Chapter 10:
Loyalty Programs: Design and Effectiveness
Overview

Topics discussed:

- Loyalty programs: Definition and Key Objectives
- Problems with Loyalty Programs
- Design and Characteristics of Loyalty Programs
- Drivers of Loyalty Program Effectiveness
- Empirical Evidence on Loyalty Program Effectiveness
- Loyalty Programs, Shackle or Reward?
- The Seven-Point Checklist for Successful LP Design and Implementation
What is Loyalty? Behavioral Versus Attitudinal Loyalty

- Behavioral loyalty refers to the observed actions that customers demonstrate toward a particular product or service.

- Attitudinal loyalty instead refers to the perception and attitudes a customer has toward a particular product or service.

- There should be a strong correlation between customers’ attitudes and behaviors. However, in some instance customer behavior differs strongly from their attitudinal perceptions about the product or service.
What is Loyalty? Behavioral Versus Attitudinal Loyalty – A Case in Point

- A frequent flyer member of ABC airlines might continue the relationship only because she has accrued many points and wants to redeem her miles.
- Although her attitudinal preference is to travel with XYZ airlines, because of its superior quality of service and experience, she feels compelled to continue transacting with ABC.
- In this situation, her relationship with ABC reflects strong behavioral loyalty, while her negative perceptions of it reflect poor attitudinal loyalty.
What is a Loyalty Program? Definition and Key Objectives

- A loyalty program (LP) comprises a marketing process that generates rewards for customers, based on their repeat purchases. LPs offer an important CRM tool that marketers use to identify, award and retain profitable customers.

- Key objectives of introducing LPs:
  1. Building true (attitudinal and behavioral) loyalty
  2. Efficiency profits
  3. Effectiveness profits
  4. Value alignment
Building True Loyalty

- Enforcing loyalty by enticing customers with rewards and bonuses is unlikely to create true loyalty.

- True loyalty is a function of the value provided to customers, comprising various factors.

  For example:
  - Degree of involvement in the product category
  - Visibility of product usage
  - Value expressive nature of the product
Efficiency Profits

- Efficiency profits result from a change in the customer's buying behavior induced by the LP
- Change of behavior can be measured in several ways:
  - Basket size
  - Purchase frequency acceleration
  - Price sensitivity
  - Share of category requirements (SCR) or share of wallet
  - Retention
  - Lifetime duration

The most widely used measure of behavioral loyalty is \textit{SCR} which describes the extent of purchases in a category that are served by focal brand or retailer

Assumption:

Customers build up switching costs. The accumulation of loyalty-based assets encourages them to \textit{forgo} their free choice because the expected reward makes this reduction appear worthwhile
Efficiency Profits – Criticism

- Two key criticisms of this viewpoint

- 1) For a customer to engage in an LP, the overall utility of being in the LP must be higher than the utility of not being in an LP. The cost for the firm to entice the customer to change behavior accordingly may be higher than it would be without the LP.

  Money that could be invested in, for example, cutting prices

- 2) The customer segment most likely to join the LP consists of those who are truly loyal anyway, so their business is already likely. In this case, the question arises about whether LPs actually change buying behavior.
Effectiveness Profits

- **Derive Knowledge**
  - Gather information about behavior and preferences of individuals

- **Improve Knowledge**
  - This process of learning allows the firm to improve knowledge of customer preferences through effective product and communication offerings

- **Better Offerings**
  - Increasingly better-tailored value proposition offerings to various customer is possible

Effectiveness profits are likely to generate **sustainable competitive advantages** and yield the highest profits in the long run
Value Alignment

- Aligning the cost to serve a particular customer with the value he/she brings to the firm
- Allows firms to serve their most valuable customers in the best manner
- Value alignment is particularly critical when there is great heterogeneity in the customer’s value and in the cost to serve the customer
  Example: the airline business, the hospitality industry and the financial services industry

- Example of a firm with a highly heterogeneous customer base:
  Tier A represents 71% of the customer base
  Tier B 42% and Tier C the remaining 27%
Loyalty Programs: Increasing in Popularity

- Building mainly on the premise that it is cheaper to market to existing customers than to acquire new ones interest in loyalty programs exploded in the last 1990s.

- In 2006, U.S. Loyalty programs counted 1.34 billion members, 2 years the number increased to 1.81 billion members (Odell, 2009).

- Although LPs have become immensely popular, it is far from clear whether they actually help firms engender greater customer loyalty and higher profits, partly because of the considerable cost associated with managing an LP, and partly because their management can be tricky.
Examples of Loyalty Programs

- Frequent-Buyer programs
  - City Bagels, a sandwich retail chain offers customers their 10th sandwich for free

- Volkswagen Club and Card
  - Customers collect points from Volkswagen (VW) for servicing their car or buying accessories and from partners of car rental companies and tour operators
  - The points can be redeemed for dealer services, price reductions on car purchases, and catalog merchandise

- Star Alliance Frequent Flyer Program
  - Any flight on any Star Alliance airline counts towards a member's frequent flyer program
Problems with Loyalty Programs

- Although LPs have become widespread and popular, the benefits are not always clear.
- Large corporations that have spent millions of marketing dollars on LPs closely evaluated their costs.
  
  For some companies this reassessment lead to the elimination of any further investments in LPs.

- “People have lost interest in (loyalty card) points and don’t think they give value. What they really appreciate are straight forward product offers at great prices.”
  
  CEO of Safeway, Carlos Criado-Perez in May 2000.
Design Characteristics of Loyalty Programs (1)

- Reward structure:
  - Hard versus soft rewards
  - Product proposition support (choice of rewards)
  - Aspirational value of reward
  - Rate of rewards
  - Tiering of rewards
  - Timing of rewards
  - Rewards based on specific criteria

- Participation requirements:
  - Voluntary or automatic enrollment
  - Open versus closed loyalty program
  - Automatic or manual point accumulation
Design Characteristics of Loyalty Programs (2)

- Payment function
- Sponsorship: (existence of partner network, network externalities)
  - Single versus multiform LP
  - Within- versus across-sector LP
  - Ownership (focal firm versus other firm)
- Cost and revenues of LPs
**Reward Structure – Hard versus Soft Rewards**

- Hard rewards: price reductions, promotions, free products and preferred treatment
- Soft rewards: psychological benefit of having special status in addition to receiving preferred customer service
Reward Structure - Product Proposition Support

- Rewards that directly support the firm’s product proposition
  - Example: The US bagel franchise Finagle-A-Bagel has a LP that allows participants to redeem their accumulated bonus points for the firm’s own products – sandwiches and drinks
- Allows LP member to redeem points for products that are completely unrelated to the focal firm’s offering
  - Example: British Petroleum’s LP users may redeem points from their gasoline-related purchases for merchandise such as first-aid kits, photographic films, coffee mugs, and Barbie dolls
Reward Structure - Aspirational value of reward

- Consumers prefer hedonic goods as opposed to utilitarian goods when receiving a gift or a LP reward
  - Mercedes Benz’s LP makes it possible to transform points against a flight in a MIG 29 combat aircraft
  - Neimann Marcus, the US luxury retail chain, gives out each year a new list of “wow and cool” rewards. These unique rewards include a world famous photographer to come to a customer’s home for taking pictures
Reward Structure - Rate of rewards

- The rate of rewards refers to the rate of reward value to transaction volume (both in monetary terms)
- How much a consumer gets in return for concentrating his or her purchases
- Rate of rewards is one of the primary drivers of LP enrollment and active usage

**But** reward redemptions are a key cost factor for firms that run LPs
Reward Structure - Tiering of Rewards

- Rewards based on asset accumulation response functions

- In case 1, the buyer receives the same amount of rewards per $ spent, regardless of the spending level
- In case 2, the buyer receives a larger amount of rewards per $ spent, with increasing spending level. Here, the program is relatively more attractive for buyers who are high spenders. Many airline programs follow this pattern
CRM at Work: Bloomingdale’s Rewards Plus Program

- Increasing levels of rewards to customers based upon their annual spending level

- Bloomingdale Example:
  - First tier: Premier Insider - all members that sign up for a Bloomingdales credit card
  - Second tier: Premier Plus Insider - members who spend more than $1000 annually
  - Third tier: Ultimate Premier Insider - customers who spend over $2500 each year at Bloomingdales

- Bloomingdale’s seeks to distribute the most rewards to its best customers
Reward Structure - Timing of rewards

- Timing of Rewards
  - Determined by minimum redemption rules, type of reward given out, and reward rate
  - The longer the timing to build up to a certain reward level, the greater the “breakage” (the amount of rewards that are never redeemed)
  - “Lock-in” effect – firms create redemption rules that favor long accumulation periods, thereby impacting customer retention
  - Customers build up assets that function as switching cost
Reward Structure - Rewards based on specific criteria

- Rewards can be designed to fit certain parameters, such as the time period, person, categories/brands and distribution channels

  Two main goals:
  - Generating additional revenue and increasing sales during weak sales periods
  - Offering rewards targeted to a specific group of card holders, such as customers whose last transaction was long ago to activate “sleeping” customers

- Some companies tie rewards to specific categories/brands and distribution channels to boost sales in these areas
Participation Requirements 1/2

- **Voluntary or Automatic Enrollment**
  - With automatic enrollment, the company deliberately enrolls all of its customers in the LP *without differentiation*
  - Voluntary programs are more common, consumers can select if they want to join

- **Automatic or Manual Point Accumulation**
  - Most loyalty programs automatically record points, once the issued loyalty card is offered at checkout or the card number is entered in Internet transactions
  - Some programs such as “My Coke Rewards” require online consumers to enter a code that can be found on products

  Although consumers generally prefer automatic point accumulations, for companies, a manual system can be more cost effective
## Participation Requirements 2/2

- **Open versus Closed Loyalty Programs**
  - Open are accessible to anyone; closed LPs are deliberately restricted to a particular group of customers

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<tr>
<th>Open Loyalty program</th>
<th>Closed loyalty program</th>
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<td>Reach critical numbers in the loyalty program faster</td>
<td>Concentrated target group due access restrictions</td>
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<td>More comprehensive database</td>
<td>Database mainly holds members with high interest in the assortment</td>
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<td>Simplified acquisition/address of potential new customers and customers of competitors</td>
<td>Allows for more effective communication due to clearly defined member group</td>
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<td>Greater efficiency of the LP due to larger customer base</td>
<td>Membership conditions (e.g., fee) limit number of members and associated costs</td>
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<td>Conveys feeling of exclusivity to program members</td>
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Payment Function

- For some LP providers, it has become common practice to endow loyalty cards with a payment function to generate purchase statistics at the individual customer level.

In the United States approx. 60% of all consumers own rewarded-based credit cards.

- Retailers offer two types of loyalty cards that include payment functions:
  - **Open Loop**: If the transactions aim to debit the customer’s account and credit the retailer’s account, the card must involve a banking partner.
  - **Closed Loop**: If the transactions do not actually pay for the purchase but rather grant the retailer access to an existing customer account (e.g., automatic debit transfer systems), no banking partner has to participate.
Sponsorship

- Single vs. multi-firm LP
  - Single: LPs that reflect only transactions with its own customers
  - Multi-firm: LP member may also accumulate assets at organizations associated with the focal firm’s LP

- Within sector/across sector
  - Supply side dimension of multi-firm LP design-degree of cross sector partners
    - Example for within sector: The STAR Alliance of SAS, Lufthansa, United Airlines, Varig
    - Example for across sector: The LP of AOL and American Airlines, with more than 2000 partners, spans many different industries

- Ownership
  - For multiform LPs, the ownership dimension characterizes who owns the LP within the network; whether it is the focal firm, a partner firm or a firm whose sole purpose is to manage a LP
Cost and Revenue of LPs

- In an empirical study, Leenheer, Bijmolt, Van Heerde, and Smidts (2002) show that the costs related to four of the seven loyalty programs they analyze are higher than the returns generated.

Any evaluation of LPs benefits must consider various sources of both cost and revenues.

- Implementation costs (e.g., initial promotions)
- Variable expenses (e.g., discounts, rewards)
- Costs persisting after launch (e.g., maintenance of service center)

LP TIMELINE
Drivers of Loyalty Program Effectiveness

- The factors that drive the effectiveness of a loyalty program can be structured into three main categories:
  - 1) LP design characteristics
  - 2) Customer characteristics
  - 3) Firm characteristics

The configuration and interaction of these drivers determine whether an LP achieves its desired objective(s)
Loyalty Program Design Characteristics

- Classified according to:
  - Reward structure
  - Participation requirements
  - Payment function
  - Sponsorship (existence of partner network, network externalities)
  - Cost and revenues

- To know if an LP is effective:
  - From the consumer’s perspective, are rewards attainable?
  - From the consumer’s perspective, are rewards relevant?
  - From the firm’s perspective, is the LP design aligned with the desired goal(s)?
Customer Characteristics

- Skewness of customer value distribution varies across industries (value heterogeneity)
  - Similar usage and customer profitability of individual customers or accounts (e.g.: gasoline industry)
  - Different usage and customer profitability of individual customers or accounts (e.g.: financial services or the telecom industry)
- Value alignment feasible in industries such as airlines, hotels, rental cars, pharmacies, telecom and financial services
Firm characteristics

- Perishability of a product
  - Hotel LPs: frequent users get upgrades to “better” rooms subject to availability
    Upgrades are only given when there is excess capacity that night. The reward of an upgrade comes at very low marginal cost
  - Airline seats

- Breadth and depth of the firm offering the product at the store/retail level results in higher efficiency profits because:
  - A buyer is more likely to fulfill his needs
  - A buyer has more opportunities for one-stop shopping (attributed to more time saving)
  - A buyer has more opportunities for behavioral loyalty (attributed to more purchase occasions)
Drivers of Loyalty Program Effectiveness

LP Design Characteristics

Customer Characteristics
Market Characteristics
Firm Characteristics

Demand side: Attitudinal Loyalty
Demand side: Behavioral Loyalty
Supply side: Cost of Loyalty Program

LP Benefits for Organization

1. Commitment, positive WOM*, Community, True Loyalty
2. Efficiency Profits: Greater SCR² or retention
3. Effectiveness Profits: Better value proposition through learning
4. Value Alignment

*Word-of-Mouth
²Share of Category Requirement
Achieving a Competitive Advantage

- Reason a firm develops a LP program is to achieve **competitive advantage**

- Competitive advantage of a firm results in the ability to operate more profitably over a sustained period of time

- A highly frequented category like Grocery Stores is more likely to attract members into its LP

- LPs with the goal of creating Efficiency Profits provide the smallest basis for achieving competitive advantage

- The value provided to the customers participating in a LP must be greater than for customers not participating

- Industries such as financial services or telecom can expect to reap competitive advantage when pursuing a goal of value alignment
CRM at Work – Tesco: From Price Promotion to Marketing Efficiency

- Launched the first LP in British supermarket industry in 1995 called Club Card; relied on incentive aspect of the loyalty scheme

- Successful in capturing both market share and share-of category requirements in subsequent years

- Later established segmentation scheme of its customer base
  - Sends 80 different versions of its mailing to members and publishes four versions of its clubcard magazine
  - Offers tailored cards to students, families, top customers, seniors, etc

- Aligned its LP offering closely with the specific members’ needs as opposed to giving out general incentives e.g., Tesco’s Baby club

- Tesco merges information on customer transactions within Tesco’s website and with point of sale data to customize its product offerings and communications
Empirical Evidence on Loyalty Program Effectiveness

- It’s particularly difficult to get unbiased information about the performance of firm-specific LPs.

  Proper metrics *rarely* are in place and few firms are likely to admit to their poor performance.

- Conclusion drawn by a few published studies:
  - Published evidence that LPs create attitudinal loyalty is rare.
  - Some studies attest to a positive effect of LPs on behavioral loyalty (to varying degrees), but other empirical research fails to identify such an impact.
  - There is very little information on the cost efficiency of LPs. Individual cases (e.g., Safeway, ASDA) suggest the great expense of managing LPs.
  - Using LPs as a value alignment tool seems viable.
Loyalty Programs, Shackle or Reward: And to Whom?

- Loyalty programs as they exist today fall short in terms of creating attitudinal loyalty

- Loyalty programs focusing on incentives, deals, and promotions are often a very costly proposition for the firm

- “LPs that are most likely to provide sustainable competitive advantage are those that leverage data obtained from consumers into more effective marketing decisions and thus result in true value creation for customers. Loyalty is likely to follow in these cases” (Reinartz, 2002)
The 7-Point Check-list for Successful LP Design and Implementation

Is your LP’s goal compatible with marketing strategy?

Is the design of your LP aligned with the characteristics of your market, customer base, and your firm?

Is cost management of LPs possible by mitigating costs via low marginal cost rewards or via contributions from manufacturers?

For determining predicted benefits of your LP can you attempt a trade-off analysis between cost and gains of the LP program?

Avoid withdrawing an existing LP, which can have negative consequences in the form of customer dissatisfaction and defection

Design LP to achieve maximum effectiveness in marketing operations

Ensure that your firm has the necessary capabilities to manage its LP effectively
Minicase – Loyalty Program Management at Starwood Hotels

- Operates a customer loyalty program called Starwood Preferred Guest (SPG) - allows customers to accumulate points for staying and spending with Starwood

- Unique aspect: Points never expire and Starwood does not have “black-out dates” (dates when customers cannot use their points)

- Challenges:
  - Collection of too much information on individual customer behavior without knowing how to use it, exacerbated by customer’s concern about privacy invasion
  
  - Very little knowledge about a large portion of its customer base; while roughly 7 million Starwood customers are members of the loyalty program, 6 million are not
  
  - Not knowing the extent to which customers will tolerate frequent offerings
Summary 1/2

- Link between satisfaction and retention is asymmetric, i.e., dissatisfaction has a greater impact on retention than satisfaction

- Loyalty is not the only path to profitability

- The success or failure of a loyalty program (LP), whether contractual or motivated through incentives, is determined by the profitability of the customer

- Most companies need to revisit their business model
  - To reflect on the impact of Loyalty Programs on their bottom line
  - To determine how customer service initiatives add value to future revenue streams
The configuration and interaction of LP design, customer, market and firm characteristics determines whether a LP achieves its desired objective.

To know if a LP is effective, issues to be addressed include attractiveness of LP, degree to which an accumulation of assets in the program is relevant, and whether the LP’s design is aligned with the desired firm goals.

The key reason a firm develops a LP program is to create competitive advantage.

LPs that are designed to create effectiveness profits have the highest chance of creating competitive advantage.