



KAPUSTA

Looking for loyalty in all the right places

A BOOK REVIEW THAT MAY BE 10 YEARS TOO LATE

By BUD HOLLADAY

Let any store lose a 60-inch flat-panel TV and somebody at corporate will let the dogs out; the world will stop spinning until the missing inventory is recovered, Homeland Security is notified and all systems are adjusted. Does the same thing happen when a two-year employee is lost? How about when a longtime customer just goes away? If you have been listening to many experts or any of your peers, you have probably heard that loyalty is dead. Arguably, in some companies it's merely on life support and family members have been notified. ✕ But there is hope from an unlikely source: a 12-year-old book from that pop-culture factory, the Harvard Business School Press. In 310 pages, the authors blow up just about everything most of us thought we knew about loyalty, customer retention and the pursuit of profit. Along with making the proposition that value creation should be the primary aim of business, it introduces something called loyalty based management. Plenty of evidence is offered up showing how such a shift in focus can easily generate up to a 50 percent improvement in performance over the next five years. The book is *The Loyalty Effect: The Hidden Force Behind Growth and Profit*, by Frederick F. Reichheld (and Thomas Teal). I found my copy in the storeroom of a company that is going broke. You may have to find yours online; if your company is also going broke you might want to pay extra for overnight shipping.

Reichheld asserts that loyalty is neither a substitute for profit nor a gimmick for making easy gains or advances. His findings are based on 10 years of research as a key player at Bain Co., the global equity capital firm founded by current presidential hopeful Mitt Romney. Reichheld's responsibilities there included evaluating companies that Bain had an interest in acquiring. Being a naturally curious fellow, he came to wonder why some companies that seemed to have every conceivable advantage in the marketplace failed to outperform competitors that they should have flattened long ago. What he discovered might be akin to the Holy Grail of Growth.

The most identifiable and effective financial advantage one company can hold over another is having a vastly higher rate of retention across its employees and customers. More than pricing, more than costs of production or distribution, more than marketing, the rate at which your company retains its customers and employees will determine its financial performance over the long term.

Reichheld puts it in terms we all understand: "Each time we found a performance record that was hard to square with the traditional economics taught in business schools, we also found a company with superior loyalty. Each time we found a company with outstanding loyalty, we also discovered a company that was delivering superior value to its customers and employees, and, at the same time, generating inexplicably strong cash flows to fund internal growth." Value, not price, Reichheld and others assert, is a measurable commodity if you know what to measure.

He illustrates his point with examples of companies that raised their customer retention rates by just 5 percent and improved the value of a customer by as much as 100 percent. Figure all the new products, replacement goods and add-ons that a top tier rent-to-own customer can account for over several years and it's easy to see the financial impact of holding on to your best customers. That means through business cycles, economic cycles, product cycles and sales cycles.

Reichheld focuses on two costly mistakes that companies make in adding customers. The first is a general failure to quantify or study customer defections so long as replacements keep coming along. Second, most companies measure the wrong things to reach inferior conclusions about customer retention. Defining the "right customer" and measuring the impact of his loyalty on the financial health of the business is simply too complicated for many to bother with. *The Loyalty Effect* demonstrates how to do it, in language that any business leader can understand. The right customer, according to Reichheld, is one with a long and unbroken history with the company, who keeps agreements, maintains a high level of loyalty

to the company and its values and regularly sends other blue-ribbon customers or offers suggestions on ways the company can improve its delivery of products and services ("build value"). Reichheld claims that financial performance supersedes demographics in identifying this type of customer.

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Such customers universally prove to generate higher returns with less risk and lower cost of handling. It's hard to argue that anything positive results when new employees service newly acquired customers and at the same time try to reshape the business relationships already in place with old customers. Yet that is where most of our sales and marketing campaigns are designed to take us. *The Loyalty Effect* explains how a company can break this costly and unrewarding cycle and reinvest in a cycle of loyalty, learning and value creation to hold onto its best customers and its best employees.

Nearly everybody knows about Maslow's "Hierarchy of Needs." Perhaps only a handful has ever heard of its counterpoint, the "Hierarchy of Loyalties," formulated by Harvard philosophy professor Josiah Royce. Maybe that's because his book, *The Philosophy of Loyalty*, was published a century ago and has never been featured on *Oprah*. Royce determined that loyalties arrange themselves in a hierarchy much like human needs are grouped. At the lowest level is loyalty to individuals. Then comes loyalty to groups. At the pinnacle is our practical devotion—"loyalty"—to a set of values and principles. It is our devotion to principles that tells us when and if the time has come to end our loyalty to an individual or group. Loyalty to principles overrides all other loyalties. Managers who never learn this are doomed to failure by the weight of masses of people churning through their otherwise excellent processes.

The overall theme running through *The Loyalty Effect* is that money spent on most employee initiatives and clever "loyalty" programs could be better spent studying the company's value system and devising training methods that would encourage managers and workers to exemplify, communicate and uphold company values in their dealings with each other, with customers and with shareholders. Old Josiah was prescient in stating that the successful business is the one that gains the most devotion to its principles, not its principals. What employee ever quit a job because he didn't like the price of a refrigerator or the service schedule on Wednesday?

About value creation. *The Loyalty Effect* describes two kinds of profit. Virtuous profit is the result of creating value, sharing it and building assets. Those assets include human capital of the customer and the employee type (a notion certain to give your CPA heartburn). Destructive profit comes from exploiting assets to generate the short-term earnings demanded by bankers, investors and most owners. That means giving up on the oldest, most valuable customers and employees because the company has simply run out of ideas on how to keep either and is unwilling to restructure itself so that tenured workers can find profitable ways to better serve longstanding and well understood customers. In other words, build value.

Firms that practice loyalty-based management integrate customer acquisition, benchmark hiring and compensation, productivity improvements, learning, motivation and the building of value. They do not celebrate short-term gains in counts or numbers that are easily manipulated and prone to wild swings. Based on his findings, Reichheld describes a loyalty based company thusly:

“Revenues and market share increase as the best customers come into the business, building repeat sales and safe, low-cost referral business. Because the company offers great value, it can be more selective in new customer acquisition. This stimulates sustainable, profitable growth from reduced outlays.”

Sustainable growth enables the company to attract and retain the best employees.

Consistent delivery of superior value to worthy customers increases employee loyalty by giving people pride and satisfaction in what they do. As the long-term employee gets to know his long-term customers better, he learns how to deliver still more value—further reinforcing both customer and employee loyalty.

Loyal long-term employees utilize OJT to reduce costs and improve quality on their own, further enriching the customer value proposition and creating high productivity. The company can then use this productivity surplus to fund superior compensation and better tools and training—further reinforcing employee productivity, compensation growth and loyalty.

Spiraling productivity coupled with the increased efficiency of dealing with loyal customers generates the kind of cost advantage that is difficult for competitors to match. Sustainable cost advantage coupled with steady growth in the number of loyal customers generates the kind of profits that are very appealing to investors, which makes it easier for the firm to attract and retain the right

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investors (or, in some cases, lenders or partners).

The list of companies that have been successful using this approach includes many household names across dozens of industries, including retail.

A third of the way through *The Loyalty Effect*, the author offers something called a “Generic Model of the Seven Economic Effects Associated with Employee Loyalty.” Although that comes dangerously close to Harvard-speak, the model is elegant in its plainness, addressing recruiting, training, efficiency, customer selection, customer retention, customer referral and employee referral. Get these right and your business grows exponentially. Get most of them wrong and, well...

Changing old practices takes equal amounts of courage, confidence and cash in the bank. Reichheld reminds us that people learn, organizations don't. The burden is on senior management to lead the charge. Loyalty does not percolate up from the bottom because of slogans, pretty stores or promises. The things that create loyalty—principles, values, ideals—must flow down from the top and be seen walking around the back room, the hallways, the front office, the company picnic. Reichheld and Royce, writing a century apart, agree that employees who do not share your values cannot share your beliefs; if people do not share your beliefs, you are communicating in a vacuum, talking about goals and objectives that interest no one and will never come to fruition.

A little chicken sandwich company from Georgia made huge inroads in the fast-food industry with two simple but bold statements: pay a store manager half of the profit earned by his unit and close every store on Sunday. It's no coincidence that manager turnover at Chick-Fil-A runs to about 5 percent annually. *Five percent!* Chick-Fil-A managers stay long enough and have a big enough stake in the P&L that they are tireless in discovering any wasted dollar, any overlooked source of new revenue. Contrast this with the manager at the pizza joint or rent-to-own store across the street who may be there a couple of years at most and spend those in constant search of the “home run.” A \$100 monthly cost-saving just doesn't mean much, unless you work for Chick-Fil-A and you know that half of that \$100 a month is yours, every month for an average of 14 years!

If your business is suffering the effects of high employee turnover and a rapidly churning customer base, or you are just not having as much fun as you once did, I recommend you spend a few hours alone one evening with *The Loyalty Effect*. You won't be lonely long. ■

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