Managing Customers for Profit

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Chapter – 13

Managing Customer Referral Behavior

Instructor's Presentation Slides

Relevant Issues

How do we account for attitudinal behavior of customers in designing strategies?

How do we measure the indirect contribution (referrals, word-of-mouth) made by customers towards the firm's profits?

The Power of the Referral

"We know that the most powerful form of marketing is an advocacy message from a trusted friend." -Steve Knox, CEO of Vocalpoint

Customers not only contribute value to the firm through their own transactions (direct profits), but they also have an impact on the transactions of other customers through word-of-mouth and referrals (indirect profits) by helping the firm to acquire new customers at lower costs.

How can managers determine the value of a customer's ability to spread word-of-mouth and make referrals?

Customer Referral Value (CRV)

This metric enables managers to measure and manage each customer based on his ability to generate indirect profits to the firm.

Case Study: A Telecommunications firm and A Financial Services Firm

1. If a customer intends to refer a product to a friend or a colleague (prospect), how frequently does that customer actually follow through and speak to the prospects?
2. Are the prospects willing to listen if the customer talks to them about the product or the company?
3. Do the prospects actually become customers even if they are willing to listen?
4. Even if they become customers, do the prospects spend enough to be profitable for the firm?

Case Study Results

Item	Financial Services (n = 6,700)	Telecommunications (n = 9,900)
% Stated intention to Recommend	68%	81%
% Actually Referring	33%	30%
% Prospects Becoming Customers	14%	12%
% Prospects that are Profitable Customers	11%	8%

These findings show that there is a definite gap between a customer's willingness to refer and his actual referral behavior.

It is not sufficient to know whether or not a set of customers is willing to refer your products or services, it is also necessary to understand how the flow of information moves from each customer to potential prospects.

Case Study Results (cont'd)

Equation 13.1

$$CRV_i = \sum_{t=1}^{T}\sum_{y=1}^{n1}\frac{(A_{ty} - a_{ty} - M_{ty} + ACQ1_{ty})}{(1+r)^t} + \sum_{t=1}^{T}\sum_{y=n1}^{n2}\frac{(ACQ2_{ty})}{(1+r)^t}$$

Where:
T = the number of periods that will be predicted into the future (e.g. years)
A_{ty} = the gross margin contributed by customer y who otherwise would not have bought the product
a_{ty} = the cost of the referral for customer y
1 to n1 = the number of customers who would not join w/o the referral
n2 – n1 = the number of customers who would have joined anyway
M_{ty} = The marketing costs needed to retain the referred customers
$ACQ1_{ty}$ = The savings in acquisition cost from customers who would not join w/o the referral
$ACQ2_{ty}$ = The savings in acquisition cost from customers who would have joined anyway

Estimating CRV

1. Determining whether the customer would have bought the product or service anyway

2. Predicting the future value of each referred customer,

3. Predicting the future number of referrals

4. Predicting the future timing of the referrals.

Estimating CRV (Contd.)

Step 1	Step 2	Step 3	Step 4
• "How likely is it that you would have subscribed to this service without a referral in the next 12 months?"	• Predict the average referral contribution margin for each customer in each period • Use those values to predict the future profits for each referral per period in the holdout year • Next, predict the average cost of retaining each customer's referrals by looking at the past marketing costs for each period and project that average marketing cost into the future.	• Use the average number of referrals in the first 3 years for each customer and projecting that number into the holdout year.	• Splitting up the timing of referrals into a two time period is important since it can have a dramatic impact on the value of each customer's CRV

Calculating CRV – An Example

Statistics – per 6 month period	Typical Customer
Average contribution margin	$66
Number of referrals per period	4
Number of indirect referrals made by referred customers	2
Cost of referral	$8
Acquisition cost savings	$5
Marketing costs	$18
Number of referrals that would have joined anyway	2 out of 4
Yearly discount rate	15%

Calculate the net present value of the profit that each direct referral will bring to the company over the next 3 periods

Calculating CRV (cont'd)

- Separate the calculation into two parts:
  1. The value of the customers who would not have joined without the referral
  2. The value of the customers who would have joined anyway at a later time

Period 1:

$$CRV_1 = 2\left(\frac{A_1 - a_1 - M_1 + ACQ1_1}{\text{discount rate}}\right) + 2\left(\frac{ACQ2_1}{\text{discount rate}}\right)$$

$$CRV_1 = 2\left(\frac{\$66 - \$8 - \$18 + \$5}{(1.15)^{0.5}}\right) + 2\left(\frac{\$5}{(1.15)^{0.5}}\right) \approx \$102$$

*The impact grows as time progresses

Are CLV and CRV Related?

A recent marketing study suggested that the most powerful word-of-mouth comes from customers who are less behaviorally loyal to the firm.

Deciles (ranked by CLV)	CLV ($) (1 year)	CRV ($) (1 year)
1	**1,933**	40
2	**1,067**	52
3	**633**	90
4	360	750
5	313	**930**
6	230	**1,020**
7	190	**870**
8	160	96
9	137	65
10	120	46

As illustrated in the above table, after ranking the customers by CLV (high to low) into 10 deciles, the top 30% of customers based on CLV (deciles 1, 2, and 3) have no overlap with the top 30% of customers based on CRV (deciles 5, 6, and 7).

This means that managers who focus on customers based on CLV alone and provide them the best service are missing the high CRV customers and therefore ignoring these profitable customers.

Implementing CLV and CRV

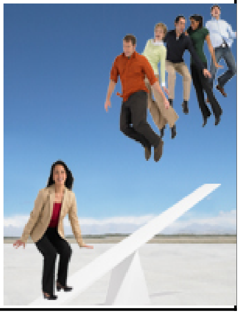
Northwest Airlines Referral Program

Get Your Friends in the Air and Watch Your Bonus Miles Soar!

Register up to five (5) friends in **Refer-A-Friend**. Each time one of them flies Northwest Airlines before , you'll both earn Bonus Miles - up to 17,500 of them!

Here's how it works:

Your Friend's Travel*	Your Bonus Miles (per friend)	Your Friend's Bonus Miles
First Roundtrip Flight	2,500	2,500
Second Roundtrip Flight	500	5,000
Third Roundtrip Flight	500	10,000
Total	**3,500 per friend,** (or 17,500 for 5 friends)	**17,500**



CLV and CRV Computation (*telecom example)*

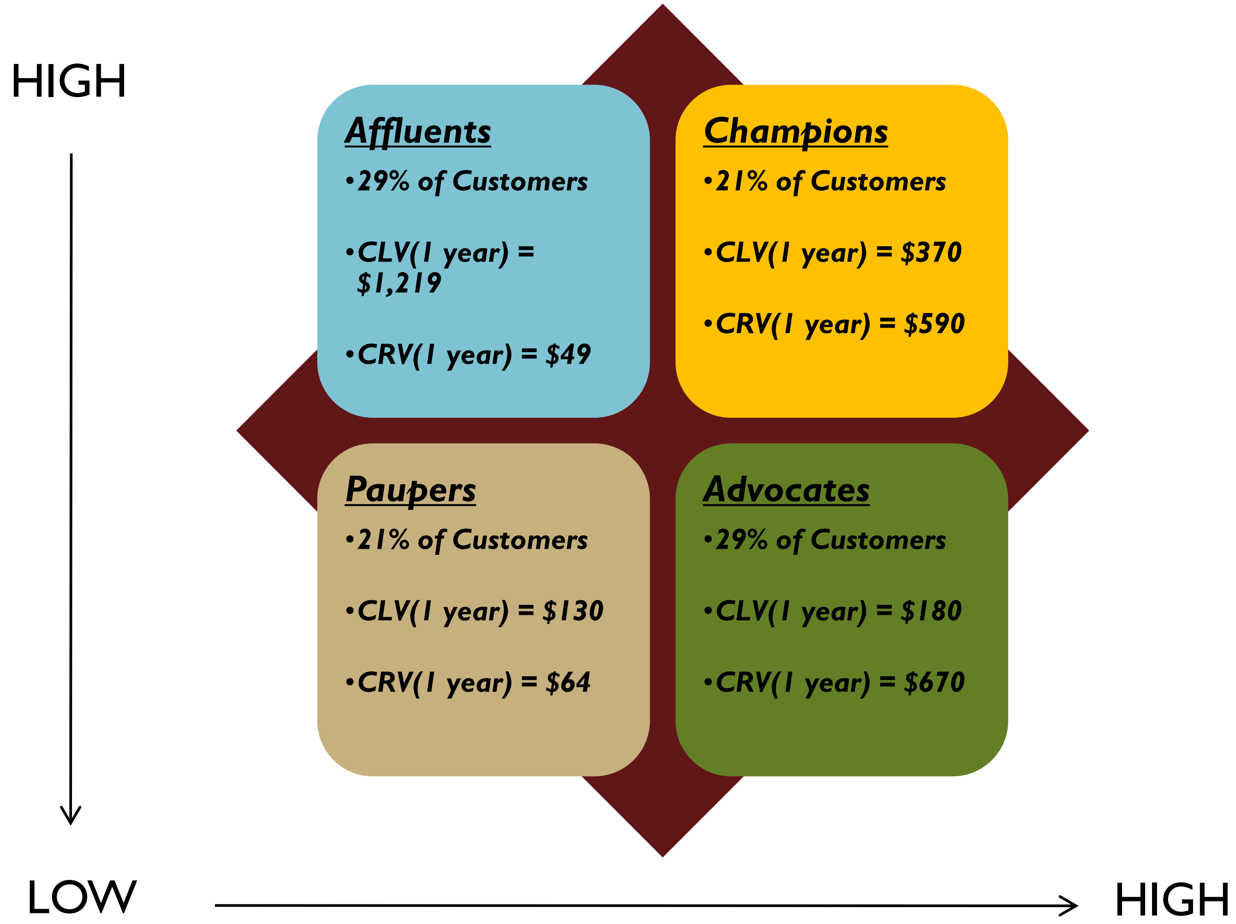


Table 13.4: CLV and CRV for a Telecommunications Firm (N = 9,900)

Campaign Objectives

Target: Advocates

- The goal of this campaign is to encourage these customers to spend more while at the same time keeping their CRV at the highest level.

These customers received a personal communication in the form of a direct mail that included offers for bundling one or more products such as savings accounts, checking accounts, and/or investment accounts. To follow up and make it more likely that the offer was received by the customer, the financial services firm sent an additional piece of direct mail within two weeks and called a sample of these customers via the telephone to answer any questions regarding the additional services and the value of subscribing to multiple products and/or services.

Campaign Objectives

Target: Affluents

- Encourage these customers to refer new customers using referral incentives, while making sure they kept their CLV at the highest level.

These customers were targeted with emphasis on the referral incentive for both them and the referred customers. These customers were also sent a direct mail communication, followed by another direct mail communication within two weeks. The main goal of the direct mail communication was to emphasize a $20 incentive for each the referring customer and the referred customer for signing up for products and/or services.

Campaign Objectives

Target: Misers

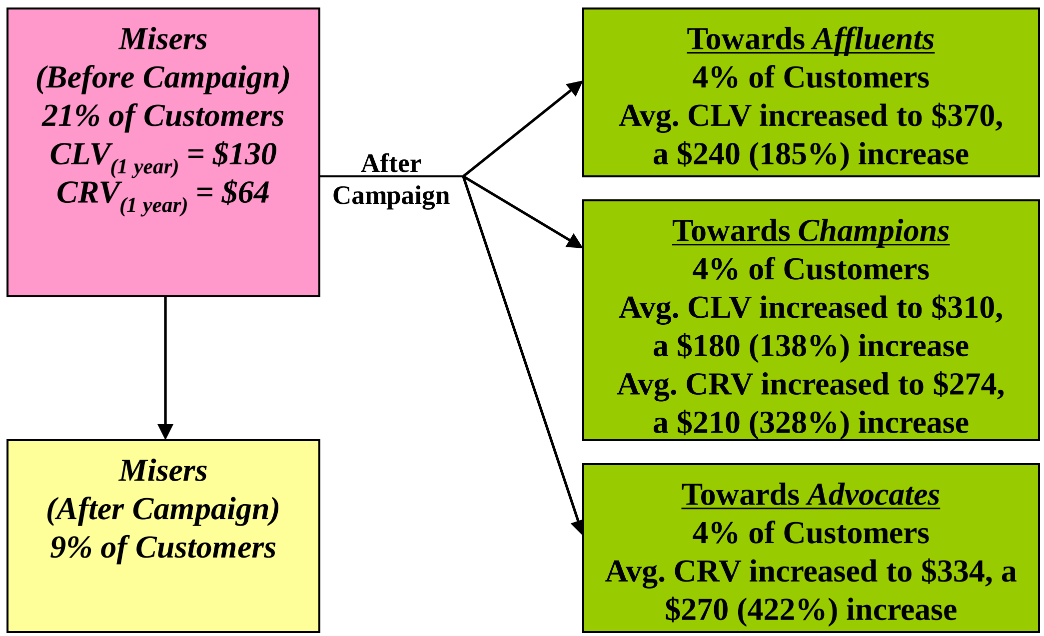
- Offered incentives for them to buy more products for their own use, (CLV Increase)
- Offered them incentives to refer new customers, which would increase CRV

Targeted with bundled offers for one or more products such as savings accounts, checking accounts, and/or investment accounts through a personalized communication sent via direct mail and followed up with another direct mail piece within a two-week period. A phone call was also made to those customers to answer any questions regarding the additional services and the value of obtaining the additional services. Additionally, the value of making referrals for new customers was highlighted for these customers by telling them that a $20 incentive will be given to them and the referred customers for making a referral.

Campaign Results (Misers)

Figure 13.7

<u>Migration from *Misers* towards *Affluents*, *Advocates*, or *Champions*</u>

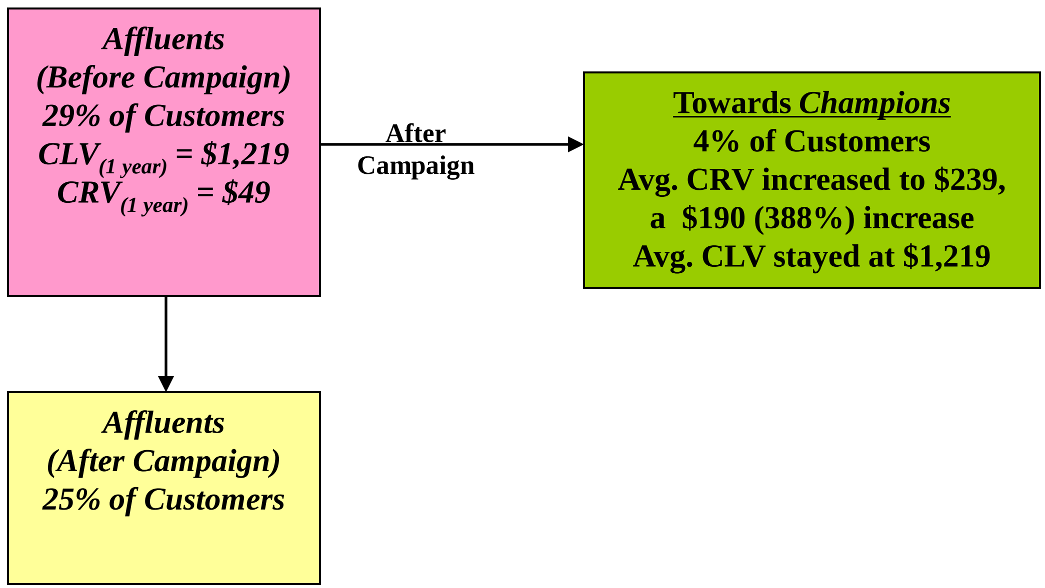


Source: Kumar, V, J Andrew Petersen, and Robert P Leone, "Looking Beyond CLV," forthcoming, Harvard Business Review.

Campaign Results (Affluents)

Figure 13.8

Migration from *Affluents* towards *Champions*

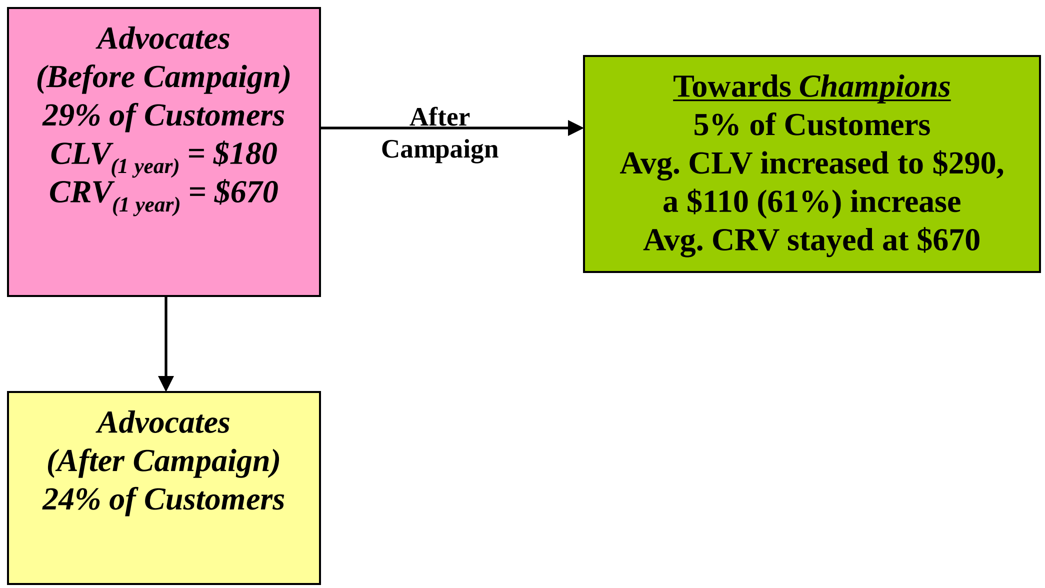


Source: Kumar, V, J Andrew Petersen, and Robert P Leone, "Looking Beyond CLV," Harvard Business Review.

Campaign Results (Advocates)

Figure 13.9

<u>Migration from *Advocates* towards *Champions*</u>



Source: Kumar, V, J Andrew Petersen, and Robert P Leone, "Looking Beyond CLV," forthcoming, Harvard Business Review

Summary Results

Table 13.4: Campaign ROI (Telecommunications Firm)

	Profit (CLV and CRV)	Cost	ROI
Campaign Totals	$486,090	$31,500	15.5

In Table 13.5 we not only show what the gains would be if these campaigns were projected across 1 Million and 10 Million customers for the telecommunications firm (their customer base has over 40 million customers), but also if the period of measuring CLV was moved from 1 year to 3 years

Table 13.5: Gains in CLV and CRV for a Telecommunications Firm

	1 Million Customers		10 Million Customers	
Projected	CLV (millions)	CRV (millions)	CLV (millions)	CRV (millions)
1 year	$22.3	$26.8	$223	$268
3 years	$66.9	$80.4	$669	$804

ROI from running these three customized campaigns have generated significant gains in profits

It is clear that there are a lot of opportunities for firms who traditionally have only used CLV as a metric to increase their revenues and profitability by selecting customers for marketing campaigns based on both their CLV and their CRV.

End of Chapter 13