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Richard Ho Leo Huang Stanley Huang Tina Lee Alexander Rosten Christopher S. Tang

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An approach to develop effective customer loyalty programs

The VIP program at T&T Supermarkets Inc.

Richard Ho

Burnaby, Canada

Leo Huang

Yonghe City, Taiwan

Stanley Huang

Taichung City, Taiwan

Tina Lee

T&T Supermarkets Inc., Richmond, Canada

Alexander Rosten

Los Angeles, California, USA, and

Christopher S. Tang

UCLA Anderson School, Los Angeles, California, USA

Abstract

Purpose – This paper sets out to present a practical approach to develop an effective customer loyalty program by incorporating competition and heterogeneity in customers' preferences, and by avoiding the pitfalls associated with different types of loyalty programs.

Design/methodology/approach – To illustrate the approach, the paper presents a case study of T&T Supermarkets in Canada to show how a retailer can develop a cost-effective customer loyalty program to retain and reward loyal customers so as to increase shopping frequency and shopping expenditure. The approach consists of four major steps, which are explained in detail.

Findings – Most T&T shoppers split their shopping trips at T&T (for Asian groceries and other specialty items) and a major competitor (for Western items). This creates a unique opportunity for T&T to develop a loyalty program that is intended to entice its loyal shoppers to increase their shopping frequency and expenditure at T&T. A "hybrid" reward structure was recommended to address the fact that there are two major segments of customers who prefer different types of loyalty rewards.

Originality/value – In addition to avoiding some common pitfalls of various loyalty programs, this paper presents a practical approach to develop an effective customer loyalty program by incorporating competition and heterogeneity in customers' preferences.

Keywords Customer loyalty, Retailing, Services marketing, United States of America

Paper type Case study



Some key ideas presented in this paper are based on a management research project conducted by the first five authors under the supervision of the sixth at the UCLA Anderson School.

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1. Introduction

As consumers are spending less and saving more during the present economic downturn, the US retail businesses are anemic: an increase of 0.3 percent in March after a 0.1 percent drop in February and a 1.8 percent increase in January in 2009. To compete in a down market, many firms are using mechanisms such as promotional pricing (Tang *et al.* (2001)), private labels that offer good value at lower prices (Raju *et al.* (1995)), and programs to reward loyal customers so as to increase the number of shoppers, shopping frequency, and basket size. As articulated by Reichheld and Sasser (1990) and Reichheld and Teal (1996), loyal customers can enable firms to generate more profit over time because of various reasons: increased purchases, reduced operating costs, and increased profit margin. In addition, firms can acquire new customers through referrals from their loyal customers.

As competition intensified during the current economic crisis, many firms are developing or improving their loyalty programs to deter customers defecting to their competitors. For instance, there are over 2,250 separate loyalty programs in the US. However, recent empirical research suggested that many loyalty programs are not effective for increasing the number of loyal customers, getting loyal customers to spend more, or improving profits (see Reinartz and Kumar (2000)). For example, retailers such as Subway, Cole's supermarkets (Australia), and Target department stores were disappointed about the results generated by their loyalty programs (see Nunes and Dr  ze (2006) and Berman (2006)). Despite some failures, there are many successful loyalty programs. For example, Tesco's loyalty program has attracted over 14 million members who contributed to Tesco's profitable growth over the last 12 years (see Leahy (2009)); and Gary Loveman, the CEO of Harrah's entertainment, attributed its 16 consecutive profitable growth to its loyalty program (Loveman (2003) and Carrolo and Lal (2004)).

As many major services firms (supermarkets, department stores, car rentals, hotels, airlines, insurance, etc.) launched similar loyalty programs, many customers participate in multiple loyalty programs offered by different firms within the same industry. Consequently, it is more difficult for firms to compete for larger "share of wallet" from their customers unless they can establish deeper relationship with their key customers (Wirtz *et al.* (2007)). To do so, many firms implement customer relationship management (CRM) systems offered by vendors such as Oracle and SAP that would enable them to capture and analyze customer information (demographics, past transactions, preferences, etc.), and to develop more customized or personalized services and customized rewards to different customers. For example, Harrah's entertainment developed a CRM system that captures and analyzes each Total Reward member's transactions at various touch points (slot machines, gaming tables, restaurants, shows, etc.) and develops "real time" personalized services and rewards to its loyal customers (Loveman (2003)). While CRM systems enable for firms to develop personalized services and rewards for their loyal customers, survey studies and recent research indicated that over 55 percent of CRM implementations failed for a variety of reasons: lack of support from top management, lack of customer focus, lack of operational support, and lack of customer trust (Boulding *et al.* (2005), Kale (2004), Lovelock and Wirtz (2008)).

There is a vast empirical research literature on examining the relationship between customer satisfaction and customer loyalty and brand loyalty is vast (e.g. Pablo *et al.*

(2006) and Yi and Jeon (2004)). Also, there is industry-based research that investigates the relationship between perceived service quality and customer loyalty in the insurance industry (Tsoukatos and Rand (2006)), hotel industry ((Kayaman and Arasil (2007), and Lee *et al.* (2003)), and transport industry (Pantouvakis and Lymperopoulos (2008)).

Despite the voluminous research literature on loyalty programs and CRM, there are two missing gaps that deserve attention. First, not much research has been done on the negative effects of loyalty programs. Stauss *et al.* (2005) presented a framework and conducted an empirical study to examine the negative effects of loyalty programs. They recommended that, when developing a loyalty program, a firm should avoid the following customer frustrations: reward criteria are perceived to be impossible to achieve, rewards are perceived to be extremely difficult to redeem, and rewards are perceived to be worthless. Their recommendations are consistent with a recent study conducted by Edvardsson (2005) asserting that negative emotions have a stronger negative effect on the perceived service quality, which affects customer loyalty. Second, Boulding *et al.* (2005) commented that not much research on CRM (and loyalty programs) that incorporates customer reaction and knowledge about competition.

In view of these two missing gaps and in view of the fact that many loyalty programs failed to keep customers loyal, it is important for a firm to examine the following questions when developing a customer loyalty program:

- (1) Is there a customer loyalty program that would result in a win-win situation (i.e. higher customer satisfaction and more loyal customers)? If yes, what type of loyalty program should the firm develop?
- (2) What is the reward structure associated with the selected loyalty program that the key customer segment would appreciate (and would not get frustrated)?
- (3) What is the appropriate implementation plan of the selected program that the firm can deliver?

The answers to the previous questions are critical because a loyalty program that is poorly developed and executed can actually cause customers to defect.

In this paper, we present a practical approach to develop an effective customer loyalty program by incorporating competition and heterogeneity in customers' preferences, and by avoiding various pitfalls associated with different types of loyalty programs. To illustrate our approach, we present a case study of T&T supermarkets in Canada to show how a retailer can develop a cost effective customer loyalty program to retain and reward loyal customers so as to increase shopping frequency and shopping expenditure (Ho *et al.* (2009)). Our approach consists of the following steps that are intended to address the issues arising from the two aforementioned missing gaps and to avoid the pitfalls of various loyalty programs. First, we examine the pros and cons of different types of loyalty programs. Second, we analyze the loyalty programs adopted by competing stores that would enable us to examine the feasibility of developing a distinctive loyalty program that creates value for customers. Third, anticipating customers' reaction, we determine some unique features of the loyalty programs preferred by T&T's customers. Finally, by analyzing the gathered information, we recommend a loyalty program to T&T that is intended to:

- truly reward T&T's loyal customers;
- entice loyal customers to increase their shopping frequency and basket size (i.e. Increase their share of wallet at T&T); and
- entice new customers to join the loyalty program. We believe our approach is applicable for service firms in other industries (hotels, car rentals, cinemas, etc.) to develop effective loyalty programs.

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2. Customer loyalty programs and their pitfalls

As retailers found it difficult to differentiate from others, some retailers developed customer loyalty programs so that they can generate switching cost to deter customer defections. As articulated in Berman (2006), there are four basic types of customer loyalty programs (see Table I). However, each type of program has certain pitfalls.

As commonly seen in supermarket chains such as Ralphs and Vons, Type 1 programs are usually free to join. However, it has some drawbacks. First, a Type 1 program does not necessarily increase customer loyalty at a store because each member receives the same discount regardless of purchase history at the store. Second, this program can hurt the profit margin as shoppers become members of multiple supermarkets (free of charge) and "cherry pick" only promotional items at different stores. Fox and Hoch (2005) confirmed the existence of cherry picking behavior that can help cherry pickers to save more than 5 percent per item. Third, without the information that links the purchase history to each customer, a retailer is unable to conduct targeted promotion to a specific segment of customers.

A Type 2 program does reward customers based on their purchase history: get a free unit sooner by purchasing more. However, this program has several shortcomings.

Program type	Characteristics of program	Examples
<i>Type 1:</i> Members receive additional discount at register	Membership open to all customers Each member receives the same discount regardless of purchase history Database may not link purchase history to specific customer	Supermarket programs
<i>Type 2:</i> Members receive one free unit after purchasing <i>n</i> units	Membership open to all customers Clerk "stamps" the loyalty card after each purchase Customer database is not required	Local car-wash, nail salon, SuperCuts, PETCO
<i>Type 3:</i> Members receive rebates or points based on cumulative purchases	Seeks to get members to spend enough to receive qualifying discount	Airlines, hotels, credit card programs, Staples, Office Depot
<i>Type 4:</i> Members receive targeted offers and mailings	Members are divided into segments based on their purchase history Requires comprehensive database of customer demographics and purchase history	Tesco, Dorothy Lane Markets, ShopRite, Winn-Dixie, Harrah's, Hallmark

Table I.
Four basic types of
customer loyalty
programs

First, it is unclear if a customer will stay loyal after claiming the free unit after n purchases. Second, the retailer will lose the entire margin of the free unit, especially when the free item is a commonly purchased item at regular price (see Nunes and Dr  ze (2006)). Third, if n is a low number, then the retailer incurs a significant cost by giving away too many free units. If n is a large number, then customers may get discouraged. Fourth, a Type 2 program does not track customer-spending behavior according to an account number. As such, a retailer is unable to develop customized promotions for different customer segments.

Unlike the previous two program types, a Type 3 program records individual customer transaction information for each account number and rewards each customer based on her purchase history. Most airline and hotel loyalty programs are Type 3 programs. Such a program usually involves a sophisticated design with several tiers that provide different level of rewards for customers in different tiers. Therefore, a Type 3 program can induce customer loyalty especially when the rewards of different tier levels align with customers' interests. A Type 4 program expands on a Type 3 program by integrating tiers of membership based on customer spending with sophisticated data analysis that allow a retailer to segment his customer base and target specific tiers with special benefits and promotions. For example, a Tesco member might receive coupons for infant foods or diapers if she has a history of purchasing diapers. This kind of customized cross selling or up selling would enable a retailer to increase store traffic and basket size.

Although Type 3 and Type 4 programs provide more insight into consumers' purchasing behavior, they have the following shortcomings. First, some of programs can be so complex that they confuse the customer (see Sharp and Sharp (1997)). Second in view of the upfront IT investment and continuing operating costs, both programs can be very costly to implement. Third, both programs can generate a significant liability on a retailer's balance sheets if the accumulated points are not redeemed on a regular basis. For example, Greenberg (2008) reported that there were 17 trillion unredeemed frequent-flier miles with an estimated liability of US\$480 billion for the US airlines industry.

Recognizing the pitfalls of all four types of customer loyalty programs and the implementation cost of each program, it becomes clearer that an effective loyal program should possess the following properties:

- (1) *The program should be simple.* It should be painless for customers to join and easy to understand. Also, to avoid customer frustration, the award redemption process should be simple (Stauss *et al.* (2005)). To gain support from top management and employees, the operational aspect of the program should be relatively straightforward.
- (2) *The program should contain special rewards only for truly loyal customers.* Otherwise, the program will not be effective and the retailer would need to spend additional efforts to earn a higher share of customers' wallets (Wirtz *et al.* (2007)).
- (3) *The program should contain "sticky" rewards for loyal customers.* Instead of offering a "me too" program, the rewards should be memorable that "stick" in the mind of loyal customers so as to increase their positive emotions

(Edvardsson (2005)). With an increase in positive emotions, satisfied customers become more loyal and more likely to generate new referrals for the firm.

- (4) The reward items should be something special that loyal customers do not plan to purchase at regular price at the store, but they may purchase elsewhere. This reward structure is more likely to entice loyal customers to increase their basket size without cutting into the retailer's profit margin significantly (Nunes and Dréze (2006)).

3. Market analysis

To illustrate our approach for developing an effective loyalty program that possesses those four aforementioned properties, we now present our case study of T&T supermarkets. In this section, we first analyze the Canadian supermarket industry in this section along with T&T supermarkets. Then we examine the loyalty programs adopted by competing stores.

3.1 Canadian supermarket industry analysis

The Canadian food retail industry is comprised of supermarkets, hypermarkets, cooperatives, discounters, convenience stores, etc. Propelled by population growth and an expansion of hypermarkets throughout Canada, industry sales revenue has grown at a compound annual growth rate (CAGR) of 4.6 percent from 2003-2007 (see, DATAMONITOR (2008a, b, c)). However, future growth rates are expected to decline to a CAGR of 4.2 percent through 2012. The vast majority of sales in the Canadian food retail industry are generated by supermarkets and hypermarkets. Together, these two segments account for 88 percent of the market in 2007 (see Table II). Specifically, the forecasted supermarket revenue increases slightly from \$39 billion in 2008 to US\$40 billion by 2012.

Despite stagnant growth, competition among supermarkets intensifies as the total number of stores increases. With 1,528 store outlets and US\$26.4 billion in sales in 2007 that accounts for a market share of over 50 percent, Loblaw (www.loblaws.com.ca) is the market leader in the supermarkets segment. Sobey's is the second largest supermarket chain that has 1,311 stores with US\$10.4 billion in sales annually. To compete in a niche market that targets Asian shoppers, T&T supermarkets (www.tnt-supermarket.com/en/) is Canada's largest Asian supermarket chain that has 16 store outlets with US\$328 million in sales annually.

3.2 T&T supermarkets

T&T was founded in 1993 by current CEO, Cindy Lee. Headquartered and privately held in Vancouver, Canada, T&T's operations include 16 stores in Vancouver, Calgary, Edmonton, and Toronto. T&T's mission is to enrich the lifestyle of Asian families in Canada by offering them a fresh variety of Asian food products and household items in a comfortable shopping environment. At the same time, T&T is proud to introduce Asian food culture to Canada's multicultural society.

To differentiate itself from other Asian and mainstream supermarkets, T&T offers high standard Asian food concept with a huge selection of oriental products including authentic Asian ready-to-eat dishes, fresh Chinese barbeque, live seafood, and Taiwanese-inspired baked goods. Because T&T is a leader in a niche market of Asian products with 16 stores, T&T can negotiate better wholesale prices from its suppliers

Table II.
Trends of mass grocery
retail sales in Canada

	Canada mass grocery retail – value sales by format – historical data and forecasts									
	2005	2006	2007e	2008f	2009f	2010f	2011f	2012f	2013f	
Supermarkets (US\$ billion)	36.26	37.52	38.4	39	39.6	39.7	39.8	39.9	40	
Hypermarkets (US\$ billion)	0	0.1	0.7	3.5	8	10	12	14	16	
Convenience stores (US\$ billion)	3.82	4	4.2	4.43	4.67	4.81	4.94	5.09	5.22	
Total mass grocery retail sector (US\$ billion)	40.08	41.52	43.6	48.43	50.67	51.31	51.44	52.09	52.47	

Note: e, f = BMI estimate/forecast
Source: Statistics Canada, Bank of Canada, Department of Finance, BMI

in Asia. Owing to this cost advantage, T&T can offer a wide variety of fresh and hard to get Asian groceries at competitive prices. To facilitate “one stop” shopping, T&T also provides similar offerings of a traditional supermarket such as produce, meat, seafood, bakery and delicatessen. However, for national brands of Western dried goods and non-food items such as cookies, soaps, and toilet papers, T&T does not have the same scale as other national chains to negotiate favorable wholesale prices with its distributors. Hence, for those Western items, major national chains have price advantage over T&T.

T&T’s product differentiation may not sustainable because major national chains are now carrying various popular Asian items such as fresh bean curds, fresh and dried noodles, and fresh Asian vegetables at higher prices. The competitive prices of Western items and the availability of popular Asian items at various major national chains can potentially cause some T&T’s loyal customers to defect. As a proactive measure to retain and reward loyal customers, T&T is interested to develop a loyalty program that would increase the number of loyal customers who would increase their shopping frequency and basket size. In order to develop a program for T&T, let us first examine various loyal programs adopted by T&T’s major competitors.

3.3 Loyalty programs offered by major competitors

T&T’s primary competitors in Canada are Canadian Superstore (owned by Loblaw), Sobeys’s, Safeway, and Save-on-Foods. As presented in Table III, each store combines different types of loyalty programs. Safeway and Save-On offer loyalty programs that focus on providing instant price discounts to their members. However, Save-On’s “Save-on More” program allows customers to earn points by making purchases at their partners such as Chevron gasoline stations.

Canadian Superstore offers a program called “President Choice” that requires each member to apply for a President Choice credit or debit card from a partnered bank. By using this card, members can earn points for their purchases within the Loblaw’s network (including Canadian Superstore). Once a member accumulates 20,000 points, he can redeem his points for 20 Canadian dollars in cash or items of equal value from the President’s Choice catalogue (Sobeys’s “Club Sobeys” program has the same structure).

By examining the loyalty programs in Table III along with our discussion in section 2, the credit/debit card requirement can be viewed as a “hurdle” for customers to join the Canadian Superstore’s (or Sobeys’s) loyalty program. However, the instant discount (Type 1) programs offered by Safeway and Save-On are certainly easy to implement, but they do not induce customer loyalty. By examining the existing programs offered

Loyalty program/ supermarkets	Canadian superstore (President Choice)	Sobey's (Club Sobeys)	Safeway (Safeway Club)	Save-On Foods (Save-On More)
Type 1: member price			×	×
Type 3: points collection	×	×		×
Type 4: partner program	×	×		×
Private label credit/debit card	Required	Required		Optional

Table III.
Loyalty programs at
selected supermarket
chains in Canada

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by T&T's major competitors, we shall take these drawbacks into our consideration when we formulate a loyalty program for T&T with distinct features.

4. Customer analysis

In order to formulate a loyalty program, we need to obtain an in-depth understanding of T&T's customers in terms of their profile, their perception of T&T versus other national chains, their shopping habits, and their preferences of different features of loyalty programs. This in-depth analysis would enable us to identify target segment of loyal customers that T&T should focus on, and to develop programs to retain and reward these key customers. We conducted our survey at two T&T stores located in Vancouver on November 8-9, 2008. We selected customers randomly to complete our survey. Overall, 303 surveys were completed without errors or unanswered questions. The analysis of these 303 surveys yielded the following results.

4.1 General profile of T&T shoppers

Among those 303 respondents, 72 percent of them were female. In terms of ethnic background, 87.8 percent were Chinese, 5 percent Caucasian, 3.6 percent South East Asian, 0.7 percent Japanese, and 3 percent others. Also, 38.6 percent stated Cantonese as their primary language, Mandarin (37.3 percent), and English (22.4 percent). (Even though T&T's key customers were Chinese female, their shopping behavior is very similar to other respondents. For brevity, we omit the details. See Ho *et al.* (2009) for details.)

In terms of age profile, we set the age categories according to the market research guideline provided by the American Marketing Association. The age profile of those 303 respondents is summarized in Table IV along with the distribution of the household size. Overall, 37.6 percent of the respondents belong to the 35-44 age group, and the most common household size was three to four persons, making up a combined 63 percent of the population.

4.2 Shopping habits of T&T shoppers

By analyzing the responses from those 303 respondents, we summarize their shopping frequency and the basket size (spending during each shopping trip) in Table V. Most shoppers spend \$40-59 CAD during each shopping trip at T&T. However, it is interesting to note that 34.7 percent = 18.2 percent + 16.5 percent of the respondents shop at T&T at least twice a week.

By examining the top three reasons why these 303 respondents shop at T&T, 43.6 percent stated "product variety" was their top reason, 27.1 percent stated "convenient

Table IV.
Age distribution and
household size
distribution of T&T
shoppers

Age group	Percent of respondents	Household size (number of persons)	Percent of respondents
0-21	7.6	1	4.3
22-34	22.4	2	18.2
35-44	37.6	3	33.3
45-54	19.1	4	29.7
55-64	9.9	5 or more	14.5
65 or above	22.4		

location” was second, and “price” was third. This result confirmed a perception among customers that T&T is not a price leader, but it attracts frequent shoppers because of T&T’s wide variety of product offerings.

To examine whether T&T shoppers visit other supermarkets, we find that the majority (51.5 percent) also shop at store C[1]. Also, most shoppers shop at those competitive stores once a week, which is comparable to their shopping habits at T&T. However, unlike the fact that 34.7 percent of the respondents shop at T&T at least twice a week, only 10.9 percent = 7.7 percent + 3.2 percent of the respondents shop store C for more than once a week (see Figure 1). Even though T&T customers shop more frequently at T&T, we learned from the respondents that over 90 percent of T&T customers purchase at least 80 percent of their Asian groceries at T&T.

The shopping behavior of T&T shoppers at T&T and its competing stores generate the following insights. First, because T&T shoppers do shop at multiple stores, it is important for T&T to retain and reward its loyal customers so as to increase its customers’ share of wallet at T&T (Wirtz *et al.* (2007)). Second, in order to increase customers’ expenditure (basket size), T&T should avoid rewarding loyal customers with price discounts on those Asian grocery items they would have purchased at regular price. Instead, T&T should offer discounts on special promotional/seasonal items or other Western dried goods and non-food items that they do not plan to purchase at T&T but they do plan to purchase at its competing stores (Nunes and Dr  ze (2006)). This way, T&T can maintain its profit margins on those items the

Shopping trip frequency at T&T	Percent of respondents	Basket size at T&T (\$ CAD spending per trip)	Percent of respondents
Once a month or less	6.3	0-19	6.6
Once every two weeks	10.2	20-39	30.0
Once a week	48.8	40-59	33.0
Twice a week	18.2	60-99	19.8
More than twice a week	16.5	100 or greater	10.6

Table V.
Shopping frequency and
basket size of T&T
shoppers

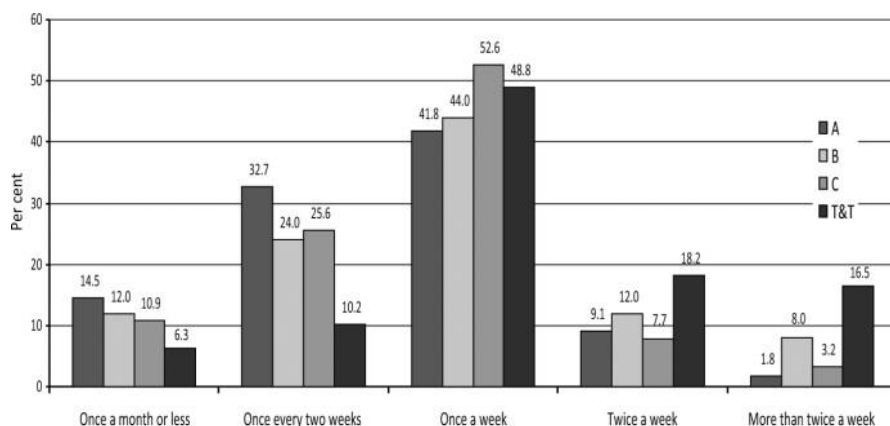


Figure 1.
Competing stores visited
by T&T customers

customers were planning to purchase at regular price and can earn additional (but lower) profit margins on those items sold under special discounts (Nunes and Dréze (2006)).

4.3 T&T shoppers' loyalty program memberships at competing stores

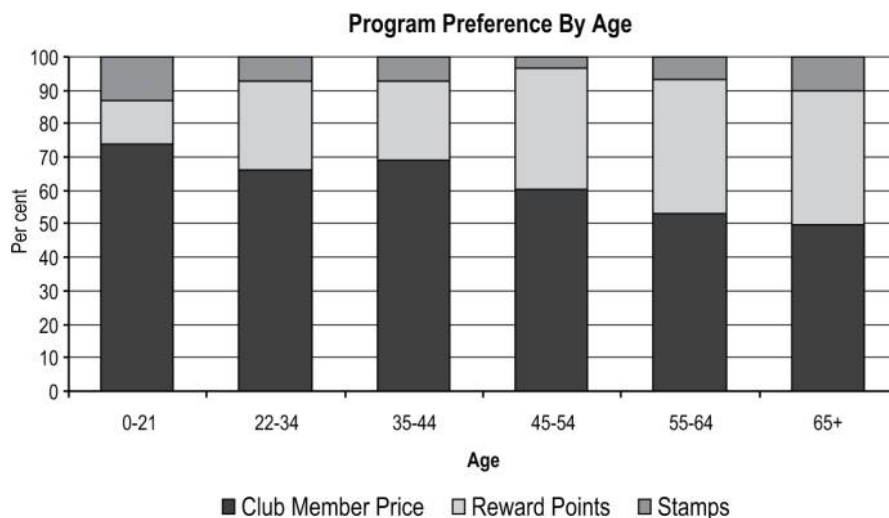
To examine whether T&T shoppers are members of certain loyalty programs at the competing stores (A, B, and C), we learned from those 303 respondents that 85.5 percent and 72.0 percent of the respondents participated in A's and B's loyalty programs (Type 1 programs with instant price discounts), respectively. However, only 21.2 percent participated in store C's program (a Type 4 program that requires each customer to apply for a credit/debit card at a partnered bank).

This result generates the following insights. First, many T&T shoppers are members of both stores A's and B's loyalty programs; and hence, they are likely to be "cherry pickers" that pick promotional items between stores A and B. This confirms the potential pitfall of the Type 1 programs that offer instant price discounts. Second, store C's program creates a major hurdle for customers to enroll, which may explain the low participation rate. Specifically, unless the reward structure of store C's program is very attractive, customers with credit cards that linked to various airlines or hotels loyalty programs will be reluctant to join. Therefore, there is a unique opportunity for T&T to increase customer loyalty if T&T can develop a program that is easy and attractive to join and a program that incorporates mechanisms to reduce "cherry picking" behavior.

4.4 T&T shoppers' suggestions for T&T loyalty program

To develop an effective loyalty program, it is important to anticipate customers' reaction to different features of the program. For this reason, we collected information regarding customer preferences if T&T were to launch a customer loyalty program. Overall, 93.1 percent of the respondents ranked instant price discounts as their top reward choice, followed by gift cards, and then free items. It is interesting to note that younger shoppers prefer a Type 1 program that offers instant price discounts for members, and older shoppers prefer a reward points (Type 3 or Type 4) program (see Figure 2). Based on our informal discussions with older shoppers, they prefer a reward points (Type 3 or Type 4) program because they are interested to wait longer to receive some unique rewards that they would not have purchased otherwise. Their rationale is especially relevant to T&T that offers unique items (hot pots during winter, moon cakes during the mid-autumn festival, and special rice dumplings during the dragon-boat festival) that are not available at their competing stores.

The features preferred by T&T customers have the following implication. By noting the age distribution of T&T's shoppers consists of both younger and older shoppers and by observing the fact that 63 percent of the respondents have three or four persons in their household with both older and younger (see Table IV), it is important for T&T to develop a loyalty program with some features (say, instant price discounts) that are appealing to the younger shoppers and other features (say, sticky rewards) that are meaningful to the older shoppers. This implication is consistent with the point articulated in Boulding *et al.* (2005) that CRM (or loyalty programs) should incorporate heterogeneity in customer behavior.



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Figure 2.
Types of loyalty program
preferred by T&T
shoppers

5. T&T's VIP customer loyalty program

We now utilize the customer analysis presented in section 4 to develop an effective customer loyalty program for T&T. First, observe from sections 4.2. and 4.3 that 51.5 percent T&T shoppers also shop at store C but only 21 percent of them are members of store C's program (that requires a partnered credit/debt card), T&T has a unique opportunity to develop a loyalty program to increase customer loyalty and to entice shoppers to shift their basket size from competing stores to T&T. Second, by examining the shoppers' profile presented in section 4.1 and shoppers' preferences depicted in Figure 2, T&T should develop a program that attracts both younger and older customers to become more loyal. For younger customers, a loyalty program would enable T&T to cultivate stronger customer relationship for a longer life time (more future shopping trips).

5.1 T&T's VIP program

By considering those insights articulated in section 4 and by avoiding the common pitfalls of loyalty programs as described in section 2, we recommended the following "VIP program" to T&T:

- *A Type 4 program that is easy to join and simple to understand.* Customers are invited to join the VIP program by providing demographics information. The program is free to join and members earn one reward point for each dollar spent. By observing from sections 4.2 and 4.3 that 43.6 percent of T&T customers shop at store C and only 21.2 percent of them participated in store C's loyalty program (due to its inherent hurdle), we have reasons to believe that a simple T&T VIP program can entice customers to participate so that T&T can capture customer information, analyze transactional data, and improve its product/service offering and delivery.
- *A tiered reward structure.* By offering disproportionate rewards to members at the highest tier, the tiered structure enables loyal customers feeling "superior",

reduces their “cherry picking” behavior, and incentivizes customers to increase spending to move up the tiers. (This phenomenon has been observed in fundraising campaigns in which the donors are honored according to different tiered levels of donations (McCardle *et al.* (2009).) Also, the tiered reward structure has been proven to be effective in increasing customer loyalty (Nunes and Dréze (2009)). Consider the airlines industry as an example. In order to maintain a certain tier status so as to enjoy certain tier-specific privileges (i.e. non-financial rewards such as free upgrade, special check-in counter, special services, free check-in bags, etc.) under the United Airlines’ Mileage Plus program or the British Airways’ Executive Club, members are required to fly a certain minimum number of miles annually (Lovelock and Wirtz (2008)).

- *Reward points expire according to a pre-specified time schedule (e.g. every quarter or every six months).* The expiration date can create a sense of “urgency” for customers to accumulate points faster especially for those who are near the threshold of the next rewards tier (Dowling and Uncles (1997)).

Also, as articulated by Bolton *et al.* (2000) and Lewis (2004), the appeal of a loyalty program is weakened if it takes a long time for customers to receive benefits from participating in the program. As such, it is important for T&T to time the reward schedule carefully so as to deter customers to become loyal to its competing stores. Also, an additional benefit of the expiration date is to urge customers to initiate additional transactions prior to expiration date and to ensure that T&T would not have to carry the liability indefinitely. As observed from the airline industry, the accumulated reward points usually expire after a pre-specified time window. For example, the points accumulated under the United Airlines’ Mileage Plus program expire after 18 months unless members incur new transactions within a certain time window; however, the reward points accumulated under the British Airways’ Executive Club program expire after three years.

- *Reward both younger and older shoppers.* We suggest a reward structure that takes into account for the heterogeneity in customers’ reward preferences for different age groups as presented in section 4.4 (Boulding *et al.* (2005)). First, the reward structure should include instant price discounts for members on certain Asian items or Western dried goods or household items that most T&T shoppers do not plan to purchase at regular price at T&T, but they do plan to purchase elsewhere. Besides being the preferred rewards structure by most T&T’s younger shoppers, this would enable T&T to entice their loyal customers to increase their shopping frequency and expenditure. At the same time, T&T can maintain its profit margins on those items the customers were planning to purchase at regular price and can earn additional (but lower) profit margins on those items sold under special discounts (Nunes and Dréze (2006)). Second, the reward structure should include “sticky awards” of special items that loyal customers can get excited about and induce viral marketing through word of mouth. In addition to the fact that sticky rewards are preferred by older shoppers at T&T, this unique feature may generate the buzz among shoppers and may entice new customers to shop at T&T.

- *Create emotional connection with truly loyal customers.* Because the reward points expire at a preset date (e.g. every quarter), we recommended T&T create a customer appreciation week for customers to claim their rewards at the stores. By displaying special awards for different tiers of VIP members prior to the appreciation week, it provides incentives for members to spend more so as to reach the next tier quickly. To connect with those truly loyal customers on an emotional level, we suggested that, on an annual basis, the top one percent of VIP members should be given truly special gifts (e.g. fruit baskets with special luxury treats such as: cognac, caviar, truffles, coupons for air travel, etc.) with a “thank you” note signed by the CEO, and the top ten percent of T&T customers should be given special “red envelope” gifts (e.g. coupons for in-store shopping, spa treatments, etc.) [2]. This emotional connection would certainly “stick” in the mind of those loyal customers and generate positive emotions that would increase loyalty (Edvardsson (2005)). Also, by displaying special annual awards in the store to be given to those top VIP members, it may generate a viral message to entice new customers to join the VIP program Lovelock and Wirtz (2008)).

5.2 Challenges ahead

Although our proposed VIP program for T&T received strong support by T&T’s executive team, T&T would need to overcome the following challenges so as to avoid potential customer and employee frustration about the program (Stauss *et al.* (2005)):

- (1) *Habitual use of the VIP program card.* A points program is more effective if members use the loyalty card every time they make a purchase so that T&T can capture and utilize this information to improve its store operations (products, price, and inventory) initially, and conduct targeted promotions eventually. To ensure members use their VIP cards every time they shop, we recommended mini-cards for key chains to improve ease of use and incentive programs for cashiers to remind customers to swipe their VIP cards during checkout.
- (2) *Design of the reward structure.* It is challenging to determine the appropriate reward tiers and the gifts associated with different tiers. If there are too many tiers, then members may find it too confusing and the gifts associated with adjacent tiers would not be substantially different in value. If there are too few tiers, then some members may not have the sense of “urgency” to spend more especially when they find it difficult to achieve the next tier level. (McCardle *et al.* (2009) presented a decision science model for evaluating different tier structures for managing fundraising programs). We have developed a financial model to evaluate different tiered reward structures (Ho *et al.* (2009)).
- (3) *Logistics for rewards redemptions.* To entice members to come in the store to redeem their gifts, each store needs to source appropriate gifts, carry extra merchandise, and potentially bring in more staff to distribute the gifts during the customer appreciation events to ensure award accessibility so as to avoid customer frustration (Stauss *et al.* (2005)). We recommended additional staffing and resources are needed for planning and execution.
- (4) *Technological and analytical capabilities.* T&T would need to select an external vendor to implement the requisite operational, technological and analytical

capabilities associated with the VIP program. We have identified 18 potential vendors such as Catalina Marketing and SHC, and made our recommendations based on T&T's needs and vendors' capabilities.

- (5) *Organizational support.* Besides support from the top, implementing this VIP program successfully would require buy-in from all employees so that they are willing to take extra steps to communicate the program to shoppers, explain any questions they may have, encourage them to join and use the card each time they shop, and remind them about the reward tier structure and the quarterly reward redemption event. We recommended in-store training and incentive programs.
- (6) *Implementation cost and implementation plan.* In addition to the cost of the rewards, there is an upfront investment cost and an on-going operating cost associated with the VIP program. To examine the financial impact of this program, we have developed a financial model to evaluate the cash flow associated with different scenarios based on different implementation plans, tier structures, different shopping frequency, and different basket sizes. This model provides some guidance for T&T to evaluate the pros and cons of different designs. Also, in order to ensure a smooth execution we suggested T&T should consider implementing the VIP program in phases that begin with the implementation in one region first and then roll out the plan to other geographical regions.

6. Conclusions

When facing fierce competition, a retailer needs to develop strategies to retain their loyal customers and acquire new customers. Despite the fact that many retailers deployed different types of loyalty programs, very few loyalty programs met retailers' expectations. In this paper, we presented the pitfalls of different types of programs and discussed ways to avoid these pitfalls. Specifically, we have presented a practical approach to develop a loyalty program for a firm by incorporating many lessons learned from previous research in loyalty programs, and by addressing two issues that are not well understood in the research literature (i.e. customer frustration in loyalty programs, and the role of competition). The loyalty program is intended to increase the number of loyal customers, and to entice loyal customers to increase their shopping frequency and expenditure (basket size). To illustrate our approach for developing an effective loyalty program, we have presented a case study of T&T supermarkets in Canada. While T&T is the largest Asian supermarkets, it is facing a plausible risk of losing its customers to major national chains. As a pre-emptive move, T&T commissioned us to determine if T&T should launch a loyalty program. Based on our analysis of the supermarket industry and the analysis of T&T customers' shopping behavior at T&T and other competing stores, we have proposed a Type 4 VIP loyalty program based on a reward point system that is intended to instill greater customer loyalty. More importantly, we have proposed certain reward features of the program that are intended to address the heterogeneous preferences expressed by the younger and the older shoppers at T&T (Boulding *et al.* (2005)).

To implement the proposed VIP program, we have recommended a three-phase approach. The first phase is a "test phase" where the basic components of the VIP program will be implemented in one region. This will allow for data collection while at

the same time testing out the different components of the program before a national launch. The second phase is the national launch, where data collected from the phase 1 will be analyzed to create an improved VIP program nationwide. The last phase is where market segmentation and customized promotions can begin after analyzing a year's worth of customer purchasing data. This phased approach allows T&T to roll out the VIP program more easily and to mitigate the implementation risks associated with the program.

Although we have used our case study of T&T to illustrate a process for developing a loyalty program for a supermarket chain, we believe the process presented in this paper is applicable for firms in other service industry such as hotels, cinemas, cruise liners, car rentals, etc. This is because the underlying approach presented in this paper incorporates the knowledge about key competitors and customer's transactional behavior, anticipates customer's reaction, and incorporates customers' heterogeneous preferences, and our recommendations avoid the pitfalls of various loyalty programs. We hope the process presented in this paper can serve as a benchmark against other approaches for developing loyalty programs in the near future.

In terms of potential future research, we would like to highlight two specific issues that deserve attention. First, it would be of interest to develop ways to incorporate strategic customer behavior when developing a loyalty program. This is because, as articulated in Lewis (2005) and Boulding *et al.* (2005), some customers are "strategic" in the sense that they may modify their behavior as firms begin to collect more customer information so as to develop various strategic initiatives such as CRM, loyalty programs, RFID enabled smart stores, etc. Second, it would be of interest to develop ways to incorporate competitors' reaction when developing a loyalty program. As noted in Boulding *et al.* (2005), there is no known marketing research literature on loyalty programs that take into account of the competitors' reaction. Without taking this issue into consideration, it is unclear if the successes of various loyalty programs are sustainable in the long run. Third, it is interesting to examine different tradeoffs associated with different loyalty programs. These tradeoffs include the cost versus benefit, short-term gain versus long-term impact, financial rewards versus non-financial rewards, high technology usage versus high human interfaces, tangible benefits versus intangible benefits. Overall, there are many research avenues arising from loyalty programs.

Notes

1. To comply with our non-disclosure agreement with T&T, the identity of stores A, B and C has been disguised.
2. In Asian culture, "fruit basket" is a common term that represents appreciation gift. It usually contains some special items. Also, the term "red envelope" is synonymous with cash reward in Asian culture.

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About the authors

Richard Ho, Leo Huang, Stanley Huang, Tina Lee and Alexander Rosten have extensive working experience in marketing, operations and finance in North America and Asia. They received their MBA degree from UCLA Anderson School in 2009.

Christopher S. Tang is Edward Carter Professor of Business Administration at the UCLA Anderson School. He has published three books, over 70 research articles in various leading international academic journals and articles in *Wall Street Journal* and *Financial Times* on Supply Chain Management and Retailing. He received his BSc (first class honours) from King's College, University of London, MA, MPhil, and PhD from Yale University. Christopher S. Tang is the corresponding author and can be contacted at: ctang@anderson.ucla.edu

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