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How Valuable Is Word of Mouth?

Key ideas from the [Harvard Business Review](#) article By V. Kumar, J. Andrew Petersen, Robert P. Leone

The Idea in Brief

Your most valuable customers are those who buy the most, right? Not necessarily. According to Kumar, Petersen, and Leone, your most valuable customers are those whose word of mouth brings in the most profitable *new* customers, regardless of how much they themselves buy.

What accounts for this counterintuitive phenomenon? High-purchasing customers who say they'll recommend your firm to others often don't bother.

How can your company encourage customers to make profitable referrals? The authors' technique enables you to segment customers into four types: those who buy a lot but are poor marketers for your firm; those who don't buy much but are strong marketers; those who both buy and market well; and those who do neither well. Armed with that data, you can tailor your marketing efforts more precisely to boost each customer's total value to your firm.

The Idea in Practice

Kumar, Petersen, and Leone recommend this process for improving your marketing ROI:

Calculate Each Customer's Lifetime Value

A customer's lifetime value (CLV) is an estimate of how much that customer would spend on your company's offerings if he continued purchasing at the current rate for some designated future period, minus the cost of marketing to him.

Calculate Each Customer's Referral Value

Each existing customer's referral value (CRV) includes an estimate of the lifetime value of any type-one referrals--people who would not have become customers if they had not been referred. In calculating CRV, you also must include the value of type-two referrals--people who would have become customers anyway, without the original customer's referral. The value of a type-two referral is the savings in the cost of acquiring the new customer, since no direct marketing effort was needed to get him.

Segment Customers Based On CLV and CRV

Since a high customer lifetime value doesn't necessarily predict high referral value, segment customers based on how they measure up on both forms of value. **Champions**, who are both excellent buyers and marketers; **Affluents**, who buy a lot but don't market well; **Advocates**, who don't buy a lot but are strong marketers; and **Misers**, who neither buy much nor market well.

Target Your Marketing Strategies by Segment

Your Champions are already producing maximum value; here's how to boost total value for the other segments:

For this segment...	Aim to...	Example: Telecommunications Company	Payoff Telecommunications Company
Affluents	Make them Champions by encouraging them to refer more new customers while maintaining their highly valuable purchasing behavior.	Sent Affluents direct-mail promotions offering a \$20 incentive for referring new customers and showing that 3-4 referrals would pay for one month's service.	4% migrated into Champions segment with their referral values rising by average \$190, a 61% increase.
Advocates	Turn them into Champions by increasing their CLV without compromising their CRV.	Focused on cross-selling and up-selling company's products; for example, by offering bundled products and giving discounts to customers signing one-year contracts.	Average CLV increased by approximately 61% improvement.
Misers	Move them to any other segment by persuading them to buy more products <i>and</i> refer new customers.	Sent same bundled product offerings and discounts and offered \$20 rewards for successful referrals, emphasizing savings on monthly service.	12% of Misers became either Champions, Affluents, or Advocates.

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