, it’s 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, however, CRM systems act as an enabler, capturing customer information and delivering it 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 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.⁴² Service Perspective 12.3 highlights some common CRM applications.

What Does a Comprehensive CRM Strategy Encompass?

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 12.11 provides an integrated framework of five key processes involved in a CRM strategy:⁴³

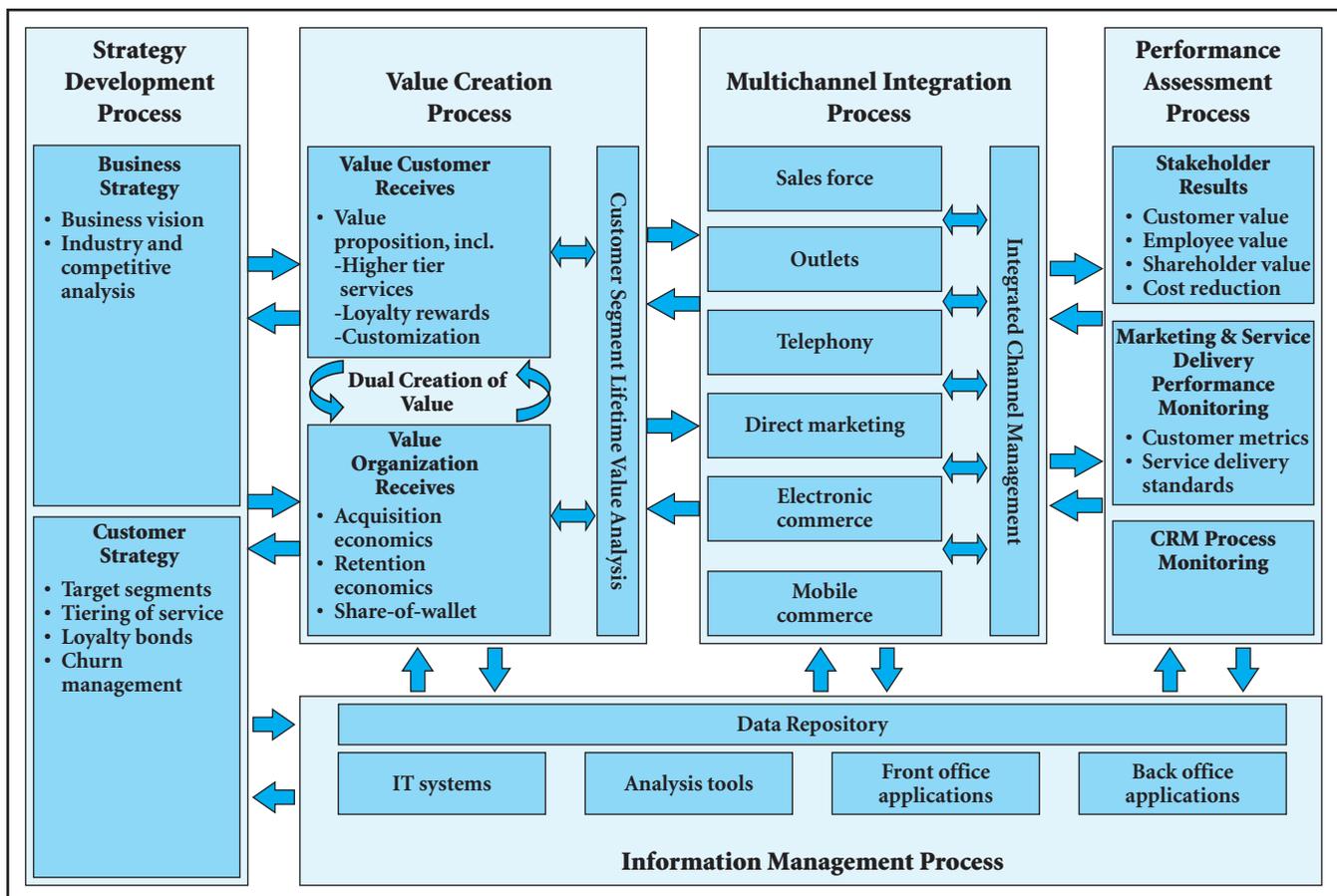
1. *Strategy development* involves the assessment of business strategy (including articulation of the company’s vision, industry trends, and competition). The business strategy is typically the responsibility of top management. Once determined, the business strategy should be guiding the development of the customer strategy, including the choice of target segments, customer base tiering, the design of loyalty bonds, and churn management (as discussed in the wheel of loyalty, Figure 12.4).

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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 are analyzed and categorized by the system according to criteria set by the firm. This information is then used to tier the customer base and tailor service delivery accordingly.
- **Sales force automation.** Sales leads, and cross-selling and up-selling opportunities, can be effectively identified and processed, and the entire sales cycle from lead generation to close of sales and after-sale service can be tracked and facilitated through the CRM system.
- **Marketing automation.** Mining of customer data enables 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 return on its marketing expenditure. CRM systems also enable assessment of 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. Furthermore, caller ID and account numbers allow call centers to identify the customer tier to which the caller belongs, and to tailor the service accordingly. For example, platinum callers get priority in waiting queues.

Figure 12.10 An Integrated Framework for CRM Strategy



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

2. *Value creation* translates the business and customer strategies into specific value propositions for customers and the firm. The value created for customers includes all the benefits that are delivered through priority tiered services, loyalty rewards, and customization and personalization. The value created for the firm needs to include reduced customer acquisition and retention costs, and increased share-of-wallet. Core of CRM is the concept of dual creation of value—customers need to participate in CRM (e.g., through volunteering information) so that they can reap value from the firm’s CRM initiatives. For instance, only if my driver’s license, billing address, credit card details, and car and insurance preferences are stored in a car rental’s CRM system can I benefit from the increased convenience of not having to provide those data for each reservation. Firms can even create value through 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 customer ratings of books). CRM seems most successful when there is a win–win situation for the firm and its customers.⁴⁴
3. *Multichannel integration*: Most service firms interact with their customers through a multitude of channels, and it has become a challenge to serve customers well across these many potential interfaces and offer a unified customer interface that delivers customization and personalization. CRM’s channel integration addresses this challenge.
4. *Information management*: Service delivery across many channels relies 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 encompasses the data repository (which contains all the customer data), IT systems (which encompasses the IT hardware and software), analytical tools (which include data mining packages, and more specific application packages such as campaign management analysis, credit assessment, customer profiling, and churn alert systems), front-office applications (which support activities that involve direct customer contact, including sales force automation and call center management applications), and back-office applications (which support internal customer-related processes, including logistics, procurement, and financial processing).
5. *Performance assessment* must address three critical questions. First, is the CRM strategy creating value for its key stakeholders (i.e., customers, employees, and shareholders)? Second, 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, abortion, and first-time resolution rates) being achieved? Third, is the CRM process itself performing up to expectations (e.g., 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

Unfortunately, the majority of CRM implementations failed in the past. According to the Gartner Group, the implementation failure rate is 55 percent, and Accenture claims it to be around 60 percent. 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 itself.

Furthermore, CRM cuts across many departments and functions (e.g., from customer contact centers, on-line services, and distribution to branch operations,

employee training, and IT departments), programs (ranging from sales and loyalty programs to launching of new services, cross-selling, and upselling initiatives), and processes (e.g., from credit-line authorization all the way 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:⁴⁵

- **Viewing CRM as a technology initiative.** It's easy to let the focus shift toward technology and its features, with the result that the IT department rather than top management or marketing takes the lead in devising CRM strategy. This often results in a lack of strategic direction and of understanding of customers and markets during implementation.
- **Lack of customer focus.** Many firms implement CRM without the ultimate goal to enable consistent service delivery for valued customers across all customer service processes and delivery channels.
- **Insufficient appreciation of customer lifetime value (LTV).** The marketing program of many firms is not sufficiently structured around the vastly different profitabilities 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 Chapter 5).
- **Inadequate support from top management.** Without ownership and active involvement of top management, the CRM strategic intent will not survive the implementation intact.
- **Failing to reengineer business processes.** It is virtually impossible to implement CRM successfully without redesigning customer service and back-office processes. Many implementations fail because CRM is being fitted into existing processes, rather than redesigning the processes to fit a customer-centric CRM implementation. Redesigning also requires effective change management and employee engagement and support, which are often lacking.
- **Underestimating the challenges in data integration.** Firms frequently fail to integrate customer data, which are often 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.

In the long run, firms put their CRM strategies at substantial risk if customers believe that CRM is being used in a way that is detrimental to them. Examples include perceptions of not being treated fairly (including not being offered attractive pricing or promotions that are offered, for example, to new accounts, but not to existing customers), and potential privacy concerns (see Service Perspective 12.4). Being aware and actively avoiding these pitfalls is a first step toward successful CRM implementation.

How to Get CRM Implementation Right

In spite of the many horror stories of millions of dollars sunk into unsuccessful CRM projects, more and 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.⁴⁶ Even existing CRM systems that have not yet shown results can be well positioned for future success. Seasoned McKinsey consultants recommend taking a step back and studying how to build customer loyalty, rather than focusing on the technology itself.⁴⁷ Rather than using CRM to transform entire businesses through the wholesale implementation of the CRM model advanced in Figure 12.11, successful implementations zero in on clearly defined problems within the firm's customer relationship cycle. These narrow CRM strategies often reveal additional opportunities for further improvements, which taken together, can evolve into broad CRM implementation extending across the entire company.

SERVICE PERSPECTIVES 12.4

CRM Extreme—A Glimpse into Ordering Pizza in 2012?

Operator: Thank you for calling Pizza Delight. Linda speaking, how may I help you?

Customer: Good evening, can I order. . . .

Operator: Sir, before taking your order, could I please have the number of your multipurpose smart card?

Customer: Hold on . . . it's . . . um . . . 4555-1000-9831-3213.

Operator: Thank you. Can I please confirm you're Mr. Thompson, calling from 10940 Wilford Boulevard? You are calling from your home number, 432-3876, your cellphone number is 992-4566, and your office number is 432-9377?

Customer: How in the world did you get my address and all my numbers?

Operator: Sir, we are connected to the Integrated Customer Intimacy System.

Customer: I would like to order a large seafood pizza. . . .

Operator: Sir, that's not a good idea.

Customer: Why not?

Operator: According to your medical records, you have very high blood pressure and a far too high cholesterol level, Sir.

Customer: What? . . . Then what do you recommend?

Operator: Try our Low Fat Soybean Yoghurt Pizza. You'll like it.

Customer: How do you know?

Operator: You borrowed the book, *Popular Soybean Dishes*, from the City Library last week, Sir.

Customer: OK, I give up. . . . Give me three large ones then. How much will that be?

Operator: That should be enough for your family of 8, Sir. The total is \$47.97.

Customer: Can I pay by credit card?

Operator: I'm afraid you'll have to pay us cash, Sir. Your credit card is over your limit and your checking account has an overdue balance of \$2,435.54. That's excluding the late-payment charges on your home equity loan, Sir.

Customer: I guess I'll have to run to the ATM and withdraw some cash before your guy arrives.

Operator: You can't do that, Sir. Based on the records, you've reached your daily machine withdrawals limit for today.

Customer: Never mind. Just send the pizzas. I'll have the cash ready. How long is it gonna take?

Operator: About 45 minutes, Sir, but if you don't want to wait you can always come and collect it on your Harley, registration number L.A.6468. . . .

Customer: #@\$#@%^%#@.

Operator: Sir, please watch your language. Remember, on April 28th of last year you were convicted of using abusive language to a traffic warden. . . .

Customer: (Speechless)

Operator: Will there be anything else, Sir?

Source: This story was adapted from various sources, including www.lawdebt.com/gazette/nov2004/nov2004.pdf, accessed January 2006; and a video created by the American Civil Liberties Union (ACLU), available at www.aclu.org/pizza. This video aims to communicate the privacy threats that CRM poses to consumers. ACLU is a nonprofit organization that campaigns against government's and corporations' aggressive collection of information on people's personal lives and habits.

Rigby, Reichheld, and Schefter pose 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.⁴⁸

Among the key issues managers that 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 haven't we taken more steps in that direction in the past? What can we do today to develop customer relationships without spending a lot on technology?

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

CONCLUSION

Many elements are involved in gaining market share, increasing share-of-wallet, cross-selling other products and services to existing customers, and creating long-term loyalty. We used the wheel of loyalty as an organizing framework, which starts with identifying and targeting the right customers, then learning about their needs, including their preferences for various forms of service delivery. Translating this knowledge into service delivery, tiered service levels, and customer relationship strategies are the key steps toward achieving customer loyalty.

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. Programs to reward fre-

quent users—of which the most highly developed are the frequent flyer clubs created by the airlines—identify and provide rewards for high-value customers and facilitate tiered service delivery. These programs also 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 product they buy, and how much they spend.

Customer relationship management is a key enabler for the strategies discussed in the wheel of loyalty and is often integrated with loyalty programs. From a customer perspective, CRM can result in a vast service improvement and increased customer value (e.g., through mass customization and increased convenience).

REVIEW QUESTIONS

1. Why is targeting the “right” customers so important for successful customer relationship management?
2. How can you estimate a customer’s lifetime value (LTV)?
3. Explain what is meant by a customer portfolio. How should a firm decide what is the most appropriate mix of customers to have?
4. What criteria should a marketing manager use to decide which of several possible segments should be targeted by the firm?
5. What is tiering of services? Explain the rationale and strategic implications.
6. Identify some key measures that can be used to create customer bonds and encourage long-term relationships with customers.
7. What are the arguments for spending money to keep existing customers loyal?
8. How do the various strategies described in the wheel of loyalty relate to one another?
9. What is the role of CRM in delivering a customer relationship strategy?
10. Review the reading, “Why Service Stinks” (pp. 471–477). Do you agree with the author’s view that loyalty programs result in poor service for less valuable customers? If so, what do you recommend should be done about this?

APPLICATION EXERCISES

1. Identify three service businesses that you patronize on a regular basis. Then, for each business, complete the following sentence: “I am loyal to this business because. . .”
2. What conclusions do you draw about (a) yourself as a consumer and (b) the performance of each of the businesses in Exercise 1? Assess whether any of these businesses managed to develop a sustainable competitive advantage through the way it won your loyalty.
3. Identify two service businesses that you used several times but have now ceased to patronize (or plan to stop patronizing soon) because you were dissatisfied. Complete the sentence: “I stopped using (or will soon stop using) this organization as a customer because. . .”

4. Again, what conclusions do you draw about yourself and the firms in Exercise 3? How could each of these firms potentially avoid your defection? What could each of these firms do to avoid defections in the future of customers with a profile similar to yours?
5. Evaluate the strengths and weaknesses of frequent user programs in different service industries.
6. Design a questionnaire and conduct a survey asking about two loyalty programs. The first should be a membership/loyalty program your classmates or their families like and keeps them loyal to that firm. The second should be about a loyalty program that is not well perceived, and does not seem to add value to the customer. Use open-ended questions, such as “What motivated you to sign up in the first place?”; “Why are you using this program?”; “Has participating in the program changed your purchasing/usage behavior in any way?”; “Has it made you less likely to use competing suppliers?”; “What do you think of the rewards available?”; “Did membership in the program lead to any immediate benefits in the use of the service?”; “What role does the loyalty program play in making you loyal?”; “What are the three things you like best about this loyalty/membership program?”; “. . . liked least”; and “Suggested improvements?” Analyze what features make loyalty/membership programs successful, and what features do not achieve the desired results. Use a framework such as the wheel of loyalty to guide your analysis and presentation.
7. Approach service employees in two or three firms that have implemented CRM systems. Ask the employees about their experience interfacing with these systems, and whether the CRM systems help them understand their customers better and whether this leads to improved service experiences for their customers. Do interview them about potential concerns and improvement suggestions they may have about their organization’s CRM system.

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