5-2-2011

Customer Loyalty: A New Look at the Benefits of Improving Segmentation Efforts with Rewards Programs

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Abstract
Reward programs continue to proliferate nearly three decades after American Airlines launched the modern day customer reward program in 1981. Due to rapid growth in these programs in the hospitality sector, it appears that many firms have fallen into the trap of developing "me too" loyalty programs that provide little differentiation from the competition. The most telling sign of these copycat programs is that the basis for most program tier structures is based on industry convention rather than a strategic analysis of a firm's customer base and the needed differentiation in the marketplace. To demonstrate a data-driven customer segmentation strategy for a loyalty program, this study collected customer data from a major international hotel chain to track spending in three categories: rooms, food and beverage, and such supplemental services as the spa or health club. The resulting customer segments, which were based on common demographic criteria and spending patterns on these three spending categories, showed a weak match with the current three tier system offered in the chain's rewards program. In fact, some tiers included vastly different market segments that had different spending and stay frequency. Although too many additional tiers would probably invite complications, it's possible to create or augment loyalty program tiers that more closely match customers' travel habits. One goal would be to encourage certain high-spending guests to visit more frequently. Creative, flexible rewards should reflect guests' desires, but should not involve price concessions.

Keywords
hotels, rewards programs, customer spending, segmentation

Disciplines
Business | Hospitality Administration and Management

Comments

The Center for Hospitality Research

Hospitality Leadership Through Learning

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Cornell Hospitality Report

Vol. 11, No. 11, May 2011

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Cornell University
School of Hotel Administration

The Robert A. and Jan M. Beck Center at Cornell University
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Cornell Hospitality Reports,
Vol. 11, No. 11 (May 2011)

Cornell Hospitality Report is produced for the benefit of the hospitality industry by The Center for Hospitality Research at Cornell University

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EXECUTIVE SUMMARY

Reward programs continue to proliferate nearly three decades after American Airlines launched the modern day customer reward program in 1981. Due to rapid growth in these programs in the hospitality sector, it appears that many firms have fallen into the trap of developing "me too" loyalty programs that provide little differentiation from the competition. The most telling sign of these copycat programs is that the basis for most program tier structures is based on industry convention rather than a strategic analysis of a firm's customer base and the needed differentiation in the marketplace.

This approach has led to the predictable result of programs that appear to provide little value to customers or returns on the firms' investments. Instead, loyalty program managers must conduct careful analysis when developing and optimizing their program structure. This report **(1)** examines in detail how a firm might properly segment its loyalty program members into groups that maximize their value to the firm, and **(2)** offers a recommendations on how programs might take advantage of segmentation opportunities to realize the full value of the customer within each segment.

To demonstrate a data-driven customer segmentation strategy for a loyalty program, this study collected customer data from a major international hotel chain to track spending in three categories: rooms, food and beverage, and such supplemental services as the spa or health club. The resulting customer segments, which were based on common demographic criteria and spending patterns on these three spending categories, showed a weak match with the current three tier system offered in the chain's rewards program. In fact, some tiers included vastly different market segments that had different spending and stay frequency. Although too many additional tiers would probably invite complications, it's possible to create or augment loyalty program tiers that more closely match customers' travel habits. One goal would be to encourage certain high-spending guests to visit more frequently. Creative, flexible rewards should reflect guests' desires, but should not involve price concessions.

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Reward programs have become a mainstay for most hospitality operators. While their origins can be traced to the original S&H Green Stamp program, the modern day program launched by American Airlines (AAdvantage) in 1981 has become the program prototype. Due to rapid growth in these programs in the hospitality sector, it appears that many firms have fallen into the trap of developing "me too" loyalty programs based on the initial model introduced by American Airlines, employing a relatively simple tier structure that may not accurately reflect the spending or needs of a firm's customer base.

As loyalty programs continue to evolve and firms compete for the loyalty of their customer base, many program managers are now faced with decisions regarding the optimization of their programs. During this process, a critical question that is often raised is: "Do I have the right number of tiers and are the requirements for tier promotion set at appropriate spending intervals?" This simple question is rooted in the basic tenets of market segmentation, but the answer can often be quite difficult to nail down.

Adding to this challenge, the issue of tier structure and reward levels represents only a fraction of the operational issues facing program managers. Based on our review of recent research on program management, design, and assessment, we suggest that the main drivers of loyalty program effectiveness can be categorized into three main "buckets":

- The structure of the loyalty program,
- The structure of the rewards, and
- Customer fit with the loyalty program.

The recommendations that we put forth in this report apply this framework to a detailed analysis of how analytics-based customer segmentation can enhance program performance while driving customer loyalty. We illustrate these ideas by re-evaluating the tier structure used by one major lodging firm and looking at the example of one hotel chain that seem to be "getting it right" when it comes to developing improved tier systems.

Strategic Frameworks for Reward Program Management

At the core of most marketing approaches are the intertwined processes of segmentation, targeting, and positioning (STP). The basic loyalty-program assumption is that the lodging market includes relatively stable, homogeneous groups of consumers who can be identified, reached, and satisfied by manipulating various aspects of the marketing mix. The STP framework remains a mainstay of modern marketing strategy and its core tenets provide an excellent strategic framework for assessing loyalty program design and effectiveness.

Segmentation

Segmentation in rewards programs is manifested in established tier structures that are often given status-oriented names derived from precious metals such as platinum, gold, and silver. When evaluating these core tier structures, the real challenge that emerges for managers is the ability and need to identify opportunities either to collapse some tiers or possibly develop new tiers based on customer spending and interests.

Here's an example where an additional or augmented tier might be indicated. One well-known hotel chain offers their first reward tier after customers stay a minimum of 10 nights. The next upgrade occurs when this traveler reaches a 50-night stay during the same 12-month period. The final upgrade in tier status occurs after 75 nights within a calendar year. The gap between a 10-night customer and a 50-night customer is considerable. A customer who stays 11 nights is in the same tier with one who stays 49 nights. But the customer who stays 11 nights annually is likely to be more similar to the customer who stays 10 nights than to the customer who stays 49 nights. The 11-night customers and the 49-night customers are likely to have distinctively different needs and desires and, most to the point, each could be activated by very different reward incentives.

So, let's examine the issues plaguing the design of tier structures. To do this, we suggest taking a step backward to facilitate a leap forward. We'll use market segmentation for this purpose. This provides the basic foundation for any sound marketing strategy and represents a starting block for firms looking to re-evaluate their tier structure. To facilitate the discussion of segmentation within reward programs, we pause to review the fundamentals of market segmentation strategies.

Segmenting Your Guests

In developing any segmentation strategy, marketers must select bases that result in relatively discrete segments that meet six criteria: *identifiability, substantiality, accessibility, stability, responsiveness,* and *actionability*. *Identifiability* is the extent to which one can identify consumers in each segment by using the segmentation criteria. *Substantiality* requires that market segments are large enough to meet organizational performance goals. *Accessibility* is the extent to which managers can reach the targeted segments. Market segments must also be *stable* so that they can effectively be targeted over time. *Responsiveness* requires that segments be distinctive enough to respond to differentiated marketing mixes. Finally, to satisfy the *actionability* requirement, the identification of each segment must provide enough information for managers to take effective action with their targeted marketing campaigns.

Now, let's look at typical loyalty programs against this framework. Currently most programs segment solely on customers' spending volume or stay frequency. This approach does not provide a segmented solution that addresses the critical criteria for segmentation, and, thus, program managers do not have a complete basis for their decisions related to designing, targeting, and positioning the program. To overcome those limitations, a broader set of segmentation bases is required. We first list several possible segmentation criteria and then assess which are most appropriate for loyalty programs.

In Exhibit 1 we provide an overview of potential segmentation bases of reward programs. We group these bases into three primary categories: **(1)** descriptive segmentation

Exhibit 1

Segmentation bases for customer-loyalty programs

Descriptive Segmentation Bases	
Demographics	Demographics serve as the skeleton for any segmentation strategy, as they allow for easy identification of segments and description and comparison across groups. Also, by segmenting reward members based on demographics, managers can potentially develop customized rewards for varying segments according to demographic-specific tastes.
Psychographics	Psychographics represent consumers' activities, interests, and opinions. They really provide the "muscle" for the demographic skeleton that starts to differentiate customers on a deeper level. Developing an understanding of the psychographics of program members is critical as firms strive to develop differentiated rewards focused on consumer engagement rather than simple price discounts and promotion.
Customer Financial Value Segmentation Bases	
Spending Volume	Loyalty programs are designed to reward the "best" customers. The most common metric used to determine reward levels is spending volume during a particular time period; thus, it represents possibly the most critical variable for tier separation. Volume estimates allow for firms to clearly identify not only customers that purchase often, but those that may also be purchasing at premiums, thus signaling that these customers may offer higher margins to the firm.
Spending Frequency	In addition to volume, many programs reward simply on frequency. For example, frequent flier programs often reward based on the number of trips rather than dollars spent (JetBlue's program is an exception). This complementary data point on consumer spending provides an additional assessment metric in determining the quality of a customer as it represents a level of engagement or commitment to brand that may not be capture with a simple volume estimate.
Profitability	A key challenge faced by many rewards programs is that the discounts offered to their reward members essentially serve as coupons that erode margins in transactions where rewards are redeemed. As a result, some programs may actually be creating less profitable customers through promotion in their rewards program. Overall, reduced margins can be overcome with increased transaction volume or frequency, but profitability remains another critical basis for segmentation.
Customer Engagement Segmentation Bases	
Referral Activity	Referral activity represents that extent to which a customer refers others to do business with a firm. As recent discussions on "customer referral value" suggest, customers can provide direct benefits to a firm through purchasing, as well as indirectly through referral. In some service industries this referral value has been shown to be four times greater than lifetime value connected to direct spending; thus, accounting for and rewarding referral behavior is critical as programs continue to advance.
Brand Engagement	Brand engagement provides additional touch points between a customer and firm and offers a rare opportunity to foster attitudinal loyalty in addition to behavioral loyalty. These activities can include corporate events or participation in emerging social media environments. Ultimately, engagement with the customer provides a firm with an opportunity for a focused discussion and if managed correctly can have profound impacts on loyalty. Thus, segmenting and rewarding on levels of engagement also provides value.

bases, **(2)** customer financial value segmentation bases, and **(3)** customer engagement segmentation bases. Descriptive segmentation bases provide critical information that address stability, identifiability, responsiveness, and actionability criteria for quality market segments, because they provide explicit insight into what types of customers exist in the segments and their underlying value. The customer financial value bases address the criteria of stability, substantiality, and accessibility, since they provide benchmarks for spending volume and frequency of interaction with the company. Finally, the engagement bases address issues related to responsiveness, substantiality, and accessibility. Collectively, the consideration of all these bases would provide program managers with the insight into the potential segments in the market that can be targeted with their rewards program.

Targeting

Once potential market segments are identified, program managers must then identify the subsets of customers to target with a reward program. This critical step seems to be missing in the design of many reward programs. While some reward programs are necessarily offered to the "masses," targeted reward programs ideally must be tailored to meet the needs of the most attractive subsets of customers. By developing a program with a focused structure and rewards that best meet the needs of a targeted set of customers, the program is better positioned to truly reward a firm's "best" customers. In a well designed program, effective targeting allows a firm to develop optimized tiers that provide customized, differentiated rewards for their best customers. Without proper design, mass-marketed loyalty programs may simply entitle undeserving customers and create an additional couponing motivation for value seekers.

Positioning

Finally, the program has to be positioned in the marketplace. However, without taking the necessary steps to properly segment the market and then identify target markets, a program is destined to find no unique position in the market. This appears to be the case for most programs, which seem to offer benefits analogous to those of the competition. In these instances the program is relegated to an entirely support role and becomes about as effective as a continual price promotion. Alternatively, by developing a clearer understanding of customers' needs through the first two steps in the planning process, firms can then develop a customized theme for their program and offer supporting rewards and tier requirements that provide customers with a truly differentiated benefit for remaining loyal to a firm.

President's Club Promotes Recognition

One firm that seems to have successfully navigated this process is Fairmont Hotels and Resorts. In an effort to re-invent their President's Club program to better satisfy the needs of their loyal customers, Fairmont engaged in extensive customer research. This study revealed that customers enjoyed the utilitarian benefits provided by the program, but the fact was, they could purchase most of the perks that it offered. Instead, Fairmont reasoned that if rewards could be offered that made guests' travel experience easier and potentially memorable, then that would provide differentiated value. Based on this customer information, Fairmont developed a new recognition program designed to connect with their best customers at a higher level. The program now offers a series of differentiated benefits focused on improving the entire travel experience and creating memorable touch points with consumers. Upon arrival at the hotel, for example, program members have complimentary use of such items as Adidas running shoes, yoga mats, and TaylorMade golf clubs, which frees them from the task of packing this equipment. Moreover, platinum and premier members have access to exclusive vacation experiences, referred to as "Fairmont Moments," which provide customers with access to truly exclusive vacation experiences that cannot simply be purchased. These experiential rewards also provide the company an additional opportunity to create customer bonds through intimate engagements with their best customers.

In addition to several other benefits, the program also provides additional incentives for members to keep spending even after achieving platinum status—a step that addresses a common problem in loyalty programs. After reaching top reward status, Fairmont's loyalty members can continue to earn complimentary nights for accumulating additional hotel stays in 10-night increments. This addition limits the incentive of customers to manage their portfolio of reward programs and switch to a competitor once they reach elite status.

Case Study: Re-Evaluating Tier Structure for a Multinational Lodging Firm

In an effort to highlight the potential value of re-evaluating the tier structure of an established rewards program, we partnered with a large multinational hotel chain through the Center for Hospitality Research at the Cornell University School of Hotel Administration. Our goals were to perform a segmentation analysis using their existing databases and then, based on the findings, provide recommendations on how tier structure could be improved to better position the program in a competitive marketplace.

The lodging partner provided a large database that included eight years of transactional data from 100,000 loyalty program members that included 1.2 million transactions. The data set included number of years and tier status within the reward program for each member, basic demographics, transaction spending totals (broken down into room revenue, food and beverage revenue, and other revenue), and reward program points. Within this program, members are placed into three tiers, which we will call base, middle, and elite, to disguise the actual descriptors.

Analysis

Analysis was limited to demographic and spending variables, given the data available from the corporate partner. As a result, a hybrid clustering approach was adopted. First, we established the "years" of activity for each customer as a strata variable. Then, within these strata we used the following variables as segmentation bases:

- Room revenue,
- Food and beverage revenue,
- Other revenue, and
- Accumulated reward program points.

Once the segments were established, we then we classified respondents based on the levels of the segmentation bases as well as descriptors for their status in the reward program, as well as their age and sex.

Exhibit 2

Results of segmentation analysis: seven potential customer tiers

Segment Number and Name	Size	Percentage of Existing Tiers	Average Time Between Transactions (Months)	Room Revenue per Customer		Food and Beverage Rev. per Customer		Other Revenue per Customer		Total Revenue per Customer	
				Mean	Total	Mean	Total	Mean	Total	Mean	Total
(1) Mixed Company	1,803	Base = 58.0% Middle = 0.1% Elite = 41.9%	3.39	3,730	13,909	1,455	11,168	81	469	5,268	25,547
(2) Once a Year	18,520	Base = 87.7% Middle = 7.1% Elite = 5.2%	14.15	1,650	18,419	675	11,988	21	269	2,346	30,677
(3) Value Seekers	329	Base = 88.4% Middle = 5.8% Elite = 5.8%	9.60	1,317	20,410	407	12,619	39	670	1,764	33,700
(4) Baseliners	47,091	Base = 100% Middle = 0 Elite = 0	7.62	6,511	26,915	3,200	14,585	77	308	9,789	41,809
(5) Middlers	7,458	Base = 0 Middle = 100% Elite = 0	12.55	23,607	145,977	6,070	64,414	158	1419	29,835	211,810
(6) Whales	1,013	Base = 26.4% Middle = 29.6% Elite = 44.0%	19.31	33,778	251,463	9,175	63,876	612	2896	43,566	318,237
(7) Elitists	3,525	Base = 0 Middle = 0 Elite = 100%	16.32	20,230	366,162	5,033	127,115	101	2274	25,364	495,552

Findings

The results of the segmentation analysis suggested that a seven-segment solution provided the best representation of the data. In Exhibit 2 we document and name the seven segments, as follows: Mixed Company, Once a Years, Value Seekers, Baseliners, Middlers, Whales, and Elitists. This chart also shows the size of each segment and arrays the seven segments as tiers. Critically, we present the average time between transactions that attempts to describe and capture the purchase cycles for each of the segments. Each segment's purchases are broken out into the three categories (i.e., room revenue, food and beverage revenue, and other revenue), and also their total revenue. (Revenue figures are multiplied by an undisclosed multiplier from their USD base in an effort to conceal absolute values of the partner's reward program.)

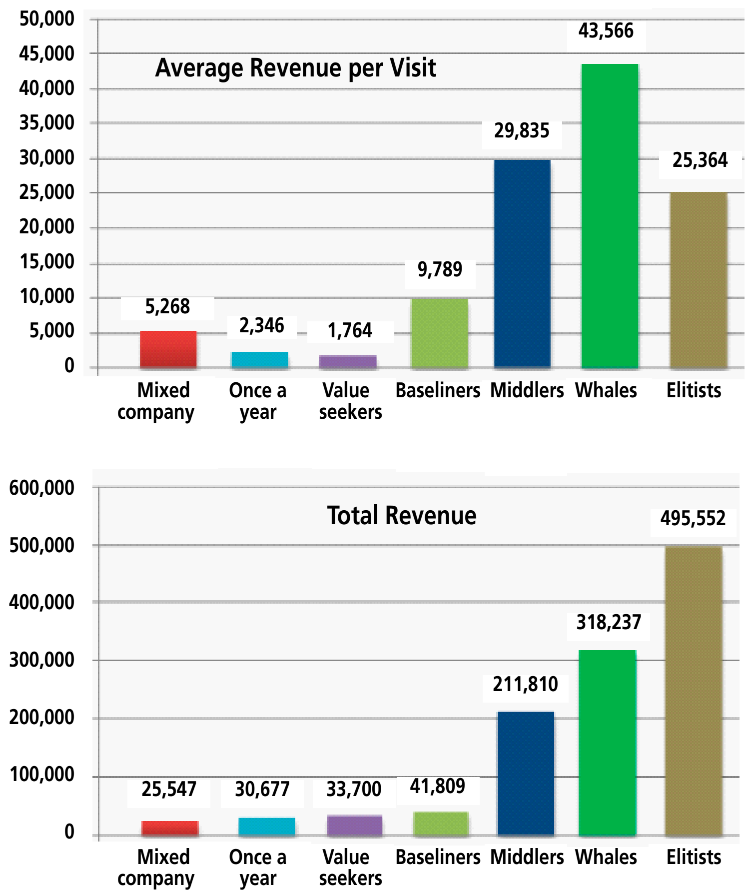
We can match up three of the newly identified tiers in Exhibit 2 with the chain's existing tiers. The Baseliner corresponds to the base tier, the Middler is the middle tier, and the Elitist group covers the existing elite tier. The relative size of these groups is consistent with the proportion of members in the various tiers of the program.

The critical part of this analysis is shown in the other four groups. The other newly identified segments include more of a mixture of program members that have essential spending and utility needs in common. These results provide evidence of the potential heterogeneity that may exist among customers nestled in the current program structure. So, for example, we used total lifetime spending as a segmentation variable, and we found that this solution mixed historical high spenders that have dropped off in patronage with new members to the program that have just begun to spend at high levels. This phenomenon appears in the Mixed Company segment. You would correctly expect to find members of the existing base tier in the Value Seekers and Once a Year segments, and indeed these two new segments predominantly include customers in the base tier. However, we also saw a few higher tier customers enter this mix because some of them have a high purchase frequency but low average spending, while others make infrequent trips but their average spending is high.

The most interesting group that didn't correspond to one of the existing three tiers is what we call the "Whales," so called because their average amount of spending is exceptionally high. They have the single largest average spending in all three categories: room spending, food and beverage spending, and other-revenue spending. Not surprisingly, the total revenue for this group of customers is quite high. The only catch is that their travel patterns are extremely intermittent—in this case, an average of 19 months between transactions. This suggests that these guests engage in heavy spending with the firm about once every other year, or else they take frequent extravagant trips but the actual share of wallet for this chain is relatively small.

Exhibit 3

Average revenue per visit and total revenue across segments



Average and Total Revenue Calculations

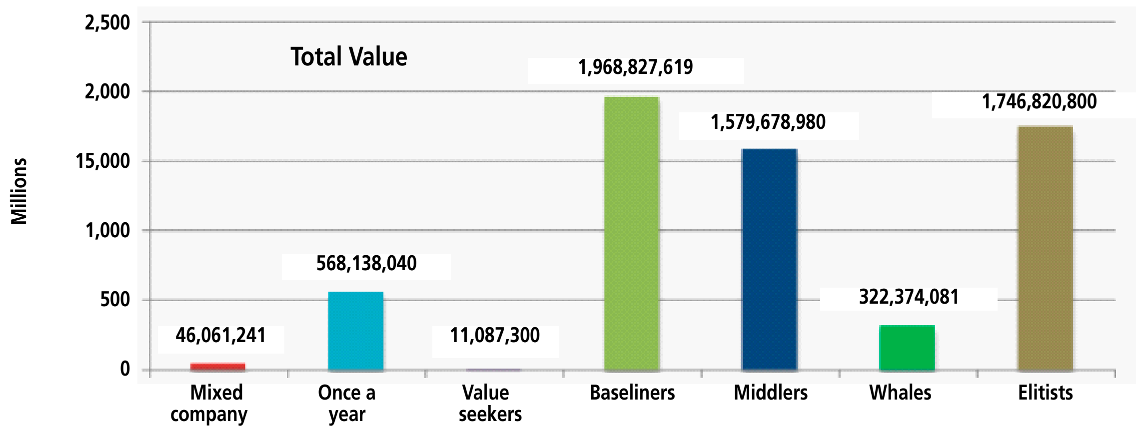
Exhibit 3 provides more detailed analyses of these groups and offers insight into their spending habits. This chart presents two parallel sets of comparisons. First, in the top graph we present the average revenue estimated for each of the spending segments. Customers identified as Whales generated the most revenue per visit. Middlers were second in average spending, and Elitists were the third highest on average. The average per-visit spending for the other four segments combined was less than any one of these top three. Further analysis of these results reveals an interesting finding with respect to the spending levels of the Middlers and Elitists groups. The Middlers actually outspend the Elitists on average, as we said, but the Elitists visit these hotels more often. This observation suggests a potential opportunity to engage Middler program members to increase their frequency, as their volume-per-visit level is already quite strong. Thus, rewards for the Middle tier may want to focus on incentives to increase the number of visits per year.

The bottom graph in Exhibit 3 plots the total spending for customers in each segment. As expected, the Elitist group emerges as the leaders, followed by the Middlers. Interestingly, the Whales are caught in between these two groups.

This chart suggests that an opportunity exists for additional tier creation or structural modifications. Here's how that might work. The Baseliners constitute the single largest group, and their revenue generation and spending is relatively constant. However, if we think of the Middlers as the "next" category of membership, the gap between the two is substantial, given that the Middlers' average revenue per visit is nearly three times that of the Baseliners. We think that this suggests that an intermediate step might be useful between these two tiers. Along these same lines, there may be a need to improve the reward offerings across the tiers to

Exhibit 4

Total value of the customer segments



better encourage repeat visits. Right now, the Whales are almost equally split across the three existing reward tiers. Because they spend incredible amounts when they do visit, the only differentiator in their tier status right now is frequency. Thus, by providing improved incentives for repeat visits by the Whales, the hotel firm could enjoy substantial top-line growth. These are the reasons that we suggest further tier creation and improvement in the rewards at each level. Taken together, the graphs in Exhibit 3 provide a glimpse into the spending habits of various customer segments. Further, it suggests that greater attention should be paid to both Elitists and those members identified as Whales, given that both their spending and revenue generation potential are among the best for the firm.

Value of Customer Segments

An important managerial question concerns an assessment of the total value of each segment. Exhibit 4 presents estimates of the total value of each segment, which is calculated based on the revenue totals per visit and the total visits during the eight-year time span included in the data. The biggest change in these calculations compared to those presented in Exhibit 3 is the fact that that total value calculations account for the relative size of each segment in addition to the average spending levels per customer in the segment. Because of the size of the Baseliners segment (47,091 members), this group emerges as the segment with the highest combined financial value. Also, noteworthy is the fact that while the Whales represent a great opportunity at the individual level, the relative size of this group is modest, reducing the total financial value of the segment. However, given the potential of this group based on their per visit spending, specific promotions or rewards could be developed to engage them to increase stay frequency.

General Discussion and Managerial Implications

Based on this analysis, it appears that the hotel chain's current tier structure may not be optimal given the heterogeneity present in their customer base. The following are some principles that could help inform future optimization efforts within the rewards program.

Augmenting the Tiers

The program evaluated in this research features a base membership tier with no requirements for membership and two elevated tiers (Middle and Elite) that are earned. Our review of the reward program segments revealed that the majority of customers fall into the base tier, which is typical for most loyalty programs. However, the results in Exhibits 2 and 3 demonstrate that not all base members are created equal, and there may be an opportunity to provide an initial promotion in the program for the base customers that spend more per visit and stay more often than the typical customer. As we noted, a comparison of the Baseliner group to the Once a Year segment reveals that on average the Baseliners stay with the lodging firm twice as frequently as the Once a Year segment, and the Baseliners spend substantially more during each trip. Interestingly, the demographics for the two groups are quite similar. This result suggests that there may indeed be an opportunity to introduce an additional tier between their current base and middle structure that provides tangible rewards for these customers who are familiarizing themselves with the brand. By rewarding these customers early, the firm increases their chances of earning their loyalty as they enter the category.

These conclusions mirror some research in the academic literature that suggests consumers understand and appreciate some differentiation in rewards tiers. These changes would require a shift in the conventional wisdom that a three-tier program is preferable. These data provide some evidence to challenge this conventional wisdom. First and perhaps foremost, these data suggest that at least seven different segmented groups exist within this particular firm's customer base. Consequently, it makes sense for program managers to look carefully for non-linearities in spending that may represent opportunities to further segment groups. We realize that a seven-tier program would certainly be too complex, but the results do reveal the potential to provide better rewards to the Whales based on their spending level when they do business with this hotel provider.

Chase the Whales

Let's look more specifically at the "Whales." This group spends large sums when they visit. Given their ability to spend at this level it becomes important to better understand what factors drive their hotel selection. In other words, given that this particular group is willing and able to spend at a high level, they have greater flexibility in selecting various hotels and it is critical to understand what specific needs these customers have. By targeting these individuals with exclusive promotions (not price discounts), the hotel may shorten their purchase cycles and capture a larger share of wallet. For these types of customers, the approach taken by Fairmont may be substantially more effective than providing them simple discounts.

Improve Reward Flexibility

Currently the hotel firm offers rewards at set intervals. One way to extend this system would be to offer multipliers to points for upper-tier consumers, thereby augmenting their status perceptions, making it easier for established members to maintain their status, and driving continued engagement. For example, at the basic level, customers could be provided rewards for simply updating and confirming their contact information as part of annual program maintenance. That simple step would help to ensure accurate data in the program database and provide customers with an excuse to visit program websites and re-familiarize themselves with the potential benefits of membership. Building on this baseline, companies should consider providing rewards for other forms of engagement like membership in brand com-

The presence of unrelated market segments in a loyalty program tier indicates the likelihood that additional tiers would be appropriate.

Hotel managers should consider the opportunity to segment program tiers based on factors other than spending.

munities or specialized brand events. Generating this level of customer involvement increases opportunities to foster emotional connections with customers.

Additional Bases for Segmentation

Finally, managers should also consider the opportunity of segmenting program tiers based on factors other than spending. For example, CVS recently launched a spin-off from their traditional ExtraCare program exclusively for diabetes patients. By making subtle changes to the rewards that are offered and supplemental services, the pharmacy may have discovered a simple way to differentiate its program among diabetes patients by simply recognizing their particular needs and offering rewards that better align with those needs.

Informed Decisions

The goal of this report was to provide a brief discussion and demonstration of the benefits of improved segmentation within rewards programs. As data quality continues to improve, program managers have a wealth of information available to help make informed decisions about the design and promotion of their program. The case study discussed represents the simplest form of segmentation and was limited due to the types of data being gathered by the partner firm. More sophisticated analyses are possible with better data integration, which could result in actionable insights from the differing ROI of tiers within a program, or the identification of key customer characteristics for program enrollment to expand the program. The key lesson of the case study is that by applying the basic foundations of marketing strategy, rewards programs have the opportunity to mature into programs that drive revenue, rather than the simple copycat mentality that cripples their effectiveness and relegating many programs into proxies for coupons or promotions. ■

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