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The Economics Behind Customer Loyalty: Using Coalition Program Assets to Turbo-Charge Results

White Papers

- [Coalition Loyalty: A Model with Sustainable Advantages for Retailers](#)
- [The Economics Behind Customer Loyalty: Using Coalition Program Assets to Turbo-Charge Results](#)
- [The High Cost of “Ghost” Points: Will the short-term gains from high breakage gas discount and other “loyalty” programs yield long-term pain?](#)
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Summary:

Part 1 – The Economic Benefits of Customer Loyalty

Loyal customers can be several times more profitable for consumer businesses, driven by the five economic benefits of increasing customer loyalty:

1. ***Reduced defections***
2. ***Increased spending per customer***
3. ***Lower cost to serve***
4. ***Increased purchases of higher margin products/services***
5. ***More customer referrals.***

Loyalty 2027
Delta, et al. v. Loyalty
CBM2014-00096

Part 2 – Loyalty Program ROI Economics 101

Well-designed loyalty programs can help drive each of the five economic benefits of customer loyalty, while also driving a sixth benefit:

6. More efficient acquisition of highly profitable new customers (outside of referrals).

The overall financial impact of a loyalty program can be evaluated based on several key customer behavior metrics, including:

- **Retention** – the incremental percent of current customers who are program members that remain loyal.
- **Lift** – the incremental increase in spending by current customers who are program members.
- **Shift** – the incremental spending from competitors' customers who are program members and start shopping at your business.

Using the “loyalty math” behind retention, lift, and shift, executives can quantitatively evaluate the economic value from implementing a loyalty program and answer the critical questions revolving around “What do I need to believe?” in terms of customer behavior change in order for a program to drive an attractive ROI.

A well designed loyalty program can be profitable, but only if the incremental value exceeds the program cost, and will only be sustainable if it offers a truly unique consumer value proposition.

Part 3 - The Superior Economics of a Coalition Program

A coalition loyalty program maximizes opportunities to generate and reward loyalty and optimizes the ROI to sponsoring companies because:

1. *A coalition program will accelerate the consumers' time to earn a reward and therefore drive much greater behavior change than a standalone loyalty program.*
2. *A coalition loyalty program will almost always be lower cost to operate than a single company program and will therefore typically generate a meaningfully higher ROI.*
3. *A properly designed and managed coalition loyalty program will always generate better data for results analysis and opportunity targeting, enabling participating sponsors to identify high potential customer households who currently only shop at competitors.*

Part 1 – The Economic Benefits of Customer Loyalty

Why is Customer Loyalty So Important?

Customer loyalty has become an increasingly important focus area for creating sustainable stakeholder value. Harvard Business Review editor Theodore Levitt wrote 30 years ago, the “purpose of business is to create and keep customers”^[1]. There is ample evidence that not all customers are equal – loyal customers are far more profitable. Frederick Reichheld's pioneering work at Bain & Company in the 1980's demonstrated the powerful economic benefits of increasing customer retention across multiple industries, product and service companies. Concentrating management's attention on attracting and maintaining loyal customers is crucial for businesses to succeed in today's competitive world.

Even small changes in customer retention rates and spending levels of loyal customers can have a very big impact on companies' bottom lines. Also, transforming customers into staunch “promoters” or “raving fans” of your business – referring others to become loyal customers too – can turbo-charge profitability as well.

So how does one measure and quantify the benefits of customer loyalty?

Basic Customer Loyalty Math

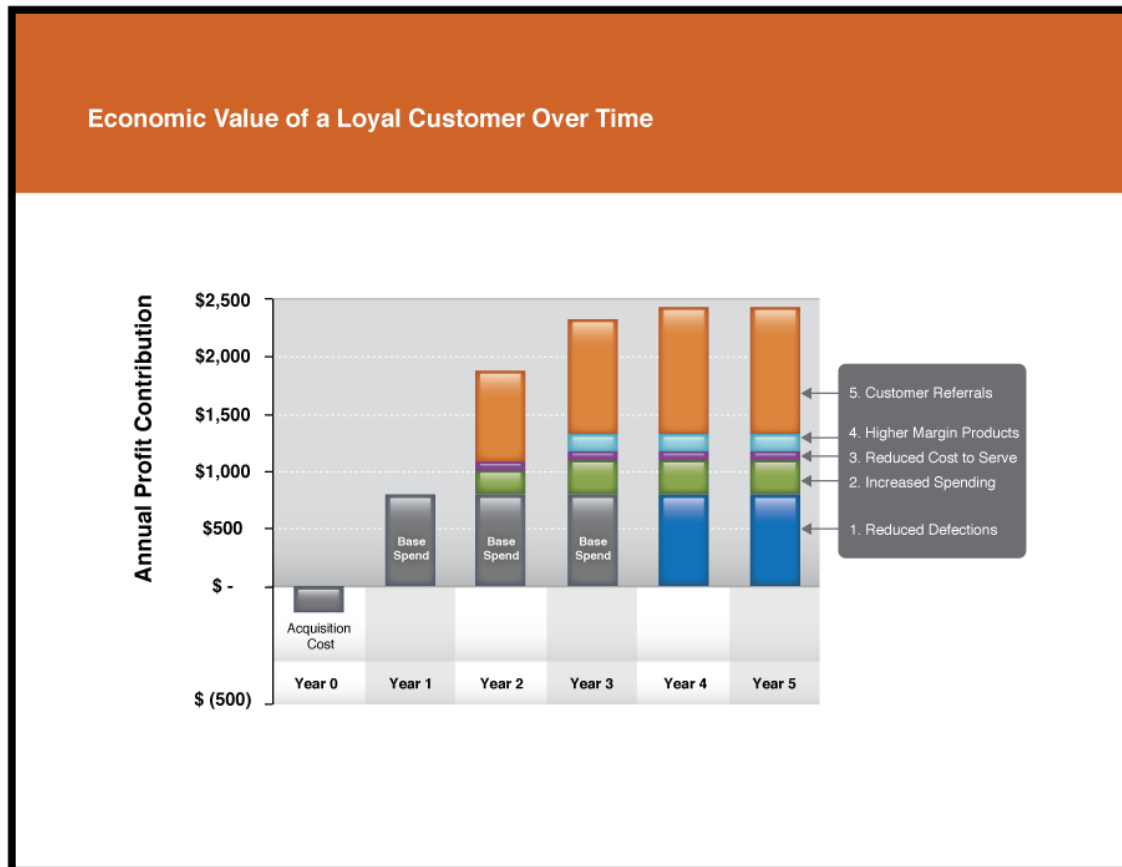
The following framework for measuring the benefits of customer loyalty was originally developed by W. Earl Sasser Jr. and Frederick

Reichheld in a 1990 *Harvard Business Review* article^[ii]. Earl Sasser is a renowned Harvard Business School professor and Frederick Reichheld, head of Bain & Company's Customer Loyalty Practice, went on to publish several books on loyalty including *The Loyalty Effect: The Hidden Force Behind Growth, Profits, and Lasting Value* (1996) and *The Ultimate Question 2.0: How Net Promoters Thrive in a Customer-Driven World* (2011).

The primary economic benefits to a business of increasing customer loyalty include:

1. **Reduced defections to maintain base profits**
2. **Increased profits as loyal customers spend more over time**
3. **Increased profits as loyal customers cost less to serve**
4. **Increased profits as loyal customers purchase higher margin products**
5. **Increased profits as loyal customers refer others to the business they love**

Using this framework, we can quantify the economic value of a loyal customer. The following chart shows the potential value of a loyal supermarket customer over a five year period.



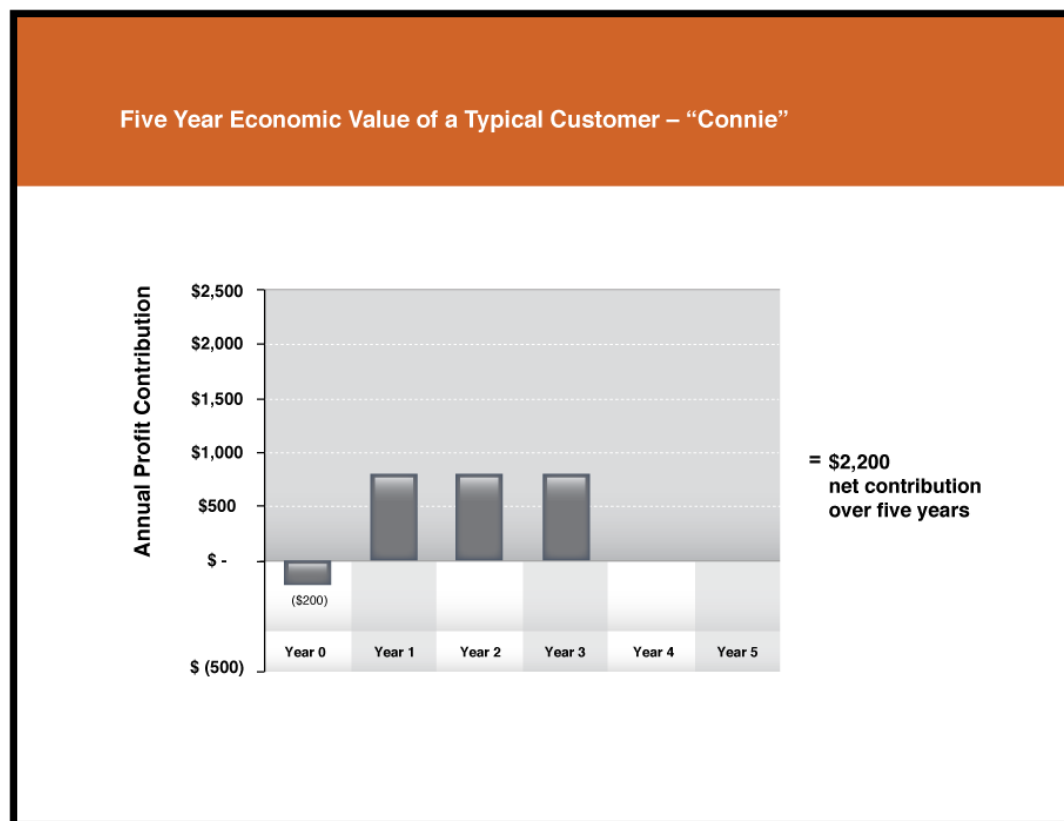
In this section, we will walk through simple examples of each driver of the incremental economic benefits of increasing customer loyalty to a consumer business – in this case, a supermarket company “Super Foods.” We will show the economic impact to Super Foods of turning an illustrative customer, who we’ll call “Connie”, into a loyal customer.

For purposes of the illustrative analyses below, we’ll assume that Connie is a fairly typical Super Foods customer who shops there weekly and spends \$80 of her \$120 total weekly grocery budget at Super Foods. (Her remaining \$40 of weekly grocery spend is split between big box stores such as Walmart and Costco). We’ll also assume that Super Foods has a gross margin of 20%. So assuming \$80 per week x 20% gross margin x 50 weeks per year, Connie is contributing \$800 in annual gross margin to Super Foods.

We'll also assume that, in acquiring Connie as a new customer of Super Foods, the company spent approximately \$200 in marketing costs (direct mail, mass media, etc.) to entice her to begin shopping there.

Historical research by various sources has shown that 20-50% of customers switch grocery stores each year^[iii]. A recent *Consumer Reports* study in 2012 found that 33% of 24,203 surveyed shoppers had switched grocery stores in the past year^[iv]. For the purposes of this analysis, we'll assume that Connie will defect to another store after 3 years.

Thus, the overall economic value of Connie to Super Foods over five years would be \$2,200 (\$800 x 3 years – \$200 acquisition costs = \$2,200), and her individual yearly contribution to the company's bottom line would look like the chart below. (*Note: For simplicity, we are not applying a discount factor to arrive at a customer NPV.*)

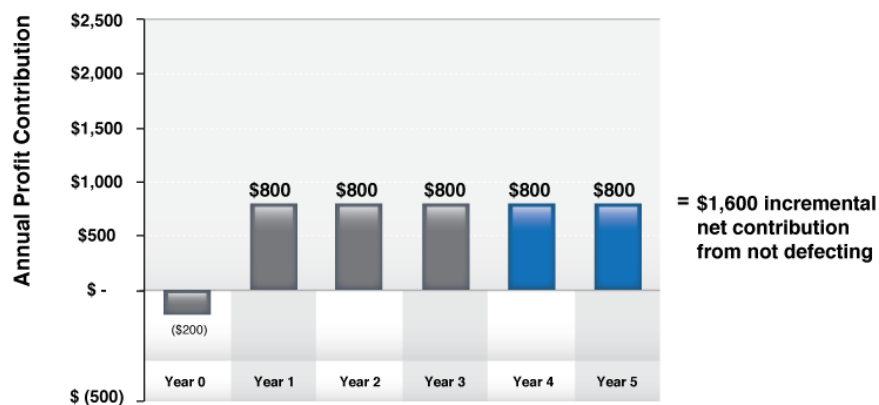


Here's how Connie's economic value to Super Foods would increase over the same five year period if she becomes a loyal customer:

1) Reduced defections to maintain base profits

If Super Foods were able to keep Connie as a customer over the full five years, and maintain her current spending of \$80 per week, *the company would generate another \$1,600 in economic value from Connie (\$800 annual gross margin x 2 incremental years).*

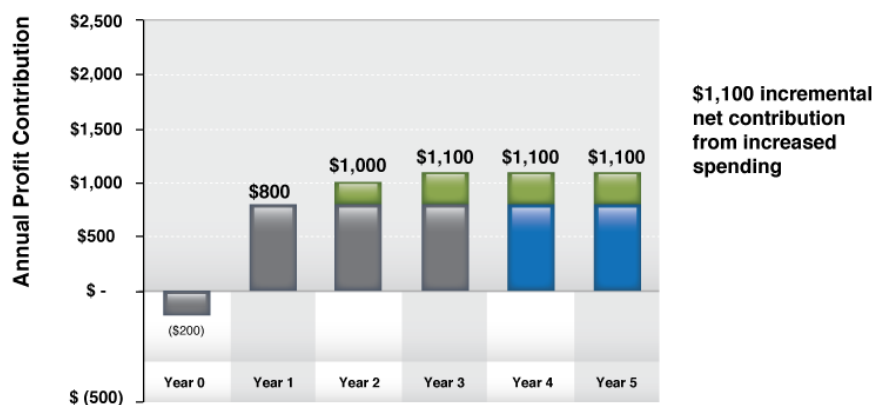
Incremental Economic Value of Reduced Defection



2) Increased profits as loyal customers spend more over time

If Connie were to increase her spending at Super Foods from \$80 per week in year 1, to \$100 in year 2 to \$110 in year 3 and remain at that level of spending through year 5, *the total contribution to Super Foods' gross margin from Connie's increased shopping would be \$1,100 over the 5 years* (\$200 in year 2, and \$300 in each of years 3-5).

Incremental Economic Value of a Loyal Customer Increasing Spend Over Time



It should be noted that increasing Connie's spending at Super Foods from \$80 per week to \$110 per week by year 3 does not necessarily mean that she is spending more on groceries (or her family is eating more food!) each week. Remember, we assumed Connie was spending a total of \$120 per week on groceries, and more than likely, she would be shifting only some of the \$40 per week she was either spending at the big box stores or the occasional "convenience shop" at other local stores near Super Foods.

SLI's primary U.S. market research confirms that most consumers spread their grocery shopping over several retailers. According to SLI's quantitative research of over 10,000 U.S. grocery shoppers, less than 10% of shoppers are spending 100% of their grocery budget at one retailer^[v]. We found a significant opportunity in every market we've researched for grocers to incentivize current customers to consolidate spending at their store and effectively take share from competitors.

3) Increased profits as loyal customers cost less to serve

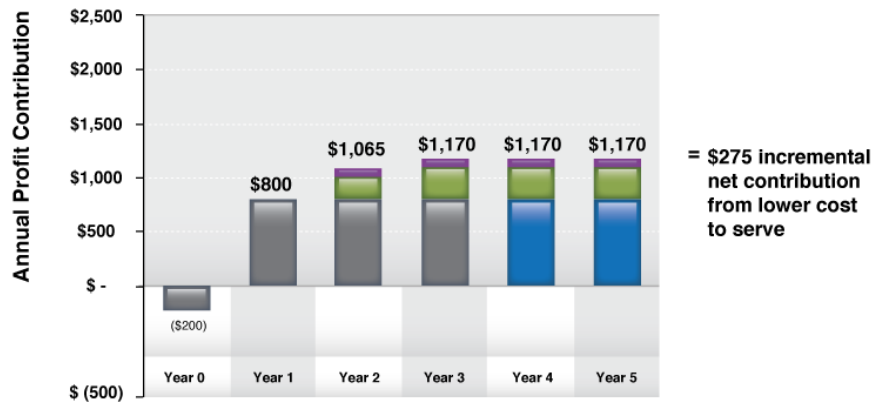
Let's assume that Connie is like most customers who shop frequently at a grocery store – she takes less time to shop and check-out as she has become very familiar with the store. She also continues to look for ways to shop as efficiently as possible, to minimize the time it takes to complete her grocery store visits.

In year 2, Connie discovers Super Foods' well-designed shopping app and downloads it to her smartphone for free. The app is able to send her targeted offers while she is in the store, and allows her to pay with a prepaid card and scan and bag her items as she shops. Checkout is simple as she completes her order by scanning her smartphone as she walks out the door.

Let's assume that this shopping app and payment device reduces the transaction cost that Super Foods incurs each time Connie pays for groceries from 2% of sales (typical of credit card purchases) to 1% of sales for Connie's prepaid card linked to the store's shopper app. This would lower Super Food's cost of servicing Connie as a customer, representing an annual cost reduction of \$55 per year by year 5, and \$215 total cost savings for Super Foods through year 5. (Note: these figures are illustrative – transaction processing costs can vary for credit cards, mobile payments and prepaid cards.)

In addition, as more and more customers learn how to efficiently shop using the mobile app, and effectively bag their own items and self-checkout like Connie, fewer in-store workers would be required to service Super Foods customers. Using conservative estimates, using the mobile payment and self-checkout app would save \$15 per year per active customer starting in year 2^[v]. So adding this \$60 cost savings through year 5, we derive a *total cost savings from Connie using the retailer's shopper app of \$275 through year 5 (\$60 + \$215 saved in transaction costs)*. See Exhibit A1 in the Appendix for calculations detail, and the chart below for the illustrative net contribution from lower cost to serve Connie over the five year period.

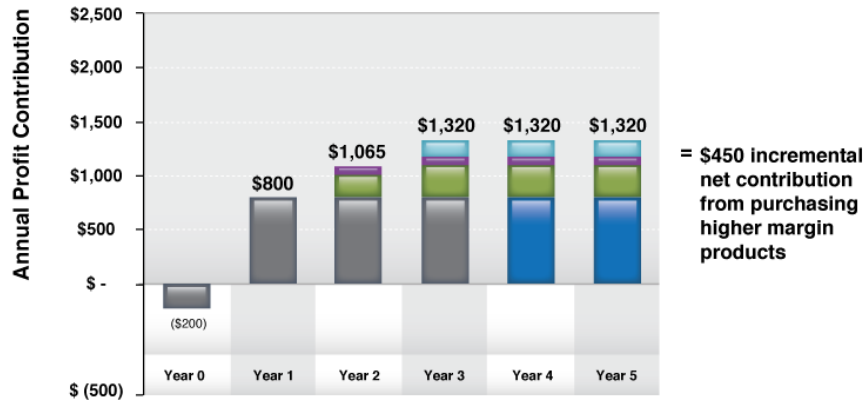
Incremental Economic Value of Cost Savings from Serving a Loyal Customer



4) Increased profits as loyal customers purchase higher margin products

As Super Foods is able to learn more about Connie and her shopping habits over time, there will be increasing opportunities for Super Foods to target Connie and persuade her to buy higher margin products. For example, Super Foods could offer Connie an incentive to try store brand products. If Connie discovers that Super Foods' store brands are better value than national brands, she will start buying them on a weekly basis. Let's assume that she starts spending \$20 (of her \$110 total weekly grocery spend at Super Foods) each week on store brands by year 3. Assuming a 35% gross margin for the store brands (vs. 20% average gross margin for other products sold at Super Foods), *buying the store brand products would result in a \$150 annual impact in incremental gross margin per year through year 5, or \$450 total GM impact.*

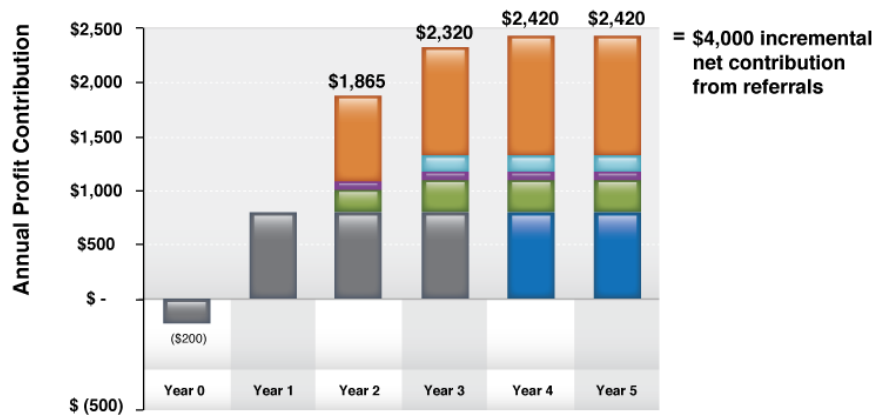
Incremental Economic Value of a Loyal Customer Purchasing Higher Margin Products



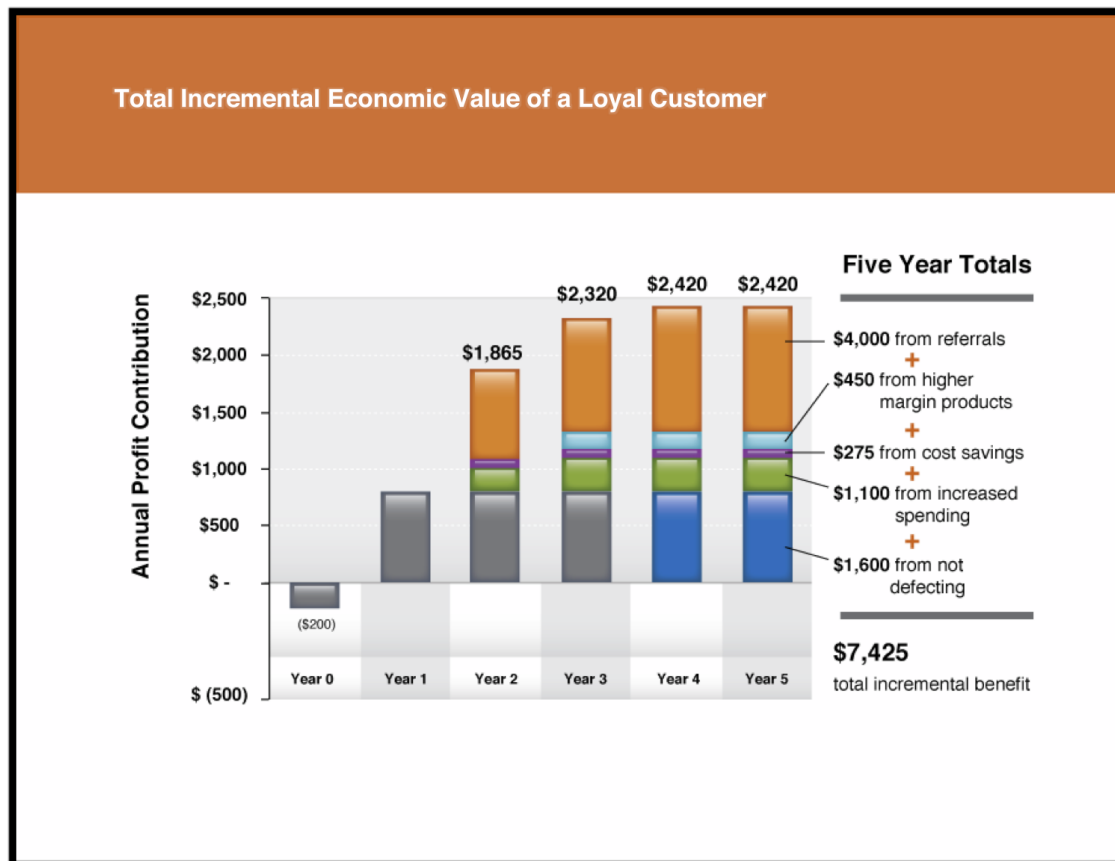
5) Increased profits as loyal customers refer others to the business they love

Now suppose that Connie has become a fan of Super Foods and convinces her friend Sally to join her for a shopping trip early in year 2. Sally becomes a customer of Super Foods starting in year 2 and spends \$80 per week. Like Connie, she too becomes a more loyal shopper over time and spends \$100 per week by year 4 and \$110 per week at Super Foods by year 5. *The incremental contribution to Super Foods of Connie referring Sally would be \$4,000 over the five year period*, as illustrated in the chart below.

Incremental Economic Value of a Loyal Customer Referring Others to Your Business



Adding up all 5 benefits of Connie's increased loyalty, the total incremental contribution from Connie over the five year period is \$7,425. *So, converting Connie from a typical customer to a loyal customer increased her overall contribution to Super Foods from \$2,200 to \$9,625 over five years – that's more than a four-fold increase to the company's bottom line.*



Part 2 – Loyalty Program ROI Economics 101

Now that we have explained the benefits of customer loyalty, and illustrated how to quantify them, we will focus on the loyalty programs offered by consumer businesses, and how executives can evaluate and measure the effectiveness of these programs. Provided that the business offering rewards for increased loyalty has a solid consumer value proposition, a well-designed loyalty program should drive greater customer loyalty, and generate value to the company from the five benefits that we discussed in the previous section. In addition, a *great* loyalty platform should be able to more efficiently attract *new highly profitable loyal customers in addition to referrals from existing customers*.

The chart below summarizes the key benefits of a successful loyalty program, adding a sixth item to the list of five from the previous section: “other new customer acquisitions.” We’ve also split-out the targeted consumers of a loyalty program between current customers and non-customers or competitors’ customers, defined as those who are category shoppers but only patronize competitors. This will better illustrate which group is driving each of the key benefits of a customer loyalty program.

Key Benefits of a Successful Loyalty Program	
Targeted Consumers	Key Benefits
Current Customers	1. Reduced defections
	2. Increased customer spending
	3. Reduced cost to serve customers
	4. Increased customer spending on higher margin products
Competitors' Customers	5. Increased referrals from existing customers
	6. Other new customer acquisitions

In an effort to simplify these six key benefits, and to square them up with high level research findings and actual financial results from existing loyalty programs, businesses often focus on three drivers of value for a customer loyalty program: “retention”, “lift” and “shift”.

1. **Retention** represents the percentage of current customers who remain customers over a period of time (typically a year) as a result of the loyalty program. Any change in this metric will identify whether a loyalty program is indeed driving reduced customer defections.
2. **Lift** is the collective sales lift from current customers driven by the loyalty program. This measure can typically be broken down further between those current customers who lift their spending (“lifters”), and those not lifting (or even reducing) their spending (“non-lifters”).
3. **Shift** represents the sales impact from newly acquired customers driven by the loyalty program.

A simplified way to quantify the key benefits of a loyalty program would be to capture the gross margin impact of each of these three key drivers of value. The chart below summarizes how these three high level drivers of value relate to the six key benefits of a loyalty program mentioned previously. (Note: This analysis does not quantify (i) reduced cost to serve customers, and (ii) increased spending on higher margin products).

High Level Benefits of a Loyalty Program		
Targeted Consumers	Key Benefits of a Loyalty Program	High Level Benefits (Gross Margin Impact)
Current Customers	1. Reduced defections	A. Retention
	2. Increased customer spending	B. Lift
	3. Reduced cost to serve customers	(not quantified)
	4. Increased customer spending on higher margin products	(not quantified)
Competitors' Customers	5. Increased referrals from existing customers	C. Shift
	6. Other new customer acquisitions	

Loyalty programs typically have a variable cost related to the program, which is the cost associated with the rewards given to participating customers in the loyalty program. The rewards can take the form of cash back discounts, free products (12th cup of coffee is free) or points redeemable for travel, free merchandise or other products and services.

The resulting “loyalty program economics” framework is illustrated below.

Loyalty Program Economics Framework			
Targeted Consumers	High Level Benefits (Gross Margin Impact)	Variable Cost	Total Profit Contribution
Current Customers	A. Incremental Retention of Program Members	D. Cost of Rewards for All Program Members	E. Total Profit Contribution (A + B + C – D = E)
	B. Incremental Lift of Program Members		
Competitors' Customers	C. Incremental Shift of Program Members		

This framework provides the following equation to estimate the total value of a business's loyalty program:

$$\begin{aligned}
 &\text{Total profit contribution of a loyalty program} = \\
 &\text{Gross Margin impact from incremental "Retention"} \\
 &+ \text{Gross Margin impact from incremental "Lift"} \\
 &+ \text{Gross Margin impact from incremental "Shift"} \\
 &- \text{Cost of rewards to ALL program members}
 \end{aligned}$$

Note: This economic framework focuses on variable costs and benefits of a loyalty program, excluding any fixed costs that may be required to implement the program (e.g., systems integration, etc.) or to operate the program on an ongoing basis (staffing costs etc.). For a well-operated loyalty program, which can leverage economies of scale across many stores, these incremental fixed costs typically will be much smaller than the variable cost of rewards. Coalition loyalty programs (described further in Part 3) and other outsourced rewards platforms can significantly reduce or even eliminate this fixed cost component for retailers, as these fixed costs are borne by the program operator.

This framework can also be used to calculate a loyalty program's Return on Investment (ROI), as follows:

$$\text{Loyalty Program ROI} = \frac{\text{Total profit contribution from program members' Retention, Lift, Shift benefits}}{\text{Cost of rewards to ALL program members}}$$

The following examples help to demonstrate how retention, lift and shift economics work for loyalty programs. *For each example, we seek to determine what behavior change a loyalty program must deliver in order to drive an attractive ROI.* We assume in our analyses that an ROI of 15% or more is considered attractive for business purposes.

Note: The analyses that follow center around achieving a 15% ROI for the loyalty program, but can easily be adjusted to solve for "breakeven" or 0% ROI, to answer the question: *"What do I need to believe for the loyalty program to reach profitability?"* We also recognize that for certain companies (or in specific markets) there may be other targeted metrics besides ROI that are more relevant or pressing for executives evaluating their loyalty program, including market share or overall sales growth. This framework can easily be modified for these metrics as well.

"Retention" Economics Example

"Fresh Foods" is a single store supermarket with a 20% gross margin considering launching a loyalty program to improve its customer retention. The loyalty program it is evaluating provides discounts as rewards (perhaps for gas and groceries) and will cost an estimated

1.5% of total sales. This assumes Fresh Foods pays upon redemption of discounts at 3% total value back to consumers on their grocery spend, and is based on an overall 50% redemption rate (i.e., 50% “breakage” of points issued for discounts). For simplicity, we assume that all customers are auto-enrolled, and immediately begin earning points in the loyalty program at launch.

Fresh Foods is focused on retaining customers, as 25% of its customers are defecting each year. Therefore their “retention rate” currently is 75% year-over-year.

In evaluating the new loyalty program, the key question Fresh Foods executives might ask is:

By how much will the company’s retention rate need to improve in order for the loyalty program to drive an attractive ROI of 15%?

If we assume that the only behavioral impact this program will have on its customers is increased retention (or reduce defections), and there is no impact from “lift” or “shift,” we can solve for the key variable “r” for retention rate – percent of customers who remain customers over the period – in the equation below.

“Retention Only” Loyalty Program Economics Example				
Loyalty Program ROI	=	Total Profit Contribution from Program Members’ Retention + Lift + Shift	÷	Cost of Rewards To ALL Program Members
Loyalty Program ROI	=	(GM Impact from Retention + GM Impact from Lift + GM Impact from Shift) – Cost of Rewards	÷	Cost of Rewards To ALL Program Members
15%	=	[(“R” + “L” + “S”) – “C”]	÷	“C”
15%	=	[(R + 0 + 0) – C]	÷	C
15%	=	[R – C]	÷	C
15%	=	[Gross Margin Impact from Retention – Cost of Rewards]	÷	Cost of Rewards
		$\frac{[(r - 75\%) \times 20,000]}{2} \times \$1,500 \times 20\%$		$1.5\% \times \frac{[(20,000 \times r) + 20,000]}{2} \times \$1,500$
		$1.5\% \times \frac{[(20,000 \times r) + 20,000]}{2}$		
r = 91.5%				
Solve for the annual retention rate, “r” – Note: Analysis above assumes 1.5% cost of loyalty program (as % of sales), 75% retention rate (pre-program) and a 20% gross margin. For illustrative purposes, calculations assume 20,000 customers at the beginning of period, spending an average of \$1,500 per year.				

Assuming that the new loyalty program drives no increase in “lift” or “shift”, **the required improvement in Fresh Foods’ annual customer retention rate would be 16.5 percentage points – from 75.0% to 91.5% retention** – in order to drive a program ROI of 15%. This would imply Fresh Foods customers would need to become 22% more loyal for the program to be a success (91.5% / 75.0% – 1 = 22%). Exhibit A2 in the Appendix summarizes the math in more detail.

“Lift” Economics Example

Using the same example of Fresh Foods, we now assume that the primary goal of the loyalty program is to improve overall spending from existing customers – in other words, to drive sales “lift”. In this case, the key question that Fresh Foods executives would likely ask in evaluating the new loyalty program is:

By how much will current customers need to lift their spending in order for the loyalty program to drive an attractive ROI of 15%?

If we assume that the only behavioral impact this program will have is an increase in spending from current customers (“lift”) and there is no change in retention or increase from “shift”, we can solve for the key variable “l” – percent increase in average spend by current customers – in the equation below.

"Lift Only" Loyalty Program Economics Example				
Loyalty Program ROI	=	Total Profit Contribution from Program Members' Retention + Lift + Shift	÷	Cost of Rewards To ALL Program Members
Loyalty Program ROI	=	(GM Impact from Retention + GM Impact from Lift + GM Impact from Shift) – Cost of Rewards	÷	Cost of Rewards To ALL Program Members
15%	=	[("R" + "L" + "S") – "C"]	÷	"C"
15%	=	[(0 + L + 0) – C]	÷	C
15%	=	[L – C]	÷	C
15%	=	[Gross Margin Impact from Lift – Cost of Rewards]	÷	Cost of Rewards
		$\underbrace{17,500 \times L \times \$1500 \times 20\%}_{\text{Lift}} \quad \underbrace{1.5\% \times 17,500 \times \$1500 \times (1 + L)}_{\text{Cost of Rewards}} \quad \underbrace{1.5\% \times 17,500 \times \$1500 \times (1 + L)}_{\text{Cost of Rewards}}$		
		L = 9.44%		
Solve for the percent increase in sales ("lift") from current customers – Note: Analysis above assumes 1.5% cost of loyalty program (as % of sales), 20% gross margin, and 17,500 avg. customers over the period (i.e., 20,000 customers at the beginning of period and 15,000 customers at end of period, assuming a 75% retention rate). For illustrative purposes, calculations assume customers spend an average of \$1,500 per year.				

Assuming that the new loyalty program drives no increase in customer retention or impact from "shift", the **required increase in Fresh Foods' customer spending (or the required overall sales "lift") would be 9.4%** in order to drive a 15% ROI for the program. This could be viewed as the average customer enrolled in the loyalty program (including frequent and occasional shoppers) increasing their grocery spend at Fresh Foods by \$142 annually, from \$1,500 per year to \$1,642 per year, or \$2.83 per week, from \$30 per week to \$32.83 per week. See Exhibit A3 in the Appendix for further detail.

Lifters vs. Non-Lifters and Dilution

Research on customer behavior usually reveals that, while overall sales for a retailer may increase among current customers enrolled in the loyalty program and the *average* spending per customer may go up as a result of a loyalty program, not *all* current customers enrolled in the loyalty program will change their behavior and increase spending. As such, there is always an element referred to as "dilution." Dilution refers to the cost of rewarding customers who are program members, but do not spend more (or engage in other more profitable behavior) as a result of participating in the program. We believe this "cost" can be looked at as an ongoing *investment* in rewarding loyal customers for their existing level of shopping (i.e., rewarding them for *retaining* their business), and also for providing information as a byproduct of earning points. Nonetheless, we always include the cost of "dilution" in our economic models.

In order to quantify this "dilution", executives examining the impact of a loyalty program on sales lift often will dive a level deeper by breaking down overall sales lift between: (i) current customers who increase their spending (lifters), and (ii) current customers who do not increase their spending (non-lifters).

By adding this dimension to sales lift, instead of having one variable – average percentage sales lift among *all* current customers enrolled in the program – we now have two variables: (a) percent of current customers enrolled in the program who lift and (b) \$ amount of spend lifted by "lifters" (or *percent* increase in spend among only those current customers lifting).

Going back to our Fresh Foods example, executives might believe that the new loyalty program could motivate a certain percent of their customers to spend \$10 more per week (or roughly a 33% increase in spending for this group). Fixing this dollar increase in spending among "lifters", executives might ask:

What percentage of my current customers will need to spend \$10 more per week in order for the loyalty program to achieve an attractive 15% return?

or

What level of “dilution” can we tolerate for this program, assuming the requisite percent of current customers increase their spending by \$10 per week?

Again, assuming no impact from retention or shift, **28.3% of current customers would need to increase their spending by an average of \$10 per week** in order to drive a 15% ROI for the loyalty program. That would imply that approximately 72% of customers do not lift their spending as a result of the program, and any cost associated with rewarding those customers could be viewed as “dilution”. See the illustrative math in Exhibit A4 in the Appendix for additional details.

We can also construct a ROI Sensitivity Matrix that illustrates the combinations of (a) percent of current customers lifting and (b) average \$ amount of spending increase per “lifter” that result in a 15% or greater ROI (cells highlighted in green). Again, this analysis assumes no impact from retention or shift, and assumes 100% of customers are enrolled in Fresh Foods’ loyalty program:

Fresh Foods Loyalty Program					
ROI Sensitivity Matrix: Percent “Lifters” vs. Avg. Spend Increase per “Lifter”					
		Average Overall “Lift” in Spending By “Lifters”			
		\$7.50 / week (\$375 / year)	\$10 / week (\$500 / year)	\$15 / week (\$750 / year)	\$20 / week (\$1,000 / yr)
		+25.0%	+33.3%	+50.0%	+66.7%
% of Current Customers Lifting Spend (“Lifters”)	50.0%	48.1%	90.5%	166.7%	233.3%
	28.3%	(11.8%)	15.0%	65.4%	111.8%
	15.0%	(51.8%)	(36.5%)	(7.0%)	21.2%
	5.0%	(83.5%)	(78.1%)	(67.5%)	(57.0%)

“Shift” Economics Example

As we’ve discussed, well-designed loyalty programs can attract new customers. Suppose that Fresh Foods is interested primarily in attracting new customers from competing grocery stores, convenience stores and big box retailers who sell groceries. If sales “shift” is a key focus of the new loyalty program, Fresh Foods executives will want to know:

What percentage of those customers in my store’s “catchment area” who are shopping only at my competitors’ stores must shift their spending to Fresh Foods in order to drive an attractive ROI for the program of 15%?

For purposes of determining the required “shift only” impact of the new loyalty program, we assume that Fresh Foods currently has a 45% “coverage market share” in its area (i.e., 45% of area consumers shop at Fresh Foods). Thus, if we assume an average of 17,500 consumers shop at Fresh Foods over the period, a 45% coverage share would imply 38,889 total consumers in the catchment area ($17,500 / 0.45$) and 21,389 non-customers in this same area ($38,889 - 17,500$). We also assume that those non-customers who shift from a competing retailer to Fresh Foods would spend \$30 per week (\$1,500 per year) at Fresh Foods. Assuming that the only behavioral impact from this program is an increase in “shift”, we can solve for the key variable “s” – percent of non-customers who start spending at Fresh Foods – in the equation below.

Fresh Foods Loyalty Program ROI Sensitivity Matrix: Retention vs. Lift					
Average Overall "Lift" in Spending By Current Customers					
Post-Behavior Change Retention Rate	Increase in Retention Rate	+\$0 / year	+\$37.50 / yr	+\$75.00 / yr	+\$141.60 / yr
		0.0%	2.5%	5.0%	9.4%
91.5%	+16.5%	15.0%	44.7%	73.0%	120.1%
85.0%	+10.0%	(27.9%)	2.8%	32.1%	80.9%
82.4%	+7.4%	(45.9%)	(14.7%)	15.0%	64.4%
75.0%	+0.0%	(100.0%)	(67.5%)	(36.5%)	15.0%

In the Sensitivity Matrix above, you can see the previously discussed required "Retention Only" rate of 91.5% to achieve a 15% ROI (top left box in matrix), and it shows the sales lift of 9.4% required to hit a 15% ROI in the "Lift Only" scenario (lower right box in matrix). The Sensitivity Matrix also reveals, for example, that a 15% program ROI could be achieved for Fresh Foods if the loyalty program increased retention rates by 7.4 percentage points from 75% to 82.4% *and* current customers collectively lift their spending by 5%, or \$75 per year to \$1,575 annually (or \$1.50 per week to \$31.50 in average weekly spend).

Lift + Shift Economics Example

Similar to the Retention vs. Lift Sensitivity Matrix, we can also analyze the sensitivity of the loyalty program's ROI to "lift" and "shift" factors only – assuming the loyalty program drives no change to customer retention rates. Here we see the 9.4% lift in sales to current customers required in a "Lift Only" scenario to achieve a 15% return (lower right box in matrix) and we also see the 7.7% required shift to hit a 15% ROI in the "Shift Only" case (second to top box on the left).

Fresh Foods Loyalty Program ROI Sensitivity Matrix: Lift vs. Shift					
Average Overall "Lift" in Spending By Current Customers					
Percent of Competitors' Customers "Shifting" Spend to Fresh Foods	Fresh Foods Coverage Market Share Post-Shift	+\$0 / year	+\$37.50 / yr	+\$75.00 / yr	+\$141.60 / yr
		0.0%	2.5%	5.0%	9.4%
12.5%	51.9%	76.7%	101.3%	124.8%	164.3%
7.7%	49.2%	15.0%	42.2%	68.2%	111.7%
3.6%	47.0%	(23.2%)	5.7%	15.0%	79.4%
0.0%	45.0%	(100.0%)	(67.5%)	(36.5%)	15.0%

Note: Analysis assumes that "shifters" start spending \$30 per week at Fresh Foods, or \$1,500 per year.

Variability Across Industries – Gross Margin Impact

It's important to note that the loyalty program economics described above are relevant for a supermarket business operating with a 20% gross margin. When analyzing other consumer businesses, variability in gross margins can have a significant impact on the required behavior change metrics needed to drive an attractive loyalty program ROI. Businesses with higher operating leverage, such as cable or wireless phone services companies – which typically operate near 60% gross margins – will require much lower retention, lift and shift metrics to drive loyalty program profitability (assuming the same cost of rewards as a percentage of sales). For example, below is the Retention vs. Lift ROI Sensitivity Matrix, this time for a Cable Company with 60% margins.

Cable Company Loyalty Program ROI Sensitivity Matrix: Retention vs. Lift					
Average Overall "Lift" in Spending By Current Customers					
Post-Behavior Change Retention Rate	Increase in Retention Rate	+\$0 / year	+\$37.50 / yr	+\$75.00 / yr	+\$112.50 / yr
		0.0%	1.6%	3.0%	5.0%
87.5%	+7.5%	60.0%	118.6%	170.4%	242.9%
85.3%	+5.3%	15.0%	74.3%	126.7%	200.0%
82.5%	+2.5%	(45.2%)	15.0%	68.2%	142.7%
80.0%	+0.0%	(100.0%)	(38.9%)	15.0%	90.5%

Note: Analysis assumes that current customers spend \$1,500 per year (\$125 / month) before sales "lift", and "shiffters" start spending \$1,500 per year (\$125 / month). Also assumes the Cable Company has the same cost of rewards as Fresh Foods' loyalty program – 1.5% of sales.

Notice that the required retention and lift figures for the Cable Company to achieve attractive returns for its loyalty program are *significantly lower* than they are for the Fresh Foods supermarket loyalty program (assuming the same cost of rewards for the Cable Company program as the Fresh Foods program: 1.5% of affected sales). The "Retention Only" increase in the retention rate to achieve a 15% ROI for the loyalty program is only 5.3 percentage points for the Cable Company, vs. 16.5 percentage points for Fresh Foods. Similarly, the "Lift Only" sales increase among current customers required to achieve a 15% ROI is only 3.0% for the Cable Co. vs. 9.4% for Fresh Foods.

By contrast, lower gross margin businesses such as gas stations which typically have gross margins in the single digits will require greater behavior change metrics in order to drive profitable programs (assuming the same cost of rewards in terms of percentage of sales).

Below is a summary table that illustrates the variability in required "Retention Only", "Lift Only" and "Shift Only" metrics needed to drive a 15% ROI for businesses operating a loyalty program that costs 1.5% of sales.

Consumer Behavior Change Metrics Required to Drive a 15% ROI for a Loyalty Program Costing 1.5% of Sales				
Business Type:		Gas Station	Supermarket	Cable Company
Illustrative Gross Margin:		5.0%	20.0%	60.0%
Required Behavior Change To Achieve 15% ROI	"Retention Only" % increase in annual customer retention	N/A*	16.5% (From 75.0% to 91.5% retention)	5.5% (From 85.0% to 90.5% retention)
	"Lift Only" overall % sales lift from current customers	52.7%	9.4%	3.0%
	"Shift Only" % of competitors' customers shifting spend	13.2%	7.7%	4.4%

* Note: Under these parameters, a gas station with a 50% customer retention rate cannot achieve a 15% ROI for a loyalty program costing 1.5% of sales by only improving the retention rate. The gas station will need to rely on a combination of "lift" and "shift" to drive attractive returns.

Please note, in order to more accurately reflect industry dynamics, the table above assumes the following illustrative local market share percentages: 20% for the gas station, 45% for the supermarket, and 60% for the cable company. Also, we assume annual retention rates of: 50% for the gas station, 75% for the supermarket and 85% for the cable company.

It bears mentioning that while a gas station's required behavior change may be greater than what is required for higher margin businesses to drive attractive ROIs, gas stations also have the most potential to drive behavior change and take share from competitors since: (i) they sell a 100% commodity product with little differentiation between stations, other than location, (ii) gas retail is typically a very highly fragmented space, with no dominate players and (iii) customer loyalty / retention at competing gas stations is likely fairly low.

Market Share Implications

A business' market share will also have an impact on its loyalty program economics. Generally speaking, more competitive industries and markets, with many companies commanding low market shares, have a higher potential for loyalty programs to move the needle in terms of behavior change and taking share from competitors.

The matrix below illustrates how Fresh Foods' market share impacts the required "shifting" of spend from competitors' customers required to achieve a 15% ROI (assuming no impact from retention or lift). Clearly a lower market share for Fresh Foods requires a lower, perhaps more achievable, level of shift, and post-program market share. For instance, Fresh Foods would only need to drive only 2.4% of competitors' customers to its store, and increase market share from 20.0% to 21.9% if it had a low coverage share. By contrast, if Fresh Foods had high market share, it would need to drive 37.8% of competitors' customers to its store, and increase its coverage share from 80.0% to 87.6% — likely a more difficult challenge.

Required Shift to Drive a 15% ROI for a Fresh Foods Loyalty Program				
Market Share (Pre-Program)		20.0%	45.0%	80.0%
Required Behavior Change To Achieve 15% ROI	"Shift Only" % of competitors' customers shifting spend	2.4%	7.7%	37.8%
	Coverage Market Share, Post-Program (and % increase)	21.9% (+1.9%)	49.2% (+4.2%)	87.6% (+7.6%)
Note: Analysis assumes cost of rewards of 1.5% (as % of sales), 20% gross margin, and that "shifters" spend \$1,500 per year at Fresh Foods.				

Based on this shift analysis alone, it can be more difficult for higher market share businesses to justify costly loyalty programs. Therefore, higher market share businesses should focus on retention and lift benefits.

Cost of Program

In addition to the impact of gross margin and market share on loyalty program economics, the overall cost of a loyalty program also has a major impact on the required consumer behavior change needed to drive an attractive return. The higher the cost of rewards, the greater the consumer behavior change that is needed in terms of retention, lift and shift in order to drive a profitable ROI.

Below is a summary table of what the required behavior change metrics would be for a Fresh Foods program that costs 1.5% of sales vs. a program that costs 3% or 5% of sales.

Consumer Behavior Change Metrics Required to Drive a 15% ROI for a Fresh Foods Loyalty Program				
Cost of Rewards (% of Sales):		1.5%	3.0%	5.0%
Required Behavior Change To Achieve 15% ROI	"Retention Only" % increase in customer retention, y-o-y	16.5% (From 75.0% to 91.5% retention)	N/A*	N/A*
	"Lift Only" overall % sales lift from current customers	9.4%	20.8%	40.3%
	"Shift Only" % of competitors' customers shifting spend	7.7%	17.0%	33.0%
* Under these parameters, Fresh Foods cannot achieve a 15% ROI for its loyalty program by <u>only</u> improving its retention rate. Fresh Foods would need to rely on a combination of "lift" and "shift" to drive attractive returns. Note: Analysis assumes 20% gross margin, current customers spending \$1,500 per year (pre-program), 75% customer retention rate (pre-program), 45% coverage market share (pre-program) and "shifters" spending \$1,500 per year at Fresh Foods.				

As can be seen in the data above, it's important that the cost of the loyalty program be managed, as an expensive program can be difficult to justify in terms of the required behavior change it must drive in order to be profitable.

Differentiation vs. Competing Programs

As the loyalty space has matured over the last 20 years, many consumer businesses today are facing a challenge that can prevent loyalty programs from truly "moving the needle" in terms of driving the company's bottom line: no differentiation in the loyalty program vs. competing programs. There are a myriad of "me too" rewards programs in the U.S. retail landscape today. Many of them offer very generic discounts (e.g., 2% cash back at CVS, 5% cash back at Target) that are easy for consumers to compare with competing loyalty offers.

Undifferentiated rewards can make it difficult for programs to achieve the kind of behavior change metrics that are required to make the programs profitable, particularly when these programs enter the "race to the bottom" of needing to provide ever more value back to the customer. A popular way to handle this trend in the U.S. is for loyalty programs to promote a substantial cash back offer that will appear to be high value back to capture the consumer's attention ("3% off gas" or "\$0.10 off a gallon of gas for every \$50 of grocery spending"), but require high spending thresholds, redemption limits, and / or tight expiration dates to ensure that few rewards are actually redeemed. These methods can help drive consumers' *perceived* value back for these programs, while effectively managing the cost and long term liability for the business by driving high "breakage" – i.e., rewards points earned that are never redeemed. (We discuss the impact of these programs, which we argue do not drive long term loyalty, in SLI's "Ghost Points" white paper.)

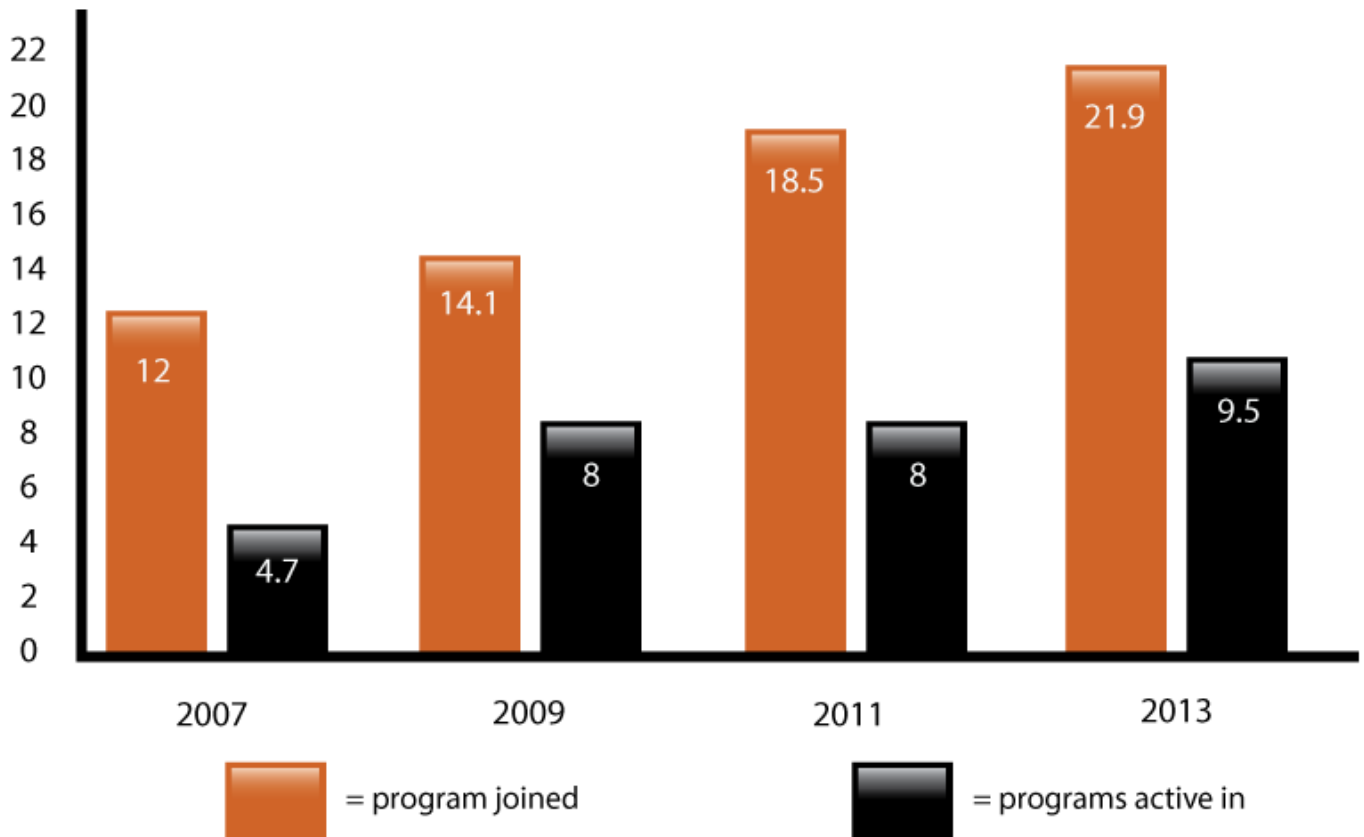
But these tricks can only persist for so long before customers become frustrated with the hoops they must jump through to get the rewards they feel they deserve. Regardless of all the restrictions placed on these loyalty programs, when the only point of differentiation is the transparent percent cash value back provided to consumers, it becomes a simple price war in the loyalty space where there are rarely any winners. When this happens, as it has in the U.S. market, loyalty programs can become simply a cost of doing business that every business must incur. This is reminiscent of the green stamps phenomenon in the 1960's, which eventually went away.

Therefore, a more sustainable, winning strategy for loyalty programs is to provide a truly unique value proposition to consumers that cannot be easily duplicated by competitors. This can be achieved by offering an exclusive, highly motivating rewards inventory and/or making a bold move: partnering with other non-competing consumer businesses in a coalition loyalty program.

Part 3 – The Superior Economics of a Coalition Program

Consumers are bombarded with loyalty programs currently in operation in the U.S. market. But quantitative research suggests that the overall market is super-saturated with standalone "me too" loyalty programs that offer undifferentiated rewards (e.g., "cash back discounts"), and/or low perceived value rewards, with few programs resonating with consumers and leading to active customer engagement. A clear indication of this is the "loyalty fatigue" that can be seen in data from recent COLLOQUY surveys, which show that the average U.S. consumer has joined more than 22 loyalty programs, but remains active in only 9.5 programs – and the number of active programs per consumer has flat-lined over the last few years^[vi].

No. of U.S. Loyalty Programs Joined Continues to Increase While Consumer Engagement Has Flat-lined









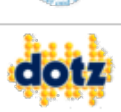

Source: COLLOQUY Loyalty Census, 2007 - 2013.

So are there any loyalty programs that can truly “break through the clutter” with a unique value proposition and meaningfully “move the needle” in terms of customer engagement and ROI?

Yes. Coalition loyalty programs with well-designed reward platforms have driven sustainable value to customers and superior returns to consumer businesses around the world for over two decades.

A coalition loyalty program is a multi-company, shopper rewards program. Consumers who participate in these programs are rewarded with a common points-based currency for shopping at exclusive (or co-exclusive) sponsors within each major consumer spending category: e.g., one supermarket sponsor, one gas station sponsor, one department store sponsor, one credit or debit card sponsor etc. Points earned collectively at these sponsors can then be redeemed by consumers for a variety of rewards such as travel, merchandise and gift cards or discounts at the sponsors.

Coalition programs like AIR MILES (Canada), Nectar (U.K.), Payback (Germany), Fly Buys (Australia) and others have been extraordinarily successful. Several of the top coalition programs have 60-70% of all households as active members of the program i.e., members who earn points by shopping at sponsors on at least a monthly basis. Below is a summary of the world’s leading coalition programs, highlighting the businesses originally founded by SLI’s Chairman Sir Keith Mills.

World's Leading Coalition Loyalty Programs			
Coalition Loyalty Program		Country	Household Penetration
	Travel Club*	Spain	70%
	AIR MILES Canada*	Canada	70%
	Nectar*	U.K.	68%
	Payback	Germany	60%
	Fly Buys	Australia	60%
	AIR MILES Netherlands*	Netherlands	60%
	Dotz	Brazil	46%**
	Avios (f/k/a AIR MILES UK)*	U.K.	18%

* Coalition loyalty programs developed by Sir Keith Mills, SLI Chairman

** Based on markets where Dotz operates as of 9/19/13

Source: SLI estimates based on publicly available data

As companies like AIR MILES and Nectar have demonstrated over many years, the coalition model provides tremendous value and a sustainable long-term competitive advantage for its sponsors. AIR MILES has partnered with sponsors like American Express, Canada Safeway and Shell for over 20 years, and Nectar has partnered with UK supermarket chain Sainsbury's and BP gas stations for more than 10 years.

Why are these coalition programs so sustainable, and how have they created so much value for sponsors?

The simple answer is that coalition programs are able to enhance or “turbo charge” a company’s loyalty efforts in many ways. A coalition program typically drives profitable behavior change far more effectively than a standalone program.

A coalition loyalty program has 3 major advantages over a standalone loyalty program:

i. Faster attainability of rewards + greater selection of rewards = higher value for consumers.

Members of a coalition program can earn points much more quickly from tens (and even hundreds) of sponsors. These points typically can be redeemed for low level discounts as well as higher level, more aspirational rewards (travel, more expensive merchandise etc.) vs. standalone programs. Consumers really like the ability to earn points from purchasing products and services from many sponsors and then redeem these points for a greater selection of motivating rewards. Consumers get it: *faster is better*.

ii. Lower cost to participate for program sponsors.

Administrative costs are shared among all program participants, and coalition loyalty operators typically cover the upfront investment in systems and other initial administrative costs to develop and launch a program.

iii. Better customer data and targeting abilities for program sponsors.

Coalition programs collect customer data across sponsor categories (e.g., supermarket, gas, bank, department store), which provides sponsors the opportunity to provide highly targeted, relevant offers to current shoppers and those who only shop at their competitors.

The chart below illustrates just a few of the many ways in which a coalition program is able to drive increased value from customer loyalty, using our “Key Benefits of a Successful Loyalty Program” framework:

Key Benefits of a Successful Loyalty Program and How a Coalition Program Enhances Results		
Targeted Consumers	Key Benefits	Examples of How a Coalition Loyalty Program Can Enhance Results vs. A Company's Stand-Alone Loyalty Program
Current Customers	1. Reduced defections	<ul style="list-style-type: none"> With numerous sponsors in the coalition, and many channels to earn points, a member is more likely to remain a customer to earn points toward higher level, motivating rewards. Aggressive coalition promotions when new competition enters market. Coalition welcome kits when members move or at other key life-stage events.
	2. Increased customer spending	<ul style="list-style-type: none"> Bonusing of higher spending. Using the program's coalition database asset, sponsors can offer targeted bonus points for increased levels of spending based on current spending vs. potential spending of each member household.
	3. Reduced cost to serve customers	<ul style="list-style-type: none"> Bonusing of more cost effective payment methods. The coalition database can identify those members most likely to sign up for direct deposit, self check-out mobile apps or other lower cost tools and behaviors.
	4. Increased customer spending on higher margin products	<ul style="list-style-type: none"> Bonusing of higher margin products. The database can identify program members who are most responsive to product level bonus points, receptive to trying store brands, or are in the "market" for specific products (e.g. frozen meats, diapers, pet products).
Competitors' Customers	5. Increased referrals from existing customers	<ul style="list-style-type: none"> Member-get-member bonusing. The database can target those members most likely to recruit other program members to shop at specific sponsors.
	6. Other new customer acquisitions	<ul style="list-style-type: none"> The coalition database can also be used to target high potential value non-shoppers. <ul style="list-style-type: none"> e.g., "consumers living close to sponsor, with 5 members in the household, and already shop at other coalition program sponsors" Cost-effective, ubiquitous coalition marketing, using all sponsors' assets, drives massive consumer impressions / awareness.

In addition to these benefits driving increased gross margin for sponsors, ***a coalition program is typically designed as a cheaper alternative to a standalone loyalty program.*** Standalone programs have lower attainability of rewards, since points earned are limited to consumers' spend at one retailer, and they typically have less differentiation of rewards vs. a coalition program. As a result, standalone programs must give more back in terms of value to the customer, especially in today's mature loyalty market where marketing simply 1% cash back in a standalone program is no longer exciting to consumers, and retailers continue to move toward increasingly-richer loyalty offers of 3%, 5% or even 10%+ back.

Below are more detailed explanations as to how a coalition program can enhance or “turbo-charge” customer loyalty:

1) Reduced defections to maintain base profits

By participating in a well-designed coalition loyalty program, which offers a highly motivating points currency and gives customers access to rewards they would not otherwise be able to attain through a standalone rewards program, sponsors provide a compelling new reason for customers to remain loyal to their business. Points in a coalition program also typically don't expire (or expire after many years) so consumers are less likely to defect if they are walking away from a large points balance. In addition, the coalition platform offers unique tools for sponsors to help combat potential customer defections.

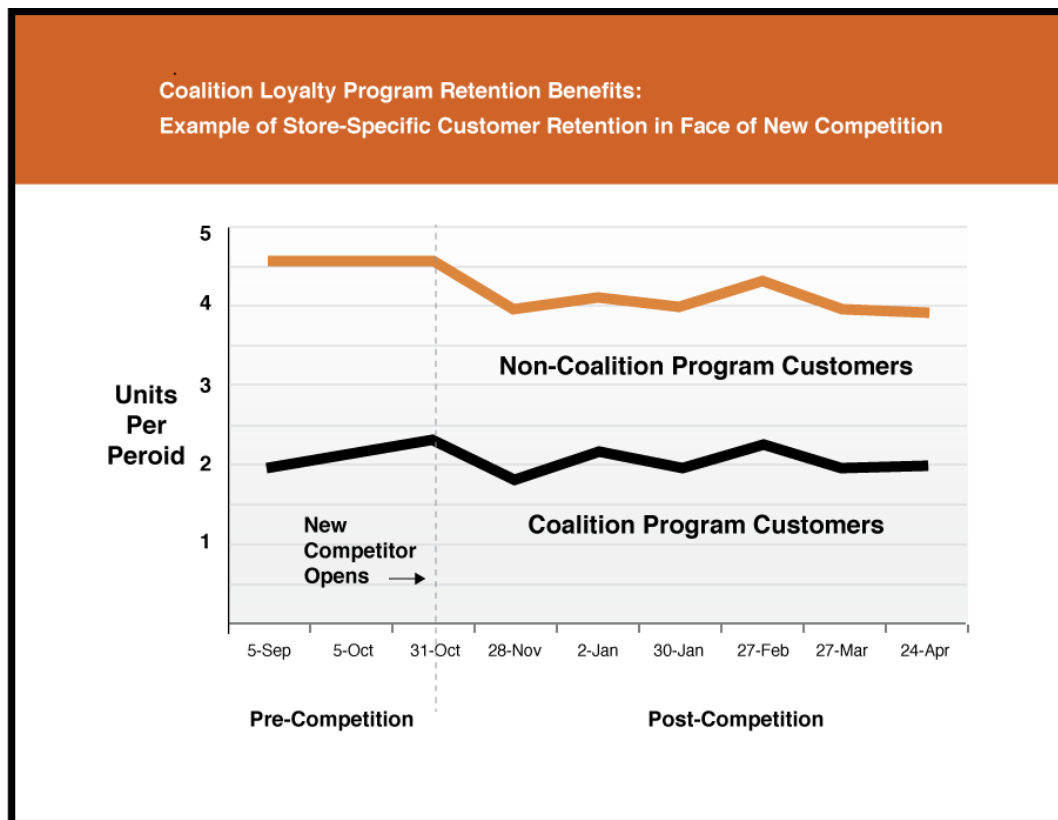
There are two situations when businesses typically face the highest risk of customer defections: (i) when a customer moves, and (ii)

when a new competitor enters the market. The coalition platform can help participating sponsors retain customers in both situations.

“Welcome Kit” for Movers: When a member of a coalition program moves their residence, coalition sponsors can automatically be informed of this move, and offer a targeted “welcome kit” that contains information about coalition sponsors’ located near the consumer’s new address and one-time promotions to entice the consumer to shop at these coalition sponsors.

Unique Promotional Platform to Defend Against New Competition: When a competitor opens up across the street, businesses typically lose customers – some temporarily, some permanently. A true test of a loyalty program is to see how many customers the business can retain in the face of aggressive new competition. The unique promotional platform of a coalition loyalty program generally helps participating sponsors retain more customers in the face of new competition.

Below are real-world results of a business that was participating in a coalition loyalty program and faced new competition. The chart shows how the business’ sales reacted when a new competitor entered the market among both the business’ customers who were coalition loyalty members and those customers who were not members of the coalition program.



The vertical line in the chart above indicates when the competitor opened its doors. You’ll notice that both groups of customers – coalition members and non-members – shopped at the new competitor, as seen by the dip in sales for both groups after the new competitor entered the market. However, the percentage of customers who were coalition program members who tried the new competitor’s store was significantly less than the non-coalition customers. More importantly, coalition customers quickly rebounded their spending to near the same level as before the competitor entered the market, while many customers who were not coalition members defected to this new competitor.

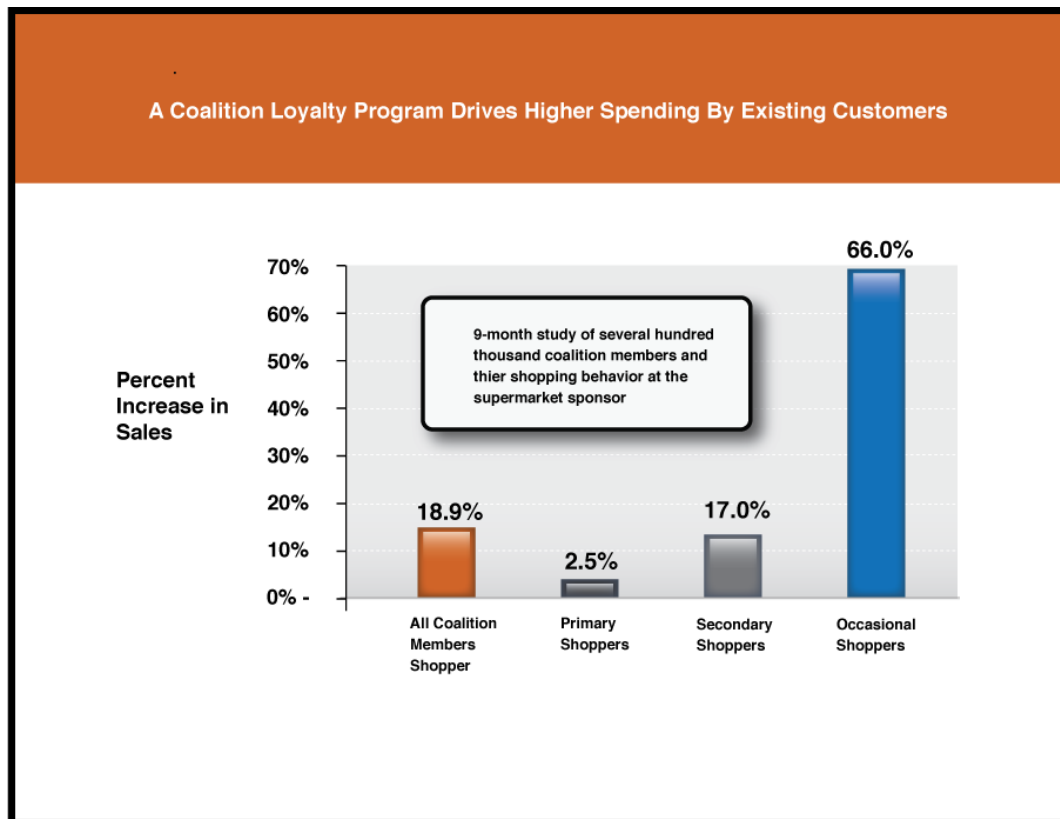
It should be noted that the retention impact illustrated in the example above happened *without any incremental promotional activity*. Driven by the motivating points-based currency and unique promotional platform of a coalition program, participating sponsors can actually enhance the retention effects in the face of new competition if they offer aggressive one-time promotions to coalition members around the time that the new competitor enters the market (e.g., “double points” week).

2) Increased profits as loyal customers spend more over time

Shoppers that are members of a coalition loyalty program are encouraged to increase spending at participating sponsors, often by consolidating their budgeted category spending, in order to earn more points toward frequent or longer-term, aspirational rewards.

Coalition sponsors can also incentivize customers to increase their spending by bonusing the purchase of larger baskets or more frequent visits (e.g., “100 bonus points for members who spend over \$100 per week”). These kinds of promotions can convert “occasional” or “secondary” shoppers to “primary” shoppers – e.g., customers buying most of their household’s grocery shopping at the supermarket sponsor.

The chart below presents actual results of a 9-month study of several hundred thousand members of a coalition loyalty program, analyzing how their shopping at the supermarket sponsor increased over the period. The coalition members were segmented by their frequency of shopping at the supermarket sponsor: “Primary shoppers” were defined as members spending at least 70% of the grocery category spending at the sponsor. “Secondary shoppers” were spending approximately 50% of their category spending at the supermarket sponsor, and “occasional shoppers” were spending less than 30% of grocery category spending at the sponsor. The results showed that **coalition members increased their spending at the supermarket sponsor by 18.9%**, with primary shoppers increasing spending by 2.5%, secondary shoppers by 17% and occasional shoppers by 66%.



3) Increased profits as loyal customers cost less to serve

Typically coalition loyalty program members shop more frequently at program sponsors, so their familiarity with the sponsor stores and related services allows them to become more efficient shoppers over time, and therefore cost less to serve. Coalition sponsors are also able to use the motivating points currency of the program to drive more cost effective behavior by customers.

For example, coalition sponsors can offer bonus points for switching to online billing, providing additional personal data (email address, phone number etc.) or for using the store’s mobile shopping app or self-checkout line. Just as the motivating coalition points currency generally drives greater behavior change in terms of members spending at sponsors than standalone programs, this unique promotional platform can result in greater behavior change in terms of driving desired lower cost customer actions.

Also, the unique points currency is often much cheaper to issue for the sponsor vs. the cash incentives they would have to offer to drive the same behavior change (e.g., the same customer response rate to sponsor’s offer of 100 points to provide an updated email address – costing the sponsor around \$1 – may be the same or often times *better* than the response rate to a \$3-4 cash offer for their email address).

4) Increased profits as loyal customers purchase higher margin products

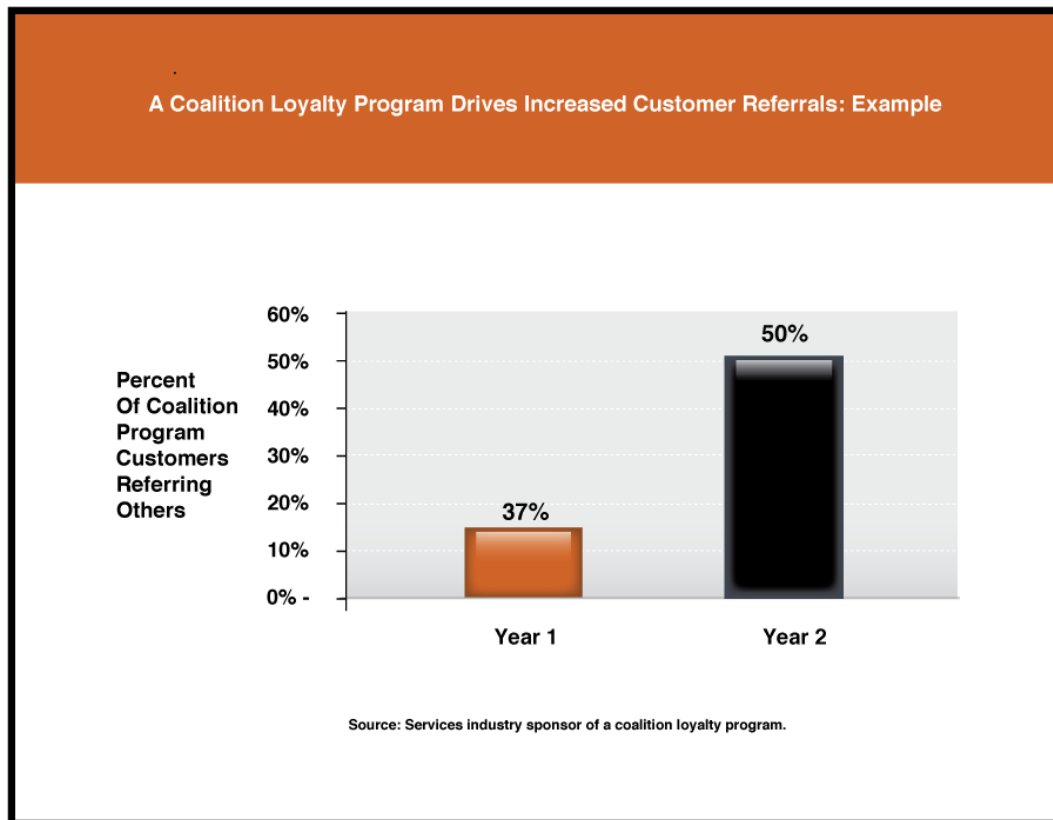
Coalition loyalty program members generally purchase a more profitable mix of products over time. Coalition sponsors can offer bonus points on higher margin products and services to motivate customers to spend more on these items. For example, gas station sponsors have been very successful in offering bonus points to drive increased spending on premium gas (e.g., double points with a minimum purchase of \$30 on premium 93-octane gas).

Again, these coalition points-based promotions on higher margin items can be a less costly way for coalition retailers such as gas stations to drive meaningful behavior change vs. cash roll-back incentives. Any gas retailer can offer cash roll-back offers, for instance, but only the coalition gas sponsor can offer uniquely motivating points on its high margin premium products.

5) Increased profits as loyal customers refer others to your business

The unique value proposition of a coalition program often creates very satisfied members. These coalition members frequently become “net promoters” of the coalition loyalty program, referring other consumers to join.

The chart below presents representative results for a services industry sponsor of a coalition loyalty program. It shows how the number of customer referrals increased dramatically over the first two years it participated in the coalition loyalty program.



Participating sponsors in coalition programs can also enhance these results by offering specific “member-get-member” promotions (e.g., “200 points for signing up your friend”).

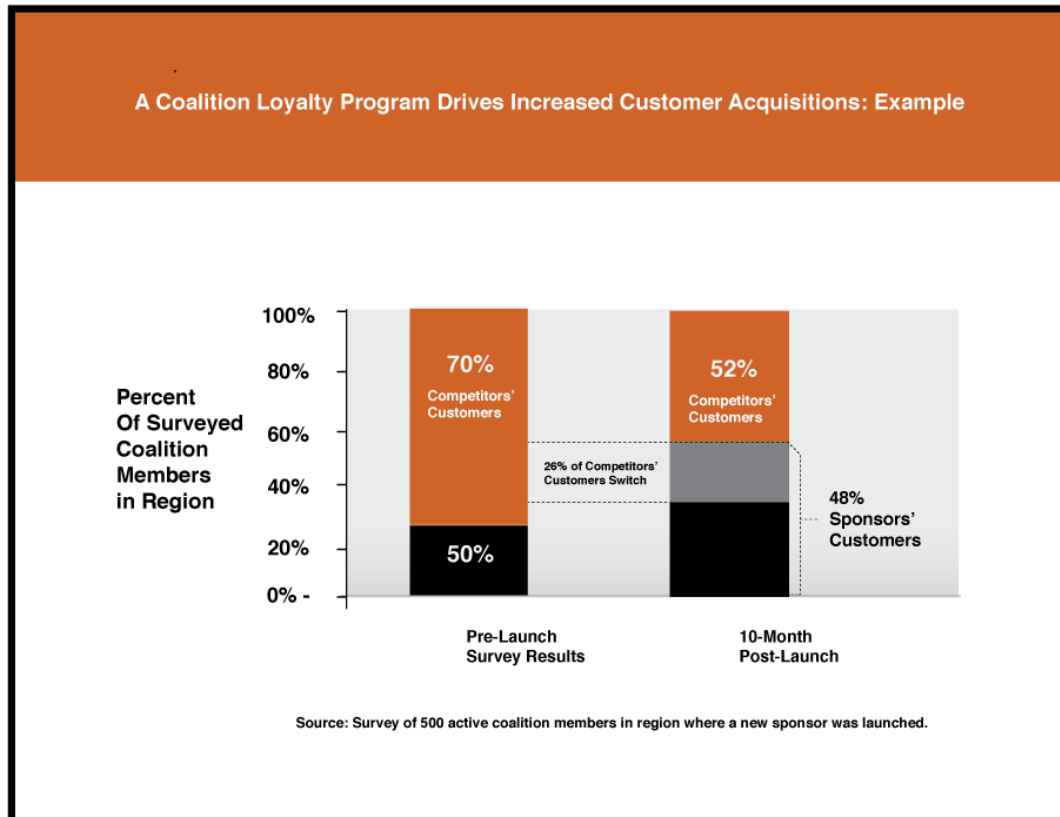
6) Increased profits from cost effectively acquiring customers by other means

One key advantage of a coalition loyalty program is its ability to attract new customers. Because there are many non-competing businesses that participate in the coalition program (unlike standalone programs), sponsors have the opportunity to convert non-customers who are members of the coalition program into new customers. Sponsors can use the coalition member database to target non-customers in their trade area with points-based offers to encourage coalition program members to start shopping there. For instance, a supermarket sponsor could target (on a no-names basis) coalition member households of 5 or more family members, within 3-5 miles of a store, who don’t currently shop at the store.

Simply promoting that the business is a coalition program sponsor can motivate many consumers to try shopping there. Coalition programs usually launch with “ubiquitous” in-store advertising, and maintain a strong marketing presence in terms of program signage at

many retailer partners all in the same region. Coalition marketing, which drives millions of impressions at non-competing sponsors, can create massive consumer awareness of the coalition program, the program's benefits and a particular business' participation in the program.

Below are the results of a coalition program case study whereby 500 active program members were surveyed in a region prior to a new sponsor joining the program. The research showed that, pre-launch, 70% of members had not shopped at this sponsor in the past year. Ten months after the sponsor joined the coalition program, 26% of these consumers who were shopping at competitors had switched at least some of their shopping to the sponsor.



In addition, new customer acquisition is often much cheaper in a coalition program vs. standalone acquisition marketing efforts, driven by: (i) lower coalition direct mail / email costs per thousand vs. standalone direct marketing costs, because coalition marketing expense is spread across many sponsors; (ii) higher consumer response rates to direct marketing offers from a coalition program, as coalition members have self-identified and often seek out offers from coalition sponsors; and finally (iii) points-based offers are typically more efficient than cash / discount based offers.

Coalition Loyalty Program Economics

Now that we understand how a coalition program can enhance the benefits of customer loyalty, let's return to our loyalty program economic framework.

The two key impacts to our loyalty program economic model from the coalition model are: (1) a coalition program is almost always lower cost than a standalone program, and (2) the coalition model typically drives greater, more sustainable consumer behavior change because it has a unique value proposition that cannot be easily duplicated by competitors.

So, not only will a lower cost coalition loyalty program reduce the required behavior change needed to drive an attractive ROI, but typically the actual behavior change that is driven by the coalition model is much stronger than a standalone program per dollar of investment in rewarding customers. All of this leads to a ***dramatically higher profit potential for a coalition program.***

As an illustration of the impact of a lower cost coalition program, below are the required "retention", "lift" and "shift" metrics needed to drive a 15% ROI for a coalition program vs. the standalone program for Fresh Foods as previously described in Part 2 of this document. Note: we assume that the coalition program costs the retailer 1.0% of sales vs. the standalone program's cost of 1.5% of

sales.

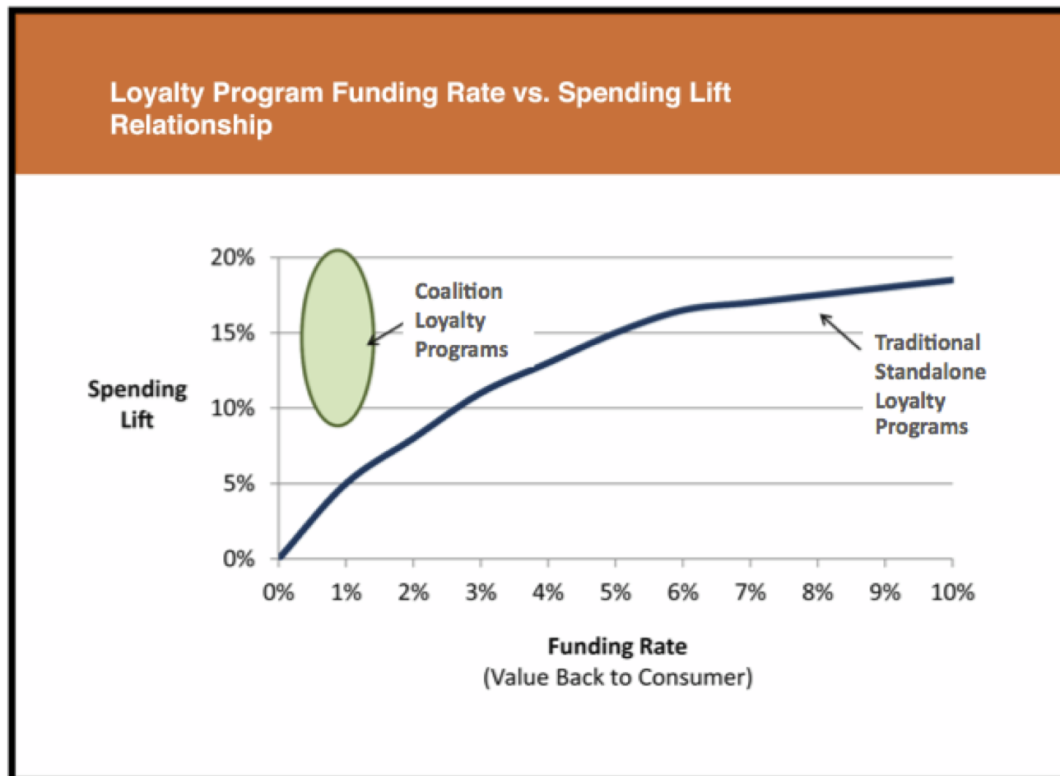
Coalition Loyalty Program vs. Standalone Program Illustrative Comparison: Consumer Behavior Change Required to Drive a 15% ROI for Fresh Foods			
Loyalty Program:		Coalition Loyalty Program	Standalone Loyalty Program
Estimated Cost of Sales:		1.0%	1.5%
Required Behavior Change To Achieve 15% ROI	"Retention Only" % increase in customer retention, y-o-y	+10.7% (From 75.0% to 85.7%)	+16.5% (From 75.0% to 91.5%)
	"Lift Only" overall % sales lift from current customers	+6.1%	+9.4%
	"Shift Only" % of competitors' customers shifting spend (\$30 / week)	+5.0%	+7.7%

SLI research results and actual coalition program results compare very favorably to all of these required behavior change metrics needed for the program to be sufficiently profitable. Below is a summary comparison of the required behavior change needed to achieve 15% ROIs with the anticipated behavior change reported by U.S. consumers in SLI's Quantitative Research results (10,400 surveys) and actual Coalition Loyalty Program results.

Coalition Loyalty Program – Consumer Behavior Change Required to Drive a 15% ROI for a Supermarket vs. SLI Research Results vs. Actual CLP Experience			
	Coalition Loyalty Program w/ 1% Cost of Sales: Behavior Change to Achieve 15% ROI	SLI Quantitative Research Results**	Actual Previous Coalition Program Experience
"Retention" % increase in customer retention, y-o-y	+10.7%* (from 75.0% to 85.7%)	N/A	~10%+
"Lift" overall % sales lift from current customers	+6.1%*	+15 – 30%	~10%+
"Shift" % of competitors' customers shifting spend (\$30 / week)	+5.0%*	+13 – 30%	~5 – 10%+
<p>*Represent "Retention Only", "Lift Only" and "Shift Only" metrics required to achieve a loyalty program ROI of 15%.</p> <p>**Based on select data from SLI's 10,400 surveys with U.S. shoppers. Percentages for "lift" and "shift" represent likely program joiners who indicated "9-10" (out of a 10-point scale) in terms of their likelihood to increase their spending at a coalition grocery sponsor (where 10 = extremely likely).</p>			

Conclusion

A coalition loyalty program is typically much lower cost than a standalone program *and* drives much greater behavior change, increased customer sales and an attractive return on investment. The unique value proposition of a coalition loyalty program effectively breaks out of the generally accepted relationship between \$ value back provided to the consumer in a loyalty program (or "funding rate") and the resultant customer spending lift. The chart below illustrates how coalition programs can deliver far more "bang for the buck" for participating retailers.



For retailers that are looking to truly “move the needle” in terms of customer loyalty, and set themselves apart from the “me too” rewards programs that currently proliferate the U.S. retail market, a coalition program can provide a key point of differentiation and unique customer value proposition that can drive a tremendous impact on profits. As described in this document, all of the “loyalty math” supports pursuing this strategy for creating sustainable value. And SLI’s detailed quantitative research with over 10,000 U.S. households demonstrates that American consumers will increase their loyalty to those companies bold enough to take the “coalition loyalty leap.”

This leap to join a breakthrough coalition program in the U.S. will require bold, visionary leaders, much like the executives who immediately saw the coalition loyalty opportunity that was presented to them in the AIR MILES Canada program in 1992.

“Twenty minutes into the presentation I knew it was the biggest thing ever...It’s a leap of faith but ... we have to go in big ... You snooze—you lose.”

– **Gerry Geoffrey, Chief Financial Officer, Canada Safeway**

(Two weeks later his AIR MILES customers had doubled their average spend at Safeway.)

“About an hour into the meeting, I stopped them and went to talk to our Vice Chairman. I told him, ‘I’d like to hang onto these guys. We need to set up a standstill arrangement so they won’t go talk to another bank’. That’s how excited we were about the program.”

– **Jim Brophy, VP Electronic Banking, Bank of Montreal**

These bold business leaders in Canada, much like the leaders who have joined similar coalitions around the world, were rewarded with extraordinary increases in sales and profits as a result of joining this pioneering coalition program.

“It grew at a rapid pace—way, way beyond our expectations. I would think it was the fastest growth in Cardmembers for any AmEx product in the world. And most of those were brand-new Cardmembers.”

– **Alan Stark, Former President, American Express Canada**

“We saw our market share increase by two full points in the first year. That is huge. Nothing we’d ever done had produced

that kind of marketing lift for the company.”

- Terry Plomske, Senior Marketing Executive, Shell Canada

We firmly believe that this same enormous potential now exists in the U.S. market for those brave enough to take “the coalition loyalty leap”.

Appendix

Exhibit A1: Super Foods’ Reduced Cost to Serve Illustrative Customer “Connie”

	Year 1	Year 2	Year 3	Year 4	Year 5	Total
Connie's Spend Per Week	\$ 80	\$ 100	\$ 110	\$ 110	\$ 110	
Weeks Per Year	50	50	50	50	50	
Total Spend Per Year	\$ 4,000	\$ 5,000	\$ 5,500	\$ 5,500	\$ 5,500	
% Reduction in Transaction Costs	0.00%	1.00%	1.00%	1.00%	1.00%	
Total Cost Reduction from Reduced Transaction Costs	-	\$ 50	\$ 55	\$ 55	\$ 55	\$ 215
Fewer Checkout Personnel	-	5	5	5	5	
Annual Cost Per Checkout Person	\$ 30,000	\$ 30,000	\$ 30,000	\$ 30,000	\$ 30,000	
Total Annual Savings from Reduced Personnel	\$ -	\$ 150,000	\$ 150,000	\$ 150,000	\$ 150,000	
Divided by: Active Customers Using App Per Store	10,000	10,000	10,000	10,000	10,000	
Total Cost Reduction Per Customer	-	\$ 15	\$ 15	\$ 15	\$ 15	\$ 60
Total Annual Cost Reduction Per Customer	-	\$ 65	\$ 70	\$ 70	\$ 70	\$ 275

Exhibit A2: “Retention Only” Loyalty Program Economics Example - Detailed Calculations

	Input or Calculation	Metric	Notes
Pre-Program	A. Avg. Annual Spend Per Current Customer	\$1,500	Assume \$30 wkly spend x 50 wks
	B. Total Customers, Beginning of Year	20,000	
	C. Annual Retention Rate (Pre-Program)	75.0%	
	D. Est. Total Customers, End of Year	15,000	B x C
	E. Est. Avg. Customers Over Full Year	17,500	(B + D) / 2
Post-Program	F. Annual Retention Rate (Post-Program)	91.5%	“Goal seek” this value in excel
	G. Est. Total Customers End of Year	18,304	B x F
	H. Average No. of Customers Over Full Year	19,152	(B + G) / 2
	I. Increase in Avg. Customers Retained	1,652	H – E
	J. Increase in Annual Sales from Retained Customers	\$2,477,700	A x I
	K. Gross Margin (%)	20.0%	Fresh Foods’ assumed gross margin
	L. Gross Margin Impact from Increased Retention	\$495,540	J x K
	M. Total Annual Sales (Post-Program)	\$28,727,700	A x H
	N. Cost of Rewards (% of Sales)	1.5%	
	O. Total Cost of Rewards	\$430,916	M x N
	P. Total Profit Contribution from Loyalty Program	\$64,624	L – O
	Q. Return on Investment (“ROI”)	15.0%	P / O

Exhibit A3: “Lift Only” Loyalty Program Economics Example - Detailed Calculations

	Input or Calculation	Metric	Notes
Pre-Program	A. Avg. Annual Spend Per Current Customer	\$1,500	Assume \$30 wkly spend x 50 wks
	B. Est. Avg. Customers Over Full Year	17,500	
	C. Total Annual Sales (Pre-Program)	\$26,250,000	A x B
Post-Program	D. Increase in Avg. Spend by Current Customers (“Lift”)	9.44%	“Goal seek” this value in excel
	E. Total Annual Sales (Post-Program)	\$28,728,000	A x (1 + D)
	F. Increase in Annual Sales	\$2,478,000	E - C
	G. Gross Margin (%)	20%	Fresh Foods’ assumed gross margin
	H. Gross Margin Impact from Lift	\$495,600	F x G
	I. Cost of Rewards (% of Sales)	1.5%	
	J. Total Cost of Rewards	\$430,920	E x I
	K. Total Profit Contribution from Loyalty Program	\$64,680	H – J
	L. Q. Return on Investment (“ROI”)	15.0%	K / J

Exhibit A4: "Lifters vs. Non-Lifters and Dilution" Loyalty Program Economics Example – Detailed Calculations			
	Input or Calculation	Metric	Notes
Pre-Program	A. Avg. Annual Spend Per Current Customer	\$1,500	Assume \$30 wkly spend x 50 wks
	B. Est. Avg. Customers Over Full Year	17,500	
	C. Total Annual Sales (Pre-Program)	\$26,250,000	A x B
Post-Program	D. Percent of Current Customers Lifting Spend ("Lifters")	28.3%	"Goal seek" this value in excel
	E. Total Avg. No. of Lifters	4,954	B x D
	F. Increase in Annual Spend Per Lifter	\$500	Assume \$10 lift per wk x 50 wks
	G. Total Increase in Sales from Lifters	\$2,477,825	E x F
	H. Gross Margin (%)	20%	Fresh Foods' assumed gross margin
	I. Gross Margin Impact from Lifters	\$495,565	G x H
	J. Total Sales (Post-Program)	\$28,727,825	C + G
	K. Cost of Rewards (% of Sales)	1.5%	
	L. Total Cost of Rewards	\$430,917	J x K
	M. Total Profit Contribution from Loyalty Program	\$64,648	I – L
	N. Return on Investment ("ROI")	15.0%	M / L
	O. Percent of Customers Not Lifting Spend ("Non Lifters")	71.7%	1 - D
	P. Annual Sales to Non Lifters	\$18,816,525	O x C
	Q. Cost of Rewards to Non Lifters ("Dilution")	\$282,248	K x P

Exhibit A5: "Shift Only" Loyalty Program Economics Example – Detailed Calculations			
	Input or Calculation	Metric	Notes
Pre-Program	A. Avg. Annual Spend Per Current Customer	\$1,500	Assume \$30 wkly spend x 50 wks
	B. Est. Avg. Customers Over Full Year	17,500	
	C. Total Annual Sales (Pre-Program)	\$26,250,000	A x B
	D. Assumed Avg. Coverage Market Share in "Catchment Area"	45.0%	
	E. Total Consumers in "Catchment Area"	38,889	B / D
	F. Competitors' Customers in "Catchment Area"	21,389	E - B
Post-Program	G. % of Competitors' Customers Shifting to Fresh Foods	7.72%	"Goal seek" this value in excel
	H. Competitors' Customers Shifting to FF ("Shifters")	1,652	F x G
	I. Annual Spend per Shifter	\$1,500	Assume \$30 wkly spend x 50 wks
	J. Total Annual Sales from Shifters	\$2,477,796	H x I
	K. Gross Margin (%)	20%	Fresh Foods' assumed gross margin
	L. Gross Margin Impact from Shift	\$495,559	J x K
	M. Total Annual Sales (Post-Program)	\$28,727,796	E x I
	N. Cost of Rewards (% of Sales)	1.5%	
	O. Total Cost of Rewards	\$430,917	M x N
	P. Total Profit Contribution from Loyalty Program	\$64,642	H – J
	Q. Return on Investment ("ROI")	15.0%	P / O
	R. Total Avg. Customers (Post-Program)	19,152	B + H
	S. Coverage Market Share in "Catchment Area" (Post-Program)	49.2%	R / E

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[i] Theodore Levitt, *The Marketing Imagination*, Free Press, 1983

[ii] W. Earl Sasser and Frederick Reichheld, "Zero Defections: Quality Comes to Services", *Harvard Business Review*, September 1990

[iii] Primary grocery store defection rate estimates from various sources, including:

- **20-25%** - Robert East, Patricia Harris, Wendy Lomax, Gill Willson, Kathy Hammond, "Customer Defection From Supermarkets", *NA – Advances in Consumer Research Volume 25*, eds. Joseph W. Alba & J. Wesley Hutchinson, Provo, UT : Association for Consumer Research, 1998
- **33%** - "Wegmans, Trader Joe's, Publix & Fareway Top Consumer Reports Supermarket Ratings", *Consumer Reports*, April 3, 2012; Survey of 24,203 supermarket shoppers
- **25-50%** - "All Customers Are Not Created Equal", *Progressive Grocer*, April 1, 1994; Survey of 83 food retailers for the Coca Cola Retailing Research Council, conducted by consultant Brian Woolf.

[iv] "Wegmans, Trader Joe's, Publix & Fareway Top Consumer Reports Supermarket Ratings", *Consumer Reports*, April 3, 2012; Survey of 24,203 supermarket shoppers

[v] SLI Quantitative Research: 20-minute online surveys with 10,400 primary grocery shoppers in 8 U.S. markets: Boston, Chicago, Columbus (OH), Detroit, Knoxville (TN), Minneapolis, Philadelphia, and St. Louis. Conducted in May 2011 and May 2012. Online surveys were conducted by SocialSphere Inc. and Research Now.

[\[vi\]](#) *COLLOQUY Loyalty Census, 2007-2013. COLLOQUYtalk* loyalty industry publication, published by LoyaltyOne US, Inc., a division of Alliance Data Systems Corporation.

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