The Loyalty Elephant

by Steve Hoisington and Earl Naumann

There is an old parable about a group of blind men describing an elephant. Lacking vision, they must use their sense of touch to understand what an elephant looks like.

One blind man touches a leg, and after careful thought, says an elephant is like a tree—round, straight and tall. Another blind man feels the elephant’s trunk and exclaims an elephant is like a big snake. A third blind man feels the elephant’s tail and says the elephant is like a broom. All the blind men are technically correct in what they are describing, but all are missing the big picture.

Recent articles about the differences between customer satisfaction, customer value and customer loyalty are reminiscent of this parable. Many authors are technically correct in what they are describing but incomplete in their discussions.

Some contend you should focus on customer satisfaction. Others say no, customer satisfaction is a waste of time, and you should focus on customer value or loyalty. Some say customer satisfaction and loyalty are strongly linked, while others say they are totally independent of one another. Arguing for or against these concepts is futile. All are important, and all are related to one another.

Customer satisfaction, customer value and customer loyalty are all indicators of an animal we’ll call “being customer focused.” An organization devoted to fulfilling customer needs is customer focused. Some describe this as their quality environment, stating everything begins and ends with the customer in mind, and all the stuff done in between is quality. Customer satisfaction, value

In 50 Words Or Less

• Customer satisfaction, value and loyalty are related.
• A four-phase model explains the major relationships leading to customer loyalty: business performance, global perceptions, loyalty behaviors and financial outcomes.
• The link to financial outcomes is strong— a good selling point when discussing customer satisfaction with executives.
and loyalty all indicate just how customer focused an organization truly is.

Customer satisfaction, value and loyalty are closely related. These are not either/or propositions. All three concepts work together and are supported by good empirical evidence.

A four-phase customer loyalty model, shown in Figure 1, explains the major relationships leading to customer loyalty. The model begins with the customers’ perceptions of an organization’s performance. These lead to the formation of global perceptions about the organization, which then lead to loyalty behavior. Loyalty behavior leads to financial outcomes.

**Phase One—Business Performance**

Customers use five major categories of performance attributes to evaluate an organization’s performance:

1. **Product quality.** This is the core dimensions of a product or service. For a tangible product, this might include features, usability or compatibility. For a service offering, this would include various dimensions of the service being provided.
2. **Service quality.** This includes all aspects of the service that wrap around the core offering. This might include sales, delivery, billing or customer service. Each service dimension would typically have several subcomponents.
3. **Quality of relationship between customer and supplier.** In most business-to-business situations, this is very important. Dimensions of relationship might be communication, follow-up and responsiveness.
4. **Image.** For many organizations, image is also quite important. Customers may use image as a differentiator when the product or service offering is difficult to evaluate. For example, IBM, Hewlett-Packard and Sony have strong images that infer product and service quality. Dimensions of image might be innovativeness, market leadership and corporate citizenship.
5. **Price perceptions.** These might include initial purchase price, ongoing cost of ownership or price of upgrades. The relative importance of price is highly variable across industries and typically becomes more of an issue during a recession.

Collectively, these five categories work together to shape customers’ global perceptions, and all should be included in a good customer satisfaction questionnaire. It is important for an organization to understand the relative importance of these categories. This information allows the organization to focus improvement efforts on issues that have the biggest impact on the customer.

**Phase Two—Global Perceptions**

When evaluating an organization’s performance, a customer formulates global perceptions. A variety of global perceptions can, and should, be examined. Six common global concepts are presented in

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**FIGURE 1** Customer Loyalty Model

- **Business performance**
  - Product quality
  - Service quality
  - Relationship
  - Image
  - Price

- **Global perceptions**
  - Overall satisfaction
  - Willingness to recommend
  - Repurchase intent
  - Commitment
  - Met expectations
  - Value for the money

- **Loyalty behaviors**
  - Customer loyalty

- **Financial outcomes**
  - Market share
  - Profit
  - Shareholder value
  - Employee attitudes
  - Reduced cost
AT&T began its research into customer satisfaction behavior in the 1980s. Ray Kordupleski, customer service director at the time, headed the research efforts.

While many issues were examined, the linkage between value perceptions and loyalty was well documented. AT&T tracked the customer’s perception of value using a five-point scale. The researchers then went back a year later to see which customers were still doing business with AT&T (see Table 1, p. 38). Customers with high perceptions of value were loyal, and those with lower value perceptions were much more likely to defect.

AT&T also investigated the linkage between value perceptions and market share, both within and across business units, tracking both for business telephone equipment for more than four years (see Figure 2). The dotted line represents value scores from customer surveys. The solid line represents actual market share four months later. Value perceptions turned out to be the single best predictor of market share across most AT&T business units.

With the data, AT&T developed value models (see Figure 3) to help manage customer perceptions. This portion of the value model includes only the dimensions of product and service quality. The issues of image, relationship and price were excluded for presentation purposes. The percentages in the value model indicate the relative importance to the customer of both the category and the attributes within the category.

**FIGURE 2**  Perception of Value vs. Market Share at AT&T

*Perception of value mirrors market share four months later.

**FIGURE 3**  AT&T Value Model

<table>
<thead>
<tr>
<th>Business process</th>
<th>Customer need/expectation</th>
<th>Internal metric</th>
</tr>
</thead>
<tbody>
<tr>
<td>30% product</td>
<td>Reliability</td>
<td>Number of repair calls</td>
</tr>
<tr>
<td></td>
<td>Easy to use</td>
<td>Number of calls for help</td>
</tr>
<tr>
<td></td>
<td>Features and functions</td>
<td>Functional performance test</td>
</tr>
<tr>
<td></td>
<td>Knowledge</td>
<td>Supervisor observations</td>
</tr>
<tr>
<td></td>
<td>Responsive</td>
<td>Percentage of proposals made on time</td>
</tr>
<tr>
<td></td>
<td>Follow-up</td>
<td>Percentage of follow-up made</td>
</tr>
<tr>
<td>Overall product</td>
<td>Delivery interval meets needs</td>
<td>Average order interval</td>
</tr>
<tr>
<td>20% sales</td>
<td>30%</td>
<td>Percentage repair reports</td>
</tr>
<tr>
<td></td>
<td>Does not break</td>
<td>Percentage installed on due date</td>
</tr>
<tr>
<td>15% installation</td>
<td>Installed when promised</td>
<td>Percentage repeat reports</td>
</tr>
<tr>
<td></td>
<td>No repeat trouble</td>
<td>Average speed of repair</td>
</tr>
<tr>
<td></td>
<td>Fixed fast</td>
<td>Percentage of customers informed</td>
</tr>
<tr>
<td>15% repair</td>
<td>Kept informed</td>
<td>Percentage of billing inquiries</td>
</tr>
<tr>
<td></td>
<td>Accuracy, no surprise</td>
<td>Percentage resolved first calls</td>
</tr>
<tr>
<td></td>
<td>Resolved on first call</td>
<td>Percentage billing inquiries</td>
</tr>
<tr>
<td>15% billing</td>
<td>Easy to understand</td>
<td>Percentage billing inquiries</td>
</tr>
</tbody>
</table>
the model, but some organizations might also use others. Each concept is different from the others, but all are closely related.

In other words, each reveals something different about the customers’ global perceptions, but the correlation among these concepts is quite high. The six concepts have been well validated with empirical data and are not theoretical in nature.

The biggest lesson to learn is each concept has a strong correlation or linkage to key financial measurements within an organization. Demonstrating the financial impact of improved customer satisfaction levels is critical to elevating customer satisfaction to a strategic initiative. This is usually accom-

IBM-Rochester

IBM’s AS/400 Division in Rochester, MN, conducted extensive research to determine actual customer loyalty behavior. Tze-Hsi “Sam” Huang headed the research efforts.

Using years of data, the researchers examined the relationship between revenue growth and satisfaction. The correlations between key variables of interest and other results are presented in Figure 4. IBM also found 95% of

|FIGURE 4| Correlation Between Employee Satisfaction, Customer Satisfaction and Financial Performance for IBM-Rochester

<table>
<thead>
<tr>
<th></th>
<th>Market share</th>
<th>Customer satisfaction</th>
<th>Productivity</th>
<th>Cost of quality</th>
<th>Employee satisfaction</th>
<th>Job satisfaction</th>
<th>Satisfaction with manager</th>
<th>Right skills</th>
</tr>
</thead>
<tbody>
<tr>
<td>Market share</td>
<td>1.00</td>
<td>0.71</td>
<td>0.97</td>
<td>-0.86</td>
<td>0.84</td>
<td>0.84</td>
<td>--</td>
<td>0.97</td>
</tr>
<tr>
<td>Customer satisfaction (CS)</td>
<td>0.71</td>
<td>1.00</td>
<td>--</td>
<td>-0.79</td>
<td>0.70</td>
<td>--</td>
<td>--</td>
<td>0.72</td>
</tr>
<tr>
<td>Productivity (P)</td>
<td>0.97</td>
<td>--</td>
<td>1.00</td>
<td>--</td>
<td>0.93</td>
<td>0.92</td>
<td>0.86</td>
<td>0.98</td>
</tr>
<tr>
<td>Cost of quality (Q)</td>
<td>-0.86</td>
<td>-0.79</td>
<td>--</td>
<td>1.00</td>
<td>--</td>
<td>--</td>
<td>--</td>
<td>--</td>
</tr>
<tr>
<td>Employee satisfaction (ES)</td>
<td>0.84</td>
<td>0.70</td>
<td>0.93</td>
<td>--</td>
<td>1.00</td>
<td>0.92</td>
<td>0.92</td>
<td>0.86</td>
</tr>
<tr>
<td>Job satisfaction</td>
<td>0.84</td>
<td>--</td>
<td>0.92</td>
<td>--</td>
<td>0.92</td>
<td>1.00</td>
<td>0.70</td>
<td>0.84</td>
</tr>
<tr>
<td>Satisfaction with manager</td>
<td>--</td>
<td>--</td>
<td>0.86</td>
<td>--</td>
<td>0.92</td>
<td>0.70</td>
<td>1.00</td>
<td>0.92</td>
</tr>
<tr>
<td>Right skills</td>
<td>0.97</td>
<td>0.72</td>
<td>0.98</td>
<td>--</td>
<td>0.86</td>
<td>0.84</td>
<td>0.92</td>
<td>1.00</td>
</tr>
</tbody>
</table>

Productivity (P) = revenue per employee
Cost of quality (Q) = hardware warranty cost
Employee satisfaction (ES) = index of job satisfaction, satisfaction with manager and satisfaction with right skills

CS = (1 - Q/P)^0.8

• To improve employee satisfaction, focus on improving job satisfaction, satisfaction with manager, and satisfaction with having the right skills for the job.
• To improve job satisfaction, focus on improving satisfaction with manager and satisfaction with having the right skills for the job.
• Improving satisfaction with having the right skills for the job will improve employee satisfaction, job satisfaction and will directly impact productivity, market share, and customer satisfaction.
• Improving employee satisfaction will directly impact productivity and market share.
• To improve customer satisfaction, focus on improving productivity and employee satisfaction and decreasing the cost of quality.
• Decreasing the cost of quality will directly impact customer satisfaction and market share.
• Improving customer satisfaction will directly impact market share.

IBM's AS/400 Division in Rochester, MN, conducted extensive research to determine actual customer loyalty behavior. Tze-Hsi "Sam" Huang headed the research efforts. Using years of data, the researchers examined the relationship between revenue growth and satisfaction. The correlations between key variables of interest and other results are presented in Figure 4. IBM also found 95% of
Three important points must be made regarding the global concepts:

1. **They are perceptual.** Customer satisfaction research measures customers’ perceptions of an organization’s performance. In contrast, customer loyalty is a behavioral outcome of the customer perceptions. To illustrate, “repurchase intent” is a perceptual indicator of actual loyalty behaviors such as future purchases, contract renewals and revenue growth. For some organizations, the linkage between global, perceptual measures and loyalty behavior is strong. For others, the linkage is weaker.

revenues came from customers who were very satisfied and satisfied (top two boxes). The ratio of revenue growth between very satisfied and satisfied customers was 3:1 (see Figure 5).

Concurrently, IBM-Rochester also looked at how customers responded to the question of loyalty in relationship to overall satisfaction. The higher the satisfaction rating, the higher the loyalty level, as Figure 5 also shows. More interesting are findings of how customers actually behaved based upon their initial loyalty ratings. Because customers repurchase major computer equipment in cycles of about 18 months, it took more than two years to determine that customers repurchased pretty much the way they said they would. IBM-Rochester thus demonstrated a direct correlation between overall satisfaction and loyalty. It also found overall satisfaction scores could be used to predict customer loyalty behavior. IBM-Rochester determined that if the customer satisfaction level improved one percentage point, an additional $257 million in revenue could be generated over five years.

**Figure 5**

**Customer Satisfaction, Revenue and Loyalty**

For IBM-Rochester

Customer loyalty — planned and actual behavior and actual dollars spent

![Customer Satisfaction, Revenue and Loyalty](image)

About 95% of revenue is from customers who are very satisfied. The higher the satisfaction rating, the higher the customer loyalty rating. Actual customer repurchase behavior is close to planned repurchase intentions.
2. Customer satisfaction research usually measures an organization’s performance after a purchase has been made or a contract has been signed. The research typically focuses on ongoing dimensions of an organization’s performance. Most customer satisfaction research does not address all the dimensions of the customer’s initial purchase decision. To illustrate, price perceptions may be very important in the customer’s initial purchase decision but are typically poor predictors of satisfaction levels once a purchase has been made.

3. The relationship between global perceptions and subsequent loyalty behaviors is strongest when top box (delighted) scores are evaluated. For example, customers who are very satisfied are much more loyal than customers who are satisfied (see Table 1).

## Phase Three—Loyalty Behaviors

Because customer loyalty is a behavioral concept, the customers’ behavior can and should be measured.

One of the primary behaviors that can be measured is defection rate. The rate is the percentage of customer accounts that go dormant in a year. If the customer-supplier relationship is continuous and the customer abruptly switches to another supplier, the defection may be obvious. If the customer-supplier relationship is sporadic, the customer may switch to another supplier without the organization’s being aware of the defection.

Defection is not the only measure of loyalty. Revenue changes—both increases and decreases—should be examined. A customer could maintain an active account, but drastically reduce the purchase level. For example, if a customer switches 80% of its purchases to a different supplier, would that be a defection? The answer is probably yes since most of the customer’s revenue has gone elsewhere. But this would not show up as an actual defection in most customer databases.

Several situational factors must be considered when evaluating loyalty behavior. The customer’s purchase cycle is an obvious one. If purchases occur on an ongoing basis, loyalty metrics are usually clear.

If purchases occur every few years, tracking loyalty behavior is more ambiguous. Competitive bidding requirements complicate loyalty evaluation. Large dollar value purchases usually involve a different purchase decision process than do smaller purchases. Industries with high rates of technological change may cause a customer’s decision criteria to change.

The implication is there are many confounding factors that could make evaluating loyalty behavior difficult.

## Phase Four—Financial Outcomes

Financial outcomes are affected by market share, reduced costs, employee attitudes, profit and shareholder value.

**Market share.** Organizations with high customer loyalty usually have high market share in their defined markets. The higher loyalty makes marketing and promotional expenditures more effective. For example, having a 15% customer defection rate is common for an average organization. To hold total corporate revenues constant, at least an equivalent number of new customers must be acquired to replace those who depart.

If an organization has a defection rate of only 5% instead, an equivalent marketing campaign will result in a 10% growth rate. Only 5% of the new customers acquired are needed to replace lost customers. The remaining 10% contribute directly to growth.

In its simplest form, high loyalty leads to higher market share because more customers are retained. And if the customer base is highly satisfied and loyal, customers are more likely to generate word-of-mouth referrals.

**Reduced costs.** New customers are more costly to a supplier than established customers are. IBM-Rochester determined a company must expend five times more money to gain a new customer than to keep a current customer and must expend 12 times more to win a customer back. Initially, there are all

### Table 1: Average Retention Rates

<table>
<thead>
<tr>
<th>Value score (five-point scale)</th>
<th>Retention rate (one year later)</th>
</tr>
</thead>
<tbody>
<tr>
<td>5 Excellent</td>
<td>92-97%</td>
</tr>
<tr>
<td>4 Very good</td>
<td>80-85%</td>
</tr>
<tr>
<td>3 Good</td>
<td>60-65%</td>
</tr>
<tr>
<td>2 Fair</td>
<td>15-20%</td>
</tr>
<tr>
<td>1 Poor</td>
<td>0-5%</td>
</tr>
</tbody>
</table>
the acquisition costs of advertising, sales calls, credit applications and processing. After the customer is acquired, still other costs arise.

New customers have much higher technical support costs as they are learning how to use the products or services. To illustrate, Hewlett-Packard’s Printer Division gets well over a million calls annually at its customer support center. About 70% are from individuals who have owned their printers for two months or less.

Higher market share contributes to lower per unit costs because marketing campaign expenditures can be allocated over a larger number of units. Because the marketing efforts are essentially an overhead charge, there is an economy of scale. The same could be said of R&D and administrative charges.

Employee attitudes. There is a direct correlation between employee attitudes and customer behaviors. The employee-customer interaction is most apparent in dimensions of service quality and relationships that directly touch the customer. Employees who have more positive attitudes make their views apparent at the points of customer contact. Both Nortel Networks and IBM have found a direct correlation between employee attitudes and customer satisfaction.1

Profit. The relationship between market share and profitability has been well documented in numerous studies. As an organization becomes an industry leader in market share, that organization tends to have higher profitability.

Also, as an organization reduces its cost structures, particularly with a higher market share, profitability will improve. Being a market leader often results in a price premium. Customers are willing to pay slightly more for well-known products because they convey a certain image. The result of reduced costs and a price premium is a gross margin significantly above the industry average.

Shareholder value. Profits, or the expectation of profits, are the key drivers of shareholder value. While many activities drive profits, customer satisfaction is one of the most important drivers. Strong correlation between customer satisfaction scores and shareholder value has been demonstrated repeatedly. An example is the American Customer Satisfaction Index score and the correlation in stock prices (see Figure 6).

The Empirical Evidence

Many organizations have empirical evidence that supports various linkages presented in the customer loyalty model in Figure 1 (p. 34), but few have tested all the linkages. Most have instead tended to focus on certain relationships of interest.

Each organization has used somewhat different methodologies, sample sizes and statistical analyses. Therefore, the results are not exactly comparable. However, the messages are generally the same. Customer satisfaction and value perceptions are strongly related to loyalty behaviors and subsequent financial outcomes.

Some organizations prefer not to share their empirical data publicly for proprietary or strategic reasons, but AT&T, IBM-Rochester and Johnson Controls did. These three firms illustrate what many other organizations have also found. Space does not permit a detailed discussion of the exact research methodologies, but all three organizations used sound research practices.

Their discoveries are revealed in the three sidebars, “AT&T” (p. 35), “IBM-Rochester” (p. 36) and “Johnson Controls” (p. 40).

Convincing Top Execs

There is a strong linkage between customer satisfaction, customer value, customer loyalty behaviors and financial outcomes. As shown by the three featured organizations, different measures can be used for each of these concepts. While each global measure will tell a slightly different story, the correlation among these is normally quite high.
Researchers must experiment and find out which measures work best statistically in their situations. Perhaps even more important is the need to discover which measures and types of data sell best to senior management in their organizations. Some executives prefer overall satisfaction measures. Some might prefer value perceptions, and some want to see market share. The exact form of customer research must be customized to fit the culture and situation of a particular organization.

All these issues are part of the same customer-focused animal. Customer satisfaction and customer value are not exactly the same but are closely related pieces of the larger animal. Customer satisfaction research, lost customer studies, value mapping and market preference studies each tell something different about customers. All are important and provide valuable data.

These types of studies require an organization to maintain good, accurate customer databases. The perceptual data gathered from surveys must be linked to various types of loyalty behaviors. It is important to remember that customers, like elephants, have very good memories. Customers do not quickly forget good or bad experiences with organizations and will usually demonstrate their satisfaction levels with their subsequent expenditures.

Assuming customer satisfaction is irrelevant could be a very costly mistake and one the organization, like an elephant, will not soon forget.

The controls group of Johnson Controls Inc. attempted to investigate the same concepts as AT&T, but in a much different industry. In the mid-1990s, Ken Bailey, customer satisfaction manager, began a revision of the customer satisfaction program. (Johnson Controls uses a five-point satisfaction response scale.)

The relationship between satisfaction levels and renewal rates was then examined. Johnson Controls found 91% of contract renewals came from customers who were either satisfied or very satisfied. And those customers who gave a not satisfied rating had a much higher defection rate (Figure 7).

By examining contract renewal rates, Bailey found a one percentage point increase in the overall satisfaction score was worth $13 million dollars in service contract renewals annually. After seeing the financial impact of changes in customer satisfaction levels, Johnson Controls made improving customer satisfaction a key strategic initiative.

**Figure 7**

*Customer Satisfaction and Renewals for Johnson Controls*

91% of renewals were from customers who were very satisfied.
NOTE


REFERENCES


STEVEN H. HOISINGTON is the vice president of quality for the controls business of Johnson Controls Inc. in Milwaukee. He earned a master’s degree in business administration from Winona State University, Winona, MN. Hoisington is a past examiner and senior examiner for the Malcolm Baldrige National Quality Award and a frequent conference presenter. He is an ASQ certified quality manager.
