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Six Myths About Customer Loyalty Programs

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Low-margin retailers often argue they can't afford customer loyalty programs, but is that true? Two business professors make the case that such programs are profit-enhancing differentiators.

There are three ways to differentiate in retailing: location, location, and location. The problem is that as markets mature, location becomes less potent as a competitive advantage because the consumer has a growing abundance of convenient choices.

That's one reason why mass retailing in mature markets is a sector notorious for its lack of differentiation between players. Once location has played out its magic, retailers tend to get squeezed in a business characterized by the infernal duo of low margin and high fixed cost. In such businesses, price wars are never far away.

Creating non-price differentiation is difficult in retail as well because development of such advantages takes time and is difficult to execute. All the while, low-price players are constantly looming to pounce.

It is therefore not surprising that many retailers have adopted loyalty programs as a convenient mechanism of meaningful differentiation. Ultimately, loyalty programs should offer incentives for shoppers to reduce their store switching by offering them better value. Loyalty programs have the added advantage of not taking much time to establish, making the threat of price wars from competing retailers less credible.

UNCERTAINTIES, AMBIGUITIES, AND DOUBT

The many advantages of loyalty programs have been well debated in the massive literature available on the subject. Yet, there remain uncertainties, ambiguities, and doubts in the minds of many retailers over whether loyalty programs offer a sustainable and profitable business model.

Retailers such as Sainsbury's in the United Kingdom illustrate this hesitation. They were early adopters of loyalty programs but dropped them, claiming they were too costly without compensating tangible benefits. (Recently they reinstalled a program in a market where all non-Every Day Low Pricing players offered them.)

A lot of this uncertainty is due to a number of myths. In this paper we want to clarify the most prominent of misunderstandings associated with loyalty programs in retailing. The six myths can be classified in three groups: (1) architecture of shopper reward (size and convexity of rewards), (2) architecture of retailer rewards (sustainable profitability and horizontal competition), (3) type of retail sector (frequently versus infrequently purchased goods).

We discuss each of these myths in turn.

SIZE OF THE REWARD

Loyalty programs do not really work in grocery stores because the rewards that grocery retailers can afford to offer are too small. They cannot offer better rewards, according to conventional wisdom, because of their razor-thin margins fueled by extremely competitive market conditions.

That doesn't stop many retailers from trying. Indeed, grocers like Tesco, Sainsbury's, Kroger, Safeway, and Stop & Shop give back 1-2 percent of the total spent to their card-carrying shoppers. Stores in other categories—Staples in office supplies, Barnes and Noble in books, Best Buy in electronics—offer similar rewards. Boots, the UK-based pharmacy and beauty supply retailer, offers a substantial reward of 4 percent, but that rate is more exception than rule.

This type of reward is actually a "thank you" to the consumer from the store for the privilege of collecting loyalty card customer data. As former Tesco CEO Sir Terry Leahy put it in his recent book referring to the 1 percent loyalty discount: "It was a thank you, pure and simple."

Can such small rewards convince consumers to favor one retailer over another? Will consumers bestow their loyalty by spending most of their grocery dollars with one retailer for 1-2 percent payback?

Let's look more closely at the actual rewards. They come in two forms : (1) turbo charged vouchers (doubling, tripling, or even quintupling the value of the voucher at partner companies such as hotels, restaurants, and theme parks and (2) "

individual shopper targeted" offers, whereby each shopper regularly receives an extensive set of tailor-made coupons predominantly paid for by supplier brand-owners. The value of tailor-made coupons and their benefit to each individual shopper builds with the retailer's increasing understanding of the contents of the consumer's shopping basket, and relies heavily on the magnitude of dollars spent in the store.

The actual value for the shopper of turbo-charged vouchers and tailor-made coupons are far more substantial than the 1 percent "thank you" discount offered on the total purchases at Tesco. The more a consumer spends in the store, the more information the store is collecting about consumer tastes and shopping habits, allowing it to direct more relevant rewards toward such loyal customers.

Thus an increase in dollars spent in the store not only increases the dollar value of the coupons received by the customer, but also yields higher redemption rates reflecting the massively improved relevance of the tailor-made offers to each individual shopper based on loyalty card data. For example, at Tesco, redemption rates on individual tailor-made coupons vary between 10 percent and 20 percent as compared to the usual 1 percent or less redemption rates.

It is therefore not the 1-2 percent payback to the consumer that makes the loyalty program work for the grocer but rather the turbo-charged vouchers and the total value of tailored coupons that shoppers stand to lose if they go elsewhere. Store-switching costs created this way increase the spending and loyalty of shoppers.

For retailers lacking the capability of using information about their card-holding customers and turning these data into tailor-made individual shopper-specific propositions, loyalty systems are no more than an expensive gadget.

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CONVEXITY OF REWARDS

It is necessary but not sufficient to offer substantial rewards to generate more loyalty from shoppers. If competing retailers copy these substantial rewards, shoppers will not be incentivized to stay loyal to only one retailer—promiscuous shoppers would not be worse off than extremely loyal shoppers if rewards were linear and uniform across retailers. In principal, rewards received by shoppers should be non-linear—spending $x at one retailer should offer the shopper a better reward than spending $x/n in different stores.

One approach to achieve this convexity in rewards is to create loyalty systems that are tiered. It is often argued that tiered rewards, such as those offered by airlines, hotels, casinos, and financial service firms, are necessary for loyalty programs to thrive.

Many companies in travel and service businesses reward frequent users by bestowing a status that allows them the privilege of high-value services. Take, for example, British Airways, which allows Executive Club members the privilege of access to airport lounges around the world. Services offered in the lounges—showers, spa, Internet connection, appetizing free food and drinks, along with the opportunity to rest during a layover—is exceptional value to members. There is even a higher class of lounge facilities for an even more frequent traveler in first class. Similar facilities, free upgrades, and better rooms are also offered by hotels.

Casinos designate their guests as silver, gold, and platinum members, rewarding frequent visits with an increasing level of attention and free services available in each class of service. In designing a tiered system at Harrah’s, CEO Gary Loveman was very clear that he wanted to ensure that customers who visited another casino would lose something by not accumulating rewards with Harrah’s: the opportunity to get to higher levels of rewards and services that have a material impact on the customer’s experience.

Furthermore, tiered systems can stimulate customers to increase their purchases to reach the next stage-and therefore more and better rewards-in the hierarchy of loyalty classes.

Even though many believe that loyalty programs that lack this feature won’t induce enough loyalty to be sustainable, no retailer offers a tiered loyalty program. Conventional wisdom has it that it is difficult for retailers to offer differentiated services or levels of prestige to their different levels of customer loyalty.

The belief that loyalty programs lacking explicit tiered reward structures are ineffective is a myth. We believe this to be a myth because successful application of loyalty systems by retailers goes beyond tiered rewards—they offer individually tailored rewards.

Tiered reward systems create some form of stratified shopper segmentation—a shopper belongs to the silver category or the platinum category. These predetermined categories are far from homogeneous and substantial variation exists between consumers in the same category. So tailor-made loyalty systems go way beyond these heterogeneous customer groupings by offering propositions at an individual customer level (truly 121 propositions).

Information technology has enabled retailers to do on a mass scale of millions of customers what shopkeepers did in their villages a century ago: offer a differentiated service to each shopper. Shopkeepers knew each one personally and treated them accordingly. If that customer went to another retailer who didn’t know the shopper as well, he or she would receive an inferior service.

Then as well as now, the more a shopper spends at a particular store, the better that retailer can offer specific value propositions that competitors can't match. Promiscuous shoppers will be disadvantaged by receiving the "vanilla service" designed for the average shopper.

While retailers do not offer tiered loyalty programs, they do offer tailored coupons and other offers valued at par with the total spent in the store. The convexity in the reward structure comes from continuous improvement in making the rewards more relevant and meaningful to the shopper, which is more likely with ever increasing data available on the customer's loyalty card.

SUSTAINABLE PROFITABILITY

As mentioned earlier, retailers are often thought of as being unable to afford substantive loyalty reward programs because of their low margins. Offering an unconvincing 1 percent loyalty reward to customers already represents a reduction of 30 percent to 50 percent of the retailer's net profits. When margins are low, the sustainability of loyalty rewards often depends on two possible sources: abundant excess capacity and exogenous subsidies.

Airlines, casinos, and hotels can offer significant rewards to their loyal customers because they often operate with substantial overcapacity. Rewards based on this overcapacity, such as air miles or stays in hotels and resorts, are highly valued by potential customers.

In regard to subsidies, retailers have two types of "sponsors" for their loyalty reward investments: manufacturers of the branded goods sold by retailers, and other partner companies presumably with higher margins, who find it economically advantageous to pay retailers to attract additional business from their shoppers (Disney, restaurants, theme parks, etc.). The former finance most of the targeted coupons while the latter contribute the lion's share of the financing of turbo-charged vouchers.

Since manufacturers already invest significantly in retailer promotions, targeted promotions are a welcome vehicle for brand owners to improve the effectiveness of these promotional investments. They are particularly attractive to challenger brands, because targeted coupon activities are extremely scalable—they can participate for a varying number of brands for a varying period of time. This scalability of the coupon activities makes them less attractive to leader brands. They prefer, ceteris paribus, heavier, less scalable promotional activities, like in-store demonstrations, big prize sweepstakes, and the like, which are less affordable for challenger brands. However, leader brands are forced to keep a fair share of these targeted coupon promotions as a defensive strategy against their challengers.

Overall, retailer-initiated loyalty systems are truly triple win marketing activities simultaneously benefiting retailers (more loyalty, more sales, better profitability given their high fixed costs); brand-owning suppliers (more effective couponing, and an offensive tool for challengers and a defensive tool for market leaders); and shoppers and consumers (more appropriate product and price propositions). Given these substantial advantages for all parties involved, retailer loyalty programs can be sustainably profitable across the whole value chain.

As the percent of retail sales associated with promotions increases over time, improving the effectiveness and the efficiency of promotional spending will continue to be of utmost importance. It is not that loyalty systems increase the amount of promotional activities in the retail industries; it is redirecting these promotions (coupons, vouchers, etc.) toward more effective and efficient uses.

UNINTENDED CONSEQUENCES

Since loyalty systems are beneficial for suppliers, retailers, and shoppers, these systems should help improve the retailer's image, but a number of unintended consequences can overshadow these positive effects for the retailer.

First, loyalty programs can negatively influence the consumer's price perception of retailers. This conclusion directly follows from the arguments presented above in that retailers are able to charge higher posted prices due to reduced price competition. However, a negative price image is again a myth because it does not distinguish between highly valued loyal consumers and less valued switchers. While the price image may suffer in eyes of the switchers, many will still patronize stores for reasons other than price. On the other hand, the most loyal consumers have a price perception that is significantly affected by the nature and value of the targeted offers they receive in exchange for their business, and therefore have a much more favorable price image relative to the competition.

Loyalty programs end up creating different realities for the most loyal and less loyal shoppers, emphasizing the different reasons for why customers shop at a particular store.

Some unintended consequences are not a myth; retailers need to consider these when they apply loyalty systems.

First, some shoppers who spend less, like older and lower-income consumers, may feel they are getting a rough deal. Individually differentiated prices tend to favor higher spending loyal shoppers. Less favored shoppers might create negative influences against the retail chain's image, especially if their story with issues of discrimination is taken up by the media or regulators.

Second, as there is more room for sales growth with consumers who are not yet top spenders compared with those who are already top spenders, strict application of loyalty system strategies enhancing sales and profit growth might result in the former shoppers receiving more appealing offers than the latter group. This might cause concerns of inequitable treatment from the point of view of your "best" shoppers.

Third, as every shopper encounters a set of prices that are different from prices provided to other shoppers, retailer price transparency might become very murky. Potentially, this can have two implications, one on retailer price image and the other on retailer competition. Since every shopper effectively faces different prices at the same retailer, how does "the market" form a price image of that retailer? Will the generic in-store prices determine the price image or will every consumer have a different price image of the retailer? Furthermore, if price offers, through couponing and vouchering, vary almost continuously over time, will the shopper truly understand the prices at a point in time at each retailer?

This complexity might lead to less price transparency for shoppers and result in more monopolistic behavior by retailers. In this case the regulator might have to step in to ensure shopper interests are guaranteed through proper competitive price offers.

LOYALTY SYSTEMS AND COMPETITION

“I am very store loyal; I hold loyalty cards from five different retailers!”

Shoppers simultaneously hold loyalty cards from competing retailers and often shop regularly at more than one competing store. Hence the belief that loyalty cards are ineffective because shoppers subscribe to multiple programs from competing retailers. This is particularly true of grocery retailing where consumers regularly shop in more than one, and often quite a few, grocery stores.

However, it is a myth to believe that loyalty programs are ineffective when consumers hold loyalty cards from competing stores. First, although consumers shop in a number of stores, the dominant spend is in the favorite store—typically, more than two-thirds of the total grocery spend occurs in the favorite store. For the shopper, the dominant store will have an informational advantage over less patronized stores.

As a result, this favorite store will be able to make far more appealing and targeted propositions to that shopper, reinforcing that customer’s spending there. Of course, that shopper will continue to visit other stores for specific reasons, on the way to work, for example. One hundred percent loyalty to one store is rare and would be uneconomical for the retailer to aspire to.

Actually, loyalty systems are unique in the sense that copying of a loyalty system by direct competitors reinforces the strength of the loyalty generating capabilities of all participating retailers. In this case, each retailer will focus on its customers for whom it has an informational advantage rather than trying to attract shoppers who are loyal to another retailer. For the latter, the focal retailer has an informational disadvantage that makes it uneconomical to try to attract those shoppers. Furthermore, such a competitive move would probably trigger retaliation from the attacked retailer, who would subsequently try to steal the focal retailer’s loyal shoppers. It can easily be seen that such a strategy would punish all players, except the shopper.

The condition for a favorable equilibrium for all loyalty driven retailers is that all players are reasonably satisfied with their current market share. If some players want to gain share at the cost of profitability, then loyalty systems can escalate into intense price wars from which shoppers win short term and the lowest cost retailer wins long term.

Loyalty systems are most valuable for Hi-Lo market leaders, players who target both ends of the spending spectrum. As loyalty systems are first and foremost effective in retaining customers, the market leader has the most to gain from using these systems. Market leaders, having more shoppers, also have an informational advantage over their followers. (It is more difficult to make loyalty systems effective for smaller followers in the market, because they tend to have fewer customers and therefore an informational disadvantage.)

Tesco’s loyalty system in Poland is getting little traction because they lack “shopper critical mass”; they are a distant middle-of-the-pack player in the country. Although they try to use the same loyalty approach as in the UK, the Polish application cannot reproduce the benefits accrued to Tesco’s UK market leadership position. The lack of success of Tesco’s loyalty system in Poland is also in part due to a very strong market leader, Biedronka, which is a world class Every Day Low Price (EDLP) retail operation.

If one of the competitors is an EDLP player, the final outcome of the competition between the Hi-Lo loyalty retailer and the EDLP retailer is less predictable. In theory, and assuming all retailers want to maximize profits, the Hi-Lo retailer should be able to hold on to its shoppers for which it has an informational advantage and therefore for whom it can offer a more appealing offer. It will be difficult for the loyalty retailer to attract loyal shoppers from the EDLP retailer because it doesn't have the necessary shopper information.

The EDLP player can, however, be a real cause of concern for the loyalty retailer. The shopper population of the loyalty (Hi-Lo) retailer can be classified in three groups: (1) those redeeming their loyalty card offers, (2) those who are price sensitive but for some reason don't redeem their loyalty card offers, and (3) those who are loyal for non-price reasons. It is the second group that is vulnerable to aggressive offers from the EDLP competitor. The latter retailer might offer a price guarantee of lower prices for the total shopping bill of a minimum-sized shopping basket of comparable products. A significant proportion of the second group of shoppers might find this offer appealing and switch to the EDLP player. This is a concern for the loyalty retailer because this is probably a sizeable group. The loyalty retailer then needs to watch carefully its generic prices and in the meantime offer a price matching guarantee with the EDLP player.

Such a situation exists in the UK where grocer Asda, owned by Walmart, follows an EDLP approach and competes with several retailers that are loyalty Hi-Lo players. To attract shoppers from other (loyalty playing) retailers, Asda has offered a 10 percent price advantage guarantee for its shoppers and will reimburse shoppers if Asda is not 10 percent cheaper on the comparable shopper's total shopping basket. This has been effective to the extent that Tesco now offers a price-matching promise vis-à-vis Asda and other retailers, on top of its own loyalty program.

Normally, one would expect this price-matching guarantee to call an end to the price war. But other, more global, issues seem to be at stake and Asda continues to guarantee a 10 percent price advantage. For Asda, short-term profits don't seem to top its list of objectives.

LOYALTY SYSTEMS AND INFREQUENTLY PURCHASED GOODS

Another myth is that loyalty programs do not work in categories that are purchased infrequently or do not affect the behavior of customers who shop infrequently in the category. Consider the impact of frequent flyer programs for families that travel mostly for vacation. It might take them more than a year to accumulate enough miles to get a free airline ticket. Would a frequent flyer program affect the choice of airline when making the next reservation for a family vacation? In other words, it is difficult to make a loyalty program effective if the consumer does not believe that the rewards are achievable.

This myth is partly true because most retailers agree with the observation but have found ways to get around it. They have done so by either making the award more lucrative and therefore more salient in the minds of the consumers, or they help consumers accumulate rewards in other ways that could be redeemed in their stores. To solve the challenge of the infrequent vacation traveler, airlines introduced credit cards so consumers can earn points or rewards for all their spending on the card and advance to levels that make the rewards more easily achievable.

Another way to support a more lucrative program is by finding other partners to pay for the rewards. This is again possible if the data available through the loyalty program can be used in a meaningful way by other partners.

SUMMARY

Retailers seem to have an uneasy relationship with loyalty rewards programs. Many believe the programs are unsustainable in low-margin businesses or industries.

But as we have shown, these myths are just that, and a variety of loyalty programs can be fine-tuned by retailers to produce differentiation and increased profits. When location, location, location is no longer enough to attract customers, a program that rewards their loyalty certainly will be.

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