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# Zero Defections: Quality Comes to Services

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The *real* quality revolution is just now coming to services. In recent years, despite their good intentions, few service company executives have been able to follow through on their commitment to satisfy customers. But service companies are beginning to understand what their manufacturing counterparts learned in the 1980s—that quality doesn't improve unless you measure it. When manufacturers began to unravel the costs and implications of scrap heaps, rework, and jammed machinery, they realized that "quality" was not just an invigorating slogan but the most profitable way to run a business. They made "zero defects" their guiding light, and the quality movement took off.

Service companies have their own kind of scrap heap: customers who will not come back. That scrap heap too has a cost. As service businesses start to measure it, they will see the urgent need to reduce it. They will strive for “zero defections”—keeping every customer the company can profitably serve—and they will mobilize the organization to achieve it.

Customer defections have a surprisingly powerful impact on the bottom line. They can have more to do with a service company’s profits than scale, market share, unit costs, and many other factors usually associated with competitive advantage. As a customer’s relationship with the company lengthens, profits rise. And not just a little. Companies can boost profits by almost 100% by retaining just 5% more of their customers.

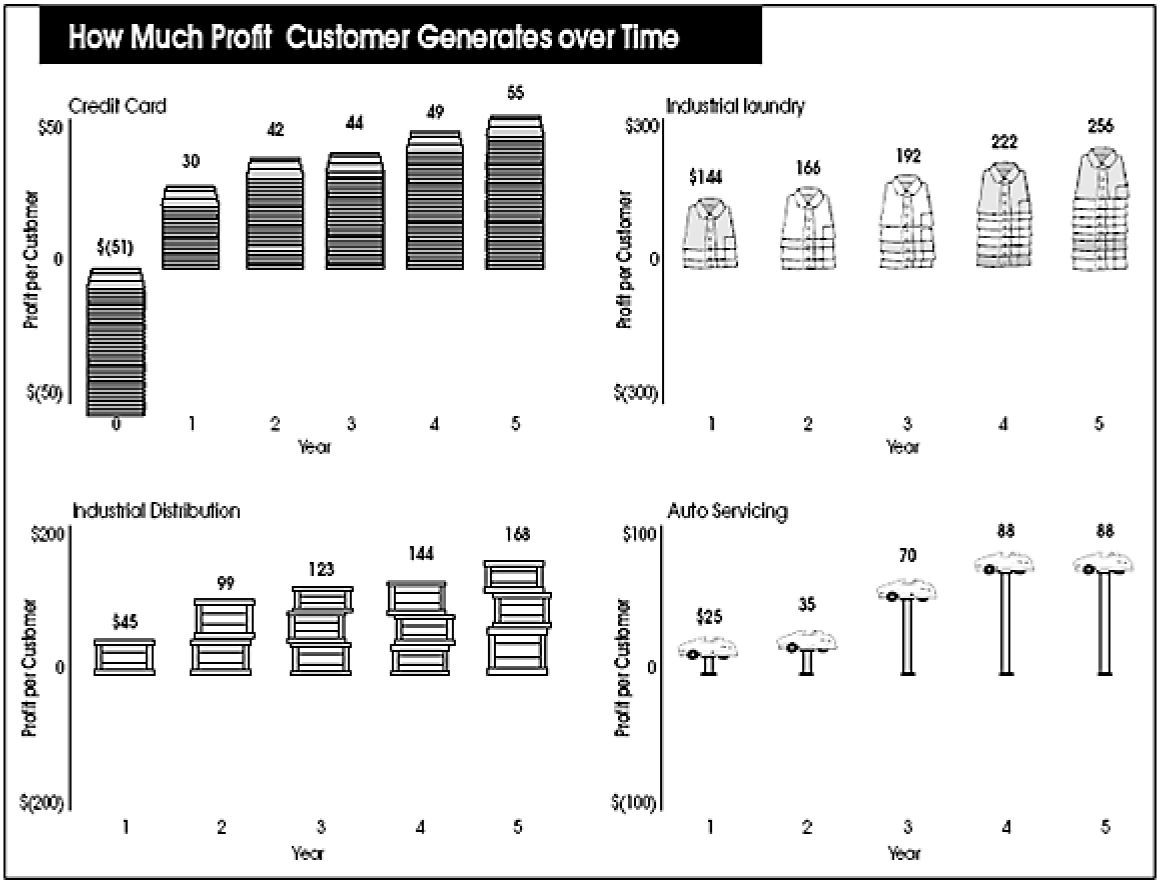
While defection rates are an accurate leading indicator of profit swings, they do more than passively indicate where profits are headed. They also direct managers’ attention to the specific things that are causing customers to leave. Since companies do not hold customers captive, the only way they can prevent defections is to outperform the competition continually. By soliciting feedback from defecting customers, companies can ferret out the weaknesses that really matter and strengthen them before profits start to dwindle. Defection analysis is therefore a guide that helps companies manage continuous improvement.

Charles Cawley, president of MBNA America, a Delaware-based credit card company, knows well how customer defections can focus a company’s attention on exactly the things customers value. One morning in 1982, frustrated by letters from unhappy customers, he assembled all 300 MBNA employees and announced his determination that the company satisfy and keep each and every customer. The company started gathering feedback from defecting customers. And it acted on the information, adjusting products and processes regularly.

As quality improved, fewer customers had reason to leave. Eight years later, MBNA's defection rate is one of the lowest in its industry. Some 5% of its customers leave each year—half the average rate for the rest of the industry. That may seem like a small difference, but it translates into huge earnings. Without making any acquisitions, MBNA's industry ranking went from 38 to 4, and profits have increased sixteenfold.

## The Cost of Losing a Customer

If companies knew how much it really costs to lose a customer, they would be able to make accurate evaluations of investments designed to retain customers. Unfortunately, today's accounting systems do not capture the value of a loyal customer. Most systems focus on current period costs and revenues and ignore expected cash flows over a customer's life-time. Served correctly, customers generate increasingly more profits each year they stay with a company. Across a wide range of businesses, the pattern is the same: the longer a company keeps a customer, the more money it stands to make. (See the bar charts depicting "How Much Profit a Customer Generates over Time.") For one auto-service company, the expected profit from a fourth-year customer is more than triple the profit that same customer generates in the first year. When customers defect, they take all that profit-making potential with them.




How Much Profit Customer Generates over Time

It may be obvious that acquiring a new customer entails certain one-time costs for advertising, promotions, and the like. In credit cards, for example, companies spend an average of $51 to recruit a customer and set up the new account. But there are many more pieces to the profitability puzzle.

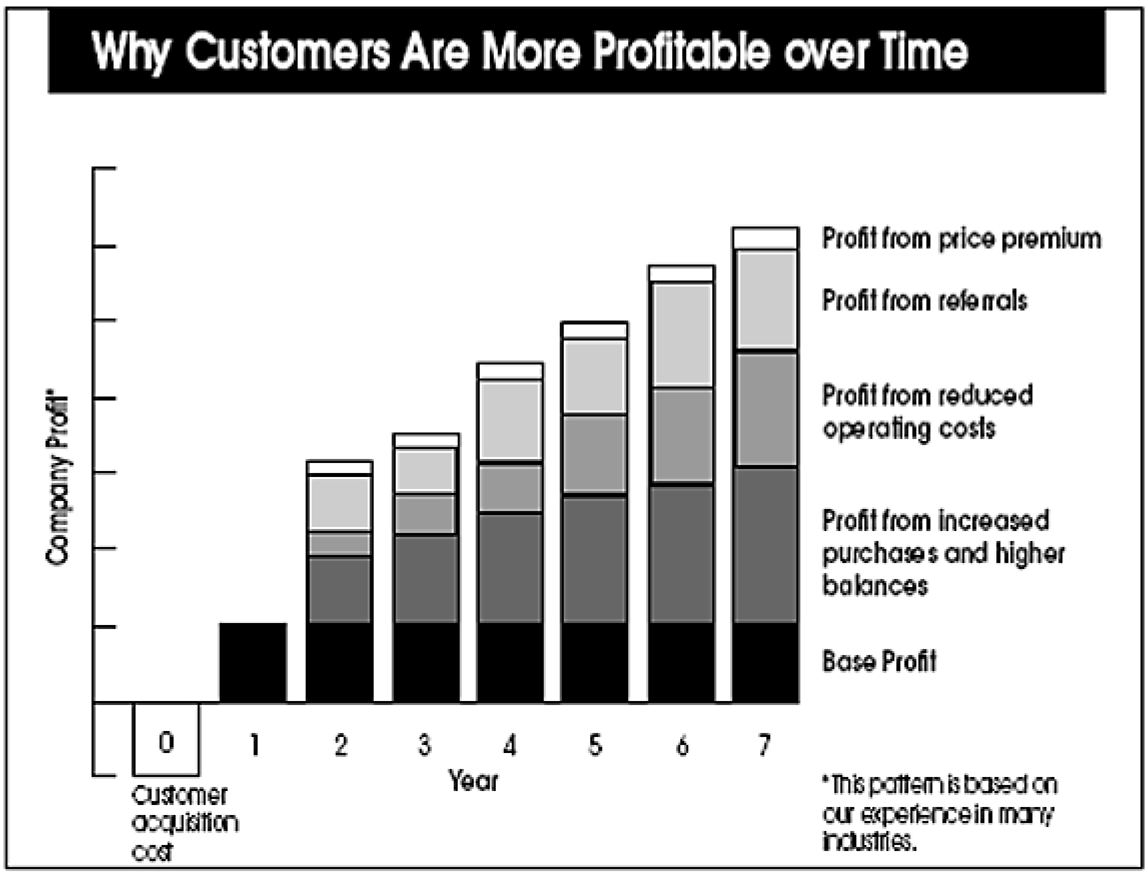
To continue with the credit card example, the newly acquired customers use the card slowly at first and generate a base profit. But if the customers stay a second year, the economics greatly improve. As they become accustomed to using the credit card and are satisfied with the service it provides, customers use it more and balances grow. In the second year—and the years thereafter—they purchase even more, which turns profits up sharply. We found this trend in each of the more than 100 companies in two dozen industries we have analyzed. For one industrial distributor, net sales per account continue to rise into the nineteenth year of the relationship.

As purchases rise, operating costs decline. Checking customers' credit histories and adding them to the corporate database is expensive, but those things need be done only once. Also, as the company gains experience with its customers, it can serve them more efficiently. One small financial consulting business that depends on personal relationships with clients has found that costs drop by two-thirds from the first year to the second because customers know what to expect from the consultant and have fewer questions or problems. In addition, the consultants are more efficient because they are familiar with the customer's financial situation and investment preferences.

Also, companies with long-time customers can often charge more for their products or services. Many people will pay more to stay in a hotel they know or to go to a doctor they trust than to take a chance on a less expensive competitor. The company that has developed such a loyal following can charge a premium for the customer's confidence in the business.

Yet another economic boon from long-time customers is the free advertising they provide. Loyal customers do a lot of talking over the years and drum up a lot of business. One of the leading home builders in the United States, for example, has found that more than 60% of its sales are the result of referrals.

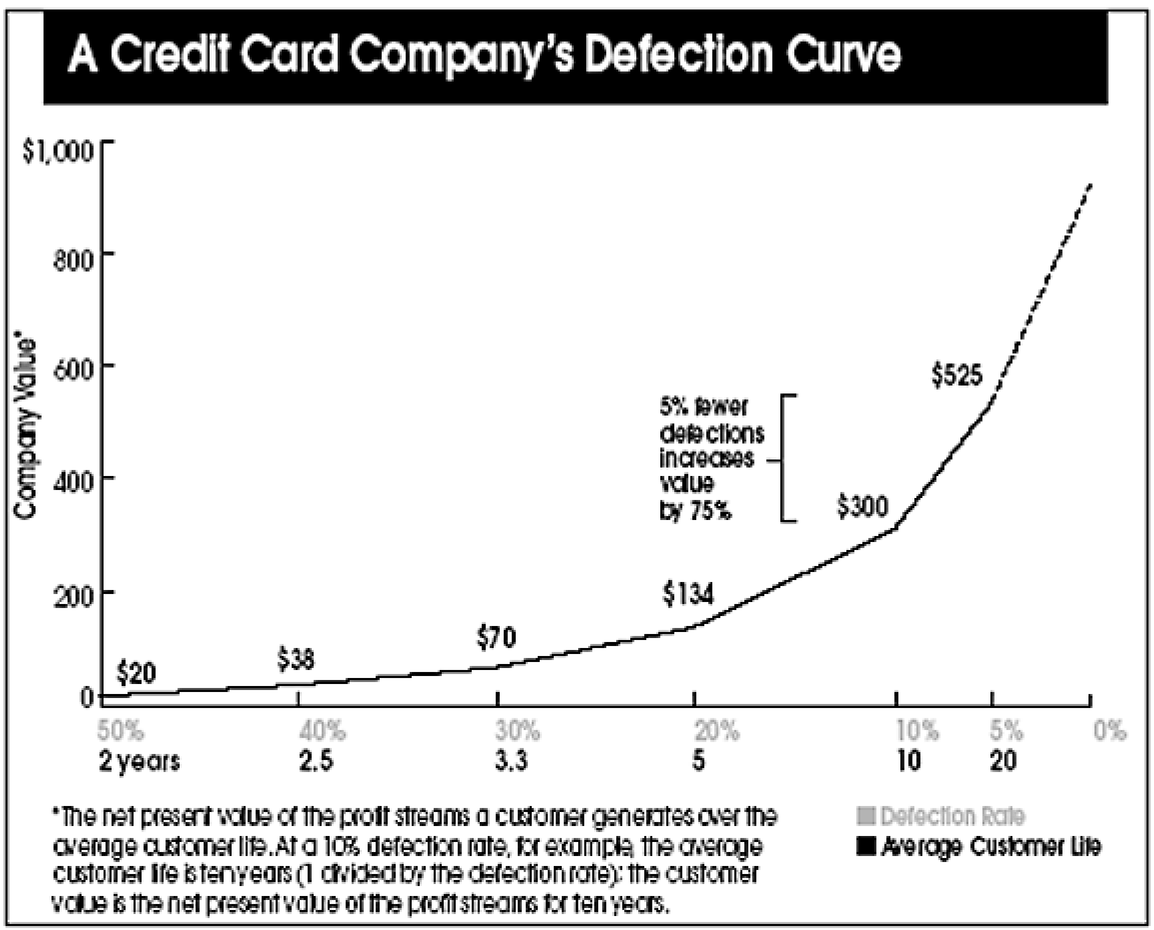
These cost savings and additional revenues combine to produce a steadily increasing stream of profits over the course of the customer's relationship with the company. (See the chart "Why Customers Are More Profitable over Time.") While the relative importance of these effects varies from industry to industry, the end result is that longer term customers generate increasing profits.




Why Customers Are More Profitable over Time

To calculate a customer's real worth, a company must take all of these projected profit streams into account. If, for instance, the credit card customer leaves after the first year, the company takes a $21 loss. If the company can keep the customer for four more years, his or her value to the company rises sharply. It is equal to the net present value of the profit streams in the first five years, or about $100.

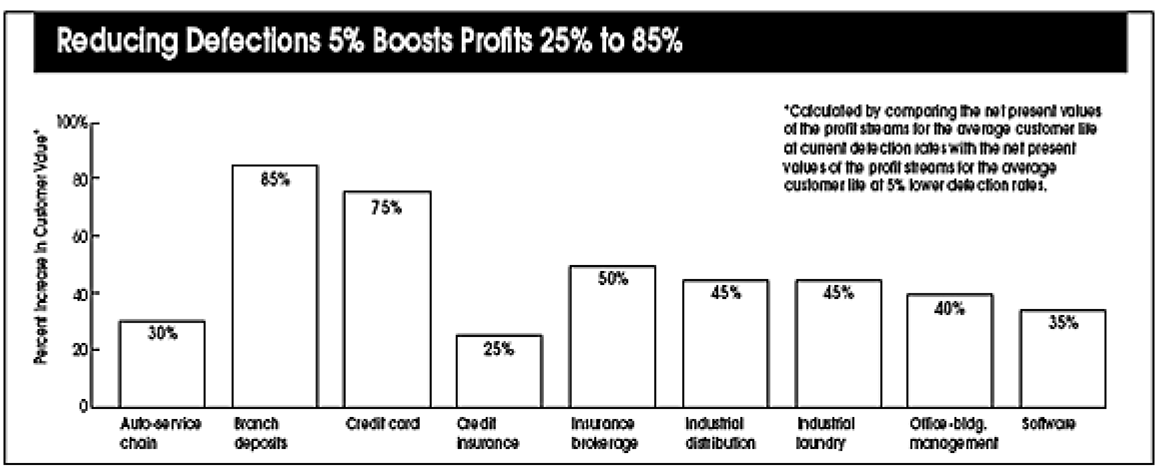
When a company lowers its defection rate, the average customer relationship lasts longer and profits climb steeply. One way to appreciate just how responsive profits are to changes in defection rates is to draw a defection curve. (See the graph, “A Credit Card Company’s Defection Curve.”) This shows clearly how small movements in a company’s defection rate can produce very large swings in profits.




A Credit Card Company’s Defection Curve

The curve shows, for example, that as the credit card company cuts its defection rate from 20% to 10%, the average life span of its relationship with a customer doubles from five years to ten and the value of that customer more than doubles—jumping from $134 to $300. As the defection rate drops another 5%, the average life span of a customer relationship doubles again and profits rise 75%—from $300 to $525.

The credit card business is not unique. Although the shape of defection curves vary across industries, in general, profits rise as defection rates fall. Reducing defections by just 5% generated 85% more profits in one bank's branch system, 50% more in an insurance brokerage, and 30% more in an auto-service chain. (See the chart "Reducing Defections 5% Boosts Profits 25% to 85%.") MBNA America has found that a 5% improvement in defection rates increases its average customer value by more than 125%.




Reducing Defections 5% Boosts Profits 25% to 85%

Understanding the economics of defections is useful to managers in several ways. For one thing, it shows that continuous improvement in service quality is not a cost but an investment in a customer who generates more profit than the margin on a one-time sale. Executives can therefore justify giving priority to investments in service quality versus things like cost reduction, for which the objectives have been more tangible.

Knowing that defections are closely linked to profits also helps explain why some companies that have relatively high unit costs can still be quite profitable. Companies with loyal, long-time customers can financially outperform competitors with lower unit costs and high market share but high customer churn. For instance, in the credit card business, a 10% reduction in unit costs is financially equivalent to a 2% decrease in defection rate. Low-defection strategies can overwhelm low-cost strategies.

And understanding the link between defections and profits provides a guide to lucrative growth. It is common for a business to lose 15% to 20% of its customers each year. Simply cutting defections in half will more than double the average company's growth rate. Companies with high retention rates that want to expand through acquisition can create value by acquiring low retention competitors and reducing their defections.

## Defections Management

Although service companies probably can't—and shouldn't try to—eliminate all defections, they can and must reduce them. But even to approach zero defections, companies must pursue that goal in a coordinated way. The organization should be prepared to spot customers who leave and then to analyze and act on the information they provide.

*Watch the door.* Managing for zero defections requires mechanisms to find customers who have ended their relationship with the company—or are about to end it. While compiling this kind of customer data almost always involves the use of information technology of some kind, major investments in new systems are unnecessary.

The more critical issue is whether the business regularly gathers information about customers. Some companies already do. Credit card companies, magazine publishers, direct mailers, life insurers, cellular phone companies, and banks, for example, all collect reams of data as a matter of course. They have at their disposal the names and addresses, purchasing histories, and telephone numbers of all their customers. For these businesses, exposing defections is relatively easy. It's just a matter of organizing the data.

Sometimes, defining a "defection" takes some work. In the railroad business, for instance, few customers stop using your service completely, but a customer that shifts 80% of its shipments to trucks should not be considered "retained." The key is to identify the customer behaviors that both drive your economics and gauge customer loyalty.

For some businesses, the task of spotting defectors is challenging even if they are well defined, because customers tend to be faceless and nameless to management. Businesses like retailing will have to find creative ways to "know" their customers. Consider the example of Staples, the Boston-based office products discounter. It has done a superb job of gathering information usually lost at the cashier or sales clerk. From its opening, it had a database to store and analyze customer information. Whenever a customer goes through the checkout line, the cashier offers him or her a membership card. The card entitles the holder to special promotions and certain discounts. The only requirement for the card is that the person fill out an application form, which asks for things like name, job title, and address. All subsequent purchases are automatically logged against the card number. This way, Staples can accumulate detailed information about buying habits, frequency of visits, average dollar value spent, and particular items purchased.

Even restaurants can collect data. A crab house in Maryland, for instance, started entering into its PC information from the reservation list. Managers can now find out how often particular customers return and can contact those who seem to be losing interest in the restaurant.

*What are defectors telling you?* One reason to find customers who are leaving is to try to win them back. MBNA America has a customer-defection "swat" team staffed by some of the company's best telemarketers. When customers cancel their credit cards, the swat team tries to convince them to stay. It is successful half of the time.

But the more important motive for finding defectors is for the insight they provide. Customers who leave can provide a view of the business that is unavailable to those on the inside. And whatever caused one individual to defect may cause many others to follow. The idea is to use defections as an early warning signal —to learn from defectors why they left the company and to use that information to improve the business.

Unlike conventional market research, feedback from defecting customers tends to be concrete and specific. It doesn't attempt to measure things like attitudes or satisfaction, which are changeable and subjective, and it doesn't raise hypothetical questions, which may be irrelevant to the respondents. Defections analysis involves specific, relevant questions about why a customer has defected. Customers are usually able to articulate their reasons, and some skillful probing can get at the root cause.

This information is useful in a variety of ways, as the Staples example shows. Staples constantly tracks defections, so when customers stop doing business there or don't buy certain products, the store notices it immediately and calls to get feedback. It may be a clue that the competition is underpricing Staples on certain goods—a competitive factor management can explore further. If it finds sufficient evidence, Staples may cut prices on those items. This information is highly valued because it pinpoints the uncompetitive products and saves the chain from launching expensive broad-brush promotions pitching everything to everybody.

Staples's telemarketers try to discern which merchandise its customers want and don't want and why. The company uses that information to change its buying stock and to target its catalogs and coupons more precisely. Instead of running coupons in the newspaper, for instance, it can insert them in the catalogs it sends to particular customers or industries that have proved responsive to coupons.

Defections analysis can also help companies decide which service-quality investments will be profitable. Should you invest in computerized cash registers or a new phone system? Which of the two will address the most frequent causes of defection? One bank made a large investment to improve the accuracy of monthly account statements. But when the bank began to study defectors, it learned that less than 1% of its customers were leaving because of inaccurate statements.

A company that is losing customers because of long lines can estimate what percentage of defectors it would save by buying new cash registers, and it can use its defection curve to find the dollar value of saving them. Then, using standard investment-analysis techniques, it can compare the cost of the new equipment with the benefit of keeping customers.

Achieving service quality doesn't mean slavishly keeping all customers at any cost. There are some customers the company should not try to serve. If particular types of customers don't stay and become profitable, companies should not invest in attracting them. When a health insurance company realized that certain companies purchase only on the basis of price and switch health insurers every year, for example, it decided not to waste its efforts seeking their business. It told its brokers not to write policies for companies that have switched carriers more than twice in the past five years.

Conversely, much of the information used to find defectors can point to common traits among customers who stay longer. The company can use defection rates to clarify the characteristics of the market it wants to pursue and target its advertising and promotions accordingly.

## The Zero Defections Culture

Many business leaders have been frustrated by their inability to follow through on their public commitment to service quality. Since defection rates are measurable, they are manageable. Managers can establish meaningful targets and monitor progress. But like any important change, managing for zero defections must have supporters at all organizational levels. Management must develop that support by training the work force and using defections as a primary performance measure.

Everyone in the organization must understand that zero defections is the goal. Mastercare, the auto-service subsidiary of Bridgestone/Firestone, emphasizes the importance of keeping customers by stating it clearly in its mission statement. The statement says, in part, that the company's goal is "to provide the service-buying public with a superior buying experience that will encourage them to return willingly and to share their experience with others." MBNA America sends its paychecks in envelopes labeled “Brought to you by the customer.” It also has a customer advocate who sits in on all major decision-making sessions to make sure customers’ interests are represented.

It is important to make all employees understand the lifetime value of a customer. Phil Bressler, the co-owner of five Domino’s Pizza stores in Montgomery County, Maryland, calculated that regular customers were worth more than $5,000 over the life of a ten-year franchise contract. He made sure that every order taker, delivery person, and store manager knew that number. For him, telling workers that customers were valuable was not nearly as potent as stating the dollar amount: “It’s so much more than they think that it really hits home.”

Mastercare has redesigned its employee training to emphasize the importance of keeping customers. For example, many customers who stopped doing business with Mastercare mentioned that they didn’t like being pressured into repairs they had not planned on. So Mastercare now trains store managers to identify and solve the customer’s problem rather than to maximize sales. Videos and role-playing dramatize these different definitions of good service.

Mastercare’s message to employees includes a candid admission that previous, well-intentioned incentives had inadvertently caused employees to run the business the wrong way; now it is asking them to change. And it builds credibility among employees by sharing its strategic goals and customer outreach plans. In the two target markets where this approach has been used, results are good. Employees have responded enthusiastically, and 25% more customers say they intend to return.

Senior executives at MBNA America learn from defecting customers. Each one spends four hours a month in a special "listening room" monitoring routine customer service calls as well as calls from customers who are canceling their credit cards.

Beyond conveying a sense of urgency, training should teach employees the specifics of defections analysis, like how to gather the information, whom to pass it on to, and what actions to take in response. In one company's branch banking system, retention data is sent monthly to the regional vice presidents and branch managers for review. It allows the regional vice presidents to identify and focus on branches that most need to improve service quality, and it gives branch managers quick feedback on performance.

Employees will be more motivated if incentives are tied to defection rates. MBNA, for example, has determined for each department the one or two things that have the biggest impact on keeping customers. Each department is measured daily on how well performance targets are met. Every morning, the previous day's performance is posted in several places throughout the building. Each day that the company hits 95% of these performance targets, MBNA contributes money to a bonus pool. Managers use the pool to pay yearly bonuses of up to 20% of a person's salary. The president visits departments that fall short of their targets to find out where the problem lies.

Great-West Life Assurance Company of Englewood, Colorado also uses incentives effectively. It pays a 50% premium to group-health-insurance brokers that hit customer-retention targets. This system gives brokers the incentive to look for customers who will stay with the company for a long time.

Having everyone in the company work toward keeping customers and basing rewards on how well they do creates a positive company atmosphere. Encouraging employees to solve customer problems and eliminate the source of complaints allows them to be “nice,” and customers treat them better in return. The overall exchange is more rewarding, and people enjoy their work more. Not just customers but also employees will want to continue their relationship with the business. MBNA is besieged by applicants for job openings, while a competitor a few miles away is moving some of its operations out of the state because it can’t find enough employees.

The success of MBNA shows that it is possible to achieve big improvements in both service quality and profits in a reasonably short time. But it also shows that focusing on keeping customers instead of simply having lots of them takes effort. A company can leverage business performance and profits through customer defections only when the notion permeates corporate life and when all organizational levels understand the concept of zero defections and know how to act on it.

Trying to retain all of your profitable customers is elementary. Managing toward zero defections is revolutionary. It requires careful definition of defection, information systems that can measure results over time in comparison with competitors, and a clear understanding of the microeconomics of defection.

Ultimately, defections should be a key performance measure for senior management and a fundamental component of incentive systems. Managers should know the company's defection rate, what happens to profits when the rate moves up or down, and why defections occur. They should make sure the entire organization understands the importance of keeping customers and encourage employees to pursue zero defections by tying incentives, planning, and budgeting to defection targets. Most important, managers should use defections as a vehicle for continuously improving the quality and value of the services they provide to customers.

Just as the quality revolution in manufacturing had a profound impact on the competitiveness of companies, the quality revolution in services will create a new set of winners and losers. The winners will be those who lead the way in managing toward zero defections.

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