Marketing ROI: playing to win

On the profit scorecard, ROI is the measure that counts.

By James D. Lenskold

There is no better example of events measured by winners and losers than sports games. At the end of the day, someone has more points, runs, or goals and is determined the winner. While the statistics are plentiful, those points, runs, or goals are the ultimate measurement of success. Similarly, all good marketers live and die by measurements of their results. Projections are made, marketing is delivered, results are measured, and the knowledge is applied to guide future marketing. Many marketing measurements serve marketers well, but many also are used inconsistently or inappropriately. The three-tiered hierarchy of marketing measurements presented here helps clarify the relationship among measurements and provides some guidelines for using them.

EXECUTIVE briefing

As marketing budgets get leaner, the pressure is on to deliver more profits. To develop effective strategies for doing this, marketers need clear measurements. Unfortunately, measurements other than ROI are incomplete and can lead to misguided spending and lost profits. The ROI measure can account for all costs and the complete customer value to prioritize marketing investments and maximize profits. Other marketing measures are merely performance indicators useful in improving the ROI of marketing programs.

Tier 1: Profits and ROI

Just as sports teams exist for the sole purpose of winning, companies exist for the sole purpose of generating profits. Maximizing profits is more important than all other long-term goals related to revenues, customers, satisfaction, or brand. These other goals cannot be ignored, however, because achieving them is essential to attaining the long-term profit goals.

While the scorecard is measured in profits, return on investment (ROI) is actually the most critical measure of marketing programs for basing decisions that will help maximize company profits. The ROI measure takes into account the limited budget resources available and establishes a clear view of the priorities for allocating the budget. Maximizing ROI is not the same as maximizing profits, but the ROI measurement tool enables valuable decision making at the corporate, department, and campaign level for marketing. (See sidebar on page 35.)

ROI in its simplest form looks like this:

$$ROI = \frac{[\text{Net Present Value of Profits \& Expenses}] - \text{Investment}}{\text{Investment}}$$

The "Investment" represents the marketing expense, and the "Net Present Value of Profits & Expenses" represents the resulting flow of profits and expenses, with future cash flow discounted back to reflect the time-value of money.

The ROI measure incorporates all the essential information necessary to guide decision making. It includes the factors that drive both value and expenses and can be customized to balance long-term and short-term profits using discount rates. It can be designed to include a monetary value for "strategic" decisions such as customer relationships that may be perceived as difficult to quantify. No other marketing measure can fully align with the company's primary goal and ensure the best decisions are being made.

The return on marketing investments is integral to strategic decisions at any level of the business. At the corporate level, a standardized ROI measurement can simplify the budget-allocation process for funding marketing programs. At the department level, measuring the combined ROI of related marketing programs can lead to a more profitable approach to managing customer segments. And at the marketing campaign level, using ROI measures for promotion planning and market testing can guide the development of strategies and tactics.

There are certainly challenges in measuring ROI, which is why many marketing organizations haven't fully adopted it as a primary measure. According to Accenture's *Insight Driven Marketing* report, a 2001 survey of 175 marketing executives in the United States and United Kingdom reveals that 68% reported having difficulty measuring the ROI of their marketing campaigns. Key challenges include projecting future customer value, establishing reliable control groups, and tracking results in multi-channel marketing environments.

These days, adoption of ROI marketing measurements is becoming more of an organizational issue than one of measurability. The advancements in customer relationship management (CRM) and business intelligence technology are making data more accessible and simplifying the analysis process. As innovative approaches close the gaps in ROI measurements, companies will need to create a solid understanding of how ROI can be used and install a culture that removes subjectivity in budget allocations and results measurements. Better ROI measurements may be the most cost-effective way to squeeze additional profits from the same marketing budget.

Tier 2: ROI Subcomponents

If you're aiming to outscore your opponents for the win, you need to monitor your performance in what you gain on offense and what you give up on defense. The same applies to what you gain in the return from marketing activities and what you give up on investment. The second tier of marketing contains measures that feed into the ROI measurement. Three key components of the ROI equation can be used to measure and plan marketing initiatives:

- **Customer lifetime value (CLV)**, which represents the net present value of profit from the stream of customer transactions resulting from the investment. ROI improves as this increases.

- **Total number of customers** generated from the marketing investment. ROI improves as this increases—so long as the CLV per customer is greater than the marketing expense per customer.

- **Marketing expense**, which is the total investment made with the expectation of generating a return. ROI improves as this decreases.

Customer lifetime value captures the impact of marketing on purchasing behavior and can be a valuable measurement for targeting marketing activities. Marketing campaigns intended to increase the profit per customer or improve retention rates

depend on measurement of the CLV to demonstrate results. Measuring CLV allows marketers to plan marketing efforts and extend offers to customers and prospects that are expected to have a higher value to the company.

The measures of marketing expense and total number of customers are typically in the form of cost per sale and conversion rate (number of customers gained per the target quantity), respectively. Before technology made sales data more accessible, each new customer was assumed to be of equal value, and these measures could be used to compare different marketing programs. Marketers can use cost per sale and conversion rate measurements as benchmarks for goals or performance improvement.

All three measures—total number of customers, marketing expense, and CLV—are less effective on their own than when used in combination as an ROI measurement. Increasing the number of customers can cause the company to lose profits if the value of the customer isn't considered. Increasing the marketing expense can increase company profits if directed toward results for high-value customers.

The CLV measure has become more important to marketers, but it too should be used with caution. Many marketing experts and CRM gurus proclaim that the ideal path to profits is to maximize CLV. Two good examples demonstrate how this approach has been applied at the expense of profits when used without the proper ROI analysis. The first lesson can be learned from companies that have lost profits by targeting only high value customers. The second comes from a report that neglected to look at the big picture of marketing investments.

Using CRM technology to target only the highest value customers without applying an ROI analysis to guide investments has led some companies to market to a much smaller segment of customers while missing opportunities with other customer segments. With this approach, the companies achieve their objective of significantly increasing the average CLV, but, as the total number of customers decreased, the total profits suffered. A well-designed ROI measurement process will determine exactly how focused the targeting should be to maximize profits. It may be best to target the top 10% or it may be best to target the top 90%.

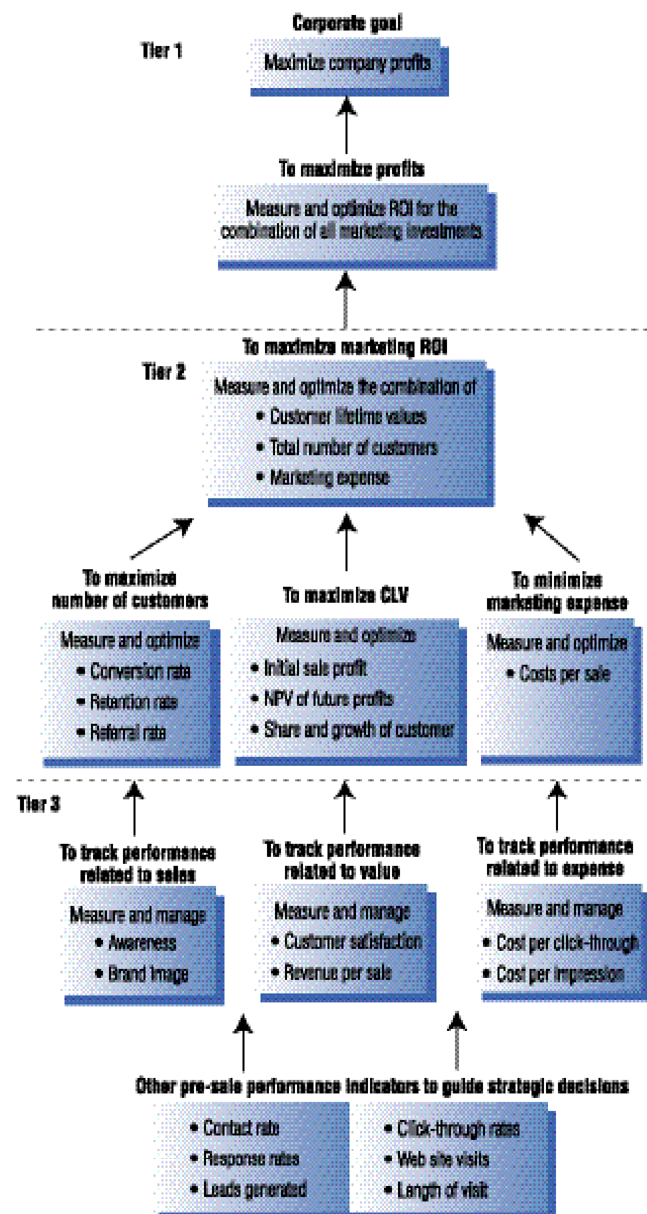
The second lesson comes from the theory that a 20% increase in customer lifetime value generates more profits than a 20% decrease in acquisition marketing expenses. The lack of an ROI analysis leads to an inaccurate conclusion that will, in fact, decrease company profits. The ROI analysis takes into consideration both the value and expense side of the equation. When acquisition costs are cut by 20%, that budget savings can then be moved from the original investment into a new one. From the company's perspective, the comparisons must be made on the total profit that can be generated with equal levels of investment. (The complete analysis is available online at www.lenskold.com/clvanalysis).

Tier 3: Performance Indicators

There's a reason why sports statistics are available on such a level of detail as a batting average against left-handed pitchers in double-headers on the home field in the rain. These are the measurements that help guide the tactical and more defined strategic decisions that make winning possible.

The measurements in this next tier are considered "performance indicators." A partial list of performance indicators is shown on the marketing measurement hierarchy diagram. (See Exhibit 1.) These are not effective for measuring success or guiding investments, but are valuable in improving marketing effectiveness. As obvious as this may be, it was only a few years ago that the results for such online measurements as Web hits, click-

EXHIBIT 1
Marketing measurement hierarchy



through rates, or "stickiness" were held in high esteem, attracting capital and skyrocketing company valuations. The dot-com fall-out was a clear signal that performance indicators don't always correlate with the company goal of generating profits.

Performance indicators have their place in forming and modifying marketing strategies. To generate profits, marketers must move prospective customers completely through the sales process from initial awareness and interest to completed and continued profitable transactions. This may involve a single marketing promotion or the integration of multiple marketing campaigns. By monitoring performance indicators that align with progress toward a closed sale, marketers can understand what marketing techniques and channels are effective at driving certain actions and identify weak areas in need of improvement. For example, if a marketing campaign is effective at driving the right prospects to the company Web site, but can't convert sales effectively, modifications can be made.

Using ROI Measures Strategically

While each measure has its value in the strategic process, the ROI measure offers the greatest benefit to marketers. Because it aligns with the company's primary goal, ROI can be used as a tool in the planning and decision-making process.

Marketers can use ROI for strategic guidance in the following ways:

- Optimizing profits generated from a company's overall marketing investments
- Measuring the combined value of integrated campaigns relative to individual campaigns
- Comparing marketing campaign effectiveness more accurately
- Understanding exactly how investments in retention marketing compare to acquisition marketing
- Setting investment limits per customer or prospect
- Segmenting customers for tiered levels of CRM investments
- Developing strategies based on customer life cycle and customer lifetime value
- Projecting the incremental results required for additional incentives and discounts
- Determining the ideal marketing budget
- Prioritizing budget cuts based on maximizing either short-term or long-term profits
- Identifying weak marketing areas in communications over a customer life cycle
- Guiding decisions following sunk-cost investments

Several key steps are necessary to integrate ROI measurements and tools into the organization. The calculations and tracking procedures for both ROI and CLV should be standardized so decisions can be based on consistent and accurate information. Research is sometimes required to establish benchmark values that can be used in projection assumptions. The company also may want to establish guidelines for allocating expenses such as development, brand advertising, or overhead costs.

The most important step a company must take, of course, is training employees to build their skills and create a buy-in to the value of "running the numbers" for ROI analyses. Financial measurements are not typically a key strength or area of interest for marketers. With systems in place to handle the calculations, marketing employees can focus on using ROI to develop more effective strategies. Once they have first-hand experience, they'll come to appreciate the greater performance benefits that ROI provides and help lead their team to a win. ■

About the Author

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Maximizing Profits or ROI?

The return on investment (ROI) is a percentage that relates the "return" to the "investment" and is one of the most important measures for planning and assessing marketing activities. The return is the net profit generated, less the investment. For example, if you start your marketing effort with $100,000 and generate $150,000 in net profit, your return is $50,000. The ROI is $50,000/$100,000 or 50%. Individual investors expect different levels of return on their investments into a savings account, a mutual fund, or a company stock. Similarly, the company in turn must generate a return on its marketing investments in excess of a certain ROI threshold in order to achieve its profit objectives.

So what's the main difference between maximizing profits and maximizing ROI? Basically, profit is a hard number that aligns directly with the company goal, and ROI is a percentage that puts the profit into perspective by making it relative to the investment. Companies clearly want to maximize profits in the long term. ROI does not need to be maximized. Rather, it needs to be optimized to generate as much profit as possible within the company parameters that drive the level of investment.

An example based on a single marketing campaign illustrates two approaches to optimizing ROI. Most marketers understand that it's typically desirable to improve profitability by targeting marketing efforts to reach the best prospects. Targeting can improve profitability when the cost per sale is decreased by removing expected non-responders from the campaign. Targeting can also generate a higher value per sale. As the target is further narrowed, the ROI can increase quite significantly. For example:

	Original Campaign Z	Targeted Campaign Z
Marketing Investment	$500,000	$100,000
Target Population	750,000	150,000
Profit (NPV)	$600,000	$150,000
Return (profit – investment)	$100,000	$50,000
ROI (return/investment)	20%	50%

The results show that ROI will increase through targeting. An investment that generates a 50% return is much more attractive than one that generates a 20% return. However, the company will gain a net return of $100,000 with the original campaign and a total of only $50,000 with the targeted campaign. The company's purpose is to maximize profits, so improving ROI in this simplified scenario of just two campaigns doesn't contribute to that goal.

Two options for ROI optimization can be used to generate the most profits from a company's portfolio of marketing investments.

Option 1: Prioritize the Marketing Budget

The more common approach to budget allocation using ROI is to rank the different marketing investment opportunities available to the company and allocate the fixed marketing budget to the best performing programs. In a greatly simplified example, here are planned marketing campaigns in addition to the new Campaign Z listed previously:

Marketing Opportunity	Investment	ROI
Campaign A	$300,000	110%
Campaign B	$600,000	60%
Campaign C	$200,000	40%
Campaign D	$900,000	30%

With a fixed budget of $1 million, the company would first invest in Campaigns A and B. The initial example above showed that a targeted Campaign Z can achieve a 50% ROI with an investment of $100,000. This new campaign gets prioritized ahead of Campaign C. The three selected campaigns happen to add up evenly to the available budget, but in reality the budget would most likely allow for partial funding of one of these campaigns. The company would need to perform additional analysis on the ROI of the partial investment.

Option 2: Exceed a Pre-Set ROI Threshold

A more appropriate approach is for the company executives to set a minimum ROI threshold (also known as a "hurdle" rate) above which all marketing activities would be funded. This can be set based on the company's requirement for achieving profit objectives or based on its ability to secure capital from the investment market.

The company executives may set an ROI threshold of 35%. In the example above, the company would then fully fund Campaigns A, B, C, and the targeted Campaign Z. The marketers would then conduct market tests to determine how to bring the performance of Campaign D above the ROI threshold.

In this approach, the company has empowered its marketing team to make investment decisions that exceed the ROI threshold. Imagine using an ROI threshold along with a standardized process for projecting ROI to fund marketing programs in place of the more traditional and chaotic process of allocating and re-allocating marketing budgets. A full commitment to using ROI throughout the marketing organization can eliminate the competition for budget, the distractions of the budget-cutting process, the subjectivity in allocating funds, and the lost revenue that comes from a budgeting process that's far from optimized.