From: The Loyalty Effect
Frederick Reichheld
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Summarised by Andrew Gibbons

P viii "...customer loyalty is inextricably linked to employee and investor loyalty, and major improvements in the one often require improvements in the other two".

"We have found that using short term earnings as the only rigorous measure of performance leads many companies to place too much emphasis on reducing costs and too little on investing in the assets (usually human) that generate growth".

P ix "Loyalty as we conceive it is critically important as a measure of value creation and as a source of of growth and profit, but we stop well short of claiming it to be a cure-all or a magic bullet".

P 1 "Loyalty is dead, the experts proclaim, and the statistics seem to bear them out. On average, U. S. corporations now lose half their customers in five years, half their employees in four, and half their investors in less than one".

Experience has shown us that disloyalty at current rates stunts corporate performance by 25 to 50% sometimes more...loyalty is by no means dead. It remains one of the greatest engines of business success.

With rare exceptions, CEOs have enough experience and common sense to understand what nonsense it is to speak of loyalty's demise".

P 2 "Yet if CEOs are wise enough to see the power of loyalty, why are defection rates so high? How do they manage to lose half their company's' customers every five years? The answer is that most of them don't measure defections, and have no idea they are losing customers at such a rate".

...customer loyalty is too important to delegate...the responsibility for customer retention or defection belongs squarely on the CEOs desk. Consistently high retention can create tremendous competitive advantage, boost employee morale, produce unexpected bonuses in productivity and growth, even reduce the cost of capital.

Conversely, persistent defection means that former customers - people convinced the company offers inferior value - will eventually outnumber the company's' loyal advocates, and dominate the collective voice of the marketplace".

P 3 "Profit is indispensable of course, but is nevertheless a *consequence* of value creation, which, along with loyalty, makes up the heart of any successful, long-lasting business institution.

Stemming the customer exodus is not simply a matter of marketing; it demands a reconsideration of core strategy and operating principles"

Today's accounting systems often mask the fact, but inventories of experienced customers, employees and investors are a company's most valuable assets. Their combined knowledge and experience comprise a firm's intellectual capital".

P 5 "Profits alone are an unreliable measure because it is possible to raise reported short term earnings by liquidating human capital.

Since the only way a business can retain customer and employee loyalty is by delivering superior value, high loyalty is a certain sign of solid value creation".

P 11 “Prodigious client churn goes hand in hand with the kind of employment policy that alternates between layoffs and frenzied hiring”.

P 14 On the efforts of Johnson and Higgins insurance brokers, to learn from defecting customers: “One of the company’s most senior executives interviews every client of any significance who defects, to help the firm learn from failure and improve its performance”.

Reichheld quotes Dave Illingworth, the first general manager of Lexus U.S. “the only meaningful measure of satisfaction in this industry is repurchase loyalty”.

P 16 ”The real trouble is that many, perhaps most, executives today have adopted a paradigm which is inconsistent with loyalty-based management. Press them, and few will insist that the primary mission of their companies is to create superior value for customers and employees so investors can prosper”.

P 18 “Profit does not have to occupy the centre of the business solar system in order to be indispensable”.

1. Revenues and market share grow as the best customers are swept into the company’s’ business, building repeat sales and deferrals. Because the firm’s value proposition is strong, it can afford to be more selective in new customer acquisition and to concentrate its investment on the most profitable and potentially loyal prospects, further stimulating sustainable growth.

2. Sustainable growth enables the firm to attract and retain the best employees. Consistent delivery of superior value to customers increases employees’ loyalty by giving them pride and satisfaction in their work.

3. Loyal long-term employees learn on the job how to reduce costs and improve quality, which further enriches the customer value proposition and generates superior productivity.

4. Spiralling productivity coupled with the increased efficiency of dealing with loyal customers generates the kind of cost advantage that is very difficult for competitors to match.

5. Loyal investors behave like partners”.

P 23 “The truth is, no company can afford to keep employees who fail to create enough value for customers to more than cover their own compensation.

The key is to compensate partner-employees by sharing the value they help create for customers”.

P 24 “When it comes to costs, the conventional approach is to redesign processes or lay off employees. But either one is likely to demoralise the workforce and impair customer service, which will decrease customer retention and send costs through the roof”.

P 28 “Choosing whom we work for and with are two of the most important decisions most of us make...yet many people look on a job as a necessary evil, the unavoidable means of achieving a desired standard of living. They don’t expect principled management, just a generous paycheque”.

P 29 “Work that is congruent with personal principles is a source of energy. Work that sacrifices personal principles drains personal energy.

Loyalty is neither a substitute for profit or a gimmick for making easy money”.

P 33 “We discovered some years ago that raising customer retention rates by five percentage points could increase the value of an average customer by 25 to 100 percent”.

P 34 “To manage customers as assets, you must be able to value them as assets. This means you must be able to quantify and predict customer duration and cash flow”.

P 35 “Accountants have developed sophisticated techniques for appraising capital assets and their depreciation; they have learned how to monitor the changing value of work-in-progress; but they have not devised a way to track the value of a company’s inventory”.

P 37 “Clearly, the economic consequences of losing mature customers and replacing them with new ones are not neutral”.

P 42 “Reichheld lists the following cost and revenue elements that contribute to net lifetime value:

1. Acquisition costs. 2. Base profit. 3. Per-customer revenue growth.

4. Operating costs. 5. Referrals. 6. Price premium.

P 43 “Whatever your industry, you must tally up *all* your customer acquisition expenses, hidden and plainly visible, to find the true up-front cost of landing new business.

All customers buy some product or service, or we wouldn’t call them customers. With rare exceptions moreover, the prices they pay are higher than the company’s costs. This basic profit on purchases, unaffected by time, loyalty, efficiency, or any other consideration, is what we call base profit.

Obviously, the longer you keep a customer, the longer you will earn this base profit, which makes your acquisition investment look better and better.

One advantage of holding onto your customers is that in most businesses, customer spending tends to accelerate over time...average annual revenue per customer in auto service (for instance) triples between the first and fifth year”.

P 45 “As customers get to know a business, they learn to be very efficient...familiarity with the company’s products makes them less dependent on its employees for help and advice”.

P 48 “A third important benefit of long-term customer retention is that satisfied customers recommend the business to others. Lexus (for instance) gets far more new customers from referrals than from any other source.

Though businesses are often quick to give the credit for good growth to sexy advertising, brilliant marketing campaigns, or skilled salespeople, the chances are that their profitable growth is driven by by referrals”.

P 49 “In most industries, old customers pay effectively higher prices than new ones. This is sometimes the result of trial discounts available only to brand-new customers...they’re less price-sensitive on individual items than new customers”.

P 53 “...defection rates run much higher than average in the early years, and much lower later on. In the first two years of customer tenure, it is not unusual to see defection rates two or three times the overall average”.

P 56 “...businesses need to know what a customer is really worth, and only actual defection rates for particular classes of customers will tell them”

P 59 “Where retention economics has never been tested under fire, event companies that have bought into the concept will quickly revert to old measurement systems in times of profit pressure. Companies that are serious about improving customer loyalty will eventually find that they *must* invest in the systems that measure retention and its economic consequences. The earlier they make this investment, the better”.

P 61 “Customer loyalty yields returns over several years; managers’ bonuses are determined annually. Understanding a business’s loyalty economics can produce some powerful short-term improvements in profit performance, but on the whole, the temptation is great to put off investing in the kind of rigorous measures that enable steady learning and continuous improvement over longer spans of time.

This is how MBNA discovered that a 5-point increase in retention lifts per-customer profit by more than 125 percent. This is how State Farm (insurance) determined that a 1-point increase in retention will increase its capital surplus by more than 1 billion dollars over time”.

P 61 “Loyalty-based management is not a matter of investing blindly in your customers in the hope that somehow profits will grow. It’s a matter of making rational business decisions about which projects to fund and which ones to cancel”.

P 164 “To understand the true long-term profitability potential of any group of customers, you have to know something about its predisposition to loyalty”.

P 65 “Most companies try to understand the current profitability of different customer groups, but this is difficult without studying *patterns* of loyalty. In fact, few businesses have tracked customer loyalty closely enough even to supply the data for such an analysis”.

P 76 “Businesses, especially big businesses, can be very sloppy about deciding which customers to seek out and acquire.

It is simply not possible to build or maintain a healthy business without learning how to get the right customers. In most businesses, the customers most likely to sign on are precisely the worst customers you could possibly find”.

P 80 “There is always tension between commission sales and customer loyalty, because a salesforce paid on commission, and hell-bent on customer volume generally finds that the easiest prospects to sell are the ones whose loyalty is low”.

P 81 “…most companies pay salespeople for conquests, not continuity. Even if a company does compensate the salesforce for repeat business, most salespeople aren’t planning to hang around long enough to reap the benefits”.

P 82 “…the customers who glide into your arms for a minimal price discount are the same customers who will dance away with someone else at the slightest enticement”.

P 84 “…the need for growth can cause companies that have captured the best of their natural customer base to recruit more and more of the less desirable customers who remain. But it’s a poor bargain, for as customer quality declines, so does the firm’s ability to deliver value; which in turn discourages good customers, stifles growth, demotivates employees, weakens the process of value creation, and encourages the salesforce to chase customers who are even less likely to be profitable and steady.
In short, the entire spiral turns upside down and drills the company into a hole”.

P 86 “It’s hard to concentrate on customer quality when gaining quality is so much easier”.

P 89 “Beware the customer-acquisition strategies that seemed to make sense yesterday. Pay close attention to the value of incoming customers in a marketplace where the best and most loyal are already spoken for…beware of quantity for its own sake; winning more and more customers may put you slowly out of business”.

P 90 The three key characteristics of the sort of customers any business needs to seek and keep:

1. Inherent loyalty. 2. Profitability. 3. Fit.

P 91 “If you wonder what getting and keeping the right employees has to do with getting and keeping the right customers, the answer is everything. Employees who are not loyal are unlikely to build an inventory of customers who are”.

P 92 “Yet the general trend in business today doesn’t seem to involve a search for ways to keep employees longer and help them earn more money. It often seems the goal is quite the opposite:finding ways to pay employees less, or actually getting rid of them, especially those with the greatest experience and the highest compensation”.

P 97 “If an operation gives the kind of value that makes employees proud, they will naturally recommend it to friends and relatives. The real surprise is that their opinion has more impact on new-customer volume than advertising and promotion put together”. Note: this example relates specifically to car retailing.

P 99 “When people don’t like their jobs, recruiting, training, and career path management may all need improvement”.

P 100 "When good, productive employees begin to flow out the door because their future careers strike them as limited, top management needs that feedback to modify the system in ways that permit promising individuals to learn and grow".

P 102 "Simply getting your employees to stay with the company longer won't necessarily produce superior economics. A lot of firms are loaded with dead wood.

Many companies seem to be trapped in a blind alley. Individual productivity is insufficient to keep the company competitive, yet managers can't tell which employees are underperforming, because they can't track individual productivity and contribution to profit".

P 111 "Just as the first step in earning high customer loyalty is to search out the right sort of customer, so the first step in gaining employee loyalty is careful recruiting".

P 116 "…no company can guarantee employment. Only the customer can do that – and customers will keep buying only as long as they receive superior value".

P 119 Henry Ford on the costs and value of people: "Cutting wages does not reduce costs – it increases them. The only way to get a low-cost product is to pay a high price for a high grade of human service".

P 123 "Customers will never pay more for anything than the value it creates for them".

P 138 On the correlation between length of service of key customer service people and business success: "Where our consulting teams have examined bank systems, they have consistently found that branches run by the same branch manager for more than seven years enjoy customer defection rates 5 to 10 percent lower than average".

P 140 "Cutting costs at the expense of the only people in the business who are in a good position to increase Revenue is a fool's solution to the productivity problem, because the proper goal is not low cost per unit but low cost as a percentage of revenues.

To magnify employee loyalty and increase productivity, companies must do all they can to promote employee loyalty and increase productivity, companies must do all they can to promote individual learning and the alignment of employee and company interests".

P 142 "The amount of profit employees contribute lies in the gap between their productivity curves and their compensation curves. In loyalty-based companies, compensation is a function of productivity, and the two grow or shrink in parallel.

…productivity won't improve until employees begin sharing in the value they create".

P 143 "Two kinds of mistakes destroy potential productivity. The first is hiring candidates who can't raise their productivity fast enough to stay ahead of their compensation. The second is hiring people, however capable, who won't stay with the business long enough to earn back what it cost to bring them on board".

P 144 On 'crazy career paths': "If the primary route to prestige and higher compensation is to move past the terminal line position to a staff job whose impact on value and profit cannot be precisely defined, then customer loyalty, productivity, profit, and overall business longevity must all suffer".

P 147 "It's hard to see how a layoff by itself could increase customer value. What layoffs *can* do is raise the level of uncertainty among employees and customers alike".

P 153 "Most management teams have put far more emphasis on delivering value to shareholders than to customers or employees, yet they've failed to improve customer loyalty".

P 156 "At most companies, the expected tenure of senior executives is dropping, sometimes as a result of investor impatience with managers who don't meet short-term goals.
In other cases, managers themselves see no reason to stick with a business through its inevitable ups and downs, given the lack of loyalty from current owners.

In either case, the end result of premature executive departures is poor continuity, limited planning and investment horizons, and a slide back down the productivity and learning curves".

P 183 "Loyal capital is more committed to your business, knows more about it, and therefore tends to demand more than the transient investors you never meet or hear from".

P 186 "Companies have free will. They can learn from their failures, and they can change – or they can decline to learn and refuse to change – the choice is theirs.

One of the reasons so many businesses fail is that all their analysis and learning revolves around profit, so they become aware of problems only when their profits begin to decline. In struggling to fix their profits, they concentrate on a symptom and miss the underlying breakdown in their value-creation system.

When profits are squeezed, it's safe to assume that something is wrong and needs fixing. But the core of the problem is usually insufficient value to customers. Managers who aim directly at higher profits by raising prices or slashing headcount often exacerbate the original problem of poor value creation".

P 187 "…the lifeblood of adaptive change is employee learning. (*Organisational learning)* is a useful term, but it's only a metaphor. People learn, not organisations, and when people leave a company they take all their personal skills and much of their experience with them.

There are two principal reasons why organisations do not study their own failures. The first is bureaucracy, which is almost perfectly designed to conceal mistakes and utterly disinclined to seek them out and lay them bare. The second is an almost universal fixation with success".

P 188 "…to do any good, the goal of failure analysis must be learning, not concealment, and the boss must lead or at least cheer on the effort, not float in blissful ignorance.

Most people discover early in life that mistakes are better teachers than success, that more learning flows from failure than good fortune".

P 190 "Psychologically and culturally, it's difficult and sometimes threatening to look too closely at failure. Ambitious managers work diligently to link their careers with successes. Failures are usually examined for the purpose of assigning blame, rather than detecting and eradicating the systemic causes of poor performance".

P 196 "The fact is, every (customer) defection is the result of inadequate value. And since value is the ratio of quality to price, price is always a factor in defection.

Occasionally, a single event is so powerful it leads to defection all by itself…but that is the exception. In most cases, a series of events leads slowly to a decision to seek better value elsewhere".

P 199 "Even in companies that care enough about retention to engineer effective incentives, it's sometimes necessary to remind employees how important it is to continue *improving* retention rates".

P 201 "Most companies have no experience measuring the value they deliver to customers, so it's hard to know where to begin".

P 203 "Every company wants more customers, and if the sales force is paid for customer acquisitions, the customers will generally appear. But if standards drop, the negative value spiral takes over. Poorer customers cost more and yield less; the Company raises prices and cuts service to save money; the value offered good customers begins to fall; defections surge, and earnings plummet".

P 204 "The danger of course, is that on the basis of inadequate information, the Company will mistakenly identify potential valuable customers as marginal or dispensable. Unfortunately, such mistakes are easy to make, because some first-class defectors wear a third-class disguise.

They were once outstanding customers, and could be again, but by the time they're ready to leave, they've already moved a substantial share of their wallet to a competitor. So they look like the kind of unwelcome customer you're eager to get rid of".

P 205 “One final reason for carefully tracking the quality of retained versus defecting customers is to make sure overzealous customer-recovery units don’t spend money to save customers who are unprofitable or even losing the Company money”.

P 213 “There is simply no substitute for having senior executives learn directly from defectors why the company’s value proposition is inadequate”.

P 215 “…there are several keys to organisational learning. The first is to understand that the true mission of any business, yours included, is the creation of value. The fact that most companies see profit rather than value as their primary business objective has inhibited their ability to learn in much the same way that the notion of an earth-centred universe stalled progress in astronomy.

Regrettably, management science has made essentially the same mistake. Research academics search out companies that look superior, usually on the basis of recent profit performance – and, regardless of whether those profits were virtuous or destructive – then use those case studies to generalise about which management practices produce superior profit”.

P 215 “The second key to organisational learning is to grasp the value of failure. Only by measuring their failures can organisations unlock the doors to real learning.

The third key to effective learning is to make sure that the right people in your organisation learn to identify and correct the failures whose frequency and severity constrain your company’s capacity to reach higher levels of value creation”.

P 216 “Finally, the best place to start monitoring failure is to watch defection rates for targeted groups of customers, employees and investors. This practice will identify the hot spots that need attention in your value-creation system”.

P 217 “…measurement lies at the very heart of both vision and strategy. It’s hard to overestimate the importance in determining the future course of a business. Measurement turns vision into strategy, and strategy into fact.

The choice of what a business measures communicates values, channels employee thinking, and sets management priorities.

Deciding what to measure and how to link measures to incentives are among the most important decisions a senior manager can make. Yet most executives today work with inherited measurement systems that distort their business strategies”.

P 218 “…measurement is far too important to delegate, least of all to accountants and MIS professionals. In a large, complex, far-flung enterprise, measures are the only systematic means an executive has For turning ideas into actions”.

P 222 “Value to the customer is the price less the cost.

Raising the price will increase value to the Company, and decrease value to the customer. Cutting the price will do just the opposite”.

P 223 “In general there are three things you can do to maximise the net present value of your customer base. First you can search for ways to cut costs without reducing customer value. Second, you can search for ways to improve value to your customers at *increased* cost, providing that increased cost is smaller than the increased benefit.

Finally, you can adjust prices to maximise profit, with or without a corresponding increase in value. You just have to bear in mind that whenever price exceeds the full value a customer receives, that customer will defect, wiping out a stream of future profit”.

P 248 “Another critical dimension to consider in building a set of measurement statistics is the number of customer segments that need to be tracked separately”.

P 253 “The best measurement systems also try to anticipate defections before they occur. In the credit card business, for example, the key drivers of lifecycle profit are the amount of customer spending and the size of the balance on which a customer pays interest. As a general rule, balances and usage decline for some time prior to a customer defection".

P 270 "When turnover rates for customers and salespeople are high, it is almost certainly a sign that the value proposition needs rebuilding".

P 273 "Select customers carefully; learn more than any other company about what those core customers value through the whole cycle of shopping, purchase, ownership and replacement; then redesign channel partnerships, sales and service processes, communications, product lines and logistics to deliver outstanding value. The new value proposition must provide better value than anything the competition can offer".

P 277 "Companies cannot succeed or grow unless they can serve their customers with a better value proposition than the competition".

P 301 "Loyalty-based management is hard work. No-one can transform measures, incentives, customer lifecycles, employee career paths and capital structures overnight".

P 302 "Unless all systems are designed to work together in harmony, you won't see much benefit. The key to ultimate, lasting success is how the parts of the system fit together.

Customer, employee and investor loyalty are so thoroughly entwined that to understand and manage one, you must understand and manage all three. But while loyalty is indeed strategic, its implications transcend strategy and point to a philosophy of business that places people above process. The central tenet of this philosophy is that the purpose of a business is to create value, not simply to create profit.

"By observing the behaviour of customers, employees and investors (do they or don't they come back for more?), you can quite straightforwardly determine where value is being delivered and where it isn't, and by extension, whether a business is succeeding or failing in its mission to create lasting value".

P 303 "While every loyalty leader's strategy is unique, all of them build on the following eight elements:

1. Building a superior customer value proposition.
2. Finding the right customers.
3. Earning customer loyalty.
4. Finding the right employees.
5. Earning employee loyalty.
6. Gaining cost advantage through superior productivity.
7. Finding the right investors.
8. Earning investor loyalty".

P 305 "Loyalty is a character trait: it cannot be created, only reinforced.

While the journey has little prospect of ever ending, it does not need to begin. For most companies, the beginning presents the single greatest challenge, because it means a fundamental change in orientation from profit to value.

You need to consider carefully whether the pursuit of value and loyalty is truly consistent with your own aspirations. For most companies that is not an exercise for one person but for the entire team that runs the business".

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