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Measuring *the* Shareholder Value *of* Marketing

BY GREGORY J. MILLMAN

The Problem

A little over a century ago, Quaker chairman John Stuart said, “If this business were split up, I would give you the land and bricks and mortar, and I would take the brands and trademarks, and I would fare better than you.” Stuart recognized that the value of his company depended not on its hard, physical assets but rather on its intangibles. He was so far ahead of his time that the rest of the world is only beginning to catch up with his insight. >>>

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▶▶▶ In recent years, it's become clear that a company's most important assets are not the ones that accountants measure. Studies by the Federal Reserve Board and by various private organizations leave little doubt that financial reports fall far short of giving a complete picture of what makes a business more or less valuable. According to an analysis by the consulting firm BrandEconomics, the market value of the S&P 500 was four or five times book value in 2003. By pricing America's biggest companies at four or five times the value of the assets on their financial reports, the stock market is saying that the real value of these companies is not in their property, plants and equipment but rather in something the financial reports often don't capture: intangible assets such as brands. "In our case, what's our asset base?" asks Rob Malcolm, president, global marketing, sales and innovation for Diageo, whose brands include Guinness, Johnny Walker and Smirnoff, "The value of our brands and the aging Scotch whiskey inventory in Scotland are the biggest assets we have."

Diageo isn't alone. An estimate by the brand valuation consultancy Interbrand suggests that 70 percent of the value of McDonald's is in its brand, and that the Coca-Cola brand accounts for over half the value of the Coca-Cola Company. But if you look at the balance sheets of most companies, you won't see an entry for their most important asset – the brand. Accounting has failed to keep pace with the growing value of intangible assets, and this creates perplexing problems for marketers.



Generally speaking, accounting rules only allow a company to treat a brand as an asset if it purchases that brand, for example, in a merger or acquisition. In that case, the money spent for the brand counts as an investment. But money spent to develop a brand in-house is an expense, according to *Generally Accepted Accounting Principles (GAAP)*, the accountant's rulebook. Therefore, the Burger King brand appears on financial reports while the McDonald's brand does not. Why? Burger King has been acquired, and McDonald's has not. The fact that accounting treats marketing investments as if they were mere expenses often causes trouble for marketers.

"It's pretty clear that the value of the brand generally exceeds all of the stuff on the balance sheet for a consumer-oriented company," says Donald R. Lehman, the George E. Warren Professor of Business at Columbia University in New York. Yet because of the quirks in accounting rules, investments in the firm's brands don't look like investments on the financial reports. According to accounting, the language of finance, marketing expenses are just expenses. So when the chief financial officer looks for costs to cut, the marketing budget looms like so much fat.

New research may give marketers the ammunition they need to prove otherwise.

Marketing and Shareholder Value

It makes sense that strong brands and high customer satisfaction ought to translate into higher profits and greater shareholder value. Proving it is another matter. One consulting firm examined a two-

day stock market dive that occurred in October 1997; they found that stocks of companies with strong brands took a little dip but bounced right back, while stocks of companies with weak brands lingered in the red. But marketers will need more rigorous analysis to convince the finance department that marketing investments really do contribute to shareholder value. And now they're getting it.

In a yet-to-be-published study, Professors Tom Madden and Frank Fehle of the University of South Carolina, with coauthor Susan M. Fournier of Dartmouth's Tuck School of Business, found that stocks of companies with strong brands outperformed the market as a whole and had less risk. They approached the task with rigorous financial discipline, examining monthly stock returns from 1994 to 2000 and comparing a portfolio of strong brand companies to a portfolio of the overall market. (Although this study has not yet been published, a draft is available from the SSRN Electronic Library at papers.ssrn.com). "Unless we are going to get those kinds of links, the chief financial officers are going to look at marketing spending with a careful and skeptical eye – and maybe they should," Madden says.

Other researchers are reaching similar conclusions about marketing's impact on shareholder value. In an article to be published by the *Journal of Marketing* in October 2004, coauthors Claes Fornell, the Donald C. Cook Professor of Business Administration at the University of Michigan, Eugene W. Anderson, Associate Dean of the University of Michigan, and Sanal K. Mazvancheryl of Georgetown University proved that customer satisfaction had a direct and measurable impact on stock performance. "We document a positive

association between customer satisfaction and shareholder value,” the authors write. “For a *BusinessWeek* 1000 [company] with assets of about \$10 billion, a 1percent improvement in satisfaction implies an increase in the firm’s value of approximately \$275 million.” In more technical language, the higher a company’s customer satisfaction scores, the higher the financial ratio known as “Tobin’s q” (the ratio of the market value of the firm to the replacement cost of its assets).

What It Means in Practice

In order to make effective use of these insights into how marketing builds shareholder value, marketers will have to change the way they talk and think about marketing. Marketers too often speak as if the connection between marketing values and financial value could be taken for granted. In a simpler age, when competition was less intense and the market for products insatiable, this may have been true. But it is no longer true. As Professor Don Schultz of Northwestern University observes, “We’ve had a hard time connecting attitudinal change to behavioral change,” and it is behavioral change – more people buying the product – that matters to the bottom line.

Now, marketers need to prove the case to a demanding and skeptical audience. “If the customer is brand loyal and less available to the competition, it means that the business is less vulnerable to competition, so it should lead to lower risk and, therefore, higher value,” says Rajendra K. Srivastava, the Daniel J. Jordan Professor of Marketing at Emory’s Goizueta School of Business, “Yet marketing people

stop at the level of saying, ‘We ran a campaign and increased brand loyalty.’ They haven’t said what it means in language Wall Street would pay attention to – such as the percentage of cash flow based on recurring business.”

Some marketers are beginning to do just that. At Diageo, for example, Rob Malcolm defines precise business objectives for marketing programs in advance and monitors their performance against objectives as they proceed. “It’s not 100 percent a perfect science, but it serves our purpose,” he says. While many marketers speak only in terms of traditional marketing metrics, such as awareness, Malcolm combines measures of effectiveness at changing customer behavior with measures of Return on Investment (ROI). Programs are not considered successful unless they score high on both the effectiveness and the ROI scale.

Although ROI is an increasingly popular metric, some critics say it is in fact confusing and often misapplied. Confusing because, when marketers use the term ROI, they mean the difference between what they spend on a program and what they receive from it – essentially the profit on the program. In financial terms, however, ROI is a ratio – the return divided by the investment necessary to get the return. For example, if a company invests \$100,000 in a project that will return \$5,000 per year, the ROI is 5%. This points to a shortcoming with ROI analysis. A marketing officer comparing several potential marketing programs may be tempted to pick the one with the highest profit in absolute terms. But if the ROI in percentage terms is less than the company’s cost of capital, the most “profitable” could be the worst investment.

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There are numerous other approaches to evaluating marketing programs, often misapplied. Professor Tim Ambler of the London Business School says, “In the course of my work, I’ve strengthened my hostility to bogus financial indicators because I think that while marketing should be more accountable, it should be done professionally. Some techniques are appropriate for forecasting, others for performance, and they’re not interchangeable.” For purposes of evaluating the relative merit of marketing investments intended to produce results both in current and future years, Ambler suggests using discounted cash flow (DCF) analysis instead of ROI. Simply stated, discounted cash flow compares the present value of future cash flows for the programs under consideration. A dollar received this year is worth more than a dollar received next year or the year after; the difference in value is a function of the fact that someone who receives a dollar today can invest it and have more than a dollar next year or the year after. Discounted cash flow analysis brings a greater level of financial sophistication into the marketing function.

In fact, discounted cash flow analysis is fundamental to the way that many brand consultancies value brands. Yet while they may use this technique as part of their evaluation process, firms differ enough in other elements of their approach that their valuation estimates may diverge widely. To some extent, differences in valuation may be a function of the purpose of the valuation. The job of accounting for the value of brands acquired in a merger requires a different set of metrics than the job of deciding which of several brands in a company’s portfolio should receive more investment and which should be treated merely as a cash cow.

Finance

Marketing

Moreover, although it is important to link marketing to financial results, too great a reliance on a single financial metric may deter firms from undertaking marketing initiatives that add great value. When UK retailer Tesco launched its loyalty program Tesco Clubcard in 1995, it was largely a leap of faith. Yet the Clubcard is now responsible for £100 million (pounds sterling) of incremental revenue each year and has provided Tesco with a much better picture of what customers want.

Of course, in many situations the outcome of a marketing campaign may be difficult to forecast. Sometimes the greatest value of a marketing investment is that it makes possible some initiatives that would not be possible without it. In this case, the investment is something like an option. Just as a stock option or a real estate option gives one an opportunity to take further action (buying the underlying stock or real estate) but does not require one to do so, a real option makes it possible to take certain actions but does not obligate one to do so. Eli Lilly, for example, used real-option analysis to decide whether to launch a new product whose success would make two other new products possible.

Firms that are just beginning to get their arms around the marketing-finance relationship need to recognize that picking the “right” marketing metrics is something like picking the “right” accounting principles. Just as different accounting rules apply in different industries, so do different marketing metrics. In consumer packaged goods, for example, brands are paramount; in bulk chemicals, they may be nearly negligible. The following self-diagnostic checklist is a good starting point:

- 1** Does your firm research customer motives and behavior? This step is fundamental. Research may take different forms depending on the industry, but understanding the customer motives and customer behavior is a necessary first step.
- 2** Have you made a clear connection between marketing, market performance and financial performance? If not, appoint a task force to analyze the linkages and report to senior management. If you do not understand how these dimensions interact, your marketing initiatives are shots in the dark. The task force should include representatives of both finance and marketing.
- 3** Have you defined “success” in quantitative terms and decided how you will measure progress toward the goal? This is basic strategy. Goals must be specific and clear. Progress must be measurable, and the team must know when it is moving toward or away from success.
- 4** Do your marketing metrics align with your strategy? Make sure that your marketing metrics include an explanation of why and how achieving a particular marketing objective, such as increasing awareness, will help the bottom line. Marketing metrics should not only be clear but relevant to the company’s financial objectives. Metrics will differ depending on the task at hand. New product launches obviously require a different set of metrics than a promotion campaign for a well-established brand.

5 Does top management pay attention to your marketing metrics and to marketing's contribution to financial goals? If top management is not watching, no one else will pay attention either. One way to make sure that senior management will pay attention is to involve the CFO in the effort to define appropriate metrics.

6 Does top management ask for and review reports using these metrics and compare actual to forecast performance? If top management is not asking for these reports, it suggests that the metrics you are using are irrelevant to the company's overall strategy. As you develop new metrics, make sure they pass the "Who cares?" test. Show why they matter.

7 Does management benchmark its performance on these metrics against competitors' performance on these metrics? If not, do so.

8 Is effect on brand equity – financially measured – a part of the evaluation of marketing programs? There are several ways of evaluating brand value and brand equity. Three of the leading firms in the field are BrandEconomics, BrandFinance and Interbrand. Each has a distinct approach. Familiarize yourself with these approaches, and decide whether any is appropriate to your case or whether you need to look elsewhere.

Conclusion

Marketing has long operated on the assumption that marketing value led to shareholder value – and recent research confirms that a connection exists. But turning that insight to business advantage requires marketers to make financial analysis an integral part of marketing decisions and to speak about marketing in language that financial analysts can understand. Picking financially valid marketing measures is not yet an exact science, and no single financial metric can fit all categories. But every firm should be able to define a set of metrics appropriate for its business in order to monitor the effect of marketing investments on financial performance. ■

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