

Customer Loyalty: The New Competitive Advantage

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EXECUTIVE OVERVIEW

Customer loyalty might be the only sustainable competitive advantage, especially in challenging economic times. Yet, so few businesses understand how to create customer loyalty that, according to Frederick Reichheld, the average U.S. company loses half of its customer base every five years.¹ Hence the need for a systematic approach to this competitive differentiator and for a methodology that can help companies identify and improve their key drivers.

Customer loyalty depends on providing satisfaction not simply to customers themselves—although this is critical—but also to those employees and partners who can positively (or negatively) influence the customer relationship. Effectively managing relationships with all three of these constituents is the key to customer loyalty, competitive advantage, and financial stability.

For a company to sustain customer loyalty, it must identify “loyalty drivers”—the key business attributes that have the greatest impact on the satisfaction of customers, employees, and partners. While certain factors can be considered valuable to customers everywhere, a company gains competitive advantage only when it can identify, measure, and track the loyalty drivers for the three constituents in its specific industry and field of operations. To achieve a competitive advantage, companies must adopt a satisfaction measurement system that is empirical, integrated, and customizable. This system must also provide real-time feedback to enable corrective action. This white paper summarizes the results of recent research on customer loyalty, presents the case for loyalty-based satisfaction measurement systems, and describes how one system, Oracle’s Siebel Satmetrix eSurveys, helps to create customer loyalty, employee retention, and partner allegiance.

Customer Loyalty and the Bottom Line

Customer loyalty can be defined as a customer’s sustained commitment to a company as demonstrated by repeat purchases, increased wallet share, and positive word-of-mouth referrals. Research indicates that when a company can command such loyalty, the benefits include, but go considerably beyond, incremental revenue.

¹ Reichheld, Frederick, *The Loyalty Effect: The Hidden Source Behind Growth, Profits, and Lasting Value* (Boston: Harvard Business School Press, 1996).

In a pioneering *Harvard Business Review* study, Frederick Reichheld and W. Earl Sasser identified numerous bottom-line benefits of customer retention.² They found that loyal customers purchase more, they will pay higher prices, they are easier to service (thus reducing operating costs), and they help expand the customer base by giving positive referrals. The numerical evidence cited in this study was particularly telling:

- A mere 5 percent increase in customer retention increases an organization's profitability by 25 to 100 percent.
- Securing customer loyalty is cost effective because acquiring a new customer can cost five to twelve times as much as keeping an existing one.
- Loyal customers, encouraged by the relationship building of loyalty-driven companies, increase their purchasing over time. The tenth purchase of the average online apparel customer is 80 percent larger than his or her first one.

There is evidence that customer satisfaction and customer loyalty are related to key measures of financial performance. In a national study, satisfaction measurement researchers at Satmetrix Systems found that the average stock price-to-earnings (P/E) ratio of companies with above-average customer loyalty scores is more than double that of companies with below-average customer loyalty scores.³ This translates into US\$1 billion in additional market valuation for even the smallest Fortune 1000 firm.

Loyal customers also tend to become more evangelistic about their relationship over time, thus helping the company expand its market presence by personal referrals. In a study of online retail profitability, Bain & Company and Mainspring, found that after a single satisfying purchase the average customer referred three friends or colleagues, but after ten such purchases the number of positive referrals went up to seven.⁴ Thus customer loyalty more than doubled the number of new leads.

The evidence is clear. Companies receive proven bottom-line benefits from establishing long-term customer relationships, and those companies that invest strategically in improving customer loyalty can expect significant gains in profitability and other financial measures.

Three Critical Relationships

The key to customer loyalty is customer satisfaction. That much is obvious, but the means of achieving customer satisfaction are not so obvious. Customer satisfaction begins with providing customers with superior service, it but cannot stop there.

² Reichheld, Frederick, and W. Earl Sasser, "Zero Defections: Quality Comes to Services," *Harvard Business Review*, September–October 1990.

³ Brooks, Laura, "Market Stat Benchmark Database Study," Satmetrix Systems, Inc., 2001.

⁴ Bain & Company and Mainspring, "Conclude that Customer Loyalty Is the Key Driver of Online Retail Profitability," *Business Wire*, March 30, 2000.

Studies of the factors that lead to customer satisfaction point in nearly all cases to one basic finding: customer loyalty comes from satisfying not just customers themselves, but also from satisfying the employees and partners who interact with them. It is only by effectively managing these three critical relationships that the benefits of customer loyalty can be achieved.

The logic of this observation is clear: employees and partners provide the touchpoints at which customers everywhere interact with companies. If at those touchpoints customers meet individuals who are in any way dissatisfied with the company, that dissatisfaction will become evident in the interaction—and the opportunity for increasing customer loyalty will be lost. On the other hand, satisfied employees and partners will be likely to increase customer loyalty, because they will be more ready and willing to provide the superior service that is a fundamental contributor to customer satisfaction.

Virtuous Circles of Satisfaction

The satisfaction level of employee and partner constituents is directly related to their ability—as they perceive it—to provide the superior service that customers demand of them. This is a subtle but critical point that is seldom articulated. Not only will employees and partners be more *ready and willing* to provide superior service, they will also be more *capable* of providing it.

For employees, this means there is a direct link between their actual ability to provide superior service, their perception of that ability, and the shared satisfaction that results for them and their customers. Companies that invest in employee service capability will see a typical virtuous circle.

- Employees who are given the appropriate information, resources, and tools to serve customers better will be more likely to succeed at their jobs, and thus remain there.
- Through increased customer contact and ongoing training, these longer-tenured employees will further improve their ability to serve customers.
- That improved ability will increase customer satisfaction and customer loyalty, and will increase customer appreciation for the employees themselves.
- By tracking these results, loyalty-driven companies will continue to invest in training, reward their most effective customer-facing employees, and further strengthen the virtuous circle of employee-customer satisfaction.

Studies have verified the connection between employee satisfaction and customer satisfaction.

- In their book, *The Service Profit Chain*, James Heskett and his colleagues at Harvard Business School analyzed the relationship between service delivery and financial success. In a model that links service effectiveness and corporate profit, the authors showed that customers' perceptions of service

quality are a direct result of their interactions with customer-facing employees.⁵

- In two studies of the banking industry, Benjamin Schneider and his associates documented clear links between customer satisfaction and employee perception of service training, organizational practices, and management support.^{6, 7}

For partners, a similar virtuous circle ensues. When partners are given the tools and resources they need to deliver superior customer service, their satisfaction level rises, and they are better equipped to improve the satisfaction level of customers. Moreover, companies that support their partners in this way typically realize additional important benefits.

- Satisfied partners demonstrate allegiance to the partnering company and are more likely to report their satisfaction to other business associates.
- Satisfied partners are more willing to commit matching resources to joint projects than are partners who feel they have been shortchanged in the business relationship.
- Satisfied partners are far less likely to form alliances with competing firms.

In an economy in which employee productivity and global alliances are essential to success, a customer loyalty strategy must embrace all three constituents: customers, partners, and employees. Only by measuring the satisfaction and performance of all three can companies understand which business attributes really drive customer loyalty. And only by interactively managing all three relationships can they ensure the appropriate allocation of resources for the greatest customer retention.

Perceived Value and Loyalty Drivers

In a general and undisputed sense, companies earn customer loyalty by delivering value. But what value? To deliver value effectively and thus secure greater customer loyalty, businesses must begin by identifying the parameters of value as they are perceived by customers and the other two constituents. They must begin by asking these questions:

- “What key service or other business attributes do our customers truly value?”
- “What are the real loyalty drivers in our business?”

⁵ Heskett, James L.; W. Earl Sasser, and Leonard A. Schlesinger, *The Service Profit Chain: How Leading Companies Link Profit and Growth to Loyalty, Satisfaction and Value* (New York: Free Press, 1997).

⁶ Schneider, Benjamin; John Parkington, and Virginia Buxton, “Employee and Customer Perceptions of Service in Banks,” *Administrative Science Quarterly*, no. 25 (1980): 252–67.

⁷ Schneider, Benjamin, and David Bowen, “Employee and Customer Perceptions of Service in Banks: Replication and Extension,” *Journal of Applied Psychology*, no. 70 (1985): 423–33.

- “What performance measures must we meet to respond to these drivers?”

The failure to answer—or in many cases, to ask—these questions is a principal cause of the 50 percent customer attrition rate experienced by the average U.S. business. When companies fail to identify what their customers truly value, they often fall prey to one of two common miscalculations. Either they treat all customers the same, assuming erroneously that all customers have the same perceptions of value; or they invest in inappropriate product or service development, throwing capital at features or other offerings that customers don’t want. This not only wastes corporate resources—it loses customers.

The solution to this problem is to refocus corporate attention on loyalty drivers; that is, to take customer perception of value as the defining standard and invest predominantly in those products and services that will most directly increase customer loyalty. In operational terms, this is accomplished by adopting a loyalty-based satisfaction measurement system. Such a system is built on four sequential steps:

1. Identify loyalty drivers—those key service or other business attributes that have a substantial impact on customer loyalty, employee retention, and partner allegiance.
2. Allocate the necessary people and other resources to ensure superior performance against these loyalty drivers.
3. Measure and track performance results against these key attributes.
4. Periodically readjust allocations as performance measures indicate, and as customers’ perceptions of delivered value change.

While all four steps are necessary for implementing an effective loyalty-based satisfaction measurement system, only the first step falls within the scope of this white paper.

The “Obvious” First Step

Although identifying loyalty drivers might seem to be an obvious first step, it is actually less intuitive than conventional loyalty measurement suggests. For example, it is clear that loyalty is not the automatic reward for “superior service.” In an economic environment where Web-speed responsiveness has become a new entry fee, that driver alone cannot ensure customer retention.

An effective loyalty-based satisfaction measurement system must acknowledge the great diversity of potential loyalty drivers. Managers who implement such a system must begin by recognizing the three interlocking constituents and by understanding that an attribute that is indispensable to one constituent might not be critically important for another. Each has its own loyalty drivers.

For example, customer loyalty can be driven by such standard service dimensions as reliability, responsiveness, and empathy. It can also be affected by a company’s

performance on “tangibles” such as physical facilities, equipment, and the professional appearance of customer-facing personnel. Employee loyalty is likely to be affected by financial benefits, on-site working conditions, training, management style, and performance appraisals. For partners, loyalty is more likely to be driven by how easily and productively the partners can engage the company’s sales, service, marketing, and alliance personnel.

A good customer loyalty program must manage all of these disparate value perceptions simultaneously.

Company-Specific Surveys: Four Criteria

Even more important than the differences among the three constituents is that all loyalty drivers are industry-specific—even company-specific—rather than generic. Something that is of great importance to a retail clothing industry employee—store discounts, for example—might have no bearing on employee satisfaction in the construction or bookselling industry.

For this reason, no company can safely assume exactly what drivers they consider important without first surveying the members of its three constituents. Relying on generic “value markers” will only lead to misperceptions. Loyalty factors must be determined by each company, for each company.

Determining loyalty factors means employing a survey methodology that meets four criteria. A sound survey methodology must provide results that are

- Empirical
- Integrated
- Customizable
- Actionable

A good example of how these four criteria work together is provided by Oracle’s Siebel Satmetrix *e*Surveys, a loyalty-based methodology by which companies identify business attributes that are responsible for maximizing customer loyalty, employee retention, and partner allegiance. Siebel Satmetrix *e*-Surveys were developed with Satmetrix Systems, a leading provider of customer experience management solutions. They help companies identify and act on their loyalty drivers through a combination of Web-based surveys, survey results Web sites, and post-survey consulting, during which clients receive recommendations for improving the loyalty of their three constituents. An overview of the survey’s methodology further describes the four criteria.

Empirical

To determine which loyalty drivers are significant in any given company, Siebel Satmetrix *e*Surveys measure which business attributes have the largest impact on customer loyalty. They do this by asking respondents to rate, on a zero to ten scale, various loyalty measures (for example, the likelihood that they will buy from the

company again) and satisfaction measures for specific business attributes (for example, how satisfied they are with service responsiveness). Correlating the two measures provides an index of the relationship between satisfaction with a business attribute and likelihood of loyalty—what the survey calls the “derived importance” of each business attribute.

Integrated

Because customer loyalty is affected by the satisfaction levels of all three constituents, surveys must coordinate the three in an integrated model. In Siebel Satmetrix eSurveys, customers, employees, and partners all contribute to operational strategy and better service delivery by providing survey input to a closed-loop information system. The empirically based, integrated information model is based on the “service profit chain” model developed by James Heskett and his colleagues at Harvard Business School.⁸ A modification of that model in Figure 1 includes partners in the information flow.

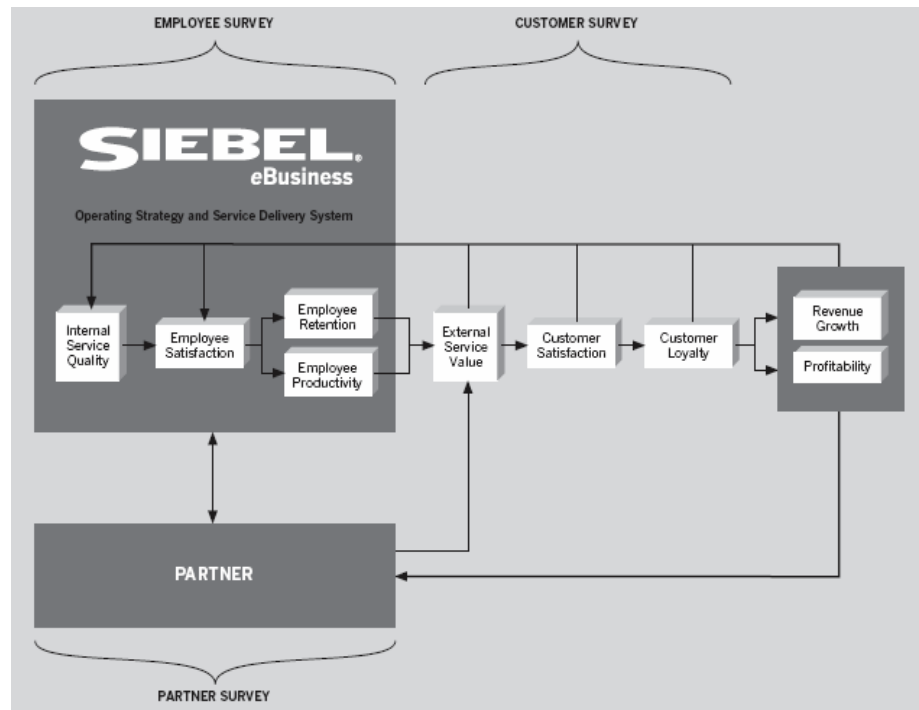


Figure 1: Customers, employees, and partners all contribute to operational strategy and better service delivery by providing survey input to a closed-loop information system.

Customizable

Because loyalty drivers are specific to the industry and the company, surveys must be customized to the criteria of each individual firm. Users of Siebel Satmetrix eSurveys meet this requirement by working with consultants to modify a prebuilt

⁸ Heskett, James L., W. Earl Sasser, and Leonard A. Schlesinger, *The Service Profit Chain: How Leading Companies Link Profit and Growth to Loyalty, Satisfaction and Value* (New York: Free Press, 1997).

questionnaire template—a process that is usually faster than designing a traditional market research study.

Actionable

Because dissatisfaction can so rapidly erode customer loyalty, survey results must be available as quickly as possible so that companies can take corrective action. The Web-based Siebel Satmetrix *e*Surveys provide real-time results, identification and analysis of improvement opportunities, automatic e-mail alerts to management about trouble areas, and consulting help in designing appropriate responses.

Key Indexes and Benefits

The insights gained from an integrated survey program allow companies to create not only greater customer loyalty, but also the employee retention and partner allegiance that are critical to maintaining it. The Siebel Satmetrix *e*Surveys methodology measures performance in each of these three general areas—customer loyalty, employee retention, and partner allegiance—and tabulates the findings into constituent-specific key indexes. By improving their performance levels on these key indexes, companies can realize significant benefits, both in the management of key relationships and in bottom-line results. The most commonly reported benefits are summarized in the following table.

Constituent	Key Index	Benefits
Customer	Customer Loyalty Index: Measures the customers' likelihood of purchasing again, referring others, and experiencing positive feelings toward a company	<ul style="list-style-type: none"> • Attract and retain customers • Improve sales and marketing efforts by highlighting perceived value • Improve resource allocation for better ROI • Increase revenue and profits • Improve lifetime value of customers
Employee	Employee Retention Index: Measures the employees' likelihood of remaining on the job and expressing positive behaviors toward the company	<ul style="list-style-type: none"> • Attract and retain exceptional employees • Deliver superior service to customers • Create work climate that supports great service delivery • Achieve higher customer satisfaction and loyalty
Partner	Partner Allegiance Index: Measures the partners' likelihood of continuing and investing in the partnership	<ul style="list-style-type: none"> • Attract and retain exceptional partners • Deliver superior service to joint customers • Ensure partners are offered necessary support for delivering superior service • Achieve higher customer satisfaction and loyalty

Figure 2: Loyalty-based satisfaction measurement: key indexes and benefits.

CONCLUSION

Because customer loyalty has become central to business health, and because that loyalty is severely influenced by employee and partner satisfaction levels, companies must be able to identify, measure, and track the loyalty drivers that are important to these three constituents in their specific businesses. The challenge is to achieve this capability cost effectively; that is, to implement those changes—and only those changes—in a customer loyalty strategy that will most predictably have a quick and positive effect on this critical business driver.

This is why the most fundamental benefit of a loyalty-based satisfaction measurement system might be that it helps managers allocate limited resources for optimal return in both bullish and bearish times. Such a system brings logic and empirical insight into an arena that is all too often characterized by guesswork, wishful thinking, and misperception of the customer.

The point is made effectively in the words of one telecommunications executive who recently approved the use of Oracle's Siebel Satmetrix eSurveys to measure and improve the effectiveness of his firm's sales methodology:

These surveys not only help you identify what areas to address, but also how to allocate people, money, and time so you will get the greatest impact from your

investment. They really help you to rationalize your resources. That is a real competitive advantage in today's economy.



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Oracle Corporation
World Headquarters
500 Oracle Parkway
Redwood Shores, CA 94065
U.S.A.

Worldwide Inquiries:
Phone: +1.650.506.7000
Fax: +1.650.506.7200
oracle.com

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