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Reward-scrounging in customer referral programs

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ABSTRACT

Rewarding existing customers for the recruitment of new ones has become an increasingly popular acquisition tool for companies. However, when a company rewards the recruitment of a new customer, managers are unaware of whether the rewarded referral was actually necessary or whether “reward-scrounging” has occurred because the referral receiver would have converted anyway. As a consequence, companies risk overestimating the effectiveness of their referral programs, which is why gaining insights into how and when reward-scrounging occurs is crucial. In this study, we employ a large data set from the telecommunications industry to analyze the drivers of reward-scrounging. The results indicate that reward-scrounging reduces the effectiveness of referral reward programs over time and that its likelihood depends on both the referral sender’s network position and the company’s marketing activities. The findings are used to develop managerial means to alleviate the negative effects of reward-scrounging.

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1. Introduction

Each time a new customer is recruited by an existing customer through a company’s referral reward program, managers typically face uncertainty about whether the rewarded referral has actually contributed to the purchase decision. In some cases, the rewarded referral may actually lead to conversion, but in other cases, the company’s referral reward is not necessary because the referral receiver would have converted anyway. This *reward-scrounging*—namely, the receipt of a reward by an existing customer for recruiting a new customer who would have signed up with the firm, regardless of the rewarded referral—has a substantial impact on the evaluation of a referral reward program because it may also incur high opportunity costs. Such costs are incurred because the money that was spent could have been better invested in the acquisition of as-yet undecided prospects. Given the substantial investment that firms undertake in their referral reward programs (e.g., *American Express* pays \$100 for each referred customer, and *AT&T* offers its customers as much as \$575 per year for recruited customers), large amounts of money are consequently spent on unnecessary rewards. Furthermore, the effectiveness of the entire referral reward program can be highly overstated if reward-scrounging is neglected. As a result of its importance, measuring the actual value of a referral has already gained attention in the marketing research, and the share of unnecessary rewards has been shown to be substantial—up to 50% (Kumar, Petersen, & Leone, 2010; Libai, Muller, & Peres, 2013).

However, the popularity of referral reward programs has been constantly growing in recent years, and companies from a variety of industries, such as telecommunications, media, banking, and insurance, increasingly value referral programs as efficient tools for customer acquisition (Garnefeld, Eggert, Helm, & Tax, 2013; Schmitt, Skiera, & Van den Bulte, 2011). As a consequence

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of their practical relevance, numerous research studies have investigated various aspects of referral programs. For example, some studies have analyzed the value of referred customers (Armellini, Barrot, & Becker, 2015; Schmitt et al., 2011) and the profitability of referring customers (Garnefeld et al., 2013). Other research has examined optimal reward designs (Biyalogorsky, Gerstner, & Libai, 2001; Kornish & Li, 2010), drivers of participation in referral programs (Claus, Geyskens, Millet, & Dewitte, 2012; Ryu & Feick, 2007; Verlegh, Ryu, Tuk, & Feick, 2013), optimal customers to target (Hinz, Skiera, Barrot, & Becker, 2011; Kumar et al., 2010), and the effectiveness of marketing instruments to stimulate rewarded referrals (Barrot, Becker, & Meyners, 2013; Ryu & Feick, 2007). Although these initial studies provide preliminary insights into the phenomenon (Kumar et al., 2010; Libai et al., 2013) by including reward-scrounging in profitability analyses, marketing research still lacks insights into the specific circumstances under which reward-scrounging occurs and the managerial means that could be used to reduce or to prevent it. Finding such instruments that actively reduce reward-scrounging would be an important step for the profitable management of referral reward programs.

This study contributes to the existing research on referral programs in multiple ways. We developed an empirical model to determine whether a referral receiver (that is, the referred customer) would have converted anyway, and we use the data to analyze multiple drivers that influence reward-scrounging and examine strategies for how companies can use these insights to reduce or prevent reward-scrounging. For our analysis, we employ comprehensive and unique industry data from two competing mobile phone operators that include customer data (such as demographics, profitability, and social networks), referral data, and advertising spending.¹ The results indicate that reward-scrounging reduces the effectiveness of referral reward programs over time, thus making alternative marketing and seeding approaches necessary.

2. Theoretical background

Given that between 20% and 50% of all purchase decisions are based on personal recommendations (Bughin, Doogan, & Vetvik, 2010), companies seek to stimulate and manage word-of-mouth (WOM) by providing rewards (e.g., cash, gifts, or free services) for new customer referrals (Garnefeld et al., 2013; Kornish & Li, 2010). Such referral reward programs offer incentives to existing customers to bring in new customers. For instance, the referral program that is analyzed in this study is typical for a mobile phone provider. Here, customers go to the provider's website, type in the name and e-mail address of a prospective customer, and initiate a referral message. Once the receiver reacts to the link and signs up with the provider, the sender of the referral receives a reward (e.g., airtime credit). Alternatively, a prospect can indicate the existing customer from whom he or she received the recommendation during the sign-up process.² In both cases, the referral receiver is fully aware that the sender receives a reward for the referral. Hence, we do not encounter issues of negative responses to referrals as a result of undisclosed rewards such as lack of authenticity of the recommendation or the inference of ulterior motives by the referral receiver (Mayzlin, Dover, & Chevalier, 2014; Verlegh et al., 2013).

The benefits of referral programs are widely accepted and have been shown repeatedly in previous studies. For instance, customers who are acquired through referrals are considered more valuable than other customers because they yield a higher contribution margin than customers who are acquired through other channels (Armellini et al., 2015; Schmitt et al., 2011). Similarly, referred customers exhibit a higher willingness to refer people, thus adding to the profitability of referral programs (Gilly, Graham, Wolfenbarger, & Yale, 1998; Von Wangenheim & Bayón, 2004). Several studies also suggest that WOM-induced customers are more loyal than are customers who are acquired through advertising (Schmitt et al., 2011; Villanueva, Yoo, & Hanssens, 2008). The same applies to referral senders, who also yield higher retention rates after engaging in WOM communication (Garnefeld et al., 2013). These direct and indirect effects increase the profitability of referral programs and explain their popularity in marketing practices.

However, the profitability of referral programs may be substantially impaired if companies provide rewards for referrals that actually do not contribute to purchase decisions (Kumar, Petersen, & Leone, 2007; Kumar et al., 2010). In this case, a prospect is very likely to convert irrespective of the rewarded referral, thus rendering the reward unnecessary and causing the profitability of the referral or the entire program to be overrated. Hence, the *reward-scrounging* phenomenon occurs when referral receivers' conversion probability is already high enough to make them purchase the product, regardless of whether the referring customer receives a reward. In such cases, it is irrelevant whether the reward is taken intentionally as a welcome add-on or whether consumers are simply unaware of their preferences, as the reward actually would not have been necessary in either case.

Previous studies in marketing research have already acknowledged the existence of reward-scrounging or similar phenomena in customer referral programs. Focusing on the referral sender's perspective, Biyalogorsky et al. (2001) develop an analytical model and demonstrate that if the level of customer delight is sufficiently high, the customer is likely to recommend a product. In this case, offering a reward would not be necessary because the sender's motivation to spread the word is already high enough. To estimate the customer's referral value, in Kumar et al.'s (2007, 2010) survey, referral receivers were asked to determine whether they would have joined irrespective of the referral. Their results indicate that 50% of all referred customers stated that they would have signed up anyway, which needs to be accounted for in the customer referral value. On a similar note, Libai et al. (2013) divide the overall contribution of WOM seeding campaigns into market expansion and the simple acceleration of adoption. Using simulations that depend on social network structures and different market conditions, they show that on an aggregate level,

¹ The focal product in this study is a prepaid mobile phone plan that includes a per-minute/per-message tariff.

² In the following, the two modes are referred to as sender- and receiver-stated referrals. In both cases, the airtime is credited to the account after three weeks. The number of referrals per customer is not limited.

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