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The Effects of Loyalty Programs on Profits and Customer Retention

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### **Abstract**

The purpose of study is to do an empirical analysis of the effects of customer loyalty and how it relates to customer retention and increases overall profits, particularly in the hospitality industry. The hospitality industry is continually changing and is encompassed in a highly competitive environment. Loyalty Programs are a form of marketing strategies that are set to attract, maintain, and enhance customer relationships (Yoo, 2011). The discussion of the study indicates that there is a significant increase in company profits due to customer retention and loyal customers.

In any business customer loyalty is a factor that drives the overall success of the company. It can be quite challenging because there are many other variables that affect customer loyalty which effects customer retention and profits. Variables that affect customer loyalty are increased competition and duplicate of products and services. Another variable is Customer relationship management, which is a strategic necessity for attracting and increasing loyal customers. This relationship encompasses every service related process and direct interaction ultimately enhancing the customer's overall experience.

*Keywords:* Customer loyalty, loyalty programs, rewards, service, corporate strategy, net promoter score, perceived program value, service quality

## **Introduction**

In a highly competitive environment, large and multinational companies must continue to innovate and focus towards improving the quality of their products and services. Hospitality executives are challenged with the need to retain current, future, and potential customers. Many consumers state that their favorite go to places are the ones that offer incentives. With that being said, perhaps customer loyalty programs really do keep customers loyal for the long-term. Customer loyalty is more than just finding and keeping the right customers. It is the key to maximizing profits. Acquiring a new customer is anywhere from 5 to 25 times more expensive than retaining an existing one (Gallo, 2014). Ultimately, keeping the right customers adds value and other benefits to the company. This would entail that companies do not necessarily have to go out and find new customers, they just have to keep the ones they have happy. According to Fred Reichheld (n.d.) of Bain & Company, inventor of the net promoter score (NPS) “Increasing customer retention rates by 5% increases profits by 25% to 95%.” (p. 2). Customers that return not only spend more over time but refer others as well.

## **Review of Literature**

The hospitality industry embraces loyalty programs for a variety of objectives including rewarding loyal customers, generating customer information, increasing profits, manipulating consumer behavior and defending their market share (Xie & Chen, 2014). Loyalty programs are essential not only to ensure customer retention but also to encourage active purchases. This serves as motivation for customers’ to continue purchasing while accumulating rewards (Lewis, 2004). A study by Xie & Chen (2014), *How loyalty programs: how valuable is valuable enough?* Examines the effects of perceived program value in determining customers’ active loyalty. The study (Xie & Chen, 2014) breaks down loyalty program practices and compares loyalty program

value of 11 major hotel loyalty programs.

A book written by Stephan Butscher (2002), a partner with Simon-Kucher & Partners Strategy & Marketing Consultant in Bonn, Boston, London, Munich, Paris, Tokyo, Vienna, and Zurich. He is a managing director of their London offices. He has published two other books on customer loyalty as well as 80 articles on retention marketing, international strategy in various professional journals in Europe and the United States. The book *Customer clubs and loyalty programmes* (Butcher, 2002) emphasizes that in every industry and company, customer loyalty marketing is an important pillar of corporate strategy.

Author Stephan Butscher (2002) explains in detail the necessary steps to research plan and launch a successful program that will build long-term relationships between the company and consumer. The book contains case studies and emphasizes value measurement so that it will enable companies to integrate loyalty programs into every part of the organization. This article will contribute greatly to research. Having insight from an expert who has had experience in other industries will bridge the gap to what customers are enticed to when it comes to customer loyalty programs. With this book this will give a mean understanding about loyalty marketing from a general perspective.

The professional journal article is associated with is the International Journal of Hospitality Management. The purpose of the authors is to explore the effectiveness of loyalty programs in the lodging Industry. This article was developed by authors who are considered experts in their field also all employed at Ming Change University for the Department of Hospitality Management. The article, *Do reward programs truly build loyalty for the lodging industry*, examines whether customer's value perception of loyalty program truly affect brand loyalty or program loyalty. Only the customers can determine value. You cannot build value or

even create it through clever marketing. Value is only created when a customer puts it into use (Vargo & Lusch, 2004). Hotels continue to explore the effectiveness of customer reward programs. The research investigates how the timing of rewards affects customer loyalty for hotels and customer satisfaction.

As a result of Vargo & Lusch (2004) study, immediate rewards are more effective in building a program value to the customer. Managers need to consider the timing of rewards as an important factor when designing loyalty programs. This will help in the design of their reward programs to meet customer's wants, needs and overall true loyalty behavior that will yield profits. The research (Vargo & Lusch, 2004) also emphasizes the need to first understand the customer experience. This can be done by striving to offer the best value to form program loyalty and provide a positive satisfied experience to win customer loyalty.

An additional review written by Amy Gallo (2014) of *Harvard Business Review*, which provides academic authors, lecturers, and experts in the field, the importance of keeping the right customers is so valuable, spending time and resources to go out to find new clients is helpful, but unnecessary. By understanding whether your company is retaining customers you must know your customer churn rate. This metric measures the percentage of customers who end their relationship with a company in a particular period. The churn rate is measured by month, quarter, or year depending on the industry. With being able to calculate a company's churn rate this will allow opportunities to identify what factors contribute to why customers are leaving or better yet identify ways of better management of customer relationships so that they don't leave.

Bain & Company is one of the world's top business consulting firms that help companies get results they desire by focusing on strategic decisions and actions that are tailored to the consumer's reality. They have been in business for more than 40 years. Their services go beyond

financials, they advise global leaders on the most critical issues and opportunities across all industries. Fred Reichheld (n.d.) of Bain & Company is the author of *Loyalty Rules! How Today's Leaders Build Lasting Relationships?* He is also the inventor of the net promoter score, which is a management tool that can be used to gauge the loyalty of a firm's customer relationships. This tool can be used to predict business growth. It has transformed the business world and provides the core measurement for customer experience management programs around the world.

The article, *prescription for cutting costs*, emphasizes the importance of loyal relationships with customers and other stakeholders. Return customers have the tendency to buy more from a company over time while leading to referring the company to others. Loyal relationships overall is cost saving, the article has a systematic approach to ranking all customer acquisitions on the basis of their loyalty. This can be done by shifting resources towards programs that attract a mix of loyal customers. So that companies do not waste marketing expenses on disloyal customers who won't be around in the long run to pay back the acquisition investment.

The article, *The secret to creating loyalty programs that actually work* (Nideau & Singer, 2014), questions whether loyalty programs pay off for companies that offer them. Discovering that loyalty programs have more of a positive impact especially in the hotel sector. Companies that have developed loyalty programs that succeed and see revenue growth share common characteristics such as integrating loyalty into the full experience. Examples such as integrating payments and mobile technology to make transactions more enjoyable. Using the data, building partnerships and to maximize the difference between perceived value and real cost.

This article will be useful for this research because not only does a business have to grow



their loyalty program they must be involved with the supporting brand, experiences by offering customers smooth and continuous experiences across all mediums such as internet, mobile channels, and etc. “To reap the full benefits of customer loyalty, they must create a differentiated experience, consistent with their brand, to provide a step change in brand preference.” as stated by Nideau and Singer (2014).

An empirical study by Roger Hallowell (1996) encourages the influence of relationships between customer satisfaction and customer retention, and between customer retention and profitability. This study’s (Hallowell, 1996) analysis provides an indication of the increase in profit resulting from an improvement in customer satisfaction only if the environmental and technological conditions remain essentially stable. Hallowell’s (1996) research reliance on OLS regression of cross-sectional data, which is Ordinary Least Squares (OLS) regression. It is used to examine hypothesized relationships (measures of satisfaction, loyalty, and profitability) in which customer satisfaction, customer loyalty, and profitability are related to one another (Hallowell, 1996). The study measured perceived program value and active loyalty.

## **Customer Loyalty**

### **Understanding Customer Loyalty**

Customer loyalty is the result of consistently providing positive emotional experiences. It is an indication to which customers are satisfied and in return are devoted to a company’s products or services and how strong their likelihood to choose a particular brand over the other competitors. Customer loyalty reflects a customer’s willingness to buy from or work with a brand over and over again in which they make continuous purchases, spread positive word of mouth of their experiences and it results into a positive customer experience, customer

satisfaction, and added value to the overall brand (Xie & Chen, 2014). Implementation of customer loyalty initiative must have a way to measure the effectiveness. By knowing the customer retention rate companies can gauge how long customers stay with their company and the overall effectiveness of the loyalty initiative.

Customers make decisions of where to spend their time and money. To make a particular business, products, or services as the preferred choice, companies build offers that will differentiate themselves from other competitors, demonstrate exclusivity and value. To measure customer loyalty means to measure the strength of one's relationship between customer and the organization. This can be quite difficult to ask whether a customer is 'loyal' therefore, does not provide a valid measure. Loyalty has been perceived as a two dimensional concept both attitudinal loyalty and behavioral loyalty. Measuring attitude and behaviors make up the concept of loyalty this includes likelihood to recommend products and services to others, likelihood of continuous purchases of products and services, believing that products and services offered by an organization are superior to other competitors, and etc.

### **Customer Satisfaction**

Satisfaction with a product or service offered by a company has been identified as a key factor for loyalty (Hu, Huang & Chen, 2009). This is due to an emotional bond companies build with customers. Loyalty is built when the physical, emotional and value elements blend into one cohesive experience. Customer satisfaction is the key in creating long-term relationships with current and future customers. Ongoing satisfaction leads to customers placing trust in a business, which is added assurance of their loyalty. Satisfied customers tend to participate and become more involved eventually becoming an advocate and brand ambassadors which is strategically significant due to the fact that not only do they buy more for themselves but also influence

others; behaviors and willingness to purchase by endorsing a company's products or services (Kandampully, Zhang, & Bilgihan, 2015).

### **Service Quality**

Service quality is a measure of how well the service level delivered matches customer expectations. Delivering quality service means conforming to customer expectations on a consistent basis (Lewis & Booms, 1983). Customers have a tendency to compare the service they experience with the service they expect. If the experience does not match the expectation, there arises a gap. These gaps can be major hurdles in attempting to deliver a service, which consumers would perceive as being of high quality (Parasuraman, Zeithaml, & Berry, 1985). From a customer relationship management approach, service quality is the basis for attraction and retention. Service Quality must be viewed as a strategic force, but also as the key problem of service marketing management. Service quality is a significant source of sustainable competitive advantage, as it affects the constant improvement of service performance by increasing market share and profit growth (Grubor, Salai, & Lekovic, n.d.).

### **Profitability**

Customer loyalty and satisfaction are the key elements of business success and profitability. Loyalty in multiple forms whether its word of mouth, relationship continuance, perceived value of one supplier greater than other all create increased profit through enhanced revenues, reduced costs to acquire customers, and lower price sensitivity (Hallowell, 2014). A strong loyalty program encourages existing customers to purchase more frequently, which results in their increase in spending. Retaining loyal customers reduces the necessity of replacing customers while reducing marketing costs.

### **Research Methodology**

The research method that would be most appropriate for this study will be an empirical analysis, so that it may yield better opportunities to answer how do loyalty programs increase profits and customer retention. An empirical research is the systematic and scientifically rigorous capture and analysis of experience. Empirical research method follows both an exploratory and experimental methods based in statistics (SchererRath & Ven, 2004).

Research by Lijia Xie and Chih-Chien Chen (2014) provide their analysis of 252 respondents from US domestic tourists using quantitative data collection of online surveys questionnaires. Researchers sent out emails, embedding a link to a brief questionnaire to respondents. Part of their industry investigation included conducting a general idea, of the current hospitality industry loyalty program practices by major hotels. Of the survey results, 50 percent hold a basic membership, 28 percent hold an advanced or elite membership. The respondents on average consumed 12 room-nights in the past year. This in fact results into maintaining a long-term relationship with their favorite loyalty program. The average age of participants is 52 and majority is females. 53 percent of respondents hold an undergraduate degree and report an annual household income above \$80,000 (Xie & Chen, 2014).

### **Research Findings**

The findings did however show financial value towards high-end luxury hotels, overall a positive impact on revenues and occupancy. A factor that did affect profitability was hotel location. The research provided strong empirical support towards hotel's firm investment in loyalty programs pay off. Hotel Loyalty Programs Intercontinental Priority and Wyndham Rewards indicated strong financial values due to program rewards and partnerships with affiliated credit cards.

### **Future Research Opportunities**

Future research opportunities that can be further discussed to understand the effects of loyalty programs has on profits and customer retention are the following:

1. Emerging trends and the impact of new technologies. (Breugelmans et al., 2015)
2. The effects of partnership loyalty programs, whether it attracts a broader customer base and higher participation rates. (Breugelmans et al., 2015)
3. Further exploring the implications for the design of a successful customer loyalty program. (De Wulf et al., 2003)

Further exploring emerging trends and the impact of new technologies rather than traditional forms will provide further discussion into what implications may come about with social media, internet technology, and mobile platforms. This will allow opportunities for convenience for both company and participant to gain knowledge. Partnership loyalty programs include multiple firms that have joint programs where members may earn and redeem awards or points from participation. The rationale behind this concept is to lower cost, attract a variety of customers and increase participation. Structure and design of loyalty programs are components to further research. Rewards structure, member requirements, program communication, and etc. all contribute to increasing participation. This overall determines the perceived quality where now customers become more selective.

### **Conclusion**

In conclusion, although much research has been conducted in the effectiveness of customer loyalty, customer retention in relations to company profitability, not all loyalty programs is successful. There have been constant arguments that loyalty programs generate negative business cash flow, there is not one loyalty program that fits all. For a loyalty program

to be successful it must create a convenient consistent experience that provides added value.

Loyalty programs were made to maintain customer loyalty, it is imperative that managers pay attention to designing a loyalty scheme that improve their value chain of products or services, focuses on their target customers, due to the fact that many other competitors may provide the same kind of loyalty program.

Although loyalty programs can be difficult to launch due to costs, it should be maintained and as part of a company's long term commitment. The results for this hypothesis indicate that loyalty programs have a positive impact and in fact produce profitability because of customer retention. Customer loyalty increases profits by encouraging repeat business, generating referrals, reducing operating costs and lowering customer acquisition costs. Loyalty Programs should be viewed as a marketing tool or defensive strategy because after all, loyalty scheme can succeed where customers get the loyalty program right and perceived as good value resulting in loyalty programs as financially valuable. (Hu, Huang & Chen, 2009).

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