UNLOCK Profit Potential

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Align marketing with financial performance.

BY JAMES LENSKOLD

Are you still questioning where return on investment (ROI) fits into your objectives, dashboards, and decision process? Maybe there's a concern that it's not the right metric. Maybe there's a bit of hope that this push for greater accountability will fade away, allowing you to avoid the pain and troubles of managing organizational change. Perhaps it's just a question of how to get ROI measurements and analyses under way. What marketers need to recognize is that implementing marketing ROI techniques generates valuable, actionable insight to guide more profitable returns for their marketing investments.

When we talk about using ROI to manage marketing performance, it's not about introducing a new calculation or replacing other marketing metrics. Instead, it's about establishing discipline and processes to guide strategic and tactical decisions. The importance of ROI is like the importance of the score in sports. We manage the score to maximize profit, where profit serves as the ultimate goal just like a win over the competition. As we do in many sports, marketers use lots of other metrics to track their performance toward their ultimate goal and diagnose their strategy to make adjustments.

For the most part, marketing ROI is gaining acceptance within corporate marketing. Measuring and managing the financial outcomes that result from our marketing activities, and ensuring that we generate more cash flow than we spend, is a healthy and productive undertaking that strengthens company performance. In companies adopting ROI processes, marketers unlock profit potential by understanding the financial dynamics of the business and how marketing influences and contributes to financial outcomes. Huge knowledge gaps are closing. Decisions are shifting and performance is improving as marketers get better data on which products, services, and customers are more profitable for the company. How can any marketing executive reject the opportunity to apply better insight and intelligence in their decision making?

Of course, there are still some influential experts who question the use of ROI as a primary marketing metric. Tim Ambler of the London Business School made a case against ROI and other financial metrics in his article, "Don't Cave in to Cave Dwellers" (*Marketing Management*, September/October 2006). I think very highly of Ambler and his work. But although he has contributed great insight to marketing performance metrics, I feel his position that "financial metrics are flawed" is incorrect and misleading. He conveys the message that "marketers need to escape from financial evaluations" when, in fact, embracing financial analysis is exactly what is needed to assume accountability and build credibility. As Dennis Dunlap, president of the American Marketing Association, said in his opening statement at Mplanet in November, "Half of Fortune 100 companies now have a CMO. This brings increased expectations of marketing. This is great for the industry, but with this increased emphasis, the importance of metrics and ROI are more crucial than ever."

Dispelling the Myths

Let's first set the record straight by addressing each of Ambler's six objections to ROI, which are listed here along with my counterpoint. I'll then identify the core principles critical to ROI success.

1. **Ambler:** "Marketing expenditure isn't an investment or treated that way in company accounts. Most marketing costs are for maintenance, and correctly treated as expenses."
   Lenskold: Companies must manage marketing as an investment to deliver on business objectives and earn credibility.

From a strictly accounting perspective, companies are treating marketing as an expense. Yet smart marketers know that managing the expenditure as an investment, and convincing

EXECUTIVE briefing

As companies continue to hold marketing executives to greater levels of accountability, they must determine whether ROI, or other financial metrics, can truly provide the insights they need to be accountable. ROI should not replace other marketing metrics but clearly needs to be central to improving marketing measurements and decision making. Without financial metrics, companies will continue to treat marketing as a discretionary expense managed by feel-good measurements that don't align with business objectives.

executives to do the same, allows them to focus on more profitable customers and longer-term strategies that drive profit contributions over time. Marketing ROI is a management process to maximize the incremental profits generated from marketing. Marketing is responsible for motivating customers and prospects through the buying cycle (customer funnel).

Marketers are not building strategies and tactical plans for "maintenance," and if they are, they need to better articulate their goals around acquiring, retaining, and growing customers in highly competitive markets. Even if you are in a market leader position, the marketing investment must influence prospects and customers through the stages of the buying cycle, which is more than just maintenance. Marketing that delivers no direct or indirect financial value back to the company in the short or long term is nothing more than an expense—one that should be eliminated.

Anyone questioning the value of financial metrics relative to traditional marketing metrics must look closely at the culture and operations of most marketing organizations to recognize it's time for change. Traditional marketing metrics tend to have no clear correlation to financial performance. Measurements fall short, and there is plenty of uncertainty as to marketing's impact. Last year's budget heavily drives marketing budgets without prioritization based on potential returns. Marketers use many metrics to rationalize the expense after the fact, not to guide effectiveness or efficiency. They are flying blind, using limited information to guide decisions, but many are open to accepting new information that provides better guidance toward the desired corporate destination.

2. **Ambler:** "ROI requires the profit to be divided by [the] expenditure."
   Lenskold: The ratio of return to investment provides additional insight and clear interpretation by marketers and executives.

There are some slight variations of the ROI calculation and other metrics, such as net present value (NPV) or discounted cash flows, which finance can use to assess the contribution of expenditures. In my opinion, the use of any financial metric is a huge step forward, and ROI belongs at the forefront because it is manageable and relatively easy to understand. Within a well-structured analytic and decision process that focuses on maximizing profits and optimizing spending, all these financial metrics will generally lead to the same decisions. ROI has the advantage based on the ability to clearly interpret the metric and incorporate it into a manageable process.

I advocate the formula:

$$\text{ROI} = \frac{(\text{NPV incremental gross margin} - \text{NPV marketing investment})}{\text{NPV marketing investment}}$$

Let's take an example of a $250,000 marketing investment that generates $400,000 in incremental profits for the company. This $400,000 is the NPV of the profit and expense cash flows generated as a result of our marketing. The ROI calculation is shown as:

$$\text{ROI} = \frac{\$400{,}000 - \$250{,}000}{\$250{,}000} = \frac{\$150{,}000}{\$250{,}000} = 60\%$$

The simplicity of this formula is that 0% is the break-even point (reached if your $250,000 investment generates just $250,000 in profits), positive ROI represents a positive contribution, and negative ROI represents a negative contribution. If you can earn more profits with the same budget, the return goes up as does the ROI. If you can earn the same profits with less budget, the investment goes down and the ROI goes up. The benefit of using a ratio is that it provides insight into the financial resources required to generate the return. Companies set an ROI threshold (or hurdle rate) above which they should fund marketing initiatives to meet financial objectives, which makes the objectives and decision process very straightforward.

Using the NPV financial metric, the calculation would show the value of this initiative as $150,000, which is the same as our "return." But the NPV value shows no difference between one campaign that used $250,000 to generate $400,000 in profits (resulting in an NPV of $150,000 and an ROI of 60%) and another campaign that required $2 million to generate $2.15 million (also a $150,000 NPV but resulting in an ROI of just 7.5%). The ROI process is much more effective at informing decisions to lead you toward the highest profit returns from your marketing budget. There is no flaw in dividing the return by the investment as the finance organization does for countless other investments within the company.

As with any good metric, the calculation alone does not generate the answer, and a good process is necessary to apply the

right techniques. Because we are maximizing profits and not ROI, we'll want to apply incremental ROI analysis.

3. **Ambler:** "ROI is maximized when profits are still growing." **Lenskold:** Incremental ROI determines the point of diminishing returns and maximizes profitability, which other metrics cannot easily do.

As I detailed in my *Marketing Management* article "Marketing ROI: Playing to Win" (May/June 2002), the goal is to maximize profits, not marketing ROI. Within the ROI process, we have the ability to use incremental ROI to identify the optimal marketing expenditure and maximize profits. Ambler's argument here is pointless because no marketing metric perfectly aligns with optimized profits. In fact, you're much more likely to see traditional metrics (e.g., response rates, cost per sale, brand awareness, market share, customer perceptions) increase while profits are decreasing than you are to run into the occasional situation where ROI is not aligned with profits. (See Exhibit 1.)

In our original ROI calculation, we showed an investment of $250,000 generating $400,000 in profits for a return of $150,000 and an ROI of 60%. If we're trying to determine the right strategy and spending level for a marketing campaign, we might find that as we enhance our campaign with additional spending, ROI indeed maximizes while profits are still growing as shown in the following example:

	Original	Alternative 1
Investment (Invt)	$250,000	$300,00
Gross margin (GM)	$400,000	$470,000
Return (GM-Invt)	$150,000	$170,000
ROI	60%	57%

Ambler's statement is technically correct in that profits can continue to increase while the actual ROI number decreases, so uninformed marketers maximizing ROI might choose the original version of the campaign with the higher ROI (60% vs. 57%) instead of the enhanced version where profit contribution (the return) increased from $150,000 to $170,000. Marketers should be running ROI analyses to determine whether an enhancement such as adding a new tactic, increasing the target audience reached, or increasing the ad spend in a market is worthwhile. But the analysis has to take the form of an incremental ROI analysis where we determine whether the incremental investment ($50,000 in this example) exceeds our ROI threshold or hurdle rate (let's use a 30% ROI threshold for this example).

The incremental ROI analysis is as follows:

	Original	Alternative 1	Incremental
Invt	$250,000	$300,00	$50,000
GM	$400,000	$470,000	$70,000
Return (GM-Invt)	$150,000	$170,000	$20,000
ROI	60%	57%	40%

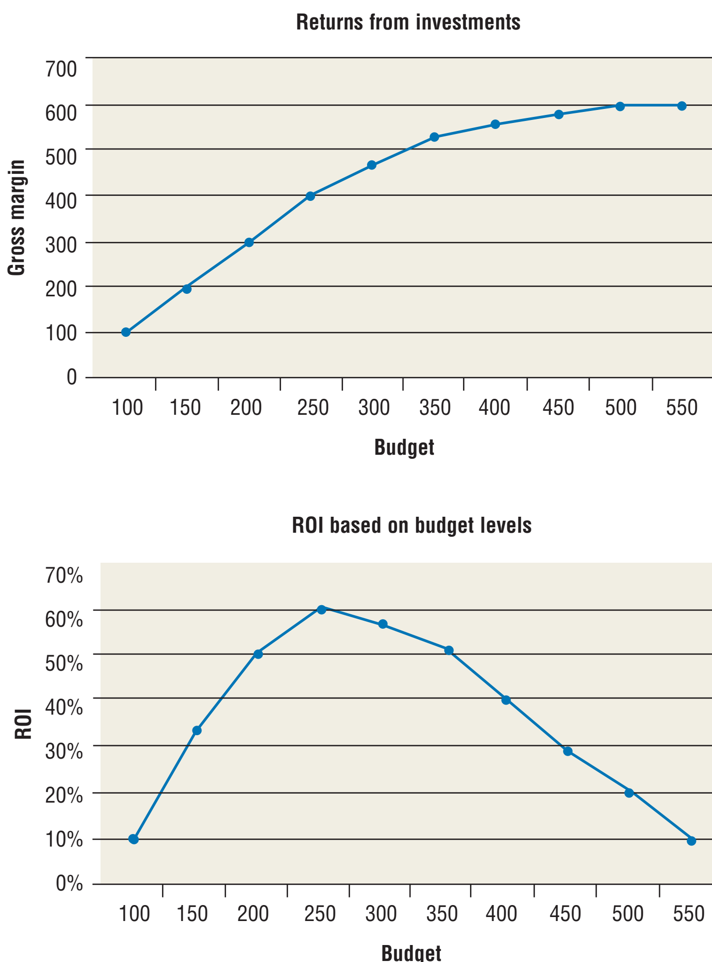
Here we see that the incremental investment of $50,000 generates a net return of $20,000, which is a 40% ROI. So appropriately applying ROI analysis leads us to the right decision as would an NPV analysis where we approve the decision based on a positive $20,000 NPV. But if we're relying on NPV as our metric, we will not always make the best decision.

	Alternative 1	Alternative 2	Incremental
Invt	$300,000	$350,00	$50,000
GM	$470,000	$530,000	$60,000
Return (GM-Invt)	$170,000	$180,000	$10,000
ROI	57%	51%	20%

Take the following example where we make another incremental investment of $50,000. We're once again running an incremental ROI analysis, this time comparing the first alternative with the second.

In this case, the profit contribution (the return) continues to increase by another $10,000 as ROI decreases. The $10,000 is a positive NPV, which would suggest we should pursue Alternative 2 as well. But this incremental ROI analysis shows that the ROI generated does not meet our ROI threshold of

Exhibit 1



30%. We have passed the point of diminishing returns and are close to optimizing the profits from this campaign. The $50,000 is better used on other marketing (or business) activities that can exceed the ROI threshold and deliver more than $10,000 in profits.

Used correctly, ROI offers the opportunity to guide marketing decisions toward profitability better than any other metric.

4. **Ambler:** "Calculating ROI requires knowing what would have happened if the incremental expenditure hadn't taken place. Few marketers have those figures."
   Lenskold: Marketing measurements to determine the incremental impact of marketing are critical for informed decision making.

Isn't the objective of any marketing measurement to determine the incremental impact of marketing? If we use metrics that don't isolate the impact of our marketing initiative, we're most likely accounting for the impact (positive or negative) from other marketing, sales, business, and external activities. It's not feasible to measure every marketing activity and investment decision based on limited resources and opportunities. We have to be smart and prioritize our measurements based on which analysis and insight can have the greatest impact on improving profits. Market testing (experimental design), modeling, quantitative market research, and pre-post trend analyses offer us plenty of opportunity to assess the incremental impact over the "baseline" activity of sales expected in the absence of the specific marketing activity we are measuring. The ROI process establishes the discipline of measurement that is often lacking and helps prioritize marketing measurements. We can't give up on the pursuit of measurements and analyses that offer such valuable insights into the impact of our marketing.

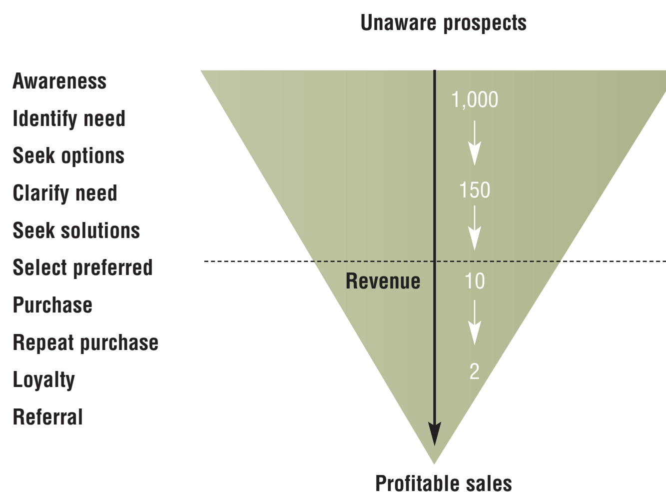
5. **Ambler:** "When executives discuss ROI with different metrics in mind, only confusion results."
   Lenskold: ROI is a meaningful metric to executives when marketing applies the same financial discipline with integrity and consistency.

One of the reasons ROI is such an important metric for marketing is that the CEO, chief financial officer, and other executives already understand and use the term. In fact, it will be less confusing and more meaningful to executives than gross rating points, brand awareness, net promoter scores, and the long list of metrics that have meaning only to marketers. ROI formulas for marketing should be consistent with the ROI formulas executives use throughout the company. Support and buy in from finance to develop and standardize the ROI calculation for marketing is critical for establishing credibility.

I do agree with Ambler's statement that "ROI has become a fashionable term for marketing productivity, and is used to describe any type of profit arising from marketing activities." If we are to build credibility outside of marketing, we need to mean what we say. Don't talk about ROI and then fail to deliver a good financial measure that meets those expectations. And if you do put an ROI metric in place, do yourself a favor and don't call it ROMI (return on marketing investment). We want to align marketing with the language of the business so instead of introducing a new term that has no clear meaning to executives, call it marketing ROI and deliver the level of financial integrity they would expect from any other ROI analysis.

Exhibit 2

Customer funnel



6. **Ambler:** "ROI ignores the effect on the marketing asset (brand equity) and the longer term."
   Lenskold: The ROI calculation effectively assesses the returns generated over any time period. Shortsighted decisions come from corporate culture and not the metric.

The ROI calculation and process are designed to account for long-term cash flow, without any time limitations. The flaw in short-term profitability does not come from the ROI metric, but from the corporate cultures that quarterly results drive. It's also a function of the unpredictability of longer term forecasts and the uncertainty that comes from a lack of quality measurements applied to long-term marketing initiatives. It's critical that marketing professionals avoid using terms such as "brand building" and "long-term impact" as an excuse to reject any financial analysis and to expect no short-term results. ROI is a great tool for marketers to articulate a long-term plan, showing the series of marketing investments and the impact on incremental sales that will result over time. There will be plenty of "unknowns" in those assumptions and marketers must incorporate that level of risk into the decision process as well.

It's true that no single metric can be used to manage marketing. It's also true that some metrics, such as ROI, are better

suited for managing and maximizing financial outcomes. Traditional marketing metrics are very important for diagnosing the strengths and weaknesses of your marketing, but can be misleading if you use them without an understanding of their relevance to financial metrics. And no other metric will satisfy the executive question: "What am I getting from my marketing expenditures?"

There are plenty of companies already achieving success with ROI and they are inspiring others to improve their practices as well. The biggest error any marketing organization can make is managing without ROI or other financial measures and letting the competition earn a greater share of profitable customers. Marketers who adopt the ROI process apply financial insight and measurement discipline to guide their decisions, continuously improving their performance.

Core Principles for Effective Use

Set your goals and design your measurements to treat your budget as a "managed investment" and not a "justified expense." If you have the mind-set of justifying your expenses, your measurements will tend to look back at the marketing initiatives just completed. Measurements obviously follow the marketing but the objective of the measurements will differ. The real opportunity comes when measurement objectives shift from closing out previous marketing to providing insight for future marketing. As we shift to the mind-set of marketing as a managed investment, our measurements and analyses are done for the purpose of spending our next marketing dollar smarter and more effectively than the previous marketing dollar. Profitability improvements come from applying ROI tools and insight in the planning stages.

Establish a financial framework that helps marketing understand key profit drivers and how marketing's impact contributes to bottom-line impact. Better information is needed to know how sales and revenues net to profits, which products and services are more profitable, and which customer segments are more profitable. This insight alone sometimes has significant impact on marketing decisions.

Integrate your strategies and measurements across the customer funnel. Marketing's role is to motivate customers through the various stages of the buying cycle (or customer funnel). (See Exhibit 2.) Different marketing initiatives play different roles in motivating customer perception and actions, so the funnel provides a common framework and an opportunity to assess the contribution toward the ultimate points of generating sales and profitable relationships. Improvement in metrics that one portion of this funnel (e.g., improving awareness, consideration, inquiries) drives can only generate profits if other marketing initiatives successfully continue that progression to purchasing.

Use incremental ROI to optimize spending levels and maximize profitability. As shown in the examples, our goal is to maximize profits and not ROI. We are able to optimize spending levels by assessing the incremental ROI, which ensures the incremental marketing investment generates enough incremental profits to meet the company's financial objectives. ROI most closely aligns with profitability and therefore deserves to be the central metric in decision making. A diverse set of marketing metrics for predicting and diagnosing marketing effectiveness supports this.

Quantify your assumptions in the planning stage. ROI tools and analyses in the planning stage can unlock profit potential, even using very rough assumptions to link marketing impact on customer behaviors and the financial outcomes that follow. Quite often this analysis can identify marketing initiatives that have no chance of being profitable or guide adjustments to improve profitability. Think of this exercise of quantifying your assumptions as "financial intelligence"—which one uses like market intelligence, customer intelligence, and competitive intelligence—to guide your strategic and tactical decisions. Over time, better measurements will improve the reliability of assumptions.

Align ROI assessment to your strategic or tactical decision, large or small. ROI analysis works at all levels of marketing to provide valuable insight into single marketing initiatives, integrated multichannel campaigns, subcomponents of a campaign (such as offers), segment-driven marketing, or long-term brand initiatives. We apply the same approach and process, although the demands for more data and the quality of assumptions will vary as our marketing initiatives get more complex.

Marketers can't hide behind meaningless metrics. Over many decades, marketing professionals have let metrics that were easy to measure become their objectives. We need to realign our objectives with business objectives and demonstrate that we can apply greater accountability to deliver clear financial contributions. No one can fully predict the future, but it's clear that better intelligence and the right metrics can keep us on course and potentially ahead of the competition. We track profit contribution and ROI to know how well we are doing and rely on brand, customer, service, and funnel metrics to know what is working and where improvements are necessary.

The ROI process helps us not only better manage marketing profitability, but also make informed decisions with our sales, product, and service peers on how their efforts are influencing customer profitability. We can take small steps with ROI to guide basic decisions and start earning credibility right away. Other metrics are critical but do not offer the same benefits and opportunities. ■

About the Author

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