

The Loyalty Effect

essays

on the
relationship
between
loyalty and
profits

the
forces
of loyalty
vs. chaos

essay # 4

BAIN & COMPANY

the forces of loyalty vs. chaos

Excellent Dinosaurs

Watch out! Chaos seems to have gotten a leg up in its battle against “order” and today’s marketplace is reeling. The advantages of market share, cost position and service quality no longer guarantee success. General Motors, instead of reaping the spoils of market share leadership, is struggling to reverse its downward spiral. A low cost manufacturer like Caterpillar suddenly finds itself at a cost disadvantage in key markets. And a service quality “Blue Chip” like Delta Airlines is downgraded to junk bond status. Companies such as Wang and IBM are profiled as case studies of “Excellence” one day, then as management turnarounds the next.

The Baldrige Award is trumpeted on the nation’s front pages as our competitive saviour in the crusade to reassert America’s “Quality” leadership. Then, a Baldrige winner files for bankruptcy and the award is hidden back on the fifth page of the *Wall Street Journal*. One day, market share and experience are the essential strategic assets; now, they are irrelevant compared to time, the new competitive frontier. Forget about “Total Quality,” now all you have to do is reengineer all your core business processes.

Business thinkers careen from guardrail to guardrail. One professor claims that strong leadership is really the key; another concludes that empowered, learning organizations will triumph. Is it truly chaos? Is success really so complicated, transitory and fragile? Or is the business world rational? We just don’t yet understand some of the natural forces which govern it.

From an evolutionary perspective, management science is still in its infancy. Today’s large corporations are relatively recent descendants of the industrial revolution. Unlike well-evolved institutions which transcend the lifespan of their individual members, the average Fortune 500 company expires in 40 years. Most are outlived by the majority of their employees. The study of this struggle for survival is relatively immature since business schools are inventions of the twentieth century. Harvard, for instance, began its search for *Veritas* almost three centuries before its Business School began its search for profits.

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So it would not be surprising if there are some basic flaws in our mental models of business. Management lags far behind more mature sciences such as Physics and Medicine. These disciplines probably seemed chaotic when the sun was thought to rotate around the earth or when the cure for high blood pressure involved patient bleeding — either by application of leeches, or by using tools called “fleans” or “schnappers.” Before the basic systems of cause and effect were understood, rhetorical skills and political connections determined which theories of natural science would prevail. Popular opinion flip-flopped regularly.

So it is with the current flip-flopping in business theory. Until the forces governing cause and effect in a business are better understood, we are doomed to rhetoric, confusion and inconsistency. Today’s layoffs, reengineerings and restructurings may be our generation’s leeches, fleans and schnappers. In the world of business, we may believe that the sun revolves around the earth.

Discovering The Nature Of Business

The earth has always been central to humanity’s survival. It is no surprise that ancient civilizations placed our home at the center of the universe. Today, most executives view profitability as the most important factor in the survival of their business. Is it possible that modern theories in managerial science, like ancient theories in natural science, are built around an equally false center?

We encountered evidence which supports this hypothesis when we studied the linkage between customer retention and profits. Seemingly insignificant changes in customer retention rates in several of our clients’ businesses resulted in eye-popping improvements in profits. Then, we studied a wide array of industries, and found that a 5 percentage point shift in customer retention consistently resulted in 25-100% profit swings.

These almost unbelievable results indicate that there must be powerful forces at work. What are they? How does retention drive such swings in profits? What drives customer retention? Why do companies with high customer retention also have high employee and investor retention? The answers to these questions have not only given us important new tools to improve a company’s performance, they have changed our understanding of the nature of business.

At the core of any successful enterprise, enabling its very existence, is its value creation process.

Value creation generates the energy which holds the business together. The economic “physics” which govern the interrelationships and energy states of the elementary particles in a business system (its customers, employees and investors) we have come to call *the forces of loyalty*.

These forces are measurable in cash flow terms because of the linkages between loyalty, value and profits. Loyalty is inextricably linked to the creation of value. As a first order effect, loyalty reliably measures whether superior value has been delivered (they come back for more). Next, loyalty initiates a series of second order economic effects which cascade through a business system as follows:

- 1) Revenues and market share grow as the best customers are swept into the company's book of business, building repeat sales and referrals.
- 2) Costs shrink as the expense of acquiring and serving new customers and replacing old ones declines.
- 3) Employee retention increases because job pride and job satisfaction increase, in turn creating a loop that reinforces customer retention through familiarity and better service to the customers. Increased productivity results from increasing employee tenure.

As costs go down and revenues go up, profits (the third order effect) increase. This provides the resources to invest in superior employee compensation (further reinforcing retention) and in new activities or features that enhance customer value, thus further increasing both customer and employee retention. Profits are important, not just as an end in themselves, but because they allow the company to improve value and provide incentives for employees, customers and investors to remain loyal to the company.

Deliver Us From Chaos

The Loyalty-based model effectively explains success and failure in the business world. In most industries which we have studied, the companies with the highest retention rates (evidence of superior customer value) also earn the best profits. Relative retention explains profits better than market share, scale, cost position or any of the variables usually associated with competitive advantage. It also explains why traditional management techniques often backfire in chaotic ways.

Consider how a traditional company would respond to a slowdown in its revenue growth. It might hire more salesmen, raise commissions to entice more aggressive selling, drop price to new customers, or add new products. The result: more inexperienced salesmen (low productivity/high cost), bringing in the wrong kind of customer (price shopper/disloyal), with escalating costs of product line complexity.

The traditional company attacks cost by redesigning processes, laying off employees and so forth, often demoralizing their employees, thus lowering customer service. This decreases customer retention which makes costs skyrocket! Cost reductions passed on to the customer in lower prices can increase value. Cost reductions taken only for the benefit of the shareholder (the vast majority) usually destroy value.

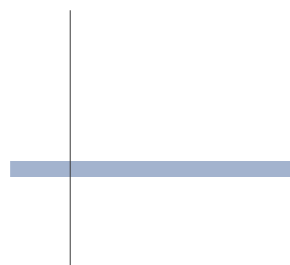
While Loyalty-Based Management® techniques may seem intuitive, they represent a radical departure from traditional business thinking. As we have learned more about the forces of loyalty, we have come to view business strategy in a new light. Its objective is to bring together a well-matched set of customers, employees and investors who will remain together long enough so they can learn to be very effective at mutually creating and consuming value. This shift for business is as fundamental as the Copernican shift to a sun-centered solar system was for astronomy. Creating customer value becomes the center of business strategy—not maximizing profits or shareholder value.

Loyalty also illuminates the physics which govern a business system. Just as friction steals the energy from a mechanical system, defection robs the energy and knowledge from a business system. Without knowing it, managers have engineered enormous friction into their businesses in the name of “maximizing shareholder value.” In fact, this friction destroys value for all the participants in a business including shareholders.

The opportunity for reducing friction in most businesses is immense. Shareholders now churn their holdings based on short term speculation at the rate of 50% per year. Employees change jobs with increasing frequency, 15% to 25% turnover is common. And customers defect at the alarming rate of 10% to 30% per year. With this much friction, it is no wonder that productivity and economic growth are languishing. Business is being conducted among strangers, trust is low and energy is sapped.

Fundamental changes are required in business practices ranging from refined customer-targeting to revised hiring strategies. New measures and incentives are required. Much more work needs to be done to develop the best method for allocating value among the stakeholders so a business can prosper and energy can be focused to sustain the value creation process.

While these changes will require significant investments, the advantages will be enormous to customers, employees and investors. Among other things, organizational stakeholders will be able to make sense out of the successes and failures around them so that meaningful learning can result. They may actually get to know and trust one another. Then the forces of loyalty can indeed triumph over chaos.





By Frederick F. Reichheld

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Bain & Company serves clients through an 18-country network of 25 offices across six continents. Since 1973, Bain has worked with over 1500 major multinational and other corporations, from every economic sector, in every region of the world, to improve bottom-line results.

Through its diverse client assignments and research, Bain has developed an immense experience base, covering a broad range of critical business issues; together with original, proven methods and powerful tools to successfully address them. Bain is known for conceiving customized, creative and often breakthrough strategies wholly unique to each client's situation. Quantum leaps in performance are a frequent outcome.

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