

The University of Economics, Prague

International Business – Central European Business Realities

Diploma Thesis:

## **Building Loyalty In Consumer Markets**

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## DECLARATION

I hereby declare that I am the sole author of this entitled “Building Loyalty In Consumer Markets”.

I duly marked out all quotations. The used literature and sources are stated in the attached list of references.

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## INTRODUCTION

A widely known and accepted truth is that it is more expensive to gain the new customers than to keep the existing ones. The phrase became recently far more important, because of the rivalry in today's more and more competitive global business environment and difficultness to find new niches and to persuade potential customers to switch from competition. Moreover, global markets become more and more customer-centric, as bargaining power of customers increase. Overcoming these obstacles and finally gaining new customers means greater and greater investment for companies. Therefore they refer to building stronger relationship with their existing customers more often.

Many studies proved that even the small reduction of apostates increases profits significantly. Loyal customers buy more and more frequently products and services of companies. They are less price-sensitive and pay less attention to competitive advertising and promotion. Managing loyal customers, who know the offer and processes, is cheaper. In addition loyal customers tend to spread positive word of mouth and, as a result, bring new customers.<sup>1</sup> There are numerous other advantages for businesses, which are associated with loyal customers.<sup>2</sup>

The topic of this thesis was chosen because of its relative importance in marketing of many businesses. Loyalty behaviour itself, however, is a field of study of marketers, which has been not explored to a greater detail and still provokes large amount of discussions. This resulted into different definitions of customer loyalty, different bases for its measurement, different determinants, which are claimed to influence customer loyalty, and different strategies and instruments how to achieve customer loyalty.

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<sup>1</sup> Schiffman L.G., Kanuk L.L., (2004): "Nákupní chování." Computer Press, Brno.

<sup>2</sup> See Chapter 2.

The purpose of this thesis is, therefore, to find the most meaningful definition of customer loyalty for businesses, to describe its concrete contributes or benefits for businesses, to suggest appropriate method of measurement and to proceed with analysis of customer loyalty determinants and their management. Further, customer loyalty programs are analyzed as being one of the tools how to promote customer loyalty. This theoretical framework about customer loyalty programs is applied on a practical case of loyalty program of Palác Flóra. In this case I highlighted benefits of this program and suggest some criticism and recommendations.

In the first chapter this thesis summarizes all different viewpoints of marketers and other experts in business concerning customer loyalty definition. The second chapter discusses a role customer loyalty plays in business of companies. By selecting appropriate definition of customer loyalty, I describe all benefits associated with customer loyalty and suggest solution for their expression in economic terms. These topics are discussed in Chapter 3 and 4. In addition in Chapter 5 and Chapter 6 management of customer loyalty and its determinants will be introduced. By selecting those determinants, which are hidden behind customer motivations to purchase company's products or services, and by managing them, company is able to build customer loyalty and enjoy all associated benefits in a form of increased profitability of its business. Finally in the last chapter loyalty programs and their management are discussed, because they are often used as tools to encourage customer loyalty. All these findings are demonstrated in a case study of Palác Flóra, a shopping mall in Prague, which introduced its loyalty program a couple of years ago. The final part of this thesis is devoted to conclusion and bibliography.

Bibliographical sources, which formed a theoretical part of this work, include mainly business journals and books devoted to this topic by specialists in marketing field, commerce or psychology. The practical part, namely case of loyalty program of Palác Flóra, is formed on the basis of Internet publications in Czech press and on the basis of personal observations and judgement.

## *Chapter 1*

### DEFINITION OF CUSTOMER LOYALTY

Customer loyalty is a concept, which has been widely discussed for many years. It gained its popularity and importance in 1990s after publication of the paper “Customer loyalty: Towards and integrated conceptual framework”<sup>3</sup> by Dick and Basu, where they firstly introduced a division between customer loyalty as attitude and behaviour.

There is no universal or even widely accepted definition of customer loyalty and a way in which it should be measured. As it was already mentioned, some experts say that loyalty is an attitude; others, on the other hand, insist that it is a type of behaviour. Some marketers claim, that customer loyalty should be identified by increased retention rate. Others claim that it should be identified by customers’ share of wallet, by frequency of their visits or by their spending. Others emphasize the role of emotional attitude or commitment toward product, brand or company itself – its character, quality and depth. Hence experts and companies use different definitions and bases for their measurement while speaking about customer loyalty.

Nonetheless, the definition and mode of measurement chosen are highly important for companies, because the objectives and strategies used by them vary considerably with their definitions and modes of measurement. For example, according to some experts, the proponents of so called “behavioural model”, customers should be considered loyal if they buy some product and continue to buy it repeatedly – whether or not they are satisfied<sup>4</sup>. The opponents of this behavioural definition oppose by saying that customer loyalty is about liking and preference – emotional attitude or feeling, which either may be expressed by

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<sup>3</sup> Schweizer B., (2007): “An examination of factors leading to abating customer loyalty towards magazine subscriptions.” GRIN Verlag, p. 5.

<sup>4</sup> Peppers D., Rogers M., (2004): “Managing Customer Relationships: A Strategic Framework.” John Wiley and Sons, p. 301-303.

repeated purchases, or may not. If we support the behavioural model, we can set an objective in a form of KPI, which would express a desirable number of purchases in some period of time. We also determine a strategy how to achieve the KPI set. Conversely, if we believe in emotional factor, as that to drive customer loyalty, we set KPI, which would express emotional picture customers have when they see or speak about our brand or use our products and services. This KPI may be expressed through customer testimonials taken from regular consumer surveys. The strategy in this case would be to promote types and depths of feelings we want our customers to feel, while being in touch with our company, brand, products or services. These examples prove the importance of definition of customer loyalty in strategy formulation.

Definition of mode of measurement is the second building block, which will take effect upon objectives and strategies of companies willing to promote loyal behaviour of their customers. We might map the competition in a product category and measure customer loyalty as a share of customer wallet spent on our product in comparison with the share of customer wallet spent on the products of competition. In this case, in order to strengthen the loyalty, we need to increase our share in product category. The strategy would include key steps aimed to realize this objective, i.e. to increase market share. On the other hand, for example, when we consider frequency rate to be a key indicator of customer loyalty, instead, we focus our efforts on increasing number of purchases in some given period of time, not on the market share. Therefore methods, how companies measure customer loyalty, influence their strategy in customer loyalty as well.

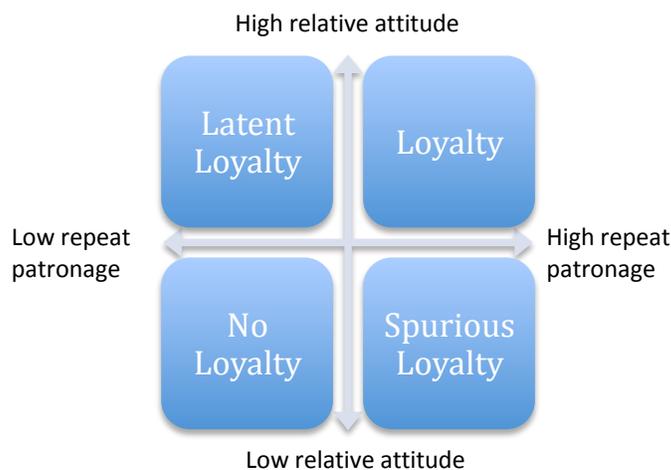
As it was previously mentioned, different companies define and measure customer loyalty differently. The definition and mode of measurement chosen directly affect corporate objectives and strategy how to achieve customer loyalty.

Many companies, however, do not pay attention to these differences. Objectives and strategies pursued by these companies are often an outcome of long-term corporate beliefs about their customers and customers' behaviour.

Because different definitions and modes of measurement of customer loyalty give different “prescriptions” to businesses, it is essential to find some definition, which is to serve as the base for further analysis and this thesis as a whole. I should emphasize, that the chosen definition and mode of measurement is not supposed to be the right one or the best one, but will be the one, that will be practical enough to proceed with further analysis of customer loyalty.

The following paragraphs of this chapter list the most popular definitions of customer loyalty.

The American Heritage Dictionary of the English Language defines the word „loyalty“ as a



„feeling or attitude of devoted attachment and affection”.<sup>5</sup>

According to this dictionary, customer loyalty can be defined as a preferable attitude of customers, which they exhibit to activities, products and services, brands, companies and other. I should note, that by customer loyalty Uncles and Dowling mean the loyalty different from brand loyalty, because the basis of the customer loyalty in contrast to brand

*Figure 2: Dick and Basu “Customer Loyalty Model”. Source: Schweizer B., “An examination of factors leading to abating customer loyalty towards magazine subscriptions.”*

loyalty is inherent to people rather than brands<sup>6</sup>.

<sup>5</sup> “The American Heritage® Dictionary of the English Language.” Fourth Edition. Houghton Mifflin Company, 2004. Accessed on 7.7.2009. <Dictionary.com <http://dictionary.reference.com/browse/loyalty>>.

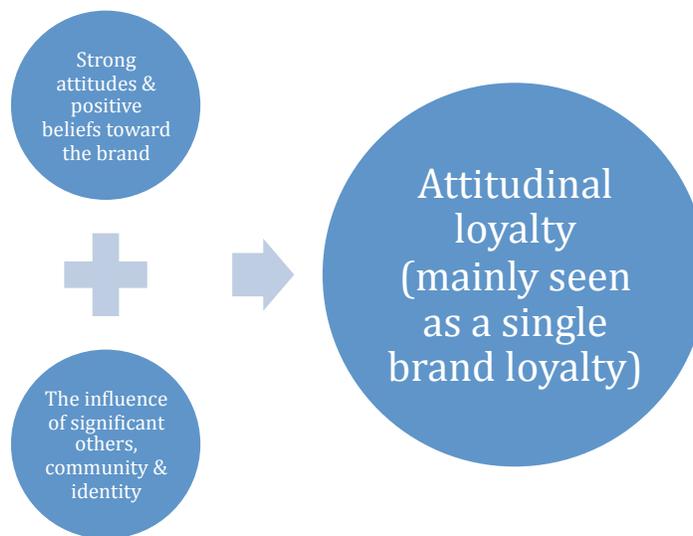
<sup>6</sup> Uncles M.D., Dowling G.D., (2003): ”Customer loyalty and customer loyalty programs.” Journal of Consumer Marketing, 20.4. p. 294-316.

Dick and Basu in their paper, which was published in 1994, introduce a model of customer loyalty with two variables – attitude and behaviour. They incorporate these variables into a single portfolio<sup>7</sup>. Many further models and studies take the model as a generic one.

Deep attitude and frequent purchasing characterize loyalty, according to their model. Absence of loyalty, on the other hand, is a result of low degree of attitude and infrequent purchasing.

Later business press publications introduced a similar concept of customer loyalty. The following figures<sup>8</sup> depict three models of customer loyalty.

- 1) Loyalty is an attitude, which results into a relationship. The attitude may, but must not, result into repeated customer patronage.



*Figure 2: Model 1 - Loyalty as an attitude. Source: Uncles M.D., Dowling G.D., "Customer loyalty and customer loyalty programs."*

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<sup>7</sup> Schweizer B., (2007): "An examination of factors leading to abating customer loyalty towards magazine subscriptions." GRIN Verlag. p. 7.

<sup>8</sup> Uncles M.D., Dowling G.D., (2003): "Customer loyalty and customer loyalty programs." Journal of Consumer Marketing, 20.4. p. 294-326.

2) Loyalty is a pattern of revealed behaviour called “repeated customer patronage”.

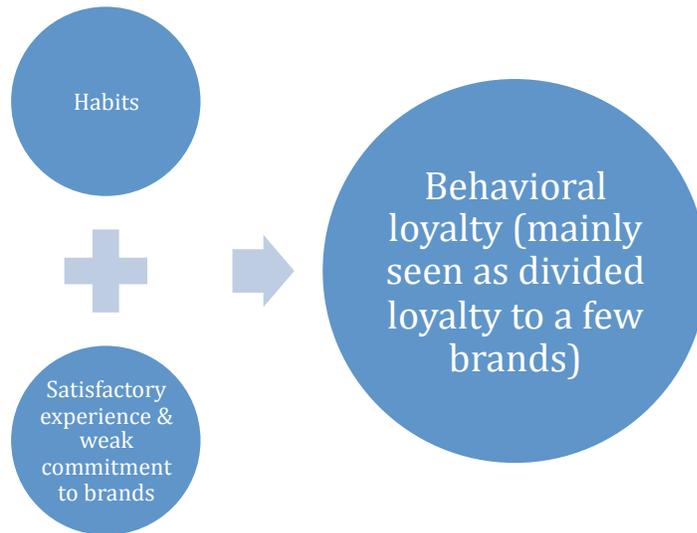


Figure 3: Model 2 - Behavioural loyalty. Source: Source: Uncles M.D., Dowling G.D., "Customer loyalty and customer loyalty programs."

3) Loyalty is more a “coincidence”, which results from personal characteristics, circumstances and/or the purchase situation.

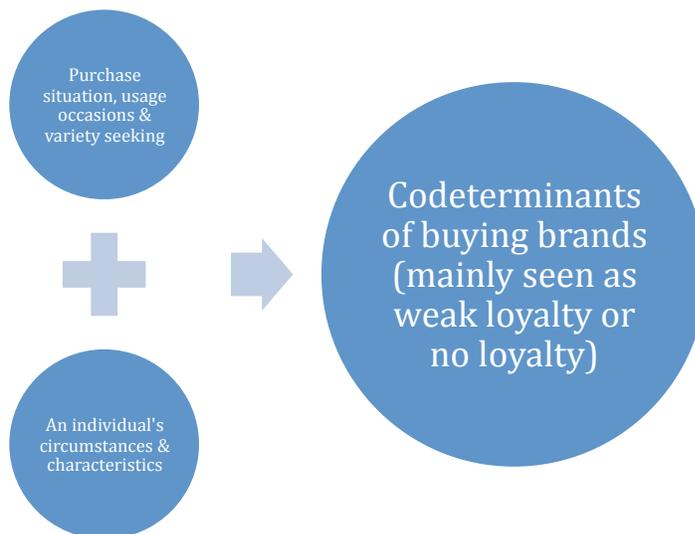


Figure 4: Model 3 - Co-determinants of buying brands (weak or no loyalty). Source: Uncles M.D., Dowling G.D., "Customer loyalty and customer loyalty programs."

The first model is an attitudinal loyalty. Many marketers agree that there should exist an „attitudinal commitment“ to a product, brand or company to make the customers loyal. The attitudinal commitment is expressed by the customers‘ deep emotional feeling and belief into a brand or product they purchase. It is claimed to be expressed by customers in a way how they tend to talk about their favourite brands, how often, how much they feel to be committed to them, if they recommend these brands etc. All of these must be contrasted to feelings, beliefs and speeches about competitive brands or products. Strength of these attitudes determines a degree of loyalty. According to Richard L. Oliver, an experienced professor and researcher of consumer psychology, customer loyalty is „a deeply held commitment to rebuy or repatronize a preferred product/service consistently in the future, thereby causing repetitive same-brand or same brand-set purchasing despite situational influences and marketing efforts having the potential to cause switching behaviour.”<sup>9</sup>

According to Uncles and Dowling, the first model gained much support of researchers and marketers in advertising and brand management. They claim that if there is a strong relationship between a company and its customers, a company may focus on building of such a relationship and make its customers more immune toward competitive offers, less subjected to the negative information about the company or its products, and ultimately more profitable for the company. Thus by motivating this kind of customer loyalty, companies are able to capitalize on its benefits.

According to authors, critics of this concept remind existence of convenience goods, which are based on frequent and/or impulse purchases. According to their viewpoint, there is minimal relationship between customer buying convenience goods (e.g. chewing gums) and some strong emotional feeling of commitment. In their viewpoint other factors, such as e.g. habit or contingency, drive loyalty in this case.

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<sup>9</sup> Uncles M.D., Dowling G.D., (2003): ”Customer loyalty and customer loyalty programs.” Journal of Consumer Marketing, 20.4. p. 294-316.

The second model is probably the best-proven concept of customer loyalty. It is based on assumption, that customer loyalty is nothing more or less than a pattern of consumer revealed behaviour and can be expressed in terms of retention rate, volume of purchases, market share etc. In addition, according to supporters of this concept, there are few customers, who are 100% loyal: the vast majority of them strongly prefer a number of brands or companies in a single product category. Therefore customer loyalty according to this model can be also defined as “an ongoing propensity to buy the brand, usually as one of several.”<sup>10</sup> In contrast to the first model, the second model is market focused. Customer loyalty is measured by the market share, average purchase frequencies etc. The motivation to be loyal, according to this concept, is mainly in the customer’s satisfaction and perceived switching costs (e.g. unwillingness to spend time on searching and fear to make a mistake). In attempt to defend this concept, its supporters refer to empirical analyses, considerable market researches and data, which provide the evidence.

On the other hand the critics of this concept claim that a pure pattern of revealed loyal behaviour (repetitive and frequent purchases) is not a true loyalty. They give an example of companies, which intentionally impose high switching costs on their customers, who are then unable to switch to competition, and therefore force them to make repetitive purchases and thus to “simulate” loyalty. An example would be contractual obligations, which prevent customers from using competitive services.

According to the third concept of customer loyalty, buying behaviour of customers is managed by his or her characteristics, situation he or she is in and external circumstances. Proponents of this concept argue that strong relationship toward the brand is simply not enough for customers to make them to purchase one alternative rather than another one. There must be some conditions, so called “contingencies”, which reinforce customers to make a decision to buy a particular product, and not a competitive one. The decision depends on the occasion, on the time a customer is willing to invest on searching, on his or

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<sup>10</sup> Uncles M.D., Dowling G.D., (2003): “Customer loyalty and customer loyalty programs.” *Journal of Consumer Marketing*, 20.4. p. 294-316.

her budget, his or her habit, product availability, promotions availability etc. Customers become loyal, when they are satisfied by these contingencies.

There are many definitions, concepts and models of customer loyalty provided by dictionaries, scientific journals and business press. Many of them differ in their perception of loyalty. However, a majority of them tend to agree, that there may be two elements of loyalty – attitude and behaviour. In some cases they come together, in other cases some of this element is absent.

As it was noted earlier, the choice of definition of customer loyalty and method of its measurement is important for businesses, since the chosen alternatives assume different implications for them, i.e. different determinants of influence (i.e. motivators behind behaviour), objectives and strategies. The choice is even more important, if company has a limited budget or does not have any budget to pursue all three approaches and implement all three strategies to achieve customer loyalty according to the first, second and third definition.

In my opinion the first concept reflects the basis of customer loyalty in its true sense, as I perceive loyalty as being much of internal emotional feeling of commitment. In my viewpoint, the second and the third concepts are based on revealed customer behaviour, which may be different from his or her degree of loyalty, as I understand it. For example, if a customer is a member of some loyalty program, he or she imitates loyal behaviour (i.e. buys more and more frequently, prefers the brand over competitive brands, consolidate his or her purchases, is less affected by competitive offerings etc.), but his or her inner preferences and attitudes may be completely different. The motivation behind this kind of imitation may be in customers' limited budget and strong wish to gain some benefits from the loyalty program, but not the loyalty itself. If we limit or remove this motivation (i.e. if we stop benefits gained from loyalty program), the “loyal” behaviour ceases.

Another example would be a customer, who is unwilling to spend too much time on searching for the best alternative, and therefore buys repeatedly from one company,

because he or she is satisfied to a degree to which it does not worth spending any time on searching for other alternatives. This customer faces high switching costs and is, therefore, “locked-in” by his company. Once we remove these costs, this customer would likely to consider competitive alternatives and finally may switch to competitor. An example of this would be appearance of internet. Before its appearance customers kept buying from selected companies, because it was difficult for them to search for other alternatives, to compare their prices, qualities, attributes etc. However with internet, search engines, e-shops, e-markets coming in, many of them have immediate and cheap access to this information. This resulted into “opportunistic” behaviour and lesser or even no impact of loyalty bonds.

None of these examples, however, expresses the true loyalty, as I understand it, - an attitude toward a brand, a relationship with the brand, and emotional commitment to the brand even in a less revealed and less behaviourally provable manner.

Nevertheless, for the purpose of this thesis, the behavioural (i.e. the second) concept will be used. The reason is that customer loyalty, in order to make value for businesses, should be translated into economic terms. „Yet if loyalty is an attitude, then by itself it has no measurable economic effect. Internally held attitudes have no intrinsic value to a firm, because there is no financial result to measure until and unless these attitudes are somehow translated into actual customer behaviours. And the financial benefit of increased customer patronage could easily accrue to a firm despite the fact that its customer is no more (or less) attitudinally loyal than before.“<sup>11</sup> I completely agree with the arguments of D. Peppers and M. Rogers. If customer loyalty is not expressed in economic terms, it does not represent any value for businesses. To be expressed, however, it has to result into revealed behaviour. Therefore the second concept or definition will be used.

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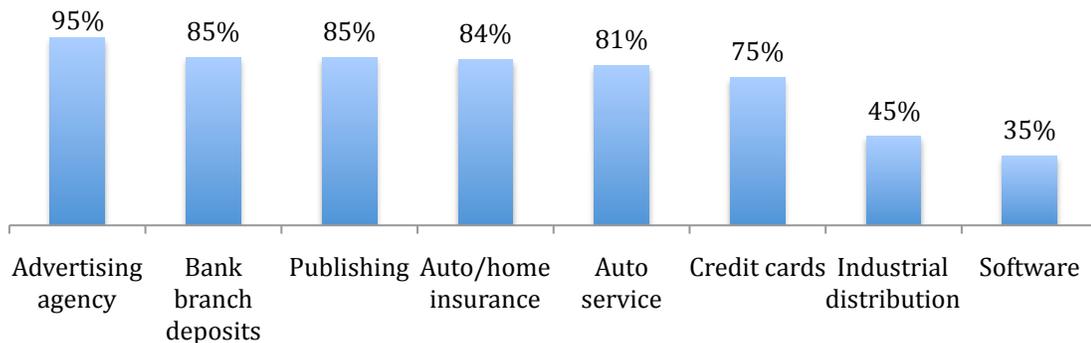
<sup>11</sup> Peppers D., Rogers M., (2004): “Managing Customer Relationships: A Strategic Framework.” John Wiley and Sons. p. 301-303.

## Chapter 2

### ROLE OF CUSTOMER LOYALTY IN BUSINESS AND ITS BENEFITS

The role of customer loyalty in business is significant. Customer loyalty, its achievement and development, is a strategic objective for most businesses. Heads of marketing, operations, finance and sales departments, all usually agree that customer loyalty is a key for a long-term success of their companies. The role of the customer loyalty is thus strategic, since it delivers valuable benefits to the businesses in a long run.

There are numerous benefits the customer loyalty gives to the businesses. They can be summarized as those resulting into higher revenues and those leading to lower costs. Coupled together they have a dramatic effect on profitability. Reichheld, a consultant at the firm Bain & Co, and Sasser, an academic from Harvard Business School, found, that even small increase in customer retention, namely 5 percent, resulted into an improvement of profitability of 20-125 percent.<sup>12</sup> Such a high disparity is attributable to a number of industries being examined by them:



*Figure 5: Impact of 5 percent retention rate improvement on profitability in different industries. Source: Peck H., Christopher M., "Relationship marketing: strategy and implementation."*

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<sup>12</sup> Peck H., Christopher M., (1999): "Relationship marketing: strategy and implementation." Butterworth-Heinemann. p. 46-47.

Another example would be Ford Motor Company, which estimated that one percent increase in customer loyalty, which was defined by number of owners, who bought a car from Ford for the next time, brought about additional profits of 100 millions USD annually.<sup>13</sup>

Hence giving increase in revenues and decrease of costs, the core benefit of customer loyalty is improvement of profitability. Let us examine in detail factors due to which these changes occur.

First of all, loyal customers represent a significant source of revenues. They buy the most and the most often. Most of loyal customers are ready to buy products they like from multiple channels, e.g. physically and online, increasing total volume of consumption of the products. Loyal customers tend to consolidate their purchases to their favourite company or brand. This leads to improved retention and increased share of the company's product in the overall customers' spending. In addition this effect is multiplied, because, as will be mentioned later, they tend to bring their friends and acquaintances with them and teach them to buy company products. These benefits highly contribute to corporate sales as a whole.

In addition, "where loyalty to a brand is increased, the revenue stream from loyal customers becomes more predictable and can become considerable over time ± as analyses of cases such as Federal Express, Pizza Hut franchises, and Cadillac dealerships have shown..."<sup>14</sup> This contributes to improved cash-flows, which allows better planning, allocation of resources, avoidance of major risks (e.g. foreign exchange exposure).

There are considerable cost savings associated with loyal customers. There are minimum marketing efforts needed to inform, persuade and remind loyal customers to buy the

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<sup>13</sup> Hoskisson R. E., Hitt M. D., (2008): "Competing for advantage." 2<sup>nd</sup> edition. Thompson Higher Education. p. 131.

<sup>14</sup> Uncles M. D., Dowling G. D., (2003): "Customer loyalty and customer loyalty programs." Journal of Consumer Marketing, 20.4. p. 294-326.

company's products or services – loyal customers either do not need any of them or are usually more perceptive for communication about favourite product, brand or company or they might even seek for this kind of information. Hence there are considerable savings in marketing.

Loyal customers make their purchases quickly, smoothly and with maximum efficient in terms of operational costs to the company. They usually know where to find the company's products, how to purchase them, how to use them etc. They do not need much of sales assistance in the process of purchase and use of products or services. Therefore they do provide additional savings in sales and operations.

In contrary to popular belief, as customer loyalty and satisfaction are reciprocally related, customer loyalty positively influences customer satisfaction too<sup>15</sup>. What is important is that satisfied customers give positive referrals to other people. They tend to mention some information about product, brand or company to their friends, relatives and colleagues and other people they are surrounded by. In some cases they give recommendations and even provide detailed information about the product, the place of purchase and other information. Hence one of the most notable, though probably unexpected, functions of customer loyalty is also customer acquisition.

If loyal customers experience some problem with product they buy, they complain, they give feedback; they try to solve their problems with their company, because they usually believe in that product and company and do not tend to simply switch to competition just because of some problem. In this sense they become an important source of information and inspiration for the company. They help companies to improve their product and their brands.

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<sup>15</sup> Yin Lam S., (2002): "Investigating the interrelationships among customer value, customer satisfaction, switching costs and customer loyalty." Accessed on 24.4.2009. <http://bmg3-notes.umd.edu>

Lastly but not leastly loyal customers are much less affected by competitive products and competitive promotions. They seem to be “immune” toward competitive offerings in their motivation either not to experience additional costs<sup>16</sup> or to stay emotionally committed to a favourite product, brand or company. Companies, therefore, may afford some failures in their search for improvements. They are not likely to lose these customers so easily.

Loyal customers are also much less sensitive to price increase or even are willing to pay the price premium for the favourite product. Hence if companies experience tougher times (e.g. appreciation of domestic currency in case of exporter) and are forced to increase prices for their products, these customers are likely to stay.

Summarizing the all advantages of customer loyalty described above, the role of customer loyalty in business is significant and largely given by extent of its benefits, which range from cost savings to acquisition function, positively influence corporate revenues, and serve as barrier from switching to competition. All of these benefits dramatically contribute to improvement of profitability and therefore move the role of customer loyalty onto a strategic level.

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<sup>16</sup> Switching costs, discussed in Chapter 3.

## *Chapter 3*

### EVOLUTION OF CUSTOMER LOYALTY

For the most of the time prior to 21st century customer loyalty was merely a private practice of merchants, which is today continued to be pursued by smaller firms: “Such businesspeople make it a point to get to know their best customers personally and often reward them with special services and attention – notifying them when sought-after merchandise arrives, for example or giving them a free drink or a special dessert.”<sup>17</sup>

During the past 20 years customer loyalty started to represent an important aspect of corporate strategies. Many companies began to explore customer loyalty, get insight about loyal customers through market researches and define and implement strategies aimed to encourage customer loyalty, as it was the one, which was considered to generate additional revenues and profits.

Recently customer loyalty became to be assessed by companies even more aggressively because of tougher competition, globalization, increasing costs of customer acquisition and probably because of natural customer attrition, which grows over time. Companies started to realize, that it costs more to acquire new customers, than to keep current ones. “This is a fairly elementary concept but it caught on like wildfire among marketers and became one of the standard concepts that appeared in all business cases supporting development and testing of future customer loyalty-building strategies”<sup>18</sup>. According to Duffy and his paper “The evolution of customer loyalty strategy”, Pareto’s law of uneven distribution appeared along with the rule of 80/20, which became heavily propagated by marketers. Desire of

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<sup>17</sup> O’Brian L., Jones C., (1995): “Do rewards really create loyalty?” *Harvard Business Review*, May-June. p. 75.

<sup>18</sup> Duffy D.L., (2005): “The evolution of customer loyalty strategy”. *Journal of Consumer Marketing*, 22/5. p. 285.

customer loyalty became like a fever for many of the companies, which devote considerable part of its revenue on different retention activities.

As a result of these corporate activities customers became confused, overwhelmed and stopped to value them. The implication for marketing managers, therefore, was that their activities became less and less effective. Dennis L. Duffy in his paper points out, that recent events contributed to growing “scepticism and a wariness of marketing messages articulated by large corporation”.<sup>19</sup>

According to him, some of significant recent developments in the marketplace had a considerable effect on customer loyalty. In most cases they undermined customer loyalty. Recent corporate scandals changed a lot customer perception about the companies. Many customers lost their jobs; many of them suffer losses as investors. These scandals and bankruptcies had a negative impact on customer loyalty. Takeovers, which are frequently seen on a globalized marketplace, leave their traces in customers’ mindsets too. Frauds and criminal cases on a managerial level, which recently became greatly medialized, contribute in customers’ distrust as well. Today customers can only hardly believe in promises of companies to build a long-lasting relationship with them.

The result of these events is that today we can see more customers switching from one brand to another without any necessity to build a relationship with a company. Companies often seek for this relationship, although it costs more and more resources to build it.

Another trend, which also worth mentioning, is majority of the developed markets went from product and service scarcity to commodization during the last centuries. Customer loyalty, which was frequent in some markets a century ago, evolved into customer finicality. Bargaining power of customers rose too. There are fewer reasons for customers to stay loyal, if there are plenty of alternatives available.

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<sup>19</sup> Duffy D.L., (2005): “The evolution of customer loyalty strategy”. *Journal of Consumer Marketing*, 22/5. p. 285.

The most recent trend and also an extreme, which resulted from growing customers' caution, is that "customers are increasingly keeping their information close to the chest unless they have broad sweeping confidence in a company they do business with"<sup>20</sup>. Customers became increasingly involved in the issue of data collection, storage and processing. Another trend is customer distrust in marketing and sales arguments used in communication. Customers became more sceptical about what they are promised by companies. As a result new regulations emerged to protect customers' rights.

In these circumstances it is recommended by researchers to focus not only on traditional marketing activities, which aim is to build loyalty, but also to build the brand, customers can trust. All further activities, which are described in this thesis, will not fulfil their purpose without customer trust in them. According to Duffy, "marketers must make sure that their companies are aligned correctly and that their value proposition helps create natural loyalty with a good product, good service and a passion and conviction for the customer that comes through honesty in everything they do."<sup>21</sup> He continues by saying that "only then will lasting relationships develop that lead to durable customer loyalty"<sup>22</sup>. Although as it was previously discussed, it is questionable whether attitudinal loyalty, which Duffy probably considers to be a "natural" one, is enough to create economic value, which is crucial for businesses, I agree and believe that customer trust is increasingly important and challenging issue in a current marketplace, which may greatly influence all marketing activities aimed to build customer loyalty.

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<sup>20</sup> Duffy D.L., (2005): "The evolution of customer loyalty strategy". *Journal of Consumer Marketing*, 22/5. p. 286.

<sup>21</sup> Duffy D.L., (2005): "The evolution of customer loyalty strategy". *Journal of Consumer Marketing*, 22/5. p. 286.

<sup>22</sup> Duffy D.L., (2005): "The evolution of customer loyalty strategy". *Journal of Consumer Marketing*, 22/5. p. 286.

## *Chapter 4*

### MEASUREMENT OF CUSTOMER LOYALTY

Having defined customer loyalty as a certain pattern of revealed behaviour and having described its benefits, which eventually result into increased profitability, we should proceed by explanation of its measurement.

Professor Kumar in his book “Managing customers for profit: strategies to increase profits and build loyalty” admits, that many of the methods used for measurement of loyalty nowadays are mistakenly based on customers’ past purchasing behaviour.<sup>23</sup> He gives examples of Recency-Frequency-Monetary value method, Share of Wallet method, and Past Customer Value. He further claims that “traditional metrics assume the past customer behaviour will be replicated in the future”, but “in reality, it is not the case, particularly in a non-contractual setting”<sup>24</sup>. The professor further introduces widely known concept of Customer Lifetime Value (CLV), which, according to him, is forward-looking metrics reliable enough for measurement of customer loyalty and for acting upon its results.

Customer Lifetime Value comprises net present value of all future profit, which company receives from a customer. It takes into consideration all revenues and expenses associated with the customer, therefore giving more accurate picture than solely taken retention rate, share of wallet and other traditional methods of measurement customer loyalty. In addition, it is not past-biased and therefore less subjected toward risk of future change and more accurate in terms of its incorporation of all future trends and developments, which may influence customer behaviour in the future<sup>25</sup>. Moreover, professor Kumar justifiably

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<sup>23</sup> Kumar V., (2008): “Managing customers for profit: strategies to increase profits and build loyalty.” Wharton School Publishing. p. 24.

<sup>24</sup> Kumar V., (2008): “Managing customers for profit: strategies to increase profits and build loyalty.” Wharton School Publishing. p. 24-25.

<sup>25</sup> Kumar V., (2008): “Managing customers for profit: strategies to increase profits and build loyalty.” Wharton School Publishing. p. 24-25.

emphasizes this metrics, because of businesses' tendencies to invest into loyalty programs and other activities aimed to increase customer loyalty, which, though delivering some benefits intended, frequently become a massive runoff of companies' resources. Investment associated with these enterprises reduces profitability of loyal customers considerably. Loyal customers may even become less profitable than non-loyal customers. Because of these reasons and because of its fit into behavioural customer loyalty definition, customer lifetime value should be chosen as the best alternative for measurement of customer loyalty.

CLV is a function of four variables, which are closely associated with customer loyalty:  $CLV = NC \times NP \times CL \times PPS$ , where number of customers (NC), number of purchases per customer per year (NP), customer lifetime in years (CL), and (PPS) profit per transaction (revenue – costs / number of purchases). Each of these variables characterizes customer loyalty in some sense. For example, frequency and volume of purchases, costs of marketing communication and serving the customer are incorporated in PPS. Customer lifetime in years reflects customer attrition. Therefore CLV and customer loyalty relate to each other.<sup>26</sup>

The relationship between two terms is straightforward. If expenses remain constant, customer loyalty serves as a catalyst for boosting CLV. More loyal customers are, more profitable they are, and higher is CLV. In contrast if customers are less loyal (e.g. buy less frequently, in smaller volumes, their attrition is higher etc.), CLV is lower.

If the condition of constant expenses is omitted, however, there is a different picture. For example, some customer segment may be chosen to be targeted through certain loyalty program. This loyalty program represents for a company certain one-time investment and recurring expenses, which may not justify increase in purchase frequency and volume etc. These investments would result into lower CLV, though revealed customer loyalty may be stronger. This fact would be discussed in later chapters, which focus on customer loyalty management.

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<sup>26</sup> Hayes B.E., (2008): "Measuring customer satisfaction and loyalty." William A. Tony. p. 155.

In their study<sup>27</sup>, however, Rowley and Dawes suggest that attitudinal element of customer loyalty should be measured too. They claim, that for this measurement three following indicators should be used: a) search motivation, b) word-of-mouth, c) resistance to counter persuasion. Search motivation indicates customer willingness and tendency to search for alternatives. Loyal customers show lower tendency to search for alternatives. Positive word-of-mouth is likely to occur if customers are loyal to company. Loyal customers also tend to demonstrate resistance to counter persuasion.

Because of our promise, however, to discuss customer loyalty, which results into economic value, these three indicators may be considered irrelevant *until* they lead to real customer actions and thus represent economic value.

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<sup>27</sup> Schweizer B., (2007): “An examination of factors leading to abating customer loyalty towards magazine subscriptions.” GRIN Verlag. p. 10.

## *Chapter 5*

### MANAGEMENT OF CUSTOMER LOYALTY

As we have already shown in Chapter 1, “prescriptions” how to manage customer loyalty depend on how company defines this term. In order to be able to achieve customer loyalty it is essential for company what is perceives as a true customer loyalty and disclose the real motivations behind the loyalty in order to identify the triggers for the loyalty behaviour and be able to influence them or even direct them.

Returning back to three different concepts or definitions of customer loyalty, because of such variety of concepts of customer loyalty (Model 1, Model 2 and Model 3, combinations of them, in Chapter 1), marketers tend to exercise different strategies aimed to reach the same goal, i.e. to build customer loyalty.

Supporters of the attitudinal loyalty discussed in the Chapter 1 attempt to give an emphasize on the emotional part of customer’s decision process and to stress appeal of its brand in order to build customer commitment and reach his or her loyal behaviour. Loyalty program managers are often the proponents of this concept. Despite of the so-called „hard“ benefits (points, rebate, discounts etc.), they focus primarily on „soft“ benefits, which are more emotionally based and aimed to tune customer’s mind positively toward the brand. The soft benefits include special service and exclusive care, aimed to exceed the customer’s expectations, surprises (e.g. gifts during the regular course of buying, without a reason) and delights etc. Advertising used by the proponents of this kind of concept is different too. They use highly persuasive advertising aimed to change the attitude of the customers.

The proponents of the behavioural concepts on the other hand tend to use informative advertising and promotional incentives. They try to focus on extensive distribution channels, error-free supplies. They use the loyalty programs too, but the expected effect of these programs is much lower: they use them to match the strategy of its competitors or just to generally give some benefits to their customers.

Those, who support contingency approach based on the Model 3, focus their efforts on improving conditions for purchases – extending opening hours, providing extra customer service etc. They tend to use different promotional techniques – discounts, price-offs, coupons, deals etc. The loyalty programs are not frequent in the companies supporting this concept of customer loyalty. Nonetheless, if some loyalty program is used – its primary concern is to improve contingency factors.

Because there is no generally accepted customer loyalty concept, supported by majority of experts in psychology of consumer behaviour, the key decision for the management of the companies, which try to improve customer loyalty, is to define it. The more the definition would reflect the real state of being, the higher is the likelihood, that the chosen strategy would be the right one to achieve the objectives.

As we previously agreed, however, this thesis focuses primarily on behavioural model of customer loyalty. The reason is that “if loyalty is an attitude, then by itself it has no measurable economic effect.”<sup>28</sup> The attitudes, as we explained in Chapter 1, have no value to a firm until they are expressed in economic terms, for which the actual revealed behaviour, such as purchasing, is needed. In contrary, if customer loyalty is not expressed in the “real” terms, it does not represent any value for businesses. Therefore we will focus on finding a way, how to achieve and keep loyal behaviour defined by behavioural concept in this chapter.

## 5.1 MANAGEMENT OF BEHAVIORAL CUSTOMER LOYALTY

Behavioural loyalty is a pattern of consumer revealed behaviour. It can be expressed in terms of retention rate, volume of purchases, market share etc. Its best method of measurement is probably customer lifetime value, which was described in a previous

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<sup>28</sup> Peppers D., Rogers M., (2004): “Managing Customer Relationships: A Strategic Framework.” John Wiley and Sons. p. 301-303.

chapter. All these measurements provide economic value to a firm, which is a primary criterion for customer loyalty in this thesis.

Supporters of this concept claim that it is influenced mainly by customer satisfaction and switching costs. Other factors, according to them, are of minor importance. These factors include the offering, marketplace, elasticity, demographics, and share of wallet.

By managing these influencers we can achieve and keep customer loyalty, which would be then expressed in economic terms, such as retention rate, market share and other. Let us, therefore, see how exactly each of the influencers should be managed to achieve a desirable outcome.

## Chapter 6

### DETERMINANTS OF CUSTOMER LOYALTY AND THEIR MANAGEMENT

What makes customers loyal? As it was mentioned earlier much attention should be paid to the definition of the loyalty. Both generally accepted definitions of loyalty, i.e. attitudinal and behavioural loyalty, have the same and distinct determinants. Attitudinal loyalty, for example, may be influenced by image of the company and by individual believes. Behavioural loyalty, on the other hand, is sometimes a result of high switching costs, such as contract penalties. Both of them, however, may be influenced by customer satisfaction. Because this thesis is intended to keep the line with behavioural loyalty mainly, unless attitudinal loyalty is expressed in economic terms, further paragraphs focus on describing determinants, which induce repeated customer patronage.

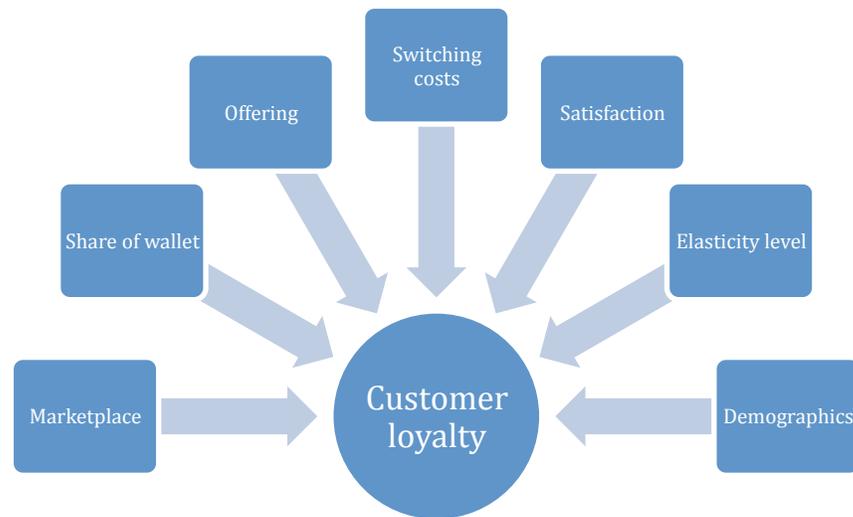
There are six determinants, which are generally considered to be those, which positively or negatively influence customer loyalty and customer commitment to a brand and its products: offering, satisfaction, elasticity level, marketplace, demographics and share of wallet.<sup>29</sup> On the other hand there are factors, which promote loyalty indirectly, by preventing customers from disloyalty. These factors include all switching costs associated with a change of company or supplier. These costs may be monetary, such as cost of time, transportation, internet connection if searching online and other. In addition they may be non-monetary, such as energy and effort, risk, stress and other.<sup>30</sup> The Figure 1<sup>31</sup> depicts all of these factors.

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<sup>29</sup> Clark, Pete. "The 6 Key Factors That Influence Customer Loyalty." Return On Behavior Magazine. Accessed on 6.5.2009. <http://www.returnonbehaviormagazine.com/>

<sup>30</sup> More on switching costs in Chapter 6, "Switching Costs".

<sup>31</sup> Clark, Pete. "The 6 Key Factors That Influence Customer Loyalty." Return On Behavior Magazine. Accessed on 6.5.2009. <http://www.returnonbehaviormagazine.com/>



*Figure 6: Factors of influence of customer loyalty. Source of the figure: the author.*

Both direct and indirect factors influence customer loyalty. The relative importance of them may be, however, different, depending on the type of business, character and intensiveness of competition, bargaining powers of suppliers and buyers etc. Some of them are critical for some companies (e.g. market determinant of monopolies for house utilities) and some may be even irrelevant (e.g. to some extent customer satisfaction determinant for commodity suppliers). Many of them therefore play different role for businesses, depending on industry, market and economy.

Companies, therefore, should take the relative importance of determinants into consideration. A close internal and external environmental and situational analysis helps in determining what determinants have major impact on customer loyalty for a particular company. Those determinants need to be identified, assessed and re-examined periodically for the company to be able to benefit from customer loyalty.

Moreover, substitutions and interrelations between different determinants add ambiguity to our discussion and show high complexity of identification of determinants of customer loyalty and their influence. Customer satisfaction, for example, may be said to be a part of

switching costs, as one may say, that risk of satisfied customer to be dissatisfied by competitive product or service represents a part of switching costs and thus prevents customer to switch to competition. The inner motivator in this case is not satisfaction itself, but fear to be dissatisfied otherwise. An example of interrelations of determinants would be interrelation of marketplace, offering, elasticity level, satisfaction and switching costs. Company's efforts to obtain competitive advantage of its commodity product may lead to differentiation of its offering (e.g. improved product, higher price), which in turn changes elasticity level (or level of customer involvement) and customer satisfaction (new performance, new received value, because of new expected and invested value relationship), marketplace (as new competitors compete with differentiated product), and switching costs (the more product is differentiated and unique, the less it is substitutable, the less choices customers have, the more barrier to switch they have to face). The examples show that some determinants may be named interchangeably and that there is a great number of interrelations between them.

Finally, it is essential to emphasize, that there is still a lot of discussion between scholars and managers on what drives customer loyalty, and there is no universal agreement on these drivers and the interrelationships between them and loyalty are still not well understood.

## 6.1 THE OFFERING

First of all the company's core offering should be appealing to the target customer group. The companies, typically by using numerous research techniques, explore the needs and wants of the target customer group. Then they define the parameters of the product, which will best satisfy these needs and wants. The parameters include attributes of the product or service (functions, performance, quality and other), convenience of its distribution locations, price, and supporting service. The relative importance of these factors may vary and usually depends on the target market, e.g. for commodity products the price is clearly a

main driver of purchasing decision, for convenience or emergency goods location is a priority, whereas for shopping goods attributes and customer service may be of primary concern. Hence the needs and wants of the target customer group should be closely examined, and the parameters of the offering should be designed in a way to fulfil them better than competition does or even the best.

Moreover the management needs to take into account the time and space influences. As time goes on the offering may become outdated, not fulfilling the developing and changing needs and wants. Competitors may enter the market and may offer a superior product or service. Therefore the company through the whole product life cycle should closely monitor the needs and wants and external environment in order to keep the product's appeal and competitiveness. The strategy may be particularly beneficial if it is proactive, i.e. if the company does not react on the events on the marketplace, but is able to predict them and change its offering in a timely manner, earlier than competition does.

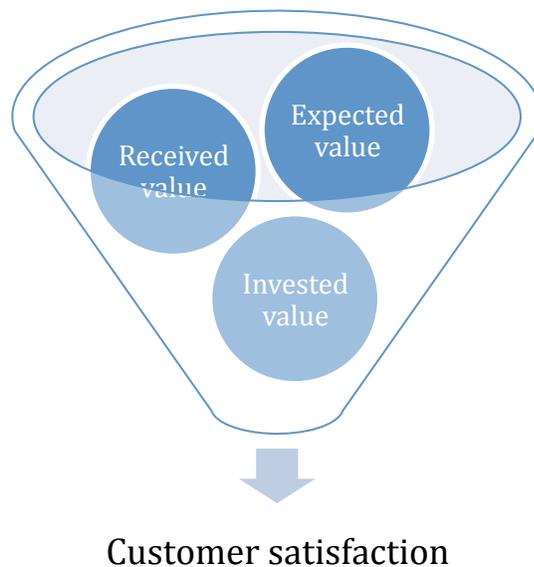
The extreme emphasize should be put on the core offering – its attributes and its value. Customers do not buy anything they do not need or want. These needs and wants are alpha and omega, which give rise to the offering, which fits them in the best possible manner. This offering then makes the customers to buy the product repeatedly and, therefore, keeps them loyal.

Another factor, which has an important impact on customer loyalty, is differentiation of product based on its competitive advantage. The more the offering is unique and is not delivered by competition, the less opportunities are for the customers to switch to competitive offer and the higher is tendency of customers to stay with the current provider. The reason is that customers cannot easily find another alternative, which would fit his or her wants and needs in the same manner as current provider. Competitive advantage may be represented, for example, by the brand names of companies, by quality of their offering, by uniqueness of the offering (e.g. unique resources, which are used as inputs in production), by trademarks and certificates gained by companies, technology, and human resources employed by companies and other. Competitive advantage creates something of

additional value that competition cannot copy and offer to customers. The customers, therefore, are likely to enjoy this value by staying with the company and being loyal.

## 6.2 CUSTOMER SATISFACTION

Customer satisfaction is a “pleasurable level of consumption-related fulfilment”<sup>32</sup>. Customer satisfaction level depends on customer expectations about the product or service and on the actual product’s or service’s performance, its availability, easiness to use, its price and other factors, which are important to customers buying the specific product or service.



*Figure 7: Expected, received and invested value influence level of customer satisfaction. Source of the figure: the author.*

customer gets by purchasing product or service. It is formed by actual performance, quality,

Further paragraphs introduce notion of expected, received and invested value. **Expected value** is one customer expects to get by purchasing product or service. These expectations are formed by company’s communication to customers, product’s price,

previous experience with product etc. **Received value** is an actual value

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<sup>32</sup> Yin Lam S., (2002): “Investigating the interrelationships among customer value, customer satisfaction, switching costs and customer loyalty.” Accessed on 24.4.2009. <http://bmg3-notes.umd.edu>

attributes, post-purchase service etc. **Invested value** is price paid for product, including all costs associated with this purchase, e.g. costs of searching for alternative, transportation, time invested etc. All of them shape customer satisfaction.

The relationship between the expected value, received value and invested is extremely important as it determines the overall customer satisfaction level. Customers buy product with some expected value in mind and pay some price<sup>33</sup> for this value (i.e. invested value). If the expected value does not match the received value (i.e. actual benefits), or the received value does not worth invested value (e.g. mainly including its price), the customer is likely to be unsatisfied with the product or service. Customer satisfaction in this case means a perfect match between customer expectations of the product's value and the value received and the value received and value invested (price, time, energy and other). If the value received exceeds the value expected and invested, customer is over satisfied. If the value received is suddenly less than value invested and expected, the difference may be compensated by reduction in price, still keeping the customer satisfied.

The relationship between customer expectations, product or service actual performance (i.e. all together they form the offering), resulting level of satisfaction and customer loyalty, can be illustrated by experience of three telecommunications operators – Eurotel, Paegas and Oskar, in 2003. Retention research conducted by TNS AISA<sup>34</sup> asked customers of these operators, if and what specific positive or negative experiences they had with their mobile operator. Results of the research showed that “customers of the cheaper mobile operator Oskar do not show such significant differences resulting from positive or negative experiences”, and “negative experiences with their operator (such as billing errors, signal

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<sup>33</sup> The price or invested value in this case should be generalized on everything, that customer “sacrifices” in order to get the product or service, e.g. price, time, effort, energy, transportation costs and other factors, which serve as customer investment into the product or service.

<sup>34</sup> Huber M., Scharioth J., (2004): “Putting stakeholder management into practice.” Springer-Verlag Berlin Heidelberg. p. 57.

problems, and quality of service) do not have such an impact on retention levels”. Authors of research further continue by claiming that customers “pay less and expect less”. By examining customers of Eurotel, they found that its customers, in contrary, pay more and expect more. According to authors, this was a reason of customer dissatisfaction, which may further lead to attrition. This example shows an importance of setting right expectations, which result into customer satisfaction and, perhaps, customer loyalty.

Satisfaction is one of the most important factors influencing the loyalty. Satisfied and over satisfied customers may, but do not need to become loyal customers, as satisfaction motivates customer to make re-purchase decisions, to stay with the company rather than going to competition, spread a positive word-of-mouth, and influences positively the post-purchase attitude. Therefore many companies continuously work on the performance of their products and services to keep customers satisfied and to exceed their expectations.

Not all satisfied customers become loyal. It may happen that company maintains high satisfaction rates of its customers, but also struggles with low retention. Therefore in order to increase customer loyalty, satisfaction cannot be emphasized in an isolate manner, without other factors influencing the loyalty.

### 6.3 THE ELASTICITY LEVEL

„Elasticity expresses the importance and weight of a purchasing decision – effectively the level of involvement or indifference.“<sup>35</sup>

There are some categories of products and services, which are considered to be commodities, i.e. products „without qualitative differentiation across a given market“<sup>36</sup>. Those products are generally associated with lower customer loyalty.

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<sup>35</sup> Clark, Pete. “The 6 Key Factors That Influence Customer Loyalty.” Return On Behavior Magazine. Accessed on 6.5.2009. <http://www.returnonbehaviormagazine.com/>

The products, which are more commoditized and require low involvement, while making a purchase decision, tend to have lower customer loyalty, than for example other categories of products, e.g. cars, which require high involvement prior to any purchase decision. The reason lies in the fact, that commodities possess more or less the same qualities and attributes. Customers do not care about product performance, satisfaction level and other benefits, because they are equal. Customers choose on the basis of product's price, availability, convenience of the purchase etc. These factors play a major role, discouraging loyalty, i.e. if some cheaper alternative is available for purchase, a buyer of a commoditized product usually does not hesitate to make a purchase decision. On the other hand, products requiring high involvement (i.e. "high-identity" products, as mentioned later) evoke higher customer loyalty. The performance of these products, their attributes, price and other factors are unique. This results into higher involvement with the product or a brand.

Generally businesses, which produce commodities, cannot expect high customer loyalty, although they can try to differentiate their products by adding supporting customer services, building brand or developing consumer experience, rather than merely providing core product. The products then stop being commodities and may enjoy benefits of customer loyalty and even charge a premium price.

In my opinion, the reason for this dependency of degrees of loyalty on degrees of involvement associated with different types of products may probably lie in different switching costs, which are described in detail further in this chapter. Products, which require low involvement, have, therefore, lower switching costs (e.g. time, energy, transport costs etc.), which may result into a switch. In contrast, products, requiring high involvement, impose higher switching costs, which usually customers are not ready to pay. The latter case, therefore, may result into loyalty.

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<sup>36</sup> Richards, H., (2004): "Understanding the Global Economy." Peace Studies Chair, Columbia University. p. 302.

To formalize the types of these products Mark D. Uncles introduced a “notion of loyalty continuum”<sup>37</sup> in his article “Customer loyalty and customer loyalty programs”.

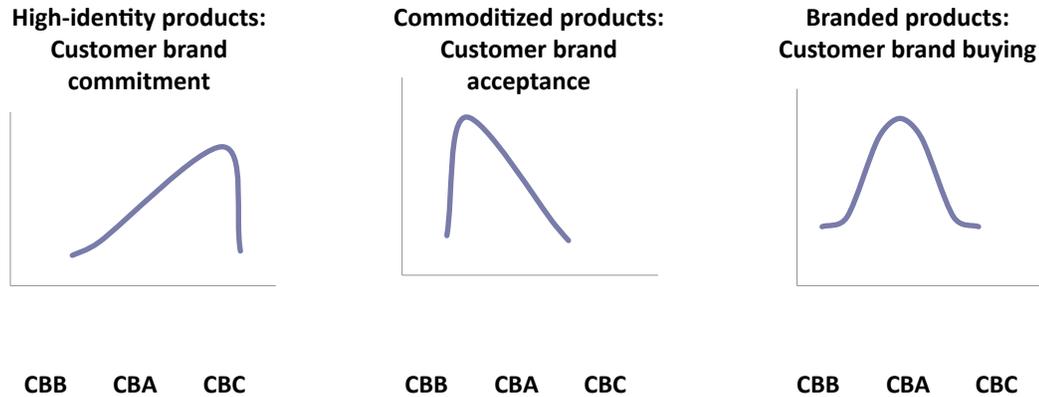


Figure 8: Distribution of customer types across buyers of a product. Source: Uncles M. D., Dowling G. D., “Customer loyalty and customer loyalty programs.”

The author assumes that high identity products are associated with customer brand commitment (CBC); brand products are associated with customer brand buying (CBB), and commoditized products – with customer brand acceptance only (CBA).

Whereas most of the experts believe that each product type depicted in the Figure 6 is associated with different *degree* of loyalty, i.e. commitment, buying, acceptance, Mark D. Uncles claims, that each of these types of the product is associated with different *type* of loyalty. He, therefore, assigns to each of these three product types, three concepts or definitions of loyalty mentioned in Chapter 1. High-identity products, according to his article, generate attitudinal loyalty. Behavioural concept is, in his viewpoint, attributable to branded products. And contingency concept is associated with commoditized products.

<sup>37</sup> Uncles M. D., Dowling G. D., (2003): “Customer loyalty and customer loyalty programs.” Journal of Consumer Marketing, 20.4. p. 299.

## 6.4 MARKETPLACE

Character of marketplace determined by number of suppliers, availability of their products, affordability of their products, products' quality and performance and other factors, influence considerably customer loyalty. If there is higher quantity of competitors on a marketplace with products of similar quality, availability and price, there is more opportunity for a customer to switch to one of the competitors. Conversely, if there is small number of competitors offering particular product, customers often stay with company simply because of inability to use competitive products or services.

Monopoly is an extreme example of customer loyalty influence by marketplace. We can barely talk about true customer loyalty in this case, but this kind of "loyalty" results in a revealed customer behaviour, which was criterion for loyalty in this thesis.

Customer loyalty mainly influenced by conditions in marketplace, however, may be dangerous for companies, as it often produces customer dissatisfaction, which may, but must not, result into customer attrition in case if marketplace is changed (e.g. monopoly is abolished by entry of new competitor). Hill N. and Alexander J. describe the relationship between customer loyalty and satisfaction in their book "Handbook of customer satisfaction and loyalty measurement"<sup>38</sup>: "Where customers have little or no choice, their loyalty is far from 'devoted'. It is often resentful. Our experience based on hundreds of customer satisfaction surveys shows that customers with little or no choice often feel very dissatisfied." The more customers feel being locked-in by some company, the more dissatisfaction arises out of regular course of usage of product or service and especially in case of their failure. Customers, therefore, would certainly look for an option to switch to competitor, if there is new one entering the market.

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<sup>38</sup> Hill N., Alexander J., (2000): "Handbook of customer satisfaction and loyalty measurement." Gower Publishing Company. p. 14.

## 6.5 DEMOGRAPHICS

Demographic, psychographic and other characteristics of customers are also one of the most important determinants of customer loyalty in some markets. These characteristics include customer age, gender, place of living, income, risk-averseness and many other characteristics.

Geographic location of customers or their place of living may play a role in strengthening or lessening of customer loyalty. Some undisclosed US insurance company found evidence<sup>39</sup>, that its customers, who lived in rural areas, exhibited much more loyalty, than those, who lived in cities and were more ready to switch. The company, therefore, later focused on these regions, realizing, that these customers were more profitable for company and that it would have been extremely costly for the company to lose them. For other companies, instead, geographical location may be irrelevant not only on a national level, but also on international and global level.

They also found that single customers were less loyal than married customers. Older customers, according to them, are less likely to switch, than their younger counterparts.

Many of these factors, however, play a secondary role in influencing loyalty. Together they shape or influence psychographic and social characteristics of customers, which in turn have impact on their degree of loyalty. For example, elder or poor customers generally tend to be more risk-averse while purchasing (or investing) some product or service. Giving this, they appreciate more reliable and once-tried product or service and would be unwilling to try another one.

In some circumstances demographic, psychographic and other characteristics of customers may be interrelated. For example, elder customers or customers of some particular ethnicity in some economies and markets tend to be also poorer or in contrast richer than the average. Single customers tend to be also younger customers, which might explain that

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<sup>39</sup> Reichheld F.F., (1996): The Loyalty Effect. Harvard Business School Press. p. 65.

married, and thus older, customers, are more loyal. Customer characteristics are therefore interrelated.

Because in some markets demographic, psychographic and other characteristics are important for customers to stay or to become loyal, it is essential for companies to determine the relative importance of this determinant and analyze its target customer groups and their characteristics, which shape their behaviour and result into certain degree of loyalty.

## 6.6 SWITCHING COSTS

Switching costs influence customer loyalty indirectly, by preventing customers from being disloyal. The customers evaluate both staying with company and switching to competition, and typically find, that there are certain costs, which they have to invest in order to switch to competition. These costs then motivate or even force them to stay with the company and thus be loyal to the company.

According to the article with the indicating title “Product loyalty: Consumers mistake familiarity with superiority”<sup>40</sup>, the switching costs present a major factor, which influences customer loyalty. According to a research, which is published in Journal of Consumer Research, comfort and familiarity, the oppositions of which are part of switching costs, play an important role for customers and keep them loyal. The article refers to the examples of Google, Microsoft and Apple, the companies, the products and services of which are difficult to “dethrone”. The research then points out, "the costs associated with thinking about and using a particular product decrease as a function of the amount of experience a consumer has with it. Thus, repeated consumption or use of an incumbent product results in a (cognitive) switching cost that increases the probability that a consumer will continue to

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<sup>40</sup> Timmer, J., (2007): “Product loyalty: Consumers mistake familiarity with superiority.”  
Ars Technica. Accessed on 20.5.2009. <http://arstechnica.com/>

choose the incumbent over competing alternatives."<sup>41</sup> The psychologists argue that attitudes such as affection, satisfaction, and product superiority do not play a decisive role in customer loyalty. According to them, customers are not willing to devote time and effort to search for alternatives, even if product they buy is not particularly easy to use and does not provide any economic or other advantage over that of competition.

This evidence takes roots in a concept of switching costs. Switching costs are those costs, which customer has to pay in a case of change of the product or service provider. They include monetary and non-monetary costs, such as “search costs, transaction costs, learning costs, emotional costs, loss of loyal customer discounts, adjustment of customer habit, coupled with financial, social, and psychological risks on the part of the buyer”<sup>42</sup>. The higher these costs are, the more customers are unlikely to change the provider, which results either into customer loyalty and brings about all benefits associated with customer loyalty to the provider, or involuntary stay with the provider, which may lead to negative consequences for provider such as for example bad word-of-mouth. The examples of both situations may be found in relationship between customer using the telecommunications services and telecommunications operator. Time and energy required for search of appropriate tariff, preparation of documents (applications, contracts etc.), transportation costs and time required for a visit of new operator’s branch to sign a new contract – all of these represent switching costs, which motivate customers to stay with current operator and therefore be loyal. On the other hand, contract obligations, which force customers to stay with operator for agreed period of time, or impossibility to use the same telephone number with new operator, which is also a part of switching costs, produce not only loyalty, but also significantly contribute to customer dissatisfaction and may result in negative word-of-mouth.

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<sup>41</sup> Timmer, J., (2007): “Product loyalty: Consumers mistake familiarity with superiority.” *Ars Technica*. Accessed on 20.5.2009. <http://arstechnica.com/>

<sup>42</sup> Yin Lam S., (2002): “Investigating the interrelationships among customer value, customer satisfaction, switching costs and customer loyalty.” Accessed on 24.4.2009. <http://bmg3-notes.umd.edu>

According to the proponents of this theory, even unsatisfied customers may be loyal, because of high switching costs. Hence switching costs have bigger impact on customer loyalty, than satisfaction. “The establishment of a new relationship represents some sort of investment of effort, time and money, which constitutes a significant barrier to moving to other service providers when the customer is dissatisfied with the services of a provider”<sup>43</sup>.

Other factors of influence, e.g. uncompetitive product offering, high price elasticity and other are also surpassed by the strong and even often decisive effect of switching costs.

However customers, who stay with the company, due to high switching costs, reveal a different kind of loyal behaviour. For example, though these customers do not buy from competition, buy frequently and their purchase volumes may rise, these customers do not tend to recommend the company once other benefits (e.g. tangible or monetary benefits) of the mutual relationship are missing. This leads into a conclusion that creation of high switching costs itself does not result into customer acquisition, which is one of the most valuable function of customer loyalty. However, if customers receive some benefits, which became a part of switching costs, they do recommend the company and spread the positive word-of-mouth. This effect can be probably explained by the fact, that benefits effectively reduce the invested value, but do not reduce received value, or effectively increase received value without any increase in invested value. Both events enhance customer value (i.e. difference between invested and received value, perceived value of the customer), thus increasing customer satisfaction, which finally contributes to positive word-of-mouth.

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<sup>43</sup> Yin Lam S., (2002): “Investigating the interrelationships among customer value, customer satisfaction, switching costs and customer loyalty.” Accessed on 24.4.2009. <http://bmgt3-notes.umd.edu>



*Figure 9: Higher switching cost, leading to a positive word-of-mouth. Source: the author.*

Continuing with our telecommunications example, if operator faces with customer dissatisfaction and negative word-of-mouth, resulting from contractual obligations or impossibility to leave the same telephone number, the operator may grant some extra benefits to those customers, enhancing customer value, increasing customer satisfaction, and thus promoting customer loyalty without negative word-of-mouth.

On the basis of this finding certain implications arise for the managers willing to promote customer loyalty. These implications will be discussed in next paragraphs.

## *Chapter 7*

### 7.1 LOYALTY PROGRAMS AND CUSTOMER LOYALTY

Loyalty programs are “marketing efforts which reward and, therefore, encourage loyal customer behaviour in order to increase the profitability of stable customer relationships”<sup>44</sup>.

Loyalty programs tended to be more popular in last decades, as competition between companies in different market increases. Companies often invest in loyalty programs and seek for panacea how to keep their customers and make them buy more and more frequently. This often contrasts with overall modern trend, that gradually customers become less and less loyal.

One of the topic heavily discussed while speaking about customer loyalty programs, is the link between customer loyalty and loyalty programs. Many researchers believe that loyalty programs do not provoke attitudinal loyalty, but behavioural loyalty<sup>45</sup>. Moreover, according to some of them loyalty programs are not about loyalty at all. They believe that customers who are members of loyalty programs simply “imitate” loyal behaviour in a way, which was suggested by loyalty program managers.

There are advantages as well as disadvantages of customer loyalty programs. Their proponents in addition to their financial benefits emphasize building of deeper relationship with customers through loyalty programs. Companies also enjoy deeper customer insight. Critics increasingly doubt whether the end justifies its means question effectiveness of these programs. They say that companies invest millions in these programs and the return on this investment is often low. Nonetheless, loyalty programs may increase number of

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<sup>44</sup> Strauss B., Schmidt M., Schoeler A., (2005): “Customer frustration in loyalty programs.” *Journal of Service Industry Management*. 16/3. p. 229.

<sup>45</sup> Rowley J., (2007): ”Reconceptualising the strategic role of loyalty schemes.” *Journal of Consumer Marketing*. 24/6. p. 367.

products bought, may decrease price sensitivity of customers, and increase positive word-of-mouth, make customers more “immune” to competitive offers.<sup>46</sup>

## 7.2 LOYALTY PROGRAMS AND MODERN PRACTICE

Many marketers today get use of IT technologies, which allow them to identify their target customers, learn in detail their profile information, needs and wants, their buying behaviour, predict this behaviour, influence it, addressing the customer by the right communication channel, with the right message, in the right time and place and offering them the right product with the right price. Customers leave their trace in POS cashiers, helplines, merchant webpages, different questionnaires and application forms and other. All this data is consolidated, filtered out and valuable information is extracted and used for strategy formulation.

Many marketers do not stop in this point, but try to influence buying behaviour by using IT. It can be CRM systems, increasingly popular today, especially in B2B segment. They are also often the loyalty programs, which may either consist of the paper coupons, which are given to the customers every time they purchase something, or may be more complex and sophisticated, e.g. built in POS equipment, connected to ERP, account systems and other back-office systems.

Loyalty programs are used in many different industries<sup>47</sup>. They are extremely popular in airlines (i.e. air miles), in financial services (e.g. co-branded credit cards), telecommunications, clothing and grocery stores etc. They cover almost all known consumer industries. Some of the best known include Tesco club card program, Starbuck’s

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<sup>46</sup> Uncles M. D., Dowling G. D., (2003): “Customer loyalty and customer loyalty programs.” *Journal of Consumer Marketing*, 20.4. p. 303.

<sup>47</sup> Uncles M. D., Dowling G. D., (2003): “Customer loyalty and customer loyalty programs.” *Journal of Consumer Marketing*, 20.4. p. 294-316.

loyalty program, Shell loyalty program. These are often claimed to be successful and therefore are examined by researchers in papers and marketers in case studies.

### 7.3 STRATEGIES BEHIND LOYALTY PROGRAMS

There are two major objectives of these programs. One is to achieve increased revenue through repetitive more frequent and larger purchases. This objective is achieved by correctly designed loyalty scheme and rewards, which will be discussed later.

Another objective is to build closer ties with customers; create barriers in order not to allow him or her to switch to competition and to consolidate his or her all purchases in a given segment at the company. This is achieved through data gathering and their interpretation about customers and their behaviour. The resulting information is used for a number of different marketing activities, e.g. one-to-one marketing or other more customized marketing activities. They lead to greater effectiveness of marketing activities of companies, help to build stronger relationship with customers and keep them loyal. Therefore loyalty programs are popular among companies. "The popularity of these programs is based on the argument that profits can be increased significantly by achieving either of these aims"<sup>48</sup>. According to Uncles and Dowling and their article "Customer loyalty and customer loyalty programs", in addition there are other "peripheral" goals, e.g. strategic alliances, PR, cross-selling etc.

Uncle and Dowling believe that all brands have some CBB (customer brand buying) customers and CBC (customer brand commitment) customers, but the prevailing majority of majority of brands are CBA (customer brand acceptance) customers. These customers buy most often those brands, which are available and exhibited the most. The result is so called "double jeopardy effect", which implies that big brands are bought more often and

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<sup>48</sup> Uncles M. D., Dowling G. D., (2003): "Customer loyalty and customer loyalty programs." Journal of Consumer Marketing, 20.4. p. 395.

by more customers than small brands, which have fewer customers who buy them less frequently.

According to them, this kind of customer behaviour enables four different strategies for increasing customer loyalty, which is interpreted as “enhancing the observed level of repeat-purchase” of a brand. There is, however, only single one, which is most common and, probably, most effective one. The strategy is to focus on CBA customers by delivering high-perceived value or benefit of being in the loyalty program. This value, consisting of hard and soft benefits, should be higher than that of competition. Managers of the program should heavily expose this program using advertising, PR and point-of-sales promotions. Extending distribution channels of the program and increasing number of occasions for customer re-purchase is also a part of this strategy. The program and company products are then placed on top-of-mind of customers, when they feel the need or want to buy the product from this category. Customer re-purchase would be here a natural outcome of these marketing activities. Gradually being satisfied or tied by switching costs, customers become loyal. Single-brand loyalty, however, even in this case would represent a very significant challenge for marketers.

This is not the only one perspective concerning target customer group. Louise O’Brian and Charles Jones in their article “Do rewards really create loyalty?” suggest that company’s best customers should be identified and rewarded: “In order to maximize loyalty and profitability, a company must give its best value to its best customers. That is, customers who generate superior profits for a company should enjoy the benefits of value creation. As a result they will then become even more loyal and profitable.”<sup>49</sup>

Therefore many companies offer better prices and services to its most profitable customers. Some airlines treat its most loyal customers with special care, some boutiques offer extended opening hours for their top clients, bank offer loans with lower interest rate

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<sup>49</sup> O’Brian L., Jones C., (1995): “Do rewards really create loyalty?” Harward Business Review, May-June. p. 76.

exclusively for their long-term customers etc. These companies realize how important is to reward their loyal customers and how to make them even more loyal.

The most common practice, though, is unfortunately another one. Most companies treat all customers equally and offer them equal service and rewards. O’Brian and Jones warn, that “a company that offers average-value products and services to anyone wastes resources in over-satisfying less profitable customers while under-satisfying the more valuable loyal customers”<sup>50</sup>. They conclude then, that more profitable customers because of this practice defect and less profitable customers stay with a company and dilute its profits.

#### 7.4 LOYALTY PROGRAM DESIGN

Loyalty program design typically consists of three main parts: a) goals, b) loyalty scheme, c) rewards.

Loyalty program design should begin with setting business goals, which are to be achieved and on the basis of which the program will be evaluated in the future. Goals should be clear, achievable, should ultimately result into revenue or profit increase, and should be measurable. Joseph C. Nunes and Xavier Dreze in their article “Your loyalty program is betraying you” in Harvard Business Review identify the following five goals<sup>51</sup>:

- 1) Keep customers from defecting.
- 2) Win greater share of wallet.
- 3) Prompt customers to make additional purchases.
- 4) Yield insight into customer behaviour and preferences.

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<sup>50</sup> O’Brian L., Jones C., (1995): “Do rewards really create loyalty?” Harvard Business Review, May-June. p. 76.

<sup>51</sup> Nunes J.C., Dreze X., (2009) “Your loyalty program is betraying you.” Harvard Business Review, March. p. 125-126.

5) Turn a profit.

All of these goals are supplemented by loyalty schemes, which encourage customers to behave in a certain desirable way to achieve these goals. There are different loyalty schemes used by retailers and service providers in consumer markets. Generally they fall to one of these groups: “retailer loyalty schemes, financial service loyalty schemes, online reward schemes, frequent flyer and other travel reward programmes, geographically based loyalty schemes, and coalition loyalty schemes”<sup>52</sup>. They are different, but they have a common purpose – to achieve goals set by motivating customers to behave in a certain way.

The first goal is most common for sectors, where customers use only one supplier, such as telecommunications operators and utility providers. Companies then try to keep these customers from defecting. Otherwise the lifetime value of these customers and often their stable regular cash flow of revenues for the company would be lost. Therefore they increase the “exit” or switching costs to motivate customers to stay with them. The authors of the article include example of US telecommunications operator Sprint, which gives its customers an airline mile redeemable with five different airlines for every dollar spend. Its competitor, AT&T, does not offer this kind of program. For many of the customers travelling by one of this airline, therefore, it is motivating to be a customer of Sprint, instead of AT&T. These customers are also said to be “locked-in” by Sprint, since the miles accrued by them over time prevent them from switching to AT&T or another telecommunications operator.

The second goal is to win greater share of wallet. Nunes and Dreze believe, that “a loyalty program can encourage the consolidation of purchases” to one company and thus encourage single-brand loyalty of customers. They say that objective is to maximize share of a company in customer spend in some product category. On the other hand, according to

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<sup>52</sup> Rowley J., (2007): ”Reconceptualising the strategic role of loyalty schemes.” *Journal of Consumer Marketing*, 24/6. p. 366.

Uncles and Dowling<sup>53</sup>, many consultants claim, that the aim of the loyalty program should be single-branded loyalty. This, however, they find to be unachievable for majority of the companies. If customers are already single-branded loyal, the program can be successful only if current customers buy more from the same company. Otherwise cannibalization of its own revenues occurs. This increase in demand of current customers, however, in many cases impossible, because customers generally buy what they need and they will not start buying more just because of benefits of loyalty program.

On the other hand, if attractive and well-done loyalty program addresses completely new customers, who do not buy anything from company, but do buy products or services from this category, may switch as result of membership in this program. This switch, however, is attributable only to benefits customers get from loyalty program. This often leads to devaluation of the market, as customers are now unwilling to buy products without incentives, which loyalty program provides to them, or makes customers vulnerable to competitive actions.

Therefore it would be logical to target loyalty programs on multi-branded customers. They have some demand, which is probably higher than demand of customers with single-branded loyalty and is satisfied by multiple companies. If some company offers attractive loyalty program, customers may withdraw their purchases from competition and consolidate their purchases to this company. This, however, according to authors, seems to represent a great challenge for marketing managers, since customers typically have a good reasons why they buy from multiple companies, rather than from single one. They may enjoy different assortment, different location of the stores and other elements of offering, which cannot be or are not delivered by a single company. It is challenging to convince sufficient number of customers to start buying from a single company. This is, however, one of the way, how to build loyalty program with positive return on investment.

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<sup>53</sup> Uncles M. D., Dowling G. D., (2003): "Customer loyalty and customer loyalty programs." *Journal of Consumer Marketing*, 20.4. p. 304-305.

Cross selling may also help in winning greater share of wallet. In this case companies motivate customers to buy different products and/or services or products and services from other categories from them. Uncles and Dowling include example of Tesco, which engages in cross-selling activities in its Clubcard member program. These activities include for example sale of credit and debit cards, insurance and other services to its customers. Nonetheless, besides of the fact, that this is difficult to achieve as well, companies here are often forced to enter or to focus more on non-core markets, which may be competitive, and therefore more expensive and risky, to operate in. This often leads to decrease in profits from customer loyalty program, the fact, which marketing managers need to be aware of.

To win greater share of wallet of their customers companies often use points in their loyalty program. Nunes and Dreze include example of Amazon.com and Visa card.<sup>54</sup> Amazon.com rewards its customers with a point, which is worth a penny, for each dollar they spend in their e-shop. The points accrued are issued in a form of gift certificates, which can be redeemed in Amazon. Even if another competitor will introduce similar program, Nunes and Dreze point out, it makes sense for customers to stay with a single company as gift certificates are issued only after some threshold is reached. Claiming, that it is possible to succeed with points-based loyalty programs, even if there are many of them in the market, they suggest a “convex reward structure, whereby greater levels of expenditure earn proportionally greater rewards”<sup>55</sup>. Loyalty programs may contain different tiers, which encourage them to buy more or more often. For example all customers may be given some percentage discount or cash-back. But if they reach certain threshold, they enter the new level of loyalty program and are given more (e.g. silver and gold membership).

The third typical goal of loyalty programs is to prompt customers to make additional purchases. Nunes and Dreze in contrary to Uncles and Dowling claim, that loyalty programs “can also create incremental demand, spurring purchases that would not

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<sup>54</sup> Nunes J.C., Dreze X., (2009): “Your loyalty program is betraying you.” Harvard Business Review. March. p. 125.

<sup>55</sup> Nunes J.C., Dreze X., (2009): “Your loyalty program is betraying you.” Harvard Business Review. March. p. 125.

otherwise be made”<sup>56</sup>. The example of these programs include those multi-tiered programs and those programs, where customers are in danger to fall into lower tier, if they buy less than some sum of money during a month or a year. Some exclusive memberships may work in this way. If customers start to buy less, they may fall into lower membership status or even lose this membership. To prevent this, they buy more even if their demand is lower. Because of this some loyalty programs do create additional customer demand, according to Nunes and Dreze.

Both authors also came to a conclusion that some schemes may create additional demand naturally, without endangering customers, that they may lose their membership. They examined car wash loyalty scheme, where drivers could enjoy a free car wash after eight purchases. They found, that this scheme led to increased frequency of car washes – the drivers did start washing their cars more often because of the scheme. The same result was observed in coffee shops, in tanning and spa sessions, in service stations. This represents another implication for program managers – some loyalty schemes in some markets may produce incremental demand.

One of the goals of loyalty program may be insight into customer behaviour and their preferences. I have already discussed the data aspect of loyalty programs. Information, program managers get from data contained in their systems, helps them to identify customer preferences and their behaviour. This allows them to customize communication form, communication and distribution channels, evaluate the attractiveness of the loyalty program, tailor it according to customer preferences and as a result to enjoy higher revenues and extended profit margin, as effectiveness of all of these marketing efforts rises rapidly.

The last common goal of loyalty program is to deliver profits. As it was mentioned previously, the critical concern for many of the companies, which run some loyalty program, should be also its costs. “A reward program should not give something for

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<sup>56</sup> Nunes J.C., Dreze X., (2009): “Your loyalty program is betraying you.” Harvard Business Review. March. p. 126.

nothing: The profits will be illusory, but the costs will be real”<sup>57</sup>. Giving some increase in revenues, produced by loyalty programs, its costs should be low enough not to cut profit margin considerably. “ In order for a rewards program to be a profit centre instead of cost enter, the payout must be inextricably linked to desired behaviours”<sup>58</sup>. For program managers to keep the line between value given to customers and value generated for company for the program to deliver desirable profits, they must be linked to customer behaviour.

In my point of view the simplicity of the program is also important question in this case. The program, despite of its attractiveness, should be simple for the staff and customers to understand it, so there would be less need to educate them. It should be also simple and less costly from technological point of view – it should deliver just what program managers want and will use, no more. There are many advantages, which may be enjoyed by companies if there are many data about customer behaviour available. But it is also costly to collect them, store and manage them. Hence only data, which will be used by program managers, should be collected by system. Overwhelming with data and useless functionalities of the system make it more costly, less understood and the whole program may be less effective.

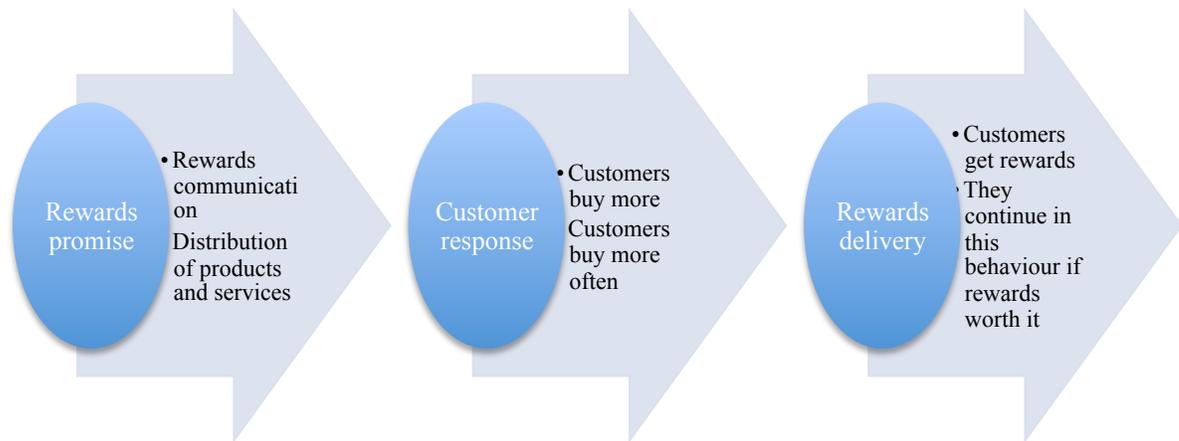
As many researchers of loyalty programs suggest, loyalty programs should have clear, achievable and measurable goals, and should be designed in a way, that their schemes would aim to accomplish these goals.

Having discussed the strategic framework of loyalty programs, the later part of the chapter would be to move further and to analyze different rewards.

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<sup>57</sup> O’Brian L., Jones C., (1995): “Do rewards really create loyalty?” Harward Business Review, May-June. p. 76.

<sup>58</sup> O’Brian L., Jones C., (1995): “Do rewards really create loyalty?” Harward Business Review, May-June. p. 77.



*Figure 10: Rewards drive behavioural loyalty in a loyalty program. Source: the author.*

The objective of loyalty program design is to arrange the program in a way that it would result into desirable customer behaviour by using different rewards and benefits:

Rewards represent another essential part of every loyalty program. They are the “key mechanism for incentivising customers to participate in the scheme”<sup>59</sup>. They also motivate customers to behave in a certain way, which is planned by managers of loyalty programs to achieve program objectives.

Loyalty program rewards can be categorized into different types and groups. As it was mentioned earlier, rewards can be of one of two characters: hard or soft. Hard rewards represent some regular tangible benefit, e.g. a free gift, voucher, which can be later redeemed, cash-back etc. Soft rewards are for example surprises and delights, priority treatment, extra customer care etc. Rewards can be also direct and indirect. Direct rewards are those that “directly support the value proposition of a given product”<sup>60</sup>. Indirect rewards

<sup>59</sup> Rowley J., (2007): “Reconceptualising the strategic role of loyalty schemes.” *Journal of Consumer Marketing*, 24/6. p. 367.

<sup>60</sup> Rowley J., (2007): “Reconceptualising the strategic role of loyalty schemes.” *Journal of Consumer Marketing*, 24/6. p. 367.

“refer to incentives that are not relevant to a given product”<sup>61</sup>. There are also immediate and delayed rewards. Immediate are those, which are received by customers at the moment of purchase (e.g. cash-back for each purchase). Delayed rewards are received after some purchases (e.g. reward received for a 10<sup>th</sup> customer visit). There are many types of rewards companies use in loyalty program design.

These types of rewards are suitable for certain markets more than for others. For example, according to Rowley, in low involvement purchases immediate rewards are more effective than delayed. Direct rewards are more preferable than indirect across majority of the markets. Both hard and soft rewards need to be balanced in different markets and for different customer target groups differently.

According to Jennifer Rowley and her paper “Reconceptualising the strategic role of loyalty schemes”, the value of rewards which are received by customers in loyalty programs is formed by their cash value, redemption options, aspirational value, relevance, and convenience.<sup>62</sup> The cash value is a “percentage rebate on what the customer spent to earn that reward”<sup>63</sup>. Obviously, the higher is the cash value, the more valuable it is for customers. Redemption choice means alternatives of reward redemption, which are available for customers. Not all rewards may be found attractive for all target customers. Therefore some flexibility in their choice and redemption may be suitable. Customers also respond by desirable behaviour only for rewards, which are aspirational for them enough, i.e. rewards should be strong enough to encourage customers to behave in a certain way. Rewards should be consistent with business and customers themselves, i.e. rewards should be relevant for customers. These factors contribute into customer satisfaction or dissatisfaction about loyalty programs, and ultimately influence whether or not he or she

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<sup>61</sup> Rowley J., (2007): “Reconceptualising the strategic role of loyalty schemes.” *Journal of Consumer Marketing*, 24/6. p. 367.

<sup>62</sup> Rowley J., (2007): “Reconceptualising the strategic role of loyalty schemes.” *Journal of Consumer Marketing*, 24/6. p. 367.

<sup>63</sup> O’Brian L., Jones C., (1995): “Do rewards really create loyalty?” *Harvard Business Review*, May-June. p. 79.

would behave in an intended way. Therefore value of rewards is of extreme importance in overall success of loyalty programs.

All parts of loyalty program, goals, scheme and rewards, need to be done in a correct manner for program to be successful. And there is no universal rule, how this correctness should look like. According to Rowley, “there might not only be differences in the effectiveness of loyalty programmes on the basis of geographical market (USA, Europe, Far East), and sector (travel, retail, financial services), but also on the basis of other parameters”<sup>64</sup>, such as for example marketplace characteristics, customers themselves, their behaviour. Moreover, loyalty program design is about the “data the business needs to optimise its offer to customers, as by the rewards to ensure customer participation”<sup>65</sup>. Therefore loyalty program design should be solved individually for each market, sector and even for company in order for the program to be successful.

## 7.5 PROBLEMS WITH LOYALTY PROGRAMS

There are many problems associated with strategy behind loyalty program. It may be poorly planned or implemented and may lead to failure of the program. One of the most common mistakes is absence of clear objectives of the program. Another problem would be addressing with loyal program company’s existing loyal customers and not encouraging them to buy more. They purchased company’s products in the past and continue in their purchasing in the same manner being now members of the program. Now, however, they receive rewards for this purchasing. Another extreme would be to reward disloyal customers. Another mistake is absence of a clear link between loyalty scheme and rewards and profits. Loyalty program often becomes a cost centre rather than profit centre. Other

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<sup>64</sup> Rowley J., (2007): ”Reconceptualising the strategic role of loyalty schemes.” *Journal of Consumer Marketing*, 24/6. p. 368.

<sup>65</sup> Rowley J., (2007): ”Reconceptualising the strategic role of loyalty schemes.” *Journal of Consumer Marketing*, 24/6. p. 368.

strategic mistakes include poorly chosen rewards, absence of competitive advantage in the programs (so the programs are easy to copy by competition) and so on.

Market devaluation is another big problem, which may result out of loyalty programs available in the market. Lisa O'Malley in her paper "Can loyalty schemes really build loyalty?" finds that many programs "are little more than sophisticated promotions"<sup>66</sup>. In her work she also cited Birds: "The emphasis o discounting has been linked to the 'commercial equivalent of cocaine snorting – where an illusory short-term benefit leads to long-term disaster'". Nunes and Dreze obviously agree with this statement by saying: "If your loyalty program is tantamount to discounting, then you are only paying people to buy and, paradoxically creating greater disloyalty. You will inevitably be drawn into the equivalent of a price war, with tit-for-tat competitive moves basically yielding parity and lower profitability all around"<sup>67</sup>. Other companies in the market may join the trend and offer some program in return in order to stay competitive. Gradually customers may not want to buy products and services without rewards such as discounts or cash-back. This leads to profit margin decrease in the market. Therefore devaluation is a problem of loyalty programs.

Many researchers argue that loyalty programs build loyalty to the schemes and not to a brand or company. O'Malley adds that though many loyalty programs are able to encourage differentiation between the brands, "they are difficult to sustain as a prime reason for purchase, because fundamentally '...it is difficult to increase brand loyalty above the market norms with an easy-to-replicate 'add-on' like a customer loyalty programme"<sup>68</sup>. Customers who become members of some loyalty program may change their behaviour and buy more and more often because of rewards they get. Once these rewards are eliminated, they stop being loyal and may switch to competition. Therefore "disloyalty" without loyalty program is one of the most important weaknesses of loyalty programs.

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<sup>66</sup> O'Malley L., (1998): "Can loyalty schemes really build loyalty?" *Market & Intelligence Planning*, 16/1. p. 52.

<sup>67</sup> Nunes J.C., Dreze X., (2009): "Your loyalty program is betraying you." *Harvard Business Review*. March. p. 129.

<sup>68</sup> O'Malley L., (1998): "Can loyalty schemes really build loyalty?" *Market & Intelligence Planning*, 16/1. p. 52.

Customers become increasingly frustrated about loyalty programs. Strauss, Schmidt and Schoeler prove in their research, that members of loyalty programs often experience incidents, which frustrate them. The most frequent incidents are, according to them, “difficulty of access (qualification barrier), impossibility of claiming the reward (inaccessibility), low value of the reward (worthlessness) and being required to invest additional material and mental costs in order to enjoy the benefits (redemption costs)”<sup>69</sup>. According to the authors, if these customers do not leave the company, they express “protest behaviour” and “avoidance behaviour”, which not only leads to customer attrition, if not taken seriously, but also to the absence of feedback, which further undermines relationship between company and its customers.

## 7.6 CASE STUDY: PALÁC FLÓRA AND ITS LOYALTY PROGRAM

The purpose of this part of the thesis is to apply theoretical materials presented in Chapter 7 in preceding parts discussing loyalty programs onto a practical case of loyalty program of Palác Flóra.

In November 2008 Prague shopping mall Palác Flóra introduced a loyalty program for its customers. This loyalty program is different to other loyalty programs available in retail industry in the Czech Republic in many areas. First of all 130 different shops participate in the program. All of them offer different percentages of cash-back for their customers. There are only two simple requirements for those customers, who wish to acquire these cards – buy at least for 500 CZK at once and submit registration form. The customers do not get discount, but cash-back bonuses for their purchases, which are loaded to their loyalty cards. The bonuses collected may be redeemed in any shop participating the program and in any time (i.e. even immediately). Other benefits of program include, for example, free parking tickets. Furthermore, customer may top-up their cards by whatever amount, and may give

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<sup>69</sup> Strauss B., Schmidt M., Schoeler A., (2005): “Customer frustration in loyalty programs.” *Journal of Service Industry Management*, 16/3. p. 247.

them as gift cards to their relatives and friends, who, later on after cards redemption, may continue to use them as loyalty cards. Altogether these features make this program unique.

According to reputable server “Strategie.cz”, preparation of this program took about one year. Besides of setting up of a central system, which processes all transactions in this loyalty program, terminals for card processing needed to be installed in the shops<sup>70</sup>. There are no doubts, that program preparation also included personal trainings, marketing and sales support preparation, reporting and credit management setup, clarification of legal issues and sales conditions drafting, human processes management, etc. These activities took considerable amount of time, work and investments of Palác Flóra, its shops and its outsourcing partners.

## PROBLEMS AND RECOMMENDATIONS

In my viewpoint, one of the most important problem that can be observed in Palác Flóra’s loyalty program, is, that it is offered to all customers, who spend at least 500 CZK and submit a registration form. Marketing managers do not differentiate between those customers, who represent potential in terms of profitability and share of wallet and those, who do not. This may result in a fact, that program attracts for example those customers, who are least profitable (e.g. those who will visit the shopping mall once or twice and will never come back), or those who already visit and buy at Palác Flóra very often. The first effect leads to decrease in profits, as costs of program per head remain the same, but revenues per head are low. The latter effect leads to cannibalization of existing revenues. This is the first problem, which, in my opinion, should be verified by Palác Flóra management.

The second problem, which was already discussed in this chapter, is that equal treatment of customers in customer loyalty program, may over-satisfy less valuable customers and

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<sup>70</sup> Strategie, ČTK, (2008): “Palác Flóra s věrnostním programem”. Strategie.cz. Accessed on 24.4.2010. <http://www.strategie.cz/scripts/detail.php?id=388349>

under-satisfy more valuable customers. The result may be negatively reflected on company revenues too. Less valuable customers stay with the company and “eat” the profit margin. More valuable customers defect.

To prevent this from happening I would recommend conducting a complex research that would deliver segmentation of Palác Flóra’s customers, main segments for targeting with its loyalty program and implications for communication and distribution activities. There should be two phases of this research – qualitative and quantitative. The qualitative phase would help to create a rough picture, who and where are the key customers. The quantitative part would deliver statistically unbiased results, on the basis of which future strategy for loyalty program will be formulated. The results of the segmentation should be several segments of these characteristics:

- Segments with higher needs and lower barriers to be the members of the loyalty program of Palác Flóra. An example of lower barrier would be living, working or studying nearby the shopping mall.
- Segments with higher average profitability or CLV of customers. We should know who the most profitable customers of this program are.
- Segments with appropriate share of wallet of Palác Flóra and its competitors. Finding out share of wallet of Palác Flóra and its competition enables to determine where the highest potential to grow is. We should target on those customers, from whom we can generate additional revenue. Multi-branded customers, who were mentioned in part 7.4 of this chapter, may represent this group.
- Segments where Palác Flóra has higher than average share of wallet. Targeting them should be careful since may result into cannibalization of existing revenues. However if we ignore them, they may defect.

The segments should also be big enough, should be different among them, should be homogenous and should be actionable. These characteristics are very important for communication and distribution.

Once we have the segments, we should choose one or several segments with highest potential to drive revenues and profits. Once we choose them, the features of the program should be tailored to their needs and other characteristics. The resulting program should be attractive in terms of conditions, rewards and other characteristics for our chosen customer segments.

Communication, distribution and promotion should be planned in two ways: a) to acquire new customers into the program, b) to up sell, to x-sell, to retain and to keep satisfied those who are already in the program. The reason of it is because, for example, communication form and channels for both groups of customers, new and existing ones, is different. For example, we should inform our new potential customers about general benefits associated with the program, how to become a member etc. This communication may be delivered through outdoor, print and other channels, which would be relevant for segments chosen. If we want to communicate to members of the program, direct marketing activities would be probably most effective. Distribution and promotion activities follow the suit.

In my viewpoint, Palác Flóra misses the clear differentiation of communication, distribution and promotion activities, which are aimed to acquire new customers or to retain existing ones. The communication, distribution and promotion of Palác Flóra's loyalty program are merely "plain" in this sense. They universally address both groups of customers – new and existing ones. This, of course, leads to lower costs, but also results in lower relevance, and thus may produce inefficiency of these activities.

Once we have analyzed target customer segments of Palác Flóra's loyalty program and how they should be targeted by communication and distribution activities, we should refer to the loyalty program itself – its goals, its scheme and rewards.

One of the publicly known objectives of this program was to acquire 11.000 customers from 10/2008 till 12/2009<sup>71</sup>. I assume that other main objectives may include, e.g.:

- 1) To increase average spend of customers by certain percentage,
- 2) To increase frequency of their purchases by certain percentage,
- 3) To gain effective communication channel,
- 4) To get customer insight.

These all objectives correspond to generally practiced objectives of customer loyalty programs introduced in part 7.3 of this chapter. They may be summarized into two main ones: 1) increase in revenue; 2) improving customer insight for number of different purposes, incl. communication. The only objective, I would suggest to be added to the list on the basis of our previous theoretical analysis, and to be monitored by management carefully, is profitability. As I mentioned in the beginning of this part it is essential to target customers who will deliver not only revenues, but also profits. Therefore one of the objectives should be to manage some appropriate profit margin and to achieve some determined amount of profits for some period of time in absolute terms.

Concerning the design of the program, its scheme and rewards, in my opinion, it is done well. Conditions of the program are simple and easily reachable. Rewards, even in absolute terms, are encouraging. Redemption of rewards is perfect – customers may redeem their reward for any items in any of the participating stores. The only one comment may be said to stores participation – not all stores participate the program. This may represent some barrier for those customers, who are used to shop in non-participating stores. Palác Flóra, generally, fulfils criteria of attractive rewards presented in the latter part of the part 7.4 of this chapter, namely – cash value, redemption options, aspirational value, relevance and

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<sup>71</sup> Ekonom, (2008): “Pro věrné zákazníky”. Accessed on 24.4.2010. <http://ekonom.ihned.cz/c1-29624470-pro-verne-zakazniky>

convenience. Rewards, however, may be improved by introduction of “convex” structure and “soft” rewards, which were discussed in this chapter previously.

Concerning other program benefits Palác Flóra acquires through this program, according to my viewpoint:

- Expands revenues of the shops since discounts are not immediate, but instead reloaded back to loyalty cards and are added back to revenues, once they are redeemed
- Extends profit margin because of absence of immediate discounts
- Improves retention since customer is forced to come back and spend the amount he or she has on his or her card (i.e. switching costs in form of bonuses loaded onto a card)
- Improves cash-flow since gift card program is offered simultaneously
- Serves as a creative tool for marketing purposes (e.g. the cards may be reloaded by some amount of money and may be given to customers as trials)
- Allows better tracking of customer transaction behaviour and reporting, since all transaction with cards are recorded
- Delivers customer insights, as registration forms need to be fill in by all customers willing to participate in the program

The scheme, rewards, additional benefits presented above and my suggestions concerning customer target group, communication and distribution activities, and concerning monitoring of profitability, in my viewpoint, will effectively help to fulfil objectives of this program to increase revenues and profits and get deeper customer insight.

## CONCLUSION

The purpose of this thesis was to find most meaningful definition of customer loyalty for businesses, to describe its benefits for businesses, to suggest appropriate method of measurement and to proceed with analysis of customer loyalty determinants and their management, including loyalty programs as one of the tool how to promote customer loyalty. Loyalty program management was to be demonstrated on the practical case of loyalty program of Palác Flóra.

Further paragraphs of the conclusion summarize if and how these purposes were achieved.

This thesis introduced three notions of customer loyalty: attitudinal loyalty, behavioural loyalty and contingency loyalty. Behavioural loyalty was chosen to proceed with further analysis, as it is one, which is translated into economic terms and thus represents economic value to a company.

This customer loyalty is a pattern of revealed customer behaviour, which results into repeated number of customer purchases, their increased volume, consolidation of customer purchases instead of those of competition and other benefits described in Chapter 2. Summarizing these benefits, we may suppose, that by driving more revenues on the one side and by curbing costs on the other side customer loyalty results into higher profitability.

Profitability of customers is expressed in terms of CLV, which thus can be used as unbiased measure of customer loyalty.

Meanwhile, behavioural customer loyalty can be influenced by a number of determinants – offering, customer satisfaction, switching costs, elasticity, marketplace, demographics and other. Switching costs are often claimed to be those of the most importance to customer loyalty. By increasing these costs, companies are able to capitalize on loyalty. However, other factors may be important too. By finding the right factors, which serve as motivators or triggers behind purchases of company's product, we are able to focus on them and influence them (e.g. increasing customer satisfaction or switching costs etc.). If we manage

them correctly, these impacts may lead to stronger customer loyalty and higher profitability, which is then expressed through higher CLV.

There are numerous techniques and marketing activities, which help to influence these determinants. Loyalty programs became a popular solution. They often create additional switching costs for customers, increase their satisfaction and ultimately improve their loyalty. They encourage customers to behave in a certain way to increase company's revenues and profits.

These programs, however, have many problems. They are often very costly for companies. Therefore the monetary benefits should be evaluated and costs should be estimated to find, whether loyalty programs bring incremental value to a company or not. Ideally there should be a clear link between customer behaviour, rewards and profitability. They also may produce disloyalty, as customers got used to rewards they get and are not willing to buy products without them. They may result into price war and market devaluation. They may become a reason of customer frustration and customer defection.

Concerning loyalty programs, the case of Palác Flóra and its loyalty program is discussed in this thesis. The program, though, having unique and substantial benefits, has, in my opinion, some problems, which may be corrected and the effect of the program may be improved. First of all, the program is not targeted onto its potentially most profitable customers. Secondly, communication and distribution does not have a clear cut among communication and distribution to new and to existing customers. Lastly, the program may not address some customers at all, because not all stores of Palác Flóra participate in the program. On the other hand, however, the program has very sound advantages, which increase revenues, improve profit margin and cash flows.

In my viewpoint, marketing tools, as loyalty programs, cannot be used solely to increase loyalty in a true sense, as I mentioned it. They give a lot of knowledge about customers and customer behaviour, they create new communicational ways, they create opportunity for one-to-one marketing tactics, they may serve as a way for customer feedback; and these all

is extremely helpful in building customer loyalty. However building customer loyalty should be done through managing determinants, which influence it – product offering, satisfaction, switching costs and other. By managing them correctly and with the help of other tools, as loyalty programs, companies are able to build and keep customer loyalty.

Once it is achieved, however, it should be clearly linked to profitability, as this economic value, in my opinion, is a major ultimate goal of all marketing activities, including those associated with building customer loyalty.

In my viewpoint the purpose of this thesis, which was once more repeated in this part of the chapter, was fulfilled by delivering theoretical background, which discussed the implications of the purpose, and by practical case, which was to demonstrate theoretical implications, which aroused in Chapter 7 discussing loyalty programs in particular.

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