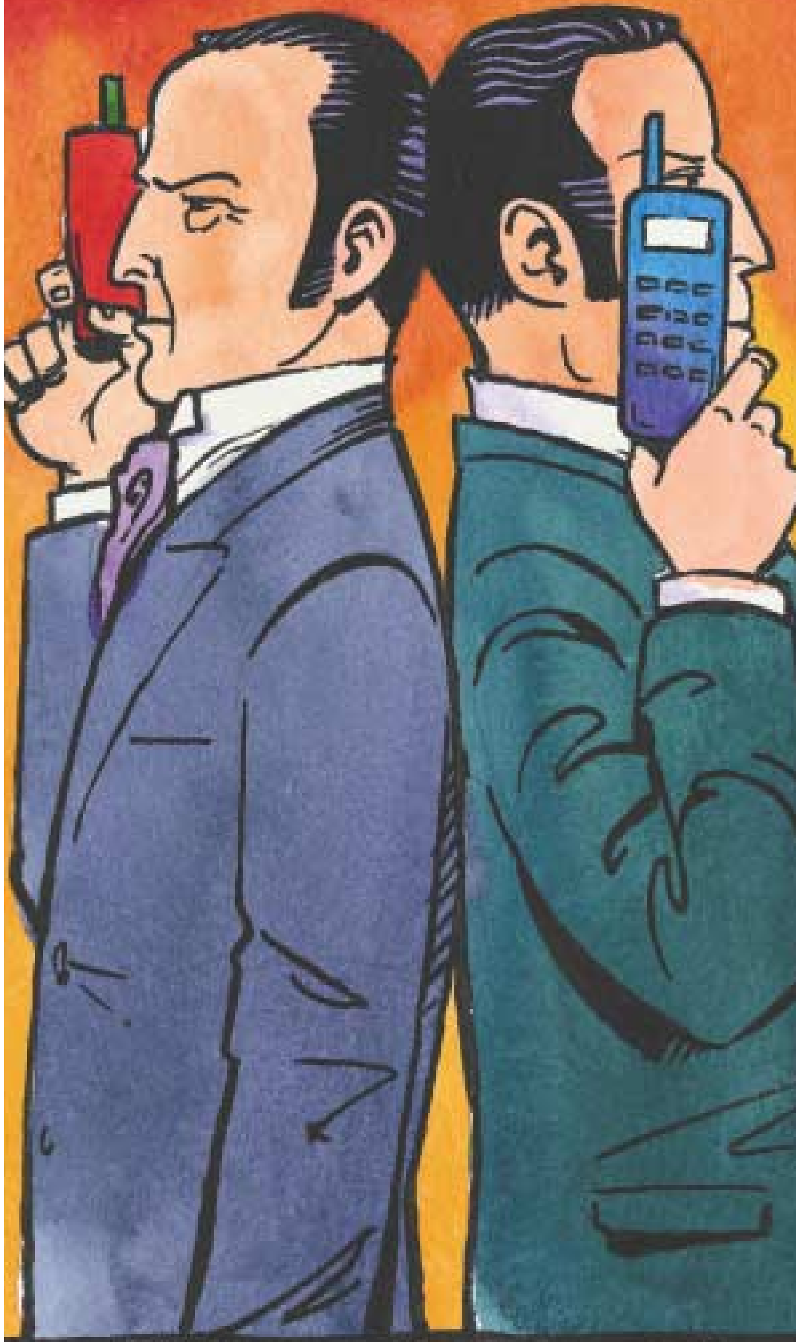
Learning to like each other



Jonathan Knowles explains why marketing and finance must overcome their traditional animosity if a company is to realise its full potential

Among the many disciplines in business, few have so antagonistic a relationship as marketing and finance. A major source of friction is their use of the same words to mean different things. This is particularly apparent in their use of the term 'brand equity'. The marketing professional uses the term to describe the health of the brand's franchise with its key audiences; the financial professional uses it to characterise the brand as an economic asset.

In theory, the two perspectives should be compatible. How can a brand deliver premium margins unless its customers hold it in high regard? And what does strong brand health mean if not the ability to drive growth through customer preference? In practice, however, it has proven extraordinarily difficult to determine the connection between many of the most popular marketing metrics and financial performance.

Major positive effects

In the late 1890s John Wanamaker, a pioneer of fixed prices and money-back guarantees at his Philadelphia and New York department stores, famously remarked: 'Half my advertising is wasted, I just don't know which half.' More than 100 years later, it is depressing to observe how little appears to have changed. In his 1997 book, *The Laws of Choice: Predicting Customer Behaviour*, Eric Marder reported that of the large sample of TV and print advertising campaigns that he analysed, approximately 30% produced major positive effects for the

Value represents the ratio between the perceived benefit that a product or service offers and its cost to the customer

advertised brand and 20% produced small positive effects. Sadly, true to Wanamaker's maxim, the remaining 50% of advertising generated no positive effect and, in an estimated 10% to 30% of cases, in fact damaged the advertised brand (primarily by inviting a comparison with a specific competitor, and then failing to outperform that competitor).

In marketing's defence, it must be recognised that marketing is a social science and deals with relationships that are inherently hard to quantify because they are often highly context-dependent. Marketing professionals do themselves a disservice to suggest that customer behaviour can be modelled with the same precision as chemical or physical reactions. But rather than embracing this uncertainty, many marketing professionals cling to the tried and trusted metrics of unprompted awareness and market share, and assert their importance as indicators of future performance.

These metrics were certainly good proxies for current earnings in the less competitive markets of the 1960s and 1970s when, given a limited consumer choice set, awareness of your brand was a good indicator of future purchase. But in the hyper-competitive landscape of today's consumer markets, there is essentially zero correlation between awareness and intention to buy.

Finding common ground

Whatever their differences, most marketing and finance professionals can find common ground in the observation that ' the brand is one of our most valuable assets'. They both observe that tangible assets account for less than 25% of the market value of the average company and that brand is one of the important intangible components of value. The challenge is how to substantiate this assertion in financial terms. A good starting point is to define ' brand equity' in terms of those marketing metrics that have acted as leading indicators of future financial performance, rather than as correlates of current financial performance (as, for example, market share generally is). The concept of relevant differentiation has a proven record as a reliable indicator of brand potential.

Defining ' brand equity' in this way will enable productive collaboration between the marketing and finance functions because it turns brand equity analysis and shareholder value analysis into complementary disciplines. In so doing, it will resolve the endless debates about what forms of marketing activity represent ' brand building' as opposed to ' tactical marketing'.

The article explores what is required to bring about this closer collaboration between the marketing and finance disciplines.

Efficiency vs effectiveness

Shareholder value analysis (SVA) is a very powerful tool that has found almost universal acceptance in the boardroom. By requiring companies to acknowledge that there is a cost for the use of capital, shareholder value analysis has illuminated the true economics of doing business. It has facilitated insightful analysis of the economics of shared assets and the identification of under-utilised assets and inefficient processes. In doing so, it has greatly enhanced the basic efficiency of companies (especially in asset-intensive industries) and has clarified what level of performance is required in order to create economic profit rather than simply accounting profit.

SVA has proven a useful hammer in the hands of the finance department in enforcing a discipline of capital budgeting and accountability. The problem is that SVA has a tendency to view all business issues as nails. Marketing issues, in particular, have proven difficult to resolve through SVA alone.

Business issues can broadly be divided into those that focus on efficiency and those that focus on effectiveness. Peter Drucker illuminated the difference between the two when he said: 'Efficiency is doing things right; effectiveness is doing the right things.' SVA has clearly excelled as an efficiency tool. But, finance professionals should remember that Peter Drucker went on to remark that 'there is nothing so useless as doing efficiently that which should not be done at all.'

To a large degree, the efficiency/effectiveness debate represents the battle lines between the finance and marketing disciplines. Marketers accuse the finance folk of being like Oscar Wilde's cynic because they know the price of everything but the value of nothing. Finance professionals accuse marketers of knowing how to create value for customers, but not for their own employers!

A basic understanding of business reveals that both disciplines are vital to the success of a company. Companies need to know both what to do and how to do it efficiently if they are going to survive in today's highly competitive markets. This means understanding what creates value in both the marketing and financial senses of the word.

A question of perception

Marketing and finance both have well-developed ideas about what value is and how it should be measured. Unfortunately, their ideas are fundamentally different.

For marketing professionals, value is a customer concept. Value represents the ratio between the perceived benefit that a product or service offers and its cost to the customer. Customer value is determined by answers to the two questions: 'What do I get?' and 'How much does it cost?' Viewed from this perspective, value is a concept external to the company.

For finance professionals, the notion of value is bound up with the concept of value creation. The core issue is whether the price received for delivering a product or service exceeds the full cost incurred in producing it. The key issue is 'Does this activity earn a sufficient return on investment?' Viewed from this perspective, value is a concept internal to the company.

Marketers accuse finance people of confusing value with price. They acknowledge that finance professionals know the minimum price at which a product or service must be sold in order for a profit to be made, but accuse them of lacking an understanding of the utility that is provided to the customer. In return, finance people accuse marketing people of frequently being clueless when it comes to understanding the economic consequences of their actions.

Few examples are more notorious than the marketing promotion by Hoover vacuum cleaners in the UK. Consumers were offered a free airline ticket to the US if they bought a new vacuum cleaner, irrespective of the model chosen. Given that the cheapest models cost less than £100 - that is, less than the cost of a transatlantic airline ticket - it is not surprising that the promotion was hugely popular. In total, some 300,000 people bought inexpensive Hoovers and applied for their free tickets.

The Hoover management team had naively assumed that the majority of buyers would not redeem their prizes because of the restrictions on the dates on which the airline tickets could be used. After all, 'breakage' (that is, the failure of customers to redeem their rewards) forms the basis for the successful operation of many loyalty schemes. Of course, few loyalty schemes offer a guaranteed reward larger than the price of entry.

Faced with massive negative publicity when it attempted to change the rules of the promotion, Hoover decided to honour it. The subsequent annual report revealed that Hoover booked a £48m loss on a promotion that generated an estimated £30m of incremental sales.

Leaving aside such aberrations, the fundamental issue remains whether the marketing or finance definition of value is more helpful. This article argues that both are useful as far as they go - and that neither goes far enough. The finance perspective understands the true cost of delivering a product or service. The marketing perspective understands that price is irrelevant if there is no utility to the customer.

Peter Drucker powerfully articulated the importance of a customer-centric concept of business in *Management: Tasks, Responsibilities, Practices* when he said: 'It is the customer who determines what a business is. It is the customer alone whose willingness to pay for a good or for a service converts economic resources into wealth, things into goods. What the business thinks it produces is not of first importance - especially not to the future of the business and to its success...What the customer thinks he is buying, what he considers value, is decisive - it determines what a business is, what it produces, and whether it will prosper. And what the customer buys and considers value is never a product. It is always utility, that is, what a product does for him. And what is value for the customer... is anything but obvious'.

Understanding the challenge

Seen in this light the fundamental challenge of business is to understand how to deliver customer value. But for the business to be sustainable, you need to understand how to do so at a cost that leaves you with adequate profit. We need to satisfy both the marketing and finance definitions of value.

The fundamental equation of business is revealed when we integrate the marketing and finance concepts of value that we defined above:

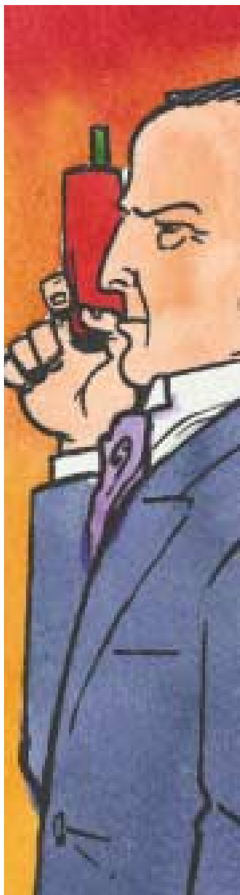
$$\frac{\text{Customer benefit}}{\text{Price (paid)}} \times \frac{\text{Price (received)}}{\text{Economic cost}} = \frac{\text{Customer benefit}}{\text{Economic cost}}$$

Business success is built on delivering customer benefit that exceeds its economic cost.

A mindset that focuses solely on customer benefit risks bankrupting the company. The business landscape is littered with examples of companies that created happy customers but failed to cover their costs. Many dot.com companies enjoyed loyal support so long as their customers were not required to pay for the services.

A mindset that focuses on minimising the cost base for a given customer benefit may

A mindset that focuses solely on customer benefit risks bankrupting the company



The vitality of a brand depends on its ability to occupy a unique territory in the minds of its customers

improve short-term profitability but leaves the company vulnerable to a competitor who redefines the customer utility ratio. Schlitz, a major player in the US beer market in the early 1980s, is a tale of cost control taken to the extreme. For many years one of the most profitable brands in the industry due to its large volumes and a single-minded focus on ways to reduce its cost base, Schlitz ultimately destroyed its brand by allowing its preoccupation with cost reduction to justify the use of inferior ingredients in its beer. The Schlitz brand lost out to Budweiser and Miller which, despite their higher price points, delivered a significantly better customer value proposition

Determining what drives utility for a customer is a complex subject. Brands are an important component of customer value analysis because they represent vehicles for customer meaning. They encompass both rational and emotional dimensions and allow us to select products and services on the basis of both their functional and emotional utility. They allow a company to respond to the two questions posed by customers ‘ what will you do for me?’ and ‘how will you make me feel?’

The core of the marketing discipline is how to answer these two questions in a way that creates a perception of uniqueness in the minds of customers. That uniqueness depends on a combination of functional and emotional/ symbolic benefits. In a later section of the book quoted above, Peter Drucker states: ‘Because [the] purpose [of business] is to create a customer, the business enterprise has two - and only these two - basic functions: marketing and innovation. Marketing and innovation produce results; all the rest are costs. Marketing is the distinguishing, unique function of the business.’

Understanding the relationship of marketing to business performance therefore requires two sets of skills - marketing *evaluation* skills to understand the dimensions that are important to consumers; and marketing *valuation* skills to measure the relationship of these dimensions to the value drivers of a business.

Combining these skills is the answer to the ‘marketing paradox’ described by Professor Peter Doyle in the preface to his book *Value Based Marketing*: ‘Many senior managers have noticed a paradox in how firms perceive marketing. On the one hand, every chief executive and mission statement puts marketing at the very top of the agenda... At the same time, marketing professionals, marketing departments and marketing education are not highly regarded...The paradox will never be resolved until marketing professionals learn to justify marketing strategies in relevant financial terms.’

Reliable metrics

Quantifying how the strength of a brand’s franchise with consumers impacts the revenues and costs of a business requires understanding customer behaviour, an extraordinarily complicated subject. Our current knowledge is not - and may never be - at a level sufficient for us to be able to provide a simple algorithm for inclusion in the finance department’s Excel spreadsheet. Nevertheless, in order to ‘justify marketing strategies in relevant financial terms’, we need to develop some directionally reliable metrics for linking marketing measures to financial performance.

As suggested above, a valuable first step is to identify the marketing metrics that have provided a reliable indication of a brand’s ability to generate future cash flow (the criterion for regarding the brand as an economic asset). Such metrics provide a measure of a brand’s economic potential. Research by BrandEconomics suggests that there are two key aspects of potential - the first, and most important, is differentiation. The vitality of a brand depends on its ability to occupy a unique territory in the minds of its customers. The second aspect of potential is relevance. Relevance describes the size of the audience to which the brand can appeal. In financial terms, differentiation correlates closely to a brand’s ability to command a premium margin, while relevance is highly correlated with the breadth of the audience to which the brand appeals.

Combining differentiation and relevance into a single measure of brand potential creates a marketing metric that has a remarkably strong correlation to the intangible value of businesses (the excess of their market value above the value of their physical assets) across a wide variety of industry sectors.

The science of this is still at an early stage. But this approach has provided the most robust econometric evidence to date of a consistently positive relationship between a marketing metric (relevant differentiation) and value creation. The evidence is certainly strong enough to argue that no marketing strategy should be funded unless it is explicitly expressed in terms of how it will enhance the brand on the dimensions that are

important for differentiation and relevance in that brand's specific industry context.

The methodology may not be sufficiently precise to 'pick the winners' from among different marketing strategies but it can certainly 'spot the losers'. Given this, marketers should make use of a modified version of shareholder value analysis to frame the debate around marketing strategy. Rather than defending a single number for the value of the strategy, they should focus the debate on the question 'what do I need to believe about certain key variables in order for this strategy to create value?' By highlighting the conditions under which value will be created, this approach maintains the financial rigour of SVA but allows key inputs to the valuation model to be estimated with an appropriate degree of certainty (or, rather, uncertainty). 'Losers' can be flushed out, leaving the debate to focus on which of the potential 'winners' to back.

This approach acknowledges that there are multiple variables that can influence the outcome of marketing strategy, and concentrates on establishing the combination of those variables that will produce a 'zone of rightness' in which financial value will be created. I know from experience that this approach can provide a substantive breakthrough in the quality of the relationship between marketing and finance. It provides a rigorous analytical framework within which to explore the financial implications of different market outcomes, and identifies those market strategies that offer the greatest chance of generating both customer and shareholder value.

Beyond the numbers

One particular advantage of this approach is that it gives appropriate weight to the requirements for growth and efficiency. Business success depends on both operating excellence and the ability to innovate (either in product development or marketing terms) in order to produce both top line and bottom line growth. It is hard to find companies that are good at both. GE under Jack Welch was a rare example of a company that seemed to do both equally well. GE's strategy sessions generated some truly innovative business ideas that were subsequently implemented with admirable discipline. One magazine attributed GE's creativity to the decision to outlaw the use of Excel. This is patently untrue, but I can believe that Excel models were banished from the brainstorming workshops at which GE's future strategies were debated. SVA and Excel spreadsheets are wonderful analytical tools but a large part of strategy formation is about the ability to go beyond the numbers. Business decisions are always based on imperfect information, and marketing decisions especially so.

The requirements of efficiency and innovation demand skill sets - and mindsets, even cultures - that are hard to combine. Companies that are focused primarily on the 'operating excellence' model are generally voracious consumers of market data and prize deductive logic. They excel at identifying and exploiting market opportunities using the bare minimum of operating costs and investment capital. Companies that are biased towards the innovation mindset tend to prize lateral, inductive reasoning to identify trends and opportunities that are not yet visible in the data. They run less of a 'tight ship' because they realise that good things happen when smart people are allowed to pursue their pet interests on company time (for example, 3M's '15% rule' that specifies that up to 15% of engineers' time can be spent on private projects).

The tough thing is to combine the strengths of the marketing and finance perspectives (innovation and efficiency) and avoid their respective weaknesses (wastefulness and myopia). One way to achieve this is to champion the use of marketing metrics that have a proven relationship to the creation of value. Doing so creates a common language and framework for the strategic planning, marketing and finance departments to collaborate on the development of strategies that will maximise the contribution of marketing to the success of the overall business.

The collaboration between these disciplines will produce strategies that maximise the key ratio of customer benefit to economic cost. Developing such strategies requires an understanding of what creates utility for customers and how this utility can be delivered at an attractive economic cost. That is why marketing and finance are so important and why, for the sake of the business, it is vital that they find a way to be friends. ■

Jonathan Knowles is a senior vice-president at BrandEconomics (www.brandecon.com), a brand consultancy with offices in the US and Europe. He can be reached at jonathan@rainburst.com. This is the fifth article on branding that he has written for Professional Investor.

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