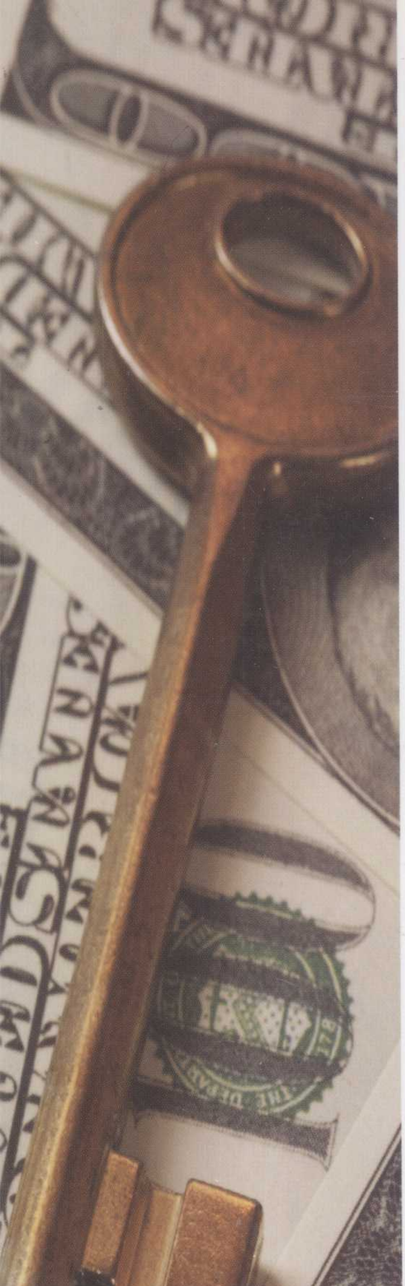

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Decision Equity

The Ultimate Metric to Connect Marketing Actions to Profits

Piyush Kumar
Kunal Gupta

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Abstract

More than even before, marketers need to justify their decisions by linking them to the corporate bottom line. While this is a challenging task, what makes it more daunting is the absence of a systematic approach and an overarching metric to help make financially sound marketing decisions.

In this new book, Kumar and Gupta resolve both problems. They introduce breakthrough thinking around the financial consequences of marketing actions and propose *decision equity* as the ultimate metric to connect marketing strategies to financial success. Using numerous case studies from small firms to global conglomerates, they provide a comprehensive and robust framework for implementing a *decision equity*–based strategic approach within an organization.

The authors build a compelling case for fact-based decision making and illustrate the power of cross-functional participation in strategic problem solving. They provide a step-by-step approach to build *decision equity*–based systems within firms. They show how organizations can win and achieve their strategic vision by developing a *linkage orientation* and learning how to connect their *Actions to Profits*.

Keywords

Action profit linkage, linkage analysis, decision equity, linkage orientation, customer satisfaction, service quality, return on marketing, customer equity, brand equity

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Prologue

The excitement around the boardroom was palpable as department heads streamed in with a shared sense of both victory and optimism. There were plenty of smiles to go around, and warm handshakes and hot coffee were the order of the day. As they slowly settled into their chairs, they chatted about how the firm's stock price had responded favorably to the change in strategy over the last three quarters.

The fortunes of the firm had indeed made an impressive turnaround since the previous vice president of marketing had left. Rumors were that he was judiciously let go because the firm's flagship brand in the marketplace had been steadily slipping and losing share to private labels. The vice president of human resources had launched an aggressive search for a replacement and, in a significant departure from past practice, had strived to and been successful at bringing in someone from outside the industry.

What subsequently transpired reflected a different approach to how the firm did business. The market research process was formalized and the results of extensive customer feedback resulted in a major design change in the packaging of the firm's key product, including a change in the color of the package from yellow to blue. Postlaunch tracking had indicated that customer response to the change was both positive and immediate and had improved the sales per customer by about 50%. The brand was stronger and the private label challenge seemed to have waned.

Today's meeting was to celebrate the firm's recent success and to share thoughts about future strategic moves. The chief executive officer (CEO) walked in with a wide smile on his face and the now familiar and well-known management consultant and advisor at his side. As they settled in and exchanged pleasantries, the CEO gave a general overview of the turnaround at the firm and highlighted the fact that the value of the firm had increased by about $20 million since the time the key strategic change was made to the firm's flagship brand. He then invited each of the departmental heads to give their own perspectives on what had transpired and what the next few steps should be.

The new vice president (VP) of marketing was first and gave an articulate presentation of the major change in the fortunes of the flagship brand. She touted the success of the research-driven approach that had pointed to the brand's key deficiency in packaging and the subsequent strengthening of the brand brought about primarily by the change in the color of the brand's package. She then went on to present the financial consequences of the change in strategy by outlining the dramatic increase in the flagship brand's equity. She explained that she computed the future incremental cash flow that the brand would have generated over a comparable no-name product under the previous strategy. She had calculated the present value of these incremental cash flows using the firm's cost of capital for discounting and called it the baseline *brand equity*. Next, she presented results from a similar analysis using the revised projections of future cash flows under the new brand strategy and called the metric the updated *brand equity*. And there was a mild applause from the CEO when she showed that the change in strategy had increased the equity of the firm's flagship brand by an estimated $20 million, which was very close to the increase in the firm's value over the same period. The VP of marketing enjoyed the moment and took a few questions and suggestions on the future course of the strategy.

The VP of sales stepped up next and shared the details of how the customer response to changes in the firm's strategy had been positive and the sales per customer had registered a significant increase. He then went on to show that the value of an average customer was now much greater than what it had previously been. Interestingly, he said that he had computed the future cash flow per customer under the previous strategy, discounted it, and called it the lifetime value of the customer. He then proceeded to explain how he had aggregated the lifetime value of all the customers and had computed a metric called *customer equity*. Much like the VP of marketing had done, he too had computed the change in the value of *customer equity* following the change in strategy and placed the difference at about $20 million. He hurried through the next slide that showed that the change in the value of the firm could be traced almost entirely to changes in the firm's *customer equity*. The CEO gave him a somewhat confused look and whispered a question into his consultant's ear. The consultant gave a thoughtful glance at the VP of sales but kept quiet.

What followed next was somewhat dramatic. The VP of human resources touted the shift in the firm's hiring strategy and the recruiting of people from outside the industry. She hailed the almost newly minted VP of marketing as a prime example of how the shift had increased the value of the firm by enhancing its *people equity*. By now, the story was clear and the method to compute *people equity* was no different from what those who preceded her had followed. Less surprising was the conclusion that the shift in strategy had enhanced *people equity* by about $20 million, roughly the same amount that firm's value had increased over the same period.

The smile had vanished from the CEO's face, and he was increasingly turning to his consultant to seek clarification regarding what was causing the increase in the value of the firm. Why was it that *brand equity*, *customer equity*, and *people equity* had gone up to the tune of about $20 million each, yet the firm value was up by only around $20 million? He sent a questioning glance at the chief financial officer (CFO) of the firm and tried to read whether he felt that the truth was better than they thought or that there was less credit to go around than was being claimed. The head of packaging and the chief of market research were yet to make their presentations, and the CEO was trying to guess whether they too would claim returns on packaging and returns on market research to the tune of $20 million each. Was he about to learn about things such as *research equity* and *packaging equity*? As he was lost in his thoughts trying to make sense of all that he had heard, the consultant got up to speak.

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PART I

Competing by Verification

CHAPTER 1

Harnessing the Power of Data

Let us begin with a few actual stories to set the tone for the book. The first one is about a leading consumer brand whose managers were perpetually enamored by technological improvements they were making to the products in their portfolio. Not surprisingly, top management had also committed to substantial funds for improving the technology across the product line, a strategy that was well in line with the firm's long-term vision established a few years earlier. Along the way, however, the marketplace underwent dramatic changes. The most significant of these was that the product category in which the company competed was itself increasingly replaced by a better, faster, and cheaper alternative. Despite the writing on the wall, this firm continued to invest millions of dollars in enhancing its existing product portfolio and made no effort to invest in the new technology that was attracting an increasing number of customers. As a result, while the ongoing investments in technology did produce a substantially "improved" product, ironically the product class itself became "irrelevant."

Over time, the market share and financial performance of the firm deteriorated significantly, and its misfortunes continue even to this date. While management did see the train wreck coming its way, nobody stepped up to challenge product policy decisions that were made earlier. There was widespread organizational belief in the strength of the firm's existing product portfolio as well as its customer base. The belief created a flawed assumption among managers that the *technology-driven* product strategy that had served them in the past would continue to work equally well in the future. The marketing problem was exacerbated by the fact that senior management was constrained to planning from quarter to quarter, and long-term investments in an emerging product category seemed too stretched out to be explained to the investor community. Now this is not an isolated example, and we have come across several similar instances including video rental companies investing in redesigning their stores just as customers were migrating to ordering movies from the comfort of their living rooms. Similarly, there are examples of others who invested in superior quality on music CDs even as the market was moving toward downloading music directly from online sources.

Our second story is a very different scenario, which again, in our experience, is quite representative of a wide range of industries. In this case, the firm received thousands of inbound calls from its customers every month across its support centers spread throughout the state it operated in. Following industry practice, each incoming call was routed to the next available support representative, who was trained to make certain inquiries and then take appropriate actions. The call routing system, however, was antiquated and incapable of differentiating among calls from high-value versus low-value customers. To make matters worse, the representatives were not given any training or advice on how to handle the two groups of customers differentially. Instead, the focus was on *cost containment* and productivity—which led to the representatives attempting to maximize the number of calls handled per hour. They were also instructed to be strict about reneging late payment and other similar fines—a big reason for customer calls in the first place.

Senior management treated these call centers strictly as cost centers. It was insistent on keeping costs down through higher employee productivity and minimal cancellation of penalties and fees. Therefore, when a call came into the call center, the representatives treated the high- as well as the low-value customer groups in an identical fashion for all issues ranging from late payment to bill correction. A customer who had paid sizeable bills on time for the last several years but missed one payment because of a vacation was treated identically to another with a recurring record of missed or late payments. Not surprisingly, the system resulted in an exodus of a large number of the high-value customers who were always being solicited by competitors. Over time, the firm was left with a substantially less profitable customer base.

These remaining customers had a shorter tenure and smaller lifetime value, and the firm faced greater uncertainty in the cash flows expected from this pool. To make matters worse, given the high level of service required by these customers, the firm continues to spend a lot on servicing their needs. Suggestions to update the call center infrastructure to link a customer's value and payment history to the incoming call identification or the account number of the customer have been ignored for years. Now in an environment of belt tightening, these investments, or "costs" as senior managers often call them, are even more difficult to justify to investors, and the status quo is maintained. Management continues to treat the call centers as mere cost centers and gauges their performance solely on metrics of productivity and cost containment. New investments in these locations contradict management belief, while the firm continues to see an exodus of its high-value customers. From an external observer's perspective, even a cursory look at the data makes it painfully obvious that customer exodus often follows an unsatisfactory call center interaction, but the faith and belief in a well-established, productivity-driven model continues to drive decisions even in the face of compelling evidence to the contrary.

Finally, in a somewhat similar but generalized example, we often find that retail firms emphasize *productivity* in their individual stores. These productivity improvements are believed to have a strong positive impact on the financial performance of the firm. However, a recent engagement with one such retail firm suggests that caution should be exercised when boarding the "productivity wagon." Productivity improvements, especially beyond a critical point, often lead to compromises in the level of service quality experienced by customers. For example, customers experience great resentment when they find fewer employees available to help them in these so-called productive stores and fewer stock-keeping units to choose from within a "rationalized" product assortment. While such adverse customer experiences are often not obvious in the short term, they lead to an erosion of customer loyalty in the long term. Extensive work, done by the American Customer Satisfaction Index (ACSI)[1] research team, also supports our observation, where they find that service companies, such as airlines, often score below manufacturing organizations in the ACSI report card. This poor performance can often be attributed to attempts made by these firms to boost their productivity levels. Interestingly, these strategic choices are often not made in isolation but are the result of boarding the *benchmarking* bandwagon. Management feels the pressure to match its industry peers on select metrics, including those related to productivity, without giving deep thought to the ultimate consequences of adopting common industry practices and metrics. The underlying assumption, which we find often seriously flawed, is that not everyone within the industry can be wrong, especially when the short-term financial merit of emulating them can be observed relatively quickly. For example, we often read statistics about the "instantaneous" extra revenue airlines make because of new baggage fees, food for sale on board, and the removal of pillows and blankets from their aircrafts. However, we seldom hear about the potential adverse long-term consequences of such choices.

Our interactions with thousands of managers, consultants, management students, and academic thought leaders suggest that such stories can go on endlessly. In fact, we find that every day, a large number of managers make decisions based on intuition, entrenched mental beliefs, or knee-jerk reactions to competitive actions, without pausing to seek empirical support or validation. While observing the inner workings of big and small businesses, we have been a regular witness to the execution of beliefs-based decisions that rely on untested and unvalidated assumptions. Even as we write this book, we can find many senior leaders who continue to place extreme levels of confidence in the benefits of their unwavering beliefs in a variety of performance drivers, including *innovation*, *cost control*, *productivity*, *benchmarking*, and many more. In addition, the long-term effects of decisions that generate a positive short-term return, such as higher customer fees and lower levels of customer service, are seldom tested or validated.

The corporate world seems to have little time to pause and think and plan for fact-based decision making, for fear that nervous investors are ever so willing to abandon the ship and invest in alternatives. Such short and finite periods also correspond with the finite tenure of top management within most organizations. For example, in 2005, about 6 in 10 chief executive officers (CEOs) of Standard and Poor's (S&P) 500 firms had less than 6 years in their jobs as CEO.[2] In addition, as is well known, these leaders are evaluated and remunerated based on financial results produced *during* their tenure. This short-term orientation exacerbates the problem and the vision, and decision making at the top remains myopic. In such an environment, rapid fire, beliefs-based decision making continues to thrive at the expense of fact-based and data-driven decisions that possibly require longer periods of incubation and an alternative strategic mind-set.

The Data Deluge

Yes, we could give these decision makers some benefit of the doubt. We could possible argue that, even if they wanted to, these managers might not have ready access to data to test and verify their hypotheses. Alternately, we could reason that the data are actually available to test management beliefs and their mental models but are not deployed effectively while making key strategic and tactical decisions. While until a few years ago, it might have been possible to make a case for the absence of good quality data, a number of recently published studies suggest that high-quality data are now widely available. Most organizations today live in an extremely data-rich environment. Recently reported statistics[3] suggest that over 160 exabytes (1 exabyte = 10^{18} bytes) of digital data were generated worldwide in 2006. This is the equivalent to 36 billion digital movies, 43 trillion digital songs, or 1 million digital copies of *every* book in the Library of Congress. In 2006, these books would represent about 6 tons of books for every man, woman, and child on earth—approximately the weight of a large adult elephant. By the end of 2010, this number was expected to grow to about 1,000 exabytes at a whopping 57% compounded annual growth rate and was projected to outpace the capacity to store such data. Another way to think of this volume of data is that in 2006, the digital universe was the equivalent of 12 stacks of books extending from the earth to the sun, or one stack of books twice around the earth's orbit. By the end of 2010, the stack of books could reach from the Sun to Pluto and back![4]

While a lot of the information, such as digital entertainment, is for consumer consumption, it is also generated by various for-profit and non-profit organizations through customer relationship management (CRM) systems, internal metrics and processes, as well as external organizational measures of sales and competitive activities. In 2006, about 25% of the worldwide digital data were generated in the workplace—approximately 40 exabytes. By the end of 2010, this volume is expected to rise to about 30%—about 300 exabytes. Wal-Mart's gargantuan database, for instance, has grown from 110 terabytes in 2000 (1 terabyte = 10^{12} bytes) to half a petabyte in 2004 (1 petabyte = 10^{21} bytes). These data are generated primarily to support internal decisions and provide information to other partners, such as suppliers in the value chain. The point is that an absence of adequate and readily available data no longer seems to be a justifiable reason for the pattern of intuition-based decision making that is rampant among various layers of management today. Instead, it is perhaps time for them to leverage the vast amounts of well-structured data at their disposal and to hone their skills to make more effective decisions.

Critical Leadership Skill

We believe that in this environment of data sufficiency and perhaps excess, coupled with the impatience of the investor community, a key managerial skill is the ability to sift through piles of data and hone in on those pieces of information that are most critical to organizational success. This requires decision makers to be quick and articulate in summarizing the situations they face, to convert them into sets of formal or informal hypotheses, to identify the data requirements to test the hypotheses, and then to make strategic calls at high speed.

For example, let us say that you are the country manager for a quick-serve restaurant in an emerging market. At the current juncture in the organizational evolution, you are faced with the task of increasing your market penetration. One morning, you hear unexpected and potentially game-changing news that a key competitor has big plans of entering the marketplace! Being from the trade, you recognize the competitor's likely entry strategy, but at best, it is an intelligent guess. What would you do? Would you make changes to your prices to attract more customers? How would you assess if you could afford it? Alternatively, would you seek greater retail outlet penetration? How would you know if you can find good sites at a fast pace? Would you spend more on advertising? Would you make changes to your menu items? Or would you do some combination of these possible reactions, or do nothing? Can all the learning from brand equity, segmentation, category and brand awareness, and pricing studies aid you? Think fast—time is running out!

How can this be done? While we will go into the details of the answer to this question, we will briefly illustrate the importance of this critical