A Master at Work

How Tesco, a global Loyalty Leader, commited what was thought to be economic heresy but confounded its critics—and competition—because it truly understands loyalty marketing's economics and trade-offs

by Brian Woolf (October 7, 2010)

It's a pleasure to watch a Master at work.

Tesco launched its loyalty programme in 1995 with its mailed, 1%-quarterly rebate (plus coupon offers). Over the years, it has taken this simple, core reward and made it "more different." It has deliberately widened the loyalty moat separating it from its competitors. Classic strategy.

To put its Clubcard moat-widening of recent years into perspective we need to understand Tesco. Consider CEO Sir Terry Leahy's positioning statement: *The goal of the Clubcard is to earn and grow the lifetime loyalty of the customer*. Note two things: lifetime, and not one word about Groceries! Remember, too, that after Clubcard was launched, Tesco began to widen its product offering: from department-store items (eg, clothing, cookware, soft furnishings) through to Banking and Personal Finance. And, to solidify this new stake-out, Tesco.com was launched in 2000. Since then, Tesco's product range keeps growing (Tesco has even included caskets!), store numbers keep growing (they now have a store in every UK postcode, bar one!), and their web presence grows better and stronger. The path they have trod suggests their underlying UK strategy: *To be their customers' shopkeeper, providing them with more and more of their total needs, in a manner that pleases them*. [And there appears to be no customer segment excluded from where Tesco is happy to attract them.]

This is why the changes in Clubcard in recent years make strategic sense. In 2009, Tesco tested *Double Points* - doubling rewards to 2 points per £1 spent. Test results were positive and, in August 2009, Tesco made *Double Points* its new reward standard - with no dilution in the rewards value. In fact, in addition to being able to redeem their new double-the-value rebate vouchers, customers were offered a large complementary range of alternative ways to redeem their points. Clubcard holders were offered a broad array of attractive alternatives at non-competitors for up to four times the value of redeeming them within Tesco. A customer could now, if desired, simply exchange one (or more) of her quarterly £2.50 Tesco vouchers for a Partner's reward voucher up to £10 in value! That's an attractive value proposition as a *thank-you* just for shopping at Tesco. So customers now receive not just low competitive prices but also, for each £125 spent, a £2.50 voucher to spend in Tesco or, alternatively, a voucher for up to £10 to spend on specific Partner rewards. As seen on Tesco's website, these Partners' offers cover a broad front: Flights. Restaurants. Days Out. Cinemas. Travel. Indulgence. Hotels. Holidays. For example, one multi-country hotel offer gives a £40-off voucher for each £10 of Tesco vouchers. Likewise, at various restaurants. Likewise, at Goldsmiths, a jewelry chain. Offers are even posted for trips to Disneyland Paris.

In effect, Tesco has created an alternative currency with its vouchers. Earn vouchers (at the most generous rate offered by any UK food retailer) at any Tesco or Tesco-affiliated business within its moat and redeem them within the moat at a 2% rate or for higher value in non-competing businesses outside the moat.

Over time, we should expect to see the value of Tesco's alternative currency enhanced through increased points for shopping at Tesco (currently, they are already testing triple points among their higher spenders!) and offering an even broader and richer range of Partner redemption options. Many possibilities spring to mind. Tesco's alternative currency is still in its infancy.

In essence, shopping at Tesco has, over the past year, become more valuable and attractive. Tesco has provided yet another reason why a customer should buy more of her needs from them. And that is what has happened since the advent of*Double Points*. This week, in its first Half Year Report, the company states that "whilst loyalty has been declining across the industry as a whole, in contrast Tesco has maintained its high level during the first half, widening the gap with its key competitors." It explains that "Tesco enjoys the highest level of customer loyalty among the major supermarkets - as measured by the percentage of customers who do more than half their shopping with one retailer." And sales have followed. They continued: "Despite low levels of industry like-for-like growth, Tesco grew sales faster than the market as a whole and achieved a pleasing improvement in profitability."

When *Double Points* were announced, some in the financial community were skeptical how Tesco could afford the increase in costs. The analysts had done the math. Estimating that

78% Tesco's sales were captured on Clubcard and earned a 1% rebate voucher and that 90% of these vouchers were actually redeemed, they estimated that Tesco's cost of their original 1% programme was 0.70% sales (ie, 78% x 1% x 90% = 0.70%). But now, with *Double Points*, that cost would more than double to 1.44% sales. [The share of sales on Clubcard would increase from 78% to, at least, 80% sales because a bigger reward encourages more customers to present their Clubcard.] (80% x 2% x 90% = 1.44%) The analysts fretted that this would increase Tesco's costs by 0.74% sales! (ie, 1.44%-0.70%) This would put a huge dent in their Trading Profits (ie, Profit Before Taxes) which were 6.0% sales before the launching of *Double Points*.

Surprise - it didn't happen! The first Half Year's results just published show that their Trading Profit didn't drop at all. Instead, it went up, marginally, to 6.1%!

So how did the 0.74% disappear? Essentially, it got absorbed in trade-offs and productivity gains. Only Tesco knows the actual details, but we can surmise. First, Tesco told us that they offset some of the *Double Points* cost against gains made from the company's on-going *Step-Change* productivity-enhancement programme. It also seems likely that Advertising costs were trimmed (less is needed when you increase rewards directly to customers!) and there was probably some item margin realignment (without increasing the overall price level) adding to gross margin. It's also likely that Tesco's average cost of those £10 Partner vouchers was less than the £2.50 they would have to pay if they were redeemed internally.

That's not all. There are the economic gains that come from strengthening customer loyalty. First, the more a food retailer increases a customer's frequency (visits per week or month), the higher her average transaction of all visits rise. [This is counter-intuitive, but it appears that the more a customer shops with you, the more she gets to know what you offer and, thus, the more she buys on each visit!] So the more attractive value of the *Double Points* programme will have increased their average customer's frequency and weekly spending. This means, in turn, that her annual spending increased which, in turn, increased the quality of Tesco's sales.

Why? Because Loyalty Leaders have learned that the more a customer spends, the less likely she is to defect. To illustrate: in one major chain, the defection rate of customers with an annual weekly spending rate of over £100 was less than 3%. Yet those with an average weekly spend under £25 defected at a rate over 30% - more than ten times greater!!! In other words, increasing the frequency and spending of customers not only increases their annual spending but also their retention rate! Thus, the higher the proportion of customers you have at higher spending levels, the longer your customers' average projected lifetime of shopping (and amount spent) with you, ie, the higher the quality of your customer base.

Remember Sir Terry's statement? - *The goal of the Clubcard is to earn and grow the lifetime loyalty of the customer*. Ah, now, Tesco's Double Point decision becomes clear in its strategic setting.

Loyalty Leaders also understand that the gains from an improvement in your customer mix don't stop there. Higher spenders incur less processing costs per item, spend less time asking employees for directions, need less advertising, and are your best word-of-mouth advocates. In other words, they give a lot back that the loyalty masters see but the accountants miss.

Now, all of these gains didn't burst to the surface in the first year of *Double Points*at Tesco. Some were absorbed as productivity gains to help stop the 0.74% adversely impacting their Trading Profits. But these gains are now imbedded in the system. Expect to see more of them appear over the next two years.

What can we learn from this Master's latest Masterpiece?

- Taking the differentiating point of your loyalty programme and deliberately making it more different makes strategic sense - it widens the moat between you and your competitors.

- Your loyalty programme is an integral part of your total strategy and operation. Therefore, as you enrich it, avoid increasing total costs by making internal trade-offs and productivity.

- The cost of a points programme should not be listed as a static line item in your Profit & Loss Statement. Its better placed in your Gross Profit Statement which helps encourage the ongoing trade-offs required.

- The obvious is not always obvious.

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About the author...

Brian Woolf is a global leader in loyalty marketing and has written three definitive works on the subject, Measured Marketing: A Tool to Shape Food Store Strategy, Customer Specific Marketing, and Loyalty Marketing: The Second Act. He devotes his time to helping retailers develop, critique and strengthen their loyalty programs.

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