IESE Business School University of Navarra

Buzz is better for bottom line

April 4, 2008

The answer to the question "How did you hear about us?" offers startling insights into how people become customers.

Companies need customers, but not just any old customer - the right customer. Acquiring this choice client plays an important role in the newly emerging paradigm of customer equity.

The acquisition process is particularly important for start-ups and for firms competing in growth markets. For these companies, acquisition spending eats up the biggest chunk of the marketing budget. Of course, the money should be spent in the best way possible, knowing that not all customers are profitable customers.

Many Internet start-ups have learned this the hard way. Through aggressive spending, they aimed to attract what they call the "eyeball" of potential customers, believing that browsing customers would later lock in revenue. Yet, many of the eyeballs kept their wallets closed and the start-ups were left pondering the link between acquisition, spending and long-term profitability.

In the paper "The Impact of Marketing-Induced Versus Word-of-Mouth Customer Acquisition on Customer Equity Growth," published in the *Journal of Marketing Research*, authors Julian Villanueva, Shijin Yoo and Dominique M. Hanssens forge the link and divulge the best ways to attract long-term, profitable customers.

Word of mouth versus marketing

To grow their business, companies pursue customers in various ways, but especially through marketing and word of mouth (WOM).

©IESE Business School

Marketing actions include: online ad banners; TV, radio, magazine or newspaper advertisements; e-mail links; and direct mail.

WOM channels refer to more spontaneous references, such as: referrals from friends, colleagues, professional organizations or associations; links from other websites or search engines; and articles in magazines or newspapers.

Recently, WOM has attracted more attention from both managers and academics alike. In fact, the Marketing Science Institute named the "connected customer" as one of its "2006-2008 Research Priorities."

Hard metrics

So, how does a company know when its customers are truly connected? "We believe that, whenever possible, acquisition effectiveness should be measured not by 'soft' metrics of communication effectiveness (e.g., brand awareness), but rather by 'hard' metrics of profitability," write the authors.

To measure this hard metric - the bottom line - they study the effectiveness of acquisition methods with respect to their long-term financial contributions to the firm in the form of customer equity.

Customer equity works like this: Each time a customer is acquired, customer equity increases through several effects.

First, the customer adds a stream of future cash flows generated through his or her relationship with the firm.

Second, the customer may generate WOM (positive or negative) and act as a salesperson for the firm. Thus, it is possible for a firm to assign the profitability of future customers acquired through WOM, or the direct network effect.

Finally, by contributing to the firm's performance, a new customer may improve the future acquisition process in both channels, which is an indirect network effect.

In the study, the researchers measure not only the expected customer's value in and of itself, but also the customer's net contribution to the growth of customer equity. To do so, they use a statistical model and the case of an Internet company.

©IESE Business School

So, how did you hear about us?

This is the golden question and it's the first thing that the Internet firm under question, which provides free web hosting to registered users, asks of its customers.

During the registration process, the company also solicits their demographic profile. With this data in hand, for 70 weeks, the researchers observed each registered customer's unique behavior when he or she logged in to use the firm's services.

It is commonly believed that high log-in intensity provides a firm with more revenue. There is a correlation between customers' perceived value of the service and their willingness to subscribe to the fee-based service. In other words, the more a customer logs in, the more he or she might be committed and even emotionally attached to the site, and more willing to pay.

The researchers' statistical model links customer acquisition to long-term profitability by measuring the impact of each customer acquisition on the firm's value, in both the short and long term.

So, which works best: costly but fast-acting marketing investments or slow but cheaper word of mouth?

For the long haul, stick to WOM

The case of the web hosting company revealed that marketing-induced customers do add more short-term value, but word-of-mouth customers add nearly twice as much long-term value to a firm.

After 10 weeks, the impact of marketing had faded and WOM channels were still going strong, with almost double the cumulative impact. While the effect of marketing acquisition settles down after only three weeks, the buzz of WOM channels lasts for approximately six weeks.

These dynamics are critical when planning a customer acquisition strategy because they show that a manager who spends to acquire a short-term customer is not spending in an optimal way. Customers acquired through marketing channels tend to focus more on "trials," or short-term effects, while customers acquired through WOM tend to provide the firm with more "repeats," or long-term business.

©IESE Business School

Creating buzz about your business would seem the best strategy for the long haul, the authors conclude.

www.iese.edu/insight

©IESE Business School