How Today’s Leaders Build Lasting Relationships

LOYALTY RULES!

THE SUMMARY IN BRIEF

Loyalty, the key to success in today’s economy? Be serious! What relevance could such a quaint, old-fashioned notion hold for a world in which customers defect at the click of a mouse and impersonal shopping bots scour databases for even better deals? What good is a small-town virtue amid the faceless anonymity of the Internet’s global marketplace? Loyalty must be on the fast track toward extinction, right?

Wrong.

Far from being dead, loyalty is at the heart of every company that boasts high productivity, solid profits and sustained growth. For example, Harley Davidson recovered from near bankruptcy by building loyal relationships with all stakeholders. And Southwest Airlines, which has never had a layoff, is the only consistently profitable major airline in the United States every year since 1973.

According to author Frederick F. Reichheld — who wrote the bestseller The Loyalty Effect — the acid test of leadership is the ability to build strong bonds of loyalty in an age when leaders too often confuse profits with purpose, taking the low road to short-term gains at the expense of employees, customers and ultimately, investors.

This summary will show you how to become a loyalty leader — a leader who can transform customer, employee and investor loyalty into a sustainable economic advantage for his or her company. The key is a commitment to what Reichheld calls the six principles of loyalty:

1. Play to win/win.
2. Be picky.
4. Reward the right results.
5. Listen hard, talk straight.

The following pages explore in detail each of these six principles, thus creating a step-by-step handbook on building profit-making loyalty in any company.

By Frederick F. Reichheld
Leadership Integrity Key to Employee, Customer Loyalty

We may be in the e-commerce age, but customer loyalty matters more than ever. With the high cost of acquiring customers on the Internet, e-commerce companies can’t afford to lose them. Without the glue of loyalty, even the best designed e-business model will collapse.

It’s the same for employee and supplier loyalty. Companies can’t afford high turnover rates. Customer loyalty hinges, as it always has, on committed teams of high-caliber employees and suppliers, which in turn require a core of owners committed to building an enduringly successful enterprise.

The challenge of building loyalty has become the acid test of leadership. It’s the test most leaders are flunking. Yet the long-term rewards of loyalty ultimately outstrip even the most spectacular short-term profits.

The Six Loyalty Principles

Benchmark scores from top companies reveal that the center of gravity for business loyalty is the personal integrity of the senior leadership team and its ability to put its principles into practice. Timeless principles of integrity, such as truth, fairness and responsibility, create the gravitational core for organizational loyalty.

Specifically, loyalty leaders such as Rich Teerlink of Harley Davidson and Michael Dell of Dell Computer share an unbending commitment to six loyalty principles:

1. **Play to win/win.** Profit at the expense of partners is a shortcut to a dead end.
2. **Be picky.** Membership is a privilege.
3. **Keep it simple.** Complexity is the enemy of speed and responsiveness.
4. **Reward the right results.** Worthy partners deserve worthy goals.
5. **Listen hard, talk straight.** Long-term relationships require honest, two-way communications and learning.
6. **Preach what you practice.** Actions often speak louder than words, but together they are unbeatable.

The Loyalty Acid Test

You must measure loyalty as carefully as you measure profits. Satisfaction metrics are a good start, but you can’t stop there. Better than satisfaction scores are customer and employee retention rates — real behaviors with real consequences. But even retention rates don’t tell the whole story. To get the whole story, you can use the Loyalty Acid Test Survey, which is a relationship report card specifically designed to help leaders evaluate and strengthen key relationships.

The Loyalty Acid Test is designed to prioritize your challenges and create an effective game plan for maximizing the loyalty of your business partners. Visit www.loyaltyrules.com for more information.

The Enterprise Rent-a-Car Story

Loyalty leaders have built loyalty through their personal integrity, superior business strategies and masterful implementation of the six principles of loyalty. Andy Taylor of Enterprise Rent-A-Car is one example.

When Taylor took over the company his father had started 16 years earlier, he had no idea he was on a road that would lead to the top of the car rental industry. It is his father’s philosophy that guides him: “Put customers first and employees second, and the rest will take care of itself.” Through this formula of service to others, Taylor has built the most loyal group of employees and customers in the industry and turned the car rental industry on its ear. Today, Enterprise is the largest car rental company in North America.

How did it achieve this position? First, by providing

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Leadership Integrity Key to Employee, Customer Loyalty

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prices 20 percent below the norm, giving door-to-door service, and paying managers far more than the competition. Somehow, profits have taken care of themselves.

A decentralized organization also helped. About 90 percent of the U.S. population lives within 15 miles of an Enterprise branch. These branches provide small, stable teams who are responsive, flexible and accountable. Each branch has free reign to make decisions affecting their customers. Though company owned, each unit is a separate profit center, structured to operate as an independent entrepreneurial business.

Enterprise’s compensation structure shows that the company focuses on employee loyalty as well as customer loyalty. Pay starts at $25,000 to $30,000, but can reach $200,000 within ten years of college graduation. The company has no limit on the number of managers who can earn top salaries, and officers in the company receive a base salary of about $35,000 and a portion of the profits earned by all the branches in his or her territory. The end result is a talented group of employees and satisfied customers.

Principle 1: Play to Win/Win

Loyalty isn’t about frequent-flier miles. It is about earning people’s enthusiastic commitment to a relationship that will improve their lives over the long term. When partners trust that you have the capability and commitment to help build their success, they will commit to doing the same for you, and profits will soar. But they must see more than good intentions; they must see a rational strategy for creating superior economics.

Every loyalty leader you will be introduced to in this summary understands that basic premise, and has built structural economic advantages through focused competitive strategies grounded in a thorough understanding of industry economics, customer segmentation and competitor capabilities. They have extended their advantage by ensuring that all partners understand the strategy and their role in making it happen. When partners are convinced that the strategy can create superior value to the ultimate customer, and trust that the leaders will follow high-road principles and work hard to assure each partner succeeds and is rewarded fairly, then they can concentrate their full energies on the most essential goal — delivering customer value.

More Than Profits

An unrelenting focus on customer value provides both economic and ethical superiority. This focus creates a win/win strategy in which the entire chain of relationships with employees, dealers, vendors and investors creates superior value for the ultimate customer. Only the continuous creation of customer value can fund the aspirations of a worthy organization and its network of partners.

If you want to deliver superior customer value, you must refuse to be satisfied. Only by helping partners...
Principle 1: Play to Win/Win
(continued from page 3)

reach for the stars — by targeting customer value that is better than the best — can a leader ensure that the organization will stay on the high road to success.

As an aspiring loyalty leader, you must work hard on the continuous improvement of cost and quality in your organization. But even the achievement of Six Sigma standards of excellence does not allow you to ease up on the throttle. To ensure that your organization continues to set the standards of excellence, you must focus on the basics of cost, quality and timeliness and on discovering new levels of excellence.

Play Where You Can Win

Committing to a win/win strategy cranks up the pressure to create truly superior economic opportunity for your organization and your partners. You cannot afford to waste time and energy with businesses and customers with which you don’t have a legitimate opportunity to be the very best. You must have the discipline to play only where you can win.

Here’s how:

● Get rid of distractions.
  Don’t struggle to improve business lines that cannot realistically be expected to deliver the best customer value and that have little strategic importance to the core of the company.

● Beware of the Rotting Core.
  In your attempt to pare away distractions, remember that they don’t always come from new ventures. Sometimes, the distraction you need to excise is what was once the core business.

● Be Wary of Wall Street Wisdom.
  Some of the most lethal distractions that suck leadership time and energy away from core priorities are provided by the constant flow of advice from Wall Street. Investors have a legitimate demand for outstanding financial results, but leaders who bow to investor advice on how to achieve them and allow themselves to be distracted from their tried-and-true strategy do so at their own risk.

● Grow From Positions of Strength.
  Your company must maintain a winning level of growth to attract and retain outstanding partners. The source of growth preferred by loyalty leaders is from deepening relationships with existing customers and from developing concentrated positions of strength rather than from spreading resources too thinly.

  A second way to growth is to acquire additional customers that belong to the same segment as the firm’s existing book of business.

How Dell Got Rid Of A Distraction

In 1994, Dell Computers was selling computers directly to customers as it had since the beginning, but had also established relationships with giant retailers like Circuit City and CompUSA. But after four years of effort, the Dell team couldn’t find a way to make sales through retailers profitable. Worse, surveys showed that customers who bought Dell computers through retailers weren’t as satisfied as those who bought direct. Not only weren’t any profits being generated through the retailers, but the retail sales were actually harming the Dell brand. The answer was to concentrate on the original direct sales model and exit the retailer channel.

Principle 2: Be Picky, Membership Is a Privilege

Nothing speaks more clearly about your values and principles than your choice of associates and who you promote to positions of authority. When it comes to running a business worthy of loyalty, not all employees, customers, suppliers and vendors are equally worthy of membership on your team. Loyalty leaders will be the first to admit that they discriminate — not on the basis of race, religion or gender, but on the basis of character, capability and performance. They know it would be unfair and absurd to treat unprofitable customers the same as a highly profitable and loyal ones.

Loyalty leaders are especially concerned about who is invited to join the team. With so many hours devoted to the workplace today, success and happiness can result only when these hours are shared by people with the capacity to create financial results and the character to treat each other right in the process.

Picking Your Employees

Loyalty leaders list employee recruiting and selection among their most vital functions. They know that their employees are ambassadors to the outside world. Employee behaviors and attitudes communicate most directly to customers and suppliers just what the company stands for.

A high degree of initial selectivity lets leaders invest aggressively in each person’s success. They can stick with employees much longer than less selective organizations can. Turnover rates will be minimal in companies that get the selection process right.

An example of the benefits of careful employee selec-
Principle 2: Be Picky, Membership Is a Privilege
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The success of Chick-Fil-A, the loyalty leader in quick-service restaurants.

Much of Chick-Fil-A’s success results from the company’s ability to be pickier than the competition, especially for the store operator position. Candidates for this position include graduates of West Point and Annapolis as well as management alumni from talent troves such as Accenture — credentials unheard of elsewhere in the fast-food industry.

The company can attract and retain outstanding talent because it offers a uniquely attractive entrepreneurial opportunity to earn as much as $200,000 to $300,000 with no more equity investment than an up-front $5,000 franchise fee. Its superior operating pool then allows the company to attract a higher-quality part-time workforce. The company targets high-end high school students, and offers them scholarships as well as excellent training.

Don’t delegate employee selection more than absolutely necessary. Loyalty leaders are involved in this crucial aspect of leadership. For example, at Home Depot, which hires 75,000 workers every year, some delegation had to take place. But leaders worked hard to assure that prospective employees are carefully screened for values and cultural compatibility. Every store has a computer kiosk that includes a screening test for core values important for success as a Home Depot employee.

Be picky about employees’ initial experience. The first 40 hours of on-the-job experience make an indelible cultural imprint on employees. It frames their understanding of the company and its business. For this reason, loyalty leaders devote enormous attention to those hours. Most senior executives in high-loyalty firms find the time to get involved personally in employee orientation and training.

Be picky about who stays and who is promoted. When you hire carefully and then invest heavily in your recruits’ development and initial career experiences, you can reasonably demand superior performance. Set “stretch goals.” Many loyalty leaders have raised performance standards and created up-or-out career paths that make it difficult for executives to coast or become complacent. High-performance cultures cannot tolerate mediocrity.

Select Your Customers With Care

Being picky about customers may be a foreign concept for many companies, but it shouldn’t be. Loyalty leaders are very picky about targeting only the right customers — those for whom their firms have been engineered to deliver truly special value. If you want to maximize sustainable growth and profits, focus on the right customers. Every customer acquisition involves an up-front investment that will be paid back only if the customer’s loyalty is earned. Attracting the wrong customer will result in costly churn, diminished reputation and unhappy employees.

Pick customers carefully for faster growth. Ironically, by focusing on selectivity and discrimination rather than on unbridled customer acquisition, high-loyalty firms are growing into market leaders. Consider the example of The Vanguard Group, which is on track to become the largest mutual fund family in the world. The company wants loyal, long-term investors and scrutinized redemptions to assure that it is attracting those who aren’t inclined to short-term investments.

Pick the right customers to reduce costs. For example, Dell Computer focuses on repeat customers rather than new computer users, because experienced users don’t drain support and service assets the way new computer owners do. Dell narrowed its customer segment by focusing on the Internet as its primary consumer channel. Since only customers who already had a computer could get online, they were most likely experienced users and the least expensive to service.

Don’t lure butterflies, collect barnacles. Unless you’re managing customer acquisitions carefully, you’re probably letting the wrong ones in the door. Marketing and sales departments often invest in lures to catch butterflies when they should be searching for barnacles. Consider the menagerie of prospective customers in your industry. Then consider who is the ideal match for the superior, long-term value your company can deliver. These are the customers who are likely to stick around for a lifetime if they are treated right. These are the barnacles. The butterflies tend to flit to today’s sweetest deal.

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Incentives aimed at attracting high volumes of new customers, such as price breaks and advertising campaigns that stress the latest fad, are sure to yield an inflow of butterflies. Unfortunately, butterflies aren’t very loyal, and their lifetime value is likely to be the lowest, and may even be negative!

**Don’t reward volume alone.** Don’t reward an employee for mere volumes of new customers. Loyalty leaders create incentives for growth in profits and cash generation, not for new account volume.

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**Principle 3: Keep It Simple**

Complexity is the enemy of speed and flexibility. Like it or not, the world today runs at Internet speed. Companies must have the capacity for rapid learning and rapid response. The link between loyalty and your capacity for speed and adaptability may not be apparent to everyone in your organization. You must convince them that the past will never be as good as the future. Great leaders know that the best business is so reliable and so adaptable that it does the best possible job in the fastest and simplest way. So to be an effective leader, you must resist the world’s inevitable drift towards complexity by simplifying your organization.

**Simple rules are golden.** Almost nothing reduces complexity and slows organizational progress as severely as uncertainty and confusion about core values and operating principles. Loyalty to a clear and simple set of principles is the basis for flexibility and speed.

**Treat them right.** Some years ago, a father tried to purchase life insurance on his infant daughter. The company’s agent submitted the application with the premium, but the baby’s doctor was slow to send the necessary medical records. Finally, after weeks of prodding for the records, the company decided not to issue the policy, and called the father to explain. He told them it was too late, since his daughter had died from sudden infant death syndrome that morning. The insurer decided that if the medical records would have allowed the policy to issue, it would do so. When the records revealed a healthy baby, the policy was issued, and the policy paid. It was the right thing to do, and one of the reasons the insurer is a leader.

**Keep score keeping stable and simple.** If you want your partners to act according to simple rules, you must help them track their progress. Keeping score is one of a leader’s most powerful tools for clarifying the rules and focusing the energies of his or her people. Avoid changing the rules. For example, Chick-Fil-A has kept the same simple pay formula since 1967. Operators earn a base salary, which is updated to account for inflation, and 50 percent of the store’s net profits. Even though that means there are operators earning substantial sums, the result is operators who dig in and make their stores highly profitable.

**Simplify with small, flexible teams.** Loyalty comes naturally in a small town. People know each other and treat one another as neighbors might. Companies should think small if they want to recreate the small town feeling. Create small teams that work together to solve problems. Unfortunately, many growing companies let teams grow out of control rather than develop more small teams. **Teams of ten or fewer are the most effective.** Don’t be tempted to increase the span of control for supervisors. The cost of supervision may fall, but overall productivity will too.

**Simplify by outsourcing.** Outsource all functions for which you cannot deliver uniquely outstanding customer value to partners who can. Perhaps the best example of this principle at work is Dell Computers. Dell’s partner relationships with the best component suppliers saved the firm from having to pour precious capital and management resources into areas where Dell couldn’t create an outstanding customer value. The company also

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**Avoiding Butterfly Infestations**

You can avoid butterfly infestations by doing the following:

- Analyze a list of your long-term, loyal customers to determine what product or promotional campaign attracted them. Make these the priority marketing investments.
- Since barnacles are best attracted by referrals and not advertising, invest in referral programs and communications networks.
- Develop bundled packages that appeal to customers who want to consolidate their purchases with one supplier.
- Target customers who are interested in procuring services and parts from the same source as their original purchase.
- Be cautious with young customers; their frequent moves and changes in life situations make them fickle.
- Avoid price discounts to attract new customers; distribute free samples instead.
- Avoid business customers with high employee turnover and any consumers who move frequently.
- Avoid customers known to switch suppliers often.
 Principle 3: Keep It Simple
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outsources most of its service. It insists on accountabil-
ity, though. Every replaced component is sent to Dell for
analysis, and the reason for the part failure passed on to
the manufacturer who supplied the part.

Simplify by shooting high. Many loyalty leaders
split off small teams of talented young managers and
give them breathtaking challenges with short deadlines.
In fact, this strategy may be the single most important
step you can take to simplify company focus and create
rapid and flexible responses in your business.

At Intuit, for example, an engineer with no general
business experience and an MBA were tapped to build
the company’s online mortgage business into a force in
a little over a year. Their job was to build the business
from the ground up. They built Intuit into one of the
leading providers of online mortgages in a matter of
months.

When a small team accepts ownership of a sufficient-
ly challenging mission, a wonderful dynamic emerges.
Everyone stops worrying about who will get credit or
whether this is a good career move or whether the team
will get along. There is no time for petty squabbles.

Principle 4: Reward the
Right Results

Most companies are shooting themselves in both feet
with their reward systems. They pay on results that are
easy to measure rather than on the right results.
Incentives are misaligned, so individual interests trump
team goals. Worst of all, employees and customers
aren’t rewarded for loyalty. In fact, loyalty is often
penalized. High defection rates are the norm for star
performers while loyal employees are perceived as lazy,
satisfied with modest compensation and content to aim
far below their potential.

Zero-Sum Games

Most of today’s corporate reward systems are philo-
sophically antithetical to the principles and practices of
loyalty leaders. Most systems are designed to be rea-
sonable and to satisfy the board of directors or an out-
side auditor. But the problem is that loyalty isn’t gener-
ated by reasonable performance; it is generated by
overachievement — and this level of performance
requires outstanding teamwork by partners who trust
one another’s commitment to win/win results. Today’s
compensation systems rarely align partner interests;
they create zero-sum games in which one player can
win only at another’s expense.

Examine Your Own System

Are you measuring the right things? What you decide to
measure clearly reflects your values and your priorities.
You can talk all you want about creating value, building
loyal relationships and putting customers first, but if the
majority of your score-keeping efforts go into measuring
profits, then your customers and partners will get the
unspoken message. To show them that loyalty is at the top
of your leadership agenda, you must make sure your cen-
tral metrics gauge the value you are creating for partners
and customers.

Here’s how to measure what matters:

● Measure Retention — Carefully. The most accu-
rate gauge of whether your company is delivering the
best value to your customers is customer retention rates.
You must track them. At the New York Times, for exam-
ple, executives track retention on three separate seg-
ments: new subscribers (less than 12 months); middle-
aged subscribers (13 to 24 months); and mature sub-
scribers (longer than 24 months). For mature sub-
scribers, the retention rate is an astonishing 94 percent,
far higher than the closest competition at 80 percent or
the average at 60 percent. Using the figures, the compa-
ny is striving to create even more loyal readers and to
become better than the best.

● Build a Better Dashboard. Loyalty leaders must
customize the right kind of dashboard for steering their
company. Standard accounting metrics such as profits
must be supplemented with gauges that monitor the cre-
ation of partner value and customer value. Many com-
panies now have the technology to track customers very
well, sometimes down to what they purchased, how
often they buy and how profitable each one is. In some
industries, its easy to measure retention, but in others
it’s considerably harder. For example, car makers have
irregular purchase cycles, and fast food restaurants have
a hard time tracking individual purchases. Some gauges
to consider are those that consider lifetime ownership
costs as a measure of satisfaction and those that look at
service, product performance and order fulfillment.

● Align Incentives. Once you have designed the right
gauges for your dashboard, the next step is to make sure
the gauges correctly influence the route your organiza-
tion takes. For example, companies should beware of
paying workers based on profits alone, since that can
encourage workers to think only of short-term profits,
and not long-term ones. When Enterprise, the car rental
company, became concerned that branch managers were
boosting profits at the expense of quality customer serv-
vice, the company began surveying customers with a sim-
ple two-question survey designed to identify the likeli-
hood of the customer renting from the company again.

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Branch profit statements were then redefined so that customer response to the survey was reported along with the profit report. No employee is promoted if his or her branch is below the average in the customer survey.

- **Fix the Misalignments.** There are far too many examples of employee interests in conflict with customer interests. The car salesperson’s commission is based on how much he can gouge the customer, the stockbroker is paid whenever he churns the client’s holdings. These misalignments must be corrected.

- **Reach for the Stars.** Most reward systems today are too generous to mediocrity and far too stingy in rewarding superior performance. They set reasonable performance goals and define minimum levels of acceptable performance. Forget floors on performance, and get rid of ceilings. Pay rewards according to the real profits generated, not some arbitrary limit. Surround workers with others who want to put in a world-class performance, and they will all strive for gold. Home Depot takes this advice literally, employing more Olympic athletes than any other company. Other Home Depot associates benefit from being around dedicated world-class athletes.

- **Reward Loyal Customers.** Make sure all the partners who create the most value receive the most benefits. Don’t reward customer loyalty with abuse! A classic example of this can be observed in the cellular telephone business. Most experience enormous churn rates. Yet they abuse loyal customers by rewarding new ones with the latest technology and free minutes while not offering the same to existing customers. You should share economic advantages with loyal customers. For example, loyal, profitable State Farm customers are rewarded with price reductions every three or four years.

### Principle 5: Listen Hard, Talk Straight

The Internet is revolutionizing communications. The capacity to connect your operations with those of your customers and suppliers in a seamless web of digital communications can create enormous efficiencies and profit opportunities. But what we all need isn’t more communication; we need better communication.

Too many executives define great communicators as masters of spin. Nothing could be further from the truth. Loyalty leaders tell their partners what they need to hear, even if they don’t want to hear it. They want their partners to understand the company’s strategy, core principles, priorities and problems. They want them to know what performance expectations are and where each partner stands. Loyalty leaders expect the same from their partners.

If you want to build a business community of enduring relationships, you must help everyone in your firm’s network of relationships become more effective communicators. Everyone must:

- **Listen.** Good communication begins with listening.
- **Learn.** Once you listen, you must reflect and analyze so that you learn.
- **Act.** After listening and learning, its time for action.
- **Explain.** Once you act, explain why you are doing what you are doing.

### Principle 6: Preach What You Practice

Each of us is preaching a sermon with our lives. If building loyalty is to become a central theme of your sermon, then you had better brush up on your preaching skills. You can’t go quietly about your business and presume your results will speak for themselves. Unless you preach loyalty’s wisdom with power, clarity and conviction, your actions and your words will be drowned out by the chorus of digital-age dogma that maintains that loyalty is dead and it’s time to celebrate.

Build a repertoire of teachable stories that illuminate your loyalty principles. Encourage your partners to recognize teachable moments, and communicate them to all your partners. Finally, use case studies to show your organization how to put those principles into practice.