

Return on marketing investment: A practical end to end approach for linking marketing investments to shareholder value

Liane Ringham

*INSIDE **STORY** Knowledge Management Pty Ltd*
Level 5/ 2 Barrack St
Sydney, NSW 2000 Australia
lianer@insidestory.com.au

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Abstract

Within today's organisation marketing is under immense pressure to demonstrate its value to the firm. This requires methods used to link marketing activity to financial performance. We use the recently developed customer equity approach to marketing activity evaluation and link this to a shareholder value model, the result of which we name the Marketing Investment to Shareholder Value (MISV) model. The approach has the potential to demonstrate to CEOs, CFOs, and shareholders, the financial value of marketing activities such as above the line advertising and other activities that are currently considered hard to value. From our practical experience in working with tracking brands and ads and working with Australia's largest organisations, this paper identifies three challenges to be met if an organisation is to successfully implement Marketing ROI.

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Introduction

The current challenge for marketing is for its outputs to be fully valued by the organisation. Without a language in common with analysts, CFOs, CEOs and the board, the risk is that marketing's inputs will not be valued. Many argue that this has resulted in a shift to short term tactical activities and the erosion of many marketing budgets. At the same time, it is clear that there is increased recognition of the value of brands and reputation, though relatively little published about ways of linking marketing activities and investments with these outcomes. A recent special section in an issue of the *Journal of Marketing* (Lehmann 2004) on Linking Marketing to Financial Performance and Firm Value provides a collection of papers on the current state of knowledge in this area. Also, marketers are becoming ever more interested in measuring the impact of marketing activity and investment on financial outcomes through appropriate marketing metrics (e.g., Australian Marketing Institute 2004: Swinburn 2004).

We believe that the concept of **customer equity** is a key means to achieve this outcome and is particularly relevant when revenues cannot be easily linked to marketing investments as with brand advertising and other investments that have short term and longer term impacts. Further, linking the financial estimates generated from customer equity valuations (which are in accounting terms

essentially incremental gross margins) can be usefully input into a standard shareholder valuation model which, with some adjustments, can produce a set of managerial accounts that demonstrate the return on investment in marketing activities.

In the current paper, we provide a **basic overview** of the major approaches to value creation available in the literature and show how the customer equity and shareholder value can be linked. We also identify how we have been able to link raw investments (weekly target audience rating points and weekly spend) to customer equity. In doing so, we demonstrate how marketing can potentially talk in the language of senior management and CFOs and demonstrate the value of its activities. We also share some of key challenges in implementing Marketing Return on Investment with a view to furthering this emergent field.

Customer equity – the missing link

In our review the term *Customer Equity* first appeared in a published paper in 1996. At that time it was used in a *Harvard Business Review* article written by Blattberg and Deighton (1996). Since that time, the concept of *Customer Equity* (or the net present value of current and potential future customers) has become a relatively hot topic (Dorsch and Carlson 1996). Indeed, two major books have appeared in the business literature, both of which use Customer Equity as the linchpin for the business strategy development and evaluation. These are Rust, Zeithaml & Lemon (2000) and Blattberg, Getz & Thomas (2001).

The focus on customer equity has as one aim, the redirection of primary management attention away from the product and towards the consumer. This means less attention to product-based ideas such as market share and more attention paid to consumer-based outcomes such as customer equity share which are more relevant to understanding share of wallet. Another aim is the provision of a mechanism for examination of the return on investment (ROI) in various marketing activities including making allocation decisions for investments in different marketing activities. This has been an area of great interest among both marketers as well as academics for many years (e.g., see the work on Economic Value Added, Ehrbar 1998).

Linking to shareholder value

A whole stream of academic and practitioner thinking in the financial and economic arena has identified that the key goal of a business is to generate shareholder value (McKinsey et al 2000) and the positive and negative cash flow streams discounted over time should be the focus of any investment of the organisation (Srivastava, et al 1998). This has been discussed very recently as a priority area for research by Rust, et al (2004) in their survey of what we already know and what needs to be examined in the field of measuring marketing productivity. We use the customer equity idea as the **middle part** of a model that ends with shareholder value.

The Rust et al approach to Customer Equity

Rust et al (2000) and Rust, Lemon & Zeithaml (2004) link total customer equity econometrically to a variety of brand equity, customer satisfaction and other drivers. The approach involves the estimation of a Markov switching matrix using multinomial

logit modelling and provides scope for linking customer choice drivers (e.g., brand awareness, brand image perceptions, customer preferences) to customer equity.

The advantage of the switching model is that it enables marketers to value the impact of investments beyond the immediate time frame, as many strategic marketing efforts have a short term and a longer term impact and often the longer term impact is potentially more valuable.

This is quite different from the Blattberg et al (2001) approach, which is basically spreadsheet-based where, for a sample of customers, the firm needs to calculate the initial rate of acquisition, rate of retention, and the rate of add-on sales. They also need the margins for these three activities along with the expenditure for the three activities, all at the per customer level. These are then combined to calculate measures for what they call Acquisition, Retention and Add-on equity. Finally, the per-customer amounts are aggregated up to the firm level as a basis for making strategic decisions about whether to invest in acquisition, retention or cross selling strategies and the appropriate use of above the line advertising and below the line Investments.

There is no real scope in their approach to analyse the impact of attitudes and perceptions on the various customer equity measures, something that the Rust et al approach allows. It is essentially a database method, but does not take into consideration marketing strategies that seek to position the brands in the minds of consumers and to understand the value of these investments.

Getting from customer value to ROI

Customer equity is a financial estimate of the value created by the firm by an activity or series of activities that change the driver or drivers of customer equity. Once costs are overlaid on the marketing activities that drive the changes in the customer equity, Rust et al have been able to calculate Return on Investment which is basically the increase in the dollar value created by the activity divided by the cost of the activity which is discounted over the life of the activity's expected impact as is typical of any capital investment in accounting terms.

This is truly a breakthrough as it enables business people and researchers for the first time to say for example, that the increase of the brand on a particular image dimension (e.g., caring) created by a particular investment in say a brand campaign has increased customer value by say \$2.3 million dollars. This is surely more meaningful than the current state of play that enables the researcher and the marketing director to say, for example, that a campaign has increase image for caring from 3.2 to 3.5 on a 5-point scale and that this is statistically significant.

Challenges in implementation of the customer equity approach

For three years, we have been working with tracking data and Rust's algorithms to work out practical ways we can value the efforts of marketing. We have for example, worked with data in OTC pharmaceuticals, snack foods, banking, telecommunications, and gaming. We will confine our experiences in this paper to the advertising and brand spheres though many of the lessons transfer across to the valuation of activities such as PR, service improvement, etc.

We have identified at least **three challenges**. The first challenge lies in identifying the linkage between specific marketing activity and the drivers (e.g., brand awareness, brand image perceptions, brand preference). We have found first hand what Broadbent (1990) also has found that basic regression techniques are unable to model the impact of retention factors, decay and the valuation of the creative impact of any campaign. We are indebted to the insights generated by the work of Brown (1986) and Broadbent (1990) who gave us cues as to how to proceed. Establishing these linkages is the key to any valuation of marketing activities beyond the short term and establishes the timing of cash flows that are critical to the final phase of generating incremental gross margins by period (say, for the next three years) for the shareholder value model.

The second challenge is a managerial one. To implement the Rust model, access is required to several pieces of information relating to the size and timing of the cash flow streams from the investment. The specific inputs depend on the nature of the business though typically include: customer contribution margin, frequency of purchase/revenue delivery, volume of purchase (if applicable) and size of market including growth estimates. Ideally this is at a customer level and also, where relevant, the information is needed for competitors. Our experience is that this information is still virtually impossible to get in Australia for many of Australia's largest organisations, particularly if the information is at a cross product or total brand/customer perspective. We have worked to overcome this is by making estimates based on segment membership and expert opinion where data is missing

or only partial. This is not as bad as it seems as these estimates can be put into our final sensitivity analysis.

Finally the third challenge is that any estimate contains a degree of error. The final challenge lies in the estimation of the error of the estimate. Rust's article gives some clues to this and the most rigorous way is to take the choice model classifications of individual customers and follow through the customers in real life to see what they actually do. We wonder if many marketers have the willingness or time in practical terms to track through a series of actual respondent behaviours in real life for several years. In view of realities of today's market place, we believe that the most practical outcome may be to conduct a series of sensitivity analyses on the estimates provided to the shareholder value model (i.e., the incremental gross margins). This will at least enable marketers and researchers to get up and running so that over time they can build and improve their models based on real life validations with follow up studies.

Challenges in linking marketing investments to shareholder value

The logic of linking marketing investments to shareholder value is illustrated in Figure 1. This can be termed the Marketing Investment to Shareholder Value (MISV) model.

There are several adjustments required to the usual capital investment thinking when it comes to valuing a marketing investment. The first of these is that companies need a set of **managerial accounts** as currently Australian and International accounting standards do not allow for the valuation of marketing assets. Hence, the marketing

investment must be amortised in these set of accounts over the projected life of the investment. Then the incremental gross margins (IGMs) after amortisation can be estimated. Finally, the net present value (NPV) of the IGMs is calculated using the adjusted risk index (discussed below). This NPV is essentially a measure of Market Value Added (MVA), a concept discussed by McKinsey et al (2000, p 59) as growing in popularity as a measure of financial performance.

Second, the risk index used or discount rate applied to the estimates of gross margin should not be the overall discount rate applied to the business (typically the weighted average cost of capital – WACC; see McKinsey, et al 2000, chapter 10). The risk index needs to be adjusted based on:

- ◆ Barriers to entry
- ◆ Legislation
- ◆ Customer dependency
- ◆ New product acceptance
- ◆ Customer mix
- ◆ Competition

In other words, the risk index needs to take into consideration the factors that could potentially affect the probability of gross margins not being generated in full and on time. So timing is everything. We can examine the timing issue by sensitivity analysis, systematically varying the risk and/or timing of gross margins in order to better understand the financial risk involved.

What advantages are achieved in linking marketing investments to shareholder value rather than customer equity alone

By linking to a company's accounts structured to represent a shareholder value model, several advantages are possible.

- ◆ The Rust et al (2000, 2004) model stops at the NPV of the customer lifetime value estimated from the model. The full MISV model takes this one more step into the realm of shareholder value.
- ◆ A clear understanding of the timing of the positive cash flows – so the business can see when value is delivered and how long they have to wait.
- ◆ Sensitivity analysis gives an understanding of the conditions under which the investment will be vulnerable

Hence, the estimated incremental gross margins that are the output from the Rust model are the inputs to the shareholder value model at the back end of the MISV framework. This provides a direct link from marketing investments to ultimate shareholder value so that CEOs, CFOs, board members, investors/owners can understand the true value of marketing in the today's organisation.

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Figure 1 Linking Marketing Investment to Shareholder Value

