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OPTIMIZING INCENTIVES FOR REFERRAL PROGRAMS

How to Choose The Right Incentive Structure For Your Referrals

Choosing the right incentive structure for your referral program is easy, but a little planning goes a long way. This guide will help you optimize for referrals — and ROI.

Introduction

Running an incentive program to reward your ambassadors for referrals is a time-tested method of dramatically increasing WOM success. The refer/reward structure taps into an innate desire to help others.

People already like to give referrals, but they absolutely love being rewarded for it. Such programs present a lot of room for creativity in the structure, cost and development of the referral incentives.

Incentives can run across a broad spectrum incorporating both monetary and non-monetary offers. With so many options, though, finding the right incentive can be difficult. Businesses must assess a number of financial and demographic components to ensure they are getting the most from their program.

In this eBook, you'll learn how to optimize your incentive structure to improve your business' WOM marketing exponentially.

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Chapter 1: Determining the Optimal Incentive Cost

The first step in setting up your incentive structure is determining how much it will cost you. In order to properly set the cost of your incentive you should consider:

- **The incentive should be enough to interest your customers to participate.**
- **The incentive should not erase the profit of the new revenue generated.**

A good first step is to investigate the Customer Lifetime Value (CLV) and compare that with you Customer Acquisition Cost (CAC). Warning: It's going to get a little mathematical. But we'll put everything into easy to understand terms and language.

Calculating the true CLV and CAC can become absurdly complex and relies on a number of academic studies (I tried to read them, I don't recommend it).

And while aggregating statistical data on each component of CLV is scientifically sound, don't worry if you have to apply experience or broad estimates. You'll still get a solid understanding of your customers and won't have to earn a Masters in Economic Theory.

Analyzing your CLV before starting your program is quick, relatively simple and extremely important for the sustainability of your referral marketing program.

A few definitions to get us started:

Customer Lifetime Value (CLV): The amount of economic value a customer brings over their "lifetime" of sales with your business.

Customer Acquisition Cost (CAC): The monetary cost of acquiring said customer.

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These two concepts are extremely important for businesses who are looking to get a good ROI on their marketing investment (read: every business). Say your CAC is $30, but your CLV is only $20. Your losing $10 for every new customer, not a sustainable situation in the least bit. That's just common sense.

Now let's dive into it.

First, you're going to want to calculate the marginal profit on the average sale your business makes. This is pretty simple for most businesses so let's use a typical business, say a coffee shop, to illustrate (Note: These numbers are all hypothetical).

Say your average coffee shop customer spends about $4.35 on a latte. But like in any business there are hidden costs associated with that latte (milk, cups, coffee, etc).

If those costs are $1.00, then the coffee shop is only making $3.35 on the sale. That's their marginal profit. Obviously every business has different cost structures associated with it, but this should prove a good example in illustrating the concept.

Moving on. The next step to understand CLV is to calculate the actual lifetime of your customer (CL). This number is important for understanding the amount of total profits brought in by one customer (hopefully they'll be making multiple purchases).

Your first step is calculating Customer Retention Rate (CR). This one's easy, just take the total number of customers you had last month/year/whatever who are still customers today and divide.

Equation: Marginal Profit = Revenue - Costs

The attrition rate is the percentage of customers that leave in a give time period (month, year, etc).

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So if you have 100 customers last year and 80 are still engaged with your brand, CR = (1 – 0.2) = 80%. It gets a little more complicated in the upper echelons of academia, but in an effort to cause as few headaches as possible we'll just say that's an adequate assessment.

Once you have your CR it's easy to calculate CL:

CL = 1/(1-CR)

In our example, CL = 1/(1-.80) = 5 years.

That's a great CL so don't worry if your number comes out a little lower. Also take into account that this number may fluctuate based on whether or not your business offers a subscription service.

Next we need to tackle the Cost Per Acquisition (CPA) or the cost of acquiring one new customer. Luckily running an incentive driven WOM program makes this really simple. It's just the amount your are willing to pay for your referral incentives. So your customer receives $5 from each referral that successfully converts to a sale. Your CPA is $5. That's pretty much it.

If you're currently running a traditional marketing program, you can aggregate the total amount spent and see where you're marketing budget is at. This will be important when determining how large of an incentive you are in a position to offer. In summary:

CLV = (Marginal Profit * CL) * CR

Plugging in our earlier numbers... CLV = (3.35 * 5) * 0.8 = $13.40

Equation: CR = (1 - Attrition Rate)

This means that your average customer spends $13.40 over their lifetime with your business. To set an profitable monetary incentive, you need to ensure that it does not cost more than $13.40 per new customer. Or, CLV > CPA, preferably by a large margin.

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Now, there are a lot of other metrics to take into account with referral marketing specifically. Mainly the Value of a Referral (VR).

This metric takes into account the subsequent sales generated by the referral, or the compounding effect that one brand ambassador can have on sales. This is a helpful metric for analyzing the success of your program as more data comes in.

To determine your Value of Referral, you're going to use the following equation:

(% of new customers coming via referral * # of new customers * CVL) # of referrals made

Most businesses estimate the "percentage of new referral customers" and "number of referrals made" using surveys of new customer acquisitions. But again, this equation won't really be valuable until your program is up and running.

Once you are up and running however, you can incorporate VR into your equation for CVL. This will give you an accurate assessment of the total value of one brand ambassador.

On the next page you'll find a helpful worksheet to help you keep track of all of the numerical data while planning for your program.

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Determining the Cost of Incentive Worksheet

Values:

Marginal Profit = ____________
Attrition Rate = ____________
Cost per Acquisition (total) = ____________
Cost per Acquisition (incentive) = ____________

Equations:

Marginal Profit = _______ (revenue) - _______ (cost)
Customer Retention = 1 - _____ (attrition rate)
Customer Lifetime = 1 / (1 - ________ (CR))
Customer Lifetime Value = ________ (marginal profit) * _____ (CL) * _____ (CR)

Is CLV > CPA (incentive)? ____________

One final note. It's always helpful to assess what your competitors are doing to develop an effective, competitive program. If you find that your competitors are running offers that do not meet the restrictions imposed on your business, look into a non-monetary incentive explained in the next section.

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Chapter 2: Choosing Your Incentive Structure

Now that we've determined the financial equations surrounding incentives, the next question to ask is what incentive structure will effectively generate the most referrals?

There are a number of considerations to take into account before determining which structure and reward will work best for your business. Taking the time to fully analyze your customer base will help immensely with the success of your program.

To start off, here's a good guide to keep in mind as we continue through the chapter:

Evaluating the Structure

First, you must take into account the structure of the referral program that you will run as there are many different options out there. Bear with me, because its going to be a little academic for a bit.

A study conducted in 2011 by the University of Pittsburgh and Korea University identified two types of structures, each with their own benefits and costs based on the likelihood to refer.

Single Incentive: A single incentive structure only rewards the original referrer for the new sale generated as a result of their activity.

Dual Incentive: A dual incentive structure rewards both the referrer and the new customer.

The study analyzed two levels of brands. Strong brands were defined as brands that were well-established and had a high level of brand awareness. Weak brands were defined as less-established brands with low-brand awareness.

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Taking a look at the condensed chart provided by the researchers gives us a lot of good insight on how to best target customers based on business models:

Notice that for weak brands, referral likelihood increased by a large margin when rewards were introduced in both single and dual incentive structures, although the single incentive preformed marginally better.

As explained in the study, costumers care more about the value of the reward when they are more sensitive to price. In situations where price is an important factor or when customers are not familiar with your brand, that will be attracted more towards high-value rewards programs. Generally, running a high-value rewards program can be costly in a dual-incentive structure so for weak brands a single-incentive structure makes more sense.

For strong brands, the dual incentive structure worked significantly better. The researchers attributed this to a previous likelihood to refer based on an already existing relationship and trust with the brand.

Customers who are familiar with the brand and products are less attentive to price (they had already determined the cost was worth it) so a larger reward had less of an impact than the opportunity to share with friends.

But how does this relate to your business' reward structure? For a smaller brand, a single incentive structure with higher value proves more effective than a dual incentive structure in with both participants receive less of a reward. Based on these results, it is more effective for rewards to be skewed in favor of the original referrer for smaller brands.

For a strong, established brand a dual incentive structure works better as a result of existing customers having an established relationship with the brand that deters price sensitivity; meaning that new customers should be targeted and rewarded more than existing customers.

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This data actually proves beneficial for less-established brands as a single incentive structure is inherently cheaper than dual incentive (you are only rewarding one person, not two), allowing the business to give bigger rewards to increase referral likelihood.

Both types of brands should take into account the benefits of an escalating reward structure, where-in referrers are rewarded more for each subsequent referral they loop in. This is based on the assumption that recommendations to close friends and family would have occurred anyway so it's important to keep ambassadors engaged. In this case, the structure should be geared towards rewarding referrals to casual acquaintances.

Type of Reward

After you determine your reward structure, it's time to consider what type of reward you'll be offering your brand ambassadors. These rewards generally fall into two categories:

Monetary incentives: Essentially a finders fee, monetary rewards tend to be successful at generating referrals and are easily quantifiable. These incentives can include cash, rebates/discounts, gift cards, commissions or other more creative offers.

Benefits: Monetary incentives are beneficial in a number of ways. It's extremely easy to calculate your Customer Acquisition Cost (CAC), or the total cost of acquiring one new customer (more on that later). If you already have a high CAC, a monetary incentive may not be the way to go. It can also simplify things when analyzing the effectiveness of your program as you'll have a baseline numerical value to use.

Costs: By offering commissions or cash you run the risk of the customer taking their rewards to another business. Like all social systems, there's an implicit moral hazard associated with referral campaigns that may detract businesses from simply offering cash. A gift-card, rebate or store credit will ensure more sales down the road and are relatively easy to track. You do run the risk of losing excitement with your ambassadors though as they acquire more and more credit whereas cash never goes out of style.

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Non-monetary: These are less transparent rewards that can still be used to excite new brand ambassadors. They may include access to products before non-ambassadors, public recognition (in an email shout-out, tweet, etc) or information before new product releases.

Benefits: Non-monetary rewards allow you to “shield your hand,” so to speak. Because there is not tangible value attached to the incentive you can theoretically offer something at next to nothing and still reap the benefits of referrals.

Costs: It takes a very strong level of brand engagement or a novel, exciting product to make these types of incentives effective. After all, if no one is familiar with your business it’s difficult to convince customers about the true value of your offer.

If your find that your LTV < CAC in the case of a monetary incentive, a non-monetary incentive can help alleviate the costs of payouts.

As a general rule of thumb:

Your incentives should be always be tailored to your target advocates (your customers), should be profitable for your business, and encourage engagement with your brand.

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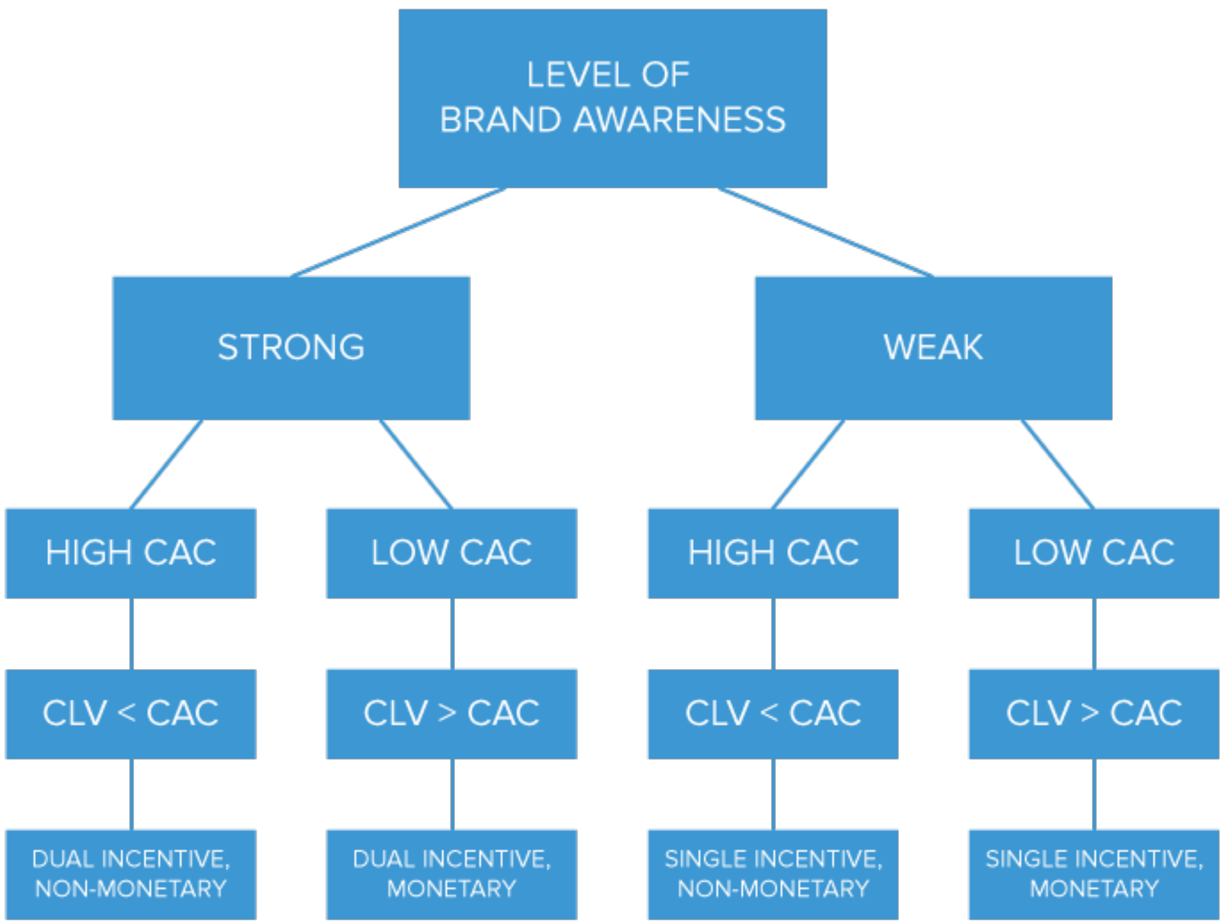
Incentive Structure Decision Tree

When going ahead and planning your campaign, use this tree to determine what type of program would be most effective for your business. Note: This is only meant to be a guide and should in no way limit your decision. In the end, your program will only be as effective as the effort and drive you put into it.



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Conclusion

Running an effective incentive program can be one of the most effective strategies towards building a coalition of passionate supporters and brand ambassadors. But without the right incentive structure in place, you may be losing out on an fully optimized ambassador program.

This is only meant to be a guide and should in no way limit your decision. In the end, your program will only be as effective as the amount of care and attention you give your customers.

Take into account survey data, competitor's behavior and your own instincts and experience when developing your program. With the right attitude and commitment you, and your customers, will start seeing real and lasting rewards.