

Ad Metrics and Stock Markets: How to Bridge the Yawning Gap

By Martin Deboo

Frustration over their increasing distance from the high table of decision-making has become something of an anguished *cri de coeur* within the marketing services community.

Agency executives rail against the iniquities of fourth-quarter budget cuts, migration of spend into 'harder-working' communications channels and the intrusion of procurement into the client/agency relationship. Agencies, they fear, seem destined to be cast into eternal damnation as mere hoop-jumping 'vendors' fighting for the scraps from investment bankers' or consultants' tables.

Behind this, say agencies, lies the dark spectre of the capital markets. A world where the imperative of brand-building counts for little and human sentiment for even less: a world characterised by the savagery of its short-termism, its obsession with cost at the expense of value and a chronic inability to appreciate the longer and broader picture.

NO CONTRADICTION

There need be no contradiction, or schism, between the forces of the capital markets and the health and longevity of brands: quite the opposite. Never before has there been such interest and willingness amongst investors to engage in the brand-building agenda and the benefits that marketing investment can bring.

The problem is that there is a gap between the two camps, in terms of both language and measurement. And it is only really capable of being bridged by marketers, not the financial community. Fortunately, given the will, it can be closed quite easily.

Why such confidence? Because I think we are entering a new age of enlightenment in terms of how management in consumer goods and services firms think about how shareholder value will be delivered. The delivery of *sustained and profitable organic growth* is the grail from which management want to sup.

Fortunately for marketers, this quest for organic growth is one with which they are uniquely qualified to assist. This provides a window of opportunity for marketers to plug themselves back into an agenda that is of signal importance to senior management and investors. However, it is an agenda from which they have become divorced. What is the way back?

PLUGGING IN TO THE GROWTH AGENDA

This requires marketers to acquire new skills and adopt new tools – and, above all, to shed some comfortable but unhelpful myths about how the financial community relates to marketing. I would like to start by debunking four of the most damaging myths and advance some practical solutions. These are that:

- the stock market is short term in character and unsympathetic to long-term investment; share prices reflect huge belief in long-term performance
- investors and analysts are uninterested in marketing; in fact there has never been greater interest in top-line growth and what stimulates it
- putting the value of brands on the balance sheet will wave a magic wand over the problem; instead, I think the way forward is common-sense reporting that makes the link between organic revenue growth and marketing investment
- (most dangerous of all for marketers) all this belongs in the 'too difficult' box; for too long marketers have distanced themselves from the shareholder value agenda; this needs to change.

MYTH 1: STOCK MARKETS ARE SHORT TERM

Figure 1 shows the price:earnings (PE) ratio for a range of well-known consumer goods firms. The PE ratio is share price divided by annual earnings to shareholders. Companies that are expected to be around for longer and/or grow their earnings faster

attract higher PE ratios and hence have higher share prices. PE ratios and comparisons are the bread and butter of the investment community and it's easy to lose sight of their true importance.

Take Reckitt Benckiser, currently trading on a PE ratio of 22 on the chart. Reckitt produces a range of household and healthcare products, such as dishwashing and laundry treatments, and insecticides. Reckitt is an excellent company, but not exactly 'new economy'. And yet, to make it worth owning a share in Reckitt today, investors must believe that they will benefit from at least 22 years' worth of earnings at the current rate. (Actually they are expecting more than this, as future earnings are worth less today.) Despite the rise of Tesco and Wal-Mart, the omnipresent threat of P&G, the death of brands and all the other threats, investors are trusting Reckitt (in the form of its people, brands and other assets) to deliver more than *two decades*' worth of further profits. Looked at the other way, Reckitt's anticipated earnings next year account for less than *one-twentieth* of the value placed on its shares.

Investors are placing enormous faith in the ability of mature branded goods companies, like Reckitt, to generate profits in semi-perpetuity. But this can only be justified if those profits can be made to grow. And there are only three levers for this: grow revenues, increase profit margins or increase capital efficiency.

MYTH 2: INVESTORS AND ANALYSTS ARE UNINTERESTED IN MARKETING

Recent history in terms of how investors view consumer goods firms can be thought of in two eras, either side of the dot.com crash in August 2000.

During dot.com, consumer goods firms were out of favour among investors, who worried about retailer power, the threat of own label and market maturity generally. Consumer goods stocks were seen as 'value' not 'growth' plays and their role in portfolios was to generate cash to reinvest amidst the sunlit uplands of the new economy.

Complementing this was the rise of value-based management (VBM). VBM is a philosophy rooted in the idea that the prime task of the firm is to generate value for shareholders. At the heart of the approach is the notion that almost any management decision can be conceptualised as an investment and that all capital has a cost, which must be earned back over the course of the investment.

VBM was embraced by a diverse set of consumer goods firms, notably Lloyds Bank, Diageo, Cadbury Schweppes and Boots. Many good things came out of VBM and many of its adopters delivered healthy returns to shareholders. However the principal benefits centred around cost reduction, capital efficiency and a retreat from diversification.

In 2001 confidence in the new economy collapsed and investors began to reappraise the potential for 'mature' industries to deliver growth. Procter & Gamble in the US and Reckitt Benckiser in the UK demonstrated that real growth could be squeezed from markets as prosaic as laundry aids and household cleaning. The recipe for success in both cases was getting back to the basics of consumer insight to inspire product innovation, backed by a huge commitment to marketing.

The consequence has been that companies, investors and analysts have started to focus intently on organic growth performance – growth from existing 'capacity' (people, markets and assets), rather than growth (or shrinkage) from acquisitions or disposals. After stripping these effects out, what's left is like-for-like growth that reveals true underlying performance.

What investors want these days is for firms to deliver top-line and bottom-line growth simultaneously – 'to walk and chew gum at the same time' in the words of Patrick Cescau, CEO of Unilever.

Cescau does not like the analogy – for good reason. There is a big challenge in doing both, but no inherent contradiction. Growing companies generate more funds to reinvest, reap the rewards of operating leverage, obtain more shelf space from retailers, and other important benefits. Rather than just walking and chewing gum, it is about walking in sync to a better, more valuable destination.

No wonder. As Figure 2 shows, PE ratios are positively correlated with organic revenue growth. The message managers are taking from this is clear: faster top-line growth is associated with a higher share price.

An important consequence of this is that investors and analysts are becoming more marketing-savvy. The 1990s obsession with finding the magic shareholder value metric is being rebalanced with an active interest in issues such as marketing spend, ratings of brands and the quality of innovation pipelines. Most large investment banks are big buyers of Nielsen and TNS data, and market research products such as YouGov's Brand Index are increasingly used as leading indicators of future growth or decline.

In a 2005 survey, the IPA found that 57% of City analysts in broadly consumer-facing sectors thought marketing 'very' or 'quite' important to achieving organic growth. The IPA felt this to be disappointingly low. I do not agree, as all sectors in the sample contained some non-consumer-facing businesses. In fact, analysts are collectively making a fair assessment of the importance of marketing to organic growth – there are other factors.

Despite these changes in both information and attitudes, investment in marketing and its effects remain under-reported. Consider as an example Cadbury Schweppes, which is admirably transparent and comprehensive in its financial reporting. In 2006, Cadbury spent c. £384m on capital expenditure, investment in 'kickable' assets such as plant and equipment, property and vehicles. Like other companies, Cadbury's reports and accounts records this expenditure down to the divisional level and asset class. Looking forward, and in common with other companies, Cadbury guides analysts on anticipated future capital expenditure and discloses information on the costs and benefits of 'big ticket' investment programmes.

So what does Cadbury Schweppes disclose about marketing expenditures? To its credit, it discloses its total Group-level spend on 'marketing and selling costs' – not all companies do. But this is as far as it goes – no further analysis is provided, either of the profile of spend (the obvious split being between consumer and trade marketing) or its allocation to operating units. What makes this more remarkable is that, in 2006, Cadbury invested £693m in marketing and selling – nearly twice its capital expenditure.

Despite the new focus on organic growth, better understanding about the numerator in the ROI equation – organic growth – is not being balanced by the same level of understanding about its principal denominator, marketing.

MYTH 3: BRANDS ON THE BALANCE SHEET ARE A MAGIC WAND

For some 30 years, 'intangible' assets (assets that lack physical substance, like brands, patents and general know-how) have grown their share of the market capitalisation of the S&P 500. In its *Global Intangible Study* in 2006, Brand Finance plc estimated that intangible assets comprise 62% of the enterprise value of the world's 25 largest stock markets.

In consumer industries, a large proportion of intangible assets are brands. In 2000, Doyle estimated that over 90% of the intangible asset value of food and luxury goods businesses was accounted for by brands. This has led to a clamour for the value of brands to appear on a company's audited balance sheet, to more clearly signal their value. However my view is that putting brands on the balance sheet would have little impact on investor perceptions of the value of marketing and make little difference to how analysts value companies.

Figure 3 shows how analysts approach valuation. In conceptual terms, the value of a company is a consequence of two (and only two) factors: its rate of return on invested capital and the rate at which that return grows over time. Some valuable companies make low returns but are growing very fast (for example, Amazon.com in its early years) while others make big returns but grow only slowly (for example, tobacco companies.) As the diagram shows, ROI is a function of the amount of profit derived from a quantum of invested capital and profit is a consequence of revenues and margins.

Figure 3 also shows the importance of the balance sheet in the model is not as a direct measure of value, but as a measure of what has been invested historically in the business to generate value.

Valuing brands automatically implies taking a view on their ability to generate profits in future. By putting that value on the balance sheet we are muddying the waters between a forecast of future value and a record of historic investment. We are blending fact with opinion, and it is not the role of audited accounts to offer opinions. That is what I do, with many others, so investors get to choose among a range of opinions.

If you disagree on the accounting arguments, let me offer a pragmatic alternative. Most analysts do not worry much about balance sheets. They spend their time trying to forecast earnings per share (EPS) accurately or work with tools like discounted cash flow (DCF) models. The value of a brand on the balance sheet has no direct impact on either. So, if you favour the 'balance-sheet-as-a-temple-of-value' model, you may find yourself in a land of non-worshippers. Indeed, the balance sheet might just be the place to go if you want analysts *not* to notice something.

So what's the alternative? There is no doubt that intangibles are becoming more important. But intangibles are best thought of as the consequence of something much simpler, more interesting and relevant to marketers: growth. Back to Figure 3. If a company can grow more quickly, it should be more valuable. If it can grow more quickly than it needs to increase its tangible assets, it should have more intangible value. But intangible value is an output measure – growth and ROI are what analysts really engage in.

So how do we better inform this debate about growth and return? How can marketers bridge the gap of language and measurement that divides them from the financial community?

The goal must be to put brand-building investment on the same footing in terms of disclosure as 'traditional' investment. That way analysts can interrogate the returns from marketing investment, as we can now with capital investment.

What is needed is a narrative reporting structure that relates growth to marketing investment in a logical, systematic way. This would require two separate strands of disclosure, which I call 'revenue development' and 'marketing investment'. These are shown in Figure 4, on a gradation from 'must have' to 'very useful' in the eyes of the analyst. The aim should be to be able to reveal the taxonomy of revenue and marketing effects, consistent with reasonable, verifiable disclosure by companies.

My proposal has a pyramidal logic, reading from left to right. Each level explains the one to its left, and each panel under 'revenue development' has a mirror image in 'marketing investment', so causality at each level can be understood and ratios, such as the ratio of growth to marketing investment, can be derived.

So, for example, if organic growth for company A has been disappointing, the analyst can trace the problem to a specific division(s). Within that division, they can understand whether it was a pricing or volume issue, or a failure of new brand initiatives. At each point in this audit trail, corresponding facts around marketing investment are available.

Analysts are trained to adopt a forensic 'drill-down' approach to company performance and my model is consistent with this. A reporting system like this would be a powerful tool to educate the investment community around marketing.

I consider this to be a relatively modest request but, as the colour-coding shows, little of it is disclosed at present. The yawning gap is disclosure around marketing investment.

Implementing the pyramid would require a major change of mindset for marketers: a move upward from a brand-centric view of the firm to a business-unit view. Consider

Unilever. Unilever has many famous brands, such as Dove, Axe (Lynx) and Knorr. While brands like these are the engine room of value creation, Unilever is obliged to report on their performance on geographic and category lines: Europe vs Americas vs Asia/Africa, and food vs home and personal care. These units define the dialogue between Unilever and investors and analysts must build their forecasts on these dimensions. The implication is that, while the performance of, say, Dove, is important to Unilever, marketing metrics will get serious engagement only if they are reported at the line-of-business level. This 'top of the pyramid' approach is critical and requires marketers to analyse their efforts at a higher level of aggregation.

MYTH 4: IT IS ALL TOO DIFFICULT

There has been an emerging trend, exemplified by companies like Diageo and Britvic, for board-level reporting on financial metrics to be complemented by reporting on marketing metrics, frequently involving 'traffic light' systems designed to signal various dimensions of brand performance and health. Given this progress towards an internal pyramid of metrics, my modest plea is that analysts get to see at least the upper layers.

But, to make progress, the challenge is with marketers to increase the rigour and financial literacy that they bring to analysis of their efforts.

Senior managers and the investment community speak the language of finance and economics – of growth, margins and return on investment. Marketers speak the language of brands and consumers – of imagery, perceptions and positionings. There is no conflict between these languages, but they have to be translated. But the primacy of economic language means that marketers are going to have to be prepared to pick up the phrase book.

The challenge for marketers is to increase their financial literacy and move their thinking up the pyramid: to re-express and re-aggregate brand-level inputs into business-level consequences. I don't think this is that difficult and know that the best companies are already doing it.

IN CONCLUSION

Let me end with four messages for marketers looking to tune in to the possibilities this new world offers.

1. Identify firmly with the organic revenue growth agenda. Make it your business to understand how marketing inputs build revenues in a measurable way. This is about more than just advertising effectiveness.
2. Do not stress about 'intangibles' too much. Get the growth/investment/margin equation right and let analysts worry about valuation.
3. Get more business-top-line centric and less campaign-centric. If you are an agency, winning IPA Awards is great, but even a highly effective campaign for an individual brand will not move the overall business revenue needle much if the client is big. Instead, think business-level revenue impact and drill-down – how much incremental revenue was generated by the totality of the firm's efforts last year and from what activities did this arise? A rough answer to this big question is better than a perfect IPA-winning answer to a much smaller one.
4. Implement a metrics-based reporting system. And then be prepared to be accountable and at risk for the consequences of what this reveals.

If you can get this right, welcome back to the high table.

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