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The Loyalty Effect

By

Frederick F. Reichheld and Thomas Teal

On average, US corporations now lose half of their customers in five years, half their employees in four, and half their investors in less than one.

Customer retention is the central gauge that measures how well the company is creating value for its customers. Creating value for customers builds loyalty, and loyalty in turn builds growth, profit and more value.

Profit is not primary. Profit is a consequence of value creation. The only way to achieve sustainable improvements in performance is by building sustainable improvements in value creation and loyalty.

In a typical company, customers are defecting at the rate of 10-30% per year; employee turnover rates of 15-25% are common; and average annual investor churn now exceeds 50% per year.

WE NEED TO SEE PEOPLE AS ASSETS, rather than expenses, and we should expect those assets to pay returns over a period of many years. Asset defection is unacceptable. Human capital, unlike most other assets, does not depreciate over time. It actually improves with age.

The Fundamental Mission of Business is Not Profit, but Value Creation.

There are two kinds of profit. Virtuous profit- the result of creating value, sharing it, and building the assets of the business. Destructive Profit - comes from exploiting assets, from selling off a business's true balance sheet.

We need to begin basing bonuses on the enhancement of customer value and loyalty. Building a highly loyal customer base cannot be done as an add-on. It must be an integral part of a company's basic business strategy.

We have to get rid of the idea that our primary mission is to maximize profits and shareholder value. To quote Henry Ford, "Business must be run at a profit... else it will die. But when anyone tries to run a business solely for profit, then also the business must die, for it no longer has a reason for existence."

Promotions and year end bonuses are tied to the annual profit plan, so managers zero in on managing those numbers, one year at a time. For several generations of managers, the link between a company's long term fortunes and the loyalty of its customers, employees and investors has become invisible. The resulting mismanagement of human capital has thwarted progress in many large companies.

The average Fortune 500 Company expires in 40 years. Most are outlived by their employees. This short corporate lifespan suggests some flaw in our current profit before value thinking.

The true measure is customer loyalty. Customers either come back for more, go elsewhere, or go out of business. You gain customer loyalty by delivering superior value. From this you get:

1. Increased revenues and market share as the *best* customers get swept into our business and we build repeat sales and referrals.
2. Sustainable growth enables us to attract and keep the best employees. As long term employees get to know their long term customers, they learn how to deliver still greater value to that customer which further reinforces the customer/employee loyalty.
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. By building a long term relationship and providing ourselves with a cost advantage of having avoided large acquisition costs, it would be difficult for a competitor to step in and take an account away from us.

Point: *No company can afford to keep employees who fail to create enough value for customers to more than cover their own compensation. "It's not what you pay a man; it's what he costs you that counts." Will Rogers.*

Strategy: To bring together a well matched set of customers, employees and investors and hold them together at least long enough for them to learn how to create and consume value to their mutual benefit. Customer values are like the sun with profit orbiting around it. Just as friction steals the energy from a mechanical system, defection steals the energy and knowledge from a business system. If we are looking at an annual employee turnover rate of 15-25% and customers defecting at a rate of 10-30% that is a lot of friction - the result is business being conducted among strangers, who don't necessarily trust each other.

We must create so much value for our customers that there will be plenty left over for employees and investors.

Based on the fact that people are far more motivated to devote energy to organizations with a service goal than to organizations that exist exclusively to make a buck. Churches and Civic Organizations could not exist without volunteers and how many volunteers would they have if they were out strictly for profit.

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 lifecycle cash flow.

Accounting needs to track the value of a company's customer inventory. We need to show a distinction between sales revenue from brand new customers and sales revenue from long term loyal customer, in order to identify how much more it costs us to serve a new customer versus an old one.

To understand the economics of customer retention we must first quantify and profile the entire lifecycle of the profits we earn from our long term customers. The trick is to identify all the significant difference between new and mature customers that affect the cash flows of our business.

O Acquisition Costs

- Advertising directed at new prospects
- Literature
- Sales force time and overhead
- Commissionable sales on new customer closes
- Demos
- Trial runs
- Credit checks
- Calls to customer service and tech support
- Etc.

Tally up all customer acquisitions costs, hidden and plainly visible, to find the true upfront cost of landing new business.

O Base Profit

Customer pay prices that are higher than the company's costs. The basic profit on basic purchases is what is called base profit. The longer you keep a customer, the longer you will earn this base profit.

O Revenue Growth

vs. **Annual Customer Profit**

One advantage of holding on to our customers is that customer spending tends to accelerate over time. As they become more and more familiar with us and what we can do for them, they put more trust and money into the value with which we provide them. To get a precise reading, you have to track the annual revenues from each entering class or cohort, of customer separately. Meaning, keep the bottle & can orders separate from wire & cable, etc. Then correlate customer tenure with annual purchases to determine a growth pattern for the cohort. Then you have to factor in the behavior of any defectors by class or cohort as well.

O Operating Costs

As customers get to know our business, they learn to be very efficient. They don't waste time requesting things we don't provide. They don't need a lot of information from our tech and sales people, because they already know the answers. And, they don't make a lot of calls to Customer Service. Repeat customers are also cheaper to serve because they call in advance for appointments and are more flexible on scheduling. They know what we keep in stock and know what is standard items versus non-standard. There are no credit evaluations to go through each time they place an order which can drive up overhead. Old customers come to know our internal system and to place orders at times that will not stress our ordering process.

O Referrals

Customers who come to us on a referral are usually there for all the right reasons. Veteran customers paint a more accurate picture of our strengths and weaknesses than an ad or sales person ever could. And, if it is a very good customer who sent them, chances are that the referral will eventually become a very good customer, as well.

O Price Premium

Long term customers are less price sensitive because they are and have been pleased with the value they are receiving from us. It is not to say that we can gouge them, it just means that we don't have to drop our drawers every time we go in. Furthermore, we are not selling them, they are purchasing from us. A big difference.

The reason it is essential to know the true margins generated by long term customers is to better understand the pricing we can give them. We may very well be gouging our best customers and not knowing it.

The cost benefits of loyalty spiral directly from the way long term customers and long term employees interact and learn from one another. Repeat customers tend to be pleased with the value they receive, and their satisfaction is a source of pride and energy for employees. Motivated employees stay with the company longer and get to know their customers better yet which leads to still better service, greater customer satisfaction, and enhanced relationships. The customer can get to know a brand, but the brand never gets to know the customer - the loyalty is with our people.

To find the value of new customers, you have to know the annual profit pattern or cash flow pattern that customers typically generate through the years. You also have to know how many years they are likely to remain a customer. A customer who stays with us one year will generate only so much profit, versus a customer who stays with us ten years and provides us with referrals. You also have present values to consider. If it costs us too much to acquire the customer, even if he stays ten years, there is no sense in taking him on as a customer if we see that the future profits generated are not enough to justify it.

Let's look at our customer defection rate by cohort or market. Suppose we lose 20 customers out of 100 over 12 months, or 20%. Our retention rate is 80%. Do we expect to maintain that as our goal or increase it?

We must find out what a customer is really worth. Once we do that, we can then find out what one percentage increase in retention rate will mean to us financially.

Bank managers would never think of buying annuities for their own retirement accounts without understanding their probable lifetime returns and cash flow patterns. Potentially, at least, customers are annuities; they require upfront investment and the long term streams of revenues and costs they generate are the fundamental building blocks of corporate cash flow.

THE FIRST STEP in managing a loyalty based business is finding and acquiring the right customers: Customers who will provide a steady cash flow and a profitable return on the firm's investment for years to come, customers whose loyalty can be won and kept. Loyalty based companies should remember three rules of thumb:

1. Some customers are inherently loyal and like long term relationships
2. Some customers are more profitable than others. They spend more, pay their bills promptly and require less service
3. Some customers will find your products and service more valuable than those of your competitors.

We need to understand the "Long Term Coefficient" of our customers. That is the amount of economic force required to move different customers. It is separating the customer who will move for a 2% drop in price versus the one who would never move even for 20%. -- The unreliable customers from the reliable.

John Deere Tractors - Deere discovered that although willy-nilly dealer accumulation may bring more customers, it doesn't bring the right kind of customer - those who value reliability and service first and foremost. Deere examined the economics of distribution strategy and came to the conclusion that the company and its core customers were better off choosing dealers who could afford to provide first class service and support - and who were likely to survive.

Perhaps, like Deere, it is time to adopt a more selective outlet strategy, not being all things to all people. But to work with specialists within industries.

Deere pays little attention to annual retention rates; it wants generations of a family to buy its tractors. Delivering great value over generations requires more than a superior dealer network; it requires an entire business philosophy. Consider the way Deere manages spare parts. Most manufacturers see parts, especially for old equipment, as an opportunity for exceptional profit margins. Customers have little choice in repairing old machinery that manufacturers usually price at many multiples of cost. Deere takes a very different approach; it makes parts available for decades, and sets margins for all parts at about the same level.

Caveat Mercator

"Seller Beware." -- We need to keep the right customers, but we also need to filter out the wrong ones. When a customer gets bad value, they don't come back. The brain stops the hand for reaching for the wallet.

Business, on the other hand, is often sloppy about deciding which customers to seek out and acquire. The mind, hand, and wallet of the seller are not always tied together in a single closed loop. The brain often fails to learn from the customers who defected before their net present value climbed out of the minus column. Sometimes the fault lies with an organizational structure that isolates the sales department from the knowledge of good and evil - that is to say, the knowledge of which customers turn into profitable annuities and which don't.

We need to analyze where our good and bad customers come from? A particular magazine, tradeshow, referral, distributor, who?

We need to compensate our people for retaining customers and penalize them for customer defections. A sales force paid on commission and focused on customer volume will go after our least loyal customers. Our most loyal customers have the highest degree of loyalty coefficient and are therefore the most difficult to move.

Most companies pay salespeople for conquests, not continuity. Even if the company does compensate for repeat business, is the salesperson planning on hanging around long enough to reap the benefits? Does he have any loyalty to the company? If not, why not?

We need to give our sales people an incentive to find customers with high inherent loyalty and to screen out those most likely to defect.

To find the worst possible, least loyal customer, grab all those who are constantly beating you down on price and looking for discounts.

Convert information entered at the cash register into a database for tracking customer purchase patterns over time. If Staples knows that the average real estate brokerage uses a hundred sheet of copy paper for each ruled pad, it's easy to spot the customer who is buying copy paper somewhere else. If the customer is purchasing more cans and bottles than usual, what is the correlation to us?

Segmenting the Customers

By segmenting our customers we can determine the most valuable Y-percentage of them are worth X times more than the least valuable Y-percentage. We also need to see that winning more and more new customers can slowly put us out of business, because the cost of churning is too high.

We must design a customer acquisition strategy that searches out inherent loyalty, profitability and fit. We need to lock up the customers at the top of these three.

The Right Employees

Employees who can care about the company will also have the same attitude toward the customer. It takes time to build a solid relationship with a customer. Long term employees have a better chance to learn and increase their efficiency. The money saved by not having to rehire and retrain can be invested somewhere else.

"A cynic is the person who knows the price of everything and the value of nothing."
Oscar Wilde.

Knowing what your employees cost but not what they're worth is worse than cynical and counterproductive.

The best employees are those with the talent and motivation to raise their own productivity (and their own income) swiftly enough to fuel their motivation further still, producing even greater improvements in service and productivity and therefore a growing surplus of value for the company and its customers.

More and more, the conventional wisdom is that employees must take full responsibility for their own careers and that the key to success is watching out for number one. According to a story by the Boston Globe entitled "Broken Promises: Work in the 90's" *Employees who are scared ad bitter, working increasingly for only one thing, a paycheck. More and more, says Audrey Freeman, an economist and president of Manpower Plus in NYC, the relationship between workers and employers is exploitative on both sides. Employees are saying, all right, you use me and I'll use you. ... Loyalty today means not looking for your next job on company time.*

Employee retention is not only critical for cost efficiency but an important factor in revenue growth as well, because of its direct link to customer acquisition and retention. People feel more comfortable doing repeat business with same individual, regardless of technical finesse. They stayed with the local mechanic because they knew him, and because he knew their cars. In a study go auto garages, they found that most people go to a particular garage as a referral. The second most common source was from referrals from garage employees, who as insiders know how much value their shop provides. If an operation gives the kind of value that makes employees proud, they will naturally recommend it to friends and relatives.

Simply staying with a company longer does not guarantee increased productivity because some companies are just loaded with deadwood.

In hiring, instead of looking for a Super Hero, we need to hire those who share our philosophy, culture and values.

PRODUCTIVITY

Productivity refers to the rate of employee value creation, and growth in productivity would have skyrocketed. But productivity growth in the US has lagged that of the world's other major economies.

Our consistent goal needs to be to enrich each job and improve every employee's ability to serve the customer effectively. We need to invest in our employment and compensation policies that make employees want to stay with the company, apply their knowledge, and use their tools to create superior value for customers. The only way to reduce costs effectively is to make it possible for employees to earn more. *"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 human service...." Henry Ford*

One common barrier to better loyalty and higher productivity is the fact that a lot of business executives and all accounting departments treat income and outlays as if they occurred in separate worlds. The truth is, revenues and costs are inextricably linked, and decisions that focus on one or the other - as opposed to both - often misfire. What links them so closely is the fact that, today, employees either control or represent the lion's share of costs at the same time - in an economy where even manufacturing can often be seen as a form of service - how well they serve customers is directly responsible for the lion's share of revenues. In short, business needs to stop thinking about revenues and costs as two separate or separable cash flows. In today's service economy for the first time, employees tie the two together by exercising a decisive influence on both.

In the old manufacturing economy, we used to measure productivity by widgets per machine and by concentrating on that ratio we could determine how to lower costs. It is no longer the machine, but the employee that drives the costs and what gets processed is not widgets, but customers.

Employees can minimize the time they invest in each customer and hold down costs per transaction; or they can spend more time and give customers greater value, which may lead to higher revenues. Raising productivity in this situation is a matter of making intelligent tradeoffs. Employees must understand the economics of their job functions and they must know a great deal about customer preferences and needs.

One of the problems with the old approach to productivity in manufacturing, which focused on costs, was that it saw labor as easily replaceable. Today, because we are hopefully much more service minded, the learning curve is individual and has a profound effect on both revenues and costs.

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

Misalignment: The Bureaucratic Model

In the absence of productivity measures, bankers searched for other ways to compensate their employees and finally a Philadelphia bank executive named Edward N. Hay came up with a solution: A point system that rated a wide range of jobs on their difficulty and importance. He factored in the number of people reporting, the size of the expense budget, and the level of revenue responsibility. *It was a good idea at the time, but it no longer works.*

The idea of paying people for the importance of their jobs instead of the productivity of their teams means that the only way to get ahead and earn more money is to get promoted! This is counterproductive behavior.

To find out if you are in a bureaucracy, ask yourself this question: "If your employees want more money or greater resources, to whom do they turn? To their immediate supervisor? To You? Or do they turn to the ultimate source for all cash flow, the customer?"

The key to a career - to raises, promotions funding for projects - is the boss. Convince your boss that you are doing a fine job, and a lack of supporting evidence in the form of customer behavior may not matter for some time. Lose your boss's confidence, and even terrific numbers may not help. In this atmosphere, subordinates are understandably reluctant to share their failures openly with superiors. So people make a game of hiding or disguising their failures - or of fixing them before the boss finds out - until they get a promotion or a transfer. In a bureaucracy, the most critical skills tend to be political rather than diagnostic. 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.

Failure is too often looked at to assign blame rather than detecting and eradicating the systemic causes of poor performance. NFL coaches don't study the highlights of the game, but what went wrong and why. The only way to know why the pass worked and the defense failed is to move to a higher scale of analysis than the single play or game. Knowing how often receivers were open on similar plays over a series of games will tell the coach whether this is a systemic problem that requires a change in strategy. The right subject of analysis is failures whose frequency and severity constrain the system's overall performance. Solutions must be appropriate to the system that adopts them, not simply mimic the team that won last week.

Why not break up the company in teams of profit centers and reward them accordingly.

Every business has measures. Many fail to give employees any way of measuring their own contributions to the creation of value either for customers or the company. Most employees have no idea how their own productivity combines with other dimensions of the business to create value and profit. Why not measure the retention and defection rates of customers they affect.

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. Individuals are always seeking out ways to increase their productivity. In other companies, compensation is driven by the importance of the job or by tenure.

The US Post Office. Supervisor assigns routes that they think should take 8 hours to do. After 3 months the carrier has cut it down to 6 hours. He can't go home or get a second part time job, because the post office demands 8. If the carrier says he cut it to 6, they give him more mail to deliver with no increase in pay. There is no reward for the increased productivity. The only way to get a pay increase is to get promoted. Imagine the each post office as a local profit sharing company. What do you think the more productive carrier would do then?

Value based pay enlarges the pot out of which people get paid, while eliminating the unproductive employees.

Effective training is critical to superior productivity.

Layoffs lower productivity and sometimes decimate it. Layoffs create uncertainty among employees and customers, alike and in turn weaken customer retention.

According to the Organization for Economic Cooperation and Development, the median length of employment for US workers is three years and investment in training is far less than any other country.

Darwin showed us that the true mission of a species is to produce offspring. Any species that got muddled on this point and decided that its real purpose was to bask in the sun and chase its own tail quickly vanished. IN the same way, the true mission of a business is to create value. Any business muddled enough to believe that its real purpose is to produce profits is probably not long for this world. Profit is absolutely essential, but it is downstream outcome of creating value, and so it functions very poorly as an objective in itself. 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 is safe to assume that something is wrong and needs fixing. The core problem is usually insufficient value to customers. You don't fix it by laying off people. People, not corporations, learn. So when you let people go, they take a great deal of useable knowledge, experience, expertise and skills with them.

Two things kill a company. One is bureaucracy. In a bureaucratic organization, the key to a career, to raises, promotions, funding for projects, etc. is the boss. Bureaucrats can often succeed by pleasing their superiors in ways that have little to do with value creation, by doing favors, making your boss look good. Convince your boss that you are doing a fine job, and a lack of supporting evidence in the form of customer behavior may not matter for some time. Lose your boss's confidence, and even terrific numbers may not help. IN this atmosphere, subordinates are understandably reluctant to share their failures openly with superiors. So people make a game of hiding or disguising failure or of fixing them before the boss finds out - until they get a promotion or a transfer. IN a bureaucracy, in short, the most critical skills tend to be political rather than diagnostic. But 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.

What helps us to achieve excellence is the study of failure. Mistakes are far better teachers than success ever will be. Failures are usually examined for the purpose of assigning blame rather than detecting and eradicating the systemic causes of poor performance.

In the NFL, do coaches study game highlights, or do they concentrate on the games failures, even in victory. Failures like penalties, bungled assignments, interceptions, miscommunications. A football game is a complex interaction of two organizations with very different characteristics. The only way to know why the long winning touchdown pass worked and why the defense failed, is to move to a higher scale of analysis than the single play or game. Knowing how often receivers were open on similar plays over a series of games will tell the coach whether this is a systemic problem that requires a change in strategy. The right subject of analysis is failures whose frequency and severity constrain the system's overall performance. Solutions must be appropriate to the system that adopts them, not simply mimic the team that won last week.

We need to ask ourselves "Which units of failure do we need to measure and on what scale? How do we get a close focus on the fundamental causes of failure? How do we interpret what we find? And who in the company needs to learn from what we discover?"

Customer Defections

It is the clearest possible sign of a deteriorating stream of value from the company to the customer. Increasing defection rates diminish cash flow from customers to the company even if the company replaces the lost customers - as a result of reduced duration.

Customers are concerned about reliability of the product and the company. We need to listen to our customer's complaints and deal with them, not rationalize or explain them away.

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 a defection. But so is quality. Understanding the weaknesses in customer value is much more challenging than understanding why a part was stamped out of tolerance in a manufacturing plant.

The level of value perceived by the customer can be defined as the time-weighted sum (more recent experiences are weighted more heavily) of all interactions with the company. Occasionally, a single event is so powerful it leads to defection all by itself. In most cases, a series of events leads slowly to a decision to seek better value elsewhere. To assess the root cause, the interviewer must typically capture three or four disappointing events and weight them appropriately.

In banks, for example, branch managers confidently felt the great majority of defectors left to get better rates or better products, or because of backroom processing errors, all reasons beyond the managers' control. The real causes were customer service and problem resolution. They needed to uncover the actual root causes, not the cover up causes. Evidence eventually must overwhelm denial and people must learn from their failures.

Even if root cause analysis enables managers to learn, they may ignore the lessons or never make the effort to understand them. The first rule in education is that the student must want to learn. In many organizations, the current incentives do little or nothing to make anyone care about fixing defections. Branch managers in a typical bank are paid bonuses on a variety of measures, ranging from budgets to satisfaction surveys. Learning why customers are defecting takes time and energy. So unless it is clear to branch managers that their annual bonuses are tied to reducing attrition, supplying them with world class failure analysis systems won't improve their decision making.

Thus the first step in unleashing the power of failure analysis is to make appropriate changes in measures, incentives and career paths. Only senior executives can do that.

Mathematically, figure out by sales rep, what they would make if they could achieve a 1% improvement in customer retention for each year over the next ten years. In some cases, it turns out to be a 20% increase in annual earnings.

IN Credit and Collections, why is it the C&C person calling? Why not the manager or sales rep who they know and like? Are the C&C people too brusque? Does the collector know the worth of the customer to the company before berating him or her? Is the information correct about which the C&C person is calling?

We need to identify failure - the defection of valuable customers and the acquisition and retention of unprofitable customers - and remove the source. The combination of root cause analysis and systematic statistical of high and low attrition customer segments can pinpoint business system failure so it can be fixed.

Most companies have no experience measuring the value they deliver to customers, so it's hard to know where to begin. Some businesses we've worked with have found it helpful to map out the whole lifecycle of a customer's interactions with the company and its products.

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It's a good model for a study of customer behavior, because what determines value is the sum of relative benefits and drawbacks, advantages and disadvantages that consumers experience at each doorway along the corridor. The model can also show the frequency of those interactions. Frequency combined with interview material can tell a company which interactions are the 20% that drives 80% of the differences in loyalty and value.

*Who is a KEEPER and who is a Throw Back? Are we Getting Repeat Business and if so, How Much is it, and from whom? **“Success is getting the right customers and keeping them.”***

Whenever a valuable employee leaves it is a signal that something in the system may need fixing

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Your most loyal employees are often those referred to you by other loyal employees

The single factor that increased employee retention was hiring people who'd actually worked long hours in their previous jobs and had kept those jobs for several years. A second critical factor was that those who were interviewed by several people were most likely to last if hired.

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The true mission of any business is the creation of value.

The second key to organizational learning is to grasp the value of failure. Only by measuring their failures can organizations unlock the doors to real learning. When it comes to value creation, the search for truth is a matter of looking inward, not of copying what appears to be excellence in others.

Third, is to make certain that the right people in your organization learn to identify and correct the failures whose frequency and severity constrain your company's capacity to reach higher levels of value creation.

Finally, the best place to start monitoring failure is to watch defection rates for targeted groups of customers, employees, and investors.

Measurement

Measurement lies at the very heart of both vision and strategy. It is measurement that allows managers to harness vision to the earthly realities of daily business practice. 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. Measures define what a company will become. Deciding what to measure and how to link measures to incentives are among the most important decisions we can make.

The vast majority of the auditable measures used to run a modern company are embodied in the income statement, which shows only one dimension of the business - this year's profits. The fact is, total reliance on a single measure, current period profits, and is a form of flying blind. Measurement is the only means an executive has for turning ideas into action.

A business must find ways to pay its best people more than the competition. The problem, once again, is that we measure labor cost very effectively, but we have a cloudy notion on how well we deliver value to employees.

Customers won't keep coming back for more unless we give them good value - in fact BEST value on at least one competitive dimension - so it is essential to pay as much attention to the value flowing out of the company as to the value flowing in.

The solution is to give particular attention to one measure, the net present value of the customer base, and place it at the top of the measurement hierarchy. We have to regard customers as first among equals, because their wallets are the source of all life-giving cash flow. Remember, too, that the only way to maximize the net present value of a customer base is to earn the loyalty of its most profitable members, which means giving them superior value. Only by orienting decisions and investments toward superior customer value can you ensure that there will be plenty of value left over for employees and investors.

Value to the customer is the total value of the product or service less the price. Value to the company 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.

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In general, there are three things you can do to maximize 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 way to improve value to your customers at increased cost, providing that increased cost is smaller than the increased benefit. You can adjust prices to maximize profits, with our 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.

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On the balance sheet, the customer base is divided into new customers, gainers, decliners, and defectors. Gainers and decliners are current customers who are doing more or less business with the company than in previous years.

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The first part of the value flow statement must be a brief statement of the company's value proposition. This statement should identify the company's target customer; articulate the dimensions of quality and service that will create value for those customers (relative to pricing and competitive offerings); specify the measures by which to gauge the value proposition's success; and finally explain how the firm will deliver the value proposition in an economically advantageous manner, creating enough surplus value to provide superior compensation for employees and investors.

USAA has found that its customers care a great deal about getting their questions answered or their problems solve in one phone call. So the company has set a goal of resolving 87% of all requests on the first call and has developed the systems required to monitor its performance.

Customer retention and share of wallet are extremely summary statistics not only because they are reliable indicators of whether customer value is sufficient, but because they are key ingredients in the calculation of customer net present value.

Gain Rate: the percentage of customers solicited who actually sign up. Making loyalty based management work isn't merely a matter of holding onto present customers; acquiring the right new customers is equally important.

Yield rates: the flow of value from the customer to the firm.

Average profit per customer and average revenue per customer are also good to know.

What is our quality of defectors vs. the quality of new customers? Hopefully we are losing the bad ones and gaining good new ones.

We need to calculate the amount we have invested in each new customer. Allocate the cost of advertising and marketing, processing and setting up each new account. Figure every factor. Or, take all of our costs, and divide them by the number of new customers we acquire in a year and that will tell you the acquisition cost.

The only way to be sure your employees are paying attention to critical variables is to tie the bottom of the measurement hierarchy back to the top that is to link practical operational measures to customer net present value by way of actual differences in customer loyalty and lifecycle purchase patterns. If billing errors can explain a significant number of defections, then employees know how important those errors are.



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