AN EMPIRICAL ANALYSIS OF THE DETERMINANTS OF SME´s CUSTOMER LOYALTY: EVIDENCE FROM SERBIA

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Abstract

Small and medium-sized enterprises are regarded as the main drivers of economic growth and employment. In spite of rich empirical evidence of the determinants of customer loyalty, as one of the main precursors of enterprise's profitability, this research topic has been largely neglected in emerging economies. Therefore, this study aims to propose and empirically examine a model of SMEs' customer loyalty in Serbia, based on previously established relationships among the determinants of customer loyalty and their effects on loyalty. Proposed conceptual model was examined by means of structural equation modelling (SEM). Findings of the study indicate direct and most significant impact of customer satisfaction on loyalty, followed by market orientation and service quality as indirect determinants of customer loyalty. Theoretical and managerial implications and limitations of study findings are discussed and directions for future research are highlighted.

Keywords: *market orientation, service quality, customer satisfaction, loyalty, SMEs*

JEL Classification: M31, D12, M21

Introduction

Small and medium-sized enterprises (SMEs) are regarded by the European Commission as the main driver of economic growth, innovation and job creation in the EU. European Commission defines SMEs as enterprises which employ fewer than 250 persons, generate an annual turnover of up to 50 EUR million and have an annual balance sheet total of up to EUR 43 million (http://ec.europa.eu/eurostat). This category of enterprises comprises 99,8% of total number of enterprises active in non-financial business economy and provides employment to around two-thirds (67.1%) of the EU-28's non-financial business economy workforce and their share in value added in 2012 was 57,3% of the EUR 6.18 billion (http://ec.europa.eu/eurostat/ statistics). Micro enterprises, employing fewer than 10 persons, account for 92,7% of enterprises within non-financial business economy, whereas their relative shares in workfore and value added are significantly lower, being 29.1% and 21%, respectively.

According to the Report on SMEs and enterpreneurship of the Ministry of Economy of the Republic of Serbia for 2013, SMEs account for 99.8% of non-financial business economy and provide employment to two-thirds of workforce in non-financial business economy, whereas their contribution to GDP equals to 34% (Report

on SMEs, 2014). This category of enterprises is considered crucial for economic growth and balanced regional development in Serbia.

However in order to take more active role in economic progress of Serbia SME sector has still to resolve certain issues. The level of competitiveness of Serbian SME sector significantly lags behind the European average and most comparable countries (Report on SMEs, 2014). According to the study of the Ministry of Economy on the status, needs and problems of SMEs and entrepreneurs in Serbia, conducted on a sample of 10.000 economically active SMEs in 2013, high competitive pressures have been recognized as one of the main obstacles towards better business performance (Report on SMEs, 2014). Lack of finance (30%) and unsatisfactory market position (25%) are regarded as leading impediments towards better business performance. In order to improve business position it is of key importance to obtain solid knowledge of the factors that influence customer decision-making process and which contribute to the development of loyal customer base, as the construct of customer loyalty has been generally regarded as the proxy for profitability (Fornell et al., 1996; Johnson et al., 2001; Chiu et al., 2011).

Building a loyal customer base is considered as an important source of sustainable competitive advantage (Mandhachitara, Poolthong, 2011). Loyal customers are willing to recommend a product or service (Zeithaml et al., 1996; Reichheld, 2003) and generate higher revenues for companies due to their readiness to repurchase and buy additional goods and services from the same company (Gounaris et al., 2010; Evanschitzky et al., 2012). Building and maintaining customer loyalty also impacts company's future profitability, as it is five to nine times more expensive to attract a new customer than retain a loyal customer (Chiu et al., 2011). Previous studies have reported that the reduction of customer churn by 5% can yield profit improvements of 25% to 85% (Reichheld, 1996). Customer loyalty can offset competitors' efforts in attracting new customers and boost employees' morale and productivity (Lewis, Soureli, 2006). Due to its relevance for companies' performance the construct of customer loyalty has been the subject of extensive examinations in previous empirical studies. Most studies investigating the determinants of customer loyalty have reported significant impact of the delivery of high quality service and satisfying customers on building loyal customer base (Choi et al., 2004; Brady et al., 2005; Žabkar et al., 2010). Recent empirical evidence also provides support for the impact of company's market orientation on customer retention and business performance (Chen, Quester, 2009; Wang et al., 2012). However the studies on the determinants of customer loyalty have been mainly conducted in the context of the US economy and Western Europe. Great attention has been also paid over recent years to the influential factors of customer retention in developed Asian economies, whereas the determinants of customer loyalty in the context of emerging market economies have been largely under-studied. This is especially pertinent to Serbian economy and its SME sector. Due to the fact that SMEs generate one third of Serbian GDP, and expectations regarding their even more prominent role in the revival of Serbian economy, it is especially relevant to investigate the determinants of customer loyalty as the proxy for enterprises' profitability. Therefore by examining relationships among key determinants of customer behavioral intentions and their impact on customer loyalty this study aims to fill this void in the literature. Examination of dependence relationships among the constructs will be performed in the context of retailing, as almost one third of SMEs in Serbia (30%) operates in the field of wholesale and retail trade.

The remainder of the paper is organized as follows. The following section provides theoretical background of market orientation, service quality, satisfaction,

their interrelatedness and impact on customer loyalty. Methodology is discussed subsequently, followed by the results of the empirical examination of hypothesized relationships. Implications of the study are highlighted and limitations and suggestions for future research are indicated.

Conceptual Framework

Service quality, its traits and effects, have been regarded as the most extensively studied topic in Services Marketing literature to date. The construct of service quality, according to the most widely accepted conceptualization, is defined as „the customer's judgment about an entity's overall excellence or superiority" (Parasuraman et al., 1988; p.15). It has been generally regarded as the construct which is particularly arduous to define and measure, as it is not based on some objective criteria, but service quality impressions depend on a discrepancy between customer's expectations formed before service experience and his perceptions of delivered service. This construct is related to, but not equivalent to satisfaction, which is defined as „the summary psychological state resulting when the emotion surrounding disconfirmed expectations is coupled with the consumer's prior feelings about the consumption experience" (Oliver, 1981; p.27). A number of studies on service quality measurement, conducted in a wide range of service industries, have been dominated by Parasuraman et al.'s (1988) multiple-item scale. According to this approach service quality is a multidimensional constructs whereas customers' expectations and perceptions regarding five service quality dimensions, reliability, responsiveness, assurance, empathy and tangibles, shape customers' impressions of service quality. Numerous empirical studies have found support for significant impact of service quality on customers' willingness to repurchase and recommend the service provider to a friend (Cronin et al., 2000; Brady et al., 2005). Based on previous research findings the following hypothesis is proposed:

H1: Service quality is positively related to customer loyalty.

Due to its potential influence on customer purchase intentions and willingness to spread positive word-of mouth, the construct of customer satisfaction has also been the subject of much research attention. A considerable number of authors have argued that service quality, in addition to its direct impact on customer loyalty, adds to future behavioral intentions of customers through its positive influence on customer satisfaction. Results of the study conducted in the context of high-contact service shops in Hong Kong provide evidence of significant impact of service quality on customer satisfaction, which further leads to customer readiness to consider the service shop as the first choice in future purchases, say positive things and recommend the service shop as well as encourge others to use the services of the same provider (Yee et al., 2010). Positive effect of service quality on customer satisfaction and its relatedness to customer behavioral intentions, i.e. revisit and repurchase intentions and customer willingness to recommend, have been also supported in a number of studies conducted across service industries (Brady et al., 2001; Choi et al., 2004; Brady et al., 2005; Gounaris et al., 2010; Žabkar et al., 2010; Setó-Pamies, 2012; Calabuig Moreno et al., 2015). Therefore, the following hypotheses are proposed:

H2: Service quality is positively related to customer satisfaction;

H3: Customer satisfaction is positively related to customer loyalty.

Small and medium-sized enterprises are usually regarded as more innovative and flexible than their larger counterparts. Establishment and maintenance of close

relationships with customers is one of the key distinctive traits of small companies. Adoption of market oriented practice is what enables SMEs to compete effectively with larger companies (Raju et al., 2011). The construct of market orientation first emerged in the 1990s. According to one of the most widely accepted conceptualizations of the construct, market orientation is „the business culture that most effectively and efficiently creates superior value for customers„ (Narver, Slater, 1990; p.20), whereas the delivery of superior value is considered to be the cornerstone of true customer loyalty (Reichheld, 1996). A meta-analytical study of market orientation, conducted on a sample of 53 empirical studies from 23 countries, spanning 5 continents, provides evidence of its significant impact on business performance (Cano Rodriguez et al., 2004). Market orientatation implies sufficient understanding of target buyers, their current and latent needs, knowledge of short-term strengths and weaknesses and long-term capabilities of current and potential competitors and concerted efforts of all company's departments in the creation of superior value for customers. There are a number of positive effects of market oriented business practice. Review of recent studies conducted in the context of SME sector provides support for positive impact of market orientation on a firm performance, i.e. revenue growth, market share, return on investment, new product success rate (Raju et al., 2011). In addition to its impact on financial performance, market orientation also exerts positive influence on customer-related outcomes. A number of studies provide empirical support for the positive influence of adopting market orientation on customers' service quality perceptions and satisfaction (Webb et al., 2000; Bigne et al., 2005; Chen, Quester, 2009; Kirca, 2011; Wang et al., 2012). On the basis of aforementioned arguments, the following hypotheses are proposed:
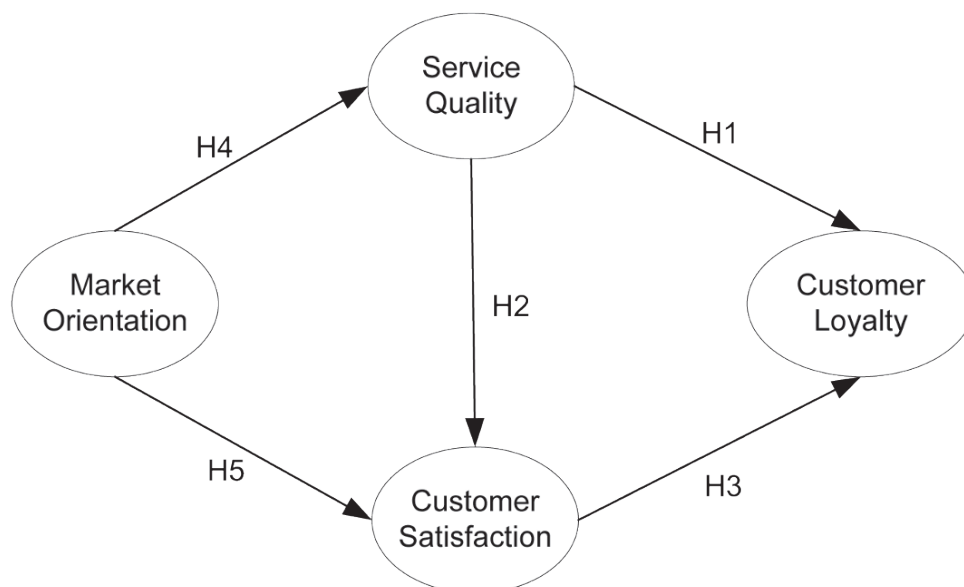
> **H4:** Market orientation positively affects service quality;
> **H5:** Market orientation is directly related to customer satisfaction.

Conceptual model comprising hypothesized relationships is presented in Figure 1.

Figure 1. Conceptual model

Methodology

The study has been performed on a convenience sample of non-specialized grocery retailing customers in Serbia. Data have been collected in personal interviewing, by means of structured questionnaire. After brief explanation of the aim of the study, respondents have been asked to rate the retailer at whose stores they make majority of family purchases for groceries and related assortment. As it has been the part of a larger study, only responses relating to small and medium-sized retailers have been taken into account for the examination of proposed hypothesis. The deduction resulted in 276 usable responses, out of 568 complete questionnaires.

The questionnaire consisted of five sections. First section dealt with respondents' overall perceptions of service quality whereas in the following sections respondents were asked about their satisfaction with service provider, loyalty intentions and perceptions of retailer's market orientation. Final section of the questionnaire consisted of demographic questions. A number of previous studies were based on multidimensional conceptualization of service quality construct. However, literature provides evidence of modelling multidimensional constructs as unidimensional, if the construct is not the focal variable in the model, but the study aims to examine causal relationships among multiple constructs (Blocker, 2011). Therefore respondents in this study were asked to indicate their overall quality perceptions, by rating on a seven-point semantic differential scale four pairs of attributes adopted from previous service quality studies (Cronin et al., 2000; Brady et al., 2001). As for customer satisfaction, the construct was measured by adapting three items used in previous studies (Brady et al., 2005; Setó-Pamies, 2012). Respondents were asked to indicate the extent to which they find that the retailer meets their needs and to what extent they find that they are satisfied, i.e. very satisfied with the service. Customer loyalty was measured on a 4-item scale, adapted from previous studies (Zeithaml et al., 1996; Brady et al., 2005; Lewis, Soureli, 2006). Respondents were asked to indicate likelihood of saying positive things about the retailer, recommending the retailer to a friend, buying again from the same retailer and likelihood of buying from the same retailer in future household purchases, even if the prices were somewhat higher than competitors' prices. Market orientation was measured on a 3-item scale. Whereas customers are not in a position to perceive the level of retailer's interfunctional coordination, other two traits of the constructs were measured by asking respondents to indicate their level of agreement with the statements regarding retailer's understanding of customers' needs, its continuous commitment to meeting customer needs and retailer's superiority in meeting customer needs in comparison with competitors' efforts. With the exception of service quality, all constructs were measured on 7-point Likert-type scales ranging from 1-strongly disagree to 7-strongly agree.

Relationships among the constructs were examined by means of structural equation modelling (SEM), using maximum likelihood as the method of parameter estimation. Two-step procedure proposed by Anderson and Gerbing (1988), implying estimation of measurement model, followed by the examination of structural relations, was utilized. Data analysis was performed using SPSS 18 and LISREL 8.80.

Results

Confirmatory factor analysis (CFA) was performed for the estimation of measurement model. The overall model fit as indicated by the χ^2 statistic (χ^2 = 186.83, df = 69, p < .01) was unsatisfactory. However, given the sensitivity of χ^2 test to sample size, attention was paid to other absolute and incremental fit measures, namely, goodness-of-fit index (GFI), adjusted goodness-of-fit index (AGFI), root mean square residual (RMSEA), standardized root mean square residual (SRMR), comparative fit index (CFI), normed fit index (NFI), non-normed fit index (NNFI). Whereas SRMR and RMSEA values up to 0.08 indicate acceptable fit of the proposed model, values of other fit measures equal to or higher than 0.90 indicate that specified model fits the data (MacCallum, Browne, 1993; Hu, Bentler, 1999). Fit indices of the proposed model and their recommended values are presented in Table 1.

Table 1. Measurement model fit

Fit indices	GFI	AGFI	RMSEA	SRMR	CFI	NFI	NNFI
Measurement model	0.91	0.86	0.08	0.05	0.96	0,94	0.95
Recommended value	≥0.90	≥0.90	≤0.80	≤0.80	≥0.90	≥0.90	≥0.90

Acceptable fit of the proposed model allowed for the assessment of construct validity, which refers to the degree to which a set of measured variables appropriately represent the latent construct they are designed to measure (Hair et al., 2010). Construct validity entails the assessment of convergent and discriminant validity. Strong evidence in support of convergent validity is provided by average variance extracted (AVE), i.e. a measure of convergence among a set of items representing the same construct, being higher than 0.50 (Bagozzi, Yi, 1991). All constructs, except market orientation with slightly lower than recommended AVE (0.49), fulfill this condition. Statistically significant factor loadings higher than 0.50, as presented in Table 2, also indicate convergent validity of the constructs. Indirect evidence in support of convergent validity is provided by internal consistency (Cronbach alpha>0.70) and composite reliability (ρ>0.70) of the constructs.

Table 2. Assessment of convergent validity

Constructs	St. factor loadings	t-values	Cronbach alpha	Composite reliability
Market orientation	0.68-0.73	10.02-10.70	0.74	0.75
Service quality	0.68-0.90	13.11-19.08	0.89	0.88
Customer satisfaction	0.88-0.91	21.07-22.37	0.92	0.92
Customer loyalty	0.68-0.94	14.18-27.39	0.90	0.90

Discriminant validity refers to the degree to which two conceptually similar constructs are different (Hair et al., 2010). Evidence is support of discriminant validity of the constructs is provided by squared correlations among the constructs which are lower than AVEs. Matrix of squared correlations together with AVEs on the diagonal is presented in Table 3.

Table 3. Assessment of discriminant validity

	Market Orientation	Service Quality	Customer Satisfaction	Customer Loyalty
Market Orientation	*0.49*			
Service Quality	0.46	*0.65*		
Customer Satisfaction	0.48	0.57	*0.79*	
Customer Loyalty	0.38	0.48	0.69	*0.69*

*Note: Correlations are significant at the 0.01 level (2-tailed)*

Due to acceptable fit indices of the measurement model and fulfilled conditions of convergent and discriminant validity, structural model was assessed in the following stage. In spite of statistically significant and thus unacceptable value of chi-square test ($\chi2$=169.69, df=69, p<0.01) structural analysis yielded an excellent overall fit of the model as indicated by other absolute and incremental fit indices. Fit statistics are presented in Table 4.

Table 4. Structural model fit

Fit indices	GFI	AGFI	RMSEA	SRMR	CFI	NFI	NNFI
Measurement model	0.92	0.88	0.07	0.05	0.99	0,98	0.98
Recommended value	≥0.90	≥0.90	≤0.80	≤0.80	≥0.90	≥0.90	≥0.90
Hypothesis testing	St. estimates		t-value				Results
H1: Service quality → Customer loyalty	0.05		0.51				Not supported
H2: Service quality → Customer satisfaction	0.63		4.91				Supported
H3: Customer satisfaction → Loyalty	0.89		8.14				Supported
H4: Market orientation → Service quality	0.87		14.38				Supported
H5: Market orientation → Satisfaction	0.29		2.25				Supported

Given the satisfactory fit of the model structural relationships were then examined. Structural model is presented in Figure 2. Contrary to what was predicted in Hypothesis 1, service quality did not exert significant impact on customer loyalty (β=0.05, t=0.51). The results showed that customer satisfaction was directly influenced by service quality (β=0.63, t=4.91) and that customer satisfaction was a significant direct determinant of customer loyalty (β=0.89, t=8.14), thus supporting hypotheses H2 and H3. Examination of structural relationships indicated significant impact of market orientation on service quality (γ=0.87, t=14.38) and its somewhat lower but still significant influence on customer satisfaction (γ=0.29, t=2.25), thus supporting hypotheses H4 and H5. The estimated R2 values of dependent variables in the model were quite high (R^2_{sq}=0.66; R^2_{sat}=0.75; R^2_{loy}=0.86) thus indicating high predictive power of the model. Results of the study indicated the most significant impact of satisfaction on customer loyalty (0.89), followed by the impact of market orientation (0.73) and service quality (0.56).

Figure 2. Structural model

Chi-Square=169.69, df=69, P-value=0.00000, RMSEA=0.073
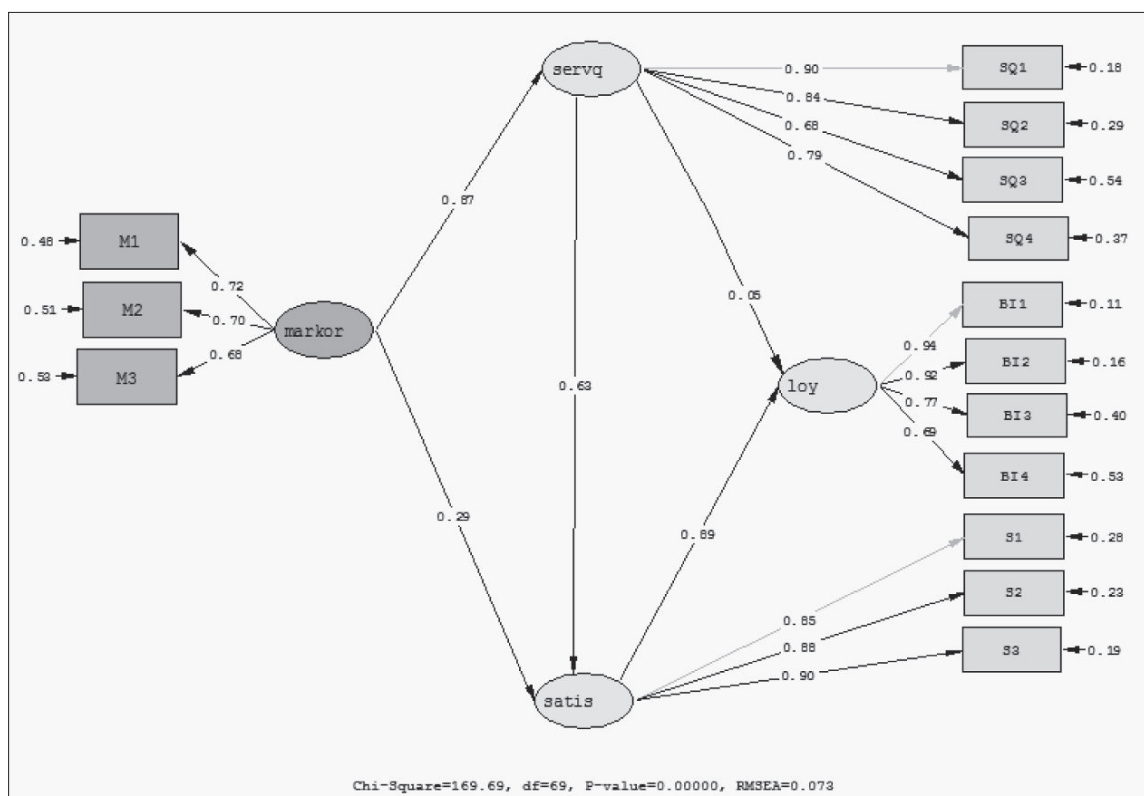
Discussion

The main aim of this study was to examine the determinants of customer loyalty in the context of Serbian SMEs and determine their relative impact on loyalty. The conceptual model was based on established relationships among market orientation, service quality, customer satisfaction and loyalty across service industries. Research findings indicate customer satisfaction as the most significant antecedent of loyalty. However, due attention should be also paid to market orientation and service quality which exert significant influence on customer satisfaction and further add to the development of loyalty intentions. As such, findings of this study bear theoretical as well as managerial relevance. From the theoretical perspective this study adds to the growing body of knowledge on SMEs' customer loyalty, especially addressing this significant issue in thus far under-researched context. As meeting, i.e. exceeding customer expectations, significantly affects customer loyalty, managers of SMEs are strongly advised to probe more deeply into the domains of service delivery deemed as satisfiers from customers' perspective. This is not expected to be an especially troublesome requirement, owing to the fact that SMEs usually establish closer communication with customers and know them personally. SMEs which are market oriented and devoted to understanding, anticipating and meeting customers' needs better than competitors are in a position to improve customers' perceptions of service quality and via customer satisfaction build a truly loyal customer base, which is expected to further add to company's future profitability.

In spite of its contribution, this study is not bereft of limitations either. The main drawback of the study is the size and scope of its sample. Findings of this study should not be generalized, due to the size and scope of the sample as well as

cross-sectional design of the study. Therefore, in order to improve generalizability of the findings, research should be replicated on a more representative sample of SMEs' customers. Furthermore, it is advisable to perform research on a longitudinal basis, in order to reach more generalizable inferences. Whereas majority of previous studies were based on a multidimensional conceptualization of service quality (Choi et al., 2004; Setó-Pamies, 2012), this study opted for customers' overall impressions of service quality. However, taking into consideration significant effect of service quality on customer satisfaction and indirect influence of quality on customer loyalty, due attention in future studies should be paid to the dimensionality of service quality construct and the examination of relative importance of service quality dimensions on customer satisfaction and their contribution to the development of loyalty intentions. Another fruitful avenue for future research would be more thorough examination of specific traits of the construct of market orientation, especially as shared variance among the traits used in this study was somewhat lower than 50%. Moreover, previous studies provide evidence in support of multidimensional nature of the construct of market orientation (Pe˜na et al., 2012), which is an avenue worthy of further examination.

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