

# Prescription for cutting costs

By Fred Reichheld

## Loyal relationships

In the current downturn, many companies are tightening belts. But *too many* are missing their biggest opportunity to keep costs down: building loyal relationships with customers and other stakeholders.

How do loyal relationships translate into cost savings? Consider the cost of serving a long-standing customer versus the cost of courting one. Across a wide range of businesses, customers generate increasing profits each year they stay with a company. In financial services, for example, a 5% increase in customer retention produces more than a 25% increase in profit. Why? Return customers tend

to buy more from a company over time. As they do, your operating costs to serve them decline. What's more, return customers refer others to your company. And they'll often pay a premium to continue to do business with you rather than switch to a competitor with whom they're neither familiar nor comfortable. Of course, not every customer has potential to be profitable and long-standing.

Cost-effectiveness dictates that you segment clients to identify the subset that holds this potential, so you can target your investment in relationship-building.

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Consider the case of Vanguard, the mutual fund industry cost leader. When Jack Brennan took over as CEO in 1996, Vanguard's flagship S&P 500 Index Fund costs were just 0.20% of assets. By 1999, they had declined to 0.18%—a 10% improvement. One of the reasons is that Brennan, like his predecessor, John Bogle, is committed to customer retention. And Brennan's particular passion is selecting the right kinds of customers up front—the kinds with high potential for long-term relationships with the firm. For example, a few years back, Vanguard rejected an institutional investor that tried to invest \$40 million in a fund, because Vanguard suspected that the customer would soon churn the investment, creating extra costs for all the existing customers. The customer complained to Brennan, who supported the decision and used it as an opportunity to underscore the need to be selective about customers.

Loyalty leaders also reduce costs by building trusting relationships with employees. Consider Chick-fil-A, a chain of quick-service restaurants that has so effectively mastered the economics of employee loyalty that it can afford to let store operators earn compensation that's double or triple industry averages, while generating enough cash to grow the chain *and* give about 10% of profits to charity. Those compensation standards help grow loyal employees who nurture attractive client relationships.

Performance feedback, too, bolsters loyalty. Every store operator can easily find out (right on the in-store computer) his or her standing in comparison to the other 600 or so Chick-fil-A operators on

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measures including sales, sales growth, and profits. The stores whose performance falls into the bottom 15–20% of all Chick-fil-A units automatically get extra attention from company consultants. Customer survey frequency is doubled, and improvement plans are developed with each operator. Operators and employees receiving the added scrutiny understand it is meant to help them get back on track; they know that long-term relationships require honest, two-way communications and learning, and they value the company's commitment to that goal. The ultimate result, of course, is a dramatic saving in hiring costs; Chick-fil-A's average store operator turnover rate is 5% versus the competition's 35–40%.

Customers, employees, suppliers, distributors, channel partners—almost every stakeholder in your company is a potential cost-reduction crusader. If you facilitate a supplier's operations by being flexible about delivery times, for example, that supplier might be more willing to flex for your special need. And over time, as you build trust, that supplier will likely be loyal to you even if one of your competitors offers a more attractive short-term contract. You'll both save on switching costs; and if you're attentive, you'll maximize the efficiency of your transactions as your relationship matures.

### **What are the secrets of the loyalty leaders?**

The companies that best understand cost savings through loyalty take very deliberate steps. A few you might consider:

#### **Modify customer-acquisition incentives:**

Reward your sales teams and marketing channels for acquiring customers that stick. Consider commission or bonus reductions if customers defect before 18 months.

#### **Reallocate marketing investments:**

Systematically rank all of your customer acquisition campaigns on the basis of their yield of loyal customers. Shift resources towards programs that attract the richest mix of loyal customers. (Many firms today are wasting half their marketing expenses on disloyal customers who will never stick around long enough to pay back the acquisition investment.)

#### **Identify ways to help underperformers:**

Develop annual relationship report cards on suppliers and dealers (and customers and employees) with as much care as you give to annual reports for investors. Test a 360-degree feedback system, starting with senior managers and rolling out to all employees.

#### **Use the Internet:**

Loyalty leaders such as Vanguard have shifted almost half of their customer transactions to the Web. Make sure your Web site is so simple to use that many customers will prefer this faster and cheaper alternative.

No company is immune to the pressures of the market. But companies that focus on building loyal relationships *that by their very nature keep costs to a minimum* are far better positioned to remain strong in the face of market turbulence.

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