

PUBLIC NOTE

Why Loyalty Programs Don't Work, Part Two

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Last month I [wrote](#) about the ways that airline-style consumer loyalty programs create value for the brands that offer them, and why they're no longer effective as they spread further into other industries and try to appeal to a wider range of customers. I used retailers and hotels as examples of two sectors where loyalty programs are now more trouble than they're worth for everyone involved.

This time I want to dig in more on hotels, which are the harder case of the two for my argument. As I wrote then, they seem to have airline-like advantages:

[Hotels and airlines] have similar exposure to reimbursed business travel and a similar type of constantly expiring inventory with low marginal costs that lowers the cost of in-kind rewards...[and] they're selling an extended service/experience, so they have lots of other cheap things to tweak, like free headphones on the plane or free bottled water in your room...

So if loyalty isn't adding value to hotel brands, it seems unlikely that it's adding value in retail or anywhere else. Let's see.

INDUSTRY STRUCTURE

Major hotel brands rarely own their hotels; the vast majority are franchises where the brand is paid off the top.

Who actually runs the hotel? It could be the owner, the brand, or (increasingly) a third company entirely, which has implications for loyalty programs too. But setting that aside, there's an obvious conflict at the heart of the brand/owner relationship, in which brands are incented to compete with their current owners by adding more hotels to their system.

For various reasons this conflict is arguably more severe in hotels than in restaurants or other commonly franchised businesses, and of course it's an ongoing subject of negotiation and debate in the industry. I won't get all the way into that here, but it's important to mention it for a few reasons:

- Loyalty programs could “work” for the brands in the sense of “splitting the market” of hotel *owners* rather than hotel guests, and in fact I think there are good reasons to believe that they do;
- Notwithstanding the above, you'd expect that certain owners would be able to capture more than their share of value from a loyalty program, and even entire segments or geographies could be net winners or losers

Maybe that will be part three, but what I'm arguing here is prior to all of that. I'm saying that if you take each brand system (the level at which loyalty programs are structured) together with its current and future owners, third party managers, lenders and so on — the net value of loyalty programs is still negative.

MEASURING EFFECTIVENESS

What exactly would it mean for a hotel loyalty program to “work” at this level? I think it would mean that for the average guest who signs up for the program, their lifetime value to the brand system will be higher than if they hadn't. But let's simplify that to a “wallet share” or even just a “night share” and say that they'll choose brands in that system for a higher share of their future paid nights than they otherwise would have.

And let's just grant that if this is happening at any material scale, it will exceed the cost of the redemption nights and other rewards, along with the allocated cost of running the program.

You can't set the bar any lower than that. What sort of evidence would demonstrate that it's being met?

Well, let's start with the evidence that would *not* demonstrate it, which is the kind of evidence you'll hear from industry commentary:

- growth in total number of loyalty members
- growth in members as a share of nights or revenue
- members spending more than non-members
- a greater share of members redeeming their points

All this demonstrates is that you're pushing the program harder. It doesn't answer the question I asked retailers in my April post about the "**omnichannel trap**": are your loyalty members becoming your most valuable customers, or have you just forced your most valuable customers to become loyalty members?

That question of causality is a lot harder to answer than you might think. For example, even if you find two otherwise-identical customer cohorts who received the same signup offer and find that those who have signed up are spending more nights with you than those who didn't, they might have been planning to do that anyway; it could be why they signed up.

What you'd really need are controlled experiments where you start by identifying a cohort of non-members, randomly assign half of them to receive an offer, and track them from there.

And even then, how long would you have to track them? Because it's possible that even if pushing them into the program increases your share of their travel in the short term, it comes at the cost of longer-term commoditization and loss of brand value, i.e. they move on faster to other brands a few years out.

THE HIDDEN COST OF "PERKS"

Why would they do that? Well, think about all the little "features" that are used to drive loyalty sign-ups. Like internet access: at a higher end business hotel you might still encounter something like a slow connection for \$5.95/day or free for basic loyalty members, and a faster connection for \$9.95/day or free for members with mid-tier status.

Now think about how hard the marketing and branding teams have worked to appeal to Millennials and Gen Z, and everything they've tweaked about the hotel design, features, services, and so on. And think about how much of that brand value is wiped out by that one transaction with the internet service. Asking a 28-year old business traveler in 2019 to fill out a form to make the internet work is like asking a 58-year old to fill out a form to make the lights work. Maybe they'll do it, but you've sent a very clear message about the relationship between your brand and the modern world.



Again, everything about hotels is complicated, and I'm not saying that login/paywalls for internet service arose *because* of loyalty programs. I think they have a lot to do with owner/management conflicts of interest, price discrimination targeting reimbursed business travelers, maybe liability concerns, poor tech decisions, who knows what else.

But I do think they'd be entirely gone by now if they weren't being used to push loyalty programs. And they *are* pretty much gone from independent hotels in these segments. And every night, that's teaching thousands more travelers (and online review algorithms) a lesson about the difference between branded and independent hotels.

CONCLUSION

Even on a per room basis (e.g. by RevPAR index) the larger hotel brand systems may still be taking share from independents — but that doesn't mean their loyalty programs have anything to do with it. Actually, you'd expect loyalty to increase along with market share *even if you do nothing to reward it* (this is the “**double jeopardy**” effect in marketing) and there are plenty of other advantages to scale. For example, their share of new development is even larger, so their average hotels may simply be getting newer.

After that April note about ecommerce, a reader in academia replied:

You're basically hitting on the Lucas Critique for retail. One of my friends is convinced someone in computer science will get a Nobel Prize for applying it to data science.

The Lucas Critique (which has to do with macroeconomic policy) is a special case of a broader rule in social science: *when a measure becomes a target, it's no longer a good measure*. And that does sound like a good rule for “data scientists” everywhere to tape to their monitors. As more of the business world is run on these pseudo-academic methods, they're at risk of making many of the same mistakes that academics have made.

But I was also thinking of the “butterfly effect” from chaos theory: in a sufficiently complex system, *the approximate present does not approximately determine the future*. Even if you had the best possible information on what loyalty programs are really doing today, it might not tell you much about how they’ll work in the future, given the rate of feedback/copying, the growing number of products and services that use them, and the multiplying connections between them in the form of transfers and status matching.

In other words, as customer retention costs and lifetime value become more complex and contingent, the premium on *simplicity* should be rising. And loyalty programs are the opposite of simple.

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