Customer Loyalty Programs: Best Practices

David Robinson
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Haas School of Business, University of California, Berkeley

It's a rare business owner or manager who can say, "We have as much revenue as we can handle, and frankly, profitability is better than we'd ever hoped for." Most executives are faced with the daily struggle to increase turnover and bring more money to the bottom line.

Customer Loyalty Programs, familiar to most executives in the form of frequent flier miles, have become ubiquitous. Companies small and large offer a myriad of loyalty reward programs but not all of them are thoughtfully designed or effective. This brief review describes when loyalty programs work well, the features of the best programs and the various types of program that can be adopted.

The rationale for Customer Loyalty Programs

Businesses grow by either *customer acquisition* or by getting *more business from their existing customers*. Customer acquisition is invariably expensive. For every successful promotional activity (spending money and gaining a new customer) there is a vast amount of wasted promotion. Attendance at a business exposition may involve hundreds of hours of expensive staff time to yield a few dozen good prospects of whom a mere handful can be converted into profitable customers. Firms that search for new customers by unsolicited catalog mailings are often delighted if the response rate is any more than just 1 percent. That is, 99 percent of the costs of printing and mailing are a dead loss.

It is much cheaper, then, to get more business from existing customers. Firms do this in two ways: Getting customers to *buy more when they buy* or by getting them to *buy more frequently*. Getting customers to buy more usually involves some kind of sales promotion such as a bundle with an attractive package price (for example, season subscriptions to theater or concerts) or promotional discounts for quantity purchases. "Buy more" can also involve "upselling" the customer once they have made a decision to buy. Examples of upselling are add-ons such as selling spa services to a hotel guest or getting a firm that has agreed to purchase software to also pay for staff training.

The second way to get more business from existing customers is to get them to buy more often. This is where Customer Loyalty Programs are most successful. There are specific prerequisites for such programs (*see text box: Characteristics of a good loyalty program*): The customer must purchase the goods frequently and must have the discretion to purchase from a number of different providers who all offer roughly equivalent goods. For example, there would be little point in developing a

Customer Loyalty Program for Steinway pianos—they are typically a once in a lifetime purchase and customers who are considering a Steinway usually hold the opinion that competing brands do not offer comparable goods[1].

Although various forms of Customer Loyalty Programs have probably been around for millennia, leadership in the modern form is largely credited to American Airlines AAdvantage program begun in 1981. American's charismatic CEO, Robert Crandall, moved the airline from thinking about selling tickets to thinking about their relationship with specific customers. Crandall noted that the airline business exhibits an extreme form of the "80/20 rule" (that 80 percent of profits come from 20 percent of customers). In the airline business more than half of all passengers may take only one trip a year, whereas the top 5 percent of customers may buy more than 20 round-trip tickets a year.

After segmenting the market for airline tickets into leisure travelers and business fliers, Crandall noted that the frequently-flying business customers are delightfully price-insensitive. While leisure travelers are brand disloyal and always search for the best deal, business fliers are concerned primarily about schedule convenience. The costs of airline tickets are relatively small compared to the full cost of sending an executive on a business trip, especially when the cost of the traveler's salary are included, and are very small as compared to the benefit hoped to be earned by taking the trip. American Airlines knew from marketing research that some of its best customers were disloyal: Since major airlines offered a largely generic product flying identical planes with only superficial differences in service, if an American routing offered a slightly less favorable time or the need to change planes on a cross country flight, good customers would choose a flight from a competing airline.

The points awarded by the AAdvantage program were meant to tip the balance towards always flying with American. For each mile flown, a customer would accumulate points. When a threshold was reached, the customer could trade those points for a free trip. The motivation to always travel on American Airlines then became this: For a modest amount of schedule inconvenience, a business traveler could earn points from business trips (paid for by his or her company!) and then use those points for a vacation trip. The motivation was compelling. American Airline's program was quickly matched by its competitors and now only deep-discount airlines (who are exclusively targeting leisure travelers) fail to have a rewards program.

Characteristics of a good loyalty program

[1] This is not to say that firms selling rarely-purchased goods should not pay special attention to repeat customers. For example, the best prospects for a photocopy distributor are customers who bought machines a few years ago. Incentives such as generous trade-in allowances are really a form of sales promotion for a specific transaction and are not true loyalty programs.

As soon as all the major airlines adopted frequent flier reward programs the competitive advantage of one firm over another was neutralized. Since there was no monetary cost or annual fee to join the programs, even leisure travelers signed up with all the airlines that they might conceivably ever fly; they reasoned that while it might take them several years to reach the reward of a free flight, there was no harm in putting points on several different programs and they continued to be disloyal. The airlines soon realized that participation in multiple programs also allowed their business travelers to go back to picking and choosing convenient flights rather than driving all their traffic to one airline, as hoped. The solution to the "join every program" problem was two-fold: First, airlines gradually matched one another in adopting a rule that points earned expired if not cashed in within a fairly generous time-frame, typically a few years. That eliminated the cost of giving free seats to leisure customers who were incapable of "buying more" (people have limited vacation time, no matter how good the airline's offer). Second, the airlines realized that to effectively drive almost all business to one airline, the membership must be *tiered* into different levels.

A typical airline rewards program will have three tiers: Entry level merely requires the customer to register with her or his name and contact information and they are rewarded with base level points (typically one point per mile flown, but some firms in short-haul markets just count number of paid flights). Customers at this base level may make some discretionary purchases to earn extra points. The second level is a segment of customers who fly regularly, say once a month domestically, or about four trans-continental flights per year and the top level is reserved for true "road warriors"—those business people who travel several times each month.

Characteristics of good programs

1. Goods are frequently purchased
2. Customer has a choice between providers
3. Providers have equivalent offerings
4. Customer membership has multiple tiers
5. Unused points should expire
6. Customer's experience is materially different in the top tiers

While higher level tiers give customers a greater ratio of points (for example, 1.5 points per mile in the middle tier) this alone is not sufficient to motivate the customer to drive all their business to a single provider. The extra points (and faster realization of rewards) are a "nice to have, not a must to have" from the customer's point of view. Consider hotels: The major international hotels such as Hilton, Hyatt, Kempinski and Sofitel all offer rooms and services that are of a roughly comparable standard. The behavior that a hotel firm seeks from a card-carrying customer is that he should insist that his taxi driver travel another 20 minutes in traffic during a monsoon to reach the preferred brand of hotel, passing competitors' properties along the way. A few extra points will not achieve this.

Firms achieve this level of devotion by offering elite tiers much more than more points—their lives must be *materially different*. Hertz is a good example of this. It's most valuable customers achieve a status called "Hertz Number One Gold". These fortunate customers never wait in line at an airport

counter; they board the car rental company's shuttle bus and announce their arrival to the driver who alerts the rental depot. By the time they reach the rental location, the customer's car is ready (often under cover), trunk open and keys in the ignition. The customer jumps in and drives off, pausing only to show a driver's license to the security guard at the gate while wondering about the sad life of lesser mortals who having queued up at the airport, must now queue up again to get their car.

In the hotel business, upgrading customers to better rooms (for example rooms with a view) is, like extra points, a "nice to have, not a must to have". Hotels can make some customers' experience materially different by allowing them to choose reward nights without any blackout dates while severely restricting the rewards for lower-tiered customers who are blocked from using rewards at peak holiday times. Airlines make even middle-tiered customers' travel experience materially different by allowing them early boarding and hence the opportunity to easily stow carry-on bags. Many airlines provide special lounges exclusively for those in the top tier; these refuges from airport crowds provide amenities and comfort while incidentally providing the psychic benefit of making the customer feel special.

In designing a tiered program a firm should make the "carrot" of material difference so large that its elite customers will demonstrate extreme loyalty in order to avoid the loss of utility associated with being relegated to a lower level of membership. Executives often observe colleagues' sudden urgent need to visit far-distant customers or branches in November and December each year to maintain their elite status. This, of course, is exactly the behavior that the airlines are seeking. Once a customer is anointed as a member of the elite tier, a company has locked-in brand loyalty for the coming 12 months.

Managing tiers of customers

In a 2001 paper, Valerie Zeithaml of the University of North Carolina and colleagues proposed a pyramid structure for thinking about customers and labeled them: Platinum, Gold, Iron and Lead[2]. The base of the pyramid is widest with the largest number of customers; these Lead customers may cost more to serve than they are worth to the firm. Iron customers are reasonably profitable but they don't respond to special offers and don't seem capable of buying more. Most of the firm's profit comes from Gold customers—there are more of them than the Platinum tier above. They drive most of their business to the firm, exhibit loyalty and are relatively price-insensitive (like the business fliers, above). Platinum customers go for every option and add-on and may spend a lot of money, but there aren't a lot of those customers around. First class passengers on three-class planes would be an example; other than privacy, prestige and slightly better food, on many airlines it's hard to see

[2] "Lead" as in the metal, not a "leading customer" or "first to adopt".

how their experience is any better than the service offered to business class patrons, but they are a market segment who will pay handsomely for this exclusivity.

A fictitious example can explain the concept of the customer relationship pyramid. Imagine that this magazine were to offer a custom-reprint service. A Platinum customer is the personal assistant of a major industrial leader. Every time is mentioned in an article, the assistant orders 120 copies. Note that this customer won't buy very frequently, however, he will pay for custom-formatting on special paper, will pay and add-on fee for customizing with the firm's logo and will pay a premium for express shipping.

At the Gold level of the pyramid, we can imagine a consultancy firm that frequently uses reprints for client training. As the cost of the reprints is small compared to their fees, they are quite price insensitive. They may purchase readily when new articles become available or new products such as case study collections, special summaries or online simulations are made available.

An Iron customer for this business might be a university that pays for reprints used once a year as part of an orientation program for incoming graduate students. They are reliable customers, but they shy away from expensive products and only order once a year. They don't respond to any special offers so it is hard to get them to buy more often.

If the top three layers of this typology seem self-evident, the lowest tier may cause some disagreement. Zeithaml argued that every business has some customers whom they would be better off not serving—the Lead customers. In our journal reprint example, imagine an undergraduate student telephoning the reprint office. He seeks an article whose title he can't remember and for which he can supply no reference information. Even if the customer service representative delights him by an exhaustive search and special handing, the potential profit from selling a single reprint would be wiped out by the transaction costs. This customer only has the economic resources to make the single transaction and is incapable of being nurtured into a more profitable Gold customer. Zeithaml's controversial recommendation was that firms should "get the lead out" by discouraging unprofitable customers, even sending them to competitors. In our imaginary example, customer service reps would be trained to weed out students and direct them to their university libraries.

With the understanding that not all businesses can necessarily be tiered into three or four levels (Hertz for example seems to do well with just two), here are some conventional-wisdom approaches to management of the tiers.

At the top, Platinum customers are great to have, but it may be difficult for a firm to make more them. For example, for a hotel, nothing would be more profitable than being "bought out" (all rooms booked) by a film crew. But that would be a happy accident—the hotel could not rely on this business. There is nothing that the hotel can do to induce more films to be made.

Gold customers should be where the firm puts in its best efforts, as American Airlines showed with its business traveler program. There is a good number of these customers and they are nicely profitable. It follows that it would be nice to have more of them. Where do they come from? They are harvested from the tier below—in Zeithaml's scheme, the iron customers and in many membership rewards programs from those how have merely signed up and been issued a card. *Some* members of the tier below are unidentified "Gold in waiting" customers. While they are waiting, these customers are being disloyal and sharing their business with other providers. A firm can readily identify those who might be ready to move up when they exhibit buying behavior that is slightly more frequent than that expected from Iron customers. For example, an airline could go after people who fly more than once a month and a theater company could note patrons who have purchased tickets to more than one play. A well-managed Customer Loyalty Program will promote heavily to this group of customers. Customized direct mail pieces should thank the customer for her increased buying behavior and the promotional piece should spell out the material differences for moving up a tier. An effective promotional technique is to give customers a "taste of the good life." For example, an airline can note intermittent international travel and can send a customer a one-time voucher for the elite lounge on her next trip. If the customer is truly Iron (the extra trips were only to visit a sick relative) the coupon expires unused at no cost. But if the customer is interested in playing the game, the firm's database will show a new purchase in response to the promotion.

Effective management of this most-valuable tier has to include banishment if the customer fails to purchase frequently in subsequent periods. This might happen, for example, when a road warrior is promoted to a head quarters staff position. Not to worry—there will be other future Gold customers to be harvested from the lower tiers. In passing it is worth noting that it is sometimes worth allowing such customers to buy back into the benefits of the elite tier; for example, the cash price for membership in airline business class lounges sets the reference value for those who earn the benefit and no monetary cost solely through the frequency of their purchase activity.

Different types of Customer Loyalty Programs

While airline, hotel and car rental loyalty programs are most visible to executives, they are widely used in other industries, with varying levels of success. Remember that the customer must buy frequently and have some discretion about his purchases. A frequent patient card for a hospital emergency room (casualty ward) is a doubtless apocryphal bad example—no one chooses to go to the hospital and in an emergency there is usually little discretion about where the ambulance takes the patient. A loyalty program for an automobile dealership's repair shop is similarly flawed—people who purchase new cars are sensitive to the new car warranty and will in general be unlikely to seek out other providers.

Not all rewards programs involve the collection and redemption of points. In a 2006 article, Hofstra

Types of Loyalty Reward Programs

1. Simple percent off on all purchases
2. Buy *n* get one free
3. Tiered rewards (airline miles)
4. Customer relationship with frequent special offers

University Professor Barry Berman suggested a categorization of Loyalty Rewards Programs (see text box) and observed that the lowest level were not true Customer Loyalty Programs, but rather were simply a *cents off sales promotion.* (Type 1 in the accompanying text box). For example, the large US bookstore chain Barnes & Noble (more than 1,000 retail outlets) offered customers a membership card (for a small fee) that would give 10 percent off on all full-price purchases. The firm didn't tier the rewards and made few special efforts to selectively promote to customers whom it had enrolled. Berman's criticism is valid—it's hard to see such a program encouraging customers to buy more, or to motivate much discretionary behavior. A few cents off a book purchase do not make a customer's life materially different (free reserved parking might). A "membership" program that is offered to all and has no tiers with special perquisites isn't likely to provide much benefit to the firm and it's better to consider simpler sales promotions to drive sales.

Many fast food chains and service providers such as car-washes offer rewards programs of the second type, *buy n get one free*. These programs may have a modest effect in encouraging customers to buy more often and to prevent switching between providers. However, they are likely to have a very limited effect on growing revenue as most competitors within a geographic area will adopt similar programs to neutralize any brand switching; and since the programs are anonymous and untiered, customers are unlikely move up or change their purchase behavior significantly.

Airline and hotel rewards programs are fully-featured tiered programs that match Berman's third category. They are not limited to the travel industry—they can be applied in any situation where the customers can be conveniently identified by name and address, where the offerings are largely interchangeable, where the customer makes repeat purchases and where the firm can make the customer's life materially different. For example, all office supply megastores offer essentially the same goods as their competitors. A tiered rewards program could be applied with small rewards offered on a points system, a middle tier of customers who can use the added service of delivery at a small fee, and a top tier whose members are given free delivery.

Grocery stores fit the criteria of frequent purchase and discretionary choice between equivalent providers. Most supermarkets carry the same nationally-branded consumer package goods as most other chains. Customers have strong preferences for where they shop but are likely to show disloyalty out of convenience. For example, when on one errand, a customer may "pop in" to an unfamiliar store just to save time. In the highly competitive British market, J Sainsbury's reward card program was largely ineffective. Customers accumulated points and could redeem them at the time of check-out. The reward of getting a free single-serving carton of yoghurt while buying a week's worth of groceries was not very motivating.

Berman notes that Sainsbury's competitor Tesco was much more successful buy integrating its reward card into its customer relationship management system. Tesco makes extensive use of individual customer's buying behavior and sends them specific targeted discount coupons. These promotions encourage customers to try high-margin products. Customers become very loyal to the store brand as they appreciate receiving valuable offers for the just types of item they prefer to buy

rather than generic manufacturer coupons. Tesco monitors customer behavior and can readily detect disloyalty. An interruption in shopping might represent a consumer's vacation or it could show that the customer is shopping at the competitor down the road. A timely promotion (if you spend x amount, you'll receive y percent off) is a good way to see if the customer can be won back. The only downside to these highly effective systems is that the expense of running a full customer relationship management (CRM) system (identifying customers by name and address, tracking all purchases, analyzing behavior and responding) requires a substantial initial investment and an on-going commitment to fund the operation.

It's interesting to think how the customer pyramid would apply to the grocery business. A Platinum customer would be one where the family frequently conducts business entertaining at home, with little regard to price. A Gold customer is a large family that cooks at home, shops every week, tends not to eat out and rarely travels away from home. Young professionals who usually eat outside the home and only buy a few staples might be considered Iron customers. The customer segments can be identified by analysis of checkout scanner data and desirable segments can be targeted accordingly without offering overly-generous discounts to customers in lower tiers.

From this typology it can be seen that there's not much in favor of the Type 1 (cents off) card as it is ineffective at growing revenue. Some firms may find a Type 2 program (get one free) all they can do, especially in retail transactions where customers are unlikely to readily give up their contact information. The classic points-for-purchase Type 3 programs are most effective when they are tiered and when those tiers match the observed purchase behavior of different customer segments. A full Type 4 program is expensive to implement and maintain but the integration with a CRM system can be powerful in achieving the goal of customer loyalty.

Business executives who clearly understand the places where a loyalty program can be useful (frequent discretionary purchase) can craft a Customer Loyalty Program that builds business and enhances profitability while simultaneously rewarding a firm's most profitable customers.

Further reading

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