The Customer May Not Always Be Right: Customer Compatibility and Service Performance

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It has been well established that it is advantageous for companies to satisfy their customers. Satisfied customers are more loyal, purchase more frequently, have a higher willingness to pay, and are more profitable over the long run than dissatisfied customers. As such, managers continuously strive to improve service outcomes and reduce the variability in the operating systems they oversee. From an operational perspective, these efforts are often inwardly directed. Employees are incented, processes are honed, and facilities are developed with an eye toward raising satisfaction levels, and in turn, firm performance. However, we suggest that an outward consideration – in particular, the fit between the needs of a firm’s customers and the capabilities of its operation, which we term customer compatibility – may have even greater implications for the level and consistency of satisfaction a service operation is able to deliver, and its resulting financial performance.

In a manufacturing operation, inputs to the production process are sourced with compatibility in mind. Service operations differ fundamentally in that an essential input to the process – the customer – gets to choose which operation he or she engages. A wealth of theory and empirical evidence suggests that focused operations are more efficient and profitable. An extension of this idea is that customers whose needs are more aligned with the tradeoffs inherent in an operating model will impose less operational complexity and may, in turn, be served more effectively than customers whose needs are less aligned. Operations and industrial organization theory suggests that the process by which customers sort themselves among firms in a local market is rational and optimal, resulting in the pairing of each individual with the operating model best equipped to serve his or her needs. However, information asymmetries and the limited availability of local options may inhibit this process in practice – undermining the degree of compatibility for some
customers. In this paper, we investigate the impact of customer compatibility – the degree of fit between the needs of individual customers and the capabilities of the operations serving them – on customer experiences and firm performance. Through three empirical studies set in the retail banking industry, we make three contributions to the operations management literature.

First, although numerous extant works have identified market, location, process, employee, and customer-level factors that covary with satisfaction, we conduct the first analysis that considers all five dimensions simultaneously, in order to quantify the relative significance of each class of factors. We decompose the variance of 58,294 face-to-face retail-banking transactions. In our models, which account for roughly a quarter of the aggregate variance in customer satisfaction, customer-level differences account for the vast majority of the explainable variance (95.9% - 96.8% of the explainable variance, 21.9% - 25.1% of the total variance, depending on the model). Differences among employees, processes, branches and markets account for the remainder. Further analysis reveals that markets, locations, processes, and employees – elements of the operating system that are traditionally considered to be within the manager’s control – exhibit limited between-group variance and considerable within-group variance. For example, each employee may deliver relatively similar levels of satisfaction on average, but individual employees provide highly variable satisfaction from one transaction to the next. In contrast, customers exhibit relatively high between-group variance and relatively low within-group variance. Average levels of satisfaction differ markedly from one customer to the next, but individual customers tend to report similar satisfaction from transaction to transaction. These results highlight how differences among customers play a critical driver in determining the outcomes of service interactions.

Second, we provide evidence that these customer-level differences are explained in part by customer compatibility – the degree of fit between the needs of individual customers and the capabilities of the operations serving them. Leveraging survey data collected by J.D. Power and Associates from 149,389 customers interacting with 166 retail banking institutions during a five-year period, we find that customers whose demographic characteristics, and in turn needs, diverge from the needs of their bank’s average
customer are less satisfied with the service they receive on a broad array of operating dimensions. We further show that firms serving more heterogeneous customer bases – whose demographic characteristics, and in turn needs, are more dispersed – have customers who are significantly less satisfied overall. We find the negative effects of customer divergence are most pronounced for firms with customer bases whose needs are less dispersed – suggesting that focused service providers, optimized around the needs of particular customers, are most vulnerable to the negative effects of customer incompatibility.

Third and finally, we provide evidence that customer compatibility has a substantive effect on a firm’s financial performance. A longitudinal analysis of branch-level deposit growth over a twelve-year period reveals that controlling for a host of factors, branches with more divergent (less compatible) customers exhibit slower deposit growth than other branches of the same institution. Against the backdrop of an average annual deposit growth rate of 6.7%, increasing a branch’s customer divergence by one standard deviation resulted in a 1.2% decrease in annual deposit growth, relative to other branches of the same firm.

We further find that the branches of firms with more dispersed customer bases experience considerably slower branch-level deposit growth over time. In our analysis, increasing customer dispersion from that of a first percentile (very focused) firm to that of the median (moderately focused) firm resulted in a 13.9% decrease in annual branch-level deposits.

Taken together, these results highlight the important role that customer compatibility plays in determining customer experiences, and in turn, financial performance, in service organizations. Although a considerable body of research has documented factors that influence service outcomes for the customer and organization that are under the direct control of operating managers, our research highlights the complementary impact of factors that are not under managers’ direct control – in particular, the degree of compatibility between the capabilities of an operation and the needs of the customers who choose to transact with it. This is an idea that has not been well explored in our literature, but it is foundational to the design and management of service operations intending to deliver long-term value to customers and shareholders alike.