Marketing

Net Promoter 3.0

A better system for understanding the real value of happy customers

by Fred Reichheld, Darci Darnell, and Maureen Burns

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Manuela & Stefan Kulpa

Summary. Since its introduction, in 2003, the Net Promoter System, which measures how consistently brands turn customers into advocates, has become the predominant customer success framework. But as its popularity grew, NPS started to be gamed and misused... **more**

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On a scale from 0 to 10, how likely would you be to recommend our company to a friend?

As a consumer, you've probably encountered this sort of question dozens of times—after an online purchase, at the end of a customer service interaction, or even after a hospital stay. And if you work at one of the thousands of companies that ask this question of their customers, you're familiar with the Net Promoter System (NPS), which Reichheld invented and first wrote about in HBR almost 20 years ago. (See "The One Number You Need to Grow," December 2003.) Since then, NPS has spread rapidly around the world. It has become the predominant customer success framework—used today by two-thirds of the *Fortune* 1000. Why has it been embraced so enthusiastically? Because it solves a vital challenge that our financial systems fail to address. Financials can easily tell us when we have extracted $1 million from our customers' wallets, but they can't tell us when our work has improved customers' lives.

That's the objective of NPS. It gauges how consistently a firm turns customers into advocates, by tracking and analyzing three segments: *promoters,* customers who are so pleased with their experience that they recommend your brand to others; *passives,* customers who feel they got what they paid for but nothing more and who are not loyal assets with lasting value; and *detractors,* customers who are disappointed with their experience and harm the firm's growth and reputation. Promoters give a score of 9 or 10, passives a 7 or 8, and detractors a 6 or less. To calculate your firm's overall Net Promoter Score, you subtract the percentage of your customers who are detractors from the percentage who are promoters.

While that arithmetic might seem simplistic, the full system is intended to inspire teams to deliver experiences that are not merely satisfactory but remarkable. When customers feel cared for, they come back for more and bring their friends.

The power of customer advocacy is evidenced by the remarkable success of NPS leaders. Consider the 11 public firms highlighted in Reichheld's most recent book, *The Ultimate Question 2.0*. Over the past decade their median total shareholder return was five times the U.S. median (for public companies with revenues of more than $500 million as of 2010). Those results motivated more firms to track their Net Promoter Scores—and some to report them to investors.

Unfortunately, self-reported scores and misinterpretations of the NPS framework have sown confusion and diminished its credibility. Inexperienced practitioners abused it by doing things like linking Net Promoter Scores to bonuses for frontline employees, which made them care more about their scores than about learning to better serve customers. Many firms amplify the problem by publicly reporting their scores to investors with no explanation of the process used to generate them and no safeguards to prevent pleading ("I'll lose my job if you don't rate me a 10"), bribery ("We'll give you free oil changes for a 10"), and manipulation ("We never send surveys to customers whose claim was denied"). No details are provided about which customers (and how many) were surveyed, their response rates, or whether the survey was triggered by a specific transaction. Reports rarely mention whether the research was performed by a reliable third-party expert using double-blind methodology. In other words, some firms have turned Net Promoter Scores into vanity statistics that damage the credibility of NPS.

Over time we realized that the only way to make the system work better was to develop a complementary metric that drew on accounting results, not on surveys. We needed one that would illuminate the quality (and the likely profitability) of a firm's growth. It had to be based on audited revenues from all customers, not just on a potentially biased sample of survey responses, so that it would be far more resistant to gaming, coaching, pleading, and the response biases that plague the results of non-anonymized surveys. We're confident we've successfully developed that metric.

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In this article we introduce *earned growth* as the accounting-based counterpart for the Net Promoter Score, one that will reinforce the effectiveness of NPS, providing firms with a clear, data-driven connection between customer success, repeat and expanded purchases, word-of-mouth recommendations, a positive company culture, and business results.

The Origin of Earned Growth

The superior economics of companies with high Net Promoter Scores prove that generating more promoters (assets) and fewer detractors (liabilities) drives sustainable growth. But we knew we needed to reinforce NPS in a more objective way. Even when augmented with digital signals and big-data tracking, survey scores are inherently soft.

Executives (and investors) need a hard metric to which people can be held accountable.

Reichheld had his “aha!” about earned growth while studying an investor presentation slide in preparation for a keynote at First Republic Bank’s executive conference. The bank had quantified how much of its growth resulted from customers’ coming back for more—and bringing their friends. The slide showed that existing customers accounted for 50% of the growth in deposit balances, and referred customers another 32%. In other words 82% of the bank’s growth in deposits came from delivering great customer experiences. In loans 88% of growth resulted from making current customers happy.

The bank has data on referrals because it asks each new customer about the primary reason for selecting the bank and records the answer in the customer’s file. The bank’s customer accounting system automatically consolidates households with any related small businesses, so the bank can also easily see how much existing customers’ deposits and loan balances have grown. The primary reason First Republic collects this data is to prove to investors (and regulators) that its rapid growth is safe and high quality. The bank has been growing loans 15% a year in an industry that typically grows 2% to 3% a year. In many cases that would raise a red flag, since it might suggest the bank was lowering credit standards to gain share. But the data demonstrated that it was growing without adding risk. Its new business came from customers it already knew well—and from individuals referred by long-term customers.

Manuela and Stefan Kulpa are a husband-and-wife team and are fascinated by the distinct personalities of the animals they photograph and the essential connection that exists between humans and animals. Manuela & Stefan Kulpa

The presentation slide inspired Reichheld to develop a new metric, *earned growth rate,* which measures the revenue growth generated by returning customers and their referrals. A related statistic, the *earned growth ratio,* is the ratio of earned growth to total growth. That is what First Republic illustrated in its slide—82% for deposits and 88% for loans. Since the bank's total loan growth was 15% a year, its earned growth rate in loans was 13.2%. We predict that few other banks will be able to match First Republic's earned growth performance, but we won't really know for sure until more banks start measuring and reporting their own earned growth statistics. We do know that the portion of new customers generated by referral at First Republic—71%—far exceeds the portion seen at its peers in retail banking (measured through Bain's NPS Prism research), where it ranges from 21% to 53%.

In a very different industry, Warby Parker, the direct-to-consumer pioneer in prescription eyeglasses, earns almost 90% of its new customers through referrals. Warby was one of the first places where we tested the earned growth framework. The metric helped us appreciate Warby's impressive loyalty-based growth. The company is a longtime practitioner of NPS and plans to continue using Net Promoter Scores as a key metric for internal management. But it also plans to augment its learning with earned growth.

Calculating Earned Growth

Although it's possible to estimate earned growth without access to internal company data, investors will demand accurate (and audited) statistics based on actual results. To gather the hard data needed, firms must upgrade their systems to incorporate customer-based accounting.

Basic customer accounting continually tracks costs and revenues for each customer over time, patterns of defection, reductions, and price discounts, along with segment identifiers including tenure. It also captures the reason each customer joined (for instance, whether the customer was "earned" through referral or reputation or "bought" through advertising, promotional deals, or commission sales), along with that customer's acquisition and onboarding costs.

Essentially, this is the core information required to estimate customer lifetime value (CLV). However, CLV is complex and incorporates probabilities and higher math (think actuarial science). Although it can generate powerful insights, its application is dependent on sophisticated expertise. CLV involves a projection about the value you can expect to gain from customers, while earned growth looks at real results and quantifies the value you actually received. Earned growth can help every team learn how it is performing—by keeping track of how much growth results from customers' coming back for more and bringing their friends.

Earned growth has two elements. The first is the back-for-more component captured by a battle-tested statistic called *net revenue retention* (NRR), which is used in several industries, most notably software-as-a-service (SaaS). Once you have organized revenues by customer, you can determine your NRR. Simply tally this year's revenues from customers who were with you last year, divide that amount by last year's total revenues, and express that figure as a percentage.

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The second component is *earned new customers* (ENC). It is the percentage of spending from new customers you've earned through referrals (as opposed to bought through promotional channels). This component will take a bit more effort because firms must ascertain why new customers have come on board. We have developed a practical solution to this challenge, and while it may require some experimentation and refinement, ENC is important to track. The sooner you have a reasonable estimate of revenues from ENC, you can better focus your customer acquisition investments—and justify more investment in delighting current customers. Firms today undervalue referrals. They treat them as icing on the cake rather than an essential (perhaps *the most* essential) ingredient for sustainable growth.

To determine your earned growth rate, begin by calculating your NRR—since this is usually the larger of the two components. To get a sense of the importance of this statistic, consider the sensitivity of SaaS companies' valuations to modest shifts in their NRR. Firms with NRR over 130% are valued more than 2.5 times higher those with NRR below 110%.

Despite its importance, even experienced SaaS firms report NRR inconsistently. Some use samples of customers, some exclude new customers who also defect within the same period or customers with multiyear contracts, and so on. Our strong recommendation to regulators is to make this a formal GAAP metric with precise reporting rules.

Quantifying NRR may require homework in some industries. For example, not all brands consolidate household accounts across multiple product lines or services. Accounting for customers who join and defect within the same period must be handled consistently. Business-to-business firms will require rules for determining whether separate divisions (or purchasing units) of the same company represent one or multiple customers. But with today's sophisticated CRM technology, big-data tools, and a little analyst elbow grease, all that is doable, and it will require less work than arcane accounting metrics like goodwill and depreciation—which are demanded by GAAP but provide far less useful information.

We realized that the only way to make the system work better was to develop a complementary metric that drew on accounting results.

Now let's consider how best to approach the second component of earned growth: the portion of revenues resulting from newly acquired earned customers. Few firms can quantify this today, so we have pioneered a solution that is proving effective in several ongoing beta tests. We add a relatively painless step to the process for onboarding new customers: asking them the primary reason they decided to give the company their business. By doing this right at the beginning of the relationship, we ensure that the decision is fresh in the customer's mind.

The reasons given are then sorted into earned versus bought categories. For example, if a customer chooses "trustworthy reputation" or "recommendation from friends or family," that customer and associated revenues count as earned. Customers who select "helpful salesperson," "advertisement," or "special deal or promotional pricing" are tagged as bought. Our goal is to develop a universally applicable process so that every firm can use the same methodology, resulting in comparable reported numbers. But for now a good solution is to pick the handful of reasons you expect customers will choose along with an open-ended "other" response where verbatim comments will help you adjust or augment the categories over time.

Tracking the behaviors of customers tagged as earned versus bought will help you determine their relative lifetime value, illuminating which customer segments and acquisition channels represent the best investments. In our consulting work we've seen that most firms find earned new customers to be far more profitable than bought customers, many of whom are revealed to be money losers over their life cycle. This customer-based accounting data is vital for implementing customer strategies such as those developed by our Bain colleague Rob Markey. (See "Are You Undervaluing Your Customers?" HBR, January–February

2020.) Viewing customers as a company's most important asset is just talk until each customer's value is tracked and quantified.

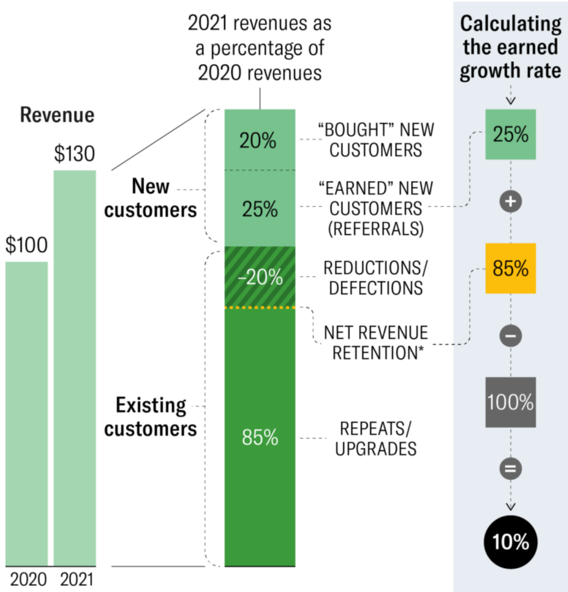
To determine your earned growth rate, add NRR and ENC together and then subtract 100%. Let's look at a hypothetical example. Company A's revenues grew from $100 in 2020 to $130 during 2021, or 30%. In 2021 customers who were on the books in 2020 accounted for $85 of revenues. Some of them expanded their purchases by a total of $5, but that growth was more than offset by other customers who reduced purchases by a total of $20, resulting in an NRR of 85%. New customers accounted for $45 in revenues—$25 from earned new customers (referrals) and $20 from bought new customers. Adding the NRR (85%) and ENC (25%) and then subtracting 100% results in a 10% earned growth rate.

Next, consider another hypothetical firm with the same reported revenue growth as Company A but very different sources of growth. Company B has an NRR of only 65%—far lower than Company A's. Although the two companies appear to be on the same trajectory, Company B is achieving its revenue growth by aggressively buying new customers. That will almost certainly penalize current and future earnings and prove to be an unsustainable strategy. Today's GAAP accounting obscures this vital difference.

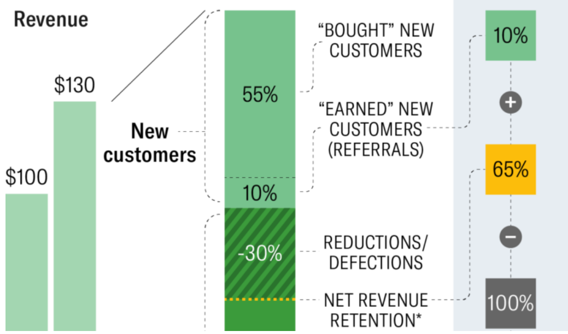
Comparing the Quality of Two Firms' Growth

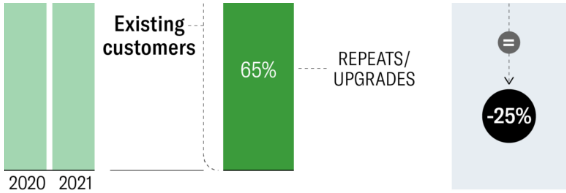
Companies with the same revenue growth may have starkly different earned growth rates. The hypothetical firms in this exhibit have increased revenue at a similar pace. But by looking closely at the sources of this revenue one can see that Company A has earned its growth by satisfying existing customers who come back for more and bring their friends, while Company B has generated significant revenue by aggressively buying new customers through advertising and promotions.

Company A: Growth through earning new customers



Company B: Growth through buying new customers





*To calculate net revenue retention, divide current period revenues from customers who were already on the books at the beginning of the period by total revenues from the previous period.

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The real-world business impact of customer loyalty hasn't been lost on savvy investors and executives. By developing auditable statistics, brands will be able to validate significant investments in providing superior customer service. Now we'll look at two actual firms, FirstService and BILT, that have begun using the earned growth rate as a gauge of customer loyalty.

The Long-Term Economic Value of Referrals

When he was just a teenager, Jay Hennick founded FirstService as a pool-cleaning company. Fifty years later, FirstService generates more than $3 billion in annual revenues and employs 24,000 people. It is North America's largest manager of residential communities, such as condominiums and homeowners' associations, and it owns a portfolio of property services, including CertaPro Painters, California Closets, Century Fire Protection, and First Onsite.

FirstService began implementing NPS across all its businesses in 2008. When Reichheld met the current CEO, Scott Patterson, in 2011, Patterson explained that he was keenly interested in finding out more about how NPS could help his business leaders build even stronger relationships with customers. The more we learned about the company, the more intrigued we became (Reichheld eventually joined its board), mostly because it seemed to care about customer loyalty as much as we do. When Patterson heard about Reichheld's plans to develop earned growth, he responded: "That's a great idea. It perfectly reflects the way we think here at FirstService."

FirstService attributes much of its success to a customer-focused culture. All its local business leaders understand the enormous expense required to replace a customer lost through defection. They also know how much more efficient it is to earn new customers through word of mouth from existing customers. Patterson estimates that more than half of all new customers in its Residential business (that is, residential-community management) are referrals. In its California Closets unit, 70% of the quality leads are. In painting, CertaPro finds that 80% to 90% are. Local franchisees know that word-of-mouth leads are likely to result in good business (CertaPro closes on more than 90% of them—about twice the rate for other leads). And because franchisees remain close to the customer, they can learn who made a recommendation and ask the recommender what turned him or her into a promoter.

FirstService provides a compelling example of how investors win with customer loyalty. The firm listed its stock on the NASDAQ exchange early in 1995. When a Bain team examined all U.S. public companies that had revenues of at least $100 million that year—approximately 2,800 companies—and ranked them by their total shareholder return through the end of 2019, FirstService ranked eighth (ahead of superstars such as Apple), with an annual total shareholder return of almost 22% a year. One hundred thousand dollars invested in FirstService stock in 1995 would have grown to $13.6 million by 2019. By tracking and publishing auditable earned growth rates, companies like FirstService will be able to credibly demonstrate the sources of their advantage and thereby help investors understand the sustainability of growth generated by loyalty.

Manuela & Stefan Kulpa

Patterson admits that he struggles to convince investors of the sustainable advantage that FirstService's customer-centric culture delivers. "They hear my words," he says, "but their financial mindset just can't make sense of them. They keep asking for the real secret sauce behind our impressive track record so they can assess our future." He views the development of a measurable science around earned growth as advantageous. He's not worried about giving away the secret sauce—after all, a service-based culture is hard to build and maintain.

BILT Pioneers Earned Growth Reporting

In 2016, BILT launched a mobile app to replace paper instructions with step-by-step 3D instructions for products requiring assembly, installation, setup, repair, or maintenance. Manufacturers and retailers send BILT computer-aided design files for products, and BILT converts them into digital animations with voice instructions and text prompts.

Amazon, IKEA, and Wayfair have acknowledged the negative impact that poor assembly processes have on customer experiences, and they've tested new methods to simplify home assembly. In 2017, IKEA purchased TaskRabbit, an online marketplace that today provides access to more than 100,000 freelancers, to make it easier for its customers to hire a handy person during the checkout process. Wayfair has partnered with Handy.com to offer a similar service. Earlier this year, Amazon began experimenting with a premium service that automatically includes assembly upon delivery.

BILT helps retailers eliminate the added expenses associated with assembly and customer support calls, and it gives buyers the knowledge and coaching needed to put items together on their own. BILT even keeps track of the time that people spend on each instruction screen, which helps manufacturers and retailers identify steps in the assembly process that are confusing or nonintuitive so that they can modify and improve the experience. The app also provides consumers with a virtual filing cabinet for all product registrations, warranty information, instructions, and troubleshooting tips. Updates to instructions saved in the filing cabinet are made in real time, so they never become obsolete. In other words, BILT helps retailers and brands improve customer experiences even after a product is assembled.

At the end of the assembly process, the BILT app generates a classic NPS survey asking how likely the consumer would be to recommend the product on a scale of 0 to 10, with an open-ended question about the reason for the rating and how the experience could be improved. Because of this, the app can provide retailers with rich customer feedback linked to specific SKUs and customer purchase records.

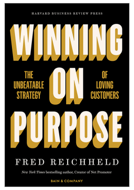
The firm's mission, according to its website, is to create "an experience so enabling and empowering, it transforms consumers into promoters of the brands we serve." It's fascinating to see the emergence of a business entirely devoted to helping other companies improve their NPS results.

When Reichheld first encountered BILT, in early 2020, its revenues were growing more than 175% a year. As happens at most start-ups, the business was eating up cash. But BILT's NRR was running at 150%, and most of its new customers came through referrals—resulting in an earned growth rate of 160%. That evidence persuaded Reichheld that the company's growth was sustainable. Since then, he has made a substantial investment in BILT and joined its board of directors.

Prosper by Helping Others

We had no idea how far-reaching our impact on the customer-centricity movement would be when Reichheld began writing about loyalty in *Harvard Business Review* more than three decades ago (in "Zero Defections: Quality Comes to Services," September–October 1990). We're proud of what we've helped companies accomplish, but we realize there is still very far to go. Early on, we saw that customer loyalty had little to do with marketing gimmicks and slick advertising, and we later proved that it generates bountiful economic advantages, including efficient customer acquisition.

Today we can establish that business success begins with leaders who embrace a fundamental proposition that their firm's primary purpose is to treat customers with loving care. That approach begets loyalty, which powers sustainable, profitable growth. It underpins the financial prosperity of great organizations and helps make them great places to work, but its effect has been notoriously difficult to quantify. It's time to get serious about measuring (and reporting) the progress made toward fulfilling that purpose and to recognize that improving the lives of the people we serve is the only way to win.



Editor's note: This article is adapted from Winning on Purpose: The Unbeatable Strategy of Loving Customers *(Harvard Business Review Press, 2021), Reichheld's forthcoming book with Darnell and Burns.*

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Fred Reichheld is a fellow at Bain & Company, creator of the Net Promoter System®, and best-selling author of several books on customer and employee loyalty, including *The Ultimate Question 2.0: How Net Promoter Companies Thrive in a Customer-Driven World* with Rob Markey.

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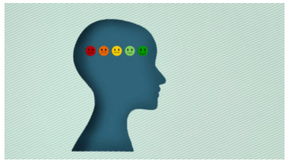

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