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A satisfied customer isn't enough

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By Fred Reichheld

Deep loyalty turns customers into word-of-mouth promoters—and that's a force you need for growth. An excerpt from the new book, *The Ultimate Question: Driving Good Profits and True Growth.*

Editor's note: It's fine to have customers who like you, but satisfaction isn't going to stoke the growth engine, argues loyalty expert Fred Reichheld. The goal is to turn a customer into a promoter, someone who would answer yes to the "ultimate question": Would you recommend us to a friend? Reichheld's new book, The Ultimate Question: Driving Good Profits and True Growth, *offers a system called the Net Promoter Score that helps rate customers based on their view of your company. The goal: Cut out "detractor" customers and promote recommenders. In this excerpt, Reichheld outlines the payoffs from developing deep customer relationships and outlines the NPS system.*

The economic power of high quality relationships

To understand the connection between customer relationships and growth, begin with a simple fact: In business, every decision ultimately involves economic tradeoffs. Every company would want better relationships with customers if these relationships were free. Every CEO would prefer to meet earnings goals with good profits than with bad if there were no cost involved. Indeed, the abuse of customers would end tomorrow if ending it had no effect on companies' financial performance. But of course building high-quality relationships does cost something—often a considerable amount. It requires investment. It requires reducing a company's reliance on bad profits. There is no way to deceive or exploit customers and build better relationships with them at the same time.

But the real question is not just the costs but the benefits, and how the one stacks up against the other. Companies need to understand the economic value that results from building better customer relationships. They must be able to answer questions such as these: What would it be worth to raise our NPS (Net Promoter Scores) by ten points? Where would this improvement show up in our financials? At the moment, few managers can answer these questions. This [section] will begin to clarify the economics in terms that numbers-oriented executives will understand.

First, however, it may help to see some real-life examples of how great customer relationships generate economic benefits.

The home mortgage business provides one good illustration of the connection between good relationships and good economics. An average mortgage originator (salesperson) earns about $50,000 per year, with repeat customers and referrals accounting for between 20 and

40 percent of revenues. By contrast, the most successful mortgage originators can earn $1 million a year or more and typically generate at least 80 percent of their revenues from repeat customers or referrals. Getting customers to return—and getting them to bring their friends with them—completely changes the economics of the business for individual sales reps.

That kind of relationship building can also transform the economics of a company. Consider HomeBanc Mortgage Corporation, an Atlanta-based firm that traces its ancestry to a bank chartered in 1929. In the early 1990s HomeBanc was a small company with about 150 employees, only one office outside Georgia, and mortgage volume of about $500 million. By early 2005 the company had grown to some 1,200 employees, twenty-two branches in Georgia, Florida, and North Carolina, and more than $6 billion in mortgage volume. CEO Pat Flood's loyalty-based strategy depends heavily on repeat business and referrals, and it works. The company does little consumer advertising, yet growth in mortgage originations has exceeded 25 percent a year for the past decade, more than double the market average. The average NPS in the mortgage industry is 3 percent; HomeBanc's latest figure exceeds 80 percent.

High-quality customer relationships can transform the economics of retailing.

The economic advantage of this kind of growth enables HomeBanc to invest a significant amount of time and money in training. As part of the company's boot-camp-style training programs, for instance, new recruits spend seven to nine weeks at corporate headquarters before making solo calls on their first customer. The training—coupled with careful hiring—leads to high-caliber service, infrequent errors, and happy customers. Repeat business and referrals, in turn, allow HomeBanc to record productivity levels 60 percent higher than recent industry standards. As a result, compensation of mortgage originators is well above industry norms.

HomeBanc has effectively eliminated bad profits by offering a money-back guarantee. Any customer can reclaim the $375 application fee if he or she is dissatisfied for any reason. Fewer than 0.5 percent of HomeBanc's customers claim this refund. The company piles up good profits with loan-loss rates more than 20 percent below industry averages. Already a market leader in Georgia, it is rapidly expanding in both Florida and North Carolina.

High quality customer relationships can transform the economics of retailing as well. Costco, the wholesale club company, boasts an NPS of 79 percent and has grown to 45 million members despite spending little on advertising or marketing. While a typical big-box supermarket carries forty thousand SKUs, Costco stores have only forty-five hundred—only those items on which it can provide outstanding value. Sales per store are almost twice those at Wal-Mart's Sam's Club, its closest competitor. Costco's success funds a generous compensation package for its employees. New hires start at $10 an hour—high for the retail industry—and progress to $40,000 a year after three years. They receive a benefits package virtually unequalled in the industry. Low turnover and long tenure reduce hiring and training costs and boost productivity; they also contribute to Costco's remarkably low inventory-shrinkage rate, which is only 13 percent of the industry average. The company eliminates bad profits through a generous return policy—there is no time limit on returns except for a limit of six months on computer technology items. Costco's earnings grew at 16.5 percent a year from 1994 to 2004, while the stock-price gains exceeded 20 percent a year.

The storyline is much the same at every company that has built communities of good relationships. Enterprise Rent-A-Car charges less than competitors, pays its employees far more, and has grown so fast that it is now the largest single buyer of cars and light trucks in the United States. Chick-fil-A was able to grow nearly 15 percent annually between 1994 and 2004, despite ranking near the bottom of its industry in national marketing expenditures as a percentage of sales. The company generates superior profits in the price-sensitive fast-food business while helping the average operator of a freestanding restaurant earn more than $170,000 a year, far more than comparable managers at competitors. Both companies have recorded Net Promoter Scores well above the rest of the industry. Clearly, superior relationships drive economic advantage in ways that leave the competition mystified.

Why NPS works

Let's strip away the mystery. The value of a promoter or a detractor can be quantified. Given the vital role of word of mouth, indeed, NPS *must* be quantified. You may not have all the data you need at your fingertips, but most companies are able to produce it. If exact figures aren't available, use reasonable estimates.

The first step is to calculate the lifetime value of your average customer. This process is described in Chapter 2 of my book *The Loyalty Effect* and in many other books as well. The fundamental approach is to tally up all the cash flows that occur over the life of a typical customer relationship, then to convert this total into today's dollars using a reasonable discount rate.

The next step is to understand that the lifetime value of an average customer by itself isn't very useful. In fact, promoters and detractors exhibit dramatically different behaviors and produce dramatically different economic results. The following list describes several factors that distinguish promoters and detractors and offers some tips for estimating their economic effects on your business.

Retention rate. Detractors generally defect at higher rates than promoters, which means that they have shorter and less profitable relationships with a company. By tagging customers as promoters or detractors on the basis of their response to the "would recommend" question, you can determine true retention patterns over time and quantify their impact. You can estimate the average tenure of your current population of detractors and promoters even before gathering the time-series data. Just ask them on the same survey with the "would recommend" question how long they've been customers, and then use this average tenure to infer likely retention patterns.

Margins. Promoters are usually less price-sensitive than other customers because they believe they are getting good value overall from the company. The opposite is true for detractors: They're more price-sensitive. You'll need to examine the market basket of goods or services purchased by promoters and detractors over a six- to twelve-month period and then calculate the margin on each basket, keeping track of discounts and price concessions.

Annual spend. Promoters increase their purchases more rapidly than detractors. The reason is that they tend to consolidate more of their category purchases with their favorite supplier. Your share of wallet increases as promoters upgrade to higher-priced products and respond to cross-selling efforts. Promoters' interest in new product offerings and brand extensions far exceeds that of detractors or passives.

Cost efficiencies. Detractors complain more frequently, thereby consuming customer-service resources. Some companies also find that credit losses are higher for detractors. (Perhaps that is how the detractors exact revenge.) Customer-acquisition costs are also lower for promoters, due to both the longer duration of their relationships and their role in generating referrals.

Word of mouth. This component of NPS merits a somewhat more detailed consideration because it is so important and because it seems to be the one that stumps most analysts. Begin by quantifying (by survey if necessary) the proportion of new customers who selected your firm because of reputation or referral. The lifetime value of these new customers, including any savings in sales or marketing expense, should be allocated to promoters. (Between 80 and 90 percent of positive referrals come from promoters.) Keep in mind that referred customers usually have superior economics themselves; they also have a higher propensity to become promoters, which accelerates the positive spiral of referrals.

Detractors, meanwhile, are responsible for 80 to 90 percent of the negative word of mouth, and the cost of this drag on growth should be allocated to them. Perhaps the easiest way to estimate the cost is to determine how many positive comments are neutralized by one negative comment and how many potential referrals have therefore been lost. This number can be accurately determined only through customer interviews, but for an initial estimate it's safe to assume that each negative comment neutralizes from three to ten positives. For example, consider the process you might go through in searching for a dentist when you move to a new town. If you hear one negative comment about a particular dentist from a trusted friend or colleague, how many positive comments will you need to hear before you select that dentist?

Fred Reichheld is Director Emeritus and a fellow at Bain & Company. He wrote The Loyalty Effect *(1996) and* Loyalty Rules *(2001), both published by Harvard Business School Press.*