Customer Loyalty

- The New Corporate Benchmark

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The Loyalty Effect

It is a well-known fact, but almost impossible to document in most companies, that it is less expensive to keep customers than to find and acquire new ones. Yet, new marketing efforts, incentives based on growth in customers, new sales or even sales calls are often the stated goals. According to Frederick Reichheld (author of the best selling book: *The Loyalty Effect*[1]), just about everything that's done in business today is wrong. In our haste to cut costs, we've created a generation of:

- Disposable employees, unable to trust the companies they work for;
- Job surfing careerists, who view more than three years with the same company as the death-knell for their careers;
- Fickle customers, who think only about price;
- Fast-money speculators, intent on milking one company and then moving on to the next;
- Short-term managers, who care only about quarterly profits.

When Reichheld first spoke up to suggest that there might be a place for loyalty in the modern company, he was unanimously shouted down. But not any more.

The Loyalty Effect takes a long, detailed look at the economics of loyalty, providing concrete examples to support the conclusion that the goal of a business must be the creation of sustainable value for customers, employees and investors.

Reichheld addressed delegates from the Institute of Direct Marketing on the subject of Customer Loyalty. What he had to say appears on the following pages.

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Fred Reichheld is the founder of Bain & Company's Loyalty Practice which helps business leaders to achieve superior results through improvements in customer, employee and investor loyalty. His pioneering work in the area of customer, employee and investor retention has quantified the linkage between value, loyalty and profits.

FREDERICK REICHHELD

"Loyalty - The New Corporate Benchmark"

"Well, this subject of loyalty is one I have been struggling with for the last ten or fifteen years at least and to hear myself now introduced as a leading expert on the subject is in some ways very pleasing but on the other it constrains my options for the future. My wife, who has been my greatest supporter since I decided to become an expert on the subject of loyalty, thought that was just a wonderful idea, has given me so much positive feedback. I don't know if you have in Britain vanity license plates for your cars where you can actually print words on it, lots of people have sports teams and so forth. Well my wife got me *loyalty* as my brand and so I drive around my home town in a car that says "loyalty" on it and I thought that was sort of nice until I noticed the police trailing me around. They presumed that someone with that kind of brand positioning had to be associated with organised crime. They thought it was a Mafia connection - who else would say loyalty above all else. You know there is truth there. My partners at Bain & company have had mixed feelings about making loyalty my prime focus in life. Not that they didn't want me to be loyal to them or that they didn't want to be loyal to me but the whole idea was a little confusing. For example, for them to be loyal, does that mean that I can be a partner at Bain for the rest of my life, irrespective of whether I create any value for the firm. Or conversely, I have seen a long string of people, in the consulting business primarily, where you would write a book in the hopes that it would become a best seller (which I was lucky enough to do). But then when the best seller was on the subject of loyalty you couldn't go the next step which is break off and go on your own and create your own firm. Because if (at least in my subject, I hadn't thought this through) loyalty is what you are trying to be an expert in, you really can't leave your partners behind and go off on your own. So here I am still with Bain & Company, wondering what this loyalty is that I am trying to explain.

I have learned a great deal. I am working on a new book with Harvard Business School Press, which I will mix into this discussion. I hope it is not too confusing but the more I have worked on the subject of loyalty the more convinced I have become that it is not simply a subject for a group like yourselves who are focusing on one component, customer loyalty. Even within customer loyalty I think many of you probably focus on the kind of communication with the customer you can have through direct communication. That is a fundamentally important component but it is very hard to make much progress unless it is in a framework where the leadership of the firm also thinks about loyalty in a constructive way. I have titled this talk *"The leader's ultimate challenge"*. Why would loyalty be the leader's ultimate challenge? In this day and age where there is a war for talent and a war for customers, it is sort of common sense that great leaders are those people, men and women who can command the commitment of people around them that sets them apart. And I do think that thinking about loyalty as the litmus test of great leadership is not a bad way to start with this.

I run a series of classes back in the US, executive seminars for chief executives and the next level down in organisations, those who aspire to become chief executives, and they focus on this subject. "How can I make, how can I inspire the loyalty of my customers and employees?" Which I think is a pretty good thing to focus your thinking on. And they come away at the end of two days recognising that the only way that you can make your customers and employees more loyal to you is for you to be more loyal to them. That loyalty is a two-way street and that, of course, raises the question "How is it, if what I really want to do, and I think this goes for you as well, throughout the organisation how can I make my customers look more loyal to me?" The real question you are trying to ask yourselves is "How can I be more loyal to them? How can I treat them in a manner that is worthy of their commitment and trust, of their loyalty?" And when you reverse that I think it becomes much clearer how you can take practical steps to make it come about.

How it Works

The following simple worked example on customer retention rates is quoted directly from The Loyalty Effect:

First count the number of customers who defect over a period of several months, then annualise this figure and express it as a fraction of the customer base you began with. Say you lose 50 out of 1000 customers over the course of three months. This works out to 200 customers a year, or one-fifth of all the customers you had at the outset.
The second step is to invert, which simply means turning the fraction upside down. One-fifth is inverted to 5 over 1, or 5. Presto: your average customer stays with you five years. (In percentage terms, which is how we usually express these ratios, losing one-fifth of your customers means your defection rate is 20 percent, and your retention rate, consequently, is 80 percent).

Now, one of the greatest challenges for all of us who care about earning the loyalty of people, of treating them the right way, is that they have some portion of their brain that has been convinced, it has been, brainwashed maybe the wrong word, but certainly close to brainwashed, that loyalty in the arena of business is a joke, it is absurd.

When my book came out, within a week the Wall Street Journal had a headline that I like to review. Here's what they think about loyalty [here, Mr Reichheld referred to his slides]. Now, after I had spent three to four years of my life writing this book. I am a slow writer but I finally got it done and I know timing is everything. So when you come to market with one of the 50,000 business books, it is a matter of luck. And for people to have this headline the week my book comes out I thought there's three, four years down the tubes - what do I do now? I hope my partners are loyal to me because I haven't been doing much for them. Why would people say this? It's layoffs 10,000 layoffs, customers surfing the internet for the best deal, every day, the whole notion of loyalty seems absurd. I feel the same way a little bit myself. When I got out of the Harvard Business School a little over twenty years ago the advice was "make sure you change companies every three or four years because you career surf your way to the top that way and if you are very ambitious and you want to have a big impact then you will." And I thought, that's inconsistent with loyalty. I have had executive recruiters call me on the phone. Actually not much lately but up until 10 years ago warning me that if I didn't make the shift soon that my résumé would be, useless because it is so clear that someone who stays one place has no ambition, no breadth, no hopes of doing something important with their life. That is why loyalty is dead, dead, dead.

Now my wife, who as I said, has been a great supporter on this quest of mine, said, don't worry too much this is the Wall Street Journal after all. They are not in some great quest for truth. This is journalism. This is about entertainment, They are just trying to sell newspapers and so wait until next week until the other ones come out and take the opposite point of view because who would bother to read the weeklies if they always agreed with the things that the dailies like the Wall Street Journal - it's common sense. I said: "that's brilliant".
So here's Fortune magazine comes back two weeks and says "No" we're going even.. [here, Mr Reichheld referred to his slides]. Is it worse to be dead or to cease to exist? I was wrestling with that metaphysical conundrum for quite a while trying to gear myself up and take the optimistic point of view which I always try to do but it's hard to sometimes. And why would corporate loyalty cease to exist? I got a recent quote from Fortune. I want to read it to you… because not all loyalty, it's impossible for loyalty to cease to exist - there would just be nothing - it's what you're loyal too that is the question. Like the executive recruiters, you want to be loyal to yourself, create self interest-that's one kind of loyalty. But what Fortune had to say: "The primacy of shareholder value is one tide that is unlikely to turn in our lifetime." You like that? That's not a new idea They taught me at Harvard Business School about shareholder value - if you maximise shareholder value, you are really doing something almost religiously wonderful because it's an ethically pure motive to maximise shareholder value. Adam Smith's invisible hand will allocate resources in the right place, capitalism will triumph and we are all better off as a society. You know there is something sort of true about that - sort of - but there is also something deeply wrong with the way it is applied today. And I'll get into that in one second, why that is.

Is loyalty to your shareholders a good thing?

Probably. Loyalty to most people is a good thing but what does it mean? Some people think that loyalty isn't dead (that's the good news) but boy! It would be a much better world if it were dead because it is getting in the way of change and progress. This too, I am ticking down some of these notions that are wrapped up within the word loyalty and most people don't bother to tease it apart and think about. Many chief executives of my clients, especially Europeans, would like me to stop talking about loyalty because they have got too much of that, thank you. They have way too many employees that they consider dead wood, who aren't being loyal to the company or to them or frankly to the customers because they are not adding more value than they are costing in salary and benefits. And those people have started using loyalty as a defence for not changing and not feeling compelled to progress. And you've probably heard that. So is loyalty good or bad? Well if we could stamp it out, would it be a better place?

And Tom Peters, always there with a pithy quote to capture the spirit of the moment "Forget loyalty, try loyalty to your Rolodex". I know you probably don't remember what Rolodexes are now we are in a computer society but it's loyalty to your own career, make sure you build your own network of customers, contacts and... Because, heaven sakes, you can't rely on your company, your corporation to be loyal to you. It's impossible in this day and age. The fellows running the firm have to be loyal to their shareholders? What is shareholder loyalty? Stupidity, to stick with a loser even if it is headed down. Well the Harvard Business School, right up there with Tom Peters in being able to capture the essence in just a few words or a symbol, paid me the great honour of making one of my articles their lead article in an edition, several years ago now. And when they do that they have to come up with a cartoon or an icon or something that captures the essence of loyalty. So here you see what they did.

They called me by the way and said: "Fred, We have great news, (It's hard coming up with one symbol that is a caricature of loyalty - that is hard) but then they said "it's a dog" and I said: "That's great". I had this picture in my mind of a Saint Bernard risking its own life saving someone in an avalanche.

And I said: They've finally got it - loyalty - really it is fundamental to a good life. But no, it's a stupid mutt who is being obedient [here, Mr Reichheld referred to his slides] and, here's the sad thing, many people come to hear me speak to learn how to get this kind of loyalty because what they want is customers who will be obedient and do what they want. Even though it is not very good value, even though it is not something you would want done, not a golden rule kind of treatment. They want... I won't, well I will. Bankers, for example, have hired me to get more dumb customers. What is a dumb customer? Someone who is willing to take a low rate of interest, even when there are better alternatives in the marketplace. They think of those as loyal customers and I think of them as idiot customers and yet (you know) - the client is always right. No, the client is not always right.

So what is loyalty if it is not to your client or your employees? I think the only way this stops being confusing is if you think about loyalty as being to a higher set of principles that guide your life. And they are pretty simple, the golden rules, and some of the basics that have been around for centuries - they're pretty good. And if you think of all of these things in that frame, I believe it will make more sense to you. For example, you all know this statistic. This is old but tuck this away in your brain that a 5% change in customer retention rates will swing profits and growth by between 25% and 100%. It's one of those simple notions but I find that most companies still don't measure retention rates very rigorously. I can tap the CEO on the shoulder and ask him "By the way what happened to your earnings per share" and they will know to two or three significant decimal places. I ask, "What is your turnover rate of employees" and they roughly know; "What's your turnover rate of customers?" they have no idea. They may bluster some number but they really have no idea, which is really astonishing. Because if you believe this, that a 5% shift in retention rate drove profits and growth by such an astonishing amount to 25 to 100% depending upon the industry, wouldn't you measure it perfectly. And yet there is a disconnect. And I think to some degree this lack of follow through of rigorous measure, is one of the challenges we all have in making loyalty a focal point of business.

Why customer retention rates?

Well, what better way to see if you have been loyal? Back to my idea - you want customers to be loyal to you, have you been loyal to them. If you have been loyal to them, customers come back for more, voluntarily. They don't need long term contracts to lock them in, they don't need exit barriers which you learn about in business school strategy. You need to treat them in a way that makes them come back for more. If you lose customers it is the best vote of no confidence around and it means that you have failed.

This leads to a framework of thinking about business that is a little different. It is different than maximised shareholder value. Well, it's not really different but it puts it in a different light. It says "the purpose of a business is to create value and share it with your partners" and when you share it effectively your partners stick around. Unlike today, and these haven't changed much over the years, 15% to 20% of customers continue to defect from the typical businesses. Is that good or bad? To me that's outrageously awful. That means that it takes only five years for you to lose half your customers. How can you feel proud about coming to your job every day when you are so mediocre in being loyal to your customers that most of them would rather go down the street and do business with strangers within five years? It is hard to get excited about a job that's not worthy. Of course it shows up in the employee statistics, 10% to 30% turnover rates. This used to be true for North America, now we find it exported to the UK and the Continent. Huge turnover of employees, well it's not shocking when they know that their companies cannot afford to be loyal to them and offer them long-term careers and at the same time they know that people working on either side within three years are going to be gone. So why should I as an employee do the right thing and stick for the long term - it's absurd and, by the way, how can I feel proud when half my customers are telling me I am mediocre and they would rather do business with strangers. You can see why loyalty is starting to go down in a cycle.

Investors - now I don't take the view that investor loyalty is a bad thing. I want investors to be loyal to me and I want to serve them in a way that makes me proud. But what has got out of whack is shareholder value as, somehow, a more important force in our future success. There is an irony here, despite this fixation, 50% investor churn that's actually misinformation. Let me bring you up to date. Investor churn rates in 1960 were 12%. Maximising shareholder value is a really good thing. 12% churn is something in the order of nine years average tenure, length of investment. So if you are going to maximise value for someone that is going to be with you for nine or ten years it is a good thing. You can't take short cuts. You must have loyal customers and loyal employees if you are going to serve a long-term investor. So capitalism used to be based on very solid foundations. Then in 1970 churn rates crept up, disloyalty crept up and up until last month I saw the statistics for the New York Stock Exchange. The first quarter of 1999 annualised leads to investor churn rates of 90% a year. So picture the wonderful situation of a CEO being owned by a group of people who couldn't care less about the future success of long-term customers and long-term employees because the investor will have sold their shares within a few months. I think today it is actually running over 100%. It has never been that fast since the 1928/29-recession-depression.

So this notion of loyalty is quite confusing. What do you do about it? I think, luckily, there are role models to think about following; because, while the average company is losing half of their customers ever five years, half of their employees every three years, half of their investors every six months, there are a set of companies you can look to who have remembered that loyalty really is about fundamental commitment to the things that count in life and they have demonstrated that you can get rich. You can't just grow and create lasting value - you can become billionaires if you do that very effectively. Let me start with a few of these. I hope they cover some of the industries that you are engaged in now. I am going to cover as many different perspectives as I can.

I'll start with *Chick-fil-A* because I find it one of the most interesting. I know they don't do business here. They are in South Africa. *Chick-fil-A* turns over about $1 billion in sales via a fast food restaurant chain. What do I have to learn from them about loyalty? Well, that is what I said because I had never heard of *Chick-fil-A* but one of my friends said: "They have 5% turnover rates of their employees" in a world where McDonalds and Pizzahut turnover rates are 40% to 50%.

That's pretty bizarre because my Harvard Business School mind says '5% turnover rates that's 20 year' careers in the same chicken sandwich shop. That's a lot of grease that will build up on your shoes. What kind of people would be willing to wreck their lives by staying in the same chicken sandwich restaurant?

So, I interviewed some of these people. Bain is a real fact-driven place so I didn't let my biases overwhelm me. I talked to some of these guys. Actually I did some phone interviews because I was a little afraid to meet someone who would stay in a restaurant. So I was thinking, what do they put in the chicken that would keep people for all those years? So you know what I found though - instead of what I thought... They focus on the South Eastern United States and they had a reputation in the Harvard's and Yale's of the world Southern Baptist, sort of a cult, it's a religious thing. So I am looking for people who are different from me; and what do I find -"Why do you stay there so long? Well, we are proud to treat people the way *Chick-fil-A* treats us as partners and allows us to treat our customers and that's one reason we stay here for as long as we do, and the other is we earn twice as much money as they would pay us at McDonalds or Pizzahut. And I say it is a religious cult because, you know the fast food business, you know how price sensitive it is? There is no way on earth that you can afford to overpay your most important employees by two or three times and, this is a private company, and generate the cash flow to build a billion dollar firm.

Because I also knew that the founder of this company is a billionaire, you can't afford to overpay people when you are generating your own cash. Every one of these stores costs about a million dollars to build now. There are eight hundred of them. Eight hundred times one million - that's a lot of cash to generate and overpay your people. And I knew they were closed on Sundays (this was the religious cult thing) and I go: "Why do you close on Sundays?" and they say: "Well, it is the Bible, but you know, more than anything it is practical. We want owner operators on site and we know you can't run a business seven days a week. So it just sort of fit that we close on Sundays and we could actually have the same person run the store that does everything else and not have to hire flunkies." I said "Okay" and then like every other... Oh I didn't tell you the facts. You know I didn't believe this overpay thing. Do you know how much the top *Chick-fil-A* operators earn? This is for running one chicken sandwich shop, maybe two. $40,000 is the average compensation for a Pizzahut or McDonalds store operator. $40,000. The top *Chick-fil-A* operators earn over $300,000 a year without ever having put up any equity of their own. What happens, you are rigorous, analytical people, I can tell. I can tell by the number of notes I hear being scratched out there. Well.. How? You can't pay $300,000 that's just ridiculous and it doesn't fit my world view. So like all you analysts out there, I just think, a data point that doesn't fit - get rid of it. It's got to be an outliner. Correct? So I managed to forget it, purge it from my memory but not completely until I run into VanGuard Mutual Funds.

Vanguard also isn't a household name here I know but it is the second largest family of mutual funds in North America. Growing like Topsy -30% per year growth for the last twenty years, year in year out. This is not because of the market boom. Vanguard Mutual Funds started when I got out of college in 1974, now they have $500 billion in assets under management, not through big acquisitions. This is consumers like you and me with their own hard earned cash putting it in savings and I asked the guy who founded this "How did you do this? You are a mutual, you can't get all this crazy money from the stock market to finance your growth and yet you are number two." Most people predict, I think everyone predicts they will be number one given their successful track record. He said "Well, you know we have the highest retention of customers in the industry?" And I thought he might but I didn't know that. But he knew to several decimal places what the retention rate is of his own company versus his competition, and he went on to explain to me why that meant he was growing faster, and why it meant that he was lower cost (lower costs, I'll show you the facts in a minute) but their cost structure is about one fourth the level of a typical mutual fund in North America and I have never heard anyone say "I am low cost because I have high customer retention". I always thought you had to do great things, spend a lot of money on customers that made you high cost but he is saying "No, no, no". And then I say: "You're low cost, you don't pay your employees very much - that doesn't seem very loyal". He says "No, we pay 30% above market". Suddenly it clicks and I say: "You don't close on Sunday, do you?" He says: "No, we close Saturdays and Sundays because we find that people who work for us don't, you know, 24 hour days don't work." So I am thinking Wow.

Enterprise Rent-A-Car. Have you heard of Enterprise yet? You will. Enterprise is the largest car rental company in North America. I believe it will be the largest car rental company in the world before too long. It was founded in St Louis Missouri. I went to St Louis. Private company. The guy who owns this private firm is reputed to be worth $5-lO billion. It is quite a success story. And I ask him "How did you profit at other people's expense?" Like all the professors teach you, you must. "You must have gouged a lot of people to get this rich? He said "No, we think of partnership, we actually try to create partnerships with our people. We have the highest loyalty in our business, we have the highest retention rate of customers, we measure that, and we have the highest retention rate of our employees. We try to give them a chance to earn more money (I'll show you the facts on that in a second) and of course we are the lowest costs. Our prices are 30% below the prices of Hertz and Avis at the airport." I say "Wait a minute, over paying people and yet you are low cost, growing like Topsy, generating enough cash and loyalty is the fundamental driver of this - that's pretty interesting".

And you go on, State Farm, I won't go into detail right now. State Farm is the best, in my mind, insurance company in the United States. You know where Direct Line just took over your insurance market so quickly with efficiencies of direct communication. It hasn't happened in the United States. Why? Because State Farm that operates through agents, has done such a great job of delivering value to their customers. They have the highest customer retention rate of all the insurance companies. You talk to the guys at their headquarters, the CEO; he says: "You have a frequent flyer scheme that I haven't heard of with marketing wizards? No. Loyalty is about giving people best value year in year out and if you mess up they'll give you a chance to fix it. That's what customer loyalty is about and they measure it. They have the most loyal agency force. Agents on State Farms stay 20 years on average, they earn what doctors and lawyers earn, as insurance agents, which doesn't seem fair. It seems inconsistent with giving great value to your customers - the kind of value that would have customers coming back for more. Oh! They're a mutual; $38 billion of retained profits on their balance sheet. It's one of the largest pools of retained earnings on Earth, all in the same place, where they're over-compensating people and over-compensating customers.

What I hope I am hammering in is - loyalty isn't about trade-offs, loyalty isn't about not maximising value for your investor at the expense of a customer. Loyalty is about treating people with the highest standards where your hope is to be loyal to them; and the only test of how loyal you have been is - do they come back for more? Harley Davidson, you've heard of; they're not big, but I've got to tell you this; they claim (I watch for this) they claim to have the most loyal customer base on Earth. That's a nice humble point of view, isn't it? You know why they say that? They say they measure not retention rates of customers, but the percentage of their customers that tattoo the Harley logo on various body parts. Certain body parts count more - the weight average - so Harley truly is a cult and the guys that run that think the same way. They measure loyalty, they think about how they can be loyal to their employees. I walked through a Harley plant where they build these motorcycles that make the huge noise and these guys who have beards and tattoos and are built like motorcycle guys -they're talking about relationships and loyalty and how they can treat people with dignity and respect. It just boggled my mind.

But at the core of Harley Davidson, trust me, is a company that understands loyalty at its most fundamental levels. Oh, and they're a public company. You think they give lousy returns to their investors? Harley Davidson ranks just after Microsoft, and Microsoft and Home Depot bracket them in terms of returns to shareholders over the last ten years. Fortune magazine did a list, I think there are only 17 companies on the Fortune 1000 that returned over 30% per year to investors over that whole decade, and Harley Davidson was in the middle of that pack. Awesome! So loyalty's dead? And you talk to these people and they say 'Yeah, we're glad that everyone thinks loyalty is dead because loyalty is at the core of our success.' I will mention North Western Mutual, which is the life insurance company that deserves the loyalty leader moniker in the US, MBNA, the credit card company who has started to expand to the UK from what I understand. The New York Times has a 92% retention rate in the newspaper business which, I think, a typical newspaper might have 60% retention rate or 70%. Nordstrom, the department store has earned that.

How do they do it? They recognise what loyalty is not, it doesn't start with frequent flyer bonus schemes and it doesn't start with a cafeteria of benefits for employees and treating employees well, it actually starts at a much higher level. It's the principles that guides a leader's life and that's the centre. What are the principles? I hope this is helpful. I call this the 'pillars of partnership'. Loyalty, it seems, only comes from building relationships on the basis of letting them earn their way into partnership, whether it's customers, employees, suppliers - people are people - the same kind of things drive their loyalty. At the core is leadership. What are the principles that leadership puts in place? One: strategy. You don't hear people talk about strategy when you hear loyalty. You expect 'treat everybody nice' and 'golden rule' but loyalty in business is founded on the same kind of real economic advantage that, how can you possibly be loyal to someone unless you have built the economic engine that lets you treat them well? Values? But it's also about treating people right more than economics. Selecting the right kind of partners, the people to whom you can be loyal, communicating in an honest way with them, aligning rewards effectively and then finally setting the right goals. If you have those pillars in place, and I will guarantee you're in a position today that can affect several of these pillars, communication is an honest one. But you'll see, I hope, ways where you can link your own job to making these principles come to life in your own organisation because when they are in place you can start talking about trust and partnership and loyalty in the right sense of the word.

Let's start with strategy. What do I mean by strategy? Charlie Collie of MBNA, the credit card company, puts the same thing on his annual report every year, it's been on the cover of his annual report since they went public, seven, eight, nine years ago:

"Success is getting and keeping the right customers."

Boy! Is that a bunch of nothing from a public services company?

What's different about MBNA? The size, that they're growing faster than anyone in the industry, they have, without any major acquisitions become the third largest on earth of the bank card issuers, making many millionaires. They measure it. They actually put the retention rate of customers in their annual reports, so they've turned this platitude of 'be nice to your customers - get the right customers and keep them' into a science by measuring and managing. Part of that science is something I have talked about for many years but still people resist getting the facts. There are economics associated with customer loyalty that you have to understand in your business if you're going to turn it into a science and make it part of the fundamental management system and build it into the strategy of your company. This is the model, I won't go through it in depth, I've written about it many times and this is what it looks like. 'Can you do this for your business?' is the test. For MBNA, they know - well this is a little bit outdated -$51 was the cost of bringing in a new customer.

The reason I use old data is because it's not proprietary. They have updated this every quarter. They know it for segments of their customer base. If a customer stays in the credit card business it's a string of positive cash flows that they measure. Why? Well, long term credit card customers tend to have lower charge offs, they tend to consolidate their balances on their favourite cards. There are all sorts of advantages of long-term customers. In addition to just getting the business each year which helps you grow. On the bottom is retention rate. All of you know this: retention rate gives you the average duration of a customer. 90% retention is the same as 10-year duration. 80% is the same as 5-year duration and then I like to compare this to, why is retention such a powerful driver of cash flow. How can you afford to over compensate *Chick-fil-A* store managers and give their customers great value and make the founder a billionaire?

Well take MBNA. Their retention is much better than 90% but let’s say 90% for simplicity. That's their set of cash flows that forms the economic molecule, the molecular basis of their company. Compare it to somebody who has 80% retention, which is 5 year duration, which is about average for the business and you say 'For the $51 those guys have to put out they don't get nearly the string of cash inflows.'

Just to give you a sense of what a good business credit card was, and is for MBNA, how many of you have investment opportunities where you can put out $51 and then get a string of cash flows that look like that for 10 years? The answer is not many. At least not many of you who don't participate in illegal gambling schemes because that's over 100% return. That's 100% interest rate per year. That's awesome. MBNA knew that as that's the framework they thought about their business. The internal rate of return for the average credit card is quite average and you thought 'This is how enterprise is taking over from Hertz and Avis and getting rich as Hertz and Avis look like the lower set of blue bars versus enterprise. State Farm looks like the top set versus their competition.' There really is a strategic cash generation difference. A fundamental difference between loyalty leader companies. You can't skip this step. If you try to implement loyalty approaches without getting the basic economics required for strategy it won't go very far because business really is based on realities of cash flow.

If you understand the world that way it leads you to some very different strategies. How you, for instance, manage your pricing. Pricing is one of my favourites. You know how you get new customers in the door. You give them a deal, give them a discount. Then if somebody is silly enough to stick around, you get a dumb one. If you get an ignorant customer on the line, you raise the price. I don't need to tell you this, you learnt this in business school, or wherever you were trained. Magazine subscriptions are the classic. You get a cheap, special deal and then, if you like it you renew and if you're silly enough to renew you pay twice as much money and then, if you do it for the second and third year you pay more and more until you're paying five times as much as a new subscriber and finally everyone figures it out. Nobody is stupid enough to keep renewing for 20 or 30 years. Magazines wonder why we have turn rates of 40 or 50% a year and can't get enough dumb customers to stay with us because the pricing it's gauging, it's disloyal pricing. Is it just magazines? No it's actually most companies.

Do you work with automobiles companies or heavy equipment or computer manufacturers? It is the same philosophy that has crept into - it's an anti-loyalty philosophy which means get them in the door with a cheap, let's say, computer but then we're going to make our money back on the service contract. Or if I buy office equipment or elevators, or anything. Quite often you'll have most of the profits being earned in the "out years" through aggressive pricing on service contracting or spare parts or advisory services.

So what do loyalty leaders do? They charge top dollar for a new customer because they think of pricing as a screening mechanism. You don't want to do business with everybody. You only want to do business with the customers for whom you can offer them great long-term value and you can be loyal to and still make money. So State Farm Insurance, for instance, charges top price for a new customer. If they are a good customer, after 3 years, they give them a discount. Another three years a deeper discount. 10 years with State Farm, you not only get the lowest price but in most States a guarantee to never cancel your insurance as long as you have a drivers licence, which is a very good deal. You're loyal to them for 10 years and they will be loyal to you for the rest of your life. You wonder why the Direct Line approach hasn't stolen away all State Farm customers - because the best customers, who have been treated so well for so long, are actually getting an awesome deal.

This happens in nearly all the loyalty leaders. It's a pricing philosophy that says, well take *Chick-fil-A*, as maybe a silly example to you, they hate the idea of price coupons to bring in new customers because you bring in price sensitive customers. They think those are evil guys - you don't want to do business with them. They want somebody who likes two way street loyalty, real value but how do you get a new store started in a strange community. They give away free take ones to the right target population to get them to sample the product and word of mouth from that experience is how they get their new volume. But they never use price coupons and I will show you in a more scientific way why that's true in most businesses.

Vanguard, I said was low cost, I want to put this up because it's almost unbelievable. Vanguard Mutual Funds. The way they measure cost, in a mutual fund business, is costs as a percent of the assets that they have under management and for them 30 basis points is that ratio. For the average North American mutual fund 120 basis points, say 1.2% of assets. One fourth of cost structure and I'm thinking and he's overpaying his people by 30% according to him and his people tend to back this up. How is this happening? He said it's retention rates of customers that does this. So what is it? This "retention rates of customers" - does this happen in other industries beside mutual funds and here I look at the life assurance business. Each of these red dots is a life insurance company and the vertical is their cost position, so high is bad and low is good for cost.

On this horizontal axes, it's their customer retention rate. They said 'Wow, it's not a perfect relationship' but it does look like there is a low cost envelope, a potential cost position is determined by how well you bring your customers back for more each year. When you think about it, it's common sense. If you ran a plant and you had a 15% defect rate you know you'd have tons of scrap and re-work and you would be horribly inefficient because that framework of thinking of everyone has been trained. And in a business like that top red dot where they are losing 14%, or so, of their customers a year. Customers are really the product in a service business. Most of the investment is being made in them in their acquisition and training them and communicating with them. So when you lose 14% a year it's unbelievably wasteful. The accounting practices that we use don’t track that and it makes it invisible. So common sense 'Of course you have to have a high retention rate of customers to be low cost', and in this business North Western Mutual, who I mentioned is the retention leader, they lose 5% of their customers a year and they have wonderfully low costs and their competition scratches their heads and wonders how in heaven's name they can be so low cost. They take tours of their plants and figure out how to use a new computer system and they do all those things well.

The thing that is invisible because all of our brains are worked to see the world through accountants glasses - it's a sad state of affairs. You don't know how much that paradigm has worked our thinking about business and success because you all measure your success and your bosses measure their success in accounting terms, I'm not sure accountants are against loyalty but the accounting framework ignores loyalty completely.

Remember this: North Western Mutual is the lowest cost. This dot that is below the line is State Farm. State Farm also sells life insurance to their auto insurance customers. Those are the two that have astonishing low costs. Now I want to tell you about another pillar that would seem to be high cost but it's not. It's the values. When you talk to the leaders of the company, to their agents and to their customers, North Western Mutual, for example, I have researched for this new book. I find that they are famous in the industry for being the most generous in paying claims. I don't mean if you have a million dollar policy that they pay you a million and ten, they always find a way to pay if it's ethically right.

For example, a fellow had an application for a life insurance policy for his infant daughter and the woman who was the life insurance agent had written the policy correctly and put the application in. Then the underwriters at North Western Mutual couldn't get the verification of the medical records from the physician. It happens in all countries - the doctors are too busy. It was going on for months and months and they tried. Finally they said we have to withdraw the policy if we don't get the doctor to put in the information because everything else is ready to go and we can close this policy.

Well the agent, who is irate, calls up the customer and says can't you please ask the doctor one more time or we will lose this policy and he said 'Don't bother, my daughter died of sudden infant death syndrome - it's a tragedy'. The agent obviously felt terrible about the situation and there is no policy in place because the doctor never closed the loop.

It's not right. They decided that the right thing to do was get the physician records (if they had to go to the guys office, which they did) got the records and underwrote the policy without knowing that the baby died. They said if it would have been approved with the right records we will pay on the policy even though it never existed and that is what they ended up doing. And that company is the one with the low costs position. How can State Farm Insurance talk to a group this size in the US and yet you hear stories like this. In Florida for example, State Farm, who is the low cost, when hurricanes blew the roofs of homes, they put better roofs back on the home than the contract required because they expected to have these customers for many, many years and now that that new construction approach was possible, they actually paid more than the claim required. It's sounds kind of goofy and you might think of those as "outlyers" and yet they are not. That's how those low cost competitors behave, in a very generous way to their people.

Selection - course you can't be generous to everybody if you're not thoughtful about who you're going to do business with. Selecting the right partners, and I'm going to go back to credit cards here. If you do the math carefully, you will discover customer segments that are wonderfully loyal to you and represent much better cash flow annuities. And in the credit card business teachers, through traditional accounting lenses look like they are about 1.5 times as valuable as an average customer. Whereas when you use Charlie Collie's accounting life cycle cash flows that I've shown you on the blue bars, you see teachers are awesome, as they don't move very frequently, they are loyal. When you know that you can gear up your customers acquisition toward teachers, which is pretty simple if you do the math and why has Charlie Collie's business grown like crazy and had plenty of excess cash generation - because his product line has been orientated toward teachers. His direct marketing capability is brilliant at teachers. They have the richest mix of teachers of any credit card. That means the other credit cards have very few teachers and therefore differential cash flows. The molecule of economic reality is different because of this selection advantage. It's not just teachers; it's many different types of people. Sometimes it's geographic, sometimes it's demographic, and sometimes it's psychographic. I will give you advantages of each if we have time. People who buy multiline have greater loyalty than those who don't. State Farm recognises that and gives a better price to people who buy several product lines. If you buy home and life and auto in the same bundle they give you a much better deal.

Why? Because they know from their scientific analyses. Their actuaries know that this group will stay longer and they will generate better cash flows as an asset, so it's a win/win proposition.

These guys they talk about barnacles and butterflies, they look for barnacle segments because those are the groups that customers are going to stick with them through thick and thin - whereas the butterflies are going to flit off to the next deal. The marketers are getting scientific about barnacle rich marketing programmes. The price people? People who come in on price everybody knows they are less valuable because of the discount. And the discount may be 30% so average accountings says 'Well it's 0.7 times the average customer value.' The truth is, in most businesses, if you use price as a way of attracting customers you are bringing a pond scum up to the surface, to clog the engines, which makes it impossible to run an efficient ship.

But you don't know and I wouldn't be stupid enough to do this. Let's say I hired you and paid you a bonus for bringing in new customers. Irrespective of whether they are barnacles or butterflies because it's hard to measure. That's years out and I've got to pay you a bonus this year. So what kind of customers are the easiest for a good marketer to bring in the door? Obviously it's the butterflies, the guys who are easy to switch. It doesn't take strategy for that it - just takes gimmicks and promotional schemes; which I hear you guys talking about. When I see loyalty in the British press, it's usually associated with loyalty schemes. It's an unfortunate name, because in the USA, at least, the word "scheme" has a more unfortunate interpretation; scheme means you are manipulating people, it's scientific abuse of how you bribe people into doing exactly the wrong things for themselves but to benefit you.

Well price is the wrong way to bring in customers. Each one of those companies I mentioned has a way of targeting. North Western Mutual - they target by hiring a certain kind of agent. They know that agents hang around with people like themselves. And you discover things about North Western Mutual Life. For example, they have 30 or 35% market share of Fortune 500 CEO's. Now why would that be? Because over the years they have found that that group is a smart customer segment, that they're in a position to give great value to and they stick around for a lifetime.

You can make your companies rich or poor just on that single insight but there's more. Which channel? Cellular Telephone Companies are a wonderful example of, 'I don't know how to control whether I'm getting barnacles or butterflies because it's my channels that are bringing in the customers for me, but then if you analyse which channels are bringing in the best customers, in terms of length or retention, we found for one of our clients that electronic chains generated customers who had 41% turn rate average on the first year. Whereas car dealers and some of the other specialities had 18% and 13% turn rates and common sense says 'If I could find a way to have all of my growth through the channels that bring in the richest mix of barnacles I could just change the whole cash generation nature of my business~' which is at least what one company, actually several companies, in that business are doing. Their competitors are blind to this fact, because their competitors also think loyalty is important but they're are going at it by training their phone reps how to be more prompt in picking up the phone in two rings, as opposed to thinking about the fundamental nature of loyalty as the customers you bring in, and therefore the value you can share with them.

The automobile business gives you another rich example of sillier approaches to loyalty.

Monty Python, if they were still active, could do wonderful things with the auto industry and loyalty. The 45% is the average for the industry. That means that they are so bad, that the average customer would rather do business with strangers than come back and experience that again, thank you very much. And that's at the brand level. You know what it is at the dealer level? About 20%. One out of five customers are stupid enough to come back to the same car dealer for the next car. Now how can you make money in a business like that? In short, you really can't.

If you looked at the auto industry, the biggest picture of companies making autos for the last 20 years, it hasn't earned its cost to capital. I have never found a business that's earned its cost to capital. Obviously there are peak years like now and then it goes up and down and the newspapers always focus on the current. But these businesses that turn customers don't make their investors happy.

Honda and Lexus have done breakthrough kind of things, especially in marketing, but throughout the organisation to earn customer loyalty that I would be proud of. If I was coming out of school today and I knew this and I wanted to be in the auto industry, I know where I would try and get a job. This of course is going on with all the loyalty leaders. Loyalty leaders can attract the best talent because of their track record of attracting the best customers, treating them the right way, generating excess cash flow. I know you would hope to have a talk from me completely on customer loyalty because that's your focus but it doesn't work that way. It really is part of an interactive system.

Let me go through some of the things Lexus have done. A lot of it has to do with honest communication. Not a traditional strength of the automobile business, at least in North America. Sadly the cellular telephone and many of the phone systems have started adapting marketing tactics from the auto business. In terms of pricing and special deals they don't tell you what the real best price is unless you are aggressive enough to find out. Their loyalty experience has been appropriately parallel. But what do Lexus do? They said 'We have to find out why the good customers leave?' They developed an approach much like the manufacturing of Toyota, which is the parent company. So instead of looking for the defect in the plant that made the part come out through wrong, these guys would call the customer and keep asking till they got to the root cause of defection and they would train their people to interview in a way that would go through the moments of truth or the life cycle customer experience and listen for 'Where was it that the flaw happened, where do we have to improve to not have that customer go away? And when they did this initially in the USA, Lexus new brand didn't exist so they talked to who their targets were. Mercedes and Cadillac. Why a Mercedes and Cadillac? Because they had the richest mix of barnacles in the industry at the time. Not a very impressive track record but they were the best so that's where Lexus were going to start. And when they did these root cause analysis interviews they found where most of the defections were taking place. It was at the service and that's hard because if you're making cars and your dealers control the service, it's easy to say "Well I can't do anything about that, I'll do a better direct mail programme.' But that is useless if your most important driver of customer defections has to do with the car not being ready at five o'clock as promised, which happens to be the truth in that case. So you know what Lexus did? Lexus subsidised the largest fleet of loan cars and they took over the parts distribution. They made it so the parts logistics is now done by Toyota, which is really good at precisely getting the part there when it was needed. And they have "Engineers defections" out of the system, by investing themselves to make the customer experience far better. That seems a little generous because the guys who make the most money out of service retention are the dealers.

But they also think, we want to make our partners rich (this is a mind set by the way that loyalty leaders have). We don't want to find a way to just treat our partners fairly. We want to discover a way to make them rich. Therefore they will appreciate our relationship above all and that's what drives loyalty, is when you can help people grow to their full potential or even beyond their wildest dreams. That seems a little pie in the sky but that is what makes them do shocking things. Now how do they afford to subsidise the largest fleet of loaner cars to make service very convenient? They know the cash flow and they know that if they get rid of 20% of the defectors, their growth in their cash generation will respond in a predictable way and they can share that excess with the partners. They measure it.

Remember we were on the pillar about truthful communication? Part of that formula at Lexus, is they've got a satellite dish on top of every dealer. If you want to be a Lexus dealer and you're good enough, then you have to pay for a computer and a satellite dish. So Lexus' Headquarters knows, unlike any other car company, exactly who is buying cars and getting them serviced at what dealer today; which is quite impressive knowledge if you care about barnacles and butterflies.

And Lexus has achieved about 80 cents of every post warning service dollar staying inside the Lexus' dealer ship system. Which is awesome, but when you project forward even under twenty, thirty, forty cents of the post warning service cash generation potential, Lexus at 80 and you think 'no wonder Lexus dealers are getting rich'. Lexus is famous (I know it's not a big brand here, it was a North American focus brand) but they're famous for having flowers on the tables at the dealership, free car washes. If you buy at Lexus you can get it washed at any time for free. All this stuff costs money. And everyone is scratching their head, how can Lexus afford this, the pricing of the cars is pretty good, where's the money coming from? Well, it only becomes apparent when you think about a life cycle cash flow and they're getting 80% of the potential service cash flow, which is the highest margin business for the dealer but that's what's paying for the flowers and the car washes. But they're not satisfied with 80% - they want 100%. They're into zero defects and they're into zero defections. So how do you get there? They keep calling up and finding out what's going on and, because they measure this, they know which dealer has the highest retention rate of customers.

There is a guy in Arizona and they took five of their executives and a consulting team out to look at this dealership. This dealership was getting 93 cents of every post warning service dollar - it's unbelievable. In the car industry, people would say 'unless you had the facts that's impossible'. What were they doing? Because they went through the service bays, they were looking for what they had engineered, some new process. It was all-standard, by the book Lexus service.

What they found finally was not in the service department, but in the marketing. They didn't pay the full sales commission to the dealer, the salesman, until Mr Jones who bought the car, came in six months later and got it serviced at that same dealer. And so what happens to the sales process is it becomes very focused - 'Let me introduce you to the Service Manager, he's a hell of a guy, and he'll really take care of your car, he sets it up correctly'. And then when six months roles around, the salesman is on the phone who established the initial contact anyway saying 'Sir it's time to get your car serviced, can I put it in the schedule for you? And if you don't bring it in he calls again and offers to bring it in for you.

Do you have "repol" men in this country? There's a way of getting cars into garages that, I think they may go one step further, but that car gets into the garage to get serviced and that's what the difference is. You wouldn't know that unless you measured retention. Not just for Lexus repurchase of cars, but for the service retention of your channel.

Yeah I know, it's a big joke everywhere. I won't embarrass all of you by saying how many of you have worked for the same company for the last 25 years like myself. I actually have been at the same company for almost 25 years. My kids think, they think I'm a dinosaur anyway, but now they have evidence, you know, why would you stay? So you actually redefine loyalty. It works the same way.

The reason I go through this is cash generation of an employee is an asset. It has the same potential pattern as for a customer. You want the same kind of approach I philosophy to cash generation and if this is so obvious that a new employee, some part of your brain knows this and is bored by it already, you've got recruitment costs, you've got training costs, long term employees are the ones that know who the good customers are, they know how to be productive. So why is everyone thinking loyalty is bad and we've got a dead wood problem? It's because most companies have not aligned the awards appropriately. They don't share the upside with those employees who create it. And because they don't measure it and share it correctly you get into these weird situations of dead wood and people getting confused about whether they're adding value or not. That doesn't happen. This rewards pillar is mighty important. Some of you will find it counter cultural, maybe to American individualist capitalism here, but these loyalty leaders think the right way to treat people is to reward them "meritacratically" to share value back with those people, those employees, who create it generously.

Like I said Pizza Hut pays $40,000 to a Branch Manager, a Store Operator. The average at *Chick-fil-A* is $85,000 and, as I said, they can go as high as $300,000. Not <u>can</u> - they <u>do</u>. There are, I think, a dozen store operators earning over $300,000 a year and that's not something that Mr *Chick-fil-A* is embarrassed about. He celebrates that fact. You know why? Because the deal at *Chick-fil-A* is, they don't pay a base salary that's very good, $35,000. And yet, then the deal is we split profits at the store level, 50/50. That's a simple bonus plan you don't have to get promoted to Headquarters to get rich. All you have to do is make a lot of profits at your local level because *50%* of them are yours and that's what has opened up this unbelievable efficiency and productivity. Right now, if you build a Chick-fil-A across the street from McDonalds - *Chick-fil-A* sells more per square foot. McDonalds has to advertise with about eight per cent of sales to generate traffic. *Chick-fil-A* has about one and a half to two per cent advertising costs. So you start seeing what happens. You know what kind of talent *Chick-fil-A* can bring in when they compensate that way?

I rode on a bus home with a group of *Chick-fil-A* store operators. I sat next to a guy who ran a *Chick-fil-A*. He graduated from West Point, the Military Academy. And the guy on the other side had been a Manager at Arthur Anderson, the accounting firm. A manager at an accounting firm and a West Point graduate running fast food outlets, doesn't make sense until you're, Oh, but you're making partners! They're not lowly employees who have to do what they're told. They are actually business people who are partners in the business. *Chick-fil-A* staff turnover, the high school kids who work the front desks at the counter - 85% turnover may not seem low to you until you consider the competition has 300% turnover. How do they do that? Well the guy at the West Point is a little better at recruiting quality help and they pay a scholarship. If you work at *Chick-fil-A* for two years as a part time high school student and do a good job, at the end of it they give you $1000 or $2000 scholarship.

So who comes to work at *Chick-fil-A*? It's kids who are thinking about going to college, or thinking that two years is a conceivable thing in their mind, and so they have positive selection on the employee front. And it's the same structure, remember how I told you how State Farm rewards customers for their loyalty, *Chick-fil-A* reward their employees, using that same parallel philosophy and it gives them an enormous advantage on turnover.

Enterprise Rent a Car. I know car rental is not the sexiest business on earth but to me a strategy that generates 24% growth over a decade in an industry that is declining. That's awesome! Of course North Western Mutual life is growing at 15 or 20% for the last two or three years in the life insurance business, which, at least in the US, people think of as an anachronism, you know it's gone away but ordinary life, standard old fashioned life insurance, that North Western Mutual continues to grow in a shrinking market. They went from a little niche competitor who focused on higher end and corporate CEO's to being the largest in the industry now in writing ordinary life. And the same thing is going on in this car rental business and talk price sensitive.

In private business how can you possibly do this? They hire better people and pay them more - it's part of the equation. Enterprise Branch Managers earn $50,000 or $60,000. It's much like *Chick-fil-A*. They pay a $30,000 base but they split profits at the branch so you get people who are very effective at recruiting good kids to work for them and in building a business and treating people right. And when you're paying $50,000 or $60,000 to someone you get better talents than Hertz of Avis can afford. So that service experience is wildly different. It opens up strategies for growth. Enterprise doesn't have airport locations. That's a commodity business. They have little locations out in the suburbs and it's called home market. And they focus on body shops and insurance agents, people who have to get people into cars after they've had an accident or their cars being worked on. So the guts of their business is running around building a network of referrals and that's how they do it. You can't do that unless you have a pretty hard working group of energetic sales people.

Now, Enterprise is the largest hirer of college graduates in America today. They hired over 10,000, unbelievable. I think Arthur Anderson is the number two hirer and hired five or six thousand college kids last year. I have a boy about ready to go to college. I know the phone call I don't want to get in four years is, 'Dad, guess what? I got my first job working behind the rental desk of the car firm in some suburb outside Boston'. You pay $100,000 to pay for your kids to go to college. You don't want them to go into car rental business. And yet 10,000 phone calls, 20,000 parents have accepted that bad news and they continue to grow. The reason I keep harping on this is this: you can't serve customers brilliantly unless you put better frontline people out there with them. Talent means better in character. People who are going to treat them right and make the right decisions for the long term because they are building something worthwhile for themselves.

It's that quid-pro-quo that has to be behind meaningful lasting loyalty.

Cellular Telephone - someone who most certainly does not understand this it's a little tip for any of your businesses. Analyse defection rates - not just on average. New York Times - when I phoned the New York Times and said do you track your defection rates and they said yes, absolutely. We read your book and four years ago - we have built the whole marketing system around loyalty so we know the retention rate of first year customers, second year customers and then beyond second. We have made it scientific.

If you do this in cellular phone. Let's look at retention rate or defection rate for people that have been around 3 months, 6 months, 12 months and 15 months. Cellular telephone has a pattern that is quite unusual versus a typical business where most of your defections take place in the first several years of the customer relationship. Why would this be? You know why. Because they have the magazine subscription pricing philosophy. They say, well if you're not a customer of ours we will give you a Start Tex 6000 high tech handset for free but if you're a current customer - no way - you have to pay full ticket for that handset. Eventually customers get it and say, well I've got to switch because my handset is so heavy I can barely walk so I've got to upgrade. I can do it for free if I switch to a competitor or I can pay. Why would people abuse their most loyal customers? Does not seem smart and yet that is the pricing mechanism. Most cellular, most cable TV people and a lot of businesses abuse their best customers through their pricing. And of course they get churn rates and then they say 'Oh this is terrible and then they send people like you to conferences about loyalty to figure out how to fix the problem with a direct mail solution. Direct Mail is a big piece of the puzzle if you are building on a framework that is worthy of partnership. But if you are engaging in direct mail to sort of fool people to accept that bad offer, you're not being loyal to any kind of principals that I think are worthy of it, so it has to be consistent throughout and I think the best thing you might do is think through'. What is getting in the way of us being honourable and loyal to our best customers'? It's getting the right answers to those questions that start you on the right path. Communication is enormously important but focusing on the right customers and be sure they are worthy of loyalty.

Finally Goals. State Farm is my favourite example here because they are so big and you think of insurance companies and you think boring. Yet State Farm keeps getting and better. They have a 25% market share of North American households so they are like the phone company, they are huge. And yet they continue to be nimble, aggressive and pay high salaries. They were focusing on satisfaction as the goal that they wanted their people to strive for until they did this analysis. They looked at their defectors. Even though they have good defection rates they are big enough that they still have a million defectors a year, so there are plenty of people to call and find out what went wrong. They found that 80% of their defectors had said satisfied or very satisfied on the satisfaction survey prior to their defection. And they said, wait a minute, if we are going to set goals that are worthy of worthy partners commitment, we can't use satisfaction as the device. It's good - it gives us good information. We certainly don't want dissatisfied customers around but we have to measure retention rates, we have to measure loyalty. They went through a development where they sent satisfaction surveys as the first step to loyalty surveys. A lot of times many of your companies don't have the information technology to really track retention.

So what do you do? One thing is you just go out and ask people. Usually without telling them what company you work for. Which company they have done business with for a time, and you can get pretty good estimates of loyalty through a survey technology. Don't ask them about their intent to repurchase. That is about as useless as how satisfied are you? But ask them how often did you switch and why and you'll get to the route causes that really are actionable. Then loyalty statistics where State Farm is now. Eventually your partners, if you have structured the right rewards will be getting that information on their own and the trick is to get them to share it with you, which only a few firms have evolved toward. USAA is one that we can talk about later.

Let's focus on State Farm. What did they do to set the kind of goals that make them not be a dinosaur but continue to grow. They have done what Lexus have done but got one step better. They interview a lot of defectors, hundreds or thousands of them. They asked them what happened recently. Sometimes a customer doesn't know why they defected but if you know that it regularly happens right after they have applied for a new policy for a teenage son or daughter you get a hint they did not like the price they paid for the teenager and their household. Or right after they had a claim so there is statistical analysis you can do when you track defections and link them up to these moments of truth and they go through the life cycle stages of the customers. Because once again they find that often they won't say it's because I just moved that I switched. It's not conscious but when you look at the statistics, moving really makes people switch. So when State Farm does this on a regular basis, because they had the analysis, they could stop listening to the people in the claims department who said Claims is the moment of truth, you've got to keep investing in claims, they found out that people who had a claim customers were more loyal on average than the rest of the customers, so they were doing fine in claims.

Where were the hot spots in their system that needed to get fixed? When people moved and when people bought a new car. Not moments of truth at all but just changes in the life cycle.

What did they do about it? Well for movers they have found a brilliant solution, I think. Their mindset was, these are our best customers, we don't talk to defectors who are marginal customers, we ignore them. We talk to customers that we'd die to lose and then they found out that moving was the number one reason. Because they moved they didn't know where the State Farm agent was in the new community and loyalty is dead (we read it in the papers), loyalty is stupid so people have been re-convinced, your customers as well as your employees.

So they just go out for open bid and salesman can fool anybody in insurance. So what they thought about was how can we add value to somebody's life at the point at when they move?

Well, a huge company like us, we can probably do information processing - so we could get their credit card addresses changed, their magazine subscription addresses changed, we could probably do some group purchasing of moving vans so they get a better deal on the moving van and they build a package of services that their customers are beginning to be aware of for free that State Farm offers when you move. They found that where they tested this, they cut movable related defections in half, which is worth over a billion dollars a year to them, which pays for a lot of subsidised moving vans, but you couldn't do that if you didn't know it was a billion dollars.

That process of adding value in those spots of a customers life where they are obviously not happy with the value or they are not excited because they are defecting, that is the steady process of improvement that State Farm has gone through, much as the way Lexus have and much in the way North Western Mutual has and MBNA.

They also look at which of their agents are treating customers right and which agents are bringing in the right kind of customers because they measure retention rate by agent. Just if you're in retail business you want to measure it by store. Or if you're a New York Times and you're in the subscription business, you want to measure retention by campaign, by channel. Do you want to advertise on the discovery channel or on one of the others? Well let's look at the ratio of barnacles and butterflies that each of those campaigns brought in and that will help us guide the future.

Here, the average retention rate for a district of their agents is about 6% defection. But some of them were superstars and some weren't doing anyone a favour, even though they were earning what doctors and lawyer's do. So State Farm took the big step, they changed their contract with their agents, which politically is a very difficult thing to do. Something they only do every thirty years. But they decided that any agent that had worse than average defection rates had to be penalised and have an incentive to get good and treat customers the right way and bring in the right customers. Otherwise, writers of insurance, direct mail and phone would take over the USA just like everything else, and that's what they've done. Which took the time and energy of their senior executives for two years to implement with 17,000 agents changing the deal. Oh, but they did it as a partnership, they didn't insist. They didn't say, you've been an agent for twenty years, here's the new deal, take it or leave it.

Everyone has an option. So State Farm, their plan is to get all agents onto this new system over the next seven or eight years, if they can. They treat people like partners throughout the relationship. And as a result of setting those kinds of goals, treating people the way they do, they have ground their defection rate from 4% down to 2.5%.

I called them last year and at the end of the year their defection rate was even lower. So they are getting relatively close to where the number one route cause of defection is death. Which is a tough one! That will be a future book I'll be working on someday. But that's so good for a massive firm with that kind of size, to have that kind of loyalty, it's unbelievable. And then you think about, Oh I wonder if that has anything to do with the forty billion dollars of retained earnings on their balance sheet. And you say obviously it does. And a company that has this frame work in the way they measure, the way they manage, the way they reward leaders, loyalty is a very wise course of action.

So, in summary, when you think about how can I earn better customer loyalty, which I think is the practical thing most people have on their mind. I hope you think about, not just the campaign of the week or the frequent flyer mileage, but think about the framework of the partnership that you've built with your customers and where the weak pillar is, what needs to be fixed.

Much of the analysis, by the way, is in your area. You have the power to show people where the flaws in the system are. People have asked me, was it worth writing this book, throwing away your consulting career and becoming a preacher on the subject of loyalty. It's way too early to tell. I'm pleased I did because it feels right but I'll know when more and more companies take this idea of measuring it vigorously and seriously.

I know there's been some progress, Tom Peters from his Rolodex smart arse comment says now, loyalty is more important than ever. And yet there are intellectuals, I categorise intellectuals as barnacles and butterflies; just like I do customers, and I don't take too much from this. But I do take it when I see more customers, more clients, more investors, who recognise that loyalty really is the hallmark of great leaders and leadership. And maybe most of all, the measuring of it. Measuring is where it starts.

So if you leave with one simple idea, which ought to be the objective of any speaker, just one practical thing, there is a better way for you to measure and communicate loyalty and convince your bosses of that. Then I think that will have the greatest impact on the organisation and on how you can truly be loyal to your customers and be worthy of their loyalty.

Now like all, I try to practice what I preach, so I measure retention rates. I've only seen one person leave the room and they came back! So we have zero defections, so I want to thank you for that enormous loyalty. Thanks.

I do want to make sure there is a little bit of time for those of you who have some questions. We can spend five minutes.

Questions:

Question 1:

I have a question with regard to the chart that showed that electronic channels produced the highest turn rates. I've seen some evidence, for example looking at Amazon and their percentage repeat purchase rates which are far greater than those in traditional channels. I just wanted to know if you'd done any research to discriminate between the types of electronic channels and the types of sites. Obviously showing differences in kind of repeat purchase rates etc and loyalty?

Answer:

We have. Let me repeat just so everyone heard the question, the chart that said electronic chains had the worst defections performance in cellular phone distribution. It was the broad retailers that that referred to, not to the Amazons or the Internet connections. I find the Internet is a wonderful opportunity to build loyalty. The companies that will be in the next book I'm working on include Dell. Dell is a company, who is a classic model of loyalty because they have first of all avoided the customers they don't want. They didn't want first time users for computers. Because they did their analysis of loyalty unlike any other computer company I know. They looked at retention rates from various segments. They found that first time users weren't loyal. They also ate up amazing amounts of cost. So they then focused on corporate users and expert users and could build with the Internet a deeper link and a deeper communication, that really gives more value and Dell's a very profitable company. So that cycle does work.

One more thing on the Internet. The Internet strips away the "Bxxx Sxxx", so the advertising and what you'd like to be, I think once you're naked, customers go to the real value supplier faster. So Internet is going to make the loyalty leaders bigger winners than they are today as opposed to having a positive or negative effect on loyalty generally. I think truth will come through.

Question 2:

The justification for the move to loyalty comes from improved cash flow through time bearing in mind that you said that most companies have the wrong type of investors currently and that investors are very much focused on three - six monthly returns. How do you make the switch towards a loyalty strategy without being killed over share price or access to capital?

Answer:

The question, if I'm owned by a bunch of churning speculators who don't give a hoot about the future, how can I build a business that I'd like to spend my life in. I don't know if you can. It's a good question. I think most businesses actually have reasonable people as investors. And these companies, they're not sort of "wait a few years and show me the results" - they really have tough results. Enterprise Rent-a-car. But it's not just quarterly profits. They focus on the retention rates themselves, number of new barnacles, so they're very, very rigorous on a set of measures that are the things you'd want to measure if you were looking at building life time cash flow. The evidence that the market place is willing to consider the future is pretty strong, when you look at the evaluations of Amazon and E-bay and some of the others. And the measures that people do, new customers acquired, repeat and so forth. So how do I get investors focused on the right numbers, then you have to have rigorous numbers of the right kind and I think investors will listen to them. But today most people just want to say, I'm not going to give you something in place of quarterly earnings, just don't be so rigorous on making me earn quarterly results and I think you have to offer the quid-pro-quo.

Question 3:

How have you found that the 80/20 rule applies to loyalty? Has that been a big factor in finding companies that are looking for loyal customers?

Answer:

Yes. The 80/20 rules is built into this because most companies use that framework of, I'm going to put 80% of my energy into 20% of the customers, who are my future. They also say 'I can't fix every root cause so I'm going to fix the 20% of root causes that generate 80% of the defection cash flows'. It's a stochastic world and these people understand that and use it in their thinking. The only place where I don't think it's consistent is some of the principles about how people should be treated. When their backs to the wall these guys will do the right thing even though it doesn't seem to be the economically right thing to do. So there are some things that seem to be absolutely immutable core principles of how they want to run their lives. And it doesn't look like that hurts profits or growth. At North Western Mutual, people talk about that Sid story all the time because that's why they are proud to work at North Western Mutual."

Editor's Note:

Frederick Reichheld referred to slides during his presentation - we are unable to repeat those here. In addition, the above is the text of his talk and uses the friendly, illustrative and colloquial approach of the spoken word rather than the formality and sentence structure of written text.

Further Information

If you would like to receive further information about this subject or other publications, please call us – see our contact details on the next page.

Reference:

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