Shareholder-value-based brand strategies

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Abstract

Companies like Procter & Gamble, Unilever, Xerox, Heinz, Apple and Gillette possess great brands and outstanding brand management competencies, yet they have failed to generate value for shareholders in recent years. What these companies are learning is that having strong brands which consumers value is not enough. Whether strong brands create value for shareholders depends upon the economics of the markets in which they operate and the strategies managers pursue. By underestimating shareholder value dynamics, marketing managers risk misallocating resources and handicapping the firm's opportunities to move into new markets and find new, more profitable, growth opportunities.

This paper looks at how brands contribute to the firm's strategy and how brand planning needs to be geared to market economics and management's central objective of creating shareholder value.

INTRODUCTION

This paper shows that many marketers hold a view of brands that is too naïve. Through an uncritical belief in the importance of brands and the case for brand investment, the views of marketing professionals often become marginalised when top management debate the big strategic issues facing their business. Marketers are seen as unsophisticated advocates, rather than serious professionals able to engage in an objective review of the problems and opportunities facing the firm.

Brands are the 'big thing' in marketing. Marketing is not a highly developed discipline like economics or finance. Marketing lacks theory, breakthrough insights and firm principles that can guide the development of strategy. But marketing does 'own' the concept of the brand, and brands are now recognised by investors as a crucial source of strength and value in many industries. Brands add value by differentiating the firm's product and providing consumers with confidence in the rational or emotional benefits it offers.[1] To most marketing professionals, brands are the very heart of marketing.

But the case for brands can be oversimplified. After all, in recent years, virtually all the companies that were regarded as the paragons of brand building have stumbled. Procter & Gamble (P&G), Coca-Cola, Gillette, Apple and Marks and Spencer have all recently fired their chief executives because of their failure to create value for shareholders. Indeed, many of the most successful companies in the last decade — Dell, Vodafone, General Electric — have hardly been con-

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spicuous in their creation of great brands.

Marketers need a more sophisticated understanding of when brand-building investments make sense. The basic rule is that brand investments pay off when they generate returns that exceed the company's cost of capital. The P&G share price fell when investors believed that management was breaking this principle. Fundamentally, as is shown below, to generate an adequate return, brand investments must increase the level of the firm's cash flow and accelerate the speed of cash flow, extend its duration or reduce the vulnerability of these flows. The most important drivers of cash flow are whether the brand can accelerate growth or enhance prices. If brands cannot produce these effects, management is better off focusing away from brands to other sources of value creation.

BRANDS AS RESOURCES

Defining how brands work starts by recognising that marketing and brands are not objectives but strategies. The governing objective of business is to create value for shareholders. As a recent *Business Week* survey concluded, 'the fundamental task of today's CEO is simplicity itself: Get the stock price up. Period.'[2] Top managers nowadays do not hold their jobs long if they do not increase the financial value of the firm. Strong brands, customer awareness, market share and satisfied customers are not goals in their own right, but means to create shareholder value.

Sometimes these branding and marketing strategies create value; sometimes they do not. For example, Freddie Laker and Equitable Assurance created high awareness and great value brands that customers wanted. Unfortunately, their low prices and excessive investment levels failed to generate sufficient cash to build businesses that were viable long term. Recently many dot.com companies followed this pattern in even more exaggerated terms, spending 80 per cent of their capital on advertising and selling at prices below their costs. Hardly surprisingly, this type of brand development eventually led to a massive shake-out in the sector.

To understand how brands can add value one needs to start with a model of how the firm creates value. There is now wide acceptance for what strategists call the 'resource-based theory of the firm'.[3] This represents something of a shift from the marketing-based idea of the firm popularised by Theodore Levitt in his famous 'marketing myopia' article.[4] The resource-based theory proposes that defining a firm in terms of its assets and core capabilities offers a more durable basis for strategy than a definition based upon the customer needs the business seeks to satisfy. In other words, sustained success depends upon more than merely identifying market opportunities; more critically it depends upon having the special capabilities to deliver at lower cost or higher quality than the competition.

Figure 1 is a modified representation of the resource-based view of the firm. Starting from the top, the objective of strategy is to create *shareholder value*, as measured by rising share prices or dividends. In competitive markets the key to creating shareholder value is possessing a *differential advantage* — giving customers superior value through offers that are perceived as either superior in quality or lower in

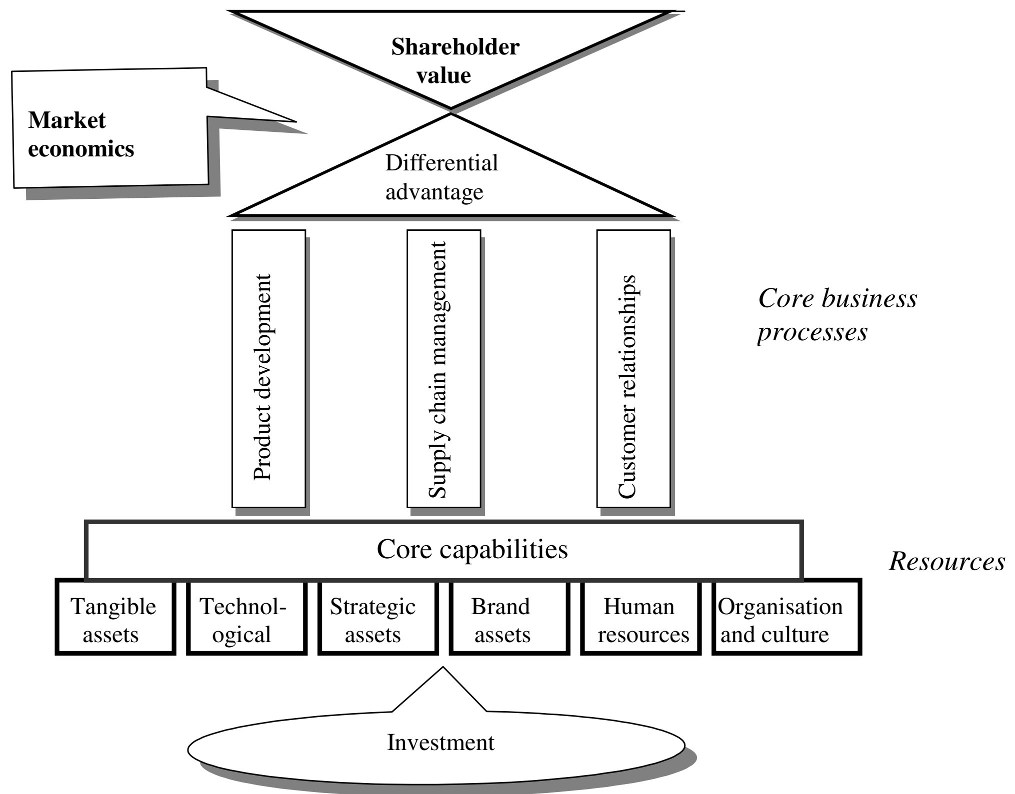

Figure 1 Intangible assets and the resource-based theory of the firm

cost. Achieving this differential advantage in turn depends upon the effectiveness of the firm's business processes. The *core business processes* of most firms can be grouped into three categories: the product development process, which enables a firm to create innovative solutions to customer problems; the supply-chain management process, which acquires inputs and efficiently transforms them into effective products and services; and the customer relationship management process, which identifies customers, understands their needs, builds customer relationships and shapes the perceptions of the organisation and its brands.

To be able to make superior offers to customers, the firm must have outstanding business processes that enable it to be more innovative than its rivals (eg Sony, 3M); have operations that deliver customer solutions at lower total cost (Wal-Mart, Toyota); or be outstanding at managing customer relationships (Dell, American Express). It is important to recognise that these core processes are not independent. For example, if a company's marketing strategy is based on achieving superior customer relationships through individualised solutions, it will also need the product development and supply-chain management processes to design and deliver the tailored responses efficiently. Without the combination of effective core processes it will not be

able to execute the strategy. Secondly, while the company has to manage these processes, it does not have to conduct them. Increasingly firms are part of networks and processes are outsourced to specialists. Companies like Dell and Virgin, for example, focus on the product development and customer relationship management processes and outsource most of their supply-chain activities.

Core business processes are the drivers of the firm's differential advantage and its ability to create shareholder value. But these processes themselves are founded on the firm's *core capabilities*, which derive from the *resources* or assets it possesses. A firm cannot have superior business processes unless it has access to the necessary resources and the ability to coordinate them effectively. Resources can be divided between tangible and intangible assets. Traditionally, the firm's tangible or balance sheet assets were seen as its most vital resource — its factories, raw materials and financial assets. But in today's information age, investors increasingly view intangible assets — the firm's knowledge, skills and reputation — as the key to superior business processes. In 2000, tangible assets accounted for less than 20 per cent of the value of the world's top 20 companies. Finally, maintaining the up-to-date asset base on which everything is founded depends upon investment. It requires investment in physical assets, but even more in recruitment, training, staff development and, in the case of brands, advertising and communications.

Brands form part of the intangible asset base that drives the firm's core business processes. The resource-based model of the firm suggests several insights into the role of brands and the creation of shareholder value. First, marketers should beware of exaggerating the importance of brands. In many industries much more important drivers of core processes and shareholder value are the firm's patents, technology and particularly the skills and commitment of its staff. An impression of the relative importance of brands against other tangible and intangible assets is given by some estimates from Interbrand (Table 1).[5] Only in luxury consumer goods are brands the dominant source of value. In many of the newer, faster-growing industries such as IT, pharmaceuticals and financial services, brands play a much smaller role. If companies overinvest in traditional branding activities, they underinvest in other tangible and intangible resources. For example, an underinvestment in new technology and lack of genuine innovation appears to have played an important part in the decline of P&G and Heinz.

Secondly, strong brands can be undermined by a poor marketing strategy. A poor marketing strategy is one that is not geared to creating shareholder value. Marketers often set their strategic objectives to maximising awareness, growth or market share rather than the value of long-term cash flow. When this happens the brand's value is eroded by the cost of servicing too many low-profit accounts, by overinvestment in marketing communications, and by underpricing.

Finally, successful brands impact most directly on the customer relationship management process — enhancing the confidence and satisfaction customers gain from the product. But effective brand management also engages with the product develop-

Table 1 Relative importance of brands and other assets

	Tangibles %	Brand %	Other intangibles %
Utilities	70	0	30
Industrial	70	5	25
Pharmaceutical	40	10	50
Retail	70	15	15
Info-tech	30	20	50
Automotive	50	30	20
Financial services	20	30	50
Food and drink	40	55	5
Luxury goods	25	70	5

Source: Interbrand

ment and supply-chain management processes. In the past, brands like Jaguar, MG and Amstrad have seen their financial values fatally eroded by the companies' inability to provide the quality, delivery and performance to make a reality of the desired images. Brand management must be seen as an integrated part of the total management process rather than a specialist marketing activity. Brand management only becomes a core capability of the firm when it is effectively coordinated with the firm's other resources to enhance all the core business processes.

BRANDS AND MARKET ECONOMICS

The resource-based model of the firm has one important weakness: it assumes shareholder value is solely dependent upon the firm's competitiveness. Unfortunately, the possession of a differential advantage is only half the picture. The other half is the attractiveness of the market in which the business operates. Industries differ greatly in profitability. For example, prescription drugs, soft drinks, tobacco and cosmetics have been consistently highly profitable; whereas textiles, steel, car manufacturing and mining have been consistently unprofitable. Market economics mean that even strong brands find it difficult to make a decent return in some markets; whereas in others, even mediocre brands can make good profits.

What determines the attractiveness and profitability of a market? The two most important factors are the *intensity of competition* and the level of *pressure from customers*. When competition is intense, brands may be unable to generate returns above the cost of capital. Four factors typically determine the intensity of competition: the amount of excess production capacity, the degree of product standardisation, the number of competitors and the growth in the market. The level of customer pressure is a function of two determinants: the price sensitivity of customers and their negotiating leverage.

Market economics explains much of the paradoxical performance of companies like P&G, Gillette, Unilever and Kellogg. These companies are stars at brand management but they have delivered very poor returns to shareholders in recent years. This is because the grocery markets in which they predominantly operate are characterised by intense competition caused

Market economics	Weak	Strong
Attractive	Equivocal — can be a profitable brand	High value-creating potential brands
Unattractive	Always value-destroying brands	Low value-growth potential
	Consumer brand strength	

Figure 2 Market economics and the value-creating potential brands

by excess capacity, me-too products, own-label products and little growth. They also face a high level of customer pressure from the large supermarket groups, which are increasingly price sensitive and possess immense negotiating power. The result has been that while these brands maintain high awareness and market shares, pressures on profit margins and the absence of volume growth have resulted in a decline in the financial value of these brands and the companies that own them.

Figure 2 summarises these dilemmas. Strong brands in attractive markets will always be profitable and create value for their shareholders. Examples of these include Microsoft Office, Nokia mobile telephones and Mercedes S class. Weak brands in unattractive markets will always be unprofitable — investment will not produce returns above the cost of capital. Examples include Rover, Smiths crisps and Radion. For the other two strategic brand positions, the results are more uncertain. Weak brands in attractive markets (such as Lotus SmartSuite and Motorola mobiles) are equivocal: if the brand leader is not aggressive and buyers are not price sensitive these brands can make modest profits. But in the long run they are unlikely to be profitable (their returns will be less than the cost of capital) because customers can choose better alternatives. Strong brands in unattractive markets (such as Weetabix and Stella Artois) will usually be profitable, but their weak growth outlook will mean shareholder returns are unlikely to be exceptional.

The importance of market economics to a brand's potential value means that marketers need a more sophisticated approach. Expressing a 'passion for the brand' has become a badge of a marketing manager's machismo. Passion no doubt has its uses, but it is hardly a sensible mechanism for allocating scarce resources among competing alternatives. Managers have to recognise in today's hyper-competitive markets that

some brands, even those maintaining high awareness and market share, do not represent sensible investments for shareholders. Rather than swimming against the tide, it is better either to refocus on innovation and strike off in new directions towards markets with more favourable economics or, if there are no viable profit opportunities, to give the money back to shareholders through share buy-backs or raised dividends.

BRAND STRATEGIES AND FINANCIAL PERFORMANCE

The value-creating potential of a brand is determined by its differential advantage and its market economics. But whether the brand achieves its potential depends upon a third factor — the strategy the managers pursue.

Many great brands have failed to deliver for their companies because marketing managers have not understood the objective of a brand strategy. Evidence shows that they commonly pursue objectives such as sales, market share, customer awareness or favourable attitudes.[6] Such goals lead to marketing decisions that destroy rather than create value. The objective of a brand strategy should be one thing only — to maximise shareholder value. The corollary is to understand what determines shareholder value. Again this is well understood by investors — value is determined by expectations about the present value of the long-term cash flow the strategy will generate.

The present value of a brand's future cash flow is a function of four factors: the level of its cash flow, the speed it comes in, the duration it lasts, and the riskiness of these future returns. The difference between a strong brand and a weak brand is that the former has more positive associations with these four determinants of value — if it is properly managed. In general, the task of brand management is to ensure that the level of cash flow is high, that it achieves its full cash-generating potential fast, that the brand endures, and that the cash flows are not put at unnecessary risk.

This paper will now briefly summarise the evidence of how successful branding impacts on cash flow and then illustrate the practical implications for managers.[7]

Brands increase the level of cash flow

The level of cash flow is the most important determinant of shareholder value. A brand's cash flow is determined by four factors: its price, growth, costs and investment. If a brand can achieve a brand premium this has a major impact on its value. There is considerable evidence that successful brands do achieve price premiums. Successful brands should also grow faster, again increasing the level of cash flow. Brand leaders commonly have lower costs, particularly because of scale economies in marketing spend. Finally, strong brands can have lower investment levels (as a proportion of sales) because of their greater potential leverage over the supply chain.

Accelerating cash flow

Because money has a time value, opportunities to reduce the lag in a brand's achievement of its potential increase the value of the brand to

shareholders. Again there is evidence that consumers respond quicker to marketing campaigns and new product introductions when they are familiar with the brand name and have positive attitudes towards it.

Extending the duration of cash flow

The longer a brand name endures, other things being equal, the greater its value to investors. One of the important ways brands add value is through increasing the longevity of the product. Most of the world's most valuable brands have been around for 30 years or more. Well-known brand names have longevity because consumers believe in them, are more willing to try new versions, and refer them to new generations of customers.

Reducing the risk attached to future cash flow

Investors discount future expected cash flow by the company's cost of capital. The cost of capital is a function of the risk investors perceive in the brand's future. The greater the risk, the lower the brand is valued. Strong brands should offer lower perceived risk because of higher consumer loyalty and reduced vulnerability to competition. If investors believe a brand's cash flow is stable and predictable it will have a higher net present value and consequently create more shareholder value.

The task of the brand manager is to exploit these advantages so as to increase the present value of the brand's future cash flow. When marketing managers are not geared to maximising the value of the long-term cash-generating potential of the brand, they erode investors' confidence in the business and ultimately undermine the viability of the brand.

DEMONSTRATING EFFECTIVE BRAND MANAGEMENT

To illustrate the problem faced by companies like P&G, Unilever and Heinz, the paper will look at Upbrand.

Upbrand is the leading brand in its sector of the household goods market. Sales are £100m, making it comparable in size to Unilever's Comfort or P&G's Daz. It has been No. 1 for over 20 years and remains outstanding in terms of awareness and preferences. Its pre-tax profit margin is a healthy 12 per cent and its EVA (post-tax profits less capital charge) is over £3m.

Surely, such a 20-year marketing success should be a source of acclaim in the company. Unfortunately, investors think otherwise. Upbrand has two major problems. First, it is in a no-growth market. Investors know it is virtually impossible to create long-term value added without volume growth. Secondly, there has been a slow decline in Upbrand's margins. To maintain volume in a sector attracting increasing own-label competition, management has not been able to raise prices sufficiently to recover rising operating and marketing costs. Annually, costs have risen 1 per cent faster than prices and investors expect similar pressures in the future.

Table 2 shows how analysts typically estimate the value-creating potential of brands and the companies that own them. Explicit forecasts of cash flow are usually made for five to ten years ahead, and then the value of the brand at the end of the period is called

Table 2 The Upbrand shareholder value analysis (£m)

	Year					
	0	1	2	3	4	5
Price £	1.0	1.0	1.0	1.0	1.0	1.0
Quantity m.	100.0	100.0	100.0	100.0	100.0	100.0
Sales	100.0	100.0	100.0	100.0	100.0	100.0
Operating costs	66.0	66.7	67.3	68.0	68.7	69.4
Marketing expenses	22.0	22.2	22.4	22.7	22.9	23.1
NOPAT	8.4	7.8	7.2	6.5	5.9	5.3
Net investment	0	0	0	0	0	0
Cash flow	8.4	7.8	7.2	6.5	5.9	5.3
Present value of cash flow		7.1	5.9	4.9	4.0	3.3
Cumulative present value		7.1	13.0	17.9	21.9	25.2
PV of continuing value						32.6
Shareholder value						57.8
Initial shareholder value						84.0
Shareholder value added						−26.2

its continuing value. The shareholder value created by a brand is the value of its cash flow over the planning period plus the continuing value. Cash flow is what is left for shareholders — net operating profit after tax (NOPAT) less net investment.

Upbrand's initial shareholder value is £84m. This is estimated by the standard perpetuity method, dividing NOPAT by the brand's cost of capital, which is taken here to be 10 per cent. Essentially the perpetuity method assumes that the brand earns just its cost of capital in the future.[8] Unfortunately, as described, investors are less optimistic about this assumption. They believe that holding volume will mean erosion of margins as costs rise faster than prices. This leads to a significant fall in NOPAT over the years and a corresponding decline in the predicted cash flow. Net investment (after depreciation) is assumed to be zero because volume is constant over the period. But the net result is that the brand's value to shareholders sinks to £57.8m — a decline of 31 per cent. If Upbrand is typical of the company's portfolio, then a similar fall would be expected in its share price. Indeed, this, or worse, has happened to many well-known branded goods companies in recent years. Investors realised that strong brands cannot offset the effects of unfavourable market economics and perhaps misguided brand strategies.

Table 3 explores whether alternative strategies could curtail the decline of Upbrand. As described earlier there are four alternatives — strategies to increase the level of cash flow, its speed, duration or stability. This paper will explore only the first of these, which is generally the most important. Growth is a powerful way to increase the level of cash flow and shareholder value. As Table 3 shows, if Upbrand could increase sales from its historic plateau to growth of 5 per cent a year, this would add £23m to its value. Unfortunately, a growth strategy in these mature markets is usually a trap that managers pay dearly for in terms of declining margins and cash flow. Increasing volume by almost 30 per cent

Table 3 Options for Upbrand in preserving shareholder value

	Shareholder value added (£m) Change in volume % pa		
	−5%	0	5%
Increase growth	−67.4	−26.2	23.2
Price increase −1% pa	−2.0	3.6	–
Price increase +5% pa	63.1	130	–
Operating costs cut −5%	3.5	16.6	–
Marketing costs cut −10%	−13.1	−4.2	–
Investment level cut −10%	−28.0	−17.1	–

in five years is unlikely to be attainable at an economic cost.

For strong brands operating in unfavourable market conditions, tactics to raise price are often a better option. Tactics can include better negotiating with the trade, reduced discounts, category management initiatives, better customer segmentation and premium line extensions. Here a 1 per cent annual price increase (ie the same inflation rate as operating and marketing costs) would increase the brand's value by £3.6m; a 5 per cent increase would raise its value by a massive £130m. The other ways of increasing cash flow are cutting operating and marketing costs and reducing the level of investment behind the brand. In principle, cutting operating costs has the biggest leverage. But in practice, most well-managed companies have by now exhausted most of the opportunities for substantial cost cuts.

What deters brand managers from considering price increases and cuts in marketing expenses is that they are likely to reduce sales. But such objections are based on a misunderstanding — the objective of marketing should be to increase the value of cash flows, not sales. Maximising sales is a recipe for ruin. As Table 3 shows, even if volume falls by 5 per cent annually as a result of higher prices or cuts in marketing spend, shareholder value is still significantly higher than under the current strategy. Indeed, one of the great advantages of strong brands is that they have lower price elasticities. One of the commonest strategic mistakes in managing brands is failing to take advantage of these economic principles.

SUMMING UP

Being passionate about brands is a questionable attribute for marketing professionals; far better to be rational about managing them. Brands are economic assets, like factories, shops or patents, whose function is to create value for shareholders. Managers operate rationally when they manage brands to maximise the discounted value of their future cash flows.

Brands are important because, when they are effectively integrated with the firm's other tangible and intangible assets, they create the capabilities to build superior business processes. These in turn enable the firm to develop the competitive advantage that is a basis for superior returns. Brands, like other assets, need to be invested in, otherwise

their value erodes. But this is not a blank cheque — just as bad market economics have made investing in UK textile or car factories a misguided strategy, so sometimes it can be for brands.

Whether a brand will create value for shareholders depends upon three factors. First, it should have a differential advantage in lower costs or superior perceived quality. 'Quality' here may be in terms of perceived functional benefits or the emotional associations the brand's image conveys. A differential advantage translates into a cash flow gain through the potential of superior profit margin. The second determinant of value creation is market economics. A market's attractiveness changes over time. In some markets, however strong the brand, excessive competition and powerful price-sensitive buyers make it very difficult to earn returns that cover the brand's cost of capital.

Finally, brand value creation depends upon a strategy based on maximising the present value of future cash flow. This means objectively projecting future market economics and assessing the implications for future investment in the brand. It also means aligning sales objectives, prices and marketing spend to shareholder value creation rather than solely marketing criteria such as market share or consumer attitudes and awareness.

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