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Competing with loyalty: How to design successful customer loyalty reward programs

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Abstract For industries with low switching costs, customer loyalty programs (LPs) have potential to drive differentiation and sustain a competitive advantage. However, incentives provided through LPs also have a potential to escalate into costly price wars. In this article, we discuss how to design successful customer loyalty reward programs that bring value to participants and that cannot be emulated by competitors easily. We focus on three distinct aspects of improvement: personalization, reward types, and additional services. Through personalization, companies can leverage the knowledge they already have on their customers to tailor offers that they find relevant and appealing. For the reward structure, we argue in favor of a certain degree of opacity. We also encourage loyalty programs to consider giveaways that are unique and difficult to imitate and to use all the information they have available to provide rewards that fit with each customers' idiosyncratic situation or preference. Finally, competitive LPs should look beyond offers and rewards. In addition to purchases, LPs can reward participants for other desirable behaviors; they can also provide additional services that impose minimal costs on firms, but bring value to customers.

1. Loyalty programs as competitive tools

On April 11, 2016—the day before Starbucks launched its new loyalty program—Dunkin' Donuts rolled out a new app and loyalty plan. It was a highly

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unlikely coincidence. The two coffee shop chains, together covering more than 66% of the U.S. market, are using their loyalty plans to fend off competition (Lal & Bell, 2003) and keep their customers hooked.

Loyalty programs are tools for building brand equity (Lemon, Rust, & Zeithaml, 2001; Uncles, Dowling, & Hammond, 2003). The specific mechanisms through which these programs achieve their goal can vary widely, from decreased priced sensitivity and increased share of wallet to increased resistance to service failures and increased propensity to engage in word-of-mouth on behalf of the brand. We focus on switching costs (Hartmann & Viard, 2008; Kim, Shi, & Srinivasan, 2001), a mechanism that puts loyalty programs into a competitive perspective. Once a consumer has accumulated a certain amount of points with the focal company, the approaching reward—in the form of a gift or a status upgrade—is likely to keep them committed to that company. Competitors need more alluring offers to sway a consumer who is very close to gaining a reward. In this way, LPs can be used as competitive tools, especially in industries with low or nonexistent switching costs (e.g., retail, hospitality, air transport).

In such environments where companies offer similar products and compete on price, decreasing prices is always a tempting option. But this strategy eventually leads to slashed margins and reduced profitability for everyone—the classic prisoners' dilemma. Adopting the right loyalty program provides marketers a tool other than price to create differentiation and make their demand more inelastic (Klemperer, 1987). However, LPs also erode margins (Dowling & Uncles, 1997) by either offering an upfront low price or by giving back rewards. Thus, we come to a key question: How can firms design and employ reward schemes without falling into the same competitive trap as that set by price reductions?

Figure 1 provides an overview of our LP framework. In essence, we argue that simple schemes like Buy N, Get N + 1 Free, instant cashback rewards, or rewards with very transparent spend/earn ratios are easily replicated and can trigger competitive reactions and price wars. In contrast, personalized offers, customizable and unique rewards that are more difficult to quantify, and loyalty programs linked to additional services are more difficult to replicate and yield more robust competitive advantages.

While the three strategies we recommend may have overlapping scopes (e.g., any effort to increase personalization can also be seen as improving rewards or offering additional valuable features to customers), we argue that there is value in zooming in on each of them separately in order to exploit their particular elements. In designing new programs or improving existing ones, managers should be able to combine and adapt these strategies to their needs.

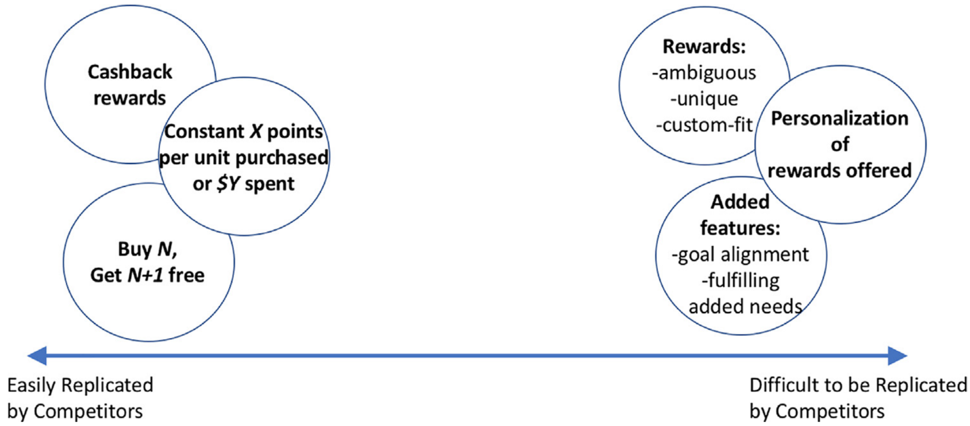
2. Personalized offers

An overused marketing adage says that it is more expensive to acquire a new customer than to retain an existing one. The kernel of truth from this expression stems from the fact that, through repeated interactions, retailers get to know their customers better. As a result, they can offer consumers suggestions or promotions that do not fall on deaf ears, thus securing those customers' business. The cosmetics retail chain Sephora builds a beauty profile for its loyalty program members. This profile is used to generate specific recommendations for different products depending on each shopper's hair and skin type or skin concerns (Colloquy, 2014). Sephora can successfully apply this strategy because there is uncertainty around the products it sells. Therefore, consumers genuinely benefit from and use the suggestions. This gives the chain a competitive edge over other retailers that sell beauty products.

The undisputed champion of personalization in retail, however, is Tesco. Launched in 1995, Clubcard was extremely successful and helped Tesco overtake Sainsbury as market leader in the U.K. grocery sector (Marketing Week, 1995). Dunnhumby, the company that ran the loyalty program, used purchase information to profile the customers and build models that could accurately predict their future needs. The CAT (Coupons at Till) system allowed Tesco to lure customers back to its stores with offers that they found relevant and appealing (Humby, Hunt, & Phillips, 2004). Over a 3-month period in 2005, Tesco sent customers 6 million personalized combinations of coupons for different products ("Tesco," 2005). But in order for the personalized offers strategy to work effectively as a competitive tool, attracting the customers to the store with the right offer is not enough. The other crucial step is to make sure that customers purchase other items, not only those for which they received the coupon.

Whenever personalized offers are used only to woo customers to the store, they may—or may not—be effective in building a competitive advantage. The outcome depends on consumers' propensity to either cherry pick or consolidate their purchases. Cherry picking consumers would selectively purchase only the item(s) presented in the personalized offer; with consolidation, customers would go to the store attracted by the offer but

Figure 1. Framework of recommendations for designing effective loyalty programs



would purchase other undiscounted items as well. Tesco seems to have experienced both outcomes. In the beginning, its Clubcard incentives were effective in keeping customers loyal. However, the raise of discounters like Aldi and Lidl made consumers more price conscious and left Tesco vulnerable (Schrage, 2014).

Personalization involves two key decisions: (1) whom to target and (2) what type of offers or promotions each targeted customer should receive. The first point is important because wrong decisions can lead to adverse selections (e.g., offering incentives to those who would have purchased even in their absence). The second point focuses on the right match between the promotions and consumers. In their work on casinos operated by MGM International Resorts, Nair, Misra, Hornbuckle, Mishra, and Acharya (2017) concluded that better matching can significantly increase revenues without necessarily increasing costs. In their case, the improved consumer-promotion match led to profit increases between $1 million and $5 million.

3. Rewards

By choosing the right rewards in terms of kind and structure, retailers can truly differentiate their schemes. They can offer something unique that can enthrall consumers and keep them loyal. There are three distinct lines along which retailers can work to design better rewards: reduced transparency, microtailoring, and uniqueness.

3.1. A healthy dose of ambiguity

In the introduction of this article, we used Starbucks and Dunkin' Donuts as exemplar companies that weave their loyalty programs into their broader competitive strategy. A distinct feature of both programs is that the reward structure is very clear and transparent: a Starbucks customer needs to spend $62.50 to redeem a free drink, while a Dunkin' Donuts customer needs to spend $40. We argue that such transparency renders loyalty schemes less effective. The reason is that such a plain structure falls dangerously close to a price discount. When competitors engage in unequivocal moves to attract customers, they easily can be drawn into a loyalty offers war that makes a dent in everyone's profits. This escalation of loyalty offers resembles a classical price war.

The Minnesota-based Caribou Coffee chain adopted an entirely different strategy for its loyalty program, Caribou Perks. In this program, the customers do not know when they will receive a freebie. Capitalizing on the idea of surprise and delight, the company simply sends notifications to the loyalty program participants at random times letting them know what reward they are eligible to receive. The program attracted about 240 members per location in its first week (Brandau, 2014). The lack of transparency in the reward structure yields two distinct benefits. It can fuel the surprise element and keep the customers enthralled by the unexpected surprises; it also makes the program more opaque for competitors. Red Lion Hotels follows the same model and keeps the tiers of its reward program, Hello Rewards, unpublished. The aim is to shift the focus away from dealmaking and transactions toward emotional loyalty. This makes the program's value difficult to read and quantify, making the chances of quick reactions that lead to competitive wars smaller.

However, a note of caution is needed with respect to the first type of benefits. The random rewards that Caribou offers to its customers might appear unfair or disempowering. When rewards are random or very difficult to predict, loyalty program participants may feel that they are not being treated fairly compared to other participants or that they do not have control over their redemption. Customers who want to boast about their gold or diamond statuses may perceive the unpublished tier structure of Red Lion Hotel's program as a hindrance. As these feelings may lead to disengagement and reluctance to participate in the program, managers still need to build reasonably well-defined expectations for their customers and then deliver on those expectations.

Fortunately, there are two other ways in which retailers can wrap their loyalty schemes in a healthy dose of ambiguity from the point of view of their competitors without confusing the program participants. The first has to do with the nonfixed rate of transformation of points into rewards. Shoppers Drug Mart, Canada's largest pharmacy chain, used this strategy until its February 2019 merger with PC Points, a grocery chain program. The store awarded consumers points proportional to the amount of money spent, but at the time of redemption, the larger the number of points redeemed, the larger the dollar value of each point. For example, a customer who decided to redeem 8,000 points received $10 in discounts, while a consumer who redeemed 12 times more points received a discount 17 times larger. The program had different thresholds that awarded participants increasing amounts of discounts per point. This structuring made it difficult for competitors to gauge the rate of consumer rewards because outsiders had no insight regarding the number of points customers redeemed. The lack of transparency, in turn, prevented competitors from engaging in more aggressive offers.

The second way in which retailers can protect their loyalty schemes from exposure to competition scrutiny is by joining a coalition loyalty program. In coalition programs, several noncompeting businesses cooperate and award consumers the same loyalty currency. In Australia, large chains like Shell and Target—together with tens of other partners—have joined the Flybuys program (Sharp & Sharp, 1997). One advantage of coalition programs is that they allow consumers to accelerate their collection rate and thus are more likely to keep them engaged. The other advantage is that each partner's competitors have little insight into how the LP shifts consumers' purchase patterns in their own markets. One of Target's main competitors in Australia, Big W, has no direct insights regarding the extent to which Target's loyalty program affects its business because Flybuys points cannot easily be compared to the Woolworths Dollars that Big W offers. This contrasts starkly with Starbucks' stars and Dunkin' Donuts' points, which can easily be brought to the same denominator.

3.2. Rewards that are difficult to imitate

Competitive edge can also be sharpened by offering rewards that are exciting for the targeted audience, unique, and difficult to replicate. In 2014, the family-oriented hotel chain Best Western centered its rewards around a teen-appeal Disney movie called *Zapped*. The promotion included a sweepstake in which the grand prize was an exclusive Disney experience in Los Angeles to meet the movie star (Global Newswire, 2014). Canada's largest bookstore chain, Indigo, also offers distinctive rewards that are specifically appealing to the members of its Plum Rewards program. They include discounts or advance ticket access to in-demand movies, exhibitions, theater or ballet shows, and meetings with popular authors.

Both examples show how marketers chose unique rewards that differentiated them from competition. In both cases, the rewards were external to the organization that offered them. In contrast, Bavarian Inn—a family run Michigan complex including a water park hotel, a restaurant, and a chain of retail stores—offers unique rewards that are made in-house. Its loyalty program, the Perk Club, is centered on the idea that customers represent an extended family. Therefore, top Perk Club members are invited to parties hosted by the owners. The owners also call their best customers around Christmas to convey greetings and solicit feedback (Tierney, 2015). This level of involvement from the owners and top management ensures that consumers perceive the perks as irreplaceable and drives a redemption rate of 86.5%, a favorable number compared to the average U.S. loyalty program, where only 66% of the earned rewards are redeemed (Hlavinka & Sullivan, 2011).

While unique rewards may enthrall some customers, they may leave others cold. Therefore, marketers need to make sure the rewards they offer are a good fit for the company's core clients. It is likely that specialized stores (e.g., Indigo) or businesses with more homogenous patrons (e.g., Bavarian Inn) are in a better position to implement this strategy than businesses that serve a wide range of customers (e.g., grocery chains).

3.3. Custom-made rewards

This strategy is a hybrid between personalized offers and unique rewards. While uniqueness refers to rewards that are intrinsically limited and hard to procure, custom-made rewards are based on customers' idiosyncratic preferences or circumstances. Any information that the company has on the customer, especially if it is contextual and not traditionally used as targeting criteria, can be used to design rewards that have a personal touch and feel more like interpersonal gifts rather than LP giveaways. These types of highly tailored, nongeneric rewards are likely to be perceived as very thoughtful and highly appreciated.

Caesars Entertainment Corporation can monitor its patrons' gambling fortune in real time; whenever a top-tier member of its Total Rewards program faces a particularly long streak of bad luck, a Caesars host can be deployed to alleviate the situation, perhaps by buying the guest dinner (Colloquy, 2013). In this case, it is the customers' particular predicament that triggers the reward. The Kimpton Hotel tries to achieve the same level of personalized targeting by learning as much as possible about its customers. Through its Kimpton Karma rewards program, it offers customers customized and unexpected amenities like a cocktail station with their favorite spirit or a sports-themed treat with their hometown team as inspiration.

One challenge with this approach is the need to balance the surprise aspect against any perceived privacy threat. Some customers may perceive the reward as overly intrusive and become wary rather than delighted. The other challenge is to keep a fresh pool of reward ideas so the microtargeted rewards do not become routine.

4. Beyond offers and rewards

Traditionally, loyalty programs create value for participants through the customized offers and the rewards they can receive. However, retailers can use loyalty programs to generate additional benefits that are highly valued by consumers and relatively inexpensive to provide.

4.1. Goal alignment

Consumers are animated by many life goals (e.g., exercising more, increasing savings, smoking less). Most marketers hope that consumers will deliberately add amassing sufficient points for a reward offered by a certain LP to their long list of aims. Securing engagement is key for the success of any a loyalty scheme. Whenever customers heedlessly collect points, LPs fail to deliver any competitive advantage and may become a burden for the company that offers them. Therefore, a good strategy to secure or increase customer engagement is to integrate the goal of obtaining a reward with customers' existing goals. This goal alignment is achieved by awarding consumers loyalty points or miles not only for purchases with the focal company—or companies, in the case of coalition LPs—but also for activities that they are already motivated to undertake.

The Australian supermarket chain Coles, together with the health insurance company Medibank, partnered within the Flybuys coalition and launched the Move More challenge—a program that ran in March of 2015. Participants that accepted the challenge needed to walk at least 10,000 steps each day during the whole month in order to earn $100 worth of fresh fruit and vegetables from Coles (McCormack, 2015). American pharmaceutical chain Walgreens employs a similar strategy on an ongoing basis. Customers who participate in its reward program, Balance Rewards, receive points for walking, exercising, and activities related to health monitoring. Concretely, participants receive 20 points for each mile walked, which is equivalent to 2 cents of rewards (Baumgardner, 2018). Admittedly, the link between the extraneous goal and the Walgreens rewards is weak. But it may be enough to forge the connection between the goal of being a loyal Walgreens customer and the stronger, more resilient goal of keeping an active lifestyle.

The programs at Walgreens and Coles are both enabled by fitness tracking technologies that allow consumers to accurately report their physical activity levels. Rewarding consumers for other types of goals can be difficult in the absence of technologies that can transparently monitor progress toward those goals. For example, if a consumer's goal is to smoke less, any marketer that tries to align its LP with this aim faces the task of corroborating consumers' reporting on their progress. One idea is to rely on goals that can be validated through social media. But this strategy is more likely to work as a social media presence booster rather than an enhancement for the loyalty scheme because social media posts, shares, or retweets are not likely to be perceived as useful pursuits for which people can use the extra nudge of a LP reward.

A case in point is Coca-Cola's My Coke Rewards (MCR) 2016 summer campaign: Share a Coke and a Song. In this campaign, participants were encouraged to share their summer song on Twitter and include a certain Coke-linked hashtag, for a chance to win 2 trips to the BET Awards (Shopper Marketing, 2016). Unlike running or maintaining a healthy lifestyle, sharing one's favorite song on social media does not impose any costs. Those who responded to the campaign's call were not likely to feel that Coca-Cola was helping them achieve a personally important but arduous goal. These types of programs may engage consumers, generate WOM, and even become viral, but they will not be perceived as being aligned with other personally important goals.

4.2. Fulfilling additional needs

Companies can use their LPs to offer customers additional benefits beyond cashbacks, discounts, tier upgrades, or other types of rewards. The capabilities that they have, or that they can acquire at reasonable costs, place them in a unique position to help customers in ways they greatly appreciate. Launched in 2011, United Community of Wisconsin ran a coalition loyalty program that implemented this idea. Starting from the premise that shoppers want to support the nonprofits that they care about, the program brought together consumers, nonprofit organizations, and local business. Consumers registered their credit or debit cards with United Community and whenever they shopped at the registered businesses, a share of their money—between 10% and 0.5%—was directed toward the organization of their choice. In this case, the LP used its infrastructure to help consumers make systematic donations, hassle-free. The participating businesses gained a competitive edge through their association with causes in which their customers were interested. While United Community appears to be no longer active, by 2016 it had managed to raise almost $280 thousand for nonprofits and humanitarian causes (Internet Archive, n.d.).

Another example of using the LP infrastructure to offer highly valued help to consumers comes from Home Depot. Its Pro Xtra Loyalty Program was developed to provide extensive support to small building professionals. Participants can track their orders, export records seamlessly into accounting programs, and retrieve receipts for tax purposes. The bookkeeping feature of the rewards program is likely to be extremely valuable for busy, small-scale home improvement professionals. By being loyal to Home Depot, they can forego costly accounting services. On the other hand, Home Depot presumably already keeps records of all its transactions. Through the loyalty program, it just allows participants to use the information that it already collects and stores, simplifying the collector's access to benefits beyond the product itself (Vandenbosch & Dawar, 2002). The cost that the company incurs is likely to be small compared to the value that it brings customers.

There is additional potential for retailers to provide extra benefits to consumers by sharing information. As consumers are becoming more health conscious, the market for nutrition monitoring apps has boomed. However, these apps require extensive user input and a significant time investment. There is an opportunity for grocery chains to run LPs that help consumers cut the costs of monitoring their eating habits. The retailers can offer shoppers

Table 1. Summary

	Details and examples
1. Personalization	
	• Especially valuable for products that carry social or financial risks (e.g., Sephora cosmetic products) • Effective if consolidation dominates cherry picking (e.g., Tesco) • Matching customers to the right promotional bundle is key (e.g., MGM Resorts International)
2. Rewards	
2.1. Ambiguity	• Makes competitive reactions less likely • Rewards can be random (e.g., Caribou, Red Lion Hotel), nonlinear (e.g., Shoppers Drug Mart), or part of a coalition LP (e.g., Target part of Flybuys coalition)
2.2. Uniqueness	• Rewards that cannot be easily replicated by competitors: either unique events (e.g., Indigo and Best Western) or in-house rewards (e.g., Bavarian Inn)
2.3. Custom fit	• Using consumers' idiosyncratic preference and situations to give out nongeneric gift-like rewards (e.g., Caesars, The Kimpton Hotel)
3. Additional features	
3.1. Goal alignment	• Reward consumers for other goals that are important to them, e.g., being physically active (e.g., Coles and Medibank, Walgreens)

nutritional summaries of the baskets they purchase. Instead of having to take time and input data for each meal, consumers can now receive the aggregate information for the whole purchase. Merchants already keep accurate records of all the food items customers purchase. By simply linking this data to nutritional information data and packaging the information for each individual customer, retailers can offer consumers a valuable service with minimal investment. Moreover, this type of information sharing has an accumulative advantage: the more they shop with the retailer that offers it, the better participants can take advantage of it.

5. Summary

Strongly differentiated brands (e.g., Apple, Harley Davidson) do not need loyalty programs; their products alone make them stand out from the pack. However, for those in the trade of selling packaged goods, hotel stays, or flight tickets, reinventing the business can be a massive challenge with questionable chances of success. For such fungible products markets, loyalty schemes can be great tools to create more personal, wholesome relationships with one's customers and ultimately build a distinguished trademark. In this article, we elaborated on three aspects of loyalty programs that can be designed to enhance their value as competitive tools: personalized offers, rewards, and additional services. Table 1 provides a summary of our discussion together with the relevant examples.

Though they may look like quantity discounts, successful loyalty schemes are, in fact, more subtle and very different. Like any form of price competition, quantity discounts can easily be copied with ruinous results for the whole market. Loyalty schemes can be used to differentiate and offer genuine additional benefits to customers (Nunes & Drèze, 2006). Be it through useful personalized recommendations, delightful rewards, or other types of benefits, wisely designed and deployed LPs provide a competitive edge in aggressive marketplaces.

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