

Customer Loyalty in the Age of Convergence

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Abstract

In the complex dynamics of the convergence of information content, packaging, processing, and transport industries, the crucial success factor for any participant is the ownership of the customer. Technology, legal/regulatory/legislative issues, and product/service offerings will continue to evolve and play significant roles. Nevertheless, the winners and losers will be determined by successful relations with the customer. Therefore, customer retention and loyalty will become paramount in any firm's fight for survival and prosperity.

This paper explores the dynamics of customer loyalty in a new and rigorous way, leading to some significant insights into loyalty behavior. The conceptual framework and methodology presented in the paper departs from currently held linkages between satisfaction and loyalty. The paper explores the fundamentals of customer loyalty behavior in order to identify the foundations and drivers of loyalty. Key findings of a study using this innovative approach and data on a sample of residential telephone service customers are presented and discussed.

Introduction: The War of Convergence

The impending competitive environment in the telecommunications and related industries is continually redefining the structure, conduct, and performance of companies — large and small — in their relevant arenas. Structural changes are taking place vertically, horizontally, and diagonally across content and connectivity providers, leading to heretofore unseen integration, alliances, and relationships among the players. In this environment of convergence, the battles may be fought over a number of aspects of their business, such as technology and legal/legislative/regulatory policy. Nevertheless, ultimately the war will be won or lost over the ownership of the customer. The future of companies in the information creation, processing, packaging, and transport industries will not depend as much on the quality of their products/services, networks, or customer care capabilities as it will on their ability to understand and respond to customer behavior (and, therefore, needs) as uniquely as is economically feasible. It is not an exaggeration to say that this will be the single most important critical success factor for participants in the war of convergence.

Customer Loyalty: The Crucial Success Factor

This paper focuses on the first and most crucial dimension of the above mentioned critical success factor — the characteristics and dynamics of customer behavior as it relates to loyalty to providers. A conceptual framework and an execution approach is presented and key findings from a recently completed study are discussed.

A compelling conceptual framework has been developed to define, identify, and measure the propensity of residential telecommunications users to stick to or switch from service providers based on their loyalty profile (as defined by a set of internal attributes) and the extent to which external stimuli can affect the internal loyalty orientation of the customer. The internal set defines the inherent propensity of the customer to be loyal to their current service provider. However, the loyalty behavior of customers — i.e., whether to "switch" or "stick" — can be influenced by a set of external factors which are within the locus of control of the service provider and have to be effectively managed in order to achieve optimal customer loyalty.

Conceptual Framework

The abovementioned conceptual framework for defining, measuring, and understanding customer loyalty is based on the fundamentals of human behavior. Stated in simple terms it is as follows:

Every individual has a certain inherent propensity to "stick" to, or "switch" from, the status quo. The magnitude of this propensity depends on the profile of that individual which is a composite representation of the individual's internal attributes. In other words, based on their internal orientation, people have different attitudes towards change. For example, some people like variety while others place a high value on stability, which in this context is defined as staying with the current situation. It is important to mention, however, that the individual's attitude towards change does not have to apply uniformly over all facets of their life; it is entirely possible for a person to seek variety and stability in varying degrees in different aspects of his or her life. This fundamental behavioral concept when applied to consumer decision making forms the basis for understanding customer loyalty.

As mentioned above, factors that determine customer loyalty fall into two categories. One set of factors is composed of internal attributes that are inherent to the customer's "make-up." These attributes can be categorized under demographics, economics, values/traditions, and lifestyle and include such things as the number of times a person changes residence, one's religious beliefs, or shopping patterns. The other set of factors that impact a customer's loyalty behavior are external stimuli — e.g., pricing and other monetary incentives, advertising, and customer service, which include variables such as treatment received when making a billing inquiry or requesting installation or repair services. Each of these factors influence how readily a customer will switch products or services.

For example, in the markets for telecommunications services, although the RBOCs currently have ownership of the local loop customer, this does not guarantee that they will continue to retain them in a competitive or converging market. Some customers will never switch telephone service providers, while others will be easily influenced. As competition increases, it will become critically important to understand the foundations and dynamics of customer loyalty. This paper provides the basis and the mechanism for understanding the customer with respect to loyalty so that incumbent providers can continually increase their readiness for increased competition. By the same token, it also provides the strategic knowledge and direction necessary for potential entrants to lure away customers from incumbents.

The approach forwarded in the paper entails:

1. classification of residential customers into loyalty-based segments
2. identification of the internal characteristics of each segment, i.e., profiles of segment members
3. determination of the external factors that impact the segments and the extent to which each factor can influence segment behavior

By creating market segments delineated by customer loyalty, relationships that both internal and external factors have with this dimension of the customer's behavior can be examined. This gives service providers the capability to predict customer/market behavior more accurately and with greater precision, enabling the development of targeted marketing strategies and programs to retain (and acquire) customers. Findings of the study can be used to define the providers' customer retention and expansion strategies not only in their traditional service market(s), but also in the arena currently being defined by convergence.

Information Requirements

As is evident from the discussion above, an essential requirement for the study approach is to capture information on both internal and external factors that could affect customer switching behavior as it relates to telecommunications service providers. Long-distance switching behavior is selected as the basis for analyzing telephone service switching for the reasons discussed below.

First, there is sound reason to believe that the fundamental drivers of loyalty and switching behavior in telephone service — local as well as long distance — are the same. Consumer usage of local and long-distance service is highly integrated, and so the distinction between the two services is not sharp. In fact, the lack of clarity which surrounds most consumers' distinctions between local and long-distance service is well established. This confusion is both a holdover from pre-divestiture times and a reflection of inadequate understanding on the part of the average consumer of the current network architecture and regulatory environment. As a result, attitudes and behaviors involving local and long-distance service are highly interrelated.

Second, a practical reason for using long-distance switching behavior is the fact that good data on long-distance switching is available. Over one-third of the population nationwide has switched long-distance providers in the past five years. Currently, local residential telephone service brand-switching behavior is virtually nonexistent; therefore, no data on actual switchers of local service are available with which to identify loyalty characteristics.

The following variables, internal and external, should be considered in defining customer segments or explaining customer loyalty. Depending on the particular situation some or all of these variables will be found to be significant.

Internal Variables

Internal variables refer to characteristics and behavior stemming from the customer, as opposed to stimuli from the outside environment. As outlined above, the internal variables fall into three general categories: socio-demographic variables, economic variables, and lifestyle, traditions, and values variables.

Socio-Demographic Variables

This category includes factors such as the customer's age, ethnicity, education level, family structure, and living situation. Age is a significant variable because it shapes people's views of change, namely their willingness and ability to seek and accept change. Ethnicity may be significant in determining loyalty behavior. The approach also investigates the effect of the customer's education level on telephone service purchasing. For example, a person with more knowledge and greater understanding of the communications industry may be more comfortable with trying new providers. Family data also play a role. Variables in this subset include the marital status of the customer as well as size of family. A person's home life clearly has an impact on telephone usage, sensitivity to pricing, and time available to make telecommunications decisions.

Since a person's living situation also affects purchase of telephone services, information regarding years in current residence and number of moves to different residences in the past years may be important. As for the type of residence, number of units in the building and own/rent fall under this heading as well. These data are supplemented by data on the participant's area of the country, namely the customer's area of dominant influence rank (ADI), desig-

nated marketing area rank (DMA), and county size. These variables provide some indication of whether a given geographic area is in an urban or rural region.

Economic Variables

Variables in this category describe the economic situation of the customer. The most direct measure is household income. Like age, income affects a person's approach to the purchase of services such as telephony, because income is likely to influence a person's price sensitivity. This in turn may enhance a person's willingness to stay with a company despite better rates from other providers or to make an effort to learn about other providers' offerings. Beyond the obvious indicator of household income, economic variables also include the purchasing power index of the household, which is calculated using household size and cost of living for a specific area. The bank card variable indicates whether the household uses an ATM card.

The study also includes data on the customers' local, intraLATA and inter-LATA toll charges, and use of custom calling and/or call control features. This information indicates the customer's propensity to use telecommunications services as a means to communicate with others.

Lifestyle, Traditions, and Values

This broad category encompasses different aspects of life and measures the importance the customer attaches to each category. The reasoning behind these "softer" variables holds that each portrays a customer's desire for stability and consistency, which in turn may correlate with the tendency to not switch providers of services.

This set of factors includes variables such as fashion consciousness, brand awareness, and the desire to maintain a steady routine. More specifically, fashion consciousness reflects the importance of brand image in the customer's eyes, as opposed to price or quality. Brand awareness breaks down into two variables: the tendency to purchase the same brand when shopping, and the tendency to prioritize brand name over product cost. Along a similar dimension, the survey asks whether one tends to buy from local companies as opposed to national ones.

While some consumers consider a brand name more important than other aspects of a product, other people show more concern for the value they receive for their money. Such prioritizing is illustrated by shopping habits such as price comparison shopping, coupon redemption, and the tendency to seek refunds when products do not meet expectations. Since the frequency of refund situations relates directly to one's dissatisfaction with products, expectation is measured with another variable, the likelihood of being disappointed with purchases.

Other aspects of the customer's lifestyle, values, and traditions that are considered deal with the customer's tendency to be involved in religion and to stay in touch with relatives and friends, which illustrate the importance of tradition in one's life. This in turn may correlate with one's desire for consistency and stability.

External Variables

Unlike the inherent internal variables, external variables designate the environmental stimuli that influence a customer's behavior. These factors fall into three distinct groups.

Experience With Service Provider(s)

The customer's experience when obtaining services from the provider clearly has some effect on the customer's willingness to continue purchasing from the provider. Such contact includes incidences of installation and repair, billing procedures, and sales inquiries. The customer's overall ratings of local and long distance carriers provide a starting point for this assessment.

To provide more specificity, various aspects of the installation process are examined, including on-time performance, whether the job was done correctly the first time, and overall rating for installation. For repair, ratings on on-time performance, done correctly the first time, and an overall rating for repairs are used. For billing, overall rating as well as ratings for the accuracy and clarity of the bill are included.

Telephone contact for sales and inquiries is broken down into ratings for both the helpfulness and trustworthiness of the employees and an overall rating of the handling of telephone inquiries. Each telephone inquiry variable is assessed for both local and long-distance providers. These numerous ratings are combined with customer prioritizing of the relative importance of the attributes: on-time performance versus first-time success; accuracy versus clarity; and helpfulness versus trustworthiness. Together these data provide a detailed picture of the customer's impression of the relevant telephone service providers.

To enhance this body of information, customers' reasons for switching — e.g., billing errors, personnel, and service problems — are considered. Finally, the customer's rating of the provider's image supplements the data to provide a complete view of the customer's experience with service provider contact.

Quality of Network Services

This category investigates the customer's view of the quality of the physical network itself. Customer ratings are of the overall reliability, ease of use, and provision of products and services commensurate with expectations, and overall satisfaction for both their local and long-distance carriers. Like the contact variables, the quality of the products and services obviously influences the customer's desire to stay with a given provider.

Pricing and Monetary Incentives

While a customer's positive experiences with products and services may enhance the customer's loyalty to a provider, it is essential to remember that money talks and that "everyone has a price." The current practice of inducing switching by sending win-back checks to customers has clearly increased the amount of churn in the industry. The impact of this factor is examined in detail. Within the broad cate-

gory of incentives, it is ascertained whether or not the customer switches because of a check, a gift, a promotion, or an "affinity" program with another vendor (such as an airline), or an offering of lower rates by a competitor. The amount of the check is explicitly considered, because a larger amount may make the customer more likely to switch.

Together with the data on the wide range of offerings designed to sway customers, data on the customer's satisfaction with prices as regards to his or her current local and long-distance carrier is also considered. Ratings of value received for the money for both local and long distance further measure the customer's reaction to price-related stimuli. Sources for the required data include:

- survey of a sample of residential telephone customers
- consumer databases (e.g., Donnelley, Database America)
- internal databases of service provider(s)

Using this mix of information allows the classification of a provider's entire residential customer base into loyalty based segments through the use of various proxy indicators (e.g., demographics, lifestyle indicators, automobile ownership, credit card usage, etc.) available from established consumer databases and internal information possessed by providers.

Analytical Procedures

A brief description of the analytical procedures employed is necessary in order to explain the manner in which the goals of the study approach are achieved. To recap, the first goal is to establish the appropriate market segmentation groupings based on the internal variables. The second goal is to add external variables to the model and determine their effect. This provides the ability to assess the impact that external factors, e.g., experience with customer service or billing inquiries, have on people who tend to be loyal based on their internal attributes.

More specifically, the following analysis is carried out. Customers are initially classified into switching categories based on long-distance switching behavior: those who switched once, twice, three times, more than three times, or not at all during the past ten years. The first step of the analysis is to perform a discriminant analysis using the internal variables with the categorical variable of long-distance switching occurrences as a proxy for customer loyalty. The purpose of a discriminant analysis is to find linear combinations of the set of variables that best summarize the differences among the classes.

The effectiveness of the discriminant analysis is tested by taking the classification that is predicted by the model and comparing it to the customers' actual classifications. The percentage of actual classifications among all the respondents is the "hit rate." A high hit rate indicates that the variables used in the discriminant analysis are effective in classifying the individual. Needless to say, a hit rate that is better than pure chance improves the accuracy and preci-

sion of customer segmentation leading to more effective marketing strategies and programs.

The above approach has three compelling strengths:

1. segments respondents based on how different or alike they are in comparison to others
2. determines which variables have the greatest impact on individuals belonging to one segment versus another segment
3. is practical from an execution point of view

Once the segments are ascertained, any customer can then be classified into a segment based on the customer's individual discriminant score.

Key Findings in a Study

The following are some key findings of a recently completed study that utilized the approach discussed in this paper. The study used a combination of information obtained from a telephone survey of nearly two thousand residential telephone customers, established consumer databases, and internal databases. A large number of combinations of forty internal variables and segments of long-distance switching behavior, the proxy variable for customer loyalty, were tested to find the optimal combinations of market segmentation and contributing variables.

This process yielded three customer loyalty segments characterized as high, medium, and low. Fifteen internal attributes were found to be significant in determining loyalty behavior. In addition, income and education proved to be prime differentiators of behavior over and above the basic segmentation.

Further examination revealed that different variables held significance for different subgroups. *Table 1* depicts which internal variables were most important for each income/education subgroup. Identification of the high-impact variables for each of the groupings allows the service provider to use these indicators to target marketing efforts.

The results are tabulated with a "+" or "-" designation for the most important variables for each subgroup. The sign indicates whether the factor loaded positively or negatively on the amount of switching.

The key impacts of the fifteen variables on the significant education and income subgroups are as follows:

Low Income/Low Education

The strongest impact on this group came from the age variable: as age increased, the amount of switching decreased. There was also a strong relationship between purchase disappointment and switching, with more easily disappointed people switching more.

Low Income/Medium Education

Overall, the higher switchers for this group had larger households and smaller inter-LATA toll charges, suggesting

TABLE 1

Importance and Direction of Internal Variables by Income and Education Subgroup

Variable	Lo/Lo	Lo/Med	Lo/Hi	Med/Lo	Med/Med	Med/Hi	Hi/Lo	Hi/Med	Hi/Hi
Years in current residence				+					
Number of changes of residence		+	+		-			+	-
Dwelling unit size			+			-	+	-	
Home ownership (own/rent)			+		+			-	
Number of residents		+	+						
Local charges							+		-
Intra-LATA toll charges	+			+			+		
Inter-LATA toll charges		-					-		
Call features		+				+	+		
Age	-		-		+			+	
Years as decision maker				-	-			-	+
Religiously active	+					+			
Coupon redemption		-				+			+
Purchase disappointment	-			+					+
Routine steady/unsteady	-					-			

A symbol indicates that the variable was one of the top five impacting the subgroup. The sign indicates the direction of the loading.

price sensitivity. Low switchers were least likely to order call features, followed by high switchers.

Low Income/High Education

The most significant impact variables were residence-related, including home ownership, dwelling size, number of moves in the past decade, and number of residents in the household. Age also played an important role.

Medium Income/Medium Education

Variables of importance included the two age-related factors (age and year as the long-distance decision maker), as well as three residence-related variables (home ownership, number of residents, and number of changes of residence).

Medium Income/High Education

One telephone usage variable, namely call features, had a significant effect. Dwelling unit size also affected the results. Two lifestyle factors, religion activity and coupon redemption, also were significant factors.

High Income/Medium Education

The two age variables both played a significant role. In addition, two housing variables, dwelling unit size and home ownership, had a significant impact.

High Income/High Education

As with their medium-education counterparts, coupon redemption had a fairly strong effect; purchase disappointment was also significant. More important, however, were the effects of changes in residence, years as decision maker, and local telephone charges.

External variables which were found to have the most significant impact were:

- price of service compared to price of one year earlier
- change of carriers because of a check
- change of carriers because of a price incentive
- overall reliability of the service company
- product/service satisfaction with provider
- value received from services for the money

The results of the effect of external variables on the income-education sub-groups are shown in Table 2.

Clear patterns are discernible from this reclassification. It appears that lower-income individuals tended to reduce their loyalty as a result of outside influences. In other words, the individual's reactions to price, reliability, and products/services in general were usually negative and had an adverse effect on loyalty. An exception to this can be seen for the medium-education individuals for the first three variables, which all relate to price; these failed to change the loyalty of the low income, medium-educated individuals.

Medium-income profiles had more positive reactions, although two variables which moved both subgroups to lower loyalty were relative price and overall satisfaction with long-distance service. The high-income subgroups had clear reduction of loyalty when the external variables were added to the picture, suggesting dissatisfaction with both prices and service. Interestingly, one factor which reinforced loyalty for both medium- and high-income individuals was the win-back check, while the same factor reduced loyalty among the low-income, low-education subgroup. This indicates that the higher-income, more educated individuals did not switch because of a check, while the low income/low education individuals clearly did switch.

TABLE 2

Importance and Direction of External Variables by Income and Education Subgroup

Variable	Lo/Lo	Lo/Med	Lo/Hi	Med/Lo	Med/Med	Med/Hi	Hi/Lo	Hi/Med	Hi/Hi
Relative price	-	++	-		-	-		-	-
Win-back check	-	++	+		++	++			++
Price incentives	-	+	-		-	++		-	-
Overall reliability	-		-		+	+		-	-
Long distance satisfaction		-	-		-	-		-	-
Long distance value	-	-			-	+		-	-

Single "+" or "-" symbols represent weak effects; two symbols indicate strong effects; no symbol if net movement was zero.

Reasons for Switching by Loyalty Segment

The reasons cited for switching providers by the different loyalty segments were also very revealing. On a general level, all three segments stated that the main reason for switching was to receive a better price for service, with 43% to 53% of each segment recording this selection. Beyond this similarity, a significant amount of differentiation occurred between segments. The least loyal segment was far more likely than the high-loyalty segment to switch because of monetary enticements, such as better price offerings, win-back checks, and gifts; they were also the most likely to switch because of billing errors. The most loyal segment, however, had a bigger percentage of switches because of advertisements or word-of-mouth recommendations. As for other reasons for switching, much smaller fractions of all three segments switched because of service problems.

These results suggest that high switchers are more likely to succumb to money-related enticements, explaining the lack of loyalty when presented with other, new offerings over time. For the most part, the low switchers tend to switch based on information they have gathered, which may explain their greater loyalty. These results have implications for the success of win-back checks and price offerings in attracting high-loyalty customers and retaining low-loyalty customers over the long term.

Relationship between Customer Satisfaction and Loyalty

One very interesting and useful analysis of the data dealt with the examination of the relationship, if any, between customer satisfaction and customer loyalty. While 98% of the whole sample gave a "good" or better rating on the generally accepted measures of customer satisfaction, the percentage giving the highest possible rating fell as switching increased. Again, in spite of generally high ratings for the whole sample, high switchers clearly expressed less satisfaction than low switchers.

This finding validates a key component of the framework: that loyalty and satisfaction are not the same. Even though all segments expressed high levels of satisfaction with their service, significant numbers of those same individuals display high switching in spite of their ratings. In other words, creating more satisfaction may reduce disloyalty, as evident in the fact that low switchers had even higher satisfaction than medium switchers; but these levels of satisfaction, although necessary up to a certain point for retaining

customers, are not sufficient. Such a result shatters commonly held conceptions of the relationship between satisfaction and loyalty, for it suggests that satisfying customers can go only so far and that it is the identification of inherently loyal customers which will enable a firm to retain market share.

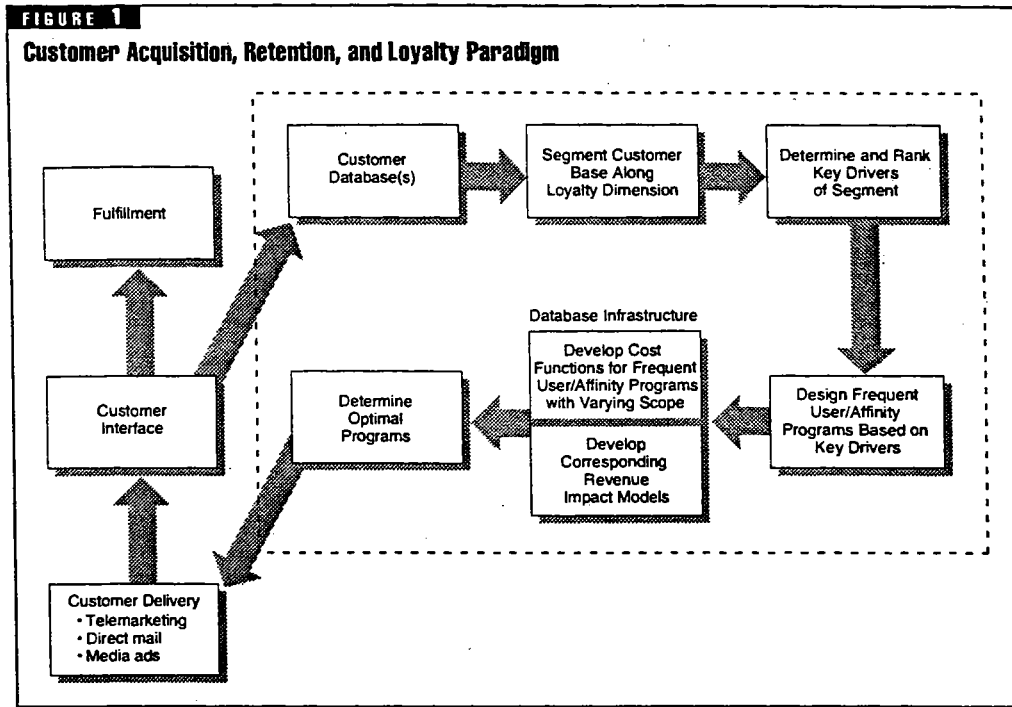
Therefore, the overarching lesson that emerged from the study is as follows: Customer satisfaction, as defined by the standard measures of providing value for money, quality and reliability of product/service, operational support, and customer care (e.g., billing, inquiries) is a necessary but not a sufficient condition for obtaining customer loyalty. Analysis of the relationship of satisfaction to switching behavior indicates that customers expect a threshold level of satisfaction from their service provider; increasing satisfaction beyond that level does not make them less likely to switch. However, a decline of satisfaction from that level makes them more prone to switching.

This point is a pathbreaking finding and should be at the heart of all customer retention, acquisition, and management activities. Stated simply, it means that the focus of customer retention and acquisition should not be on achieving more customer satisfaction but on identifying and addressing the differential behavior (and needs) of customer groups with different loyalty orientations. From a business strategy point of view, resources should be allocated to the achievement of customer satisfaction up to the threshold level and not beyond, since the additional investment will not yield any return in the form of customer retention.

Implications for Business

The crucial finding discussed above lays the foundation for marketing strategies, plans, and programs for providers in the residential market. Briefly, the rules of thumb for the incumbent provider are the following:

- Low Switcher (High Loyalty) Group: Ensure threshold level of satisfaction and provide specific rewards to further solidify the inherently loyal position of this group.
- Medium Switcher (Medium Loyalty) Group: Ensure threshold level of satisfaction combined with rewards that are tied to long-term relationships.



- High Switcher (Low Loyalty) Group: Provide cost-effective short term incentives to win members of this group and minimize costs of servicing them.

Conversely, the potential entrant provider can adopt the reverse strategies and actions to destabilize the incumbent's more loyal customers and bring them into their customer base.

Currently, the telecommunications industry has seen the proliferation of a variety of tactics for winning and keeping market share, as each carrier strives to spark loyalty among its customers. Unfortunately, the firms that use such tactics often examine only the potential revenues to be gained without examining the costs as well. For example, programs such as win-back checks have caused trouble, because the costs of the checks themselves as well as marketing and administrative costs have not been balanced by long-term revenue increases and retention of market share. The competing firms have succeeded only in stimulating a high degree of market churn, as customers switch back and forth solely to earn their win-back checks. In fact, the results of this study validate this phenomenon, with the win-back checks and gifts leading to higher proportions of low-loyalty customers than their higher-loyalty peers.

Overall, in order to optimally retain and manage customers, an infrastructure has to be established that represents a continuous cycle consisting of the following:

1. Define customer segments along the loyalty dimension.
2. Design loyalty enhancing and/or acquisition programs (e.g., frequent user, affinity, or other reward programs for each segment addressing the key drivers).

3. Perform cost/benefit analysis of the various programs to determine optimal programs.
4. Deliver program to the customer via telemarketing, direct mail, etc.
5. Obtain information through customer interface.
6. Once this last step is completed, the information should be used to update the customer databases, which in turn can be used to refine segmentation of the customer base leading to the creation of even better programs.

This customer acquisition, retention, and loyalty paradigm is depicted in Figure 1.

Conclusion

The message is clear: In the intensifying competition ushered in by convergence, all product and service providers will be vying for the most important prize in the game — the same customer. This paper presents compelling reasoning and market data to dispel currently held notions of how to retain (and acquire) customers. The key to success in the convergence industries — information content, packaging, processing, transport — is to be ahead of the curve in understanding the customer's inherent loyalty traits and the drivers of those traits. In fact, the lessons learned about loyalty behavior should be applicable to all industries serving residential customers. This enables providers to develop and implement customer acquisition and retention strategies and programs to gain optimum return on their investment. For incumbents, the need to retain desirable customers is overwhelming; market data indicates that it costs four to five times more to reclaim customers than it does to retain them in the first place. And, needless to say, whether the provider is the defender or the aggressor, the time to act is now!