## CUSTOMER PROFITABILITY SEGMENTS

Companies may want to treat all customers with excellent service, but they generally find that customers differ in their relationship value and that it may be neither practical nor profitable to meet (or to exceed) *all* customers' expectations.[30] FedEx Corporation, for example, once categorized its customers internally as "the good, the bad, and the ugly"—based on their profitability. Rather than treating all its customers the same, the company paid particular attention to enhancing their relationships with the good, moving the bad to the good, and discouraging the ugly.[31] Other companies also try to identify segments—or, more appropriately, tiers of customers—that differ in current and/or future profitability to a firm.[32] This approach goes beyond usage or volume segmentation because it tracks costs and revenues for segments of customers, thereby capturing their financial worth to companies. After identifying profitability bands, the firm offers services and service levels in line with the identified segments. Building a high-loyalty customer base of the right customers increases profits. Research suggests that it is not uncommon for a service firm to see profits increase by more than 60 percent when the retention of the right customers increases by 5 percent.[33]

### Profitability Tiers—the Customer Pyramid

Although some people may view the FedEx grouping of customers into "the good, the bad, and the ugly" as negative, descriptive labels of the tiers can be very useful internally. Labels are especially valu-

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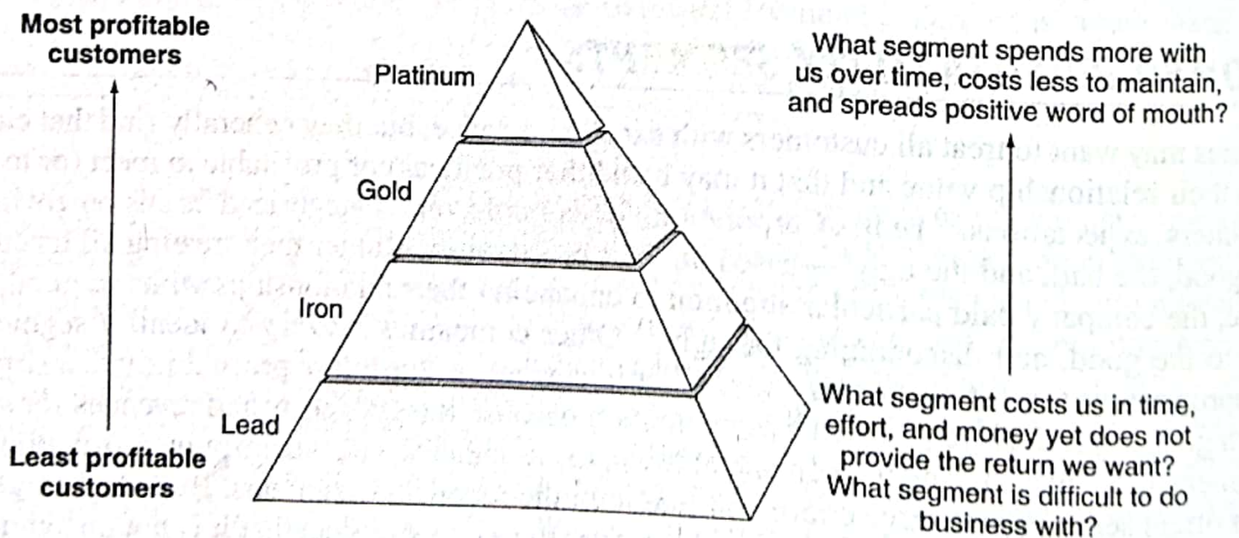
able if they help the company keep track of which customers are profitable. Virtually all firms are aware at some level that their customers differ in profitability and that a minority of their customers account for the highest proportion of sales or profit.

One useful approach for thinking of how customers differ in terms of profitability is the four-tier system, shown in Figure 6.4, which includes the following:

1. The *platinum tier* describes the company's most profitable customers, typically those who are heavy users of the product, are not overly price sensitive, are willing to invest in and try new offerings, and are committed customers of the firm.
2. The *gold tier* differs from the platinum tier in that profitability levels are not as high, perhaps because these customers are not as loyal or they want price discounts that limit margins. They may be heavy users who minimize risk by working with multiple providers rather than just the focal company.
3. The *iron tier* contains essential customers who provide the volume needed to utilize the firm's capacity, but their spending levels, loyalty, and profitability are not substantial enough for special treatment.
4. The *lead tier* consists of customers who are costing the company money. They demand more attention than they are due given their spending and profitability and are sometimes problem customers—complaining about the firm to others and tying up the firm's resources.

Note that this classification is superficially reminiscent of, but very different from, traditional usage segmentation performed by airlines such as American Airlines. Two differences are obvious. First, in the customer pyramid, profitability rather than usage defines all levels. Second, the lower levels actually articulate classes of customers who require a different sort of attention. The firm must work either to change the customers' behavior—to make them more profitable through increases in revenue—or to change the firm's cost structure to make them more profitable through decreases in costs.

**FIGURE 6.4 The Customer Pyramid**




Once a system has been established for categorizing customers, the multiple levels can be identified, motivated, served, and expected to deliver differential levels of profit. Companies improve their opportunities for profit when they increase shares of purchases by customers who either have the greatest need for the services or show the greatest loyalty to a single provider. By strengthening relationships with the loyal customers, increasing sales with existing customers, and increasing the profitability on each sale opportunity, companies thereby increase the potential of each customer.

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### The Customer's View of Profitability Tiers

Whereas profitability tiers make sense from the company's point of view, customers are not always understanding, nor do they appreciate being categorized into a less desirable segment.[34] For example, at some companies (e.g., eTrade), the top clients have their own individual account representative, whom they can contact personally. The next tier of clients may be handled by representatives who each have a limited number (e.g., 100) of clients. Meanwhile, most clients are served by a website, an 800-number, or an automated voice response system. Customers are often aware of this unequal treatment, and many resist and resent it. It makes perfect sense from a business perspective, but customers are often disappointed in the level of service they receive and give firms poor marks for quality as a result. Therefore, it is important that firms communicate with customers so they understand the level of service they can expect and what they would need to do or pay to receive faster or more personalized service.

The ability to segment customers narrowly based on profitability implications also raises questions of privacy for customers. To know who is profitable and who is not, companies must collect large amounts of individualized behavioral and personal data on consumers. Many consumers today resent what they perceive as an intrusion into their lives in this way, especially when it results in differential treatment that they perceive is unfair.

### Making Business Decisions Using Profitability Tiers

Prudent business managers are well aware that past customer purchase behavior, although useful in making predictions, can be misleading.[35] What a customer spends today, or has spent in the past, may not necessarily be reflective of what he or she will do (or be worth) in the future. Banks serving college students know this well—a typical college student generally has minimal financial service needs (i.e., a checking account and a debit card) and tends to not have a high level of deposits. However, within a few years that student may embark on a professional career, start a family, and/or purchase a house, and thus require several financial services and become a potentially very profitable customer to the bank. Generally speaking, a firm would like to keep its consistent big spenders and lose the erratic small spenders. But all too often a firm also has two other groups they must consider: erratic big spenders and consistent small spenders. So, in some situations where consistent cash flow is a concern, it may be helpful to a firm to have a portfolio of customers that includes steady customers, even if they have a history of being less profitable.[36]

Some service providers have actually been quite successful in targeting customers who were previously considered to be unworthy of another firm's marketing efforts.[37] Paychex, a payroll processing company, became very successful in serving small businesses that the major companies in this industry did not think were large enough to serve profitably. Similarly, Progressive Insurance became very successful in selling automobile insurance to undesirable customers—young drivers and those with poor driving records—that most of the competition did not feel had a sufficient relationship value. As these examples suggest, firms should think carefully and strategically when applying customer value calculations.

## RELATIONSHIP DEVELOPMENT STRATEGIES

To this point in the chapter, we have focused on the rationale for relationship marketing, the benefits (to both firms and customers) of the development of strong exchange relationships, and an understanding of the relationship value of a customer. In this section we examine a variety of factors that influence the development of strong customer relationships, including the customer's overall evaluation of a firm's

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offering, bonds created with customers by the firm, and barriers that the customer faces in leaving a relationship. These factors, illustrated in Figure 6.5, provide the rationale for specific strategies that firms often use to keep their current customers.

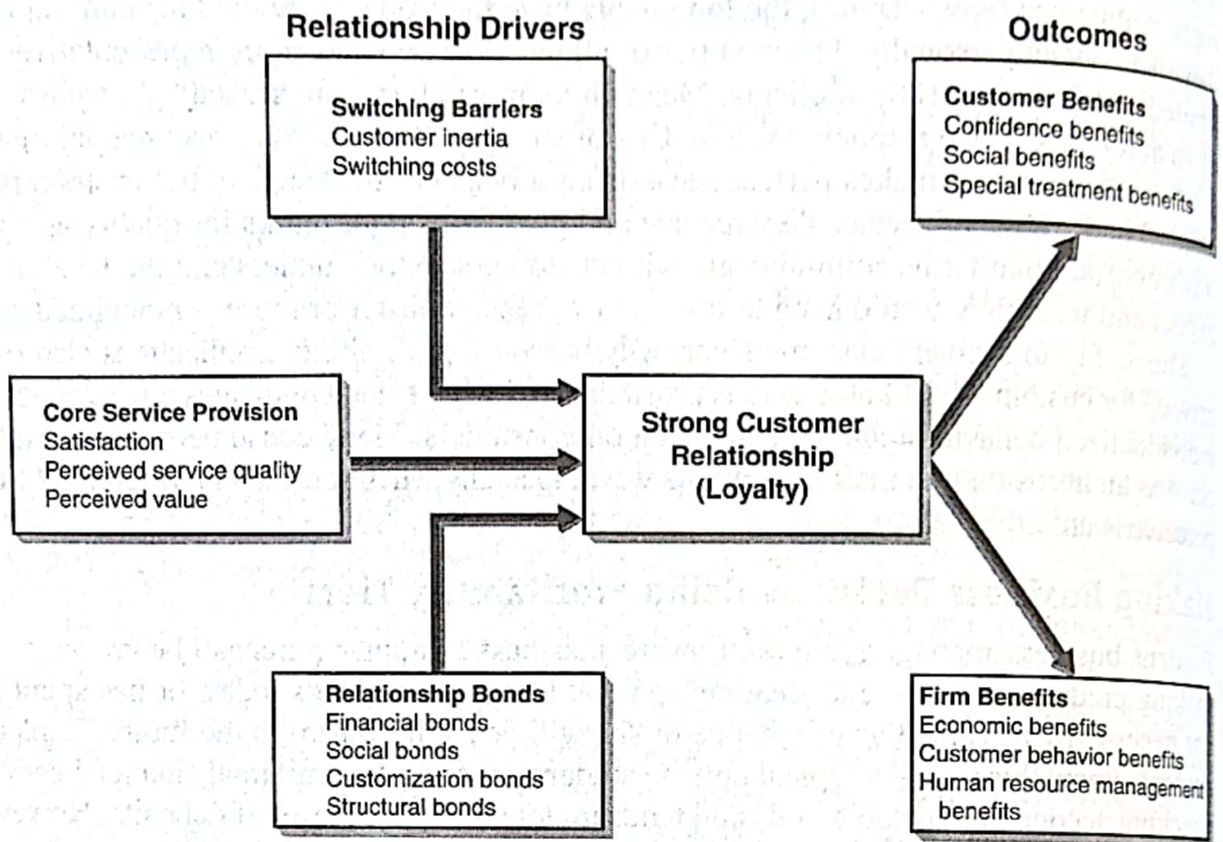


**FIGURE 6.5 Relationship Development Model**

Source: Adapted from D. D. Gremler and S. W. Brown, "Service Loyalty: Antecedents, Components, and Outcomes," in *1998 AMA Winter Educators' Conference: Marketing Theory and Applications,* Vol. 9, D. Grewal and C. Pechmann, eds. Chicago, IL: American Marketing Association, pp. 165–166.

## Core Service Provision

Retention strategies will have little long-term success unless the firm has a solid base of service quality and customer satisfaction on which to build. All the retention strategies that we describe in this section are built on the assumption of competitive quality and value being offered. Clearly, a firm needs to begin the relationship development process by providing a good core service delivery that, at a minimum, meets customer expectations and provides customers with perceived value;[38] it does no good to design relationship strategies for inferior services. Two earlier examples, Intuit and USAA, provide convincing support for the argument that excellence in the core service or product offered is essential to a successful relationship strategy. Both of these companies have benefited tremendously from their loyal customer base; both offer excellent quality; both use relationship strategies to enhance their success.

## Switching Barriers

When considering a switch in service providers, a customer may face a number of barriers that make it difficult to leave one service provider and begin a relationship with another. Literature suggests that these *switching barriers* influence consumers' decisions to exit from relationships with firms and, therefore, help to facilitate customer retention.[39]

### *Customer Inertia*

One reason that customers commit to developing relationships with firms is that a certain amount of effort may be required to change firms. Sometimes consumers simplistically state that "it's just not

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worth it" to switch providers. *Inertia* may even explain why some dissatisfied customers stay with a provider. In discussing why people remain in relationships (in general) that they no longer find satisfying, scholars suggest that people may stay because breaking the relationship would require them to restructure their life—to develop new habits of living, to refashion old friendships, and to find new ones.[40] All would require effort and a change in behavior—and people do not like to change their behavior.

To retain customers, firms might consider increasing the *perceived effort* required on the part of the customer to switch service providers.[41] If a customer believes that a great deal of effort is needed to change companies, the customer is more likely to stay put. For example, automobile repair facilities might keep a complete and detailed maintenance history of a customer's vehicle. These records remove from the customer the burden of having to remember all the services performed on the vehicle and would force the customer to expend considerable effort in providing a complete maintenance history if the vehicle were taken to a new mechanic. Conversely, if a firm is looking to attract a competitor's customers, it might automate the process for switching providers as much as possible to overcome customer inertia.

### *Switching Costs*

In many instances, customers develop loyalty to an organization in part because of costs involved in changing to and purchasing from a different firm. These costs, both real and perceived, monetary and nonmonetary, are termed *switching costs.* Switching costs include investments of time, money, or effort—such as setup costs, learning costs, and contractual costs—that make it challenging for the customer to move to another provider.[42] To illustrate, a patient may incur *setup costs* such as paying for a complete physical when changing doctors or for new X-rays when switching dentists. *Learning costs* are those costs associated with learning the idiosyncrasies of how to use a product or service; in many situations, a customer who wishes to switch firms may need to accumulate new user skills or customer know-how. *Contractual costs* arise when the customer is required to pay a penalty to switch providers (e.g., prepayment charges for customer-initiated switching of mortgage companies or mobile telephone services), making it financially difficult, if not impossible, for the customer to initiate an early termination of the relationship.

To retain customers, firms might consider increasing their switching costs to make it difficult for customers to exit the relationship (or at least create the perception of difficulty). Indeed, many firms explicitly specify such costs in the contracts that they require their customers to sign (e.g., mobile telephone services, health clubs). To attract new customers, a service provider might consider implementing strategies designed to *lower* the switching costs of customers not currently using the provider. To reduce the setup costs involved when switching, providers could complete the paperwork required from the customer. Some banks, for example, employ "switch kits" that automatically move a customer's online billing information from a competitor's bank; such kits remove the switching costs surrounding one of the biggest barriers preventing customers from changing banks—transferring online bill payments.[43]

## Relationship Bonds

Switching barriers tend to serve as constraints that keep customers in relationships with firms because they "have to."[44] However, firms can engage in activities that encourage customers to remain in the relationship because they "want to"—thus creating relationship bonds. In this section we present a framework which suggests that relationship marketing can occur at different levels and that each successive level of strategy results in ties that bind the customer a little closer to the firm—and thus increase the potential for sustained competitive advantage.[45] Building on the levels of the retention strategy idea, Figure 6.6 illustrates four types of retention strategies. Recall, however, that the most successful retention strategies are built on foundations of core service excellence.

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Hero Honda Goodlife Program's *Rishta Dil Ka*, though emphasizes emotional and social connect, is merely a kind of relationship building endeavor based on financial rewards and focuses on bundling and cross-selling spare parts and services. [www.herohonda-goodlife.com]

HERO HONDA
GoodLife
Passport to Relationship Rewards

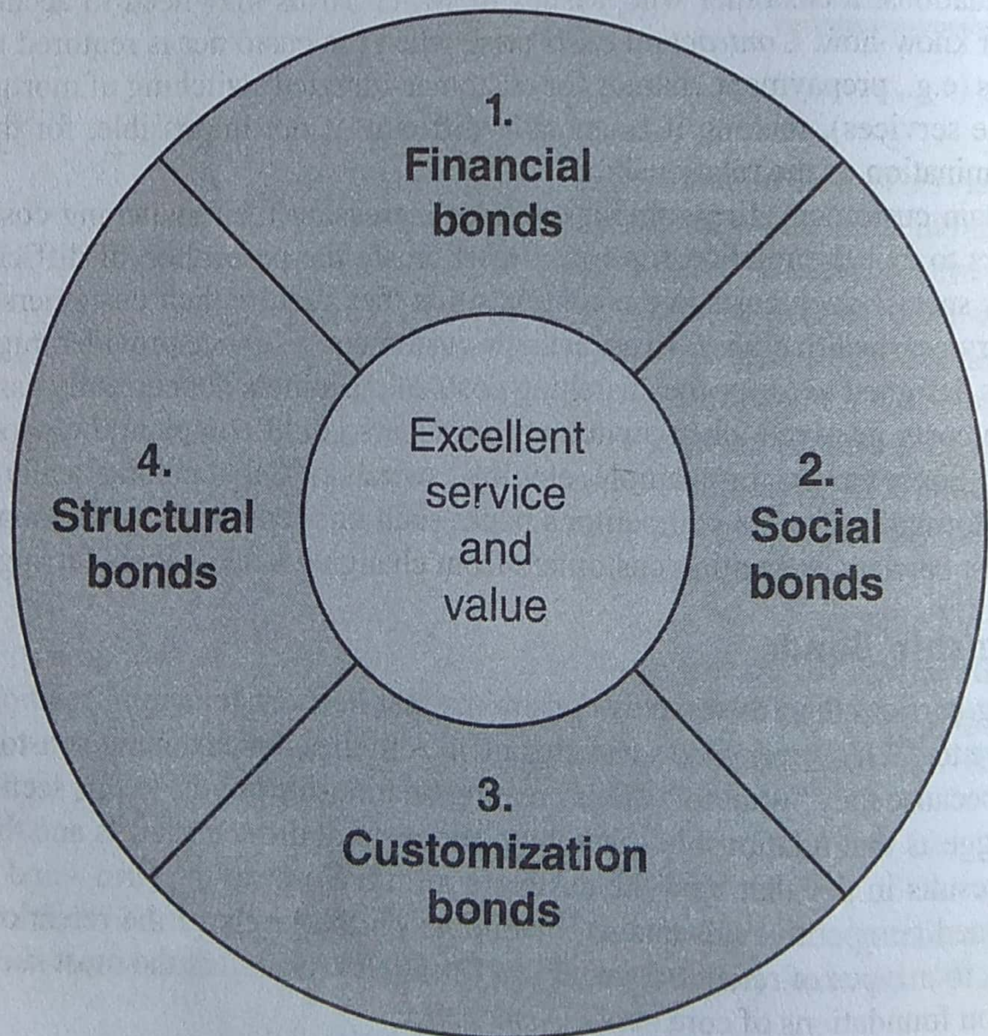
HOME GOODLIFE PROGRAM LADY RIDER CLUB BECOME A MEMBER

Rishta Dil Ka

A one-of-its-kind program that went beyond an ordinary Company-Customer Relationship, Rishta Dil Ka, was an emotional bond borne out of care, respect, trust and mutual admiration.

DEALERS / MEMBERS LOGIN HERE USERNAME PASSWORD LOGIN
FORGOT YOUR PASSWORD?

**FIGURE 6.6**
**Levels of Relationship Strategies**



### *Level 1—Financial Bonds*

At level 1, the customer is tied to the firm primarily through financial incentives—lower prices for greater volume purchases or lower prices for customers who have been with the firm a long time. For example, think about the airline industry and related travel service industries like hotels and car rental companies. Frequent-flyer programs provide financial incentives and rewards for travelers who bring more of their business to a particular airline. Hotels and car rental companies do the same. One reason these financial incentive programs flourish is that they are not difficult to initiate and frequently result in at least short-term profit gains. Unfortunately, financial incentives do not generally provide long-term advantages to a firm because, unless combined with another relationship strategy, they do not differentiate the firm in the long run because they are generally not difficult for competitors to imitate.

Other types of retention strategies that depend primarily on financial rewards are focused on bundling and cross-selling of services. Frequent-flyer programs provide a common example. Many airlines link their reward programs with hotel chains, auto rental, and in some cases credit card usage. By linking airline mileage points earned to usage of other firms' services, customers can enjoy even greater financial benefits in exchange for their loyalty.

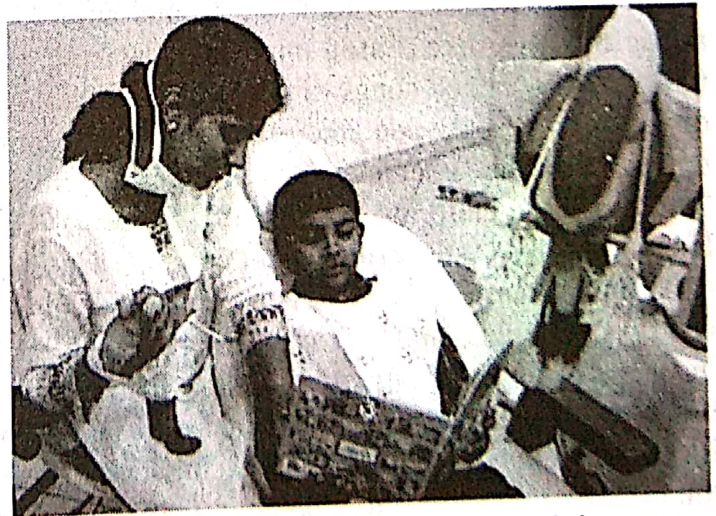
Although widely and increasingly used as retention tactics, loyalty programs based on financial rewards merit caution.[46] As mentioned earlier, these programs are often easily imitated. Thus, any increased usage or loyalty from customers may be short-lived. And, these strategies are not likely to be successful unless they are structured to truly lead to repeat or increased usage rather than serving as means to attract new customers and potentially causing endless switching among competitors.

### *Level 2—Social Bonds*

Level 2 strategies bind customers to the firm through more than financial incentives. Although price is still assumed to be important, level 2 strategies seek to build long-term relationships through social and interpersonal as well as financial bonds.[47] Customers are viewed as "clients," not nameless faces, and become individuals whose needs and wants the firm seeks to understand.

Social, interpersonal bonds are common among professional service providers (lawyers, accountants, teachers) and their clients as well as among personal care providers (hairdressers, counselors, health care providers) and their clients.[48] A dentist who takes a few minutes to review her patient's file before going into the exam room is able to jog her memory on personal facts about the patient (occupation, family details, interests, dental health history). By bringing these personal details into the conversation, the dentist reveals her genuine interest in the patient as an individual and builds social bonds.

Interpersonal bonds are also common in business-to-business relationships in which customers develop relationships with salespeople and/or relationship managers working with their firms.[49] Recognizing the value of continuous relationships in building loyalty, Caterpillar Corporation credits its success to its extensive, stable distribution organization worldwide. Caterpillar is the world's largest manufacturer of mining, construction, and agricultural heavy equipment. Although its engineering and product quality are superior, the company attributes much of its success to its strong dealer network and product support services offered throughout the world. Knowledge of the



**Level 2 strategies create positive social bonds between the client and the service provider employees.**

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local market and the close relationships with customers that Caterpillar's dealers provide is invaluable. Caterpillar's dealers tend to be prominent business leaders in their service territories who are deeply involved in community activities; the social bonds formed from these long-term relationships with customers are an important ingredient in the company's success.

Sometimes relationships are formed with the organization because of the social bonds that develop *among customers* rather than between customers and the provider of the service.[50] Such bonds are often formed in health clubs, country clubs, educational settings, and other service environments where customers interact with each other. Over time the social relationships they have with other customers are important factors that keep them from switching to another organization. One company that has built a significant strategy around customer-to-customer bonds is Harley Davidson, with its local Harley Owners Groups, or HOGs. HOGs are involved in local rallies, tours, and parties as well as in national HOG events organized by the company. Through the HOGs, Harley customers come to know each other and develop a sense of community around their common interest—motorcycle riding—as illustrated in the photo given below.

Social bonds alone may not tie the customer permanently to the firm, but they are much more difficult for competitors to imitate than are price incentives.[51] In the absence of strong reasons to shift to another provider, interpersonal bonds can encourage customers to stay in a relationship.[52] In combination with financial incentives, social bonding strategies may be very effective.

### Level 3—Customization Bonds

Level 3 strategies involve more than social ties and financial incentives, although there are common elements of level 1 and 2 strategies encompassed within a customization strategy and vice versa. A customization approach suggests customer loyalty can be encouraged through intimate knowledge of individual customers—often referred to as *customer intimacy*—and through the development of one-to-one solutions that fit the individual customer's needs.

**Harley Davidson riders develop customer-to-customer bonds through Harley Owners Group (HOG) activities.**

To illustrate customization bonds, consider Pandora—an Internet-based music discovery service that helps its customers find and enjoy music that they like. Based on a huge database that has categorized songs of more than 10,000 different artists based on unique attributes, it customizes its service offering to play music for customers that has the same characteristics of songs or artists they like. A customer can create up to 100 unique "stations" by identifying favorite songs or artists, and then Pandora's expert system analyzes what they like and provides suggestions based on this analysis. To do this Pandora analyzes each song using up to 400 distinct musical characteristics, or "genes," by a trained music analyst. Taken together these genes capture the unique and musical identity of a song—everything from melody, harmony, and rhythm to instrumentation, orchestration, arrangement, lyrics, singing, and vocal harmony—and use this information to customize music to each customer's unique tastes and interests. The earlier Technology Spotlight illustrates how Hilton Hotels uses technology to customize services to a large number of individual customers. Our Global Feature illustrates how Alliance Boots in the United Kingdom has used technology to understand its customers and build one of the world's largest smart card loyalty programs.

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### *Level 4—Structural Bonds*

Level 4 strategies are the most difficult to imitate; they involve structural as well as financial, social, and customization bonds between the customer and the firm. Structural bonds are created by providing services to the client that are designed right into the service delivery system. Often, structural bonds are created by providing customized services to the client that are technology based and make the customer more productive.

Cardinal Health's ValueLink creates structural bonds with its hospital customers.

An example of structural bonds can be seen in a business-to-business health care context with Cardinal Health. By working closely with its hospital customers, Cardinal Health has established ways to improve hospital supply ordering, delivery, and billing that have greatly enhanced its value as a supplier. Many of Cardinal Health's hospital customers use their ValueLink® service, a "just-in-time" distribution program that eliminates their need to maintain and manage large amounts of inventory. Using sophisticated technology and tracking systems to monitor inventory, ValueLink allows Cardinal Health to deliver ready-to-use quantities of supplies as needed—often several times a day—directly to the floors and departments where they are being used. By linking the hospital through its ValueLink service into a database ordering system and by providing enhanced value in the actual delivery, Cardinal Health has structurally tied itself to its more than 200 acute care hospitals in the United States. In addition to the enhanced service that ValueLink provides, Cardinal Health estimates that the system reduces the average customer's inventory by 20 percent and saves its customers an average of $600,000 or more each year.[53]

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