Performance is the culminating marketing "P".

Not-for-profit organizations *(NFPs)* may operate towards a blend of financial and non-financial objectives, but for profit-maximizing firms, **profit contribution** is the penultimate yardstick of marketing effectiveness – since profits ultimately influence stock prices and, thus, drive shareholder value *(or "shareholder wealth")*.

Accordingly, many companies are trying to explicitly link marketing to **shareholder value creation** *(both conceptually and quantitatively)*, and to treat marketing spending more like an "investment" with upside profit-generating potential than a line item "expense" on the P&L that is simply a reduction-targeted cost of doing business.

Since marketing spending is usually a significant part of a company's cost structure -- and often the most substantial part – many companies are demanding an ever increasing level of financial accountability from marketers.

That is, they are expecting disciplined cost management *(i.e. competitive sourcing of inputs and services, systematic tracking of spending)*; timely and detailed reporting *(i.e. at the campaign, product, and customer level)*; and rigorous financial analysis comparable to that done for other major expense items and asset-building capital projects.

Marketing Dashboards

At a minimum, many companies are implementing **marketing dashboards**: high-level quantitative views of "how marketing is doing" via timely reporting of multiple key performance indicators *(KPIs)* aligned with corporate strategies and objectives.[1]

These digital dashboards – when well-conceived, fact-based, and data-driven – provide diagnostic information *(e.g. what happened? why?)* that can be the basis for improved decision-making and faster market responses.

An illustrative dashboard is shown below. Often, these marketing dashboards integrate information from various sources *(e.g. internal accounting and sales reporting, external market research)*, and present the KPI metrics online with "drill down" functionality for **performance tracking** *(e.g. performance compared to benchmarks such as past periods, plan commitments, peer groups, best practice standards)* and for detailed **strategic analyses** *(e.g. micro-slicing of the data -- by customer, by product, and by region -- and re-aggregating it by strategic segments)*.

Among the metrics commonly used to gauge marketing performance are **cognitive effects**[2] *(e.g. brand awareness and associations; customer perceptions, preferences, and purchase intent)*; **customer behavior** *(e.g. inquiries, orders, sales volume, market share, target market penetration, price paid)*; **customer satisfaction and** **loyalty** *(i.e. recency of activity, tenure and churn, account penetration, breadth of purchases)*; and – the most meaningful endpoint measurement: **profitability**.

Most of these inter-related marketing performance metrics trace conceptually from two core marketing frameworks the **Customer Satisfaction Model** *(CSM)* and **Hierarchy of Effects Models** *(e.g. the ATR Model linking Awareness to Trial to Repurchase)*.


This note was developed by Prof. Ken Homa as background for class discussions and is incomplete without extensive supplemental oral elaboration.

[1] Marketing dashboards are off-shoots of Balanced Scorecards that cascade a company's strategies into specific financial, operational, and organizational objectives.

[2] Sometimes called attitudinal effects or "mindset" stages.

Customer Satisfaction Model

The ***Customer Satisfaction Model (CSM)*** integrates the 6-Ps framework -- reflecting the impact of the four "classical Ps" (product, price, place, promotion) and directly connecting the two "extended Ps" (people and performance). [3]
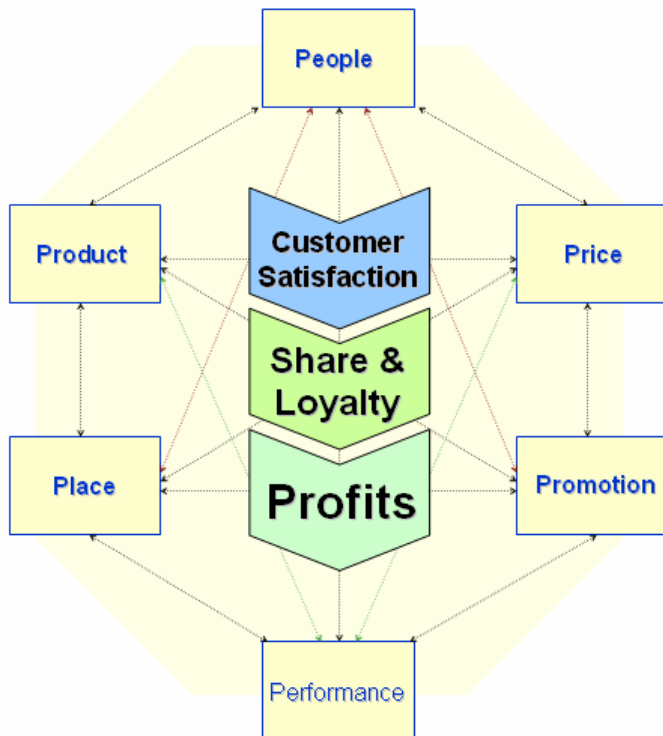
Conceptually straightforward, the CSM framework captures the essence of customer-oriented marketing:

(1) <u>Generate a high level of customer satisfaction, both in absolute terms and relative to competitors.</u>

Generally, customer satisfaction is achieved by consistently (and conspicuously) meeting, or better yet exceeding, customers' requirements and expectations, i.e. by delivering ***superior relative perceived value.***

(2) <u>Amass satisfied (and profitable) customers into a base of loyal customers and a substantial share of the relevant served market.</u>

As intuitively expected, empirical evidence usually confirms a strong positive correlation between customer satisfaction and customer loyalty.

But, some studies have revealed a "top box effect". That is, only "very satisfied" or "completely satisfied" customers tend to become "loyal customers". [4]

Some researchers conclude that a base of loyal customers is substantially more profitable than a constantly regenerating flow of new customers since longer-tenured customers:

(a) don't impose repeated acquisition costs

(b) may buy more often at "full" price instead of waiting for special deals

(c) are more likely to buy more products from a company's fully extended product line

(d) are lower cost-to-serve since they evolve to mutually efficient ways of doing business

(e) may provide free referrals or references to other potential customers [5]

While the rationale and evidence supporting these so-called ***loyalty economics*** are compelling, results of empirical research have been equivocal. Some researchers' findings have been contradictory to the above loyalty benefits, or have been inconclusive.[6]

(3) <u>Leverage market share into high profitability</u>.

High market share is, by definition, high relative sales volume – compared to competitors. High relative sales volume provides the basis for ***scale economies*** *(i.e. spreading fixed costs over a broad volume base),* ***experience effects*** *(i.e. learning curve efficiencies)*, and ***market clout*** *(e.g. getting better deals from suppliers).* A mega-research project called PIMS *(Profit Impact of*

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[3] The CSM Model is a variant of the "Service – Profit Chain"; see "Putting the Service-Profit Chain to Work", Heskett et. al., HBR, March-April 1994

[4] See "Why Do Satisfied Customers Defect?", Jones & Sasser, HBR, Nov.-Dec. 1995

[5] In fact, some consultants argue, and some companies zealously agree that the most fundamental satisfaction indicator is the question "would you recommend this (product) to a friend?" See "The One Number You Need to Grow", Reichheld, HBR, Dec. 2003

[6] For example, see "Loyalty Myths that Subvert Company Goals", Keiningham, et. al,. <u>Loyalty Myths</u>, Wiley, 2005

Market Share) built a broad-based, comprehensive data base of **market indicators** *(e.g. market share, penetration, position)* and **financial measures**. The researchers concluded that the relationship between market share and profitability is recurring, compelling, and conceptually justifiable.[7]

Subsequently, some researchers have disputed the findings, usually pointing to the unprofitable customers who are sometimes "at the margin" of share-driven companies, or to profitable niche brands with relatively small overall market shares. [8]

But, PIMS advocates tend to dismiss the criticism, arguing that taking on unprofitable business to build share is obviously wrong and avoidable, and that the niche brands do, in fact, have high shares of properly defined markets.

While the CSM Model sometimes requires a bit of nuanced interpretation and explanation, it provides a "neat" conceptual framework for isolating the stream of marketing KPIs from customer satisfaction, through share and loyalty, to profitability.

ATR Model

Hierarchy of effects models conceptualize the systematic steps in the purchase process from the early-on **cognitive effects** *(thinking, feeling, deciding)* that precede and <u>may</u> *(but not necessarily)* lead to purchase, to the **behavioral acts** of actually shopping for and buying a product.

One variant of the hierarchy of effects models is the **awareness-trial-repurchase (ATR)** framework which characterizes the buying process as three sequential steps.
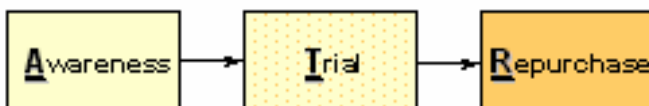
First, potential customers must become <u>aware</u> of a product <u>(or brand)</u> both generally, and specifically.

Awareness can be relatively strong and salient *(i.e. reflected as **unaided awareness** on market research surveys)*, or weak and latent *(i.e. **aided awareness**).* And, awareness can be broad and superficial *(e.g. "heard of the brand")* or deep and specific *(i.e. understand a brand's particular benefits, performance levels, and competitive positioning).*

If potential customers perceive that a brand's attributes and benefits match their requirements and deliver a competitively superior value, then the potential customers may be motivated to try the product and **purchase intent** -- an intermediate stage between awareness and trial -- is established.

Of course, **trial** -- an intended first time purchase -- may not materialize if the brand can't be found in stores *(i.e. poor distribution coverage, out-of-stock)*, or if potential customers, on closer inspection, realize that their perceptions are inaccurate *(e.g. actual price is much higher than the going-in perceived price, or actual features and benefits fall short of expectations).*

When customers **purchase** a product, they are able to validate the product's performance in their context-specific use environment and determine whether their in-going perceptions were correct and the product delivers the expected value. If it does, "triers" may be inclined to buy the product again *(i.e. **repurchase**).*

If a product falls short of customers' expectations, they *(the customers)* are unlikely to repurchase it unless the product is still needed *(versus just "wanted")* and competitive brands are even further off-the-mark.

ATR **conversion ratios** measure the proportional movement of potential customers through the ATR stages. For example, if 100 potential customers are aware of a product, and 45 of the 100 try it, then the awareness to trial conversion ratio is 45%.[9]

ATR Conversion Chain

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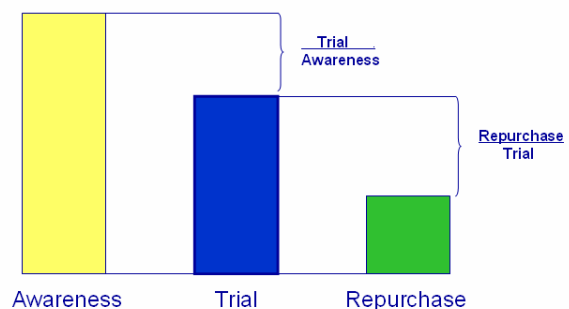
[7] See <u>PIMS Principles (Profit Impact of Marketing Strategies): Linking Strategy to Performance</u>, Buzzell, Free Press, 1987

[8] For example, see <u>Manage for Profit, Not for Market Share: A Guide to Greater Profits in Highly Competitive Markets</u>, Simon et. al.,, HBS Press 2006

[9] The conversion chain is depicted here as a classic "waterfall"; sometimes, it is portrayed as a funnel – with a decreasing number of people passing through successive stages of the funnel.

Conversion ratios can be benchmarked to draw inferences on the absolute conversion level *(i.e. are the conversion ratios over or under category norms? are they better or worse than competitors'?)* and, more importantly, conversion ratios can be a basis for calibrating the leverage from increasing the population at a specific stage.

Continuing the above example, if awareness levels are doubled to 200 customers and the awareness to trial conversion ratio stays constant, an additional 45 customers are likely to try the product. [100 additional customers who are aware times 45% awareness to trial conversion rate].

Depending on the cost to build to that level of awareness *(often imputed from a **response function** that relates spending levels to output metrics – such as awareness levels)* and the associated incremental profitability of the added triers *(taking into account profit contribution and repurchase rates),* the action – and its supportive spending -- may or may not be economically justified.

In general, higher conversion ratios provide greater economic leverage *(i.e. more "bang for the buck"),* and make it more likely that an action to improve an intermediate factor *(e.g. awareness)* would be economically justified.

More broadly, inspecting the series of conversion ratios provides insight regarding the most appropriate *(and cost justified)* strategies and tactics. For example:

(a) If awareness and trial are high, but repurchase is low, then the product or its price are suspect and little benefit is likely from building additional awareness through advertising.

(b) If awareness is high but trial is low, then customers perceptions, which may be right or wrong, may be that the product does not offer a good value, or the product may have inadequate distribution *(too few or the wrong outlets).* If the problem is erroneous perceptions, remedial advertising may be appropriate to close the perceptual gap.

(c) If trial and repurchase conversion rates are high but total sales are low, then the market may be too small, or awareness may be too low. If awareness is the problem, then more intensive advertising *(bigger budget)*, more effective advertising *(better ads),* or better targeted advertising *(to a most receptive audience)* may be required.

Again, the ATR Model provides a conceptual framework for identifying and linking marketing KPIs -- both cognitive effects and behavioral acts. So, many marketing dashboards report information on awareness, perceptions, preferences, trial and repurchase rates.

Marketing Performance Management

The CSM and ATR Models are conceptual frameworks that weave together marketing KPIs that are relevant for many companies' marketing dashboards.

But, It is important to remember that – even though some marketers tend to focus on the so-called **intermediate "mindset" metrics** *(such as brand awareness, perceptions, preferences; customer satisfaction and loyalty)*[10] or on **sales-related metrics** *(such as revenue, market share, market penetration)* – the ultimate endpoint measurement of marketing effectiveness is profitability.

Accordingly, the most disciplined profit-maximizing companies are subjecting marketing to more rigorous financial analyses, measuring the return (i.e. profitability) on marketing spending, and estimating the monetary value marketing-related assets *(i.e. customers and brands)*

More specifically, the "state-of-the-art" in marketing performance measurement and management includes:

(a) **Calculating the financial impact of marketing programs, especially promotional campaigns** *(common metrics include MROI - marketing return on investment; ROMI -return on marketing investment; ROMS^{TM} – return on marketing spending*[11]*)*

(b) **Setting a profit-maximizing marketing budget and allocating it to the highest yielding activities and programs** *(often called marketing mix optimization*)

(c) **Estimating the periodic *(e.g. annual, quarterly, monthly)* profitability of products and customers – individually and as strategic or operational groups** *(using techniques such as ABC – activity based costing; ABM – activity based management; EPA – economic profit analysis)*

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[10] Sometimes, the term "intermediate" is used to refer only to the cognitive measures such as awareness and brand preference.

[11] ROMS^{TM} is a registration-pending trademark of K. E. Homa.

(d) **Projecting and managing the lifetime value of customers** *(often referred to as customer lifetime value -- CLV, LTV, CLTV)*

(e) **Recognizing brands as financially significant intangible company assets and estimating their monetary value** *(building brand equity; computing brand valuations)*

(f) **Linking marketing performance to company stock prices and shareholder wealth creation** *(focusing on techniques such as SVA – shareholder value analysis; and metrics such as MVA – market value added; EVA – economic value added, and economic profit)*

Each of these profit management focal points is discussed in greater detail below.

ROMS™ – Return on Marketing Spending (a.k.a. "Marketing ROI")

Driven in part by the magnitude of their marketing budgets, many companies are taking a harder look at marketing spending and imposing more rigorous financial discipline on marketers.

In fact, in their quest to explicitly link marketing to shareholder value creation *(i.e. higher share prices)*, many companies starting to treat marketing spending more like "investments" with upside profit-generating potential than "expenses" that are simply a "to be contained" cost of doing business.

More specifically, many companies are using some classic financial analysis tools to manage marketing programs. For example, a near-variant of ROI analysis – referred to broadly as return on marketing investment *(ROMI)* -- uses classic ROI methods, including:

(a) Precisely tracking marketing expenditures *(the "I" in "ROI")*;

(b) Identifying and discounting directly-attributable gains *(i.e. incremental sales. profits, and cash flow – the "R")*;

(c) Comparing the projected ROIs to company hurdle rates *(i.e. minimum acceptable returns)* and to alternative investment opportunities;

(d) Skewing spending towards initiatives with the highest risk-adjusted returns, and

(e) Measuring actual program results – periodically and upon completion.

While there is broad emerging consensus that marketing spending should be subjected to profit-enhancing financial accountability, there is much debate among marketers and accountants on the specifics of how to do it. [12]

The debates generally revolve around two fundamental issues:

- *A technical issue*: How to "book" marketing spending – on the P&L as an expense item, or on the balance sheet as an investment asset?

- *A conceptual and practical issue*: How to measure and compare the profitability of marketing initiatives – individually and collectively?

Marketing spending: investment or expense?

Following generally accepted accounting principles, virtually all marketing spending is booked as a P&L expense item in a company's current accounting period[13] The implicit underlying assumption is that marketing programs generate relatively quick results – i.e. profitable revenue in the current period.

Some marketers argue that marketing programs are similar to capital investment projects *(e.g. building a new manufacturing plant or buying a piece of machinery)* and should get the same accounting treatment.

Specifically, the expenditures supporting most marketing programs are heavily front-end loaded near the start of the programs, but some *(or most)* of their associated financial benefits are realized in future time periods.

For example, an advertising campaign may elevate a customer's awareness of a brand or intent-to-purchase it, but the realization of revenue and profits from a completed transaction *(i.e. an actual sale)* may not occur until some time in the future.

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[12] In this note, "accountants" will be used to broadly represent managers with a financial analysis perspective – not necessarily accountants, per se. "Marketers" will broadly refer those people responsible for managing marketing functions and programs. Points-of–view attributed to the two groups will be composite generalizations that are sometimes stated as extreme points-of-view to highlight differences.

[13] In some instances, an estimate of brand equity value is required for accounting purposes. For example, in company acquisitions, FASB requires that "goodwill" (i.e. the difference between purchase price and book value) be split into material components. Sometimes, brand valuations are considered material components of goodwill.

Since realized benefits are not immediate or concurrently matched with the expenditure, some marketers argue that it is appropriate to:

- Capitalize marketing expenses *(or at least some portion of them)* as intangible assets on the company's balance sheet *(e.g. as **brand equity** or **customer equity**)*,

- "Depreciate" the assets over their productive lives *(i.e. for as long as they are materially producing benefits)*, and

- Match the amortized depreciation expenses – which are spread out over time -- with their related future financial benefits.

While accountants (and financial analysts) are sometimes sympathetic to the marketers' argument, they consistently reject it.

Again, accountants argue that the substantial bulk of the "returns" attributable to most marketing programs is realized relatively quickly – i.e. within a quarterly or annual financial reporting cycle – and that any far-future benefits are especially difficult to identify, highly uncertain, and minimal when discounted for risk and the time value of money. So, the "real" financial impact of future benefits is financially immaterial. [14]

This conservative accounting point-of-view is legislated in FASB accounting regulations -- so companies have little choice but to expense marketing spending on their financial reports. [15]

From an analytical perspective, the accounting distinction between expense and investment is largely inconsequential.

The financial analysis of investments is properly done on a cash flow basis -- not on an accounting "book basis". Cash "flows out" when the spending occurs, not when non-cash items like depreciation are booked to the P&L. So analytically, it doesn't matter what marketing spending is called. All that matters is when the cash flows in or out. Marketing spending is "marketing spending". Period.

Though accountants resist actually booking marketing expenses as investments, they understandably push hard for increased investment-like financial accountability. That is, making sure that marketing spending – which is often a very high proportion of a company's operating budget -- is tightly controlled and builds shareholder value by generating a profit.

Some "old-school" marketers continue to assert that marketing is more art than science, and that strict accounting controls tend to stifle creativity.

That argument doesn't carry much weight these days, and most marketers now concede that they should be held financially accountable for their spending and are developing performance measurement processes.

ROMS^{TM} Basics

The essence of marketing performance measurement is to determine the incremental profitability *(i.e. cash flow)* attributable to a specific marketing program and relate it quantitatively to the program-related spending.

Among the alternative performance metrics commonly used are:

- <u>Nominal profitability</u> – the difference between program spending and related cash inflows

- <u>Net present value</u> (NPV) – a program's time-discounted cash flows, or

- <u>ROI</u> – a ratio of incremental cash flows to program spending

At a minimum, a marketing program must generate incremental profits that are net of the marketing spending *(i.e. nominal profitability or positive NPV)*. Preferably, a program will leverage spending -- generating incremental profitability that greatly exceeds the spending *(i.e. a high ROI)*.

Marketing performance can be measured at several levels: e.g., <u>campaign</u>, <u>customer</u> *(all programs directed at specific customers or groups),* and <u>company</u> *(the aggregate of all marketing programs)*.

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[14] In theory, the riskiness of an investment can be incorporated in a financial analysis by increasing the rate that is used to discount the cash flow. The combined effect of the risk-free discount rate (usually the company's WACC) and the project-specific risk factor can be significant – especially when compounded..

[15] Again, FASB rules explicitly require that marketing spending be treated as expenses rather than being capitalized, except in very extraordinary circumstances (e.g. acquisition accounting).

At the most granular level, marketing performance measurement is done on campaigns -- marketing programs with specific objectives, target audiences, and time durations.

For example, a campaign may be a flight of commercials, a limited time price rebate, a direct mail program -- or a combination of these or other marketing initiatives.

For decades, direct marketers – motivated by their challenging business economics and enabled by readily available data -- have been at the leading-edge of measuring the profitability of marketing campaigns.

Typically, direct marketers track campaigns' out-of-pocket costs *(development of materials, list acquisition, mailing costs, fulfillment expenses, etc.)*[16] *,* and the corresponding response rates -- both "soft" replies *(e.g. web site visits, requests for information)* and "hard" responses *(i.e. purchase orders).*

In several respects, direct marketing represents the "cleanest" environment for measuring marketing performance since:

- The marketing communications are often addressed to specific individuals;

- The offers are usually for a specific product at a specific price;

- The response to the offers is timely *(often immediate)*;

- The offers are often independent of other marketing initiatives *(i.e. they are neither contingent upon or conflicted by other marketing programs)*; and

- The results are tangible behavioral outcomes *(e.g. information inquiries or purchases)* that are relatively easy to measure.

Measuring marketing performance in less direct marketing environments – which are perhaps more typical – raises substantial analytical challenges. For example:

- Some advertising may give products a brand image boost that results in future rather than immediate sales.

- Mass advertising is -- by definition -- aimed at broad audiences whose members are difficult to identify and track individually.

- Some marketing programs positively shift cognitive attitudes *(e.g. create awareness or buying interest)* but do not result in immediate sales and profits *(i.e. behavior).*

- Some programs may be dependent upon other contingent or complementary programs. For example, a consumer rebate program may be more effective if it is supported by a mass media ad campaign.

So, it's seldom unequivocally clear exactly what results should be credited to any specific marketing program.

In general, marketers and accountants agree that marketing spending should be "accounted for" and controlled, and that marketing should get credit for ***attributable incremental margin (AIM)*** -- measurable profits that are attributable to specific marketing programs and initiatives, and incremental over and above results that would be achieved without the program.

But again, attributing incremental margin to specific marketing programs is usually problematic. Many market forces, company initiatives, and competitive actions influence sales, and their individual impacts are difficult to untangle with any degree of precision.

ROMS^TM: what's "attributable"?

Marketers understandably lobby for a liberal interpretation of "program-related benefits". They typically argue that marketing performance should be measured over a time frame sufficiently long to include both current and future benefits rather than expecting a full realization of benefits in the same accounting period as the spending. And, they argue that marketing programs should get credit for both direct and indirect benefits, not just sales directly impacted by a program.

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[16] Sometimes, the accounting for program spending is less straightforward than might be expected. Some program-related expenditures are clearly associated with specific programs *(e.g. the postage on a direct mail program)*; others are subject to accounting interpretation and allocation rules. For example, creative work by an ad agency may be used on multiple programs, each of which should get allocated a shared portion of the expenses.

More specifically, some marketers argue that their programs should get at least partial credit for some program-influenced <u>future</u> sales. For example:

- A potential customer may be swayed by an ad campaign to prefer a particular brand of product, *(say, a Sony TV)* but may not have a **purchase occasion** until some time in the future *(when the current TV reaches its end-of-life)*, or

- A product *(say, an industrial product)* may have a **long sales cycle** from the time of an initial customer contact is made until all due diligence is done, all approvals are secured, and an order is actually placed, or

- It may take awhile for customers to progress through a **hierarchy of intermediate effects** – from **cognitive** changes in awareness, brand preference, and purchase intent – that naturally precede **behavioral** actions, i.e. purchases.

Marketers argue that the timing delays and order cycles can be explicitly tracked, and statistically projected *(at least in aggregate, if not individually)*. And, the cognitive effects can be measured via market research surveys, and their profit impacts can be calibrated based on hierarchy of effects conversion ratios *(e.g. the ATR model's awareness-trial-repurchase conversion ratios)*. So, marketing should at least get partial credit *(appropriately discounted to reflect the time value of money)* for the delayed and cognitive effects' profits-impact.

Similarly, some marketers argue that marketing programs should get at least partial credit for **indirect benefits** attributable to them. For example:

- An advertising campaign may strengthen a brand's image, enabling the company to secure future price premiums or grow sales at a faster rate, or

- An ad blitz may heighten interest for a direct mail campaign, increasing response rates, or

- A customer loyalty program may increase the likelihood that a customer tries a company's line-extending new products.

More generally, marketers argue that most marketing programs increase **brand equity** – which can be valued financially -- and that any change in **brand valuation** should be credited to the marketing programs.[17]

Not surprisingly, accountants tend to advocate a more conservative and narrow interpretation of program-related benefits – i.e. those that are realized in the current accounting period, that are terminal *(versus intermediate)*, and that are solely and independently driven by a program *(versus contributing to, or being contingent upon other programs)*.

Again, accountants argue that the substantial bulk of the "returns" attributable to most marketing programs are realized relatively quickly – i.e. within a quarterly or annual financial reporting cycle – and that any far-future benefits are especially difficult to identify, highly uncertain, and minimal when discounted for risk and the time value of money. So, the "real" financial impact of future benefits is financially immaterial.

Regarding intermediate cognitive effects *(e.g. increased awareness or purchase intent)*, some marketers and most accountants argue that intermediate gains -- while beneficial -- are worth nothing until subsequent programs or actions convert the awareness or purchase intent to an actual sale. So, for conservative accounting, any changes to intermediate cognitive effect variables should be outboarded when evaluating the returns of specific marketing programs. Credit should only be given to programs with culminating transactions. Otherwise, there is always the possibility of double–counting gains or booking gains that are never realized.

Regarding brand valuations, most people agree that brands can develop substantial equity over time and that brand equity is a valuable intangible asset.

But, many argue that brand equity valuations cannot be determined with any reasonable degree of precision -- for both theoretical and practical reasons -- and that brand valuation impacts attributable to any one specific program are likely to be dwarfed by the cumulative effect of past programs and actions *(some marketing-related, some not)*,and changing market conditions *(e.g. new competitors, shifting buyer tastes)*.

In other words, a single marketing program's impact on brand equity is likely to be minimal and any attributed gains are more likely to be a reflection of timing or "statistical noise" than a fundamental, undebatable change.

The "good news" is that marketing programs can often be financially justified based on their direct, short-run benefits. When they can, these indirect, longer-run benefits can simply be recognized as potential upsides which may somewhat mitigate inherent marketing program risks. When they can't be, marketers are vulnerable to aggressive accounting-based challenges.
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[17] Brand equity and brand valuations are discussed in more detail later in this note.

What's incremental?

Even when adopting a non-controversial, narrow definition of program-related benefits, determining the incremental profitability attributable to a specific marketing program is often difficult – both theoretically and in practice – even on an after-the-fact basis *(i.e. when doing a post-mortem analysis on a program).*

Conceptually, a program's incremental profitability is simply the difference between the profits generated if the program is implemented versus the "baseline" of profits if it isn't.[18]

Determining the comparative baseline is often a challenge.

The "purest" way to estimate incremental gains is to compare results from matched pairs of test and control markets -- markets that share common characteristics and programming except for the effect of the specific marketing program being evaluated.

For example, a direct mail program might have TV advertising support in some markets, and no advertising in others. If the level of advertising is the only differentiating variable between the markets, the difference in results can reasonably be associated with the advertising.

"Clean" test and control markets are a rarity. Often, it is difficult to control for all but the single program variable. That is, different markets face different combinations of customer and competitive influences.

Even when reasonably similar comparative pairs can be identified, many marketers are reluctant to commit the time and effort required to run the tests, in part fearing that they will "tip their hands" to competitors and delay the realization of benefits in the control market.

So, more typically, marketers will peg baselines by extrapolating past performance *(without the program)*, by statistically modeling market responses based on historical data, or by simply "guesstimating" based on their intuition.

ROMS^{TM} Formula

Assuming that a representative baseline can be established, a standardized comparative performance metric is ROMS^{TM} *(Return On Marketing Spending)* – a near-variant of the classical ROI metric that conveniently skirts the issue as to whether marketing spending is an expense or an investment.

ROMS^{TM} is simply the relationship between the incremental profits attributable to a program *(versus the baseline)* and the additional marketing spending on it.

For example, assume that a company ran a year-long marketing campaign with an upfront cost of **$65,000**. The campaign generated **1,000** identifiably incremental orders for **$150** each. The orders were for products with a **50%** contribution margin *(before considering the program-related marketing expenses).*

So, the program generated **$150,000** incremental revenue [1,000 incremental orders times $150 per order]. The incremental contribution *(before added marketing expenses)* is **$75,000** [$150,000 times the 50% contribution margin]. The net incremental profit is **$10,000** [$75,000 less the $65,000 marketing program cost].

For simplicity, assume that all program spending was front-end loaded at the start of the program and that the orders were received in a lump at the end of the program period. Also, assume that the company's reinvestment rate is its cost of capital: **10%**.

What was the program's ROMS^{TM} ?

The illustrative marketing program described above generated an "R" of **$10,000** on an "MS" *(or "I")* of **$65,000**. Since the program precisely spanned a year, the annualized ROMS^{TM} was **15.4%**.

This example's simplifying assumptions *(lump sums at the beginning and end of the program, 1-year time frame)* make the calculation obvious and easy. Suffice it to say (for now) that when the simplifying assumptions are relaxed, the calculations can become much more complicated.

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[18] A technical issue that is often debated is whether incremental profits should be based on margins with fully-loaded costs (i.e. "loaded" with an allocation of fixed overheads and other indirect costs) or marginal costs (i.e. only the additional variable costs that will incurred if the program is implemented). The answer is: it depends. If a company has excess capacity (of people and facilities) then marginal costing is appropriate. Fully-loaded costs are more appropriate for longer-term projects, since – economists point out -- even fixed costs are variable over long time frames.

But, even the most complicated cases can be reduced to the following generalizable ROMS™ formulae:

$$ROMS^{TM} = \frac{[\ NPV\ (IM)\ \times\ (1+r)\ ]\ -\ MS}{MS}$$

or

$$ROMS^{TM} = \frac{NPV\ (IM)\ \times\ (1+r)}{MS}\ -\ 1$$

where:

IM = the incremental margin attributed to a marketing program (before consideration of the marketing spending on the program)

NPV (IM) = the net present value of the incremental attributed margin, discounted by the company's cost of capital back to when the <u>initial</u> program spending is done

r = the company's applicable discount rate [19]

MS = marketing spending on the program (over and above "base" marketing spending that would be made with or without the program) [20]

Note that plugging the illustrative program's parameters into the formulae reconciles to the previous answer:

IM = $75,000

r = 10%

NPV (IM) = $75,000 / (1 + 10%) = $68,182

$68,182 x (1 + 10%) = $75,000

MS = $65,000

$75,000 - $65,000 = $10,000

ROMS™ = $10,000 / $65,000 = **15.4%**

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[19] The discount rate – which is used to calculate the net present value of investments -- is most often the company's cost of capital. In some instances the cost of capital is superceded by a company's investment hurdle rate (i.e. a rate higher than the cost of capital which recognizes that.—when resources are constrained – a company can not pursue all investment opportunities that simply earn more than the cost of capital).

In theory, the riskiness of an investment can be incorporated in a financial analysis by increasing the rate that is used to discount the cash flow. The combined effect of the risk-free discount rate (again, usually the company's WACC) and the project-specific risk factor is significant – especially when compounded.

[20] For programs with marketing spending in addition to the initial upfront outlay, MS is the NPV of all program spending.

The ROMS™ formulae – which accommodate different time horizons *(i.e. programs lasting more or less than a year)* and different cash flow patterns *(e.g. periodic inflows versus lump sums)* -- are neither intuitively obvious *(to most people)* nor simply deduced mathematically. Rather, they are derived inferentially from conventional ROI computational logic.[21]

ROMS^{TM}: moving forward

Both academic researchers and practioners are grappling with the **conceptual complexity** *(i.e. how exactly to measure marketing ROI or its variants (like ROMS^{TM})* and the **empirical challenges** *(i.e. where and how to collect the data).*

Some common points of agreement are emerging:

- It is worthwhile to develop a business-specific "theory of the case" that conceptually links marketing spending to profitability.

- Marketing should be held accountable for efficiently managing spending and driving profits.

- To be conservative *(from an accounting perspective)*, companies should focus on incremental costs and benefits – especially those that are "near in", directly attributable to a program, and measurable.

- With minor "tweaks", conventional financial analysis methods *(e.g. ROI-like calculations)* are applicable to marketing program analysis and planning.

- Reliance on any single metric may give misleading results *(e.g. maximizing ROI doesn't necessarily increase dollar profits)*, so it is always best to consider multiple measures simultaneously *(e.g. ROI, NPV).*

In summary, much of the financial benefit from ROMS™ accrues from adopting a conceptual framework *(forcing some analytical discipline)*, specifying a reasonable set of assumptions regarding program performance *(so that numbers are at least within an order of magnitude)*, and imposing managerial attentiveness to linking marketing spending to profitability.

So, it is generally concluded that it behooves marketers to avoid getting overwhelmed by the complexities and "just do it", refining methodologies over time.

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[21] See Homa , "ROMS™ - Analytical Note" for details regarding the formulae's derivation and more realistic (i.e. complicated) examples

Marketing Mix Optimization

Companies maximize profits by allocating scarce capital to opportunities with the highest risk-adjusted ROIs *(provided that the ROIs are greater than the company's cost of capital). [22]*

In a marketing context, this resource allocation process is called **marketing mix optimization (MMO)**.

Media Mix

The most granular level of marketing mix optimization is more appropriately called **media mix optimization**.

Media mix optimization is the selection and funding of specific media alternatives *(e.g. TV commercials, print ads, billboards, internet search placements)* within a campaign.

That is, media mix optimization is the determination of which media are the most **efficient** *(i.e. lowest cost per "hit")* and **effective** *(considering both the quantity of hits and the executional quality of each hit)* for achieving program **objectives** *(e.g. what message? to which target audiences?)*, and the **allocation of resources** to the most efficient and effective media to maximize a campaign's impact and minimize its costs.

For example, in some cases a product might require building awareness with a broad audience of potential customers very quickly with a short, impactful message. So, network TV might be the most effective choice – despite its relatively high cost -- and get allocated the bulk of a campaign's budget.

Most ad agencies have extensive data bases with ratings-based audience size estimates for specific media *(i.e. a TV show, a magazine title, an internet site)* that are sortable by market segment characteristics. And, the agencies have detailed information regarding media rates – which are commonly standardized on CPM *(the cost to reach one thousand specifically-defined targets).*

The data can be analyzed using sophisticated statistical models to optimize media mixes. That is, the models suggest how a constrained budget should be spread across specific media choices to best achieve delivery goals such as **reach** *(how many people?)*, **frequency** *(how many times?)* and **communications objectives** *(what message? what attitudinal change?)*..

When campaigns are completed, post-mortems can be done to assess whether the projections were realized and to fine-tune the models

Program Selection

At the level of aggregation next up from media mix decisions, marketing mix optimization is a logical extension of ROMS[TM] that allocates marketing resources among alternative marketing programs *(e.g. promotional campaigns)*, based on their risk-adjusted ROIs.

For example, assume that a company has 2 alternatives to consider: a direct mail campaign with a projected annualized ROI of 45% and consumer rebate promotion with a projected annualized ROI of 25%.

For simplicity, assume that the programs are equal in magnitude *(i.e. roughly the same front-end spending is required),* that the cash flows are comparably timed (*i.e. the same time horizon and pattern of results)*, and that the projected ROIs are, in fact, annualized and risk-adjusted. [23]

And, assume that company's cost of capital is 15%.

Both the direct mail campaign and the rebate program are projected to be profitable since their returns are greater than the company's cost of capital *(i.e. both 45% and 25% are greater than 15%)*. If the company has enough money to fund both, it should.

But, more typically, capital is scarce and companies can't pursue all apparently profitable initiatives. So, in general, programs should be prioritized based on their projected risk-adjusted returns – with higher return programs getting priority.

Operationally, companies don't usually decide to approve or reject projects all at one time – say, at the start of a fiscal year. Rather, programs may be proposed throughout the year. So, companies often set "hurdle rates" – higher than their cost of capital – and apply them on an on-going basis to approve or reject programs. Conceptually, if the hurdle rate is set properly, the right projects *(in terms of returns, size, and timing)* are approved and the company's scarce capital is fully deployed.[24]

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[23] If the programs differ along several dimensions, the logic is the same, but the calculations are much more complex. See Homa , "ROMS[TM] - Analytical Note" for more detail.

[24] Note that maximizing ROI (i.e. selecting only very high ROI programs) does not necessarily maximize profits. Some programs may dilute the company's ROI, but still add to profits – as long as. returns exceed cost of capital.

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[22] To maximize profits, a company with unlimited resources would simply fund all initiatives with risk-adjusted ROIs greater that the company's cost of capital.

And again, program selection may be impacted by joint effects among programs. For example, a program may be contingent or dependent upon results from another program *(e.g. an ad program may set the stage for a direct mail solicitation)*. Generally, related programs should be considered as a:"turnkey" set that produces final results.

Marketing Budgets

At the highest level of abstraction, classic capital budgeting logic can be followed to peg the size of the aggregate marketing budget. Marketing is always competing against other uses of company resources *(e.g. new manufacturing plants, more accountants, employee perks)*.

Once the marketing budget is fixed at a specific spending level, then marketers optimize the mix by allocating the budget to specific marketing tools and programs.

For example, a company might decide to redeploy $1 million from its advertising budget to beef-up its sales force *(say, by adding 20 sales people at $50,000 per year)*. Again, the underlying logic for the move would be that the projected profit gain from adding the sales people would exceed the probable losses from a cut in advertising.

In theory, companies should explicitly consider the relative marginal contribution *(to profitability)* of each spending alternative, and allocate scarce resources accordingly. In real life, though, most companies rely on executive judgment, historical precedents, or evolved rules-of-thumb to set budget levels.

Sometimes, companies do construct sophisticated econometric models that calibrate the leverage from spending on various aggregated categories of marketing "tools" *(e.g. such as advertising, rebates, trade promotions)* [25], and use mathematical methods *(e.g. linear programming)* to determine the optimal allocation of a constrained budget among alternative budget "lines".

Marketing Mix Optimization – Summary

In practice, marketing mix optimization is applicable at several levels of aggregation:

- Setting the total marketing budget *(as a proportion of total company spending)*

- Allocating a constrained marketing budget among alternative marketing tools *(i.e. budget "line items" such as "advertising", "sales force")*

- Allocating resources to specific marketing programs or campaigns

- Optimizing the mix of media used to support a specific campaign.

Many companies are becoming increasingly "scientific", especially at the more granular levels of decision-making:

- Again, some companies use econometric models to allocate a fixed marketing budget among components;

- Most companies analyze the projected profitability of proposed marketing programs *(and some do post-mortems to assess actual performance)*;

- Most companies with significant media budgets use statistical techniques to optimize their media mix.

Product Profitability

Based on broad empirical observation, it is remarkably typical that 80% of a company's sales are generated by a relatively small portion of its products (20% or fewer).[26]

Cumulative % Products

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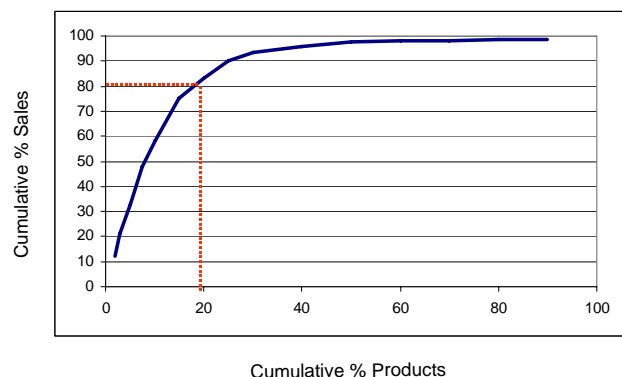
[25] The underlying analytical frameworks for these models are **response curves** that relate spending levels to expected outcomes.

[26] "Product" will be used as shorthand for physical products <u>and</u> services

On a profits basis, the effect (often referred to as the **whale curve)** is even more pronounced -- often 50% *(or less)* of all products generate more than 100% of a company's profits. That is, the bottom half of all products in a line actually lose money and reduce profits.

% Total Profits vs % Total Products
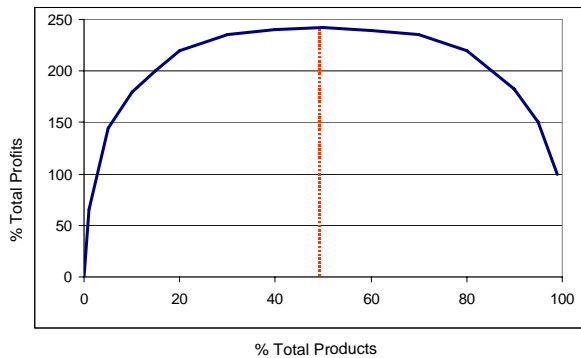
The obvious question is why don't more companies recognize these profit dynamics and pare back to a profitable core of products?

There are two basic explanations. First, <u>some products do provide substantial (and real) strategic benefits that compensate for their unfavorable economics</u>. In other words, profits earned by other products in the line, or at a later time, would not be realized if the loss-producing product were dropped. More specifically, some product models have focused strategic roles:

- *Flagship models* are often higher-end products that establish a company's image in the market despite relatively low sales.

- *Derivative models* *(slight variations of a core product)* are often tailored to specific customer requirements.

- *Sheltered models* *(also slight variations of a core product)* are unique products restricted to select accounts, intended to protect retail margins by frustrating a buyer's price comparison process.

- *Fighter models* are typically priced aggressively, sometimes offered at a slight loss, but produced in limited quantities to contain financial downsides and protect core models.

A second explanation for profit-draining products in a line is <u>that traditional accounting systems and statistical averages obscure the real economics</u>, in effect, hiding both costs and profits. In other words, managers aren't aware of the profit implications.

More specifically, most businesses *(especially those*

with a large services component) incur substantial indirect costs *(e.g. overhead, support, supervision).*

Most financial accounting systems assign direct costs *(like direct labor and material)* back to individual products with a relatively high degree of precision, but allocate indirect costs proportionately *(based on sales or some other volumetric measure)* across customers and products. So, products that actually generate proportionally more indirect costs *(e.g. low volume or specialty products)* are, in effect, subsidized by those products that generate proportionally less indirect costs *(e.g. high volume, standard products).* Profit is overstated for some products *(e.g. the low volume specials)*, and understated for others *(high volume standard products).*
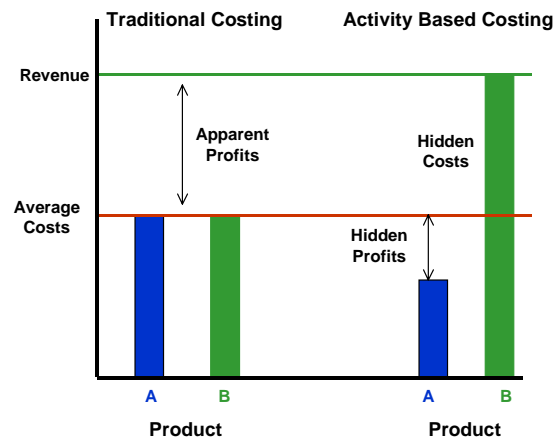
Activity Based Costing *(sometimes called **ABC**, or **ABM** for activity based management, or **EPA** for economic profit analysis))* is a methodology for reframing traditional financial accounting data to more precisely measure product level profitability by:

(a) **Mapping indirect costs by activity** *(rather than by organizational departments)*

(b) **Identifying the specific activities that actually drive most costs** *(e.g. the number of calls to a customer service centers drive their personnel costs)*

(c) **Determining the relationship between activity levels and costs** *(e.g. $25 of fully loaded cost per customer call)*

(d) **Mapping the indirect costs to specific products based on the products' activity levels**

(e) **Re-calculating product profitability based on direct and activity-based indirect costs**

Since ABC requires a reclassification if accounting data, development of approximating assumptions, and the gathering raw supplementary information, it is inherently time-consuming and, to some extent, imprecise.

But, the ABC process – and its "rough" numbers -- generally reveals the sources of product profitability , and flags profit-draining products which can be "remediated" by one or more of 5-Rs:

(a) <u>Repriced</u> at higher levels to increase margins

(b) <u>Reprogrammed</u> by modifying ordering terms and conditions for higher profitability *(e.g. instituting minimum order quantities)*

(c) <u>Redirected</u> by inducing customers to buy more profitable substitute products

(d) <u>Replaced</u> by redesigned products that are more profitable *(e.g. cost-reduced versions, or higher margin step-up models)*

(e) <u>Retired</u> from the line *(i.e. dropped),* foregoing the sales and avoiding the losses

Customer Life Time Value (CLTV)

The principles underlying product profitability apply to customers. Again, it is remarkably typical for companies to earn the bulk *(or all)* of their profits from relatively few customers. Many customers – often more than half -- lose money or barely break even when costs-to-serve are appropriately allocated.

Some companies have developed processes for sorting their "angel" and "demon" customers[27] and managing them differently. That is, they mine their data bases and accounting systems to identify the "demon" customers that generate losses -- e.g. by cherry-picking low margin items, or by being high maintenance and high cost-to serve – and try to "remediate" them with higher prices or modified buying behavior *(e.g. larger orders, fewer calls for services).* If remediation fails to turn the customers from unprofitable to profitable, the companies may take the bold step of "firing" the customers to stop their associated profit drain.

Conversely, these companies are tagging their highly profitable "angel" customers [28] and catering to them with added benefits geared to locking in their loyalty *(e.g.*

early access to new products and "deals", extraordinary customer support, volume discounts and frequent buyer privileges).

More generally, most companies now realize that the customer's value *(to the company)* transcends a single transaction or an accounting period of activity. Managed effectively, the "right" customers can provide a lifetime of transactions and an extended stream of sales and profits. That is, it may be costly to acquire and retain customers, but once "acquired", they may make repeat purchases, buy additional products, or "sell" the company and its products to other potential customers.

Customer Life Time Value (CLV or CLTV) is an analytical approach for calibrating the financial worth of customers – individually and in groups.

The essence of CLTV analysis is to project the net present value of the profitability of customers *(net of acquisition and retention costs)* based on their likely purchase patterns *(level of and corresponding profitability)* and the probability of retaining them over time *(i.e. their "tenure" as customers).*

More specifically, CLTV is a function of 4 factors:

1. Customer acquisition costs *(CAC or AC)*

2. Projected sales, profits and cash flows

3. Customer retention - defection rates[29]

4. Company discount rate *(i.e. cost of capital)*

With some significant simplifying assumptions -- i.e. a constant level of annual profitability over time, the realization of cash flows and customer defections at the end of each year, and constant defection and discount rates -- CLTV can be calculated using a modified perpetuity formula that incorporates the customer defection rate [30]

$$\text{CLTV} = \frac{M}{d+i} \ - \ \text{AC}$$

where:

M = *the annual profit margin generated by a customer*

d = *the annualized defection rate*

i = *the annual cost of capital*

AC = *the customer acquisition cost*

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[27] <u>Angel Customers, Demon Customers</u>, Seldon & Colvin, Portfolio Hardcover, 2003

[28] "The Customer Pyramid", Zeithaml, et. al., California Management Review, Summer 2001

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[29] Defection rates are sometimes called "churn"

[30] *A defection rate – or churn rate -- is the inverse of the probability of retaining a customer from one period to the next):*

For example, assume that:

- Average customer acquisition costs *(e.g. direct marketing costs, set-up expenses)* are $250;

- Annual profitability is projected to be $175 per customer, each year that a customer stays active with the company;

- The probability of retaining a customer from year-to-year is 80% *(i.e. the defection rate is 20%);*

- The company's discount rate for calculating NPVs *(i.e. its WACC)* is 10%

Then, CLTV can be calculated using the constrained perpetuity formula:[31]

$$
\begin{aligned}
\text{CLTV} &= [\$175 / (20\% + 10\%)] \ - \ \$250 \\
&= \ [\$175 / 30\%] \qquad - \ \$250 \\
&= \ \ \$583 \qquad - \qquad \$250 \\
&= \ \ \$333
\end{aligned}
$$

CLTV analyses can serve several purposes:

- At a <u>tactical</u> level, companies can determine the maximum they should spend acquiring customers. Obviously, the CAC should be less than the discounted stream of likely profits.

- At a <u>strategic</u> level, companies can use CLTV to sort customers into profitability tiers, and manage them accordingly.

- At a <u>financial</u> level – considering customers to be assets -- companies can aggregate the CLTV of individual customers *(or groups)* to estimate the aggregate financial value of the company's portfolio of customers.

In fact, some marketers argue that a company's financial value is simply the sum of its customers' lifetime values. [32]

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[31] Again, for this formula to be directly applicable, the annual profit (or more generally, the annual cash flow) must be realized at the end of the year, and the customer defections must occur in "chunks" immediately after the anniversary dates. If these simplifying assumptions don't hold, the calculations are doable but become increasingly messy. See "Homa Note – CLTV Basics".

[32] See <u>Managing Customers as Investments</u>, Gupta & Lehmann, Wharton Press, 2005

Brand Equity & Valuation

Simply stated, **brand equity** is the accumulated level of goodwill that induces customers to:

- Habitually self-limit their choice sets -- i.e. to seek out a favorite brand without giving serious consideration to competing brands

- Buy a brand with confidence and give it the "benefit of the doubt" in tie-breaking situations -- i.e. when two products seem to be about equal in price and performance

- Acknowledge the benefits received from a branded product by willingly paying "full" price *(or more)* for it

- Extrapolate brand values to an extended line of products -- i.e. be willing to try related products marketed under the same brand "umbrella".

So, brand equity can provide a current "lift" to profits from higher sales volumes and higher prices, sustained market momentum, and potentially, an entry barrier that insulates the brand from competitors.

Brand equity is built up over time – with individual customers and aggregated groups *(or segments)* – by consistently delivering the expected level of value *(e.g. benefits per dollar)* and by "framing" customers' perceptions *(via promotion)* so that the brand gets credit for the value it delivers *(i.e. perceived value).*

Prof. David Aaker is commonly recognized as the early thought-leader in brand equity research. Aaker identified 11 measures critical to brand strength: (1) differentiation, (2) satisfaction / loyalty, (3) perceived quality, (4) leadership / popularity, (5) perceived value, (6) brand personality, (7) organizational associations, (8) brand awareness, (9) market share, (10) market price, and (11) distribution coverage. He subsequently boiled these eleven attributes down to 5 defining components of brand equity:

- Brand loyalty
- Name association
- Perceived quality
- Brand associations
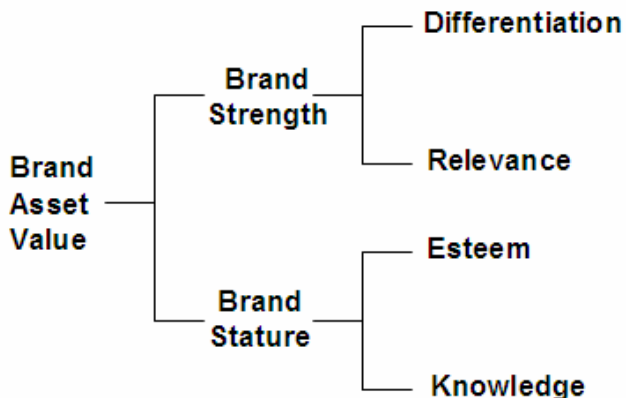- Intellectual properties (e.g. patents)

Many companies audit a brand's "health" by regularly surveying customers *(and potential customers)* to assess their brands' performance along these dimensions over time, and comparatively against other brands.

Most of the brand research methodologies currently in use have roots that can be traced to the Aaker's work.

For example, Young & Rubicam's's BrandAsset Valuator[TM] (BAV) -- one of the most prominent "models" -- is based on the premise that a brand's equity is based on its current **brand strength** and its enduring **brand stature**.[33]

According to Y&R, **brand strength** is the combined effect of **differentiation** *(a measure of distinctiveness of the brand in the market -- which drives trial, price premiums, and margins)* and customer **relevance** *(the meaningfulness and appropriateness of the brand to consumers -- which drives market penetration)*.

Brand stature – a measure of a brand's "persuasiveness" -- is the combined effect of **esteem** *(i.e. a brands popularity based on how well it fulfils its implied or stated consumer quality promise)* and customer **knowledge** *(i.e. whether consumers understand and remember the brand)*.
Y&R posits that these "Four Pillars" of BAV -- differentiation, relevance, esteem and knowledge are the foundation of brand equity, that they can be reliably calibrated -- individually and in combination -- via market research, and that they are consistently linked to a brand's capacity to deliver current and future revenue and profit.

Many marketers argue that the pay-off from marketing programs is often grossly under-estimated since short-term results *(e.g. immediate sales and profit gains)* are often considered, but longer-run benefits – which are in part driven by stronger brand equity that is "harvested" or "leveraged" in the future – are not

So, some marketers argue that brand equity is a significant intangible asset to the firm and that **brand**

value *(i.e. the estimated monetary worth of a brand at a point in time)* should be:

- Quantified to reflect the future financial benefits attributable to brands
- Shown on the balance sheet or -- at a minimum -- formally tracked over time and reported as a footnote in financial statements
- Given full consideration when evaluating the projected and realized profitability of marketing expenditures.

Said differently, they believe that brand value should be routinely estimated, and marketing should get credit for increases in it.

More specifically, a strong brand potentially impacts a company's revenue-related cash flows by:

- Increasing their magnitude *(more, bigger)*
- Accelerating their timing *(sooner, faster)*
- Extending their duration *(longer)*
- Reducing their riskiness *(more certain)*

So, in theory, a brand's value is simply the difference between its projected discounted cash flow and the hypothetical discounted cash flow of a comparable unbranded *(i.e. generic)* product.

For example, assume that a branded product getting $100,000 of brand marketing support each year is expected to sell 100,000 units annually, priced at $10 each, with a variable cost of $5 per unit. Assume that that comparable unbranded product – getting no brand marketing support -- would be expected to sell 75,000 units at $8 each *(with the same fixed and per unit variable costs as the branded product)*.

As shown in the exhibit below, the **annual incremental profit** attributable to the brand is **$175,000**.

Assuming – for simplicity -- that these volumes, prices, and costs are constant into the future and that the company's discount rate is 10%, then the **brand value** – the perpetuity value of the profit difference -- is **$1,750,000**. [34]

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[33] This description of BrandAsset Valuator is paraphrased from the Y&R web site http://www.brandassetvaluator.com.au/

[34] Some sources argue that the difference boils down to the added revenue a brand generates. That's true for a brand's price premiums since they drop straight to the bottom line. But, as this example illustrates, increased sales volume (i.e. more units sold) have corresponding costs, so the added profit – not the added revenue – is relevant.

	Branded	Unbranded	Difference
Sales (units)	100,000	75,000	25,000
Price	$10	$8	$2
Revenue	$1,000,000	$600,000	$400,000
Var. Cost / unit	$5	$5	$0
Var. Cost - total	$500,000	$375,000	$125,000
Margin	$500,000	$225,000	$275,000
Mktg Expense	$100,000	$0	$100,000
Net Margin	$400,000	$225,000	$175,000
Discount Rate	10%	10%	10%
Perpetuity Value	$4,000,000	$2,250,000	$1,750,000

Unfortunately, the theoretical approach – while conceptually straightforward -- is analytically impractical. Forecasts of a branded product's cash flows are imprecise; and the meaningful compilation of hypothetical unbranded cases is practically impossible in most instances. [35]

Some companies try to calibrate the branded versus unbranded differential using *conjoint measurement*. Conjoint measurement is a relatively sophisticated research technique that queries potential customers on a tightly specified combination of product attributes.

For example, respondents may be asked to indicate their preferences across pairs of real or hypothetical products with different prices, performance characteristics, and brand names. The responses are statistically analyzed to determine the relative importance of each attribute – sometimes called a "part-worth" or "shadow price" – and the optimum setting for each attribute *(e.g. branded or unbranded)*.

The conjoint-derived "coefficients" can be used to infer the relative preference for specific combinations of attribute values *(whether or not that specific combination was surveyed)*. For example, a statistical comparison can be made between two products that are identical except for the brand name. Any difference in preferences *(i.e. "utility scores")* can logically be associated with the brand names.

Similarly, inferences can be drawn from the conjoint results to estimate the relative prices that would make consumers indifferent between comparably featured branded and unbranded products. The difference in price – which is logically attributable to "brand" – can be extrapolated over potential sales volumes to peg an aggregate value for the brand "lift".

Some companies, agencies, and consultants have developed *brand valuation models* that attempt to statistically infer brands' financial worth from their performance on underlying brand attributes. That is, they explicitly measure a brand's market performance along multiple attributes – including consumers' perceptions of it and its competitors – and project a financial value linked to the measured components.

For example, Interbrand – one of the leading brand valuation consultants – uses a hybrid approach that combines the above methodologies to value a brand based on two factors: the brand's *intrinsic value (i.e. its current and future earning capacity)* and its *brand strength*. [36]

Intrinsic value is, in essence, the theoretical brand value – the net present value (NPV) of a brand's projected cash net of an estimate of the corresponding stream of unbranded profits.[37]

The *brand's strength* is a measure of the reliability of the projected future earnings. The stronger a brand, the greater the certainty of its future earnings, and the lesser the risk.

More specifically, Interbrand rates a brand's strength based on a weighted composite of seven variables:

- Leadership: a brand's influence in the market.
- Stability: a brand's enduring consistency
- Market: the structural attractiveness of the market that the brand serves
- Geography: a brand's attractiveness and appeal in a broad multiplicity of markets *(i.e. regional, national and international).*
- Trend: a brand's likelihood of remaining contemporary and relevant to consumers.
- Support: the amount and nature brand-building expenditures
- Protection: protection received from the legal system, patents, trademarks, etc.

In effect, the Interbrand model calibrates brand strength and incorporates the answer in the NPV discount rate to adjust the projected cash flows for risk *(of both the branded and unbranded products)*. All other factors equal, the stronger the brand, the lower the discount rate *(and the higher the present value)*.

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[35] Some companies produce both branded and generic versions of their products that can be compared. But, the accounting (e.g. cost allocations) tends to be complicated and often problematic.

[36] See the chapter "Brand Valuation" in Brands and Branding, Economist Book, 2004.

[37] Interbrand attempts to isolate a company's brand-related profits and then estimate what portion of those profits are brand dependent. The specific methodology is proprietary.

These brand evaluation models – and others like them -- provide rich detail for diagnosing a brand "health" and competitive position, and provide a conceptual logic for estimating a brand's monetary value.

And while some experts assert that the modeled brand value estimates are comparatively revealing *(i.e. over time for a specific brand, or concurrently brand-to-brand)*, most agree that the valuations are theoretically debatable *(which approach is right?)* and very imprecise *(since they depend on forecasts of cash flow streams).*[38]

So, some companies resort to crude "ballpark" brand value estimates based on retrospective accounting of brand development costs *(i.e. historical costs)*, or "guesstimates" of how much it would cost to rebuild a brand from scratch *(i.e. replacement cost).* [39]

In general, brand valuation models are generally considered more appropriate as guides for marketing decision-making and royalty-setting *(i.e. how much to charge when licensing a brand)* than for financial reporting. Accountants agree, and keep brand equity off the balance sheet, except in very special situations.

For example, in some acquisitions, the purchase price greatly exceeds book value. The difference – called goodwill – is apportioned among major components, including the brand value.

Linking Marketing to Financial Performance

Since the late 1990's, the Marketing Sciences Institute (MSI) – a quantitatively-oriented, thought-leading association of marketing academics and practitioners – has promoted marketing performance measurement as a primary research priority. Specifically, MSI has encouraged researchers to conceptualize and calibrate the linkages between companies' marketing spending and their financial results.

The elevated focus on the topic has been motivated by:

- A common and long-standing skepticism among many CEOs and CFOs that marketing spending – which accounts for a substantial part of most operating budgets – generates unsubstantiated returns that may be sub-par compared to other spending and investment options.

- A concern among marketers that their programs don't get full credit for the financial results that they do deliver, making their marketing budgets vulnerable to arbitrary top-down cuts

- A broad based recognition that many companies' marketplace differentiation and financial success is increasingly derived from intellectual property and intangible assets such as brand names.

Unfortunately, linking marketing spending explicitly and directly to financial results continues to be challenging – conceptually and practically since:

- There are many exogenous variables *(e.g. the economy)*, confounding factors *(e.g. competitors' actions)*, and co-dependencies *(e.g. manufacturing quality and customer satisfaction)* that interact, making it virtually impossible to sort out the relative contribution of any specific profitability driver – marketing included.

- Realistically, the impact of any single marketing program on a company's stock price is minimal, except for extraordinary programs that provide a quantum sales boost *(e.g. GM's dramatic "everybody pays employee price" promotion)* or that generate substantial unexpected costs and losses *(e.g. Red Lobster's infamous – and very costly -- costly "all you can eat lobster" promotion).*

- Given the time lag between "mindset" changes (that are most directly and immediately impacted by marketing) and eventual sales (the penultimate performance metric), specific correlations are difficult to pin down,

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[38] Many critics argue that most forecasts are merely "tweaks" of current product performance and, therefore, have little discriminating content.

[39] For example, Black & Decker acquired GE's home appliance business, the company estimated that it would cost $100 million to rebrand from "GE" to "B&D". See "Black & Decker Corp.: Household Products Group, Brand Transition", Quelch, et. al., HBS case, 1987

Nonetheless, valiant efforts have been and are being made to tighten the marketing to financial linkage – conceptually, empirically, and practically.

At the conceptual level, a common thought-organizing framework is a causal "value chain" that links marketing spending to financial valuations (of firms). [40]
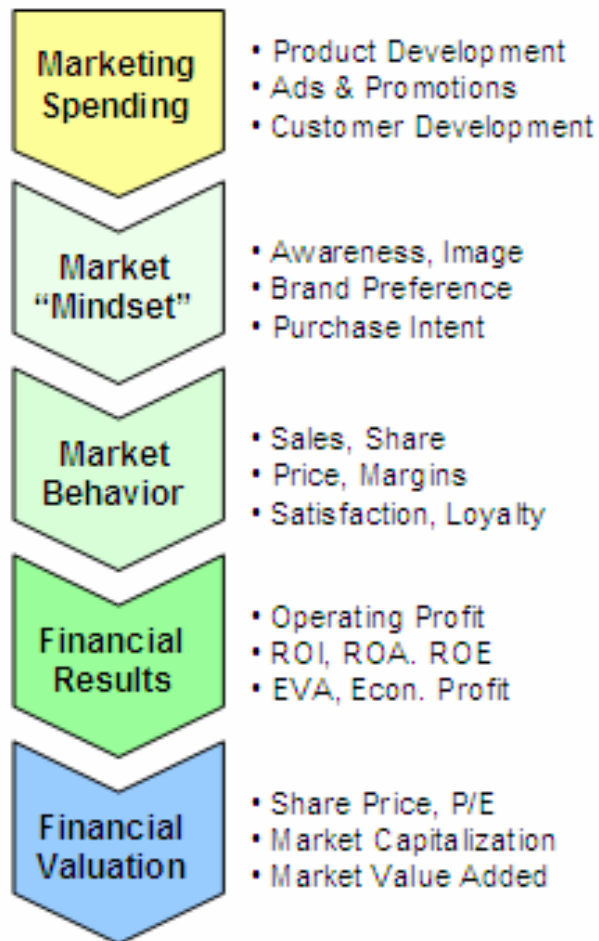
The marketing value chain starts with the level and nature of marketing underline spending – on specific programs and aggregated to spending categories *(new product development, advertising & PR campaigns, trade and consumer promotions, customer development, personal selling, etc.)*. While accounting for these costs can be complicated by allocations among cost-sharing programs and amortizations over variable terms, capturing spending levels is typically the easiest part of the value chain process.

The next link in the chain is measuring the attitudinal *(or "mindset" changes)* that are most directly impacted by marketing actions, including awareness *(of the product category and specific brand)*, brand image and associations, purchase consideration and intent, and willingness to pay *(a price premium)* or recommend *(to a friend)*.

Hopefully, any positive attitudinal shifts eventually result in buying behavior that can be measured by sales *(unit volume and dollar revenue)*; market share *(of total market, of category spending, of customers' "wallets")*, price premiums paid *(or discounts required)*, and customer count *(i.e. the number of customers)*, satisfaction, and tenure *(the length of time as an active customer, reflecting retention-churn rates)*.

Most of the buying behavior metrics are top-line related, *(i.e. measuring some aspect of revenue generation)*. But, the more important financial objective is bottom line profitability, which can be measured as operating profits *(dollars)*, return on investment *(ROI, ROA, ROE),* or economic profit after charges for capital employed *(EVA)*.

The final link in the chain is the financial valuation of the firm. That is, translating superior profitability into high and increasing share prices that in turn, drive a company's market capitalization *(in essence, share price times the number of shares outstanding)* and market value added, or MVA *(subtracting debt and invested capital from market capitalization)*.

Again, empirically measuring the variables, calibrating the conversion ratios from one step to the next, and ultimately assigning a specific value to marketing's profit contribution is difficult and imprecise.

But, leading-edge, profit-disciplined companies are continuing to try and often realize benefits simply by focusing managerial attention on the linkages in a structured way, and measuring what they can – as accurately as they can.

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Finally, closing the loop, marketing is all about creating value: creating shareholder value in profit-maximizing firms by generating superior returns on investment, or creating social value through organizations whose overarching objectives include contributions to the common good.

The 6 Ps are how marketing does it !

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[40] This particular value chain variant is adapted from Lehmann and Reibstein, Marketing Metrics & Financial Performance, MSI, 2006