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Referred customers are more profitable and more loyal.

Do Referral Programs Increase Profits?

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Consumers love to share experiences within their social networks. Just about anything – from photos to jokes or instructional material – is passed on and exchanged, either electronically or in person. Unsurprisingly, marketers increasingly use word of mouth (WOM) to promote products or acquire new customers. But is such company-stimulated WOM effective? Are customers who are referred by other customers really worth the effort?

A recent study clearly says "yes" /// We compared two groups of customers acquired by a leading German bank over a three year period. All of the first group were customers acquired through the bank´s referral program. The second group comprised a random sample of customers acquired through other means such as direct mail or advertising over the same period of time. An analysis of almost 10,000 accounts over a 33-month period showed that those referred by other customers generate higher profit margins, are more loyal and show a higher customer lifetime value (CLV).

Referred customers are more profitable /// Referred customers are, on average, 4.5 cents per day more profitable than other customers. The gap is even larger after controlling for differences in customer demographics and time of acquisition. Whereas the average contribution margin of non-referred customers is 30 cents/day, customers acquired through the referral program have a margin 7.6 cents/day higher, an increase of about 25 %. The difference in contribution margin is the highest in the first year after the acquisition, but decreases over time.

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Referred customers are more loyal /// The speed at which referred customers churn and leave the bank is, on average, about 18 % lower than that of other customers. In contrast to the eroding difference between referred and non-referred customers in the contribution margin, there is no such erosion in customer retention.

The difference in customer lifetime value varies according to customer /// The lifetime value of referred customers, measured over a six-year horizon, was 16 % higher, on average, than that of non-referred customers with similar demographics and time of acquisition. Breaking down the data by age (see Figure 1) shows that the difference in lifetime value between referred and non-referred customers is most pronounced among younger people and among retail (as opposed to private banking) customers.

The referral program pays off /// Every existing customer who brought in a new customer received a reward of € 25. Given the average difference in customer lifetime value of € 40, this amount implies a Return on Investment (ROI) of roughly 60 % over a six-year period. And this calculation does not even take into account that the total acquisition costs of referred customers are around € 20 lower than those of other customers. The 60 % ROI is therefore a rather conservative estimate.

Can these results be generalized? /// Though the findings pertain to a single company from a single industry, there are several reasons to expect referred customers to be more valuable than other newly acquired customers.

> First, people prefer to keep an even balance in their social exchanges. Because referring customers receive a reward, customers are likely to feel obliged to bring in new customers who they think may be valuable to the company. Second, even apart from any monetary incentives, people feel better if they generate a match that works for both the company and the referred person. Most people would recommend a product to a friend or family member only if they believe it to be relevant and useful for the other person.

> Further, having a person close to oneself who is a customer of the same company should increase one's trust in the company and strengthens the emotional bond they have with it. This effect implies that referred customers are less likely to churn than non-referred customers, provided that their referrer does not churn either (which is usually the case for customers who are willing to recommend a product or service).

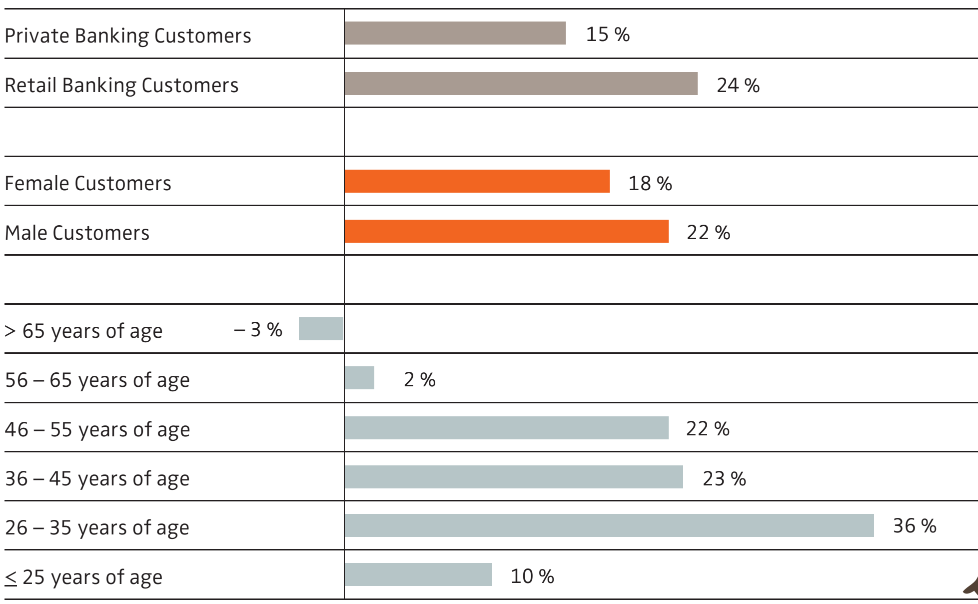
> Finally, acquisition through referral can also result in informational advantages, making referred customers more profitable than other customers. Referred customers are likely to have discussed the company's offerings with their referrer. As a result, they are likely to use its products more extensively than novice customers who take a more cautious approach in building involvement.

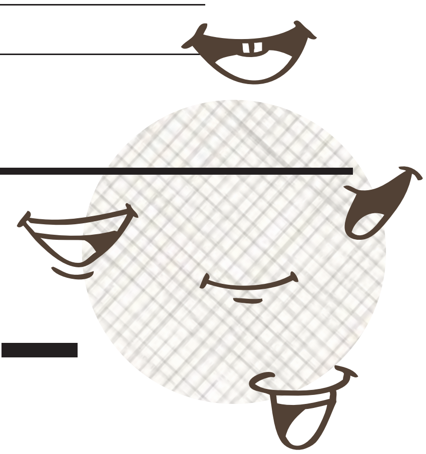
The encouraging results of this study, however, do not imply that "viral-for-hire" works in each and every case. Referral programs should be most beneficial for products and services that customers might not appreciate immediately. Products and services that imply some sort of risk should also benefit more than average from referrals because prospects are likely to feel the risk is lower when a trusted person has positive experiences.

Managerial implications /// The study shows that referral programs can help companies to selectively acquire more valuable prospects and to retain them longer at lower cost. However, companies should think carefully about which prospects to target with referral programs and how big of a referral fee to provide. For the program we analyzed, we found that the customer value differential is much larger in some segments than in others. Hence, instead of the currently practiced "all in" approach, companies should design and target referral programs such that attractive customers are more likely to be pulled in. Additionally, a referral should be monitored closely to see if it is effective at identifying good prospects and if acquisition costs do not exceed the subsequent value of the customers.

FIGURE 1:

Percentages differences in customer lifetime value





Managerial summary of the "Journal of Marketing" article that received the 2011 MSI/H. Paul Root Award for making the most significant contribution to the advancement of the practice of marketing:

Schmitt, Philipp; Skiera, Bernd; Van den Bulte, Christophe (2011), "Referral Programs and Customer Value," Journal of Marketing, Vol. 75 (January), pp. 46 – 59.

FURTHER READING

Schmitt, Philipp; Skiera, Bernd; Van den Bulte, Christophe (2011): "Why Customer Referrals Can Drive Stunning Profits", Harvard Business Review, Vol. 89 (June), p. 30.