MEMO TO THE CEO

# Winning in Turbulence

## Protect and Grow Customer Loyalty

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Previews the forthcoming book

*Winning in Turbulence*

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# Protect and Grow Customer Loyalty

Economic downturns wreak havoc with customer relationships. Deep cost-cutting compromises service. Layoffs and pay freezes leave front-line employees demoralized. To make up for lost revenues, companies sometimes look for ways to tack on new charges and fees, which make customers feel they are being gouged.

Some companies tolerate this abuse of customers as unfortunate collateral damage in a recession. After all, aren't competitors exploiting customers, too? But the negative effects of lost customer trust can be deep and long-lasting. And the advantages of loyalty are even more pronounced in a downturn. Loyal customers cost less to serve. They typically concentrate more of their spending with companies they trust to meet their needs and treat them well. They are less likely to defect than shoppers whose attachment to a company is no deeper than the latest price discount. Loyal customers also help stretch marketing dollars. Their word-of-mouth referrals to friends and associates provide a company with more like-minded customers, laying the foundation for growth when the economy turns around.

The powerful advantages of customer loyalty help explain why the biggest changes in market share occur during downturns. Many companies do well when consumer spending rises and the economy is expanding. But when spending drops, the companies focused on protecting and growing their most loyal, profitable customer segments often manage to stabilize their business. They may even attract new customers as competitors falter. Until the equity markets began to slide in 2008, for example, mutual fund companies of nearly all stripes prospered. Many investors chased hot returns, and many fund companies were happy to oblige them with an array of trendy offerings. But as returns dropped, customers quickly sold their shares. That didn't happen at Vanguard. The pioneer of market index investing remained focused on keeping costs low, offering funds with clear, easy-to-understand investment strategies, and maintaining great service. That approach has once again enabled Vanguard to outperform competitors during this recession: in 2008, Vanguard enjoyed net cash inflows of $71 billion compared with net outflows of $225 billion for the rest of the industry, according to the Investment Company Institute. And Vanguard continues to gain market share, as it has done through market downturns over more than twenty-five years.

But maintaining customer loyalty in a downturn is a difficult challenge. Nearly all customers, including the most loyal, are more sensitive to price than before. Aggressive rivals may try to lure them with discounts and rebates. If you aren't the low-cost provider in your industry, you may not be able to match those price cuts. And as we'll explain, that may not be the best strategy in any case. Most people buy on value, not price alone. But the situation does require new strategic thinking. How have your customers' preferences changed? How long will those changes last? How can you appeal to their new needs without diluting your long-term competitive advantage?

In our experience, the companies that answer those questions effectively and strengthen loyalty in a downturn share some common characteristics:

- They steer clear of three specific traps. If one of them snares you, you won't get the chance to do anything else.
- They avoid confusion about their customer "sweet spot"—the customers who matter most to the success of their business—and selectively add segments that extend and reinforce the target without diluting the brand or adding costly complexity.

- They ensure that those customers have the best possible experiences where it counts the most.

Let's take a look at how loyalty leaders follow a common course in a downturn.

## Avoiding the Traps

Trap number one is chasing revenues by trying to appeal to every potential customer group, often through aggressive discounting. These moves can seem logical and urgent in a downturn. Customers buy less, yet industry capacity is slow to adjust. Rivals compete aggressively for marginal sales. The trouble is, not all incremental sales are equal. The new customers attracted only by lower prices often fail to buy more when prices recover. Moreover, they sometimes place additional demands on the business system, creating unexpected new costs.

Saks Fifth Avenue encountered this trap during the 2001 recession, implementing deep price cuts that temporarily boosted revenues but undercut its luxury status for many longtime customers. Nieman Marcus assumed the luxury mantle, and when the economy rebounded, Saks's sales were slower to recover. In the brutal retail environment of this recession, Saks has followed a similar course, abruptly cutting prices of designer clothes by 70 percent in November 2008. Though the deep discounts provoked a rush of shoppers, Saks risks losing still more ground with the luxury-goods consumers who were once its core customers. Meanwhile, the retailer has had to lay off more than one thousand employees, and its share price is approximately 10 percent of its December 2007 level.

Trap number two is indiscriminate cost cutting. The most effective companies acknowledge that downturns require painful reductions in product and service offerings to offset declining margins. But they cut costs with a scalpel rather than a meat ax, paying close attention to their most important customers. Under pressure to prune the number of products it stocked in a weakening economy, for example, one supermarket chain reduced costs by weeding out all the items that failed to generate a threshold level of returns. But store revenues continued to fall far below expectations. When the company probed deeper, it discovered that three of the items it had cut—an artisanal cheese, specialty bread, and a tropical fruit—were especially popular with a significant number of its top-spending loyal customers. No longer finding the goods they prized on store shelves, they began to shop elsewhere.

A quick round of market research indicated that these customers were actually willing to pay more for the special products they liked. When the items were reinstated, higher-spending customers gradually trickled back in to the stores.

Trap number three is reducing investment in customer-focused innovation. There's no evidence that new-product introductions tail off in downturns, so you can't assume your competitors are cutting back on this front. Breakthrough products and services like the iPod, Xbox, Zipcar, JetBlue's low-cost flights, and the Kindle 2 e-book reader were all introduced during recessions, attracting new customers while competitors struggled. The most effective companies stay focused on the capabilities they'll need to serve their most important customers in two or three years. They use the crisis of a downturn to rally the organization around the innovations that deliver a better customer experience, both now and in the future.

## Find Your Customer Sweet Spot

Simply avoiding the traps isn't enough, of course. A company also has to maintain a strong external focus and apply a set of practical disciplines that keep its most important customers front and center. That's harder than it seems. In a downturn every company faces difficult choices about which customers it will fight to keep and which it will pass up. That requires the right information and insights to answer some key strategic questions: What customer segments are out there and how differentiated are they? How capable are you of actually meeting different segments' needs? Can you do so without diluting what you offer your most important customers? Segmentation strategies often fail during downturns because marketers cast their nets too wide, in an attempt to capture large, amorphous customer groups. By trying to satisfy all these groups, companies end up creating watered-down offerings that fail to excite anyone.

To make the right trade-offs, management teams first need to identify an attractive customer core that becomes the prime focus of their energies and investments. We call this group the *design target*. The design target comprises the heart of the segment to which your company sells. It's the group that your company comes to understand so completely that when you design products and services for them, they say: this is absolutely perfect for me. They're the customers your company can serve better than any competitor can. By doing so, you will attract others who are like them.

These customers tend to have three vital traits. They are disproportionately valuable in the amount of business they do with you now and in their potential worth to your company over the long term. They are highly loyal; they stick with your company through good times and bad. Finally, they are especially influential in the marketplace; their tastes and preferences influence or lead large populations who may want your company's products and services and whom you will want to reach. So even though the design target itself may be small, it is representative of a broad range of customers. BMW, for example, designs its cars for the relatively small group of people who truly treasure high performance and immaculate attention to detail, all for a reasonable price. One of the defining characteristics of this group, which BMW calls the "active affluent," is how they describe the elation they feel when accelerating a great car around a corner. Yet the company's products appeal to a broad range of buyers who may never make full use of the engine's power or the suspension's precise road handling.

Large companies, of course, appeal to multiple customer segments, which may mean identifying more than one design target. The buyer of BMW's MINI Cooper is different from the buyer of its M3 convertible. The issue then is how the company can meet the needs of different segments without diluting its brand image among core customers and without adding too much cost or complexity. Some companies elect to serve different segments through separate brands, channels, or both. Others tailor their products, services, and marketing strategies to appeal to different segments. But that's the value of the design target: those customers will let you know if you risk alienating them. If you do, watch out.

## Promoters, Passives, and Detractors

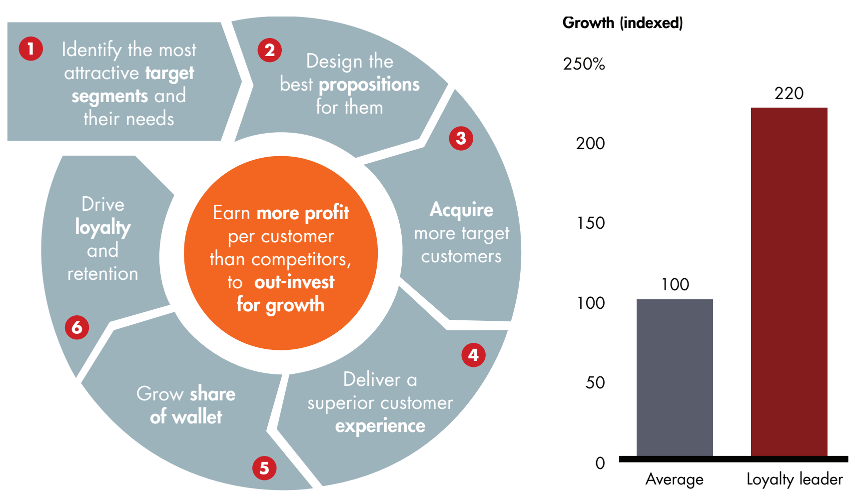
A simple way to find this elite inner circle is first to first identify discrete customer segments based on their different needs, attitudes, and behaviors. Next, sort your current customers in each segment by profitability and potential value. Then group them into "promoters," "passives," or "detractors" by asking them to rate on a scale of zero to 10: *How likely are you to recommend our company's products or services to a friend or a colleague?* Those responding with scores of 9 or 10 are promoters, your company's biggest boosters. Those answering with a 7 or 8 are passives, lukewarm at best to your company. Those giving a score of 6 or less are detractors. This group is dissatisfied with your company and is apt to drive away potential new customers through negative word-of-mouth. Subtracting the percentage of detractors from the percentage of promoters yields a company's Net Promoter® Score (NPS), which measures the degree of loyalty among a company's customers.

One way to think about this is to visualize a grid that lays out each customer segment in a scatter plot, with their loyalty to your company on the x-axis and their profitability on the y-axis. Customers in the upper right-hand corner—profitable promoters with homogeneous needs, attitudes and behaviors—form the heart of your potential design target. This group appreciates what you are providing them today and their profitability makes them important to your business during the downturn and beyond.

Defining the right core customer segment to pursue is the starting point of a virtuous cycle for boosting profitability and market share. (See figure 1.) Coming out of the last downturn, for example, Vodafone Group, the U.K.-based wireless telecom services provider, used a similar approach to identify five high-potential customer segments in its design target. Homing in on the combinations of convenience, value, and lifestyle that best met these customers' needs, the company developed new service plans to reach each one. By attaching a face, voice, and wallet to each sharply etched core customer,

**FIGURE 1**

**Build on the loyalty of your best customers**




*Source:* Bain analysis

Vodafone scored significant market share gains in eight of the ten markets in which it competed.

Concrete metrics like Net Promoter Score help sharpen a company's focus on loyal customers based on what they say and do. The metrics help to identify what loyal customers like most about today's products and services—important to maintain at all costs—as well as actions that drive core customers away. Loyalty leaders use this understanding to probe deeper into the behaviors as well as the emotions of these consumers. Many customers, after all, say they love a particular product or service until something dramatically new and different shows up in the marketplace. Anticipating breakthrough changes means moving beyond quantitative research; it means studying customers closely and trying to figure out what they truly value most. Intuit, for example, makes detailed observations of selected customers as they begin to use the company's financial software. LEGO works closely with online and off-line communities of fans to guide new product development and pricing decisions. Although it takes resources to stay attuned to consumers' unformed wants and needs, these investments pay off for companies trying to find new ways to appeal to customers in a downturn and when the economy improves.

## Invest in "Moments of Truth"

Customer loyalty is earned one transaction at a time. From the handling of an initial sale to the attentiveness of call-center personnel to the management of contract renewals, each customer contact is an opportunity to win a promoter, convert a passive customer into a fan, or disarm a detractor. During a downturn, those interactions take on added importance as customers seek more value for each dollar they spend. But not all customer experiences are equally important. That's why customer-focused companies take pains to identify the critical moments of truth that have the greatest potential to delight customers—or to drive them away.

One way to determine which touchpoints matter most is to ask customers directly. Contact them two or three weeks after a purchase, a warranty repair, or other direct interactions with your organization's front line. Invite them to rate how likely they would be to recommend the company based on that most recent experience, and give them an opportunity to explain why they gave that rating. Then feed that information back to the front line. Follow up with respondents who agree to be contacted by calling them, enabling front-line employees to uncover the root causes of problems that annoy customers and make quick, continuous adjustments. The follow-up calls also help front-line employees understand what they did to create promoters—a reward that is easily overlooked but can inject an important boost to morale during a downturn.

Closing the feedback loop in this way can provide a cost-effective early warning system for identifying service gaps before they become major issues. By continuously analyzing customer feedback about its claims settlement procedures, for example, auto insurer Progressive Corp., learned how sensitive policyholders were to reimbursement delays when their vehicles had been damaged beyond repair. Like most insurers, Progressive organized its claims processing for internal efficiency. But when operations managers dug into the customer survey results, they discovered that their NPS dropped precipitously with customers who had to wait too long for reimbursement. By fine-tuning how claims were routed, Progressive shortened the payment cycle from initial filing to the customer's receipt of a check by more than 35 percent and saw its NPS jump by more than 50 percentage points.

## Getting Started

Progressive Corp. and other loyalty leaders have distinct advantages during a downturn. But companies that didn't invest in building loyalty before the crisis hit can still make substantial gains quickly by taking some practical steps. You can begin by identifying your most loyal and profitable customers, understanding what they most like about you, and determining what you can do to improve their experience. Who among these customers are we failing to satisfy fully? What must we do to root out business processes that aggravate those customers? You may find that you can strengthen relationships with your most important customers while also reducing costs. For example, American Express found millions of dollars in savings in less than a year through quick process fixes that resulted in fewer service calls, fewer complaints, fewer follow-up calls, and less need for rework.

At a time when companies are seeking every possible advantage they can wield in a tough economy, keeping loyal customers front and center can make a critical difference—both now and in the long term.