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Reversing the Logic: The Path to Profitability through Relationship Marketing

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Abstract

Many firms have experienced greater success through implementing relationship marketing strategies. This is achieved by gaining knowledge about their own customers through database marketing and about the general marketplace through marketing research. Over time, this has led firms to adopt a general framework which we call the conventional path to profitability. This conventional framework suggests that new product innovation leads to acquisition, acquisition combined with a rich experience leads to satisfaction, satisfaction leads to loyalty and customer retention, and loyalty/retention leads to profitability. However, we show that some of the links in the framework are weak based on both academic research and marketplace realities. Consequently, we reverse the logic of the conventional path to profitability. We introduce a new approach that starts the customer relationship management strategy with customer profitability and the notion that different customers should be rewarded and satisfied differently. In addition, we outline a strategy that relationship marketing firms can implement, leading to higher levels of customer profitability and offer directions for future research.

Keywords: Customer relationship management; Relationship marketing customer life time value; Profits

Introduction

It is widely recognized that many successful firms have gained a competitive advantage in the marketplace by implementing a *relationship marketing* strategy. The success of this strategy has been built upon the constant advances in information and communication technology that allows firms to gather large amounts of information about their own customers (database marketing) and about customers in the general marketplace (marketing research). As a result, this has led to what marketers believe is the conventional path to profitability through relationship marketing (see Fig. 1). The conventional path to profitability starts with innovation being the foundation to acquire customers — where the better the products and services, the better the rate and quality of acquisition. Then, it is expected that when the newly acquired customers are given a richer experience, those customers will achieve a higher level of satisfaction. As a result, these highly satisfied customers will show stronger signs of loyalty, both through their behavioral loyalty (retention) and through their attitudinal loyalty (e.g., positive word of mouth). The improved level of retention gives the firm opportunities to cross-sell and up-sell to these customers, providing enhanced revenues and subsequently higher profits. Finally, the profits are then reinvested in new innovations of product and services, strengthening loyalty programs, and increasing the satisfaction of the firm's customers.

Intuitively, this conventional path to profitability might make sense. For example, consider a loyalty program from a firm where $1 gives the customer 1 reward point. Say, there are two customers who both enter the store on the same day and purchase $100 worth of products and services. Should both of these customers receive 100 reward points? The conventional path to profitability would suggest that by giving every customer 1 reward point for every $1 spent the firm builds loyalty — and in turn profitability. However, there is a significant amount of evidence in both the marketing literature

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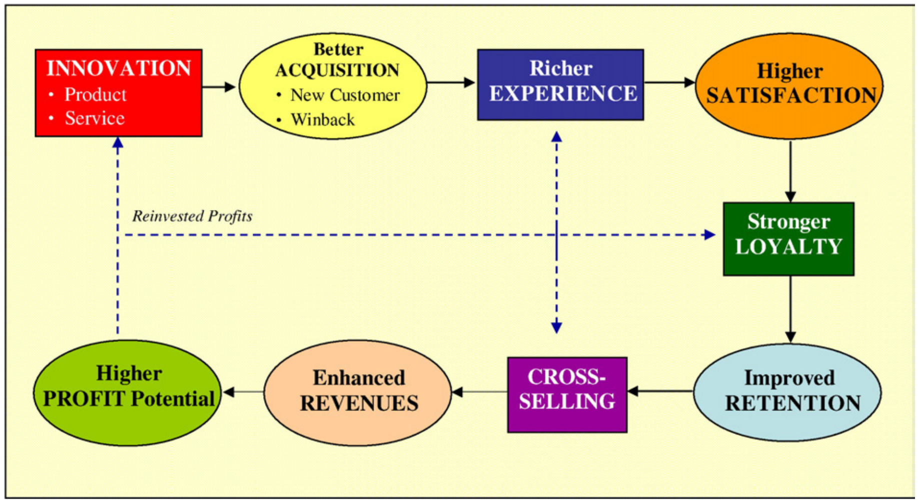

Fig. 1. The conventional path to profitability.

and in the marketplace today that suggests that this conventional path to profitability needs to be questioned and a new path to profitability needs to be developed.

Consequently, there are many firms that are beginning to deviate from this conventional path to profitability. They are doing this by first looking at each customer's profitability and then later thinking about customer loyalty and customer satisfaction. Take Sprint Nextel for example. Recently, they decided to 'fire' around 1000 of their 53 million customers for calling the call center too frequently. Sprint Nextel's justification for firing these customers was purely based on the lack of profitability from these customers.[1] A typical Sprint Nextel wireless customer spends about $55 per month, of which about $24 is profit for the firm. In addition, it costs about $2–$3 dollars per minute for Sprint Nextel to have a customer talk with a customer service representative. So, if a customer talks with a customer service representative for more than 8–12 min per month, then Sprint Nextel is going to lose money on that customer. These customers made similar calls multiple times within a month for several months.

This generates a very interesting set of questions for marketers. First, is the conventional path to profitability in Fig. 1 still the proper framework for firms to use for achieving maximum profitability through relationship marketing? Second, if it is not ideal to follow the conventional path of profitability, when firms like Sprint Nextel fire customers based on a measure of customer profitability, are they taking the right approach in building the foundation of their marketing strategy around customer profitability? To answer these questions in this paper, we proceed with the following three specific topics:

1. Questioning the strength of the links between each part of the conventional path to profitability.
2. Reversing the logic of the conventional path to profitability and proposing a new path to profitability.
3. Outlining how managers can implement a successful relationship marketing strategy using the new path to profitability proposed in this paper.

[1] For the full article, see: http://www.foxnews.com/story/0,2933,288635,00.html.

The conventional wisdom: questioning the links

In this section, we analyze each of the links in the conventional path to profitability from new product innovation to firm profitability. We provide a summary in Table 1 describing the different links in the conventional path to profitability, the weaknesses of those links, and the strategies that will lead firms to a new path of profitability.

Anatomy of the relationships

It is evident from Table 1 that the conventional path to profitability is not the ideal framework to maximizing profitability for firms using a relationship marketing strategy. Each link making up this path is only weak at best. Take some examples from the marketplace regarding the satisfaction–loyalty link. Reichheld (1996) observed that between 65% and 85% of satisfied customers will defect, calling it 'the satisfaction trap'. In some industries it is potentially worse than others. For the automobile industry, 85% to 95% of the customers surveyed report that they are satisfied with their automobile, but fewer than 40% return to buy the same brand (Reichheld 1996). This suggests that for certain industries because employee incentives are tied directly to satisfaction or loyalty metrics, the results are biased from the start. Some academic evidence does exist suggesting there is a link between satisfaction and behavioral loyalty, especially in the context of service. For example, Oliver (1980) found that a consequence of a satisfactory experience with a flu inoculation leads to a revision in future intentions. Bolton (1998) shows that customer satisfaction was more positively related to relationship duration for customers with longer prior experience with the service provider in a telecommunication context. Bolton and Lemon (1999) show for two different monthly service providers that customer