# Making loyalty pay: Lessons from the innovators

In May of 1981, American Airlines introduced its AAdvantage Frequent Flier Program, which not only put the term *frequent flier* into the popular parlance but set off the modern era of reward-oriented marketing. Since then markets worldwide have been swept with loyalty cards, rewards cards, points cards, club cards and other inducements to reward buyers for sticking with the brand. In recent years, the popularity hasn't let up. Rewards marketing has become one of the primary ways to differentiate credit cards in the high-end, and now in the mass market. Among customers, airline and loyalty program-connected credit cards remain the top-of-wallet payments vehicle. Beyond co-branded credit cards, overall loyalty memberships increased by 25 percent between 2008 and 2010, based on Colloquy's U.S. loyalty census. There are now 430 million payments and credit card loyalty memberships in the U.S. – more than one per person (Exhibit 1).

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But for all their growth and popularity, are loyalty programs really worth the effort? Do they pay off for the companies that offer them? A recent McKinsey study involving 55 publically traded North American and European companies (across seven sectors in which loyalty programs play a significant role) showed that those that spend more on loyalty, or have more visible loyalty programs, grow at about the same rate – or slightly slower – than those that do not. In fact, since 2002, loyalty-focused companies surveyed grew revenues at a weighted-average rate of 4.4 percent per year – compared to 5.5 percent for companies with lower loyalty focus (Exhibit 2).

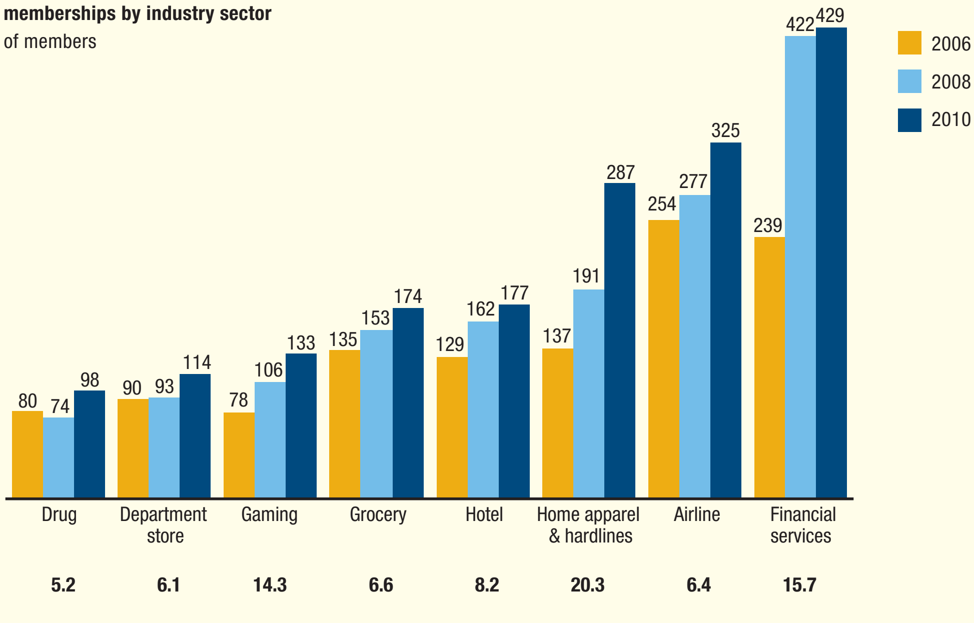
Loyalty spend also appears to have a negative correlation with the bottom line. As a whole, companies surveyed that had higher loyalty spend had EBITDA margins that were about 10 percent lower than companies in the same sectors that spent less on loyalty (Exhibit 3, page 24).

Notably, the impact of loyalty programs on revenue growth appears to vary widely

Exhibit 1

## Membership in loyalty programs is growing across sectors

**Loyalty memberships by industry sector**
Millions of members

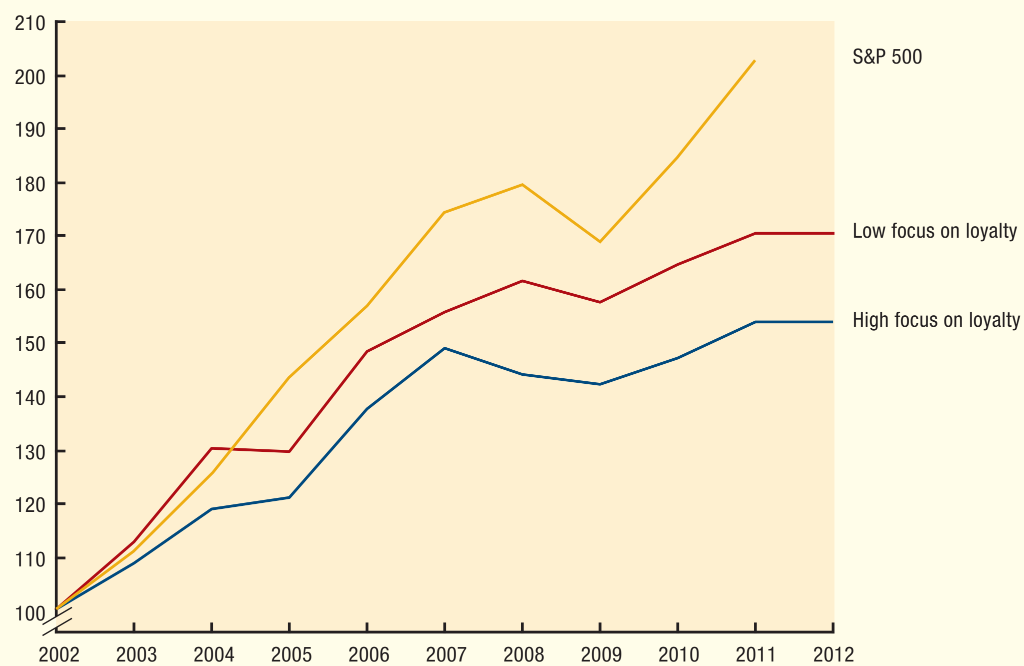



Source: Colloquy; VSS

Exhibit 2

## Loyalty programs do not appear to drive stronger revenue growth

**Revenue increase of 55 major companies with low- and high-focus on loyalty**
Indexed




Source: McKinsey Corporate Performance Analysis Tool

across sectors. Hotel chains are among the few sectors where strong loyalty investment appears to have had a positive impact on growth. On the other hand, loyalty-focused companies in the airline and car rental industries (both traditional loyalty sectors) as well as the food retail sector (where loyalty has proliferated in recent years) appear to have reaped a negative impact on their revenue growth over the past 10 years.

## Success and failure in loyalty programs

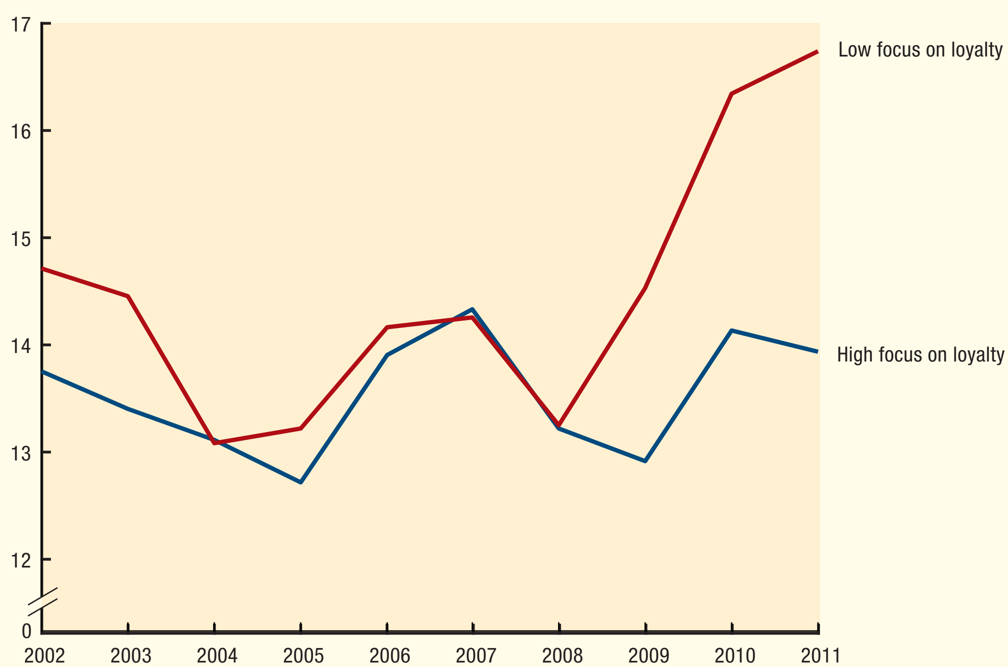
Although companies that emphasize loyalty programs can underperform in terms of revenue growth and profitability, the market appears to give them high marks for the effort. Over the past five years, market capitalization for companies that greatly emphasize loyalty programs has outpaced that of companies that don't (Exhibit 4). This may reflect the hope that deep and meaningful loyalty programs can drive long-term value – and perhaps that the information that companies with a high focus on loyalty have amassed will pay dividends in due time. This could be the case, in particular, if loyalty program payments partners can help these programs leverage and tie their internal data with aggregated (and secure) payments data.

Still, why do many loyalty programs fail to deliver long-term value? And how do the winners manage to buck the trend?

Exhibit 3

**Companies with high reliance on loyalty appear to have consistently lower EBITDA margins**

**Weighted average EBITDA margin of 55 major companies with low and high reliance on loyalty**
Percent




Source: McKinsey Corporate Performance Analysis Tool

## Why loyalty programs fail to deliver value

**Noise:** The average U.S. household has more than 18 loyalty memberships, but actively uses only one-third of them. In loyalty programs, differentiation is key; they must aim for relevance and broad usage, just as credit cards aim to be "top of wallet."

**Me-too mentality and low brand integration:** Many new programs are simply copies of other programs. Issuers partnering with consumer and retail companies must create a truly distinct loyalty proposition, in which payments and rewards experiences are fully integrated with the brand.

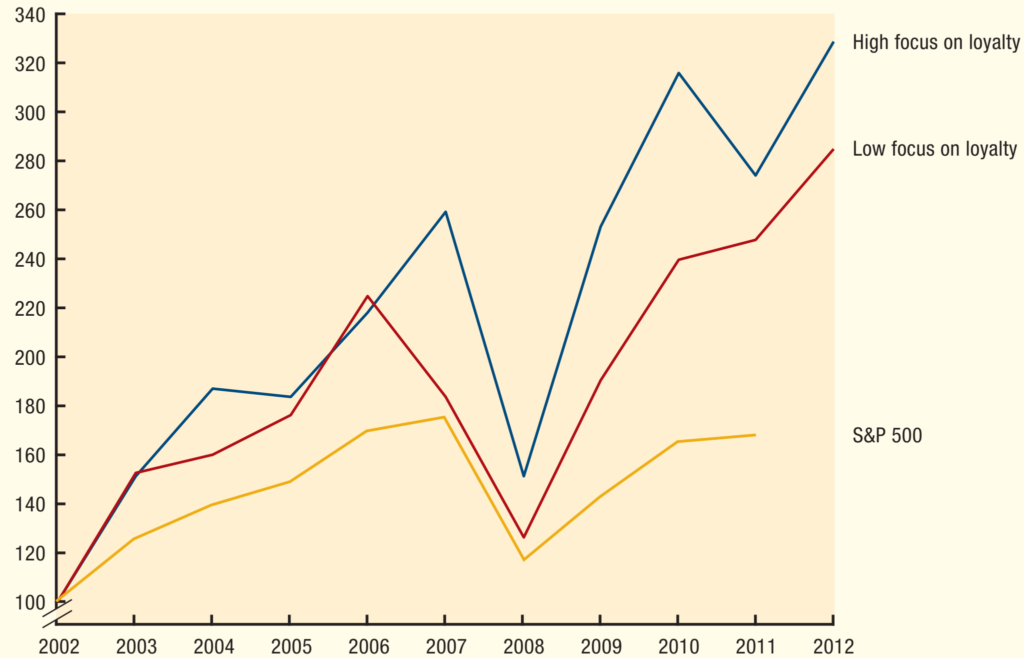
**Forced-discount programs:** A two-tiered pricing structure, in which store discounts are only for program members (as with many grocery retailers), maximizes reach and data capture. But it does not reward consumers for true loyalty. Safeway's Club Card Program was an example of a loyalty program that was more stick than carrot. In many cases, non-members could benefit from discounts by using a generic card at the cash register. In February, 2013, Safeway announced that they would be using the Club Card platform to deliver a more meaningful loyalty experience through targeted offers and digital coupons – enabling them to deliver differentiated value, and to eliminate print ads by the end of 2013.

**Lack of data capabilities:** Innovative use of data will be a key to unlocking value in

Exhibit 4

**In recent years, loyalty-focused players have seen faster increases in market value**

**Weighted increase in market capitalization**
Indexed, 2002 = 100




Source: McKinsey Corporate Performance Analysis Tool

next-generation loyalty programs, but many companies lack the talent and technology to get to this next level. Companies in consumer-facing industries without these strengths will need to rely on partners like card issuers, loyalty providers and data aggregators to leverage their data assets.

Making trade-offs between profit optimization – for example, introducing black-out rewards or thwarting extreme couponers – and program simplicity is the mark of a distinctive loyalty program.

**Inward focus:** Accumulating internal data on consumers' purchases with a single brand, without the context of other purchases and demographic data, is not enough to fully understand the customer. The best loyalty players merge outside data from partners with their own. To enable their partners to thrive, credit card issuers should think beyond "splitting the pie" through the traditional "bps and bounties" value exchange towards "growing the pie" – by offering innovative data-sharing arrangements to increase customer visibility and develop insights that work from a security and privacy perspective.

**Choosing the wrong metric:** Many program rewards are based on metrics that are not necessarily tied to profitability. For example, mileage flown or groceries purchased are somewhat correlated to revenue generation, but do not necessarily translate to optimizing profitability. The more rewards are disconnected from true value drivers, the more they risk negatively impacting the bottom line. Making trade-offs between profit optimization – for example, introducing black-out rewards or thwarting extreme couponers – and program simplicity is the mark of a distinctive loyalty program.

### Hallmarks of success

Companies that have developed loyalty programs that succeed in driving revenue growth share some common characteristics:

**Integrate loyalty into the full experience:** Starbucks, the brand that succeeded in creating loyalty by differentiating the ordinary experience of drinking coffee, has also managed to create a payments-card-linked, strongly differentiated loyalty program. To do this, the company leveraged their payments and mobile technology, and integrated it with the Starbucks shop experience. The program is not an additional card for their customers to carry – it simplifies and makes the transaction more enjoyable. Starbucks' recent partnership with Square will provide them with more functionality and will extend the relevance of the program beyond the barista line.

**Use the data:** The Target REDcard combines payments, loyalty and a valuable discount program – 5 percent at the point of sale – in a way that is highly compelling for consumers. They have moved past the flat "discount-only" model by building out industry-leading data capabilities, using the data to target highest-value consumers (e.g., future moms). They also use the REDcard to minimize acceptance costs, by clearing payments on a private network and avoiding interchange.

**Build partnerships:** Though its competitor Tesco has been massively successful at using data to drive loyalty, Sainsbury slightly outpaced the giant's sales growth in the UK for the last three to four years; in part this could be due to a new form of loyalty program. Sainsbury is the anchor retailer of the Nectar coalition, which allows consumers to collect points and rewards across a large number of non-competing retailers in the UK (including through a Nectar-branded American Express card). Through Nectar, Sainsbury offers a broader value proposition to its customers, and also captures external data from coalition partners.

Prime not only integrates tightly with Amazon's brand and value proposition (promising a reliable customer experience), it also creates a loyalty program for suppliers.

**Solve customer and industry pain points:** Amazon's largest success in loyalty is built around solving one of online shoppers' primary pain points: delivery. For $79 a year, members of the online retailer's "Prime" program get free two-day shipping, plus a selection of free streaming videos and Kindle books. Prime not only integrates tightly with Amazon's brand and value proposition (promising a reliable customer experience), it also creates a loyalty program for suppliers, who rely on Fulfillment By Amazon for two-day delivery, and thus access to Prime customers. While the stand-alone profitability of Prime is a closely guarded secret, it is estimated that members spend over four times more with Amazon than non-members.

**Maximize difference between perceived value and real cost:** Like most hotel loyalty programs, the major focus of the Starwood Preferred Guest (SPG) program is to attract high-value travelers by offering points that can be redeemed for their personal leisure travel. The majority of these redemptions occur on weekends when these hotels have relatively low occupancy. So the cost of putting an SPG member in a room for points is minimal. Starwood has also developed a series of offerings (e.g., suite upgrades, flexible check-in, free Internet) that are highly valuable to their top customers, but bear little incremental cost.

In addition, by offering a broad range of elite levels and improved services that also improve their brand appeal, as well as frequent promotions involving dynamic customer interaction (e.g., the "Nice Choice" promotion, where consumers design their own "bonus point" promotion), Starwood's loyalty program has helped the chain achieve above-market growth, despite relatively low overall guest satisfaction scores. A great number of affluent business travelers wind up with the SPG American Express co-brand card at the top of their wallet.

**Allocate loyalty reinvestment to the most profitable customers:** Southwest Airlines' loyalty program has been a hallmark of its brand and a driver of loyalty for its cost-conscious travelers. The recent revamping of the program in 2010 appears to have maintained its appeal with consumers, while better correlating its reward spend to profitability. While most airlines attach rewards to the number of miles flown (with extra points for higher-priced seats), Southwest offers rewards based on the amount of money the flier spends. In this way, their loyalty rewards spend remains similar to that of other loyalty-focused airlines (i.e., 8 to 9 percent of revenue passenger miles), but the program is better positioned to drive profitability.

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Loyalty programs are not only growing, they are also more tightly integrated, offering consumers a seamless experience across point of sale, the Internet, phone and mobile channels. Payments providers should look for ways to go beyond the simple co-brand card that drives ancillary revenue for retailers. For credit card issuers, integration with loyalty programs can differentiate them from the pack. And providing innovative ways for retailers to target and serve consumers can elevate payments providers to the rank of strategic partners.

Consumer-facing businesses and those providing payments solutions must think beyond the concept of a co-brand card with a discount. To reap the full benefits of customer loyalty, they must create a differentiated experience that will provide a step change in brand preference.

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