

The New Physics of Customer Loyalty

Manage Customer Migration Based on the
Loyalty Profile of Your Customer Base

McKinsey
Marketing
Practice

Overview

Today's rapidly changing competitive arena has caused a decline in customer loyalty in many industries. Our research has shown that marketers must handle this challenge with a whole new approach.

Manage Customer Migration, Not Retention

- Directly tied to customer value
- Can represent 2-4 times more value than attrition
- Leading indicator of defection

Understand the Loyalty Profile of Your Customer Base

- Three loyalist segments: Emotive, Deliberative, Inertial
- Three migrator segments: Dissatisfied, Deliberative, Lifecycle

Pick Effective Tools Based on the Loyalty Profile

- Broad set of tools – new and traditional – available to marketers
- Predominant customer segment in Loyalty Profile provides good guide to which tools have greatest impact

Combine Tools in an Integrated Program for Maximum Impact

- An integrated approach combining appropriate tools to highest leverage customers can yield 20-30% loyalty improvement
 - A four-step approach can achieve results quickly
-

Increased competition is causing customer loyalty to decline – customer churn is up in industries from credit cards to telecommunications, while share of wallet is down in others from grocery to department stores. More importantly, this reduction in loyalty is not tied directly to customer satisfaction levels. The key to meeting this new challenge is to manage customer migration by focusing on the highest leverage groups within your customer base.

Traditional thinking on customer loyalty has focused on customer satisfaction or customer defection, usually within single industries. To develop a new understanding of the underlying drivers of loyalty, we have recently undertaken a broad set of cross-industry research that incorporates key behaviors, attitudes, and satisfaction indicators. Our work includes more than 1,200 consumers in 16 different industry groups. Based on this research and our extensive client experience, we believe there is a new approach to allow marketers to get much higher profit impact from their loyalty efforts.

Manage Customer Migration, Not Retention

The first insight is that by far the greatest profit lever is to focus on *migration* – the change in customer value over time. Managing customer migration is a powerful new approach that we have successfully applied in industries as diverse as retail banking, department stores, and telecommunications. While traditional indicators like satisfaction or attrition are still useful, marketers who focus solely on these measures will miss a substantial portion of the opportunity. Migration

includes customer defection but is much broader. Our experience is that its potential impact in most industries is 2 to 4 times that of a narrower approach based on defection alone. In the credit card industry, for example, the annual value lost from customers who defect is only one-third of that lost from those who remain customers but use their cards less. The implication for marketers is that the opportunity is substantially larger than traditionally reported by even top loyalty research – but that focusing on defection alone misses most of it.

Managing customer migration is more powerful than other approaches for several reasons. It is directly tied to economic value. It captures much more of the total opportunity than narrower measures like defection. And it is a leading indicator that allows marketers to catch customers before they are gone for good. In addition, managing migration is highly actionable because it relies on readily available company data (a significant drawback of broader measures like share of wallet).

Finally, the importance of migration as a managing approach is increasing over time. Since customer migration includes simple switching, it can be applied to any industry. More importantly, increased product offerings and focus on broader customer/household relationships means that many industries that traditionally have been characterized by pure switching behavior are now much better captured by migration. In telecom, for example, leading providers have branched out from a single product focus – long distance service – to a much broader array including cellular and Internet service.

Understand the Loyalty Profile of Your Customer Base

While downward customer migration is a powerful measure, improving it requires a thorough understanding of customers. Understanding the Loyalty Profile of your customer base is the key to developing high-impact actions that will change customer behavior.

Based on our extensive research, the Loyalty Profile combines key aspects of customer satisfaction, attitudes, and behavior to divide customers for each company/industry into six segments (three loyal, three downwardly migrating), described in the following table.

Loyalists

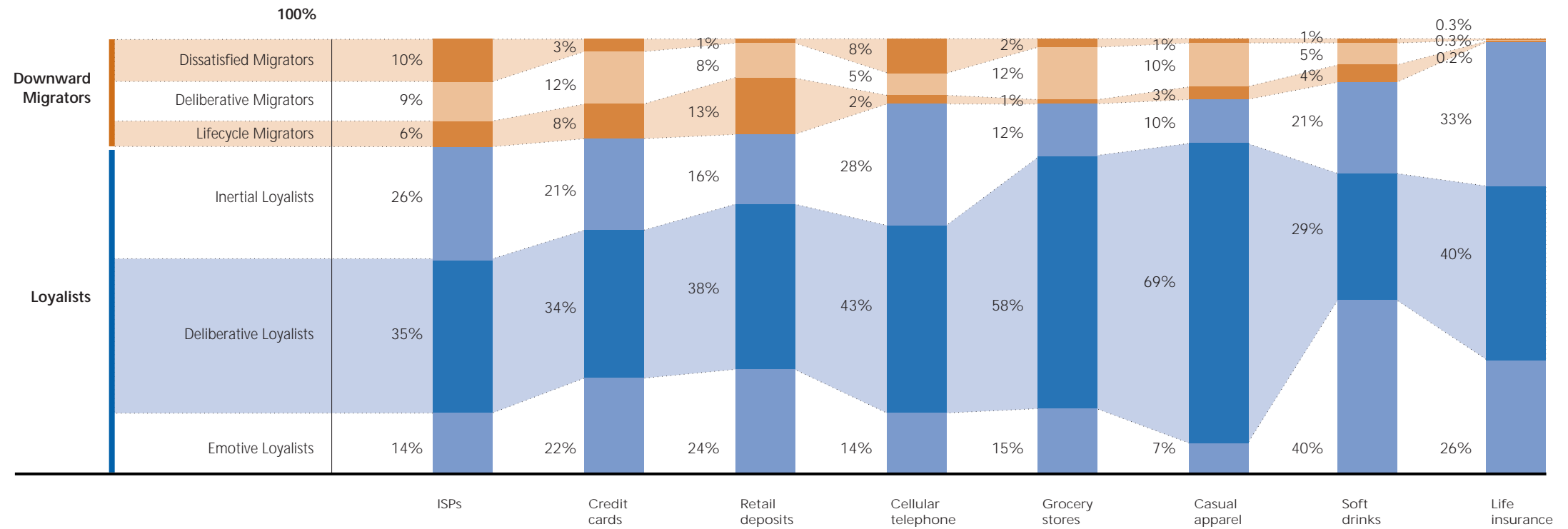
Emotive Loyalists (<i>e.g., Coke drinkers</i>)	■ Infrequently reevaluate purchase decisions ■ Strongly feel that chosen brand is best for them
Deliberative Loyalists (<i>Honda drivers</i>)	■ Frequently reevaluate purchase decisions ■ Reaffirm chosen brand based on merits
Inertial Loyalists (<i>milk drinkers</i>)	■ Infrequently reevaluate purchase decisions ■ Uninvolved; don't consider change or feel it's not worth the effort

Migrators

Dissatisfied Migrators (<i>wireless users</i>)	■ Actively dissatisfied ■ May be prompted to reevaluate based on a specific event
Deliberative Migrators (<i>apparel buyers</i>)	■ Frequently reevaluate purchase decisions ■ Choose new brand on merits; may seek variety
Lifecycle Migrators (<i>minivan buyers</i>)	■ Reevaluate purchase decision based on change in need

The Loyalty Profile provides significant insight because it highlights the key opportunities and levers. The following chart outlines the industry composite Loyalty Profile across 8 of the 16 industries we studied. Not surprisingly, it shows that downward migration varies considerably – from 25 percent for ISPs to less than 3 percent for life insurers. More importantly, the sources of downward migration are very different. For example, deliberative migrators account for over 70 percent of downward migration among apparel buyers but only one-third of downward migration in cellular or home equity. The proportion of downward migration due to dissatisfaction (a key focus area for many of our clients) varies from over 50 percent for cellular telephone to less than 5 percent for retail bank deposits. Marketers who understand the Loyalty Profile can focus their efforts and increase loyalty while lowering spending because, for most companies, between one and three groups will offer the greatest opportunity to manage customer migration.

Loyalty Behavior Profiles Differ Across Industries



The Loyalty Profile combines key aspects of customer satisfaction, attitudes, and behaviors into 6 distinct migrator and loyalist segments. The size of these segments differs significantly across industries/companies and provides a good guide to which loyalty tools will be effective.

Pick Effective Tools Based on the Loyalty Profile

Once marketers select the customer groups they want to reach, they will need to design a powerful set of actions to change customer behavior. While there are many loyalty levers available – some traditional, some new – the good news is that the targeted customer group, and some industry-specific characteristics (i.e., information availability and customer value) can provide a good guide to which actions will have the greatest impact.

The three broad levers for improving customer loyalty include redesigning the product/service (e.g., reducing sources of dissatisfaction), enhancing delivery channels (e.g., improving frontline execution), and developing new marketing programs (e.g., creating a rewards program). Each of these broad levers includes several well-known actions and some new actions, such as consortium-based rewards programs, relationship marketing, and online channels. Altogether, our research identified eight new or traditional loyalty tools that fall under the three broad levers.

Fortunately, the customer group that is being tackled provides a good guide to which tools will have the greatest impact. For example, a particularly effective way to approach dissatisfied migrators is to fix the root causes of the dissatisfaction and combine that with tailored marketing programs. One cellular company found that many of its customers were defecting to competitors because of poor customer service. By making targeted improvements in customer service and implementing a proactive call program to customers who had experienced significant difficulties (offering apologies along with free minutes as compensation), this company significantly reduced downward migration.

It also makes sense to target actions toward the loyal customer groups to ensure they stay that way. For example, product bundling is a powerful approach to increasing stickiness and making customers more inertial. Retail bank customers using direct deposit have an attrition rate many times lower than customers who do not have direct deposit. Well-designed rewards programs can have a significant impact in marginally differentiated industries where each purchase is a new choice (e.g., credit cards). These and other examples show the power of targeted actions based on the Loyalty Profile of your customer base.

Combine the Tools in an Integrated Program for Maximum Impact

Our experience has shown that companies that adopt an integrated approach to loyalty – applying the appropriate combination of tools to the highest leverage customer groups – can reduce value lost to downward migration by 20 to 30 percent. The combination of tools is important because they are self-reinforcing. For example, if you fix a root cause of downward migration, you need to let people know and reinforce the new behavior. Achieving these kinds of results requires a four-step approach that employs both traditional and new tools for managing migration, and uses them in a thoughtful, focused way:

1. Focus on the right customers. Understanding the Loyalty Profile of your customer base will quickly quantify the opportunity from reducing downward migration and focus efforts on the highest impact opportunity areas. If necessary, focus groups and additional quantitative research can help identify specific reasons for migration or defection.

2. Choose a mix of high-impact levers. Having chosen a target, marketers can identify the tools that will have the highest impact and prioritize their efforts. Importantly, don't be satisfied with just one approach; pick a powerful combination instead.

3. Launch targeted pilot programs. The third step is to begin taking action on the opportunities with the highest leverage. Most often, this will involve targeted redesign combined with proactive marketing programs, but it could also involve the other key loyalty tools. Whenever possible, marketers should leverage control groups to track the impact of these programs and continually refine the approach.

4. Build a comprehensive program based on what is learned from the pilot programs. This step includes two different streams. First, marketers should refine the pilot approach on an ongoing basis, expanding successful first-round pilots, curtailing or redesigning unsuccessful ones, and launching a new set of second-round pilots. In parallel, marketers need to build the capabilities and reallocate financial and human resources to support high-impact opportunities that are being expanded to full scale.

The impact of such an integrated program can be substantial. For example, a leading department store used tailored marketing programs proactively to contact high-value deliberative migrators to reduce downward migration among key segments by 30 percent. As a result, it expects incremental comparable store sales growth of 1 to 2 percent in each of the next 5 years. One cellular telecom provider reduced its churn among key customer segments by more than 40 percent and overall churn by 20 percent through a redesign of its service and tailored marketing programs. And a proprietary credit card company used proactive marketing and targeted redesign to reduce downward migration by 25 to 30 percent, with a much larger impact on profitability.

In sum, the changing environment is making customer loyalty more important than ever. At the same time, managing customer migration based on the Loyalty Profile represents a powerful new approach that can help marketers meet and defeat this new challenge in ways until recently not possible.

—Tim Gokey is a Principal and Harold Yin is a Consultant in McKinsey's Marketing Practice

McKinsey & Company

For additional information or copies,
please call (203) 977-6800 or e-mail
mckinsey_marketing_practice@mckinsey.com