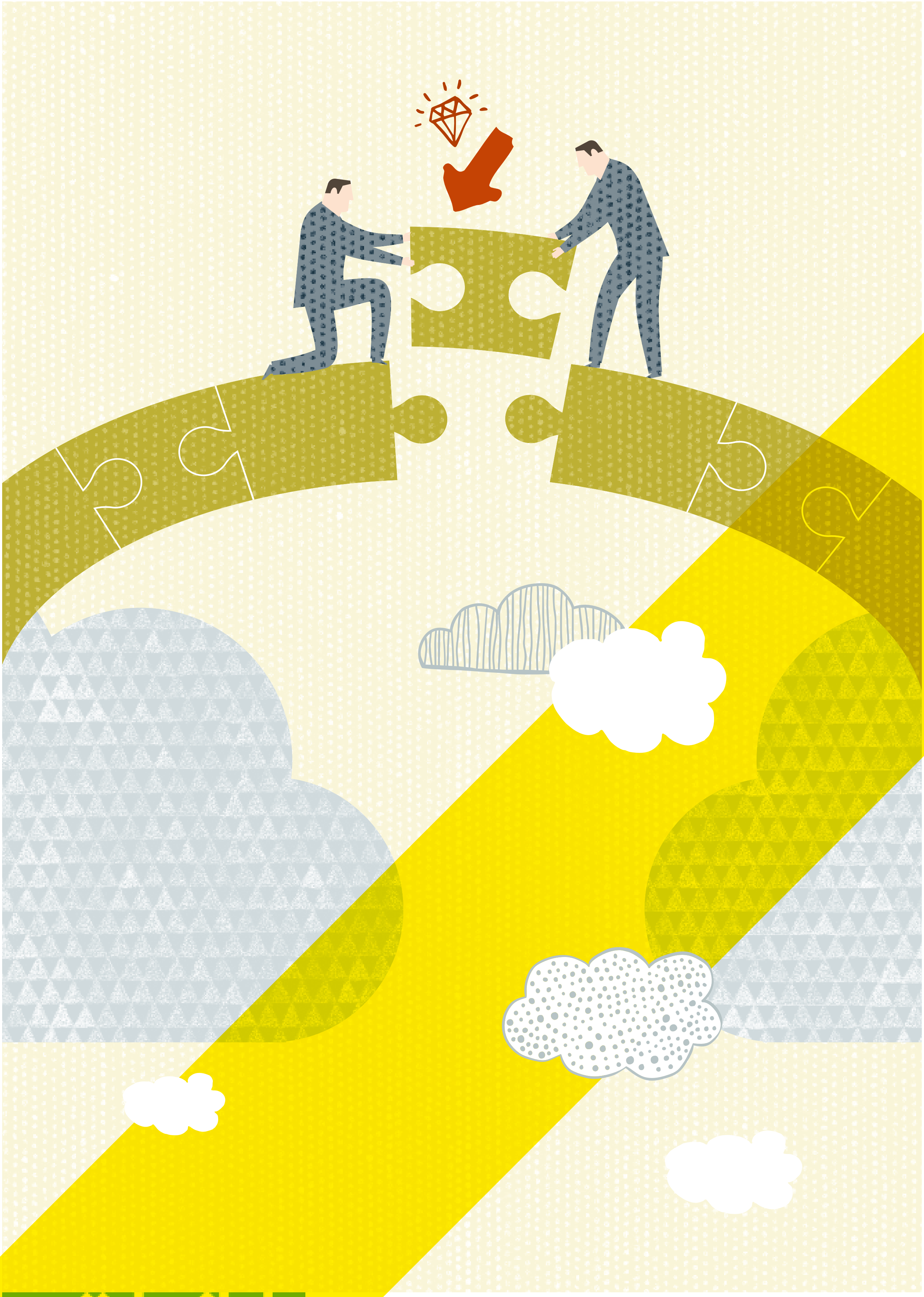

Closing the Gap between Marketing and Finance: The Link to Driving Wise Marketing Investment

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Marketing Measurement, Marketing Returns, Intangible Assets, Brand Value, Customer Value, Marketing-Finance Interface

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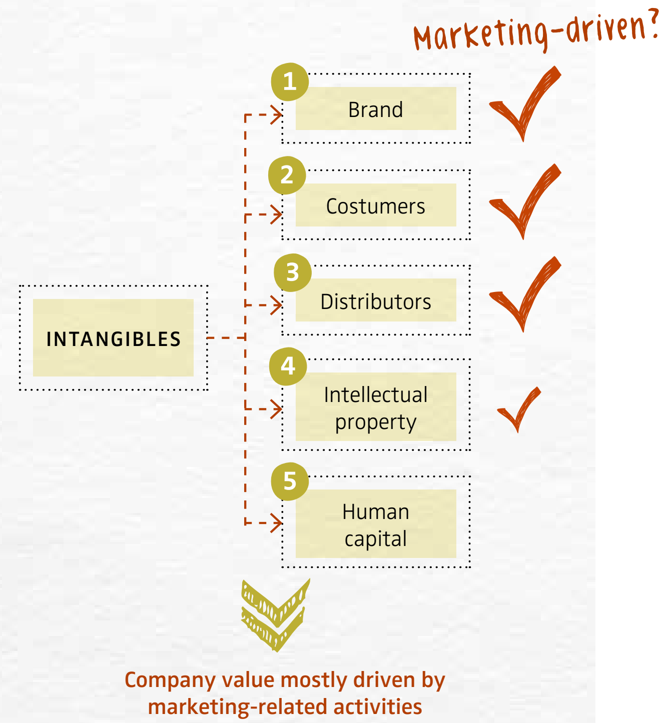
The true value of marketing investments /// What do companies with products as diverse as Apple, Red Bull, McDonald's or Ikea have in common? They have good products, right. But another even more important characteristic is their excellent marketing. For most companies, it is not the tangibles that make up their overall market value but the intangible assets, such as the brand, loyal customers or a strong network of distributors. If the market value of a company exceeds its book value, the difference arises from the value of the intangible assets. Global top-performing companies have significantly higher market-to-book ratios than less successful companies, and their value stems from a strong brand, better customer management, and/or superior distribution.

Linking marketing to market capitalization /// While the bottom-line results and rankings presented by consultants like McKinsey or Interbrand impressively demonstrate the value of brands or other marketing assets, marketing managers are still struggling to prove the value and payoff of their marketing expenditures. Marketers regularly collect a bevy of measures – from customer satisfaction, awareness, preference, purchase intent etc. The relation between financial metrics and the marketing activities that drive these measures, however, is unclear. Because finance does not see the link between marketing spending and the financial metrics of the firm, it is often difficult to get enough resources to increase short-term sales and even harder to justify

FIGURE 1:
From marketing to market capital

FIGURE 2:
Marketing's role with the intangibles



spending for long-term effects. Return of investment (ROI) is often assessed, but the intangible value of firms tends not to be well measured, well documented or carefully tracked over time. Without an understanding of the connection between marketing spending and the intangible assets, it is often treated as a discretionary expenditure and handled as a potential candidate for savings that will go unnoticed on the bottom line. Despite the pressure to prove the effects of marketing spending, marketers in many companies are still just learning to speak "finance" in order to insure their budgets and to ultimately demonstrate how marketing increases share prices or at least offers an attractive ROI.

As shown in Figure 1, it is my belief that marketing spending leads directly to quantifiable marketing outputs captured by metrics such as clicks, conversion, awareness, loyalty etc. I also contend that as these metrics rise, there is a direct impact on some market results, such as sales, market share, profits, cash flow, EBITDA and even return on investment. In turn, there is an ultimate impact on the firm's stock price/market capitalization. That is not to say that these are all positive. I am quite confident that, at least at some point, as spending goes up, share price will decline as the spending becomes less efficient. Yet, finding these links from one level to the next can be quite difficult.

Marketing's contribution to the firm's intangible assets
/// Above I suggest that the majority of firm value comes from ***intangibles***, that is, market-to-book value is greater than 2, on average. What are the key intangible assets of the firm? I would argue they are brands, customers, distribution relations, intellectual property and human capital.

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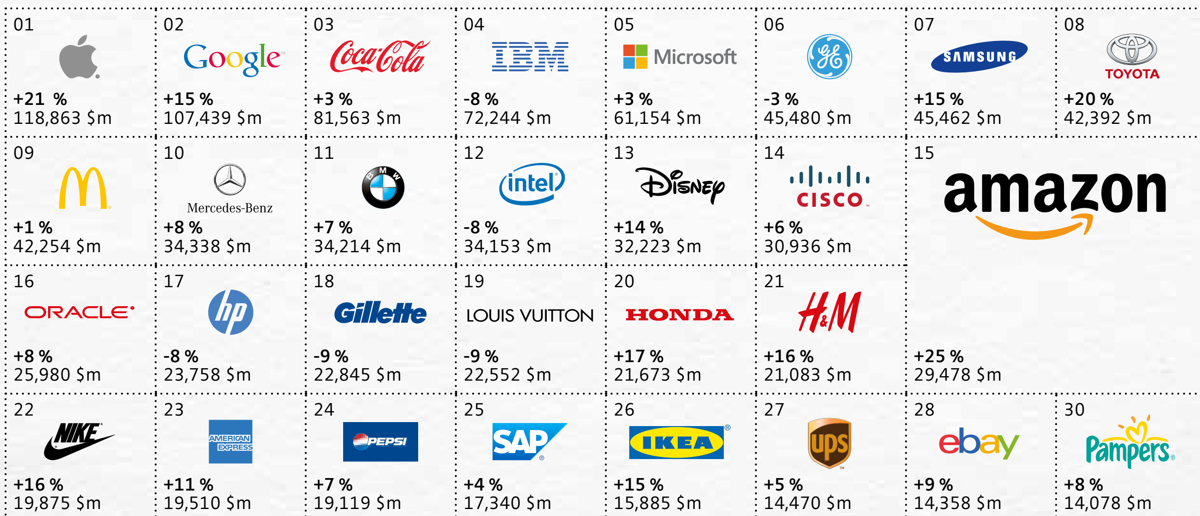
FIGURE 3:

Best global brands 2014



www.bestglobalbrands.com/2014/ranking/

For most firms these are the major intangible assets and represent the majority of firm value. As shown in Figure 2, three of the top five are the responsibility of marketing, whereas the fourth, intellectual property, needs direction from marketing. The smaller red checkmark denotes this, as marketing helps intellectual property decide what to develop and assists in bringing it to the marketplace once a new product has been developed. One could even argue that some of the human capital is marketing knowledge, but I would not be so zealous as to claim marketing's responsibility for all a firm's intangibles.

How important each of these intangibles is differs dramatically by industry and even within an industry by firm. Below, I will take two of the largest intangibles and try to quantify them.

Quantifying brand value: There are numerous companies that provide measures of a brand's value. Perhaps the best known is Interbrand. As shown in Figure 3, based on Interbrand's 2014 ratings for the top 30 global brands, brand value can be substantial.

Apple, the world's most valuable brand, is worth more than $ 118 billion. That is just for the brand itself, while Google's brand value is over $ 107 billion. Both of these are small numbers compared to the overall market cap of these two firms, whereas the Coca-Cola brand, the world's number three brand, represents close to 50 % of the total firm value. Jim Stengel, P&G's former Global Marketing Officer claims that brands overall represent about 30 % of all firm value. Figure 3

Quantifying customer value: The second major intangible, and for many firms it is the single most valuable asset, is the customer base. For a company in the cellular service, customers and their recurring revenue can almost be viewed as an annuity. If we truly understand the value of our customer base, we could discover a completely new view of the firm.

Let me illustrate this from a simple example shown in Tables 1 and 2, taken from Farris, Bendle, Pfeiffer, and Reibstein, 2012. In Table 1 there are two firms: Firm A and Firm B. Both firms have delivered the same level of profit, $ 25, for each of the last two years. Both firms have the same contribution margins of 15 %, that is, cost of goods sold (COGS) is 85 % of sales.

That is where the similarity ends. Firm A has been growing at a fast clip, increasing by more than 450 % over the five-year span. Firm B has been growing slowly, more in the vicinity of 35 % during the same period. What can be seen is that Firm A has been growing its sales by increasing its marketing expenditures, even at a faster rate than its sales have grown. On the

TABLE 1:

Comparing two firms: Which is performing better?

Firm A

YEAR	1	2	3	4	5
Revenue	$ 833	$ 1,167	$ 1,700	$ 2,553	$ 3,919
COGS	$ 708	$ 992	$ 1,445	$ 2,170	$ 3,331
Marketing	$ 100	$ 150	$ 230	$ 358	$ 563
Profit	$ 25	$ 25	$ 25	$ 25	$ 25
Cogs/rev	85.0 %	85.0 %	85.0 %	85.0 %	85.0 %
Mkt/sales	12.0 %	12.9 %	13.5 %	14.0 %	14.4 %
ROS	3.0 %	2.1 %	1.5 %	1.0 %	0.6 %

Firm B

YEAR	1	2	3	4	5
Revenue	$ 1,320	$ 1,385	$ 1,463	$ 1,557	$ 1,670
COGS	$ 1,122	$ 1,177	$ 1,244	$ 1,324	$ 1,420
Marketing	$ 173	$ 183	$ 194	$ 209	$ 226
Profit	$ 25	$ 25	$ 25	$ 25	$ 25
Cogs/rev	85.0 %	85.0 %	85.0 %	85.0 %	85.0 %
Mkt/sales	13.1 %	13.2 %	13.3 %	13.4 %	13.5 %
ROS	1.9 %	1.8 %	1.7 %	1.6 %	1.5 %

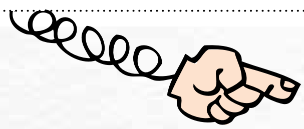


TABLE 2:

Comparing two firms: Digging deeper on customer metrics

Firm A

YEAR	1	2	3	4	5
New customers	1.33	2.00	3.07	4.77	7.50
Total customers	3.33	4.67	6.80	10.21	15.67
Sales per customer	$ 250	$ 250	$ 250	$ 250	$ 250
Mkt/new customer	$ 75	$ 75	$ 75	$ 75	$ 75
Churn rate		20 %	20 %	20 %	20 %

Firm B

YEAR	1	2	3	4	5
New customers	1.86	1.97	2.09	2.24	2.43
Total customers	3.86	4.05	4.28	4.55	4.88
Sales per customer	$ 342	$ 342	$ 342	$ 342	$ 342
Mkt/new customer	$ 93	$ 93	$ 93	$ 93	$ 93
Churn rate		46 %	46 %	46 %	46 %

other hand, firm B has been modestly increasing its marketing spending. During this period, return on sales (ROS) for Firm A has fallen by 80 % and fallen by less than 25 % for Firm B. By the time we reach the fifth year, the ROS is 2.5 times greater for Firm B than Firm A. Which firm is doing better?

I have asked many audiences this question. The overwhelming majority of respondents pick firm B. The argument is simple: Firm B can produce the same level of profit and can do so by using significantly less money on marketing: $ 226 versus $ 563. The firm can take the difference and reinvest it in an alternative investment.

In contrast, if one would drill down just a bit deeper and look at customer data as shown in Table 2, a different story is told. Firm A has been growing its customer base much faster than Firm B has. However, they have been doing so with smaller customers, who spend on average $ 250 per year. Firm B's customers are larger, spending $ 342 per year. Firm A's customers cost less to acquire, $ 75 versus $ 93 per customer. The big kicker is that Firm A's churn rate, the percent of customers lost each year or 1 minus the retention rate, was only 20 % while Firm B's was 46 %. This means that the average customer for Firm A has been buying for five years, whereas for Firm B it was just over two years. Of course, one would want to look at retention by segment and cohort rather than just at the aggregate level. None of the data shown in Table 2 changes the numbers shown in Table 1. Firm B remains more efficient in terms of profit (returns) per dollar spent.

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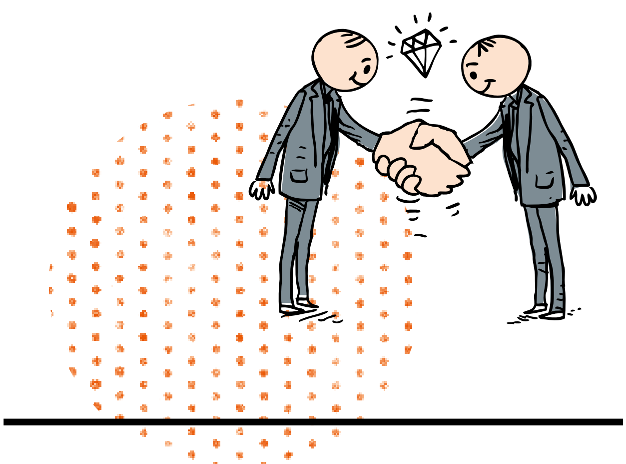

If one calculates the customer lifetime value (CLV), the sum of the margins over their life, discounted to current USD, one finds that the average CLV per customer is $ 123 for Firm A and $ 97 for Firm B. When that is multiplied by the number of customers, the customer equity for Firm A is $ 193 thousand and $ 47 thousand for Firm B; that is, Firm A has created an intangible asset called "customers." This represents the present value of an "annuity" of future income that each of the firms has created. I would argue that Firm A had been making much more money than Firm B all along. Rather than retaining it in profits, they have chosen to reinvest it to build the asset called customers.

How marketing and finance can pull together ///
Because in today's world a firm's value lies more in intangible assets, it must be in the interest of both marketing and finance to grow these assets. Marketing is, to a large extent, responsible for most intangibles, and to be successful it is necessary to explicitly measure and manage this value instead of lumping it into the term "goodwill." Doing so is not easy, considering the long-term nature of brand building or customer relations and the numerous intervening factors along the way. The following recommendations will help marketing departments do a better job in proving their contribution to financial firm performance.

> ***Select measures that work for marketing and finance*** /// Too often marketers rely on the most immediate measures, those labeled marketing metrics, whereas finance is less concerned with these intermediate measures and more concerned about the market results, in particular, profit, cash flow and EBITDA. Rather than letting marketing budgets be cut during economic downturns because managers cannot show the value marketing brings to the firm, it is essential to capture where marketing provides value. The key is for marketers to learn to speak the firm's financial language and to help train the rest of the organization to understand the longer-term financial assets resulting from marketing.

> ***Establish a common understanding of how value is created*** /// For tracking results and planning optimal budgets, the selected metrics need to be meaningful for marketing and finance alike. As demonstrated in the example of firms A and B, it is necessary for both to understand the nature of the business. This way firms can select the right metrics and pick the correct level of measurement to really see the actual value of an asset. Return-of-marketing-investment calculations only make sense if you know how value is created and link respective activities with short- and long-term objectives.
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FURTHER READING

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