John Larson & Company

WINNING WITH A CUSTOMER INTIMACY STRATEGY

Understanding and Leveraging the Various Dimensions of Customer Loyalty

The purpose of this presentation is to provide you with our view on Customer Loyalty, the field that we have worked in since 1991. In that time we have developed an exacting method for gauging Loyalty and quantifying its impact on profitability. In this presentation we will discuss:

1. Customer behaviors and outcomes that increase their attractiveness
2. The relationship of these behaviors and outcomes to the Customer's level of satisfaction
3. The relationship between Customer Satisfaction, Loyalty, and Customer-perceived risk
4. The impact of Satisfaction on Customer behavior and profitability
5. The implications of this relationship on the management of Customer relationships

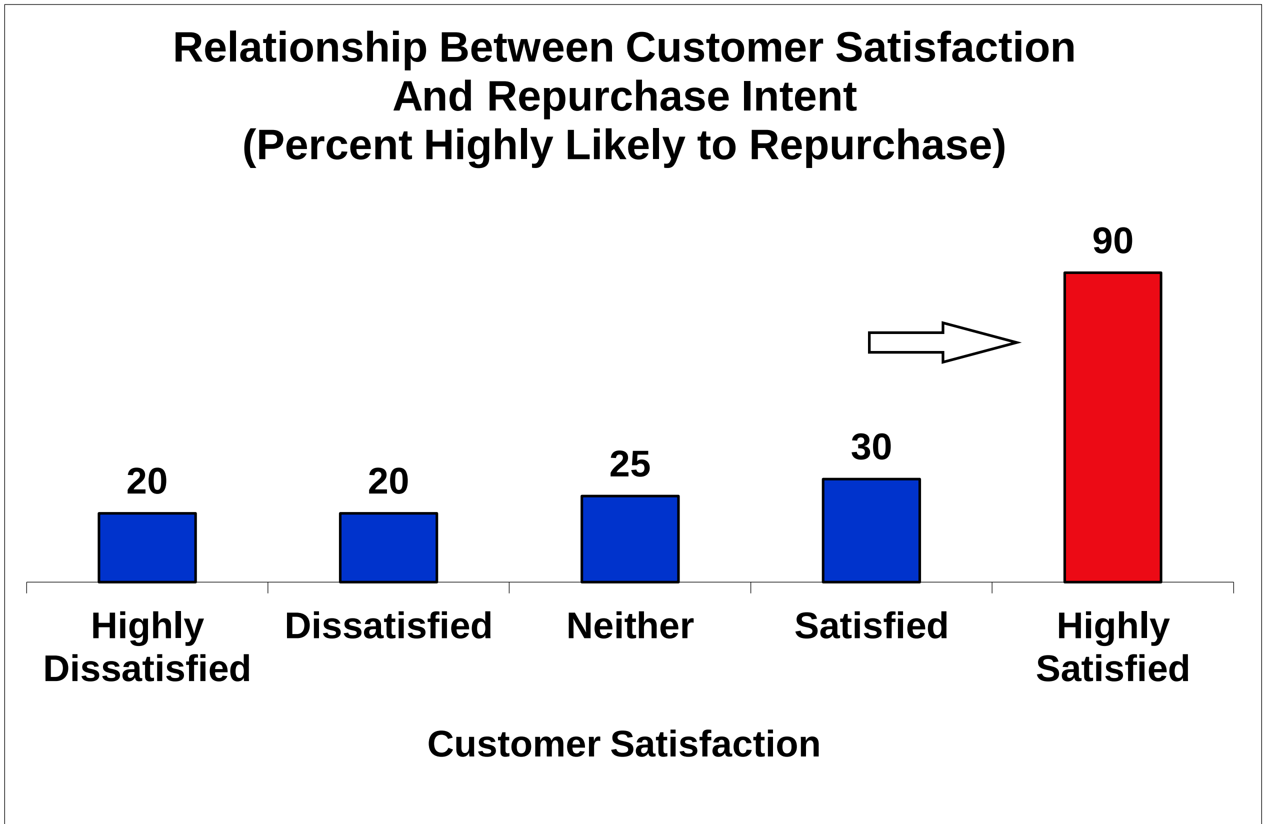
1. Customer Behaviors that Increase their Attractiveness

The value of a firm can be evaluated as the Present Value of the relationships it has with its Customers, and each individual customer relationship can grow in one of five ways:

- **Extending** the duration of the relationship by increasing Retention Rates
- **Broadening** the relationship by selling more products and services to current Customers—i.e. obtaining a greater “Share of Wallet”
- **Upgrading** current Customers
  - Higher margin products
  - Price premium
- **Streamlining** the relationship—i.e., lowering the cost of serving the Customer
- **Leveraging** the relationship to acquire new Customers

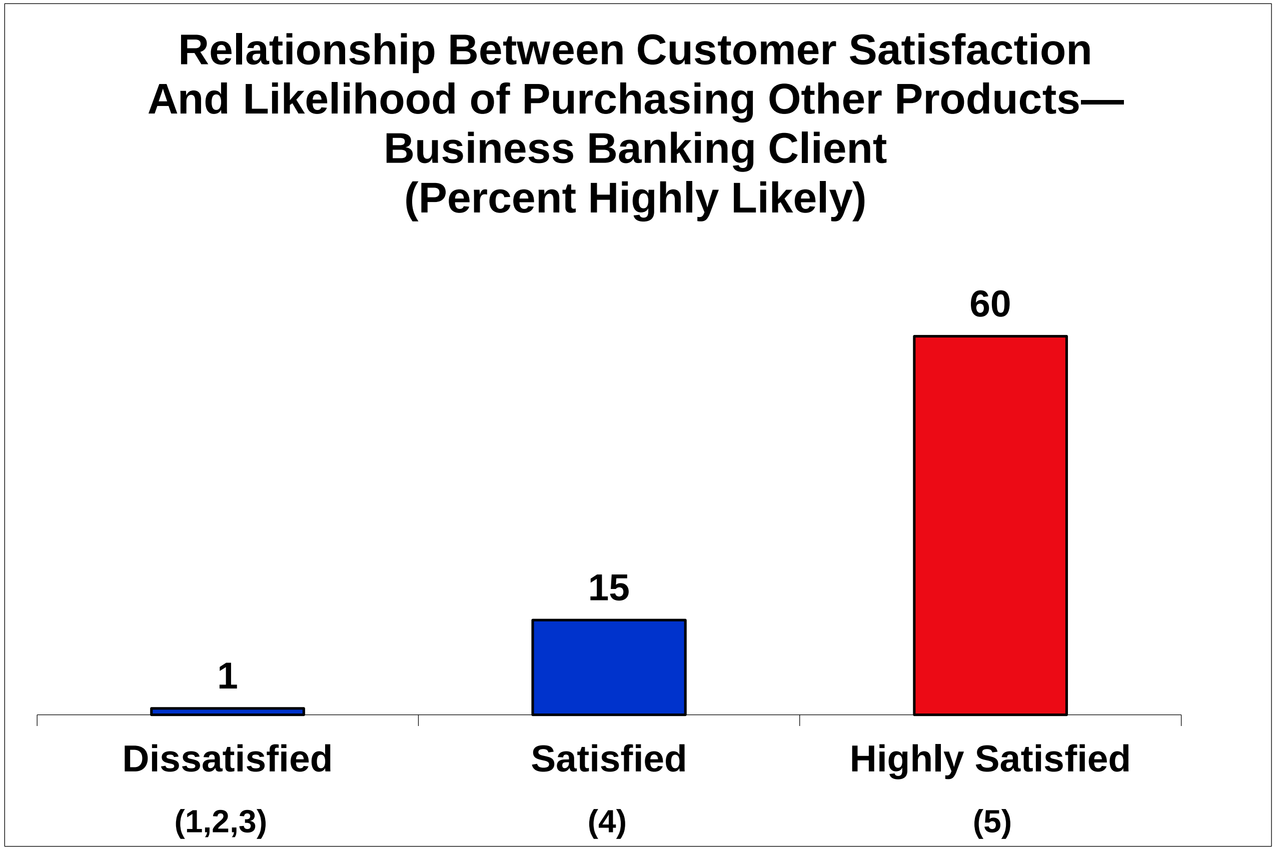
2. The Relationship of These Behaviors and Outcomes to the Customer's Level of Satisfaction

Research we have conducted across a broad series of industries indicates that only Highly Satisfied Customers exhibit the behaviors and outcomes that drive profitability as measured by Repurchase Intent…

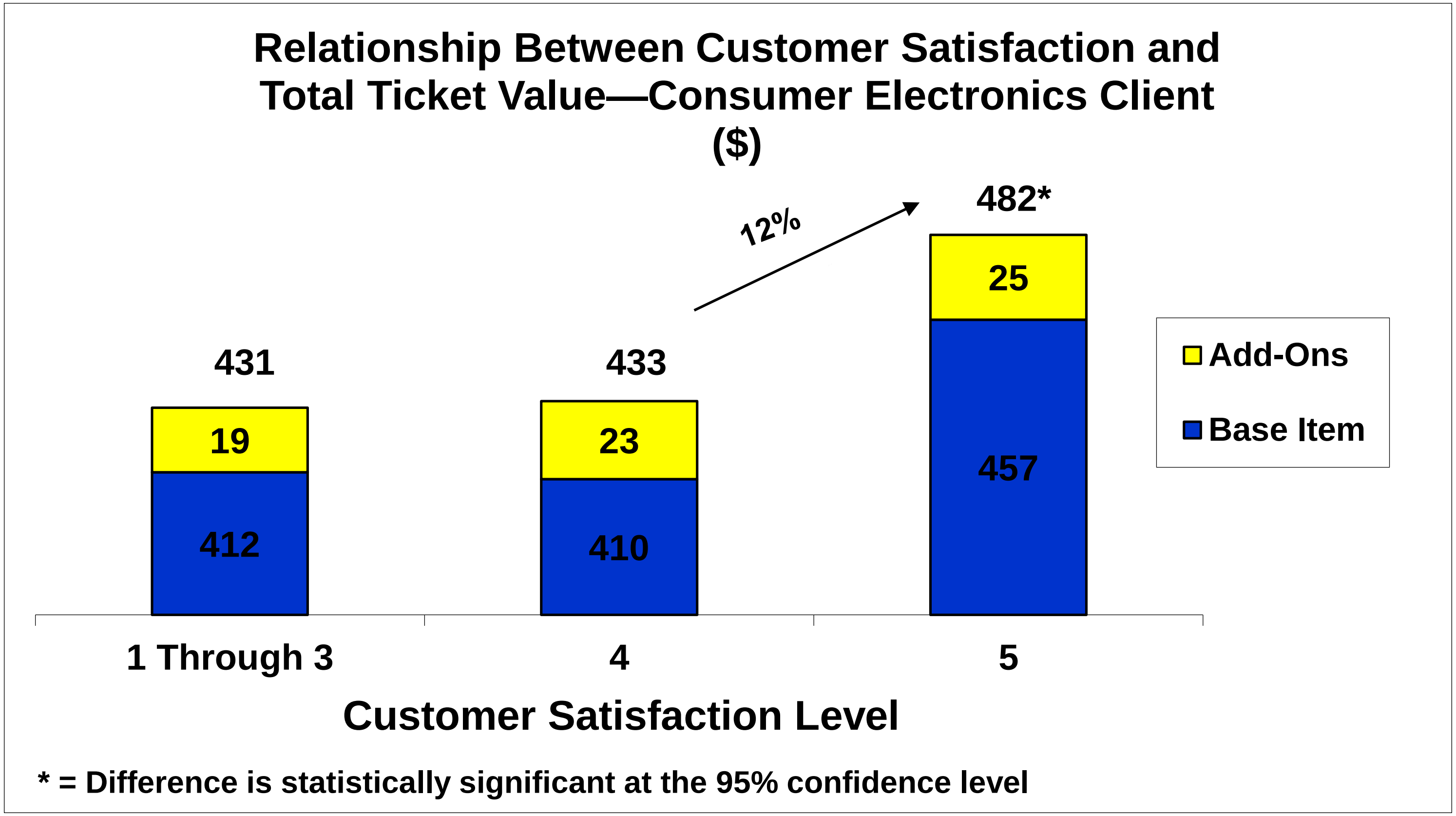


… or Share of Wallet (which may be a better measure of Customer Loyalty in a business-to-business context)

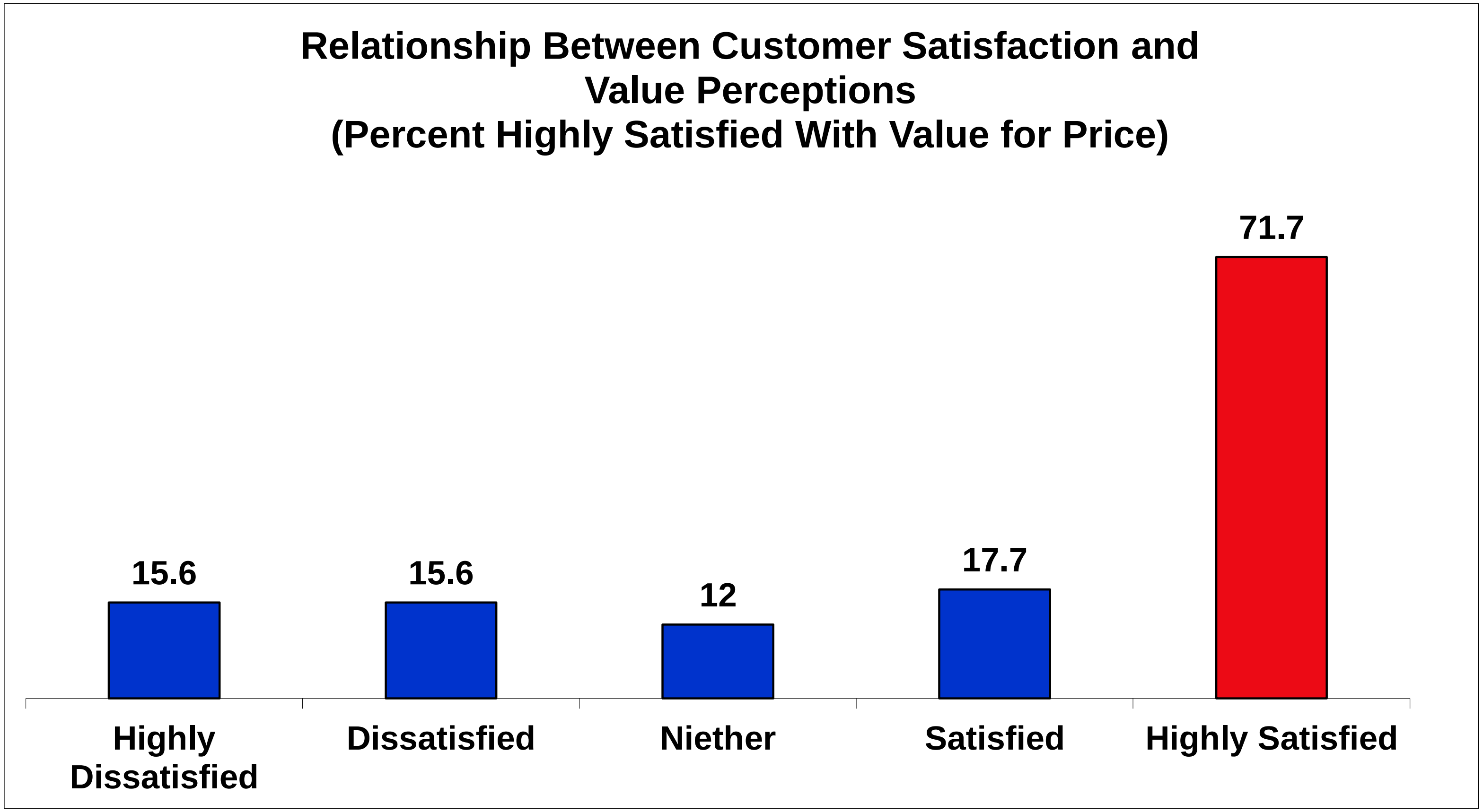
They are more likely to purchase other products and services from you



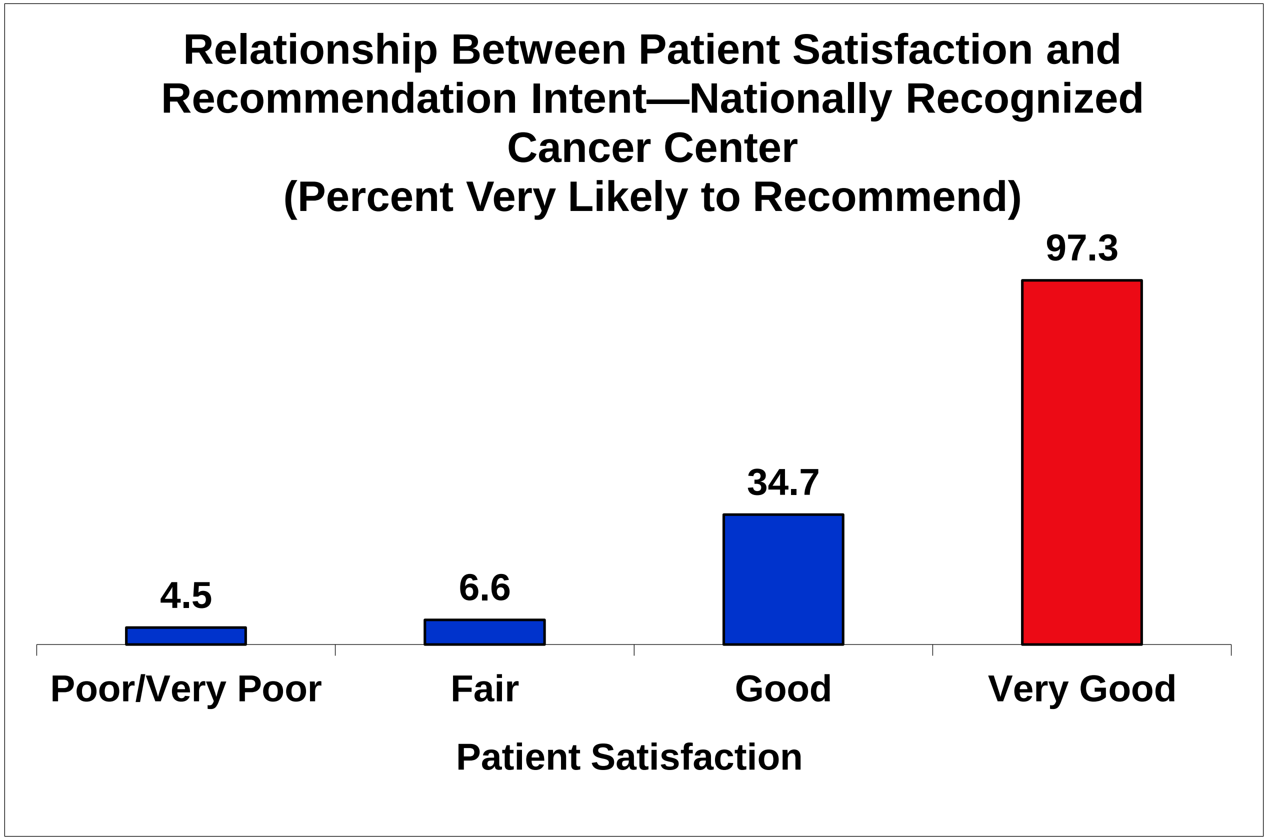
Highly Satisfied Customers purchase your higher value products and services



They have greater perceptions of the value they receive from you which helps create pricing leverage



They have significantly greater Recommendation Intent



Highly Satisfied Customers are actually cheaper to serve, as is illustrated in the following analysis

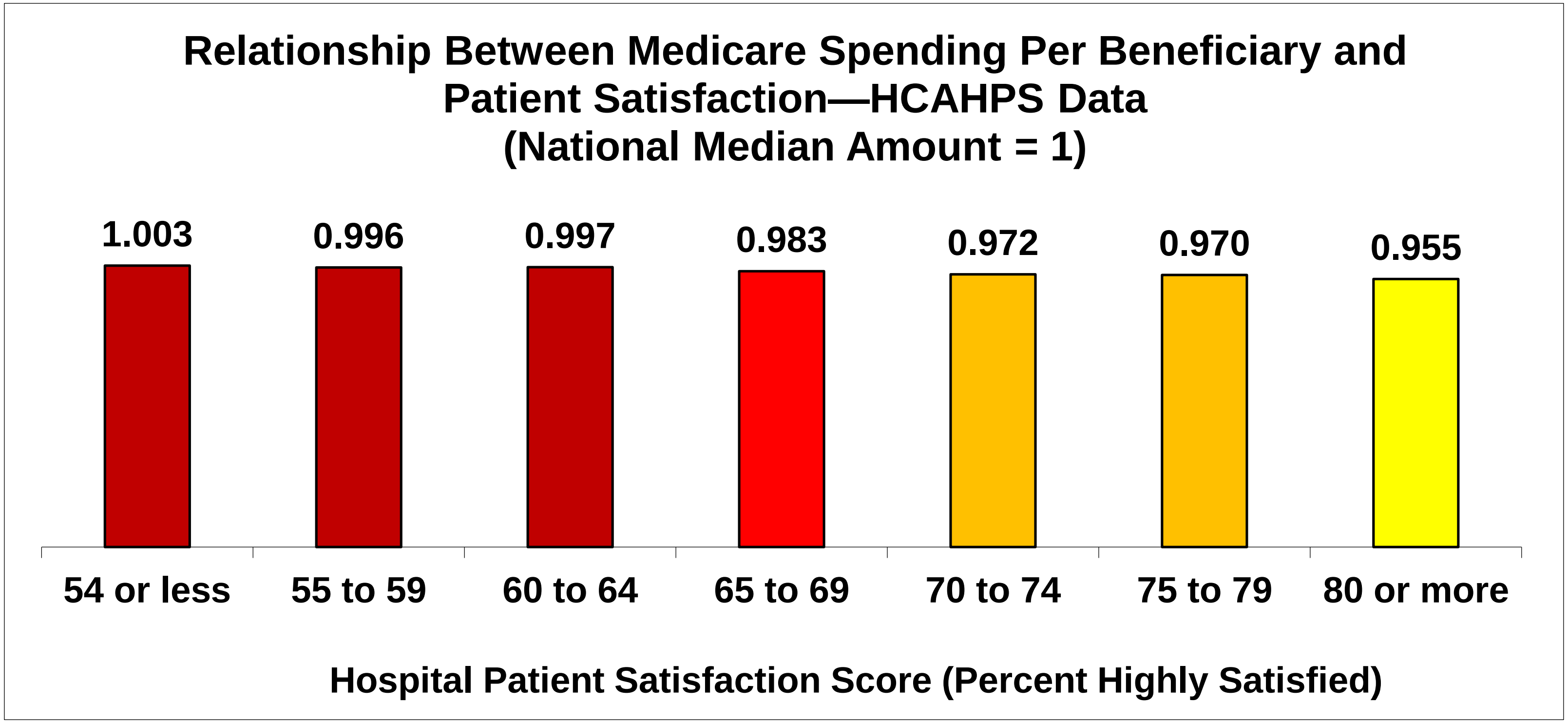
- In 2012 the Center For Medicare Services (CMS) created a data base with over 2,000 hospitals containing Average Costs Per Medicare Beneficiary for each hospital

- These costs were adjusted by CMS for two factors
  - Disease severity
  - Market cost-of-living differences

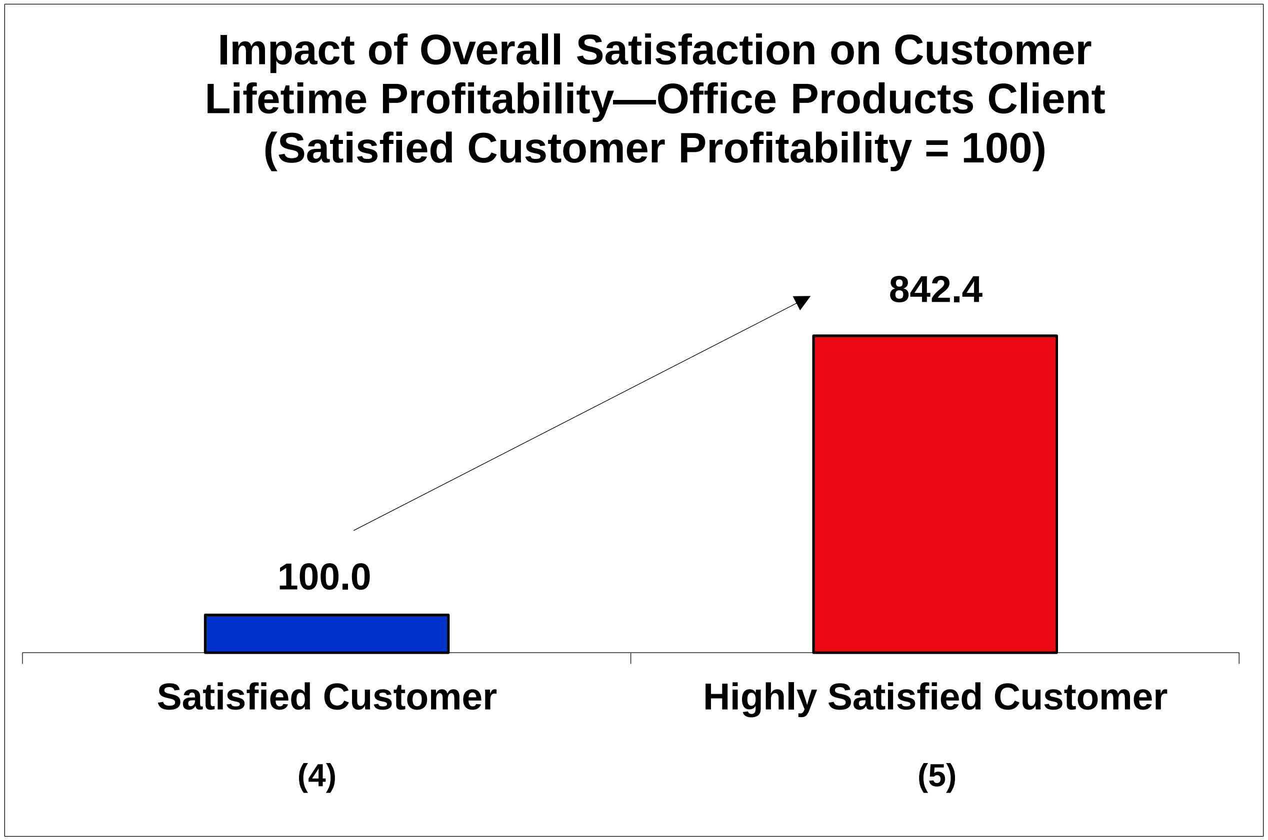
- CMS then computed each hospital's adjusted Average Costs Per Medicare Beneficiary relative to the National Median

- We then ranked all hospitals from highest to lowest based on Patient Satisfaction to see its impact on average Patient Costs

We found that hospitals with the highest levels of Patient Satisfaction had Costs per Beneficiary that were nearly 5 percent BELOW the National Median



As a result of these behaviors, your Highly Satisfied Customers are significantly more profitable than the remainder of your Customer base



3. The relationship between Customer Satisfaction, Loyalty, and Customer-perceived risk

These various behaviors of Highly Satisfied Customers that we have just described are very rational responses to reduced risk

- “5’s” are totally confident that they will have a great experience and in those rare cases when they do not, they have absolutely no doubt that management will take whatever steps are necessary to immediately make things great

- “4’s” speak about “inconsistency”—sometimes they have a very good experience, other times they do not (“You never know what you are going to get”)

Customers Will Reward You For Reducing Their Risk

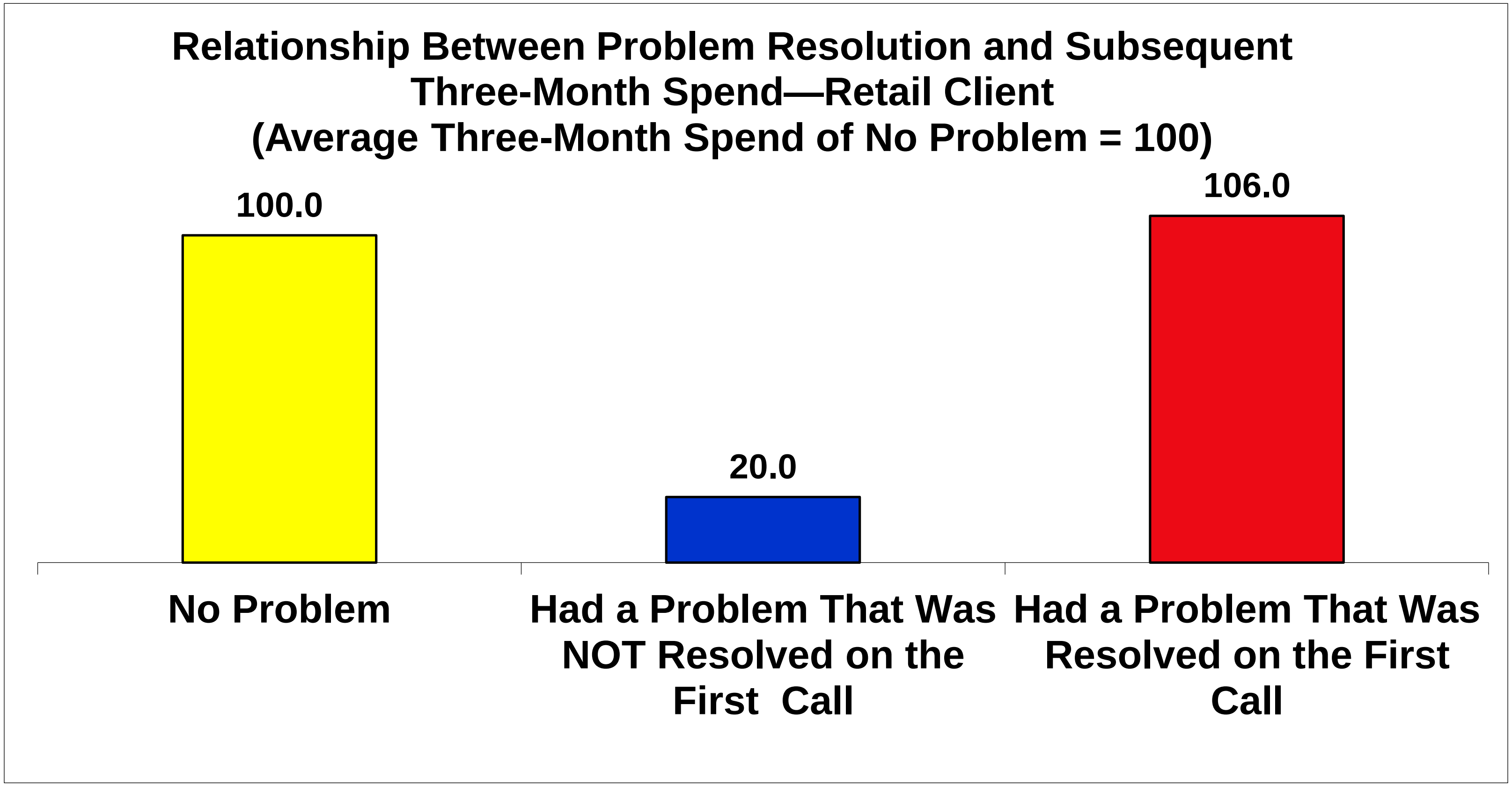
To understand how reducing risk can increase customer spending consider the results of the following analysis we did for an internet retailing client

- We created a database of approximately 1,000 respondents who placed an order with our client in January 2008

- We divided these respondents into three groups
  - Those that reported no problem with their purchase
  - Those who had a problem that was NOT resolved to their Satisfaction when they first reported it to the client
  - Those who had a problem that was resolved to their Satisfaction when they first reported it to the client

- For each group of customers we computed their subsequent purchases from our client over the following three months

Customers who had a problem resolved to their satisfaction on their first call actually spent more over the subsequent three months than those that did not have a problem at all, while those whose issues were not properly handled significantly reduced their expenditures



4. The impact of changes in Satisfaction on Customer behavior and profitability

In research appearing in March 1999 in *Harvard Business Review* we reported the results of an experiment designed to measure the impact of changes in Customer Satisfaction on actual Customer Behavior

1. We conducted a survey of 1,500 PNC Bank Customers in 1996
2. For each we obtained
   a. Their level of Satisfaction with PNC Bank (from the survey)
   b. Their total balances with PNC Bank at the time of the survey (from PNC Bank)
3. We re-interviewed these people 18 months later, obtaining both their level of Satisfaction (from the survey) and current PNC Bank Balances (from PNC Bank)
4. We then examined the relationship between changes in Customer Satisfaction and changes in their bank balances

The research clearly demonstrated that Customers will modify their purchase behavior, either positively or negatively, in response to changes in their level of Satisfaction

Impact of Changes in Customer Satisfaction On Account Balances

Change in Satisfaction During Wave 2	Highly Satisfied	Satisfied	Less than Satisfied
Increase	N/A	+$4,500	+$1,800
Remain the Same	+$4,800	+$3,700	-$1,300
Decline	-$1,100	-$1,400	N/A

Satisfaction in Wave 1

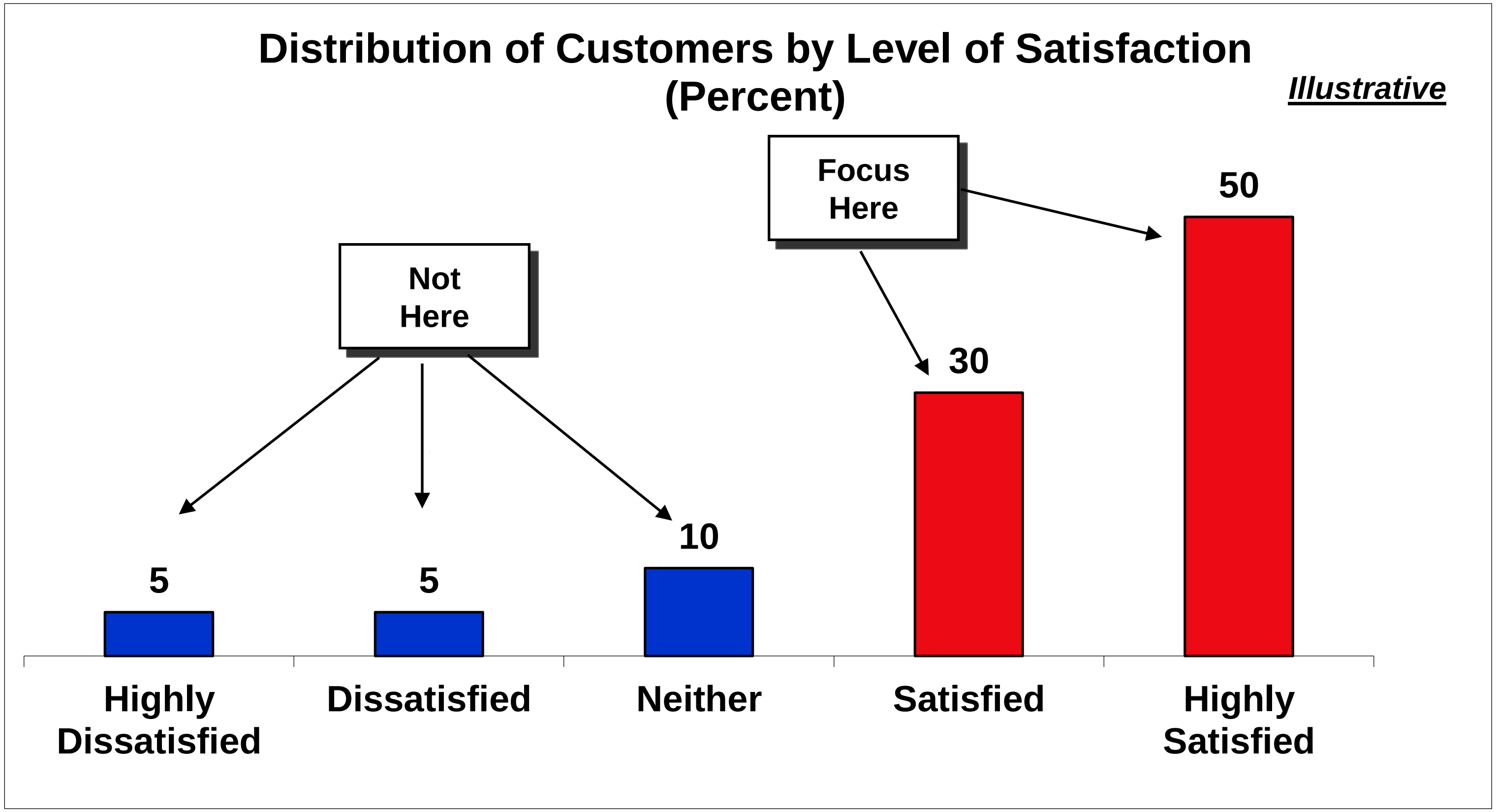
5. The implications of this relationship on managing Customer relationships

This approach has three critical implications for how you manage your Customer relationships

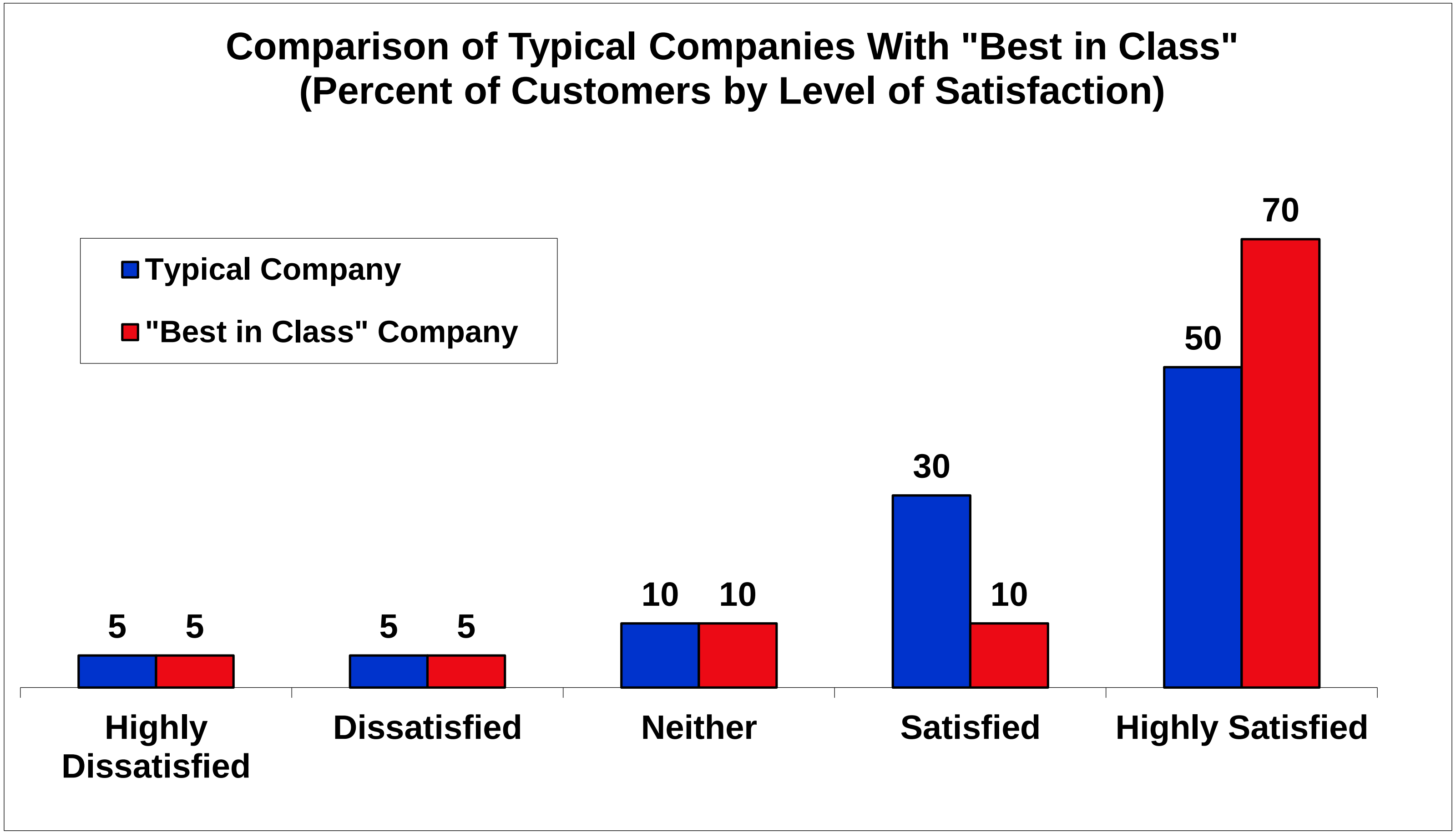
- You must focus your efforts on those Customers that you have the greatest likelihood of making Highly Satisfied
- You must recognize that a superb product is a necessary, but not sufficient condition for creating a Highly Satisfied Customer
- You must understand the importance of your Employees in developing strong relationships with Customers

Focus Required

Successful companies focus their efforts on shifting “4’s” to “5’s”



We have found that organizations win the Customer Satisfaction game by maximizing the number of Customers who **love** them, not by minimizing the number who **dislike** them



Focusing on converting “4’s” into “5’s” makes sense for a number of key reasons

- Only Highly Satisfied Customers exhibit the key Loyalty behaviors you wish to promote—shifting a “2” to a “3” will increase your average Customer Satisfaction score, but will have little, if any, impact on that Customer’s Loyalty toward you

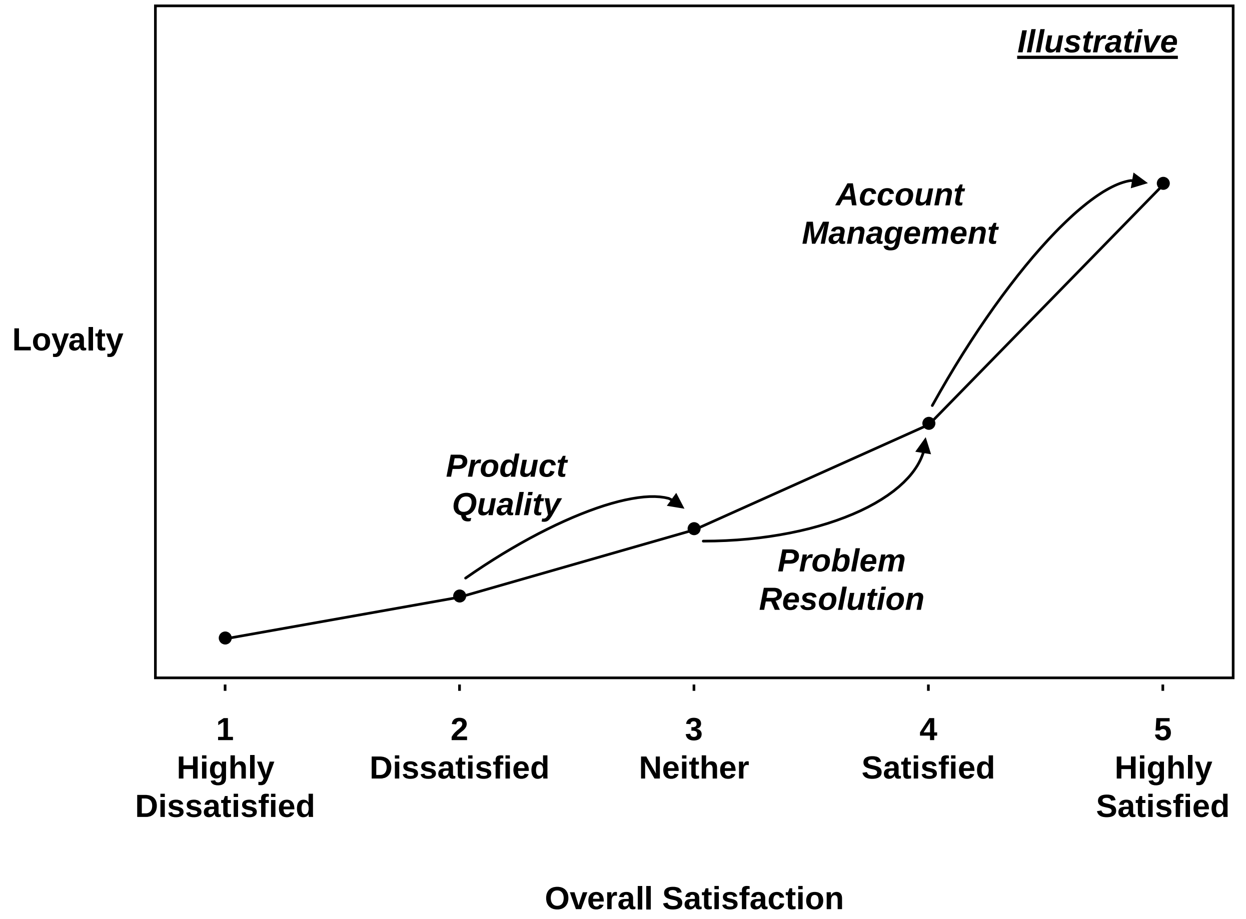
- Customers who are currently “4’s” are the easiest to move to Highly Satisfied

- “4’s” typically constitute the largest portion of your current Customer base (other than those who are already Highly Satisfied)

- Shifting “4’s” to “5’s” has an added benefit—it prevents current “5’s” from retrogressing to “4”

Your “4’s” and “5’s” have a very different set of needs than the remainder of your Customer base

Key Drivers of Customer Satisfaction



Therefore, if you want to maximize “5’s” you must focus your efforts

You Will Never Maximize “5’s” By Trying To Be “All Things To All People”

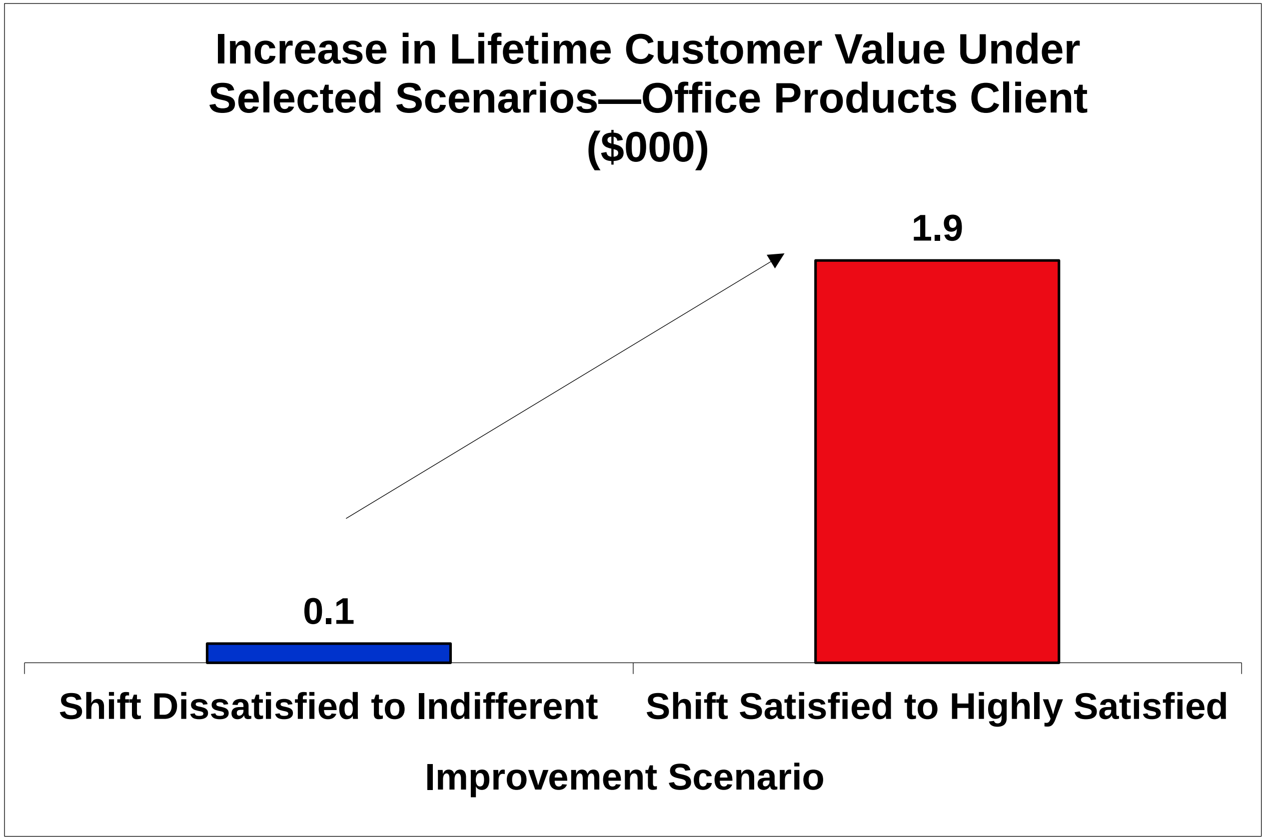
It takes courage to focus on “4’s” to “5’s” at the expense of your less satisfied Customers, but that is what differentiates the winners from the losers in the Loyalty arena. **Nordstrom** knows their target market does not include those customers who stuff the complaint box with requests for more affordable clothing. **Walmart** can safely ignore potential customers looking to buy Armani. You cater to dissatisfied customers at the risk of alienating your loyal base.

Remember: You will never have a clearly defined strategy or game plan for success until you understand to whom you must say “No!”

In spite of this, our experience indicates that most organizations' Customer Satisfaction programs are largely misdirected

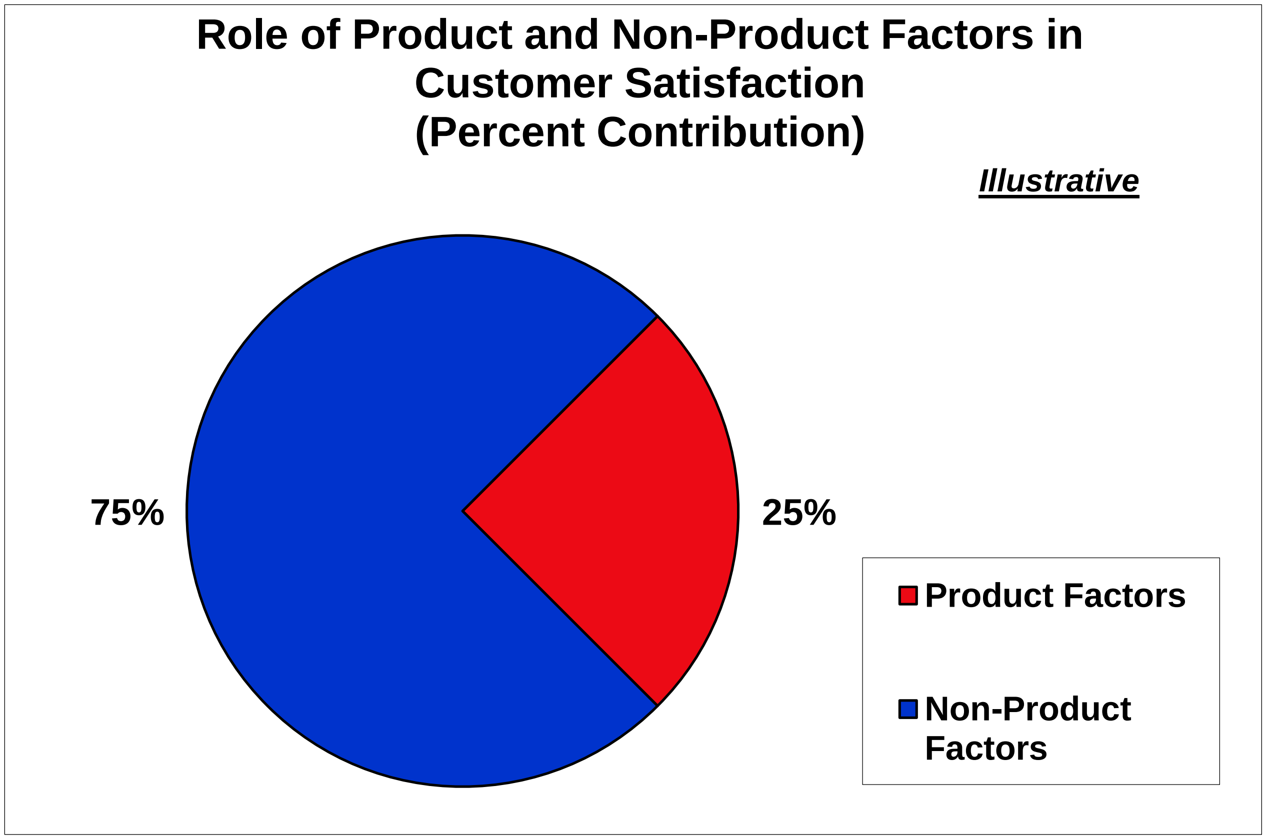
- **90 percent** of the effort is focused on Dissatisfied Customers (e.g., "800" Customer hotline, etc.)
- Yet Dissatisfied Customers represent only a small fraction (typically less than 10 percent) of your Customer base
- As a result, your "4's", who typically constitute 30–40 percent of your Customer base, generally get **ignored**

We do not mean to imply that organizations should **not** respond to complaining Customers - rather, that complaint response needs to be placed in the proper perspective with resources allocated accordingly



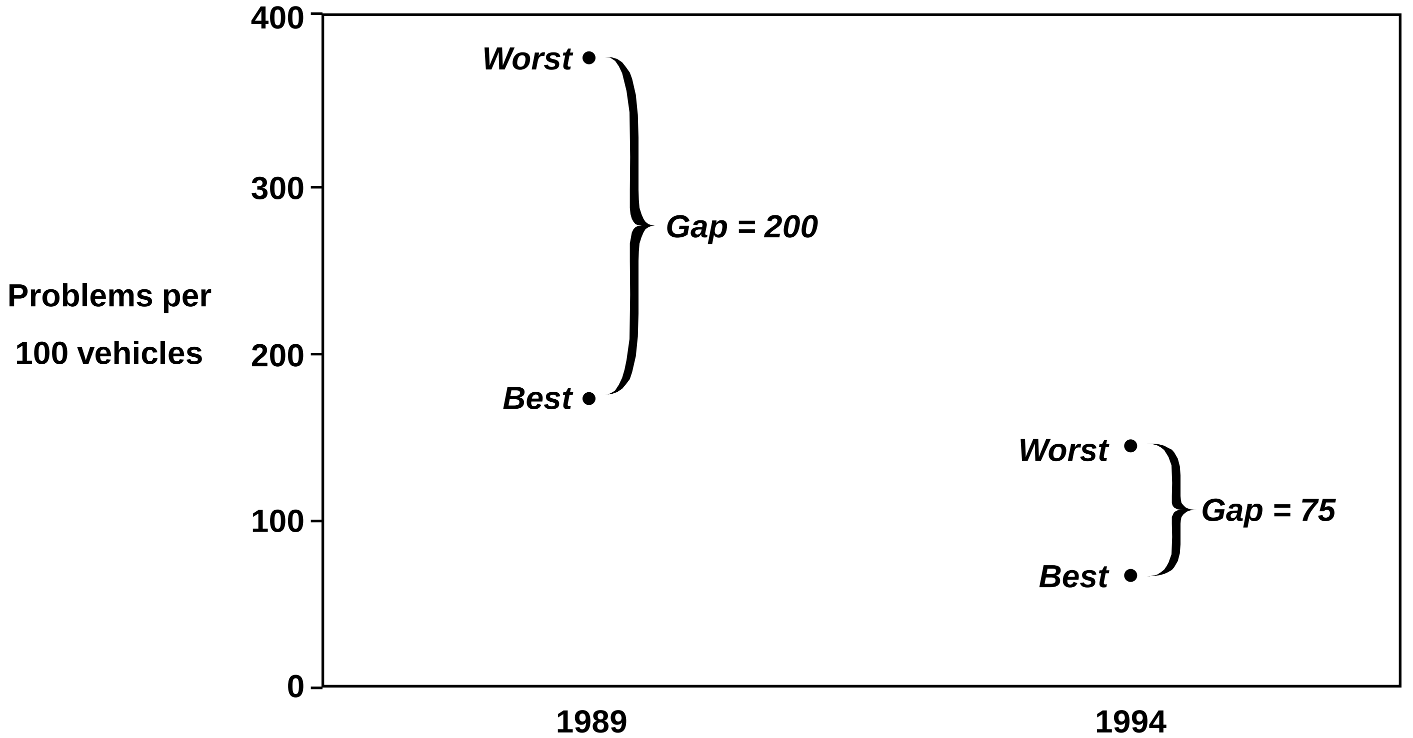
Product Necessary But Not Sufficient

In our experience "product-related" factors typically represent no more than about 25 percent of what is required to create a Highly Satisfied Customer



We have found that competitive dynamics tend to reduce product (and price) differentials over time, leaving non-product issues as the basis for competition

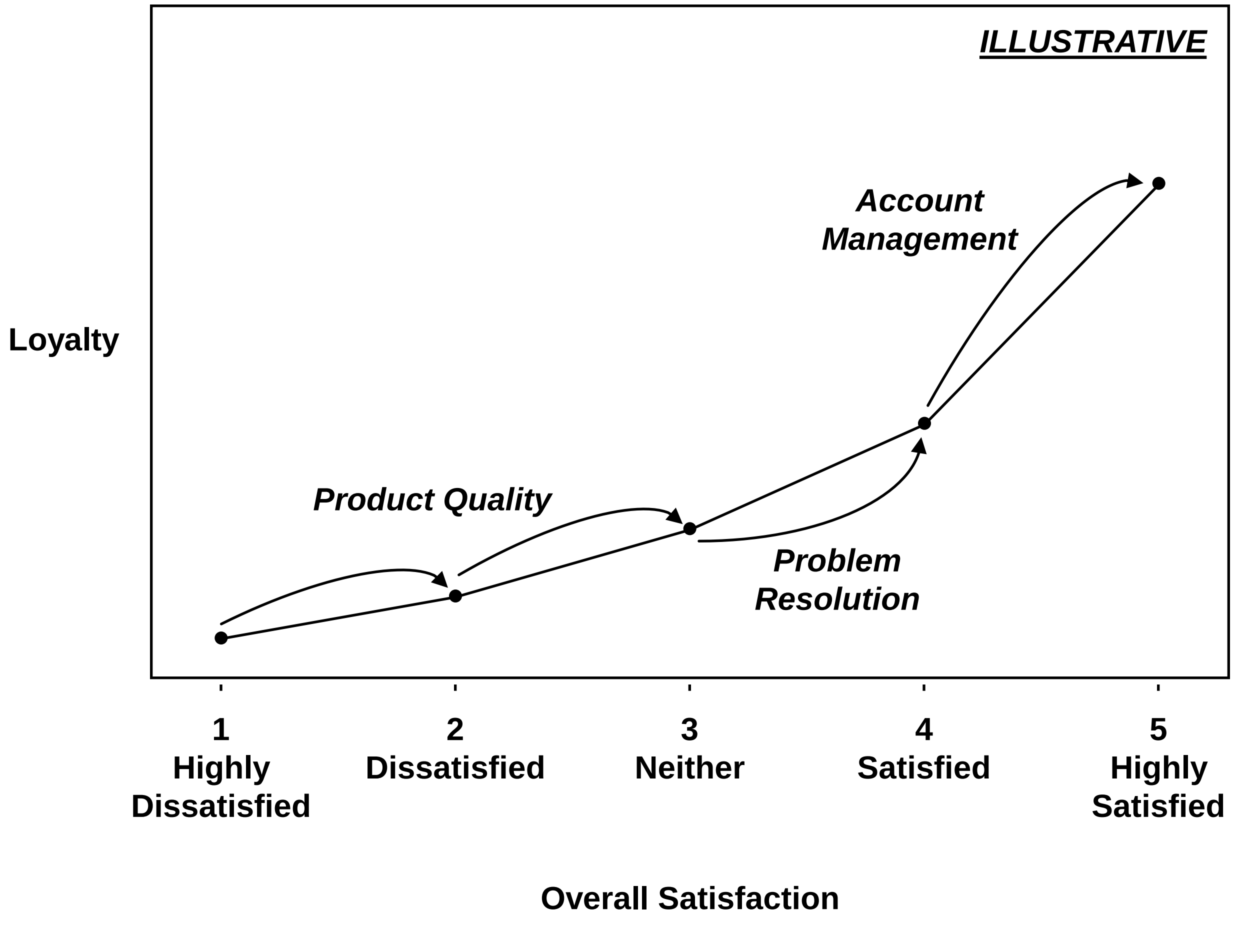
Comparison of Product Defects—U.S. Auto Market, 1989 vs. 1994



Source: J.D. Power and Associates data

Product Quality will move you up the Satisfaction-Loyalty curve, but to get to the top other issues take precedence

Key Drivers of Customer Satisfaction

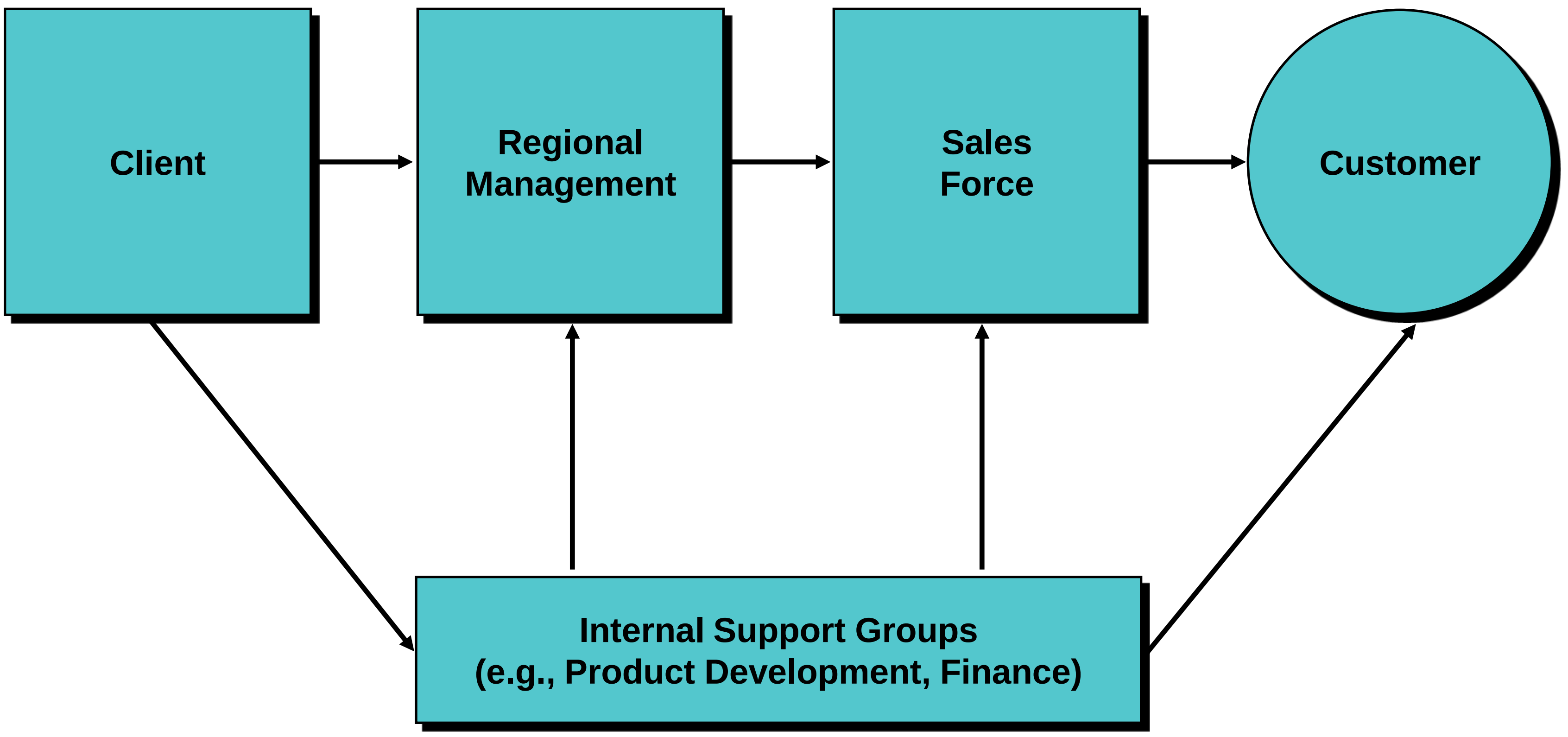


Stated somewhat differently:

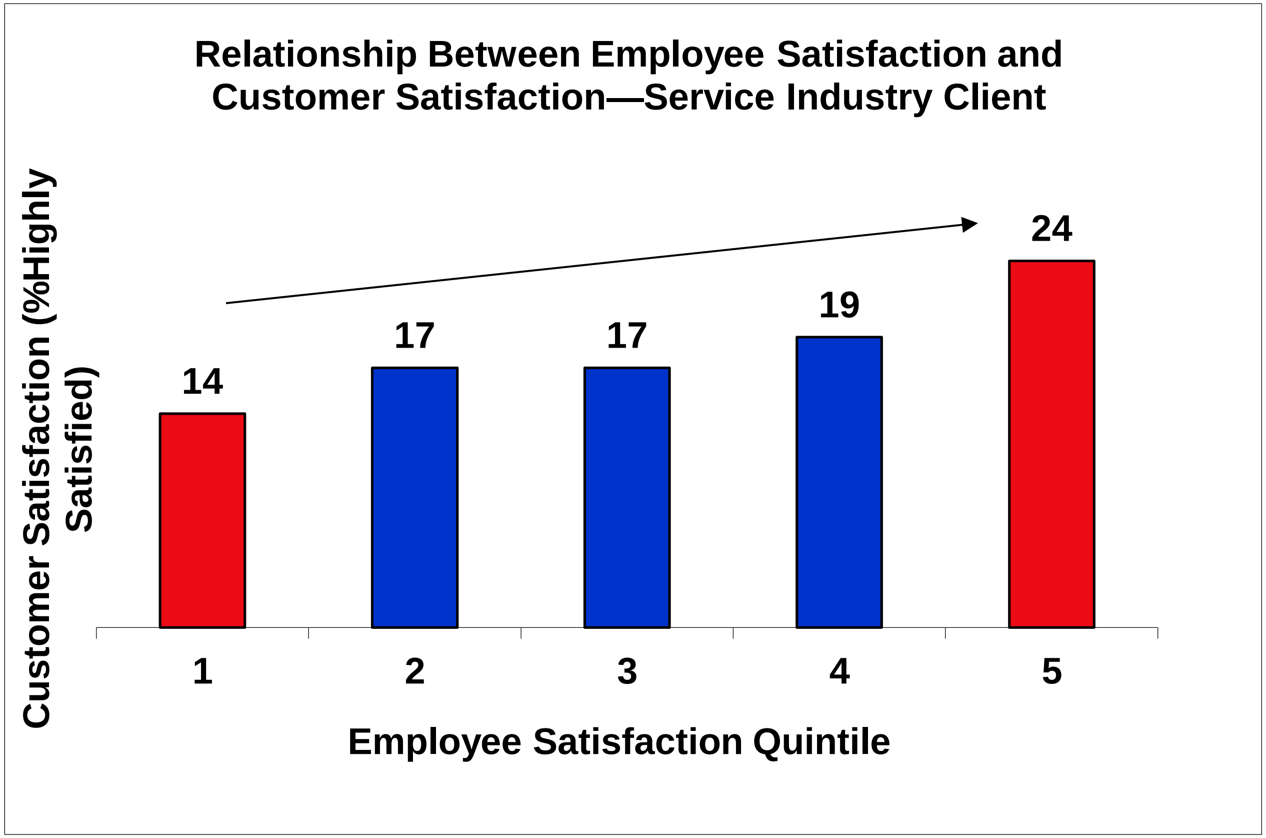
Product Quality And Performance Are Necessary,
<u>But Not Sufficient,</u> Conditions For Creating A
Highly Satisfied Customer

Recognize The Importance Of Employees

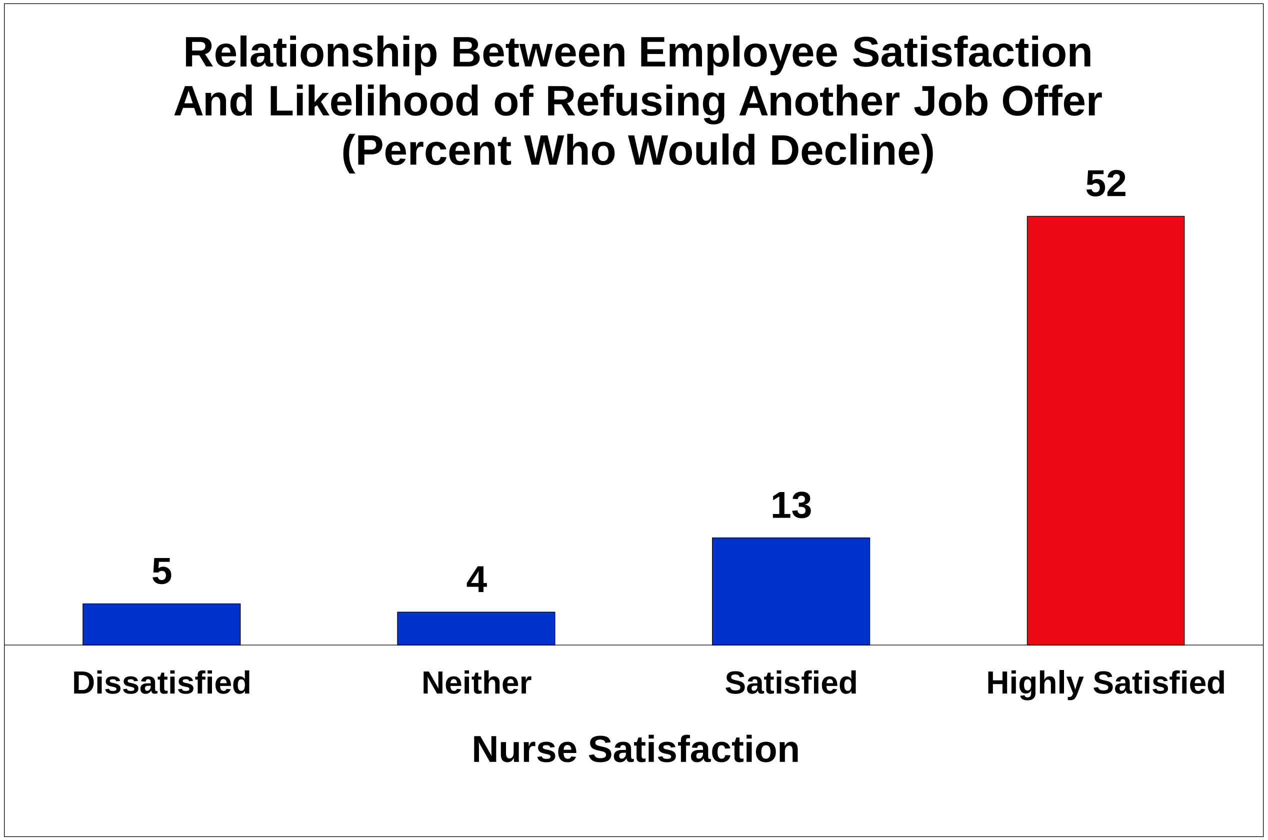
In serving the End Customer, a company serves many other intermediate Customers



As a result, we see a strong relationship between the Satisfaction of key intermediaries and End Customer Satisfaction



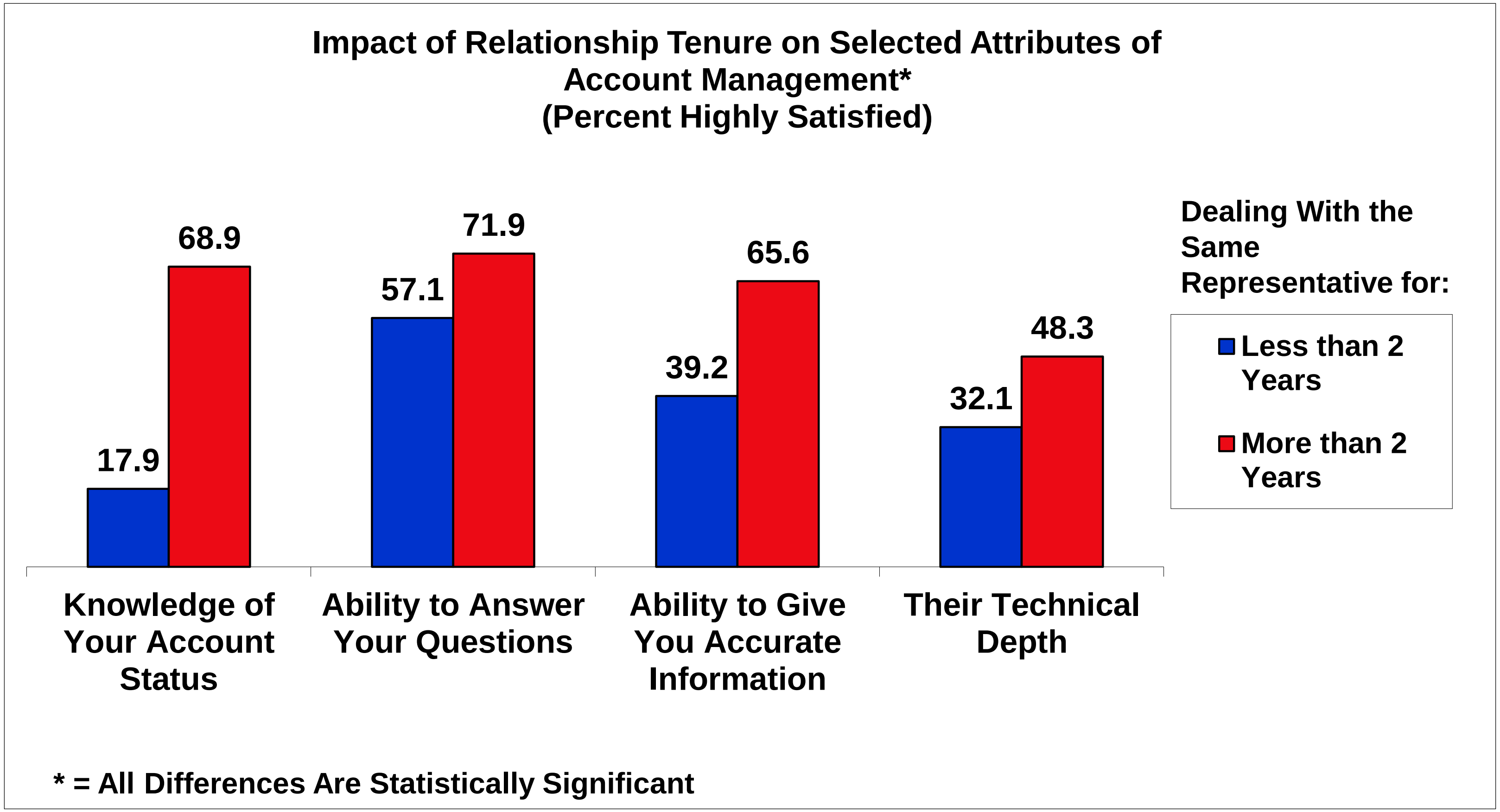
As with Customer Satisfaction, we find that only Highly Satisfied Employees and Services Partners are Loyal to you. For a nationally recognized East Coast teaching hospital we found the following loyalty trend among their nursing staff:



The increased stability that results from high levels of Employee Satisfaction provides a number of benefits that result in better service and greater Customer Satisfaction

- Employees become better at their jobs over time (i.e., a “learning by doing” effect)
- Employees develop a better understanding of the needs of their Customers the longer they deal with them
- Teamwork increases the longer Employees work together as a group
- Long-term Employees have a greater knowledge of the resources available at their companies and how to apply them to meet the needs of their Customers
- Customers are more willing to ask questions and seek the advice and assistance of Employees they know and trust

We have found in business-to-business situations that maintaining stable relationships between the Customer and the sales representative has a very positive impact on Customer Satisfaction,...

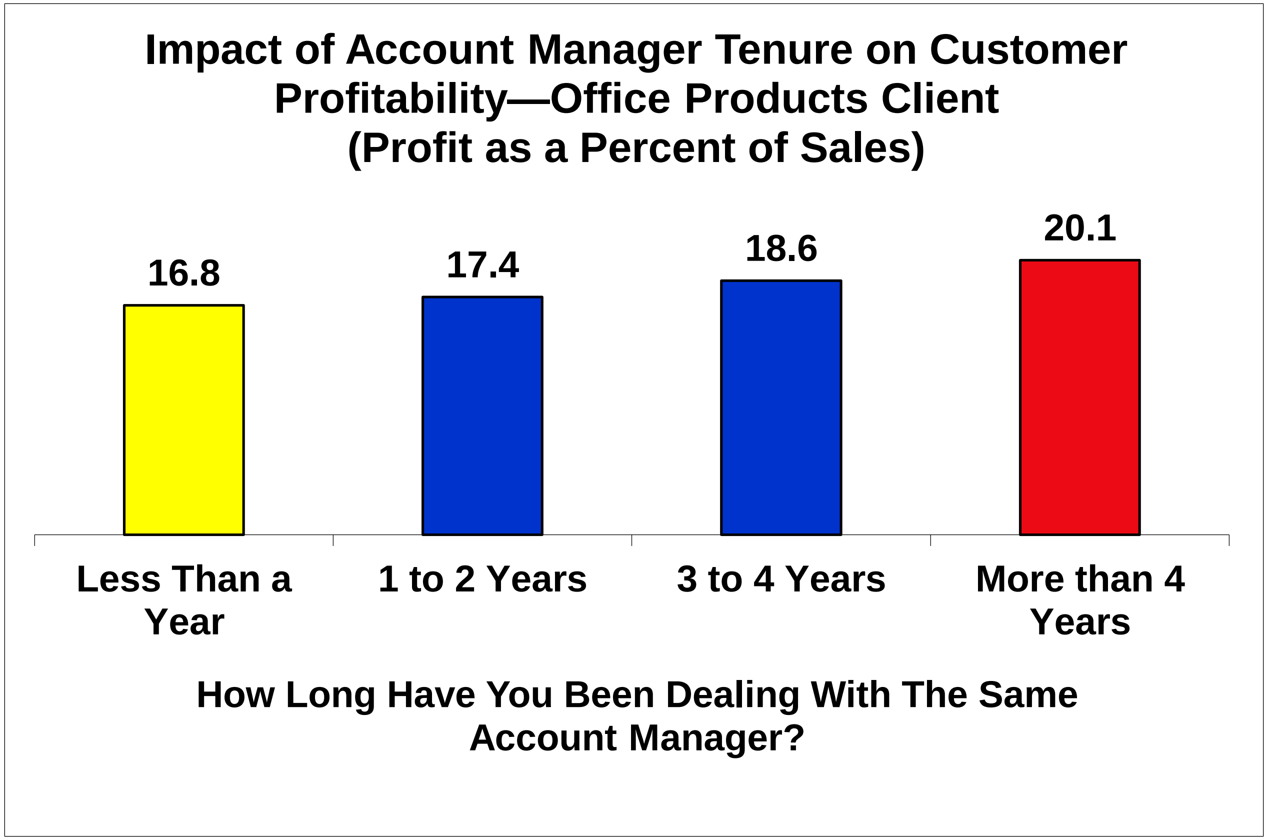


… Share of Wallet,…

Impact of Account Manager Tenure and CSR Stability on Share of Wallet (Percent of Annual Purchases from Client XYZ)

Do You Typically Deal With The Same CSR?	Account Manager Tenure (Yrs.): More Than 2	Account Manager Tenure (Yrs.): Less Than 2
Yes	66.5	55.3
No	51.9	40.7

… and overall profitability



TWO CONCLUDING COMMENTS

Superior Customer Satisfaction performance does not **guarantee** financial success, but it does substantially **increase the odds** of achieving it

- For a retail client we defined excellent performance for an individual store as achieving at least a 10 percentage point increase in sales over the prior year (Same-Store-Sales growth)
- We defined poor performance as negative Same-Store-Sales growth
- We then ranked all their stores from highest to lowest in terms of Top-Box Customer Satisfaction and divided these stores into 4 Satisfaction quartiles
- For each quartile we computed the percentage of stores that were excellent performers as well as the percentage that we poor performers

Our analysis clearly indicated that excellent Customer Satisfaction performance does not guarantee superb financial performance—rather it maximizes the likelihood of success and minimizes the likelihood of poor results

Financial Performance by Customer Satisfaction Quartile—Retail Client

Customer Satisfaction Quartile	Same-Store Sales Performance (Percent of Stores)		Success/Failure Ratio
	Greater Than 10%	Negative	
Top	**28.1%**	**13.5%**	**2.08**
2	19.9%	23.2%	**.85**
3	12.7%	24.3%	**.52**
Bottom	11.2%	27.6%	**.41**

Second, creating Highly Satisfied Customers does not involve something heroic like climbing Mount Everest, flying to the moon or coming up with a cure for an infectious disease—**creating “5’s” is about getting a small number of simple things done correctly for the Customer on a consistent basis.** For example, for a large national retailer we discovered that the most significant drivers of Customer Satisfaction were:

- Greeting Customers when they enter the store
- Offering to walk them to the product
- Checking them out in less than three minutes

It is not about performing Herculean labors; it is about identifying the correct labors in the first place.