

Working Paper

‘Exit, voice and loyalty’ in business to business markets

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Abstract

Hirschman (1970) uses an analytical discussion to consider how a customer may use 'voice' or display 'loyalty' within an exchange situation rather than discontinue the exchange by 'exiting'. While his analysis provides valuable insights into customers' behaviour towards their suppliers, the need for further development of his analysis when applied to business to business exchanges is considered and the potential of using 'event analysis' to provide insights into the dynamics of practical situations is discussed.

Introduction

The IMP Group's interaction approach does not necessarily imply that relationships of the type discussed under the broad heading of "business to business relationship marketing" will exist. Nevertheless, there is no doubt that the concepts of "commitment and trust", which have been identified to be essential components of relationship building (Morgan and Hunt, 1994), are often found within the interactions which are the central concern of the IMP Group and that examples of effective business to business relationship marketing are frequently found in the cases discussed by the IMP Group (e.g. Ford, 2002).

Yet, it is important that basis for the on-going nature of many interactions is fully understood. Indeed observations and comments on the benefits of business to business relationships should always be tempered by the recognition that there is fundamentally only one reason why a firm will enter into a relationship. This is that a firm will only enter relationships because it perceives that by doing so will it be able to create greater value for itself than if it pursued a transactional approach to the exchange. However, business circumstances are constantly changing and any firm will from time to time need to reassess the value that both its purchasing and its supply arrangements create for it. Even in those cases where a customer and supplier have had a long-term close relationship, such reassessment may lead to changes that range from minor alterations in the detailed operation of the relationship through to its being ended.

Hirschman's analysis – an outline

Hirschman (1970) uses a verbal analysis to consider the complex interplay between a customer's willingness to: 'exit from'¹; 'use voice within'; and, 'demonstrate loyalty to' a relationship. He considers how the probability of a supplier recognizing the need to remedy a deterioration in the quality of its product offering is affected by the possibility of customers 'exiting' from the exchange but that 'loyalty' may delay the use of 'exit'.

Hirschman uses these terms as follows:

'Exit' is where "The customer, who dissatisfied with the product of one firm, shifts to that of another,..." (p.15)² and he makes it clear in various places that

‘exit’ is moving from an existing supplier to one of its competitors. For example he refers to going “over to the competition” (p.30).

‘Voice’ is defined “...as any attempt at all to change, rather than escape from, an objectionable state of affairs...” (p.30). ‘Voice’ might involve individual or collective action aimed at the supplying firm’s “management or to some authority to which management is subordinate or through general protest addressed to anybody who cares to listen.” (p.4).

The ‘loyalty’ option recognizes that a customer may continue to purchase from a supplier “longer than they would ordinarily, in the hope or, rather the reasoned expectation that improvement or reform can be achieved ‘from within’ ” (p.79). Thus Hirschman suggests that, where ‘loyalty’ exists, the customer is “willing to trade off the certainty of exit against the uncertainties of an improvement” (p.77) and it “holds exit at bay and activates voice” (p.78).

Hirschman does not define the term ‘product’ but appears, as an economist, to be using it in the restricted sense of the physical attributes of the item purchased. However, there seems to be nothing inherent in his argument which would make it inappropriate to use the term in the manner more typical of marketing writers. That is where the product is made up of a bundle of attributes which “includes the functional utility of the goods, the product service that the manufacturer provides, the technical service he may give his customers, and the assurance that the product will be delivered when and where it is needed and in the desired quantities.” (Corey, 1975) Thus this paper will use the term ‘product’ in this more comprehensive manner.

Some of Hirschman’s findings, while perhaps not counterintuitive, do provide unexpected insights. For example his argument shows that, while the easy availability of the exit option makes the recourse to voice less likely, “it appears that the *effectiveness*³ of the voice mechanism is strengthened by the possibility of exit.” (p.83). Hirschman’s argument is that, if ‘exit’ is available, then a party is unlikely to take the trouble to express ‘voice’. However, where the supplier believes that the exit option is available to a customer, then if the customer uses ‘voice’, it is more likely to be effective. A specific circumstance where it seems that Hirschman feels that ‘voice’ will be particularly effective is where there are big buyers and he states: “Voice is most likely to function as an important mechanism in markets with few buyers or where a few buyers account for a significant proportion of total sales,...” (p.41)

Hirschman demonstrates that a supplier’s recognition of the necessity of remedying any deterioration that its customers perceive in the quality of its offering will certainly be affected by its assessment of the probability of its customers ‘exiting’. His analysis suggests that the supplier would perceive the ‘exit’ of a customer as something to be avoided. This paper, though, will argue that there are circumstances where, rather than to respond to the customer’s voice, the supplier will prefer the customer to ‘exit’.

Hirschman nuances his argument through the use of the concept of ‘loyalty’. He argues that “the likelihood of voice increases with the degree of loyalty” (p.77). ‘Loyalty’ he argues arises when a customer has a considerable attachment to a

product or an organization and in consequence will wish to influence the supplier rather than 'exit' - especially when the supplier moves in what the customer believes is the wrong direction with regard to their joint value enhancing activities. He reasons that not only does 'loyalty' limit the tendency of customers to 'exit' when dissatisfied with the relationship but that loyal customers will remain in a relationship in the "reasoned expectation that improvement or reform can be achieved 'from within'." (p.79) It is logical to assume that where a relationship exists then such "reasoned expectation" will be enhanced.

Hirschman points out that loyalty raises "the cost of exit" (p.80) for the customer and accepts that, if a supplier recognizes this, it may therefore take action to encourage such 'loyalty'. Indeed he would concur with the statement that suppliers: "...have an incentive to adopt strategies that make established customers unwilling to incur the time, trouble, and expense of collecting information from other suppliers." (Okum, 1981, p.170) However, the interesting contradiction arises that, if a supplier can encourage a customer to be loyal, then this reduces the likelihood that the customer will consider 'exit' and thus the need for the supplier to respond to the customer's 'voice'.

Limitations of Hirschman's analysis for business to business markets

Although Hirschman recognizes that there are some markets "where a few buyers account for a significant proportion of total sales, ..." (p.41), his work was primarily developed in the context of the behaviour of individual consumers. Nevertheless, Hirschman's analysis has been found to provide valuable insights into the dynamics that can arise within business to business interactions (e.g. Gassenheimer et al., 1998; Ping, 1997, Johnston et al., 2006; Johnston and Hausman, 2006; Kingshott, 2006).

There are though two problems in seeking to apply Hirschman's ideas to business to business exchanges. First, Hirschman says little about the financial implications of decisions to exercise 'exit', 'voice' or 'loyalty'. For example, Hirschman assumes that customers confront a number of suppliers offering similar products. So, if a consumer decides that its current supplier is unsatisfactory, then pursuing an 'exit' strategy involves nothing more radical than moving to an alternative supplier of a comparable product. He appears to assume that 'exit' involves little cost, only stating that the costs of 'exit' may be substantial when 'loyalty', which he accepts includes such matters as the personal feelings of the management (p.39-40), exists.

Hirschman states that a customer deciding whether to use the 'voice' or 'exit' option will take into account the chances of it persuading the supplier to respond to its 'voice'. It will thus be judging whether it is worthwhile exchanging the current known situation for the relative uncertainty of the consequences of 'exit'. However he does not explore what determines the "worthwhileness" of the situation. To be able to do this the customer will also need to consider the probability of encountering the following financial effects:

- a/ The financial implications of using 'voice' successfully. These are the costs of managerial time balanced by the benefits derived from the supplier's changed behaviour.

b/ The financial implications of demonstrating 'loyalty'. These are the costs of managerial time balanced by the benefits gained from persuading the supplier to change its behaviour. The cost will be extended over a longer period than 'a' above and, after some period, the strategy will switch to either 'a' above or to 'c' or 'd' below.

c/ The financial implications of using 'voice' unsuccessfully but not then 'exiting'⁴. These include the cost of the management time used without achieving its objective. Furthermore there is the risk of it becoming industry knowledge that it is a firm which has been unsuccessful in a negotiation.

d/ The financial implications of 'exit'. The costs here include: the need to find an alternative supplier; the risk that the new supplier may be no more accommodating than the existing one; and, any costs of bedding down the smooth running of the new relationship. However they must be balanced against any benefits achieved by changing supplier.

A second limitation of Hirschman's work, when applying it to business to business exchanges, is that it concentrates on the customer's behaviour. However, in business to business markets the supplier is as likely as the customer to initiate changes in its exchange activities. For example, a supplier is as likely as a customer to decide to 'exit' a relationship. Yet Hirschman represents the supplier as merely responding to a customer's behaviour, such as the threat of 'exit', rather than ever being the initiator of behaviour. Furthermore, Hirschman does not explore in any detail the supplier's response to a customer's use of voice and its threat of 'exit'. He goes no further than to imply that a supplier is more likely to respond to a customer's 'voice' if it believes that the customer's threat of 'exit' is real, suggesting that "it appears that the *effectiveness*³ of the voice mechanism is strengthened by the possibility of exit." (p.83.). He also fails to discuss any second order effects even though these, in the case of business to business exchanges, may be substantial.

The supplier's behaviour deserves more attention not least because it is reasonable to assume that any response to a customer's 'voice' will result in the supplier incurring some costs against which it must set any benefits that it believes will gain as a consequence. Furthermore, as the examples below show, no matter how probable it seems to the supplier that the customer will 'exit', the supplier may believe that the financial implications of responding are so great that it cannot afford to respond to the customer's 'voice'.

The supplier, when determining how to responds to the customer's 'voice', must therefore seek to assess the financial implications on itself:

a/ of responding satisfactorily to the customer's voice. These will include the implementation of any changes sought by the customer plus the recurring costs resulting from these changes (for example, the consumer may be seeking a lower price and/or a change in quality). However there may also be significant second order issues. For example, if the supplier responds to the customer's 'voice' requesting, say, a lower price then, if the supplier accedes

to this, there will be the risk that other customers will demand similar reductions.

b/ of the customer demonstrating ‘loyalty’. These arise (assuming that the supplier’s management does not totally ignore the customer) from the costs of management time in, at least, listening to the customer and explaining why it (the supplier) will not respond to the customer’s ‘voice’.

c/ of not responding to the customer’s ‘voice’ yet the customer still does not ‘exit’⁴. At the very least the customer will be dissatisfied with the outcome and there may consequently be a need for the supplier’s management to be especially sensitive to any further demands from this customer.

d/ of the customer ‘exiting’. These will primarily be the subsequent loss of revenue over a period of time. Where the supplier has assets that are only used for supplying this specific customer then the financial implications will include the costs of lower than expected asset utilization. There may also be second order effects. For example, should the customer’s exit become public knowledge then there may be a negative impact on the supplier’s share price which can result in the attention of the supplier’s management being distracted by fears of take-overs, etc. Furthermore other existing customers may see an opportunity to take advantage of a weakened supplier and any potential new customers may assume that they are negotiating with a weakened supplier.

Table 1 The financial implications of exit, voice and loyalty

Customer’s strategy	Customer	Supplier
Successful use of ‘voice’	Benefits arising from the successful use of voice less cost of management time in achieving it.	Costs of management time and of implementing changes in response to ‘voice’ plus the recurring costs of these changes. <i>Reactions of other customers.</i>
Demonstrate ‘loyalty’	Belief that benefits will arise from the use of voice less cost of management time in achieving it.	Costs of management time.
Unsuccessful use of voice but no recourse to ‘exit’	Cost of wasted management time. <i>Loss of reputation in the market.</i>	Costs of management time. Costs of disaffected customer.
‘Exit’	Benefits arising from dealing with new supplier less costs of management time finding new supplier and setting up new supply arrangements.	Loss of revenue. Costs of lowered asset utilization. <i>Position as a supplier weakened due to public knowledge of loss of business.</i>

Note: Items in *italics* are second-order effects.

By bringing together the financial implications of these strategies for the customer and for the supplier (see Table 1) it is possible to appreciate that the supplier's response to the customer is more complex than that implied by Hirschman. Indeed it implies that this is an interactive situation in which the reaction of the supplier will be determined by its own assessment of the financial implications for it of each of the customer's possible strategies. For example a supplier may perceive that the financial implications of it responding to the customer's voice are far more onerous than allowing the customer to 'exit' or for itself to exit the relationship. It may then refuse to respond to the customer's 'voice' and accept that the relationship will terminate.

Assessing the financial implications

Little is known about the financial implications of the possibilities set out in Table 1. Indeed it would be a very fortunate researcher that gained the type of access to firms that will enable them to identify and measure these financial implications. However, financial analysts use "event studies" (McWilliams & Siegel, 1997) to estimate how a share price would have moved over some period in the absence of new information and then compare this to the actual price during which some event or information release occurred. These studies are based on the efficient market hypothesis that "securities' pricing depends on investor expectations and that investors make good use of available information in forming these expectations." (Milgrom and Roberts, 1992, p.467). It is therefore possible in some cases to impute the relative importance of *some* of the entries in Table 1 through examination of their share price movements. For example, examination of the movement of a supplier's share price when a customer's 'exit' has become public knowledge may give some guide as to the financial implications of 'exit' as the two illustrations below demonstrate.

Tesco and Dairy Crest In the summer of 2004 Tesco (the UK's largest supermarket chain with approximately 30% of the UK market) was renegotiating its contracts with its three milk suppliers and in August 2004 it was announced that Tesco was not renewing its long-standing contract with Dairy Crest (one of the three largest UK suppliers of milk). The contract was said to be worth £60 million a year and reduced Dairy Crest's share of the milk sold in UK supermarkets from 26% to 18% and it was predicted its loss would reduce Dairy Crest's profits by £12 million. On the day that it was announced that it had lost the Tesco contract, Dairy Crest's share price fell by 18% while Tesco's share price rose by 0.6%. One result of the loss of Tesco's business was the assessment of the financial market that, because Dairy Crest now had spare processing capacity, it would find itself in a weak position when seeking to negotiate contracts with other supermarkets to replace the Tesco business. It was also assumed that this would also be the case when Dairy Crest renegotiated any other existing contracts.

Tesco and Entertainment UK (EUK) In the second half of 2005 Tesco sought to renegotiate the terms relating to the third year of a contract for EUK to supply all of its CDs and DVDs. Sales to Tesco represented half of EUK's turnover with a further 40% coming from supplying Woolworths (EUK's parent company). Tesco argued that there had been deflation in the market for entertainment software and that it therefore needed EUK to lower its prices. As a result of extensive negotiations new

terms were agreed. However, EUK announced that the contract was now unprofitable and that during the final year of the contract the new terms would reduce its profits by at least an additional £10 million on an annual turnover of £450 million. Furthermore, EUK stated that it did not, as a consequence of the renegotiation, expect there to be an agreement for an extension of the existing contract when it ended in February 2007. The seriousness of this situation for EUK was indicated by press comment such as: “Replacing Tesco, with its huge 30.5% share of Britain’s supermarket sales, will be all but impossible.” (Daily Mail, 2006, p.19).

Woolworths, because of the significant impact of the changed contract on its profits, was obliged to issue a profit warning - that is a formal statement that earnings for a specified future period will fall short of current expectations. (Bulkley & Herrerias, 2005, p.605). This led to a 12% fall in Woolworths’ share price – the largest fall on the London Stock Exchange on that day while Tesco’s shares price remained unchanged.

Comment

The examples of Dairy Crest and EUK are perhaps atypical in that they were both relatively high profile ‘exit’ situations for two reasons. First, both were large companies actively traded on the London Stock Exchange. Second, any activity by Tesco, the UK’s largest retailer, which appears to disadvantage its suppliers or its customers, attracts considerable media attention. This was so in the two above cases with newspapers headlines such as: “Tesco Tactics” and “Tesco shrinks Woolies” appearing plus editorial comments to the effect that: “Tesco was labelled ‘King Kong’ for crushing its rivals” (Manning, 2006, p.52) and “Woolworths was all but screwed to the ground when it negotiated a three year deal with Tesco...” (Daily Mail, 2006, p.19).

The implication of these two examples is that the financial consequences for both Dairy Crest and EUK of agreeing to the new terms that Tesco was seeking through the use of ‘voice’ would have been more adverse than those arising from Tesco’s ‘exit’. In other words both suppliers perceived that, given the new terms that Tesco was requiring them to meet, they would gain greater value outside the relationship than within it. Furthermore, it is worth noting that, although the consequences for these two suppliers of Tesco ‘exiting’ their relationship were similar, there is a fundamental difference in the type of product involved. In the case of Dairy Crest the product was a commodity i.e. milk supplied in standard packs identical to those used by Tesco’s two other milk suppliers. In comparison, EUK was Tesco’s sole provider of a unique supply service.

What is significant is how asymmetrical the effect of Tesco’s ‘exit’ was, with Tesco suffering no impact on its share price but both Woolworths (as EUK’s parent company) and Dairy Crest both being considered as possible take-over targets in the aftermath of the large falls in their share prices. From Tesco’s point of view the financial consequences of ‘exit’ were less severe than either ‘voice’ or ‘loyalty’ and in its pursuit of the ‘voice’ option Tesco would have been well aware of the importance of its contracts for both Dairy Crest and EUK and may as consequence, and as Hirschman’s analysis would have predicted, have anticipated them being more

responsive. In considering the risks of the 'exit' option Tesco would have been aware that there were other potential suppliers of milk and that capacity in the milk industry was far from tight. It would therefore probably have regarded the possibility of 'exiting' Dairy Crest as involving it in little risk. In the EUK case, while Tesco had no immediately available alternative supplier, the dispute with EUK occurred twelve months prior to the end of the contract. This clearly gave Tesco plenty of time to find a new supplier and therefore was also seen as exposing it to little risk.

What is also noteworthy is the existence of another asymmetry for, although both EUK and Dairy Crest did later gain new contracts from other customers, the announcements of these new contracts led to very small increases in their share prices in comparison with the falls which had followed from loss of Tesco's business. In Dairy Crest's case this perhaps reflects the press comment that Dairy Crest would now need "to bid aggressively for new customers so at least the bulk of the lost Tesco profits have gone for good." (Urry, 2004, p.24). Similar comments followed, with an emphasis on the lower turnover involved rather than its profitability when, in January 2007, EUK won a large contract that replaced most of the lost Tesco business. In fact the contract was not quite as big as that with Tesco and was only achieved by buying out an independent wholesaler for £20 million. Indeed Woolworth's share price rose by only 3% when the deal was announced.

Conclusions

Hirschman's analysis of the relationship between 'exit; voice and loyalty' is powerful and has provided many useful insights into the interplay of these three strategies. However, this paper has suggested that, while his analysis has assumed that the supplier is relatively passive, within business to business markets this is often not the case. The paper specifically suggests that: his analysis would benefit from giving more attention to the financial implications for both the customer and for the supplier of the other's view of the choice between 'exit, voice and loyalty'; that second-order effects may be significant and should be factored into the an analysis; and, that the use of 'event studies' may provide some insights into the financial implications for both customer and the supplier of the customer's strategy. In particular the paper does question Hirschman's claim that: "Voice is most likely to function as an important mechanism in markets with few buyers or where a few buyers account for a significant proportion of total sales, ..." (p.41). Indeed this paper suggests that, on the contrary, allowing a customer to 'exit' may sometimes be less threatening to the supplier than responding to a customer's 'voice'.

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¹ Where words and phrases are in single inverted commas this is because they are being used in the specific manner used by Hirschman.

² All unattributed quotes are from Hirschman (1970).

³ Italics in the original.

⁴ As the definition of loyalty on p.3 makes clear, this is not the same as ‘loyalty’.