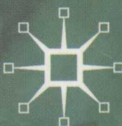
marketing and financial management

new economy – new interfaces

David Walters
Michael Halliday



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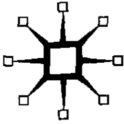

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Introduction

Business operates everywhere in an environment that is increasingly dynamic and challenging. In the emerging 'New Economy' markets have globalized, technology has become all-embracing, and relationships with suppliers, customers and competitors are undergoing constant change. *New business models* are emerging, ones in which competitive advantage is based upon *managing processes* that facilitate rapid and flexible responses to 'market' change, and ones in which new *capabilities* are based upon developing unique relationships with partners (suppliers, customers, employees, shareholders, government and, often, with competitors). The business model has often taken second place to strategy in management thinking and focus. Normann (2001) discusses 'a new strategic logic'. He suggests that: 'managers need to be good at *mobilizing, managing,* and *using* resources rather than at formally *acquiring* and necessarily *owning* resources. The ability to reconfigure, to use resources inside and particularly outside the boundaries of the traditional corporation more effectively becomes a mandatory skill for managements.'

Drucker (2001) has identified some of the changes that have occurred already within the largest US corporations suggesting these have changed many fundamental philosophies, views and practices. A similar shift, some years ago, sponsored the development of vertical integration on a large scale – and did so for many years. Drucker cites Standard Oil and Ford as examples of this earlier phenomenon. It is noticeable that large corporations are leading the changes in strategic posture. General Motors for example, have created a business that will buy for the ultimate car consumer – they will make available whatever 'make' of car and model most closely fits the consumer's preferences. As Drucker notes, the changes go beyond this, into design and development, and production. Products and services now have

multiple applications and business organizations are redefining their core capabilities and processes. In other words 'value chains' are competing with 'value chains'. The value chains are organization structures, or confederations, that are developing from traditional corporations.

Another example of the approach to the 'new economy is provided by *Millennium Pharmaceuticals*. This company was founded in 1993 and is specializing in performing basic research on genes and proteins using automated R&D technologies. In an interview with the CEO (Champion 2001) described the reasons why the company was repositioning itself in the value chain. The reasons given by Mark Levin (the CEO) were that the value in the industry has changed. Value has migrated:

> Value has started to migrate downstream, toward the more mechanical tasks of identifying, testing, and manufacturing molecules that will affect the proteins produced by the genes, and which become the pills and serums we sell. At Millennium, we've anticipated this shift by expanding into downstream activities across several major product categories. Our ultimate goal is to develop capabilities and a strong presence in every stage of the industry's value chain-from gene to patient.

Levin argues that the value chain for other high-tech products has, after all, tended to break down into a few separate, largely independent industries (each specializing in specific value positioning characteristics). The computer industry is used as an example with chip manufacturing, computer assembly and delivery and software. Where once IBM was dominant, Intel, Dell and Microsoft now coexist as a value chain. Millennium sees problems with the current structure of the industry; the profitable areas of the value chain are not in the R&D process alone. Levin suggests the future of the industry lies in personalized medicine: 'One day, everyone will have their own genomes mapped out and stored in memory chips, and doctors will look at the information in those chips and prescribe accordingly.'

The implications for management are immense. One is very clear. Unless managers operate on a basis of cross-functional decision making most organizations will not survive. This text introduces this notion by considering the interrelationships that exist between marketing and financial decision making. This is considered to be a prime requirement of managers aiming to make their mark in 'new economy' organizations.

This book is aimed at undergraduate students who have an understanding of marketing and finance, postgraduate students and experienced managers seeking a better understanding of the interrelationships that exist between marketing and financial management decisions. It assumes a familiarity with the basic concepts of both disciplines. It also assumes a shared view that any

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manager has a responsibility to work towards the overall objective of increasing the value of the shareholders' investment within the company.

The purpose of this text is to explore marketing decisions that have implications for financial management. This approach is taken on the basis that successful business decisions are those based upon achieving customer satisfaction and are, therefore, initially marketing-led. The authors have found from experience that many marketing managers often pursue opportunities without considering the wider implications of their decisions for the company, particularly for the financial management of the business.

Some examples based upon our own experiences may help to explain the basis of our concern. In one instance, a consumer durable goods manufacturer shifted its distribution emphasis away from its traditional distributors towards an emerging discounter network. The rate of growth demonstrated by the new channel of distribution was impressive and promising. As soon as the company's intentions became apparent to its existing distributors (electrical multiple retailers, department stores, large independent retailers and electrical wholesalers), they either delisted the company or made it a number two or three brand and reduced their stock cover and service facilities. As a result, it faced a major reduction in sales volume which created large inventory surpluses. The discounter network failed to sustain its initial rate of growth and, furthermore, the key companies refused to hold stock, demanded large discounts to maintain their price competitiveness and were very slow to pay for product purchased.

The financial implications were serious. The build-up of inventories required additional working capital funds. In addition, the physical storage space requirements became such that external facilities were rented at excessive rates. The reduction in sales volume exacerbated the financial problems. Reduced sales and contribution (and therefore margins) had serious implications as the company was a high fixed-cost operation. As a consequence the implications for capacity utilization and labour utilization soon required dramatic action. The decision to change its distributor network had resulted in a very large increase in working capital requirements, an under-recovery of overhead costs and serious under-utilization of fixed and human assets. In addition, the decision had put the company in an impossible situation with the established distribution channels.

Clearly, closer liaison with financial management may have identified many of these problems, could have considered their implications and may well have resulted in a different decision being taken.

In another situation an industrial equipment manufacturer sought to increase the manufactured content of its product range. At the point in time at which the decision was made it manufactured some 60 per cent of the finished product. It considered that by increasing this amount to 85 per cent

it could increase its profit margin and be in a stronger position to meet increasing price competition. It underestimated the plant and equipment costs required for manufacturing the additional product components as well as the human resources costs (which included considerable training costs). The company's problem was fundamental in that it overlooked the fact that the components it had decided to manufacture required specialist equipment and highly trained and skilled operators. The technology required to manufacture the new components was very different from that used for the more simple manufacturing and assembly activities already performed. As a result, not only did the investment costs exceed expectations, requiring additional funding, but the process was slow to come on stream and there were numerous quality control problems resulting in customer dissatisfaction and, subsequently, loss of major customers.

Once again, a joint review of the proposal (with marketing and finance together and, in this instance, with operations management as well) would have probably rejected the proposal.

These two examples are typical of the many decisions and outcomes that are made in industry. By developing a better understanding of the financial managers' role, and of the aspects of their job which are influenced by marketing decisions, the marketing manager can play a more effective role in increasing the value of the business.

This book has been developed around a number of marketing and financial management topics. The overall direction of the text is to consider the financial implications of strategic and operational marketing decisions. The text first considers the role of management in its responsibility to the shareholder. Recent views on the implications of shareholder value management on corporate decision making and performance are introduced. From these we develop a set of criteria, *shareholder value drivers*: profitability, productivity, cash flow and growth. Growth is essential for all businesses and during our discussions throughout the text it will be considered as an implicit influence on shareholder value. Typically, managers are confronted with choices between high rates of return, that is, for profitability, productivity and cash flow – in other words choices concerning projects with various rates of growth but having various levels of accompanying risk.

Chapter 1 introduces and explores the implications of shareholder value management for marketing decision makers. Shareholder value drivers are identified and discussed within the context of margin management, asset base management, and financial and investment management activities. Each is introduced in the chapter and they are then considered within the context of strategic marketing options such as: consolidation and productivity, market penetration, product and market development, and diversification.

The Du Pont approach to planning and control is introduced and is worked into the discussion. The subsequent development of the Du Pont model into the strategic profit model is also reviewed and examples are worked through to demonstrate the basic concepts of the model. Margin and asset base management are explored to identify examples of importance to the marketing/finance interface by introducing corporate activities (such as R&D, procurement and materials management, and manufacturing and logistics operations) and identifying issues of importance to marketing and finance and their interface.

Chapter 2 introduces a number of topics that are important in the business environment of the 'new economy'; the growth of customer centricity, customization and mass customization, the notion of 'value' and its application to both customers and 'organizations', the importance of planning and monitoring cash flow performance rather than just profitability, the decline of the vertically integrated organization and the growing importance of virtual structures, the preference for asset 'leverage' rather than ownership, the growth of the importance of intangible assets and the decline of tangible assets, the emergence of the notion that processes and capabilities are resources and a move away from functional 'silo' thinking, and introduction to the concept of value migration.

Chapter 3 considers the impact of the 'new economy' on current and new management thinking. It starts by revisiting Ansoff and discusses enterprise growth in the context of his model. Value-based management is reviewed with an emphasis on a stakeholder approach. The essentials of establishing and maintaining sustainable competitive advantage within the context of the 'new economy' explores new options and considers the implications for financial management. Identifying, generic business processes and their characteristics and the implications of new organizational structure options are considered. Finally, the processes and components of business model development are discussed.

The capacity size decision influences production investment and operating costs. Clearly these are all influenced by marketing strategy decisions. Chapter 4 identifies the need for a joint approach by marketing and finance. The chapter initially establishes a process by which the market volume available to the firm may be determined. Given a realistic forecast of volume potential the company should then consider the implications this presents for structuring production and specifically the implications for cost structures. The discussion considers economies of scale and the shape of long run cost curves in the determination of cost behaviour. This leads us into a discussion of strategic revenues and their implications for cost structures at a strategic level.

Operational implications are considered in Chapter 5. Topics addressed

include the consideration of risk and the cost structure of the business. (Business and financial risk characteristics are discussed.) The chapter then looks at the influence of the nature of the manufacturing process on cost structure, and in particular decisions influenced by fixed and variable cost structure alternatives. We discuss the complexity of manufacturing processes and marketing influences, which includes a review of break-even analysis and its responses to price and volume changes together with consideration of capacity expansion. The experience effect is discussed and this concept links the earlier discussion of cost structures, technology and economies of scale. Chapter 5 includes a discussion on value systems and introduces the notion that cost structures, which are an influence on product market price, can be considered as inter-company decisions as well as intra-company decisions. The principle espoused is simply that more effective decisions may be made by analysing the value chains of all members of a value-generating system (or supply chain) – that is, manufacturers, distributors and the end-users. This approach identifies the benefits that may accrue to the entire system and which, through effective distribution policies, may be both increased and delivered more equitably. Product profitability and its components are introduced in Chapter 5. The discussion considers the implications of product management decisions such as product range rationalization, value analysis, and the role of direct product profitability in pricing decisions.

Chapters 6–11 are concerned with the implications of marketing decisions for the more common financial management areas of: working capital management (Chapter 7); managing fixed assets (Chapter 8); managing cash flows (Chapter 9); capital structure decisions (Chapter 10); and investment appraisal (Chapter 11). The chapters are introduced by a discussion of financial structure and performance characteristics (Part III). Part III reviews some of the fundamental issues of the marketing/finance interface including the funds flow cycle, working capital cycles, managing fixed assets, managing cash flow and funds flows, financial structure, and investment decisions. Both marketing and finance decisions require performance measurement criteria. These are introduced in Part III, together with a simple model that considers the marketing/finance decision-making complex. The matrix used relates the decision-making process to the shareholder value drivers introduced in Chapter 1.

Chapter 6 considers the marketing influence in the creation of shareholder value. The discussion introduces and reviews recent approaches to measuring shareholder value and compares these with earlier marketing-led approaches to strategic marketing and financial performance analysis proposed by the Boston Consulting Group (BCG). The chapter concludes by using these earlier shareholder value management models to develop a marketing based model.

Working capital management is discussed in Chapter 7. A comprehensive

discussion considers the implications of marketing decisions on the components of working capital. The chapter commences with a review of the company's operating cycle, identifying important marketing/finance interface issues. This is followed by a review of working capital funding requirements for the primary components of current assets and examples are given. The topics discussed include inventory, accounts receivable and cash management. A similar treatment of current liabilities follows and here the discussion includes accounts payable (and the use of credit), bank overdrafts and other forms of short-term financing. The management of working capital and management performance criteria conclude the chapter. Examples are used to illustrate the impact that rigorous working capital management (influenced by marketing decisions) can have on the shareholder value drivers.

Managing the fixed asset base is discussed in Chapter 8. The chapter commences with a review of asset base components of particular interest to marketing decision makers. These concern the role of fixed assets in the production and delivery of an appropriate market offer. Fixed asset considerations include intangible factors such as R&D and branding. The performance of fixed assets is a concern for both marketing and financial managers. The criteria typically used are introduced and common influences are also introduced and discussed. Financing options are introduced and considered with a view to their influence on corporate performance, and debt and equity considerations. Off-balance sheet financing and leasing are all funding alternatives available to the firm which, depending upon varying circumstances, may have advantages or disadvantages.

Cash flow management is a vital activity for any organization and Chapter 9 considers the issues important to the marketing/finance interface. Cash flow and profits are distinguished, and the sources and applications report is reviewed to identify both marketing and financial points of interest. Examples are used. A marketing perspective of cash flow is taken and the Boston Consulting Group's growth/share matrix is discussed in this context. In order that marketing managers may gain a better perspective on cash flow issues (and management), the text develops a model that considers both the strategic and operational management aspects. We take the view that cash flow management requires a time perspective over which cash flow requirements and sources may be planned and controlled, with both internal and external aspects considered.

Chapter 10 considers the interface implications presented by capital structure decisions. The chapter discusses the role of gearing in the capital structure and managerial attitudes towards financial risk. The examples explore the major issues of concern to both marketing and financial management. The cost of capital is discussed and we consider both the qualitative costs (the influence on corporate control) and the quantitative costs (the interest return

required by shareholders and investors). The means by which capital is obtained are also discussed and worked examples are given. As with other chapters the marketing/finance interface issues are explored and a comprehensive model is developed which identifies issues that both marketing and finance managers should consider when deciding upon an appropriate financial structure.

In Chapter 11 we consider investment decision issues. Alternative investment appraisal methods are reviewed and their relevant advantages and disadvantages discussed. The link between net present value (NPV)/ discounted cash flows (DCF) and shareholder value is discussed. The role of the capital asset pricing model (CAPM) within the context of marketing/ financial investment decision making is explored in some detail, with its implications for both return and risk as a major consideration. The spread of returns generated by a project or product investment and the risk acceptable to management is seen as an important issue in the marketing/finance interface with much of the chapter spent on exploring the factors that should be considered when appraising returns available from alternative strategies.

Chapter 12 considers the marketing and financial aspects of portfolio management. The work of the Boston Consulting Group during the 1960s and 1970s is well documented and widely known and used. Our approach to the topic is first to review the product life cycle theory and its implications for cash flow management. The discussion moves on to consider a portfolio effect of products or strategic business units at different stages of their development and the implications this has for funding growth activities. We discuss the BCG growth/gain model in some detail, using it to explore its linkages with shareholder value management through margin, asset base, and financial and investment management decisions. The relationship between growth and internal and external funding options is also discussed using this BCG model and frontier curve analysis. We also consider the financial management approach to portfolio design and management to demonstrate an alternative method of considering return and risk. The chapter concludes with a proposed marketing/finance model for portfolio planning. This model considers business growth rate, risk and shareholders' expectations for returns and identifies the trade-off potential among these criteria.

Chapter 13 considers planning and control issues. Planning and control is discussed in some depth and the influence of organizational structure is introduced. The concept of responsibility centres is explored within the context of organizational issues. The chapter is very much concerned with performance measures and the use of budgets in planning and control performance monitoring is a major topic. The use of PPBS (programme–planning–budgeting–systems) or output budgeting is discussed within the context of the marketing/finance interface. We also consider how value chain analysis may be used

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as a planning and control mechanism. Performance is a relative measure and the company should therefore monitor its own success against that of its competitors. If it performs better than its competitors it enjoys real success. A company/competitor performance evaluation is developed for this purpose.

Marketing and Financial Management aims at promoting a better understanding between these two important management disciplines. We hope that as a result of reading this book greater cooperation will be achieved and improved performance realized.

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