OLIVER WYMAN

THE FUTURE OF CUSTOMER LOYALTY

BUILDING A NEXT-GENERATION REWARD PROGRAM

THE FUTURE OF CUSTOMER LOYALTY

In a world of new technology and high customer expectations, standard customer loyalty programs based on transactional rewards will soon be recognized for what they really are: undifferentiated, underutilized loss-makers.

Usually, retailers justify the cost of their loyalty program by the data it yields: data which can be used to inform business decisions, sold to vendors, and used to develop targeted campaigns. But on closer inspection, these additional benefits often do not materialize nor justify the investment in the program. Our analysis shows that a transaction-based loyalty program – where the customer is rewarded with a 1% return of the value of their spend – can cost a $10 BILLION retailer $30–60 MILLION in reduced margin every year. Add to this the considerable cost of running the program, and these costs will likely never be recouped with the gains made by utilizing the program's data.

Even if your program isn't analogous to the one shown in Exhibit 1, we believe the best retail loyalty programs can be better, and indeed, need to improve quickly.

In the first half of this article, we articulate the case for change, and in the second half, we explain what retailers need to be thinking about when it comes to customer loyalty programs.

PART 1: THE CASE FOR CHANGE

1. **New competitors are disrupting the market** and challenging the status quo.
2. **Customer expectations are changing**, and today's customer wants a different experience from their loyalty program.
3. **The right technology used in the right way** can help meet customer needs in a new and innovative way.

PART 2: GETTING IT RIGHT IN THE REAL WORLD

1. **Adopt a future-flexible approach to technology**, with the retailer owning the overall loyalty ecosystem, but not necessarily every specific component within it.
2. **Adopt a start-up mindset** to enable long-term investment in the loyalty proposition.

PART 1: THE CASE FOR CHANGE

1. NEW COMPETITORS ARE DISRUPTING THE MARKET

Traditional retailers are feeling the pressure to find new ways to stay close to their customers in a world where disruptive new entrants are trying to own the customer relationships that retailers once took for granted. Retailers face an assault on their status as the owner of the customer. Be it online pure-play retail competitors, manufacturers selling direct to consumers, or payment providers and digital wallets, many businesses are now trying to develop direct customer relationships. If they do not respond, retailers will find that over time their customer loyalty decreases as other players join the party.

So, reinventing loyalty is not some passing trend; it is fundamental to continued survival and future success.

Exhibit 1: The economics of a typical loyalty program

Loyalty program cash profit input at a $10BN retailer
Loyalty program gives 1% return on spend as points

VOLUME UPLIFT DUE TO SCHEME (%)

3.0	-$13MM	-$6MM	$2MM	$9MM	$16MM	$23MM
2.5	-$23MM	-$15MM	-$8MM	-$1MM	$7MM	$14MM
2.0	-$32MM	-$25MM	-$18MM	-$10MM	-$3MM	$4MM
1.5	-$42MM	-$34MM	-$27MM	-$20MM	-$13MM	-$6MM
1.0	-$51MM	-$44MM	-$37MM	-$30MM	-$23MM	-$15MM
0.5	-$60MM	-$53MM	-$46MM	-$39MM	-$33MM	-$25MM
	0	10	20	30	40	50

AWARDED POINTS GOING UNSPENT (%)

Most likely outcome is a $27–60MM loss

2. CUSTOMER EXPECTATIONS ARE CHANGING

It's not just that customers want more rewards; they want a different kind of relationship with the businesses they choose to interact with. As such, loyalty programs are changing from transaction-based exchanges between a retailer and a customer to an ongoing relationship with the customer at the center (Exhibit 2). Our sister firm Lippincott, specializing in brand and design, examines these trends in depth in the report *Welcome to the Human Era: The new model for building trusted connections, and what brands need to do about it.*

Exhibit 2: Characteristics of loyalty programs, past and present

	OLD WORLD REWARDS	NEW WORLD AFFINITY
Foundation	Formulaic deal	Relationship and belonging
Assessment	Transparent criteria, with no discretion	Role for serendipity and judgment
Time horizon	Present and future	Recognition of the past
Program language	Points, statements, terms and conditions	Symbols of belonging (without overstepping the mark)
Identification	Plastic card	Crosses all channels and platforms
Customer benefits	Economic	Broader
Feeling	**Entitlement**	**Appreciation**

Many companies are starting to update how their loyalty programs provide shared benefits with customers. Some of the most important trends include:

- Increasing use of exclusive promotions and a move away from points
- Non-monetary rewards and symbols of belonging, such as free coffee at UK grocer Waitrose, or childcare and frozen yogurt at Ikea
- Charity-based rewards and points, such as Kroger's community awards in the US, or Pets at Home animal charity program in the UK
- Services to improve the shopping experience, such as Neiman Marcus' shopping app that incorporates shopping, blogging, events, and loyalty points management
- Broader lifestyle applications, such as Walgreens' Steps program

In these examples, customers are happy to give the retailer access to their data, not because they are getting points in return, but because they are being rewarded or helped in other ways.

Once this virtuous cycle is started, it can be very powerful – customers are prepared to allow more detailed use of their data and more intimate analysis of their habits so long as they are getting useful products and services in return. For the retailer, this extension of brand permission and increase in the number of customer touch points will boost customer loyalty today, and can be monetized in the future (as it increases the range of commercial opportunities in the retailer–customer relationship). Interestingly, many traditional retailers are some of the most trusted brands in their home market, giving them more opportunity to drive this virtuous cycle than many other companies, such as financial services firms or internet giants.

3. THE RIGHT TECHNOLOGY USED IN THE RIGHT WAY

Technological advances are rapidly changing the loyalty playing field. In the old world, customers would typically have a plastic card scanned on payment, then rewards would be received as coupons or offers through the mail and by email.

In recent years, smartphones and other new technologies have transformed this playing field. Customers are always connected and the online and physical worlds are being merged, with customers expecting seamless integration across channels.

Real time or time-limited offers are becoming much more common. For example, fashion shoe retailer Meat Pack in Guatemala has GPS embedded into its app and tracks when users enter competitors' stores. At certain times during its "Hijack" campaign, this triggered a promotional discount for Meat Pack, which started at 99% and decreased every second until the customer entered a Meat Pack store. The discount and subsequent purchase were then automatically shared on Facebook, sending the app viral.

There is much more two-way communication with customers. For example, social media is now a key channel for customers to complain, and they expect their issue to be resolved via the same channel. Additionally, customers are more in control of how they interact with loyalty services; they can choose to share Facebook data to access a discount or enter a competition.

Online services are being brought in-store. For example, there are apps to help customers navigate and find products, as well as smartphone technology to accelerate self-scan and payment.

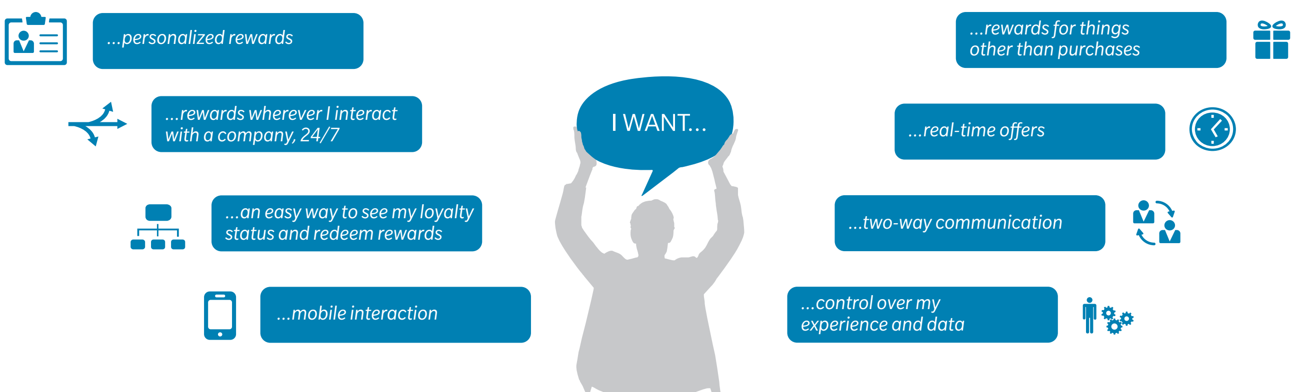
Underpinning much of this technology are more sophisticated analytics on much bigger datasets. These, along with rapid iterative app development, are becoming important new capabilities for retail IT teams.

PART 2: GETTING IT RIGHT IN THE REAL WORLD

In reality, an exceptional, original, and effective loyalty program is much easier to describe than it is to deliver. But it can be done. One example is Balance Rewards by US health and beauty retailer, Walgreens. The program is built around unique, non-purchase rewards and creates additional value for both customer and retailer. In Exhibit 3, we summarize how loyalty programs like the one at Walgreens, operate.

Exhibit 3: Loyalty program from a customer's perspective

CUSTOMER VIEW



HOW TO MEET THE CUSTOMER NEED

- Provide relevant rewards for the customer to choose from
- Perform big-data analysis using multiple sources of data to provide rewards based on consumer behavior and life cycle, with a focus on cross-selling and retention

- Deliver multichannel loyalty with consumer insights and a loyalty program that goes across all sales channels, including in stores, brands, and online

- Enable the customer to manage rewards in one place, for example, by bundling miles, points, or rewards into a single app or website

- Replace loyalty cards with apps
- Push product updates to the customer
- Distribute benefits and coupons directly to a mobile device
- Be flexible to adapt to new consumer technology (phones, tablets, glasses, watches...)

- Give rewards based on the customer sharing more information about themselves, for example by interacting on social media

- Make offers based on geolocation and customer activity, or microsegment

- Reward customers with more personalized offers when they share their likes and dislikes

- Introduce a user-friendly platform to change settings that control contact information, preferences, and so on

Today, some retailers are making successful changes to their loyalty program while others are not. Although no two situations are identical, we would pick out two themes that separate the leaders from the laggards:

1. **A future-flexible approach to technology**, with the retailer owning the overall loyalty ecosystem, but not necessarily every specific component within it
2. **A start-up mindset** (and often organizational structure) that enables long-term investment in the loyalty proposition

1. A FUTURE-FLEXIBLE APPROACH TO TECHNOLOGY

Twenty years ago, the first retail loyalty programs relied on expensive in-house systems and technology, and were very inflexible in how they operated. Back then, the only alternative to this model was partnering with third-party providers such as Canada based Aimia, or Payback, in Germany, but such a move essentially ceded control of much of the loyalty program and data.

Today, flexibility is the watchword. The cost of the technology required to run a loyalty program is much less than it once was, and there is a plethora of specialist providers offering solutions to each different area in the loyalty ecosystem. This gives retailers many options for how to set up the loyalty program: either in-house or outsourced, or a mix, each covering a different aspect of the program.

CONTROL THE LOYALTY ECOSYSTEM BUT NOT EVERY COMPONENT

Our view is that retailers' interests are best served if they take control of the overall loyalty ecosystem – rather than outsource it to a single provider – but are comfortable partnering with a number of specialist vendors where they add powerful or differentiated capabilities. Taking a leaf out of Apple's book and applying this "designed in California" mindset allows retailers to maintain control of their loyalty program without having to develop internal capabilities in every single area of activity.

BE FUTURE-FLEXIBLE, NOT FUTURE-PROOF

Given that customer expectations and technologies are changing rapidly, it is tempting to try to future-proof the loyalty ecosystem by thinking ahead and designing solutions for every eventuality. This approach is unlikely to address the as-yet unknown challenges and opportunities ahead. A far better approach is to design a future-flexible loyalty ecosystem, which allows for new components to be plugged in within a modular architecture.

DELIVER EXCELLENCE IN CUSTOMER ANALYTICS AND ITERATIVE DEVELOPMENT

Long-term, competitive differentiation will come from better customer analytics – underpinning more innovative products and services for consumers – as well as improved decisionmaking in the core business.

Linked to this, the fast and continuous development of customer services and apps is an important capability: customers expect the products they use to improve rapidly.

2. A START-UP MINDSET

It's a simple fact that an effective loyalty program and the IT that enables it, require investment. Most retailers keep tight control on such expenditures and need clear business case justification for investments.

This mindset, though, can be an issue in the loyalty arena. For example, a new menu management app for a food retailer might cost $5 MILLION to develop and launch. Although supported by a strong hypothesis that it would improve customer loyalty and "stickiness" over time, the direct sales benefit of such an app might be difficult to quantify. Understandably, this makes it difficult to raise support for the large initial investment.

In contrast, by using a start-up mindset the proposition around this app could look quite different. For example, by assigning a $50 value to each customer who downloads the app, you create a way of assessing the app's cost–benefit, which is much more tangible. Here, it would take 100,000 downloads to cover the app development costs (a small number relative to the millions who shop at large grocers), and would build a much more appealing business case.

We would encourage retailers to think about their loyalty products in this way and develop new KPIs to measure them accordingly. Doing so will enable them to make – and justify – the investments needed to make their loyalty programs successful.

Exhibit 4: The future of loyalty looks very different from the past

	15–20 YEARS AGO	TODAY	THE FUTURE
Core proposition	• Points in return for data • Vouchers	• Points • Points plus bespoke offers and rewards (for example, UK's Waitrose offering loyalty card holders a free coffee on each visit)	• Wider variety of recognition methods • More emotional content
Purpose and focus	• Observing customer behavior from a distance • Capturing data and segmenting • Sending things infrequently	• Understanding behavior and feelings • Building a 1:1 relationship • Frequent, two-way contact	• More personal • More frequent • More directly beneficial to the individual
Who is involved	• Only a few or the largest retailers	• Many retailers of all sizes and sectors	• Almost every retailer
Customer interaction	• Swiping card at till • Mailing paper statements	• Multiple ways to interact and capture data • Move to online (for example, email updates)	• Anywhere, anytime, and on any platform
Nature of ecosystem	• Invented and built largely in-house • Large one-stop-shop loyalty providers	• Established loyalty providers • Multiple specialist "component" providers • Lower entry or development costs	• Retailer-controlled third-party ecosystems • Flexible, continuously changing architecture

CONCLUDING REMARKS

Today's customer loyalty leaders are moving away from transactional points-based schemes toward more varied, flexible customer engagement systems (Exhibit 4). Technology is at the heart of this change. Retailers must ensure their programs are structured to support and enable the technological innovations necessary to deliver loyalty programs of the future. In the new world, many retailers will require new KPIs to assess the returns they make in their loyalty programs to make long-term investments possible.

For retailers who succeed, an improved loyalty program can deliver significantly better customer engagement and "stickiness". It can also act as a defense against disruptive new entrants trying to get between retailers and their customers.

FURTHER READING

THE NEW IT HORIZON

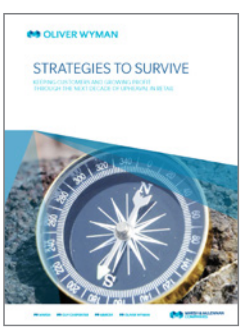
HOW THREE YEARS FROM NOW CHANGES EVERYTHING YOU DO TODAY

The timing of when a CIO moves his or her organization to be a source of business innovation is largely determined by the level of consumer demand for a digitally-enhanced retail experience. We believe this consumer shift has broadly happened, changing the question for every retailer from when to shift the organization to how to shift it. This report addresses this challenge.

WELCOME TO THE HUMAN ERA

THE NEW MODEL FOR BUILDING TRUSTED CONNECTIONS, AND WHAT BRANDS NEED TO DO ABOUT IT

In this report, Lippincott defines what being a Human Era company means, and who is doing it well. Building from a large data set of over 800 companies, the authors examine the leaders and define corporate behaviors that enable organizations to break through in this new environment and build trusted, authentic connections.



STRATEGIES TO SURVIVE

KEEPING CUSTOMERS AND GROWING PROFIT THROUGH THE NEXT DECADE OF UPHEAVAL IN RETAIL

This report discusses the changing retail landscape in detail, and suggests ways retailers can meet the challenges presented by such a changing landscape.

ABOUT OLIVER WYMAN

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

In the Retail practice, we draw on unrivalled customer and strategic insight and state-of-the-art analytical techniques to deliver better results for our clients. We understand what it takes to win in retail: an obsession with serving the customer, constant dedication to better execution, and a relentless drive to improve capabilities. We believe our hands-on approach to making change happen is truly unique – and over the last 20 years, we've built our business by helping retailers build theirs.

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