Whitepaper:

“Satisfaction, Loyalty and Customer Profitability”

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Introduction

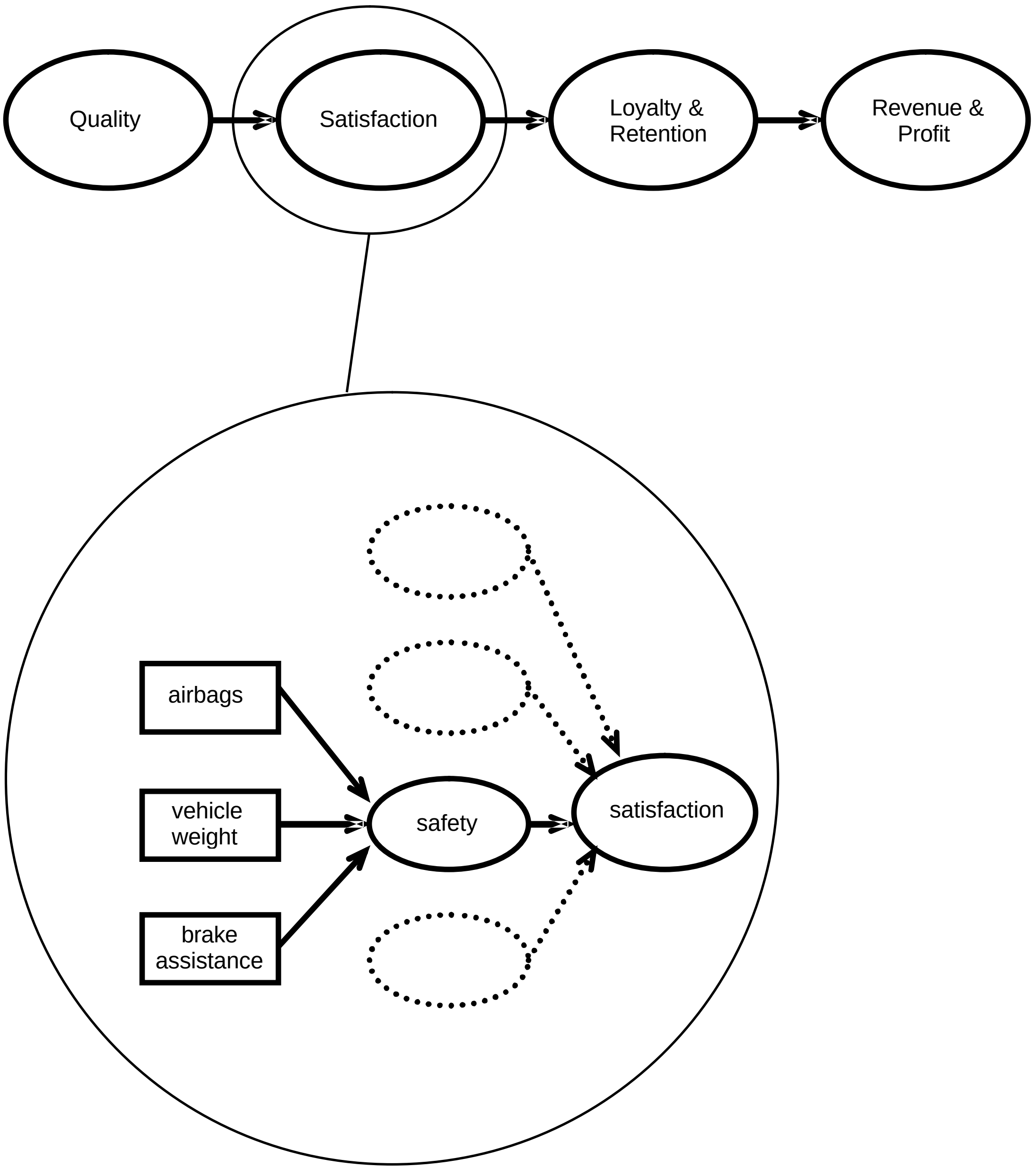
Most business people would agree that competitive pressures have increased tremendously in the past decades. Whereas the post-war decades were characterised as a ‘producer’s market’, nowadays consumers are in control. This change has been accompanied by a transition from quality movements in the 60’s and 70’s, to a focus on customer satisfaction in the 80’s and 90’s, now followed by awareness that customer loyalty is key to develop a sustainable business. The emphasis on customer loyalty follows from the truism that acquiring new customers is oftentimes much more costly than retaining existing ones. Customer loyalty is so important because of capitalisation on customer equity: continuing to serve profitable customers generates a reliable source of future revenues. This forms the foundation for developing and growing a more profitable business, and hence the creation of Shareholder Value.

So in the end, the quest for customer loyalty is driven by a need to hang on to profitable customers. Let’s assume that a business knows *which* are its most profitable customers. The question then becomes: what should one do to increase loyalty among these high value customers? The driving factors behind the causal linkage between product or service quality, satisfaction, loyalty and profitability need to be identified and measured. After all, you can’t manage what you don’t measure. Measuring this causal chain calls for an integrated model where the way product or service quality leads to customer satisfaction, and then loyalty is explained in detail. A hypothetical example is given in figure 1. Satisfied customers are more likely to remain loyal and therefore will continue to generate future revenues. Loyal customers serve as the company’s foundation for profitability and sustainable growth.

The inter relations between quality, satisfaction, loyalty and profitability are all but straightforward. Quality will only lead to satisfaction if it is perceived and valued as such by the customer. Satisfaction *may* lead to loyalty, but not necessarily so. And loyalty will only lead to profitability if either the customer was profitable from the outset, or one is successful in realizing cross- or deep-sell opportunities. Because of the sometimes-strong non-linearities in these relations, many conventional modelling attempts have fallen short of empirically demonstrating this causal linkage that seems so obvious intuitively.

Corporate management is about allocating scarce resources. How best to improve business performance? Throughout the causal chain from quality through satisfaction, loyalty and profitability, there are many tradeoffs, and choices to be made. A comprehensive framework that encompasses all these elements should give insight in how customers extract value from a company's offerings, and how this results in loyalty and profitability. This is quite a challenging task. For research like this to be useful it needs to be sufficiently abstract to shed light on sometimes non-obvious relations, yet sufficiently concrete to be actionable. The outcome of research should be aligned with senior management's information needs to drive decision making in support of the ongoing quest to make the company more customer focused.

Figure 1:



The complex relations between quality, satisfaction, loyalty and profitability

Depending on the industry and competitive forces, the gains from increasing satisfaction are greatest when either:

a) customers have a free choice between many suppliers, e.g. it's a 'buyer's market', or,
b) there exists a lot of potential in capturing future revenue streams

These conditions need not always be met. If a customer is locked into the relation with a supplier for reasons beyond her control, the impact of increasing satisfaction can be negligible. The customer has no means of 'shopping around', either because there are no competitors or because she can't switch. So increasing satisfaction will have little or no measurable impact on loyalty.

If customers can hardly switch, satisfaction obviously has no consequence for their behaviour, unless they're extremely dissatisfied. An example can be seen in retail customer finance. For many years now, satisfaction levels seem to be dropping, across the board. Yet the impact this has had on shifting market shares is not quite as big as might be expected, unless you take into account that the behavioural cost of switching banks is quite high. All sorts of notifications need to be sent and automatic payment services need to be redirected. A reverse example can be seen in telecom, where the introduction of number portability in the mobile phone industry (effectively lowering switching cost for the customer) has greatly increased competitive pressures and caused enormous market turbulence.

But in contrast, if competition is abundant, customers will *always* shop around unless they are really extremely satisfied. In a market where customers are inundated by competitive offerings, satisfaction is still important, but it won't have as strong an effect on the observed loyalty of customers. Exactly these kinds of forces give rise to strong non-linearities that have plagued many studies failing to establish relations between satisfaction and loyalty. Non-linearities are most likely between satisfaction and loyalty; much less so within the satisfaction framework itself.

To investigate and understand all interrelations within the quality-satisfaction-loyalty framework, it is necessary to tie these concepts together in a comprehensive framework. From a statistical viewpoint, this is a challenging task. But from the business perspective, it's well worth the effort. Not only do we want to know *how* strongly these factors are connected, but we also want to know about causal relations. The means to achieve this goal is through (a set of) techniques called Structural Equation Modelling[1]. This allows both causal paths to be modelled, as well as the inclusion of so-called "latent variables". Latent variables are not directly observable concepts (for instance "safety") that are derived from a set of observable variables (for instance a range of questions in a survey).

[1] Sometimes, Structural Equation Modelling is also referred to as LISREL modelling. LISREL is really a brand name for one of the software packages available. In the early days, LISREL had a very dominant market position.

The use of structural models to graphically display causal models has a number of advantages. For one thing, path coefficients (weights that can be assigned to all arrows in figure 1) in a structural model allow a quantification of *how* change in a variable upstream (e.g. vehicle weight influencing the perception of safety) will influence variables downstream. But also, the network of variables that are connected by either one- or two directional arrows will generate insight in how concepts are linked, and such insight is of great value to business stakeholders.

The latent variables in a structural model are best grouped in clusters that are consistent with the customer's perspective. This holds, even if a strictly data driven analysis might point to a slightly different grouping of variables. A more logical and interpretable model will help buy-in tremendously, and will also generate more insight. When comes the time to implement changes, again, these are much better focussed at customer centric objectives. In all, it's important to 'let the data speak', but it's an illusion to think that a *strictly* data driven modelling approach will lead to 'better' models, because it never does.

Interpreting importance-performance quadrants

When looking at all the features that are being researched (for instance items in a customer survey), it helps to visualize results by plotting your company's attributes in a two dimensional graph. On one dimension you show how your customers currently evaluate you (=performance), on the other dimension you plot the importance given to these attributes[2], the impact they have on overall satisfaction. This may then be summarized in a 2*2 matrix with high-low performance, against high-low importance. To simplify research results, continuous outcomes (e.g. average scores on survey items) are collapsed in a high or low value bin, which leads to four quadrants. A central idea behind importance-performance analysis is that for areas where corporate performance is low and importance is high to the customer, it will be most cost-effective to improve performance. In this way, quality improvement efforts are focused where impact on satisfaction, and thus loyalty and profitability is greatest. In light of the business strategy, unique competencies, and the prevailing market dynamics, priorities need to be set.

[2] The importance that is assigned to attributes (e.g. survey questions) can be derived fundamentally in two ways: directly or indirectly. A common direct approach is to explicitly ask how important a certain service attribute is to the customer. In indirect approaches, the importance needs to be derived from the data by means of some statistical measure (oftentimes standardized regression weights with the 'global' satisfaction measure as target variable).

Figure 2:

Low Impact and Strong Performance: Maintain or reduce investment or alter target market	**High impact and Strong Performance:** Maintain or improve performance- Competitive advantage
Low Impact and Weak Performance: Inconsequential- Do not waste resources	**High impact and Weak Performance:** Focus improvements here-Competitive vulnerability

From: Johnson & Gustafsson (2000), p. 13

All four quadrants have their own interpretation, and each has its own approach.

Low impact – strong performance
This might be an area where either:

a) too many resources have been deployed in the past that are not greatly appreciated by the customer, or,
b) performance is ‘taken for granted’, in other words is regarded by customers as a given. Examples might be ‘business hygiene factors’, central parts of the primary offering. A bank must ensure flawless transaction processing, a hotel must provide a bed with proper linen, parcel delivery must arrive on time, etcetera. Business hygiene factors are a company’s ticket to market.

Because customers perceive these drivers of satisfaction as basic and necessary, they will not pay too much attention to them, *as long they’re there*. Such items do little to impact satisfaction, because all competitors will deliver these. It’s a trap to be seduced into letting such items slide, because then they *can* become very important, and insufficient performance can quickly put you out of business.

The features in this quadrant may be candidates to take to new markets, or market segments. You are delivering quality, but your current client base isn’t very appreciative of it. Maybe other segments can be found (possibly after some service modifications) that will perceive more value in these features.

High impact – strong performance
This is where the company's competitive advantage lies. Although performance is high already, one should make a conscious effort to at least maintain, but if possible even improve performance here. This is where your firm's core competencies lie.

High impact – weak performance
In this quadrant you are most vulnerable to your competition. Customers consider these attributes important, but performance is lagging behind. If competitors are successful in delivering a better experience, you are in serious danger of losing your customers to the competition.

Low impact – weak performance
Items in this quadrant are best left alone. Although performance is low, there is no point in spending time and resources on these items since customers won't really value the improvement.

Making the results from research actionable
When interpreting research results, a lot of value comes from comparing outcomes of any given survey to benchmark results. These benchmarks may be either internal or external. An example of an internal benchmark is comparing with previous studies, or with studies at other departments. Or the benchmark can be external, when a company wants to compare with its main competitors or even across industries. There is a conundrum here, because the more *specific* a report is, the *less broadly* one will be able to compare or benchmark with other regions, countries or even markets. On the other hand, more specific research will be much more useful in generating detailed recommendations as to *what* exactly needs to be improved to increase satisfaction. A balance is needed here, that addresses *both* the need to benchmark against other results, *as well as* result in sufficiently concrete details so as to provide clear guidelines how the service might be improved. The importance of making the outcome of research actionable can hardly be overestimated.

It is important to focus the satisfaction questionnaire in particular on those aspects of your business that are at least partially under your control. Factors you can't influence sometimes need to be monitored as well (so called background factors, like market conditions), but these results will not help you to make any improvements.

A global structural model will give insight in how relevant aspects, as the *customer* sees your business, are related to each other. This 'global' satisfaction model *must* make an explicit connection between customer satisfaction, customer benefits, and the tangible drivers that influence these. You absolutely need to connect abstract concepts (e.g. 'safety') to concrete examples (e.g. 'airbags'). If not, the conditions that need to be improved to realize a gain in satisfaction are still largely left to guesswork.

The path coefficients in a structural model need to be displayed both in standardized form, as well as in ‘natural’ scales. The standardized path coefficients are necessary to make relative comparisons *within* the model as to where the strongest influencing variables are. Later, the abstract latent variables (like for instance ‘safety’) need to be related back to the underlying items in the questionnaire, along with their weightings. This result in itself can be very insightful. The standardized path coefficients should be interpreted as the statistical strength of the relation between an attribute (e.g. ‘air bag’), and the latent variable (say, ‘safety’). Several attributes will have an influence on safety (electronic break assistance, weight of vehicle, etc.), which don’t necessarily contribute to the perception of safety equally. These path coefficients should be translated back to their ‘natural’ meaning, for instance a point value on the scale as used in the questionnaire. These ‘raw scores’ (unstandardized weights) will greatly help interpretation as the finding can now be related to ‘events’ (e.g. an average increase in performance of 0.5 scale points) as they occur in the real world.

In some instances it may take too long for downstream effects to materialize. Depending on the product lifecycle, you sometimes can’t afford to wait until the next purchase before you establish the crucial link with repurchase likelihood. In those cases you will need to resort to smart proxies for repurchase that are available at much earlier dates. This might go as far back as repurchase intention at a moment relatively shortly after the previous purchase. It’s much better to have an imperfect proxy (like purchase intention), rather than have to wait three years (or longer!) before you can gather any data.

Organisational alignment

Oftentimes, problems in cooperation within large corporations (or small ones for that matter) to achieve improvement are due to a clash between internal, organisational silos and its misalignment with customers’ views of where the value is derived from the company’s offering. Senior management needs to take the perspective here that the perspective of the *customer* is where the value originates, and this should be enforced to establish common ground between departments that all touch on a process or product that the customer would like to see improved. A survey that aligns question areas with organisational responsibilities has the advantage of generating recommendations that are fairly straightforward to interpret, and that can be unambiguously assigned to a department or responsible manager. This makes implementing the results very easy, at least from a managerial point of view. But to make the link between quality and profitability, you really need to look at your offering *the way the customer does*, because the improvement needs to be aligned with her needs. Or else you run the risk of improving quality, without an accompanying increase in customer satisfaction. Only improved value *from the customer’s perspective* leads to higher loyalty, and allows you to command premium prices.

To ensure buy-in across the entire company, it is very important to have all parties involved as early in the research process as possible. Involvement can be further enhanced when end users of the results have a say in what will be researched. One may run into an intricate competence battle here, with regards to what issues need to be questioned. Disparate business units submit requests, that all need to be gathered and negotiated in light of the optimal research instrument that will help the business *as a whole* the most. Business end users need to specify what they *want* from the research, which then still needs to be translated in their *needs*. The business should specify *what* they want, and researchers should figure out *how* this is best accomplished. There's a trade-off here between having corporate sponsors furnish suggested questions, and letting the customer's view of the business (derived mostly from qualitative research) be the fundamental starting point for the questionnaire design. And then there's the additional constraint that the sum of all business unit requests needs to result in a feasible research instrument. Buy-in is crucially important, but should never threaten the validity of the research instrument (e.g. questionnaire). The eventual compromise that will be reached also has an impact on the cost of conducting the research. And it's not just that longer surveys cost more to execute, but they also lead to lower response rates, which is undesirable because it threatens the validity of the research outcome. This is one of the reasons why it's often a good idea to have corporate sponsors be the budget holders for research. This organisational structure will ensure alignment between corporate sponsors asking for their heart's content, but at the same time restricting them slightly because they need to 'pick up the bill', in the end.

Management 'fear' or resistance to a highly accountable framework is largely unnecessary. Information from customer research is only *input* to decision-making, it can never replace the complicated trade-offs within an organisation regarding competences, resources, strategic planning and market development. A measurement system provides information, there's no way it can replace decisionmaking.

Conclusion

A dedication to becoming more customer oriented never allows one to stop improving the match between the company's offering and changing customer needs. This holds even more in the face of changing competition. Because of immanent changes in customer needs, competition, and business technology, you are never 'ready'. Aligning one's offering with all these forces requires an ongoing commitment to monitor how you are doing, and how this effort is appreciated by customers.

Many companies gather customer data. But to make the final translation where the effect of customer satisfaction on bottom line results is made accountable is quite a challenging task. Yet at the same time, discovering the intricate relations between all relevant attributes that the customer perceives, is extremely valuable. Knowing and understanding what customers value, and how this contributes to loyalty and profitability generates tremendous insight into the business' value proposition. Finding 'levers' to influence customer satisfaction, and knowing what it 'costs' to realize change in these 'levers' are essential in putting together a business case to justify transformation. All too often, companies are not living up to their potential because processes that span multiple business units are where value originates (from the customer's perspective). But exactly these kinds of value drivers are extremely difficult to manage and change. The problem *owner* for needed change is senior management, but within the company no clear problem *holder* can be appointed. Solid research findings can pave the way to establish common ground that is needed to support improvement efforts. This is where insight *from the perspective of the customer* can greatly help in disentangling organizational gridlock.

Resources

Johnson & Gustafsson (2000) Improving Customer Satisfaction, Loyalty, and Profit