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## Loyalty programs and profitability in the telecom industry.

### MMC Group's approach in loyalty strategy

By Carlos Valdecantos / Fran Gonzalez

#### Chapter 1 - Introduction

Telecom service providers in mature markets face a sea of troubles. In wireless, the days of double-digit market growth are over, leaving competitors to fight for one another's customers. Not surprisingly, share prices in the sector have tumbled from their highs in 2000, but even today's depressed prices are hard to justify without much-improved margins.

Unfortunately, most industry CEOs are focusing on margin-improving techniques that are either hard to pull off (such as consolidation and truly differentiated products) or difficult to convert into a sustainable advantage (such as cost reductions). However the service providers have so far underappreciated an alternative: increasing customers' loyalty and maximizing their new and existing lifetime value.

The value of this approach, has been proven by several leading players not only in the telecom but in different industries such as financial services, consumer goods, etc. The objective involves capturing and analyzing data about customers for the purpose of marketing and serving them on the basis of the value they are expected to create during their "lifetime" with the company. Leading practitioners annually develop and test thousands of new offers targeted at narrowly defined customer segments and rapidly scale up only the most successful ones. Telecom carriers can secure a competitive advantage by using similar techniques to extract more value and profit from their customer base.

Although some telecom operators have already started down this path, none have embraced loyalty and customer lifetime management as a core institutional capability in the way leading financial-services pro-

viders have. Until recently, most telcos were busier expanding their customer base than increasing their existing customers' value. Now that times have changed, many carriers are intuitively striving to increase it, but they tend to tackle discrete opportunities one at a time, without fully appreciating the complexity of customer lifetime management or the careful execution required. Some, for example, have tried to reduce churn by offering discount plans and other incentives—but have ended up retaining customers they would have been better off losing and making formerly marginal customers unprofitable. Others have tried to contain the surge in unpaid bills by tightening credit limits on new applicants but are now turning away many customers who would have been profitable.

Companies that implement a loyalty program have to eschew this piecemeal approach and follow a set of basic principles. First, they must tailor the way they view and treat the customer. Second, they must follow a rigorous quantitative approach to determine each customer's value and to test initiatives that might increase it. Third, they must embrace customer lifetime management as a core institutional capability requiring a new mind-set and new incentives, processes, and tools. In return, companies will find that a single well-planned loyalty program can replace the myriad unrelated projects currently overwhelming management's agenda.

Adopting a loyalty program is undoubtedly a challenge, requiring nothing less than a transformation in the way carriers think about and approach consumers. The carriers must balance their efforts to acquire new customers with efforts to maximize the value of existing ones. They must replace "gut-feel" decision making with decisions based on quantitative facts. And throughout the organization, they must develop the skills and mentality required to treat customers by value.

A wireless provider implementing customer lifetime management projects through effectively would generate a 4 to 5 percent EBITDA margin increase within just 24 months.

However the potential payoff from a loyalty program should put it at the top of any senior-management group's agenda. Our analysis of best-in-class practitioners of customer lifetime management suggests that a typical wireless-service provider implementing it would effectively generate a 4 to 5 percent margin increase in earnings before interest, taxes, depreciation, and amortization (EBITDA) in 18 to 24 months. Loyalty's advantage over them is that it is very much under the senior-management team's control and, done well, likely to provide a sustainable edge.

## **Chapter 2 - Is a loyalty program always profitable? The never-told truth of the loyalty programs.**

To answer this question, we should look at the relationship between customer longevity and operator's profit per client, but it becomes clear that the relationship between loyalty and profits is by no means assured. A telecom operator executive should expect to find a positive correlation, so the important question would be how strong is it? We'll find the answer by challenging the 3 classic loyalty claims:

**Claim 1 - It costs less to serve loyal customers.** In the telecom industry, it is becoming clear that the cost-to-sales ratio for the company's long-standing clients is barely different from what it is for the newer ones; the subscriber acquisition costs compared with the loyalty and retention costs may justify the investment. Therefore, it is extremely important to define a well-established program with accurate financials targeting the right customer behaviors. We have to say that this finding (the link between loyalty and lower costs) is industry specific as this may differ in other non-telco sectors.

**Claim 2 - Loyal customers don't pay higher prices for the same bundle of P&S.** If loyalty doesn't necessarily lower costs, then perhaps it generates revenues. Many telecom proponents of the loyalty programs argue that the customers who stick to a operator do so because the cost of switching to another operator is too high. This is no longer valid in the telecom industry.

Customers seem to strongly resent operators that try to profit from loyalty. Surveys consistently report that consumers believe loyal clients deserve lower prices. This may well explain why telecom companies in mature markets, which routinely offer customers special deals initially only to raise prices later, all experience high rates of customer churn.

**Claim 3 - Loyal customers market the company.** The idea that the more frequent customers are also the strongest advocates for the company holds a great attraction for marketers. Word of mouth marketing is supremely effective, of course, and many companies justify their investments in loyalty by seeking profits not so much from the loyal customers as from the new customers the loyal ones bring in. But once again, not in telecom.

Overall, the link between customer longevity and the propensity to market by word-of-mouth is not strong in telecom operators. Pricing complexity, wide service offering and customer behavior diversity makes difficult to be fluently transmitted through word-of-mouths. Conclusion: If we don't reduce costs and we don't boost revenues, does it really make sense to launch a loyalty program? The answer is clearly yes, and the reason is that loyalty programs provides more than financial upsides. Operators need to judge customers by more than just their consumption actions.

## Chapter 3 - Key success factors in loyalty programs

A loyalty program in telecom is designed to retain customers by rewarding current consumption and behaviour (through handset replacement and promotions campaigns) while simultaneously enticing new acquisitions to change their behaviour. A combination of effective communications, promotions, perceived reward value and convenience are often the catalyst in predicting a program success. The price / value equation plays a strong role if the loyalty program has a participation cost assigned to it as consumers take more seriously things they have to pay for, although this practice is not spread across the telecom industry.

The following elements must be understood from the consumer's perspective for a loyalty program to be successful:

- a. Actual value of the reward
- b. Perceived value of the reward
- c. Relevance to the customer
- d. Attainability levels
- e. Convenience or ease of use

Unfortunately for many operators, loyalty programs are widely misunderstood and misapplied. Rewards are not and should not be positioned as short-term promotional gimmicks with immediate gratification. Loyalty programs are therefore akin to a good marriage, benefits accrue over time and there is a cost associated with leaving. Loyalty programs launched with a short term view will only motivate customers with a short term view and will return a mere fraction of their potential value.

Critical to the success of any loyalty program is the ability to share value with your customer in proportion to the value that the customer brings to the equation. Successful programs will constantly educate customers about the rewards of loyalty (aka handsets) as the key motivator in adoption. The following rules should be followed to develop a successful telecom model:

1. Do not treat your customers as equals: segment your clients in proportion to their value and regardless of their typology (prepaid, postpaid).
2. Do not reward your customers as equals: segment your incentives and provide redemption structures based on a client's lifetime and value.
3. Communicate relevance, not noise.
4. Create more value for the customer than for the operator.
5. Focus on the long-term relationship and not a quick fix.
6. Be creative and differentiate in the value proposition (handset diversity, alternative partners and promotions, third-parties-loyalty programs integration, etc).
7. Target customers with a high value (in both ARPU and CLT).
8. Keep your promises.

## Chapter 4 - Understanding the economic traps

As explained before, loyalty investment does not always mean success. As an example we can mention some companies across Europe that spend large amounts of money on loyalty programs that do not appear to be very successful. This should be an alert for telecom operators: handle with care your loyalty investment and rely on customer lifetime management practices as much as possible, as these programs mean money, and not succeeding will unveil financial inefficiencies. Ineffective programs often fall into one or more of the following traps:

### A) Investing too much in Free riders

As many as half of all members of loyalty programs are free riders, enjoying benefits without spending more for the operators that provides them. Since these free riders get more and give nothing in return, the incremental SAC from program members who do spend more must cover the costs of the program not only for themselves but also for the free riders.

### B) Design a reward scheme which maximizes the motivation of the customer to make the next purchase of your product.

Most existing reward schemes achieve this only indirectly because they don't account for the customer's current situation. The point here is that whatever type of reward scheme you adopt, it needs to be designed with the profitability of different types of customer in mind. Ideally, you hope that this will motivate the most profitable type of customer to give you a higher share of their business. But realistically, in a competitive market where copy-cat schemes are inevitable, the aim may be no more than to ensure you maintain market share (with the attendant level of loyalty and divided-loyalty).

### C) Blindness over the full cost of the loyalty program.

There are a number of highly visible costs such as those associated with launching the program, database creation and maintenance, the value of rewards claimed, and issuing regular activity statements (anything up to twelve a year to have a meaningful impact). These can be very high as evidenced by an estimation that the costs of loyalty programs are typically between 3% and 6% of an operator's revenue. Many other loyalty costs are less visible, namely, the opportunity cost of managers' time spent on the loyalty program rather than on other (marketing) activities, and the effectiveness of the loyalty program compared with an

alternative use of the funds. Very few operators fully account for these incremental costs—especially for the marketing support required to sustain awareness of the programs as well as their momentum and impact.

## Chapter 5 - Conclusions

There are three main lessons from the research and examples cited in this paper.

*First, it seems that in practice, competitive considerations are a major reason for the launch of many customer loyalty schemes. They may seek to preempt a competitor (and possibly secure first-mover advantages), or respond to a competitor's scheme (as evidenced by most of the operators loyalty clubs).*

*Second, apart from purely defensive reasons, if a loyalty program does not support the product/service value proposition, then it might be justified if it can entice more distributors to handle the product—a demand pull effect. As noted earlier, for many products and services, there is a positive relationship between distribution coverage and market share.*

*Third, the behavioral loyalty research reviewed in this paper suggests that brand loyalty is more likely to be the outcome of the type of market in which the provider operates and the type of brand in place, rather than the outcome of an add-on customer loyalty program. In other words, in the majority of cases, all that a customer loyalty program will do is cost money to provide more benefits to customers—not all of which will be relevant to the brand's value proposition and/or positioning. It is unlikely to significantly increase the relative proportion of loyal customers, or profitability.*

These lessons suggest that customer loyalty programs which (i) directly enhance the product/service value proposition, or (ii) broaden the availability of the product/service, or (iii) neutralize a competitor's program, may be worthwhile, although competitors are sure to counter with something of equally perceived value.

Prepare to act against competitor's offering a price cut, making the value of this immediate reward may be more motivating than the promise of just a handset-renewal reward. If they counter with a similar loyalty program, then it is likely to be better than yours in the hope of winning back any defecting customers. But this is another topic.

## More on convergent pricing

Marketing and sales executives working for convergent telecom operators interested in loyalty and retention strategy should address any inquire to Carlos Valdecantos at [cva@group-mmc.com](mailto:cva@group-mmc.com)

## About mmC Group

mmC Group is an international management consulting firm with extensive experience and a strong focus on marketing, sales and business strategy, mostly acquired in the Technology, Media, and Telecommunications (TMT) sector in engagements in more than 20 countries and 3 continents. Founded in 2003 by a group of professionals from various strategic consulting houses, the mmC Group team has extensive experience in marketing, sales and business strategy, mostly in mobile, fixed line and broadband operators.

The key characteristic of the team's experience has been the combination of strategy and execution in advising shareholders and management teams, strategy definition and business opportunity assessments and operations management.

## About the Authors

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