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Loyalty programs, which include many different types of rewards, have been in place for about 100 years. Introduced in the 1930s, S&H Green Stamps was the most widely known early program. During the past 25 years, the number of loyalty programs has increased steadily. Spurred primarily by airlines and credit card companies, more and more businesses are turning to points-based rewards and other loyalty programs as key initiatives to support their growth objectives. Customers have responded positively to these loyalty programs, appreciating the recognition of their continued business as well as the tangible 'gifts' offered by the programs. By the late 1990s and into 2000, membership in US-based loyalty programs was growing at roughly 30% per year.¹ In 2005, 69% of US credit cardholders had a rewards component attached to their card, up from 40% in 2000.² Last year, more than 75% of US consumers were carrying at least one loyalty card, and about 33% had two or more.³

To a business, customer loyalty involves the willingness to: (a) repurchase a product/brand, (b) recommend the product/brand to other people, and (c) do this by choice. To expand this definition, we use a framework that identifies: core rewardable behaviors; the types of rewards used to drive these actions; and the tangible and intangible outcomes. (See Figure 1)

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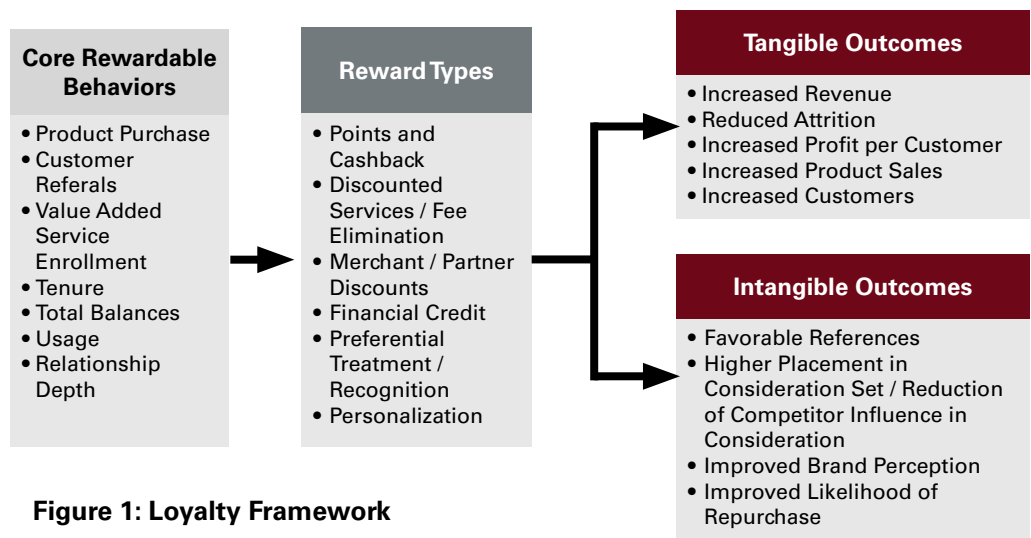


Figure 1: Loyalty Framework

¹ Source: Colloquy, "Loyalty Trends for the 21st Century"; April 2004

² Source: Knowledge@Wharton, "The Lowdown on Customer Loyalty Programs: Which Are the Most Effective and Why"; September 2006

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The phenomenal growth in loyalty programs is driven by the fact that many of these initiatives have generated a win-win situation for the corporation and its customers. Retail banking programs, for example, have had a significant positive impact on customer usage and behavior across a broad spectrum of products and services. (See Figure 2)

| Banco Popular <u>Premia</u> | | | Citibank <u>ThankYou Program</u> | |
|--------------------------------|---------------|----------------|-------------------------------------|---------------------------------------|
| | In Program | Out of Program | | |
| Credit Card Outstandings | ↑ 53% | ↑ 18% | Credit Card Volume | ↑ 37 - 120% for members |
| Card Transactions | 7/card/month | 4/card/month | Attrition | 10x lower for members |
| Checking Balance | ↑ 50% | ↑ 30% | Unique Redemptions | ↑ 10% / month in 2005 |
| Mortgages | ↑ 34% | ↑ 10% | Satisfaction | 82% overall satisfaction with program |
| Online Banking Tx. | 20/acct/month | 12/acct/month | | |

Figure 2: Sample Results from Retail Banking Loyalty Programs
Source: Colloquy, "The Million-Dollar Swing", December 2006

Airline rewards programs can also be profitable. The Aeroplan program set up by Air Canada in 1984 has been successful among Canadian consumers; Aeroplan awarded 17.2 billion miles in Q3 2006. In addition, Aeroplan is a successful business in its own right. The company completed an IPO in 2005, and in the first nine months of 2006, they posted revenues of \$561 million with net earnings of \$105 million (a 49% increase over 2005).

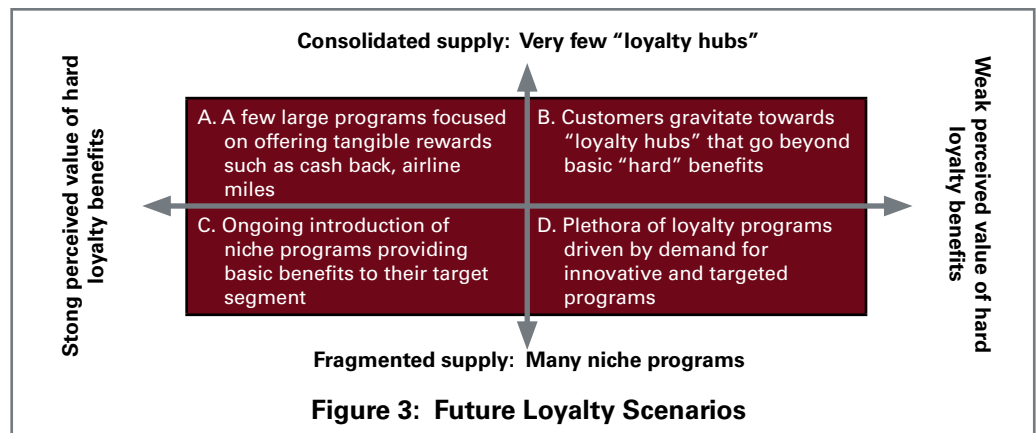
THE SHIFTING LOYALTY LANDSCAPE

Despite their success, loyalty programs run the risk of becoming stale as competitors rush to make similar offers, and customers come to take them for granted. To maintain a positive long-term impact and project a fresh perspective to customers, companies need to reinvent their loyalty programs at regular intervals.

How are loyalty programs likely to change? In our view, there are two key questions surrounding future directions:

1. Will loyalty programs consolidate or will niche programs proliferate?
2. Will the value of tangible, 'hard' loyalty benefits increase or decrease? ('Hard benefits' refers to points-based rewards programs, cash-back, merchandise, and other rewards for which consumers receive a tangible good or service. We contrast this with 'soft' benefits that are woven into a customer's experience with a company. These may include benefits such as personalized communications and preferential treatment of high-value customers.)

Figure 3 presents four potential scenarios based on the outcome of these questions.



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We believe the most likely future direction of loyalty is captured by Scenario B. In this scenario, customers are attracted to a few 'loyalty hubs' or coalitions offering tangible benefits as well as intangible, or 'soft', benefits.

Several factors will combine to shift loyalty in this direction. *Increasing* levels of consolidation among programs will result in the development of several major loyalty hubs. Drivers behind this move to consolidate include:

- Consumer demand for a wide range of reward types and redemption options
- Rising rewards costs that make program expense sharing an attractive alternative
- Coalitions that provide an effective way for partners to acquire new customers (it is important to note here that effective coalitions can be very difficult to implement)

At the same time, we believe the perceived value of 'hard' loyalty benefits by customers will *decrease*. Two major factors are driving this trend:

- Loyalty rewards are becoming commoditized as more and more programs offer similar benefits
- Commoditization decreases the value of using rewards programs to drive brand loyalty. Consumers see little differentiation when they are able to receive the same benefits across competing brands.

Loyalty program consolidation is already occurring in many markets outside the US where loyalty hubs or coalitions have been formed. Nectar, the UK's largest loyalty program, includes a coalition of corporations such as Hertz, Ford, and Sainsbury's. In US markets, the loyalty hubs tend to be linked to a specific lead company who has partnered with multiple redemption partners. American Express' Membership Rewards program, American Airlines' AAdvantage program, and many bank credit card loyalty programs offer examples of hubs that have flourished under a lead brand. Within these programs, loyalty points can be redeemed for flights, car rentals, hotel rooms, and other types of merchandise at a wide range of retailers.

FUTURE VISION: FOCUS ON CUSTOMER EXPERIENCE

We are seeing evidence that tangible hard benefits are becoming established as minimum requirements for loyalty programs. With providers focusing on better ways to control costs, opportunities for growth and differentiation will come from a focus on 'soft' benefits designed to enhance the overall *customer experience*, including:

- recognition,
- preferential treatment,
- and, perhaps most important, personalization.

Soft benefits enable differentiation. They are more difficult for competitors to replicate, and can be highly personalized, ensuring a unique experience with a particular company and/or customer segment. With the next frontier of loyalty centered around the *customer experience* (see Figure 4), programs will focus on how their business treats each customer at every point of contact: stores, websites, customer service representatives, direct mail, outbound tele-marketing, email, and through partners.

Opportunities for growth and differentiation will come from a focus on 'soft' benefits designed to enhance the overall customer experience

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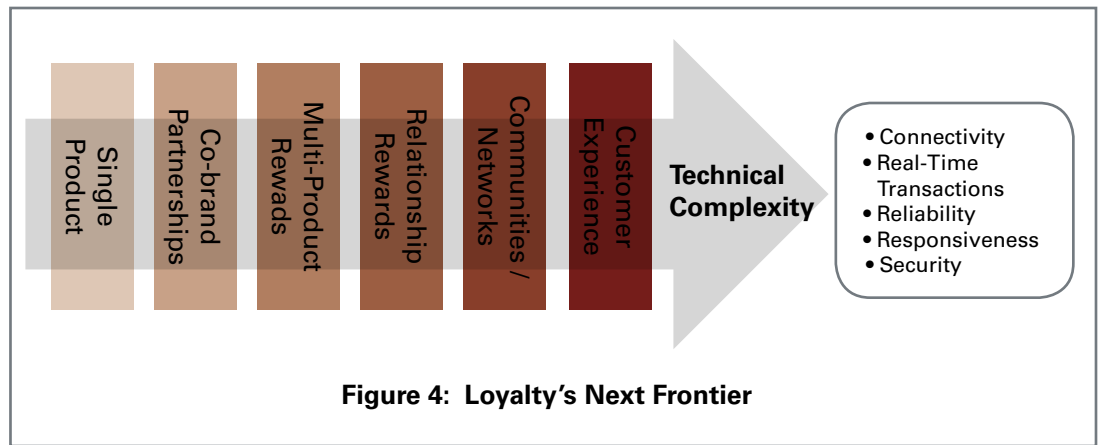


Figure 4: Loyalty's Next Frontier

Tesco, one of the most successful grocers in Europe, is a prime example of a retailer who has recognized the importance of the customer experience. Tesco has grown sales and operating profits by 51% and 47% respectively over the past five years, outperforming the FTSE stock market index by 100%. Over that same period, its archrival, Sainsbury's, experienced a 5% decrease in revenue coupled with a 30% drop in profits.

In spite of these financial successes, maximizing shareholder value is NOT the primary focus of Tesco's mission statement. Rather, CEO Sir Terry Leahy describes their core purpose as "not just to create value for *customers*, but also to earn their *lifetime loyalty*."

Tesco efforts to earn lifetime customer loyalty include preferential treatment, personalized communications, and targeted offers. The result is a highly specialized program packaged in a wide variety of forms, ranging from discounts and coupons for enrolled customers to 'ClubCard evenings' in Tesco stores. These evenings are essentially social events centered around activities that may include wine tasting, flower arranging, or after-hours shopping for Tesco's best customers.

In practical terms, delivering personalized experiences at multiple touch points requires collecting, mining and using the data from the loyalty program (1) in *real time*, and (2) *across the enterprise* (and/or across the coalition). (See Figure 5)

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Figure 5: The Increasingly Complex Requirements of Loyalty

The following case study illustrates that even the largest global organizations struggle to align their data and operations components for the delivery of unique and personalized customer experiences.

Two ingredients will be critical to run a successful loyalty program: customer information and systems reliability

| CASE STUDY: MAJOR INTERNATIONAL AIRLINE | |
|---|--|
| Background | Bob is a business person and an elite member of an airline's frequent flyer program. With more than one million miles logged, the airline knows a great deal about Bob: where he lives, his travel itinerary details, and how often he flies with them. In addition, these years of data indicate that Bob is one of their most profitable customers. |
| Good Customer Experience | On Bob's next trip, his first flight was cancelled. His next flight, that same day, was delayed three hours. The next morning, Bob received an apologetic email, and was asked to call a supervisor to discuss the problems he encountered. The supervisor spent 10 minutes listening to Bob's complaints and suggestions for improvement. At the end of the conversation, the supervisor offered Bob a \$100 voucher as a gesture of apology for the lost time and inconvenience. |
| Poor Customer Experience | The following week, the same airline sent Bob an email with a list of special fares for frequent flyers. None of these special offers involved any of the destinations recorded on Bob's many flights with this airline – simply because there was no linkage between the promotional program and the airline's customer database. |

As the loyalty equation becomes more complex, executing on this vision to provide customers a unique experience is increasingly challenging.

ARE YOU READY?

What will it take to run a successful loyalty program? Two ingredients will be critical:

1. An excellent command of **customer information**
2. Robust connectivity and **systems reliability**

Delivering a personalized customer experience will require mastering the three stages of the customer data lifecycle (see Figure 6). Today, only a handful of companies have mastered these ingredients. In fact, the growing demands of managing complex loyalty programs make them much more difficult to support individually. This is another reason we believe a limited number of loyalty hubs will flourish in the future.

Although more and more businesses are using loyalty programs (and other sources) to collect customer data, only a few possess the capabilities necessary to adequately *mine* this data. And even fewer are able to *operationalize* the data they have mined to create a stronger customer experience.

| CUSTOMER DATA LIFECYCLE | | |
|---|--|---|
| Stage 1: Collecting data | Stage 2: Mining data | Stage 3: Operationalizing data |
| <p>Objectives:</p> <ul style="list-style-type: none"> • Collect, validate and refresh data in a customer-centric manner • Gather this data in real time <p>Key Challenges:</p> <ul style="list-style-type: none"> • Data warehouse project that becomes too complex and/or too expensive • Real-time connectivity to customer behavior at the point-of-sale | <p>Objective:</p> <ul style="list-style-type: none"> • Develop customer behavior information and insights which can be used to create initiatives or promotions that will generate a positive financial return <p>Key Challenge:</p> <ul style="list-style-type: none"> • Become overwhelmed by the amount of data or by data quality issues | <p>Objective:</p> <ul style="list-style-type: none"> • Use these insights to deliver a personalized customer experience at each touch point in real time <p>Key Challenges:</p> <ul style="list-style-type: none"> • Change front-line staff, processes and systems to use insights • Real-time connectivity and reliability |

Figure 6: Customer Data Lifecycle

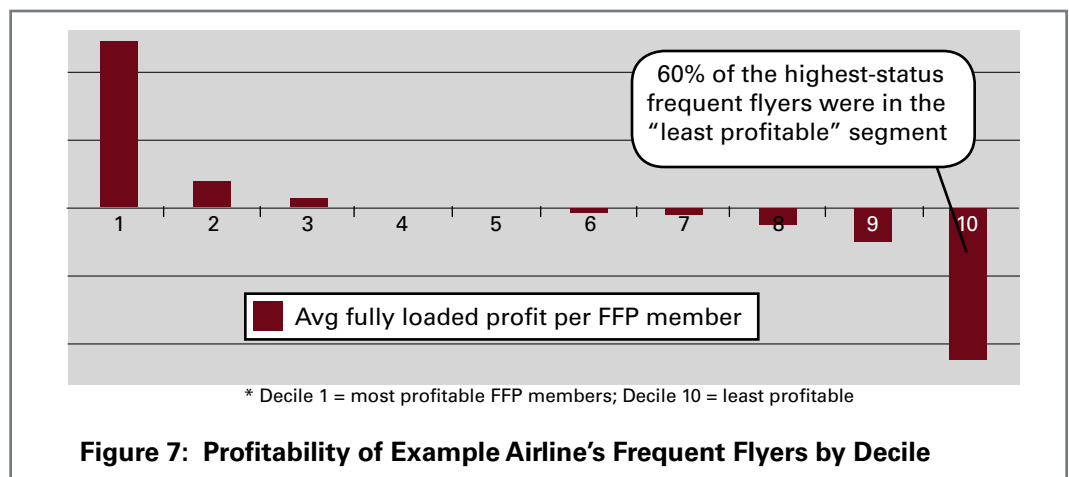
The customer data lifecycle includes three stages: collecting data, mining data and operationalizing data

Stage 1: In the first stage, loyalty programs should be used as a way to collect data about customers including, profile data (who they are), behavior data (what they buy and what services they use) and attitude/preference data. Data should be stored in a customer-centric manner that provides a single view of the multiple relationships that each customer might have with the business. Typically, this is a significant challenge for organizations with multiple product silos, even for companies that have invested in large data warehouses.

Stage 2: The second and greater challenge is to analyze and mine this customer data. One component of this analysis would be segmentation ('slice and dice') of customers based on usage and behavior patterns to build a profitability profile. This is becoming a top priority for many businesses. When retail executives were asked where they wanted to spend money to improve their loyalty program, 48% chose "segmenting customers and understanding customer behavior"⁴. There is also an emerging consensus that in-depth knowledge of profitability (and its drivers) at the customer level can be used effectively to increase profits:

*"Some customers are very profitable and loyal. Some customers are unprofitable and fickle. We are beginning to discover that we can increase our profits by studying these variations, and by using this newly acquired knowledge of our customer base to market differently to each discernable profit group."*⁵

Consider the example of a recent analysis we conducted on the Frequent Flyer Program (FFP) of a large international airline. Until then, airline management had assumed that frequent flyers with high status (based on flying many thousands of miles each year) were their most profitable customers, and therefore deserved additional benefits and preferential treatment. However, our segmentation analysis showed that 60% of these frequent flyers were *unprofitable*, and were, in fact, generating significant *losses* for the airline (see Figure 7). The unprofitable group was generating the high costs associated with frequent business travelers (e.g., upgrading to business or first class, usage of business class airport facilities etc.), along with the low revenues most commonly associated with leisure travelers (e.g., purchasing lowest fares weeks ahead of traveling).



Stage 3: The third, and most difficult, challenge is to operationalize the results of data mining and analysis to deliver a personalized customer experience at each touch point, every time. The main challenge here is to ensure that the appropriate data is available in *real time at each touch point* (in-store, at time of check-in, at the Customer Service call center, on the web, and so forth) and

⁴ Source: Fair Isaac Research, February 2005

⁵ Source: Database Marketing Institute, "Managing Customer Segments," Arthur Middleton Hughes and Paul Wang, September 2006

that the right action is taken. This becomes an increasingly difficult challenge within a network or coalition where multiple companies need to be linked in to facilitate proper program execution.

Going back to the Tesco example⁶, we found this retailer took an incremental and pragmatic approach to turning personalization into reality through a series of quarterly mailings. Their first mailing only allowed 12 permutations of messages and offers (e.g., coupons). Eighteen months later, the quarterly mailing could handle 1,800 permutations. Today, Tesco handles 8 million permutations driven by individual customer behavior.

Another example illustrates the power of incremental changes. Rejecting a full-blown information technology (IT) overhaul that would entail significant investment, an insurance company took a single step that enabled them to provide preferential treatment for their most profitable customers. They simply identified high-value customers using an on/off flag on the customer service representative (CSR) screen. The flag was easy for the CSRs to see and understand, and quickly enabled the company to improve its customer program.

THE BOTTOM LINE?

A SOLID LOYALTY STRATEGY CAN DRIVE COMPETITIVE ADVANTAGE

To effectively leverage its loyalty strategy for competitive advantage, each business must ensure that: (1) there is a clear definition of targeted behavior(s), (2) there is a match between the rewardable behavior(s) and the level and type of rewards being offered, and (3) the program is designed to meet the expected outcomes (i.e., clear business objectives and clear metrics are defined and used to measure success). This seems obvious in theory but, in practice, it is too often overlooked among the myriad of decisions that must be made to launch or enhance a loyalty program.

Another critical element of execution involves program financials. A comprehensive loyalty model and the associated business case must be built to quantify benefits (e.g., increase in number of customers, increased spend per customer, etc.) along with the costs associated with the loyalty strategy. Modeling loyalty programs can be complex, but the development process helps organizations work through many strategic, tactical, and operational issues, facilitating smoother implementation. Again, a pragmatic approach can be very helpful. Businesses that pilot and test program elements, and measure the results against their costs, are more likely to enjoy long-term success than those who do not.

There are a number of new technologies that could be leveraged to implement this new approach to loyalty programs, including RFID and smart cards. One example of this is the successful loyalty program introduced by Garanti Bank in Turkey. This program leverages smart card technology using a credit card with an embedded chip to store applications and data.

We recently conducted a survey among credit card issuers in Europe addressing the subject of innovation in financial services. One of our basic, but most profound, findings was that product innovation does NOT sustain competitive advantage, but process innovation DOES. To illustrate this point, one executive mentioned a very innovative card product that his company introduced in an Eastern European market. Within two months, it had been copied by a competitor; product innovation did not provide any sustainable competitive advantage for them.

Each business must ensure that it effectively leverages its loyalty strategy for competitive advantage

An effective loyalty strategy should also include other critical elements such as the program financials and new technologies

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⁶ Source: Scoring Points, 2nd edition

CASE STUDY: GARANTI BANK'S BONUS CARD

| | |
|---------------------|---|
| Program Description | <p>Cardholders collect Bonus points for each transaction conducted with their Bonus card. In addition, they can collect a higher level of Bonus points (1%-5%) at 120,000 merchants that have a partner relationship with Garanti Bank such as Shell or Carrefour.</p> <p>The EMV chip stores a loyalty application and the loyalty account data, which enables a number of unique features at the Point-of-Sale (POS):</p> <ul style="list-style-type: none">• Cardholders can view their Bonus point balance on the POS terminal and/or on the card receipt• Cardholders can redeem their Bonus points at the time of purchase• Merchants can set up a customized loyalty campaign such as providing a discount or a gift coupon to any cardholder that spends more than \$X over a given time period at their stores <p>In addition, Garanti Bank has built a communication platform that enables email or SMS messages to cardholders to inform them about special offers, and provides detailed reporting to merchants about expenditure and cardholder demographics by store.</p> |
| Results | <p>Garanti Bank issued its Bonus card to 5 million consumers in Turkey. Through this innovative loyalty program, Garanti Bank has increased its market share of the credit card issuing market from 8% at the time of launch in 2000, to 22% in 2005.</p> |

By investing in the resources needed to collect, mine, and optimize the use of customer data, companies can implement unique loyalty strategies

Since then, this card executive has invested significant resources in process innovation, such as developing expertise and tools to aid in customer segmentation for acquisition and retention. He strongly believes that this investment will be much harder for competitors to replicate, and will positively impact his bottom line.

By investing in the resources needed to collect, mine, and optimize the use of customer data, companies can implement unique loyalty strategies. These programs can be leveraged to achieve sustainable differentiation and attract and retain highly profitable customers. And, in so doing, customers' experiences will be improved with benefits targeted uniquely to their needs and desires.

About Edgar, Dunn & Company

Edgar, Dunn & Company (EDC) is a global strategy consulting firm specializing in financial services. Founded in 1978, the firm is widely regarded as trusted advisors in the payments industry providing a full range of strategy consulting services, expertise and market insight through in-depth industry and consumer benchmarking. Particular areas of expertise include risk management, rewards and loyalty, marketing, international global payments, technologies and retail financial services.

EDC's offices are located in San Francisco, New York, Atlanta, London, Frankfurt and Sydney, serving clients in over 30 countries on six continents. More information can be found at www.edgardunn.com.

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About Stratus Technologies

Stratus Technologies is a global solutions provider focused exclusively on helping its customers achieve and sustain the availability of information systems that support their critical business processes. Based upon its 26 years of expertise in server and services technology for continuous availability, Stratus is a trusted solutions provider to customers in financial services, telecommunications, manufacturing, life sciences, public safety, transportation & logistics, and other industries. For more information, visit www.stratus.com.

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