



OVERVIEW OF THE MARKETING MODEL



Our basic marketing model describes how potential customers become customers through the act of buying. It stipulates that potential customers decide to buy as the result of advertising or word of mouth. Underpinning the basic model is a little bit of complexity, which I'm going to walk you through in this lesson. A little time spent understanding the underlying logic will make your explorations of advertising

and word of mouth in other lessons easier to follow and more useful.

Let's start with the basics. Potential customers are people you have determined are in your target market but who have not yet bought your product. To start with, potential customers consist of your total market population. Over time, potential customers become customers by buying your product.

These mini graphs show people on the vertical axis and time on the horizontal axis. As the level of customers goes up over time, the level of potential customers goes down. The number of people per month who decide to buy because of advertising is equal to the number of potential customers times advertising effectiveness. Advertising effectiveness is expressed as a fraction of the potential customers per month.

The better your advertising content - and the greater its reach and frequency - the higher your advertising effectiveness will be. Let's say your total market population consists of 100,000 people. When you launch, all 100,000 people are potential customers. Let's also say that your advertising effectiveness is 2% per month. In month one, 2,000 people will decide to buy because of advertising, and the level of potential customers will go down by 2,000 to 98,000.

In month two, another 2% of potential customers 1,960 will decide to buy. The level of potential customers will go down to 96,040. Likewise, in month three, another 2% of potential customers will buy, and the total number of potential customers will fall to 94,119.

This graph shows the number of potential customers on the vertical axis and the number of months on the horizontal axis. It shows how the pool of potential customers is drained over time as your advertising continues to persuade 2% of remaining potential customers to buy your product. Under this set of assumptions, potential customers will go down by 62,080 to 37,920 over 48 months. Of course, as prospective customers buy, the total number of customers goes up to 62,080 people over that same 48 months.



We'll dig further into the dynamics of advertising in another lesson. For now, let's turn our attention to word of mouth, which is more interesting, but a little more complicated. People decide to buy because of word of mouth depending on the number and nature of interactions among potential customers and customers. The more frequent, favorable, and persuasive the interactions, the greater the buying rate due to word of mouth.

To be more specific requires a little math, but stick with me. The logic is pretty straightforward and is important to understand.

Let's say your total market population consists of 20 people. Potential customers are blue, and customers are red. At the time of the snapshot, you have 19 potential customers and one customer. Mathematically, the probability of selecting a customer at random is equal to the number of customers - one - divided by the total market population - 20. Similarly, the probability of selecting a potential customer at random is equal to the number of potential customers - 19, in this instance - divided by the total market population - 20.

The possibility of word of mouth depends on an interaction between a potential customer and a customer. The chance of randomly selecting two people from the total market population - one of whom is a customer and one of whom is a potential customer - is, in this instance, just under 5%. Think about the probability of an interaction between a potential customer and a customer when there are 10 of each. The odds go up to 25%. If you let the movie play and wait until almost all potential customers have converted into customers, the probability of an interaction between a potential customer and a customer goes down again.

Because of the odds of interactions between customers and potential customers changes over time, the rate at which people decide to buy because of word of mouth will rise to a peak and then fall off. So, this expression tells us the probability that any given interaction will be between a potential customer and a customer - a requirement for the exchange of word of mouth information about your product.

Now we need to know the number of interactions. The total number of interactions among members of your target market per month is equal to the total market population times the contact rate. The contact rate is the average number of times a person communicates with another member of your total market population about your product. A contact can be any relevant form of communication - in person, over the phone, by email, or through some other form of social media. Obviously, the rise of ubiquitous communication technologies has increased the possibilities for making contacts.

So, the total number of interactions per month among members of your target market times the probability that any single interaction will be between a potential customer and a customer equals the total number of interactions per month that could conceivably result in a word of mouth decision to buy. Let's clean up this equation just a little bit by deleting total market population from the numerator and denominator.



Now not all potential word of mouth interactions are going to result in a decision to buy. The referral fraction is that portion of interactions between a customer a potential customer in which the customer offers a favorable recommendation regarding your product. The happier your customers are with your product, the higher the referral fraction. The persuasion fraction, on the other hand, is the likelihood that a potential customer who receives a favorable recommendation will believe it and act upon it. The more enthusiastic and credible the recommendation, or the more trusting the potential customer, the higher the persuasion fraction.

In the language of epidemiology, the persuasion fraction and referral fraction combine to determine the virulence of your product message, while the number of potential customers and customers - along with the contact rate - determine the rate at which people are exposed to the message. All together, these factors determine the rate at which people decide to buy because of word of mouth. This is where the phrase going viral comes from. Marketers have quite literally borrowed models from epidemiology.

I'll show you how advertising and word of mouth can influence break even cash flow in other lessons. Until then, this is Dave Bayless for Human Scale Business.