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Negative Buzz Proves Doubly Damaging

12/21/2007 --

Firms can increase profitability by selectively improving service quality and generating positive word-of-mouth recommendations.

ANN ARBOR, Mich.—Companies in the service industry typically spend millions of advertising dollars on the introduction and promotion of new service offerings, in hopes of gaining market share, improving customer retention and ultimately increasing revenues. To ward off competitors, they attempt to strike the right balance between improving service quality, which can increase customer satisfaction, and containing the costs of quality improvement, which affects profitability. Fine-tuning to achieve this balance is often a challenge.

In a new marketing study, Puneet Manchanda of the Ross School of Business and colleagues demonstrate that the level of service quality directly affects how much and how long consumers use a new service. In a major departure from previous studies, the researchers measure service quality objectively rather than via surveys focusing on memory-based evaluations of service encounters.



Puneet Manchanda

What's more, the study shows that service quality has an important indirect effect on word-of-mouth recommendations—that is, whether current customers recommend (or pan) the service to their neighbors and whether these potential customers decide (or decline) to subscribe to the service themselves.

When customers are happy with service quality, the researchers say, usage levels increase and termination rates drop, and these satisfied customers tend to give more favorable endorsements of the service to others. However, when service quality disappoints, dissatisfied consumers not only decrease their usage levels and terminate the service sooner, but also create a "negative buzz."

This unfavorable spillover effect has twice the magnitude of positive recommendations on potential customers who are influenced by word of mouth, the researchers say.

Manchanda, associate professor of marketing at the Ross School, and colleagues Pradeep Chintagunta and Sungjoon Nam of the University of Chicago collected data from a large entertainment company that tested a new video-on-demand movie-rental service in three different markets from October 2003 to November 2004. The data include household-level activation, termination and rental-usage information on 4,772 subscribers.

The service works by transmitting digital movie signals via TV towers to set-top boxes in consumers' homes for decoding, and requires activation, monthly maintenance and rental fees. Every week, 10 new movies are broadcast and updated by a device that plays the movies. The quality of the update depends upon the strength of the TV signal received by each device, which can vary from home to home. Thus, a lower (higher) quality TV signal delivered to the device results in fewer (more) movies being updated.

The researchers use signal quality as an objective measure of service quality. Their results show that a 10 percent increase in service quality leads to a 7 percent increase in customer lifetime value, i.e., total revenues generated by subscribers as long as they use the service.

"Our findings suggest that the firm providing the service is better off allocating its resources toward improving the service quality for the segment of customers whose customer lifetime value (based on acquisition, usage and retention), rather than just usage, is most sensitive to service quality," Manchanda said.

In addition, the researchers find that word-of-mouth referrals affect the activation behavior of nearly one-fifth of the subscribers.

"Consumers who are affected by word of mouth are heavy users once they adopt the service," Manchanda said. "This implies that service quality is important for new customer acquisition in the sense that the heavy users tend to be acquired by word of mouth rather than advertising."

The researchers caution, however, that word of mouth is a "double-edged sword." They report that positive word-of-mouth endorsements, arising from good signal quality experienced by existing customers, increase the probability that a potential subscriber will adopt the service by more than 7 percent. In contrast, negative word-of-mouth comments, arising from bad signal quality, decrease the monthly adoption probability by nearly 14 percent.

Overall, the results suggest that diffusion and usage of new products can be accelerated or retarded by service quality, word of mouth and the interaction of the two. The implication for service managers, Manchanda says, is that "firms need to allocate marketing resources to proactively measure service quality and word-of-mouth."

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