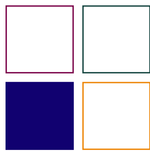


Marketing due diligence: translating marketing strategies into shareholder value

Investors and corporate financiers usually find it hard to assess the shareholder value of a company's marketing strategies. However, **Professor Keith Ward**, **Professor Malcolm McDonald** and **Dr Brian Smith** of Cranfield School of Management have developed a process that makes this task easier

The most common financial objective of modern commercial corporations is the sustainable creation of shareholder value. For the vast majority of these corporations, the major sources of any such shareholder value creation are now the intangible marketing assets of the business, such as brands, customer relationships, control of channels of distribution, in-depth marketing knowledge and consumer insights – in other words, the 80 per cent of the company's value that normally doesn't appear on its published balance sheet.

High-value brands: but how do investors evaluate these intangible marketing assets?

This means that investors and external financial analysts are desperate for information that would help them to evaluate these critically important marketing assets and strategies. Unfortunately such focused information is still normally notably absent from the increasing plethora of externally available data produced by these companies. Even more worryingly it is also true that a rigorous internal evaluation of a proposed marketing strategy and its probable impact on shareholder value is not even part of the corporate governance process within most organizations, certainly at the main board level. Yet all these companies would undoubtedly have formally constituted audit committees that are supposed to analyse and review all the major business risks that they face. Also, they would all automatically conduct a comprehensive financial due diligence process on any major acquisitions or external investment that was being considered.

As a result of new research at Cranfield School of Management, this same level of rigour can now be

applied to a company's marketing strategy. A Marketing Due Diligence (MDD) process has been developed that can subject a marketing strategy to a structured sequential analysis that will indicate the probability of the strategy leading to increased shareholder value.

Essentially, the MDD process consists of three sub-processes that together highlight the clarity with which the overall market has been segmented, the risks associated with the strategies identified for attacking each of these segments and the relative rate of return required given these risk profiles. Obviously this required rate of return is compared to the adjusted projected expected rate of return so that the impact on shareholder value can be calculated.

Background to the development of the MDD process

Most large companies have developed increasingly sophisticated major project appraisal techniques as they have realized the necessity of improving their strategic investment decision-making processes. Such techniques are normally based around discounting the cash flow forecasts resulting from these strategic investments, which include any proposed acquisitions and strategic alliances. But nowadays the evaluation of these discounted cash flows often incorporates the use of probability assessments, simulation techniques and even real option analysis.

The one major area that has most commonly been excluded from this increasingly scientific analytical rigour has been the marketing strategy of a business. Even in companies that are incredibly logical and financially rational in the vast majority of their investment decisions, the decision to enter a new market or launch a new brand is still made on very simplistic financial analysis. It is common to find no meaningful financial justification to back-up significant long-term investments that try to create new marketing assets.

Not surprisingly, this has resulted in a downgrading of the marketing function in the eyes of the rest of the corporate world. Many marketing departments still adhere to the old saying attributed to Lord Leverhulme: "I know that I waste half my advertising budget, but I don't know which half!" In the 21st century, given the scale of most marketing budgets, this is a completely unacceptable view of controlling marketing expenditure. It is also an unnecessary position for a company to find itself in as the combination of the innovative application of well-proven strategy analysis techniques and financial strategy tools with some recently developed new marketing planning analytical processes can give a quantified assessment of any proposed marketing strategy.

The MDD process

The MDD process includes a diagnostic process that reviews the existing marketing strategy in terms of its shareholder value creating potential. Where necessary this diagnostic process can then be developed through a therapeutic process that seeks to improve the probability of success of the proposed marketing strategy. The rest of this article focuses only on the first, diagnostic element of the MDD process.

The inputs required for this diagnostic process are all supplied from the existing marketing planning system of the company. Any gaps, contradictions, or confusions in these inputs are used as part of the risk assessment of the marketing strategy.

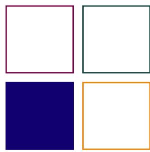
In very simplistic terms, the diagnostic MDD process could be stated as asking three questions:-

- How does the company plan to generate its predicted future sales and profits?
- Will the marketing strategy, on which these plans are based, work?
- Will this strategy create shareholder value, given its inherent level of risk?

These basic questions are then used to deconstruct the marketing strategy into a series of building blocks that can each be quantitatively analysed so that an overall cumulative probability assessment

Executive**Summary**

- Investors, financial analysts and corporate financiers do not usually have enough information for them to evaluate the effectiveness and shareholder value of a company's marketing assets and strategies. Even company managers themselves are often unable to undertake such an evaluation.
- Cranfield School of Management has developed a Marketing Due Diligence (MDD) process that can indicate the probability of a marketing strategy leading to increased shareholder value.
- Companies can use this MDD process to present to potential financiers and investors a clear assessment of the company's marketing strategy and its likelihood of success.



of the expected outcomes from the strategy can be calculated. This enables the shareholder value creating, or destroying, potential from this strategy to be highlighted. A key difference of the MDD process is that it assesses the risks of these elements, using the most appropriate tools and techniques, before combining these individual risk assessments in an overall value-adding rating for the marketing strategy.

Planned future sales revenues

The potential future sources of business can obviously have very different risk profiles depending on whether future forecast sales growth is based on creating a totally new market segment or taking a slightly increasing share of an already rapidly growing market. This first stage therefore assesses the likelihood that the predicted total market sales revenue will actually be achieved.

Another important issue is that the process is concerned at this stage with sales revenues and these are obviously the combination of sales volumes and pricing levels; in different markets, the predictability of both these components can vary dramatically. The actual outcome of the proposed marketing strategy also depends on both the timing and the sustainability of these sales revenues. Many supposedly successful marketing initiatives have failed to deliver any real shareholder value because the new products either took far too long to achieve their predicted sales revenues or peaked rapidly and then equally rapidly declined.

Market share

Having established a probability-assessed adjusted level of expected total market sales revenues, the MDD process then assesses the likelihood that the company will achieve its planned market share. The process uses some newly developed diagnostic techniques to analyse the uniqueness and defendability of the marketing strategy. Thus a well-established brand that has already gained loyal, repeat purchasing customers has a much lower risk profile than a new proposed "me-too" offering against the already entrenched competitive product.

This stage of the process also considers the specific sources of any predicted growth and the associated risk profile. For example, future growth that is to be achieved in a mature, static market at the expense of competitors is much more risky than a similar rate of growth that largely comes from the continuing rapid growth in the value of the total market.

An important consideration in assessing the probability of achieving the planned market share is the level of risk management and flexibility that is built into the company's marketing strategy. Clearly a strategy that is flexible enough to cope with a wide range of potential external environments and competitive responses has a lower risk profile than a very specific, but completely rigid marketing plan.

Resulting profitability

The third part of the MDD diagnostic process considers the projected level of profitability from this marketing strategy. Any company can achieve its sales revenue and/or its market share objectives but still end up miles away from its profit objectives. There are several possible explanations for such profit shortfalls and this part of the analysis incorporates all these possibilities and determines their probabilities in advance.

Very briefly, the profit shortfall could be caused by a lower level of overall profitability in the total market, although the total levels of sales revenues are as predicted. This can result from lower unit selling prices but much higher sales volumes. Alternatively the lack of profitability can be caused by aggressive competitor reactions that were not predicted in the marketing plans.

The third cause of lower than expected profits is a lack of internal cost control within the company itself. If high gross margins are predicted on a new product launch, the associated internal costs should have been very accurately estimated, and the ability to defend these margins needs to have been clearly defined. However, the most common causes of internal cost excesses are in the marketing area itself, where the initial estimates of marketing support expenditure are incapable of creating the impact needed to achieve the sales revenues projected.

By applying the sequential probability factors calculated at each stage, an adjusted expected financial return from the marketing strategy is arrived at. This adjusted financial return is then placed in the context of the capital put at risk by the marketing strategy, so that the impact on shareholder value is highlighted.

Capital at risk

The concept of capital at risk itself encompasses two elements regarding the capital invested in implementing any marketing strategy. The first and more obvious takes into account the value that has to be invested to achieve the expected financial return from the marketing strategy. If the focus of the analysis is on creating shareholder value, the traditional historically-based capital employed as given by the company's balance sheet is completely inadequate.

What is required is an up-to-date assessment of the value of the total assets (including intangibles such as the key marketing assets) involved in implementing the marketing strategy. For publicly quoted companies, the normal starting point is the stock market capitalization of the group and this is then split up into the constituent operating elements.

This assessment of the capital invested in the business is used as the driver of the minimum return that is required from the business in order to create shareholder value. This required level of return is then compared to the adjusted expected level of return that resulted from the MDD diagnostic review of the marketing plans.

However, the capital at risk concept has a second element that is closely related to the "value at risk" idea widely used in financial services. Some marketing strategies quite deliberately make use of existing marketing assets through umbrella and corporate branding, selling new products to existing customers, or existing products to new customers. The logical justification for such marketing moves is that it increases the chances of success of the new strategy and also normally accelerates the receipt of the resulting cash inflows.

However, such linkages also increase the financial cost associated with the failure of the strategy. If a completely stand-alone strategy fails, as long as the loss was affordable, the rest of the company can be relatively unaffected. The deliberate linkages to existing valuable marketing assets can mean that there may be massive repercussions if the new initiative either fails completely or even does not succeed sufficiently well.

These financial impacts need to be evaluated, as do the probabilities that they will occur; the good news is that these probabilities should have already been considered in the assessment of the marketing strategy. This potential decline in value of an existing asset, expressed at its expected value, should be shown as a cost of the particular marketing strategy; this is needed as the strategy evaluation includes the increased return generated by placing the asset "at risk".

Output from the MDD process

The output from the process should be a quantified assessment of whether the proposed marketing strategy will create shareholder value. Both the likelihood and the scale of the shareholder value creation can be provided if all the required inputs can be obtained from the existing marketing plans or by subsequent request from the company. In addition, the major contributors to either the value creation or the value destruction of the strategy can be highlighted, so that these can be focused on as the marketing plan is implemented or modified.

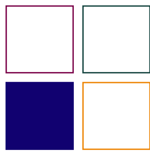
However, in some cases, it will not be possible to provide such a quantified assessment, but the output will then provide specific information on the gaps that exist in the company's current marketing plans and how these can be plugged. In response to these cases the MDD process has been further developed to provide a therapeutic process that carries out a marketing planning process audit so as to ensure that all the required inputs are available. The therapeutic process therefore seeks to improve the marketing strategy process rather than testing the existing marketing strategy with rigour.

The corporate finance implications

The emphasis throughout the MDD process of quantifying the risks associated with different marketing strategies has very clear implications for the funding of such marketing investments. Corporate financiers have long since moved away from the old style, traditional tangible asset-backed lending to a much more rational future cash flow-based approach. Any future cash flow projections are subject to some degree of volatility and it is, of course, the level of such future cash flow volatility that creates risk in the minds of the finance providers.

The rigour involved in the MDD diagnostic process should enable companies to present potential financiers with a much clearer assessment of these risks prior to the commitment of the required funding. This should enable more appropriately tailored sources of funding to be raised for the differing risk profiles of marketing strategies. In most cases today, the marketing budget is looked at as one entity in terms of its funding but, in reality, the various components of the

High-speed to France and high-value trains: but what is the value of the brand?



planned marketing expenditure can have dramatically differing ranges of outcomes.

At one extreme is the launch of a completely new brand into a new, unproven market segment, where the potential range of future sales revenues could be from virtually nothing to more than doubling the current size of the company. At the other extreme, the company may be building on the existing success of a growing branded product that has a dominant share in its rapidly growing market segment; this dominant share being protected by the patented technology on which the product is based.

Not only should the risk adjusted required rate of return differ between these two extremes, but also the funding mix can be tailored to the particular risk of the marketing strategy on the continuum that exists between these two extremes. The "boom or bust" strategy should be funded through existing equity capital that the company can afford to lose if the new launch doesn't work. However, the existing, successful, well-protected brand could already be generating good profits for the company, and a more aggressive financing strategy could be used, if necessary, to maximize the current attractive growth opportunity.

Conclusion

The Marketing Due Diligence diagnostic process uses as its inputs a company's current marketing plans and financial strategy. If these inputs are inadequate, the full output from the process cannot be obtained, but the process will highlight the specific shortcomings so that they can be rectified, and the quantified evaluation ultimately achieved.

The key element of the diagnostic process is a structured analysis of the planned future sources of business and, hence, shareholder value creation. A quantified assessment of whether the proposed marketing strategy will create shareholder value is achieved by using a combination of existing strategy, marketing and finance techniques and some completely new strategy diagnostic tools.

We believe that this process can subject marketing strategies to the same level of rigorous evaluation as are normally applied to other major strategic investment decisions. The process can be incorporated as part of the normal corporate governance of the company, such as by being applied by the business risk part of internal audit or the internal control function, or it can be required by outside parties, such as finance providers, as part of their own due diligence process. How many readers of this article could affirm that this review process currently takes place?

Recommended**Reading**

- **Bender R, Ward K, *Corporate Financial Strategy*, Second Edition, Butterworth-Heinemann, 2002.**
- **McDonald MHB, *Marketing Plans: How To Make Them, How To Use Them*, Fifth Edition, Butterworth-Heinemann, 2002.**
- **Smith BD, "The Effectiveness of Marketing Strategy Making Processes: A Critical Literature Review and a Research Agenda", *Journal of Targeting, Measurement and Analysis for Marketing*, Vol. 11(3), 273-290, 2003.**
- **Ward K, *Marketing Finance: Turning Marketing Strategies into Shareholder Value*, Butterworth-Heinemann, 2003.**

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