Electronic Loyalty Programs Comparative Survey

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INTRODUCTION

Loyalty is defined as the repeated satisfaction of a customer with purchases of products from a specific firm or brand. Firms have been developing customer loyalty programs because it is generally less expensive for firms to retain existing customers than to attract new ones (Reichheld & Schefter, 2000). Although the correlation between customer loyalty and long-run firm profitability is under discussion, there is a consensus on positive effects of customer loyalty programs on firm sales (Reinartz & Kumar, 2002). Loyalty programs are also attractive for customers since they receive special offers or discounts.

The notion of loyalty on the Internet, coined as electronic loyalty (e-loyalty), is a relatively new concept. However, because of their potential to increase sales and reduce online customer retention costs, e-loyalty programs have received much attention from both businesses and academic researchers. In what follows, we first summarize major theoretical results and empirical evidence on customer loyalty in the literature. We then analyze different types of popular e-loyalty programs on the Internet.

BACKGROUND

It is found that firms can create loyal customers in traditional markets by exploiting or artificially generating the so-called consumer switching costs (Beggs & Klemperer, 1992; Chen, 1997; Kim, Shi & Srinivasan, 2001; Klemperer, 1987a; Klemperer, 1987b). Switching costs may arise from a variety of factors such as the nature of the product (learning and adaptation costs), consumer characteristics (risk-aversion), or deliberate strategies followed by firms (frequent-usage points or cash-back rewards). Klemperer (1987a) suggests that the noncooperative equilibrium in an oligopoly with switching costs may be the same as the collusive outcome in an otherwise identical market without switching costs. Padilla (1992) finds that switching costs make overall competition less severe and may lead to local monopoly power. Beggs and Klemperer (1992) study the evolution of duopolists' prices and market shares in an infinite-period market with consumer switching costs. They show that firms' prices and profits are higher if switching costs are present in the market. In a recent paper by Kim, Shi, and Srinivasan (2004), loyalty programs are examined in the context of capacity management. They find that loyalty programs enable firms to better adjust their available capacities in response to the actual level of market demand.

The concept of e-loyalty may differ from the conventional notion of loyalty in traditional markets. Among the factors that play important roles in building e-loyalty are the prior experiences of customers with an e-commerce website, information content of the Website, the time it takes to shop, the ease and security of online transactions, and the price advantage (Devaraj, Fan, & Kohli, 2003). It is easier for e-commerce companies to track customer behavior through the use of online surveillance technologies and customize products and services for individual needs. However, reinforcing e-loyalty appears to be vital due to consumer wariness about electronic shopping, which leads to high customer acquisition costs and low retention rates.

Recent empirical research indeed supports the existence of e-loyalty in e-commerce markets. For example, by analyzing data from online price comparison software, called "shopbots", Smith and Brynjolfsson (2001) find that customers are willing to pay premium prices for books from online retailers they purchased before. Chen and Hitt (2002) also find parallel results by studying online brokerage industry. Johnson, Moe, Fader, Bellman, and Lohse (2004) report that almost 70% of online CD and book shoppers are loyal to only one site and consumers tend to search fewer sites as they

become more experienced with online shopping. Using a survey data, Devaraj, Fan & Kohli (2003) find that customer loyalty toward online stores is significantly higher than their loyalty toward conventional brick-and-mortar stores. They argue that the state-of-the-art Web technologies implemented by e-commerce firms are among the major factors reinforcing e-loyalty more than their traditional counterparts.

A SURVEY OF E-LOYALTY PROGRAMS

E-Loyalty Programs Based on Cash-Back Rewards and Frequent-Usage Points

The most common forms of e-loyalty programs today are those utilizing cash-back rewards or frequent-usage points. In the *ClickRewards.com* program, for example, customers can earn *ClickMiles* for every qualified purchase they made from the Website. *ClickMiles* are redeemable for miles on any of the ten major U.S airlines or for other rewards. Another shopping portal, *Ebates.com*, pays customers up to 25% cash-back on qualified purchases. To cover the operational cost of the program, *Ebates.com* charges companies selling products on its portal. *Spree.com* and *CashbackOutlet.com* also offer customers cash-back rewards on qualified purchases. Customers can also receive additional cash-back by referring new shoppers to the Website. Finally, the *GreaterGood.com* and *iGive.com* are both philanthropy portals where customers can donate up to 26 percent of their purchase amount to a charity they wish to support.

Affiliate marketing is another type of lucrative e-loyalty program on the Internet. It is a new method of online advertising that allows Websites to share traffic and revenue using banner and text advertisements. Firms selling goods and services online pay commissions to affiliate Websites for sending traffic to their site, which is tracked by a special software application. Firms pay affiliates according to several schemes such as cost per sale, cost per lead, cost per click, or cost per impression. Affiliate marketing creates new opportunities for online firms to increase sales, for affiliates to earn revenue from their sites, and for consumers to find the products and services on the Internet easily. Among the companies specialized in online affiliate marketing are *LinkShare.com*, *Performics.com, CommissionJunction.com,* and *eLoyalty.com*. With over 10 million partnerships around the world, *LinkShare.com* manages the largest affiliate marketing network on the Internet. It also provides merchant firms with services to create and manage their own affiliate marketing programs. Both *Performics.com* and *CommissionJunction.com* offer their customer firms performance-based affiliate marketing services supported by e-mail marketing programs. Lastly, *eLoyalty.com* offers e-commerce firms consulting services related to affiliate and targeted marketing to reinforce e-loyalty.

Comparison of Cash-Back Rewards and Equity-Based E-Loyalty Programs

Cash-back rewards are the oldest type of loyalty programs, in which customers are offered either instant price discounts or rebate checks. E-loyalty programs based on cash-back rewards can, in general, increase firm sales but may not be able to promote firm-specific loyalty since customers are not obligated to go back to the same firm after an initial purchase. The rewards gained by customers through these programs may be spent on the products of any participating firm, leading to a post-opportunistic behavior and lower levels of firm-specific customer loyalty (Figueiredo, 2000).

In equity-based e-loyalty programs, on the other hand, customers are offered a fraction of merchant firm's equity for each purchase. Customers become fractional owners of the merchant firm through the collection of the firm's equity after each purchase. The amount of equity offered to customers is very small—usually around 1% of the unit share of the merchant firm. This ownership structure gives the customers an incentive to purchase from the same firm again. If other customers purchase from the same firm and the stock price of the firm is a function of its total sales, *ceteris paribus*, existing customers can realize an increase in their wealth. Firms also benefit from equity-based e-loyalty programs because of the lowered cost of customer retention and a potential change in their stock prices through increased sales.

The incentive mechanism used in equity-based e-loyalty programs is very similar to the concept of executive compensation through company stocks, where executives become part owner of the company they are managing (Alchian & Demsetz, 1972; Holstrom, 1982; Jensen & Murphy, 1990). Although customer incentives in equity-based e-loyalty programs may