

A PURPLE PAPER

How Does Customer Loyalty Effect Profitability?

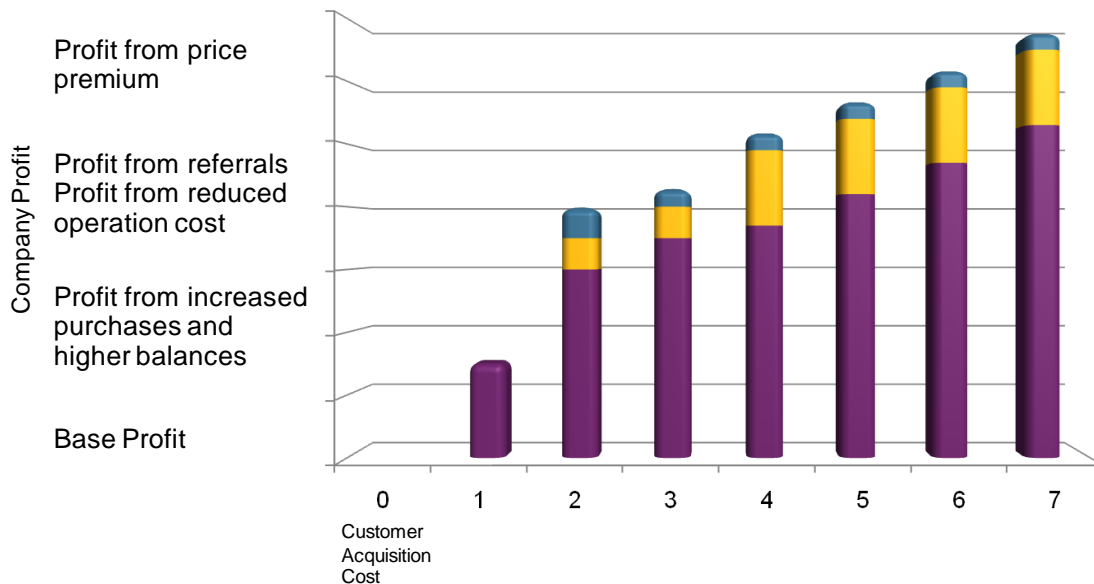
How Does Customer Loyalty Effect Profitability?

Once an organization targets its customers and begins to meet and exceed their expectations, customer satisfaction rises. Loyalty follows, bringing with it a significant and measurable impact on the bottom line.

Lifetime Value

Earl Sasser and Fred Reichheld studied a wide range of service industries, and they discovered that relationships with typical customers grew increasingly more profitable over time in all cases—regardless of industry.

Why Customers Are More Profitable Over Time



1. In year 0, customers are acquired. These acquisition costs must be recouped over the course of the relationship.
2. Early on in the relationship, purchase and profit levels tend to be low. But they create a foundation on which a longer-term customer relationship can be based.
3. Once he or she is familiar with a product or service, the customer is more likely to buy new products or services. The customer becomes less price-sensitive in making these purchases than with base product or service purchases. The profit level increases.

4. Having become knowledgeable about the company and its policies, less expense is incurred to acquire the customer; therefore, costs are reduced. Further, the truly loyal customer becomes an "apostle," someone who eagerly recommends the company to others, generating new business and greatly increasing profitability.
5. The longer the customer relationship lasts, the more profitable it tends to become. In one study of service firms, extending the customer relationship from five years to six years resulted in a 25% to 85% increase in profitability.

Calculating the Lifetime Value of Your Customer

Do companies realize how valuable loyal customers really are? Calculating the lifetime value of your customers can be an eye-opening experience. It can also help you build top management's support for customer retention initiatives.

Lifetime value can be calculated for any customer in any industry. Let's assume a business-to-business example: a small graphic design studio that buys software from a vendor.

In year 1, the owner of the design studio sees a television ad for new desktop layout software and makes a purchase. In this first year, the vendor doesn't make any money on this customer because the costs of acquiring and serving the customer are greater than the purchase price of the software program.

In year 2, the customer, happy with the layout software, buys the upgrade (which has a higher profit margin) as well as a software program for drawing and illustrating. In addition, the studio owner refers the layout software to several independent graphic designers, one of whom buys the layout software.

In year 3, the design studio buys a program for manipulating images and a clip art library from the vendor. The first referral buys the drawing software and the layout software upgrade. Another referral purchases the layout software.

In year 4, the design studio purchases a new upgrade to the layout software and an upgrade to the drawing software. The first referral purchases image manipulation software and a clip art library. The second referral purchases the drawing software and the layout software upgrade. In addition, two new referrals purchase the basic layout software.

In year 5, the design studio buys new all-in-one software combining layout, illustration, and image manipulation capabilities and also a different clip art library. The first referral buys another upgrade to the layout software and an upgrade to the drawing software. The second referral buys image manipulation software and a clip art library. The two referrals from the past year each purchase the drawing software and the upgrade to the layout software.

The purchases made in years 1 through 5 by the design studio and its referrals are tabulated below. As you can see, the initial \$800 purchase in year 1 leads to an additional \$12,850 of business from all sources in years 2 through 5.

	Year 1	Year 2	Year 3	Year 4	Year 5
Revenue from basic good and services	800	0	0	0	0
Revenue from new goods and services	0	500	500	250	3,000
		250	200	250	200
Cost to (acquire and) serve	850	100	100	100	100
Referrals: Revenue from new loyal accounts	0	800	750	700	500
				750	700
			800	800	750
				800	750
Profit (\$)	(-)50	1,450	2,150	3,450	5,800

Using the Service Profit Chain to Build Customer Loyalty and Profitability

Research across a wide variety of industries confirms the existence of strong links among profitability and growth and the following factors:

- employee capability
- employee satisfaction
- employee productivity
- employee ability to deliver good value to customers
- customer satisfaction
- customer loyalty

Employee factors produce an indirect effect on customer loyalty and profitability. For example, employee capability—built by hiring the right people, giving them training, support, latitude, and rewards—promotes employee job satisfaction. When employees enjoy their work and believe they are making a difference they tend to stay longer, to become more productive and knowledgeable – in short, they become loyal employees. Such employee loyalty, in turn, creates greater customer satisfaction. After all, customers are more likely to be happy when they are being served by motivated employees who take the time to get to know their specific needs and circumstances. Not surprisingly, happy customers tend to buy more from the company and also to refer other customers to the company more frequently. Thus, customer satisfaction breeds customer loyalty. And there is a dramatic cause-and-effect relationship between customer loyalty and profitability: in some industries, a small percentage of a company's most valuable and loyal customers can account for more than half of total profitability. Together, the mutually reinforcing connections described here form the "service profit chain."

ABOUT THE PERT GROUP

Our goal is simple: to help our clients grow their businesses and their brands. How? By establishing business decision clarity.

We are The Pert Group, a top research-based consulting firm for business leaders who require straightforward, meaningful results that lead to clear, significant decision making.

We begin with fact-based evidence integrating attitudinal and behavioral research, which allows us to create clear strategies for business growth based on fact-based insights, and our team of **market-focused experts** works closely with our clients to consistently relate our work back to their goals and strategies.

Using a balance of creativity, forward thinking and pragmatism, we **completely immerse** ourselves in our clients' businesses and apply strategic methods to help them increase business and brand performance, differentiate their companies from the competition and take advantage of all opportunities in the market space.

The result? Clarity established.