Questions directors should ask

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Bringing brands to the boardroom

"On average, the CEOs of US corporations lose half their customers every five years. This fact shocks most people. It shocks the CEOs themselves, most of whom have little insight into the causes of customer exodus, let alone the cures..." So said Frederick Reichheld, one of the world's leading commentators on customer and employee loyalty, in the Harvard Business Review of March/April 1997. There is little reason to believe much has changed.

As a company director you might be thinking that you can't be responsible for customers as well. Isn't that someone else's job, the marketing department, the sales people, the client service division - didn't we outsource that?

There are many people in every organisation who see brands, brand value and customers as their business. Yet many advertising campaigns costing millions of dollars flop every year. So where does that leave the bosses?

Even today with the increased focus on corporate governance, directors can't afford to lose sight of their real job, which is protecting and increasing shareholder value. And brands and their value relate directly to shareholder value.

The equity associated with brands is valued by shareholders as being worth literally billions of dollars. As early as the 1980s, companies in the UK were putting a value on the intangible "goodwill" they acquired when they bought companies at high multiples for the brands they owned. Consumer brand companies have the highest ratio of intangible to book value. Companies that have good brands attract a greater share P/E ratio and it has been estimated that over 70 per cent of the value of Fortune 500 companies resides in intangible assets.

A recent study of the ten-year performance of Standard and Poor's companies by Josh McQueen, worldwide director of brand value for Roy Morgan, showed share price is mostly under the company's control. Specifically, 80 per cent of any increase in shareholder value can be attributed to seven key factors. Corporate earnings and earnings forecasts were the most important, followed closely by investing in the brand, leveraging innovation and diversification. Cost reduction and cost containment were relatively weak contributors to share price.

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Brand valuation models often use a process that essentially seeks to value brands using a discounted cash flow measure. An estimate is made of future earnings, derived from current sales and the financial analyst's projected earnings for the brand. A deduction is made for the cost of capital or tangible assets and other intangible assets not associated with the brand. Profits are then discounted to a present value (NPV) based on how risky the projected earnings are in reality.

While this affects the financial value that can be attributed to a brand, what is missing for most directors is a thorough understanding of the mechanisms needed to protect the brand value, grow the brand value and evaluate and act on risks and threats to the brand.

And it is not only consumer brands where this kind of thinking is important. In business to business an understanding of brand equity is of as great, if not greater, importance.

The heart of brand equity

It is fairly obvious that consumers vary widely in their level of category purchase, and thus in their value to a brand. It is also fairly obvious that even within the high value segment of the market there are those who are loyal to a brand - these usually represent only a small minority of users, but almost always represent a majority of volume and profitability - and those who are not loyal but rather have a repertoire of brands they use.

What is less well known, but has been shown to be true over many different categories by McQueen, is that people's pattern of buying and level of involvement is more stable than the brands they choose. If someone is loyal to a brand and becomes disaffected, they usually shift entirely to another brand, not to a wide variety of different brands. If someone uses a number of brands and adopts a brand, that brand will rarely be given a higher share than the brand it displaced from the buying repertoire. This, of course, means that there is an inherently different value and risk profile for loyal vs. repertoire consumers.

There is one more element that must be kept in mind. The loyal users who use one brand predominantly today, but have a low affinity with it or are disaffected for whatever reason, represent an inherently high risk of defection.

There are many examples which come to mind - the airline which has all the flight routes covered but which you would not use given an alternative, or the bank which really doesn't suit your needs but is the only one which still has a branch in the area where your business operates.

Risk analysis and growth projections can and should be applied differentially to different consumer segments. For instance, the recent ANZ purchase of the NZ National Bank brings with it the inherent risk that high value loyal NZNB customers will have, at best, low affinity for the new owner of their bank and at worst, real antagonism.

When the Commonwealth Bank took over the State Bank of Victoria, an exodus of customers left for the relatively new Bank of Melbourne. Yet when Westpac took over Bank of Melbourne the valued customers were generally retained. Was it just an accident?

There are different risks associated with each customer segment and different strategic agendas for each. Since price-driven consumers are impacted by relative price, there is less ability to count on future purchases based on history. This is particularly important for databases built by clients based on those who have responded to offers, sweepstakes, and use of coupons.

Loyal customers who have stayed with a brand through price increases in the past can more safely be assumed to stay with the brand in the future and offer less brand volume and profitability changes.

Those who are behaviourally loyal but have low brand affinity represent a high risk of defection for the brand they are with today, and a potential windfall for the brand that can prevent their purchase tomorrow.

Take "Brand Australia". Recent Roy Morgan International research has identified large numbers of Americans and Brits who would like to travel to Australia but go elsewhere in the belief that the cost of travel to Australia is too high. A change in the perceived economics (the total cost is in fact no higher than most European destinations) could see a major increase in brand value.

Brand segmentation

Mass media like TV, national newspapers and national radio, which are useful in building and sustaining brand awareness, should not be targeted at loyal customers. These should be targeted at light buyers who have lower levels of awareness, but who can be profitable because they are unlikely to be "savvy" about the price and offer. In-store, on-pack, internet sites, and personalised direct marketing efforts would be better vehicles for loyal customers.

As an analogy, if you have deep vein thrombosis and are misdiagnosed as having had a heart attack, the best heart experts and the latest and most sophisticated equipment will probably not save you.

Similarly, if your brand value is at risk because your loyal customer base is disenfranchised and you misdiagnose it as a competitive threat due to a price war, even a brilliantly executed mass ad campaign could be the death of your brand.

The real danger area is obviously in a takeover. Often the takeover is designed to provide a valuable customer base. The board's challenge is to ensure the value in the new company is maintained and enhanced.

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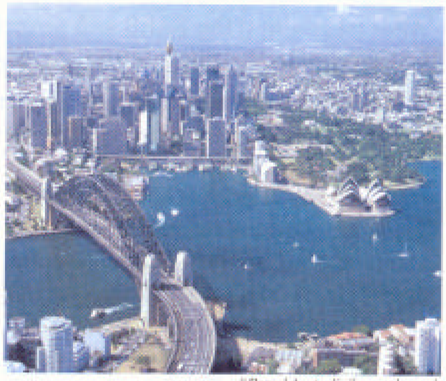

"Brand Australia" - needs work

Demystifying the business of brands and brand value

The balanced scorecard of Kaplan and Norton has been widely used to translate a corporation's mission, strategies and goals into relevant objectives and measures for future development. When it comes to brands, marketing, advertising and customers, the scorecard has not been so well articulated.

Questions directors should ask

- How confident can we be of the NPV associated with the brand?
- What are the assumptions about market share, customer retention and underlying profitability?
- What is the risk to the NPV?
- How much of the company's profit is in high value segments?
- What in the strategic plan/marketing plan is designed to protect the brand?
- What is designed to grow the value?
- What sales growth is required to meet targets?
- Where will it come from?

Directors need to be able to demystify what experts do. It is important to be able to step back and ask the right questions. One of the difficulties a board has is linking the experts' KPIs to the strategy and KPIs of the company. Common language is critical.

Directors looking at the plethora of research studies, market segmentation and advertising campaigns could be forgiven for not seeing how they translate into financials - other than the obvious, if nebulous, sense that if a brand is perceived well, then it is probably more valuable.

McQueen points out that brand equity has three major components: brand differentiation, brand strength and brand valuation. Brand differentiation resides in the perceptions consumers have about the brand and its differential attributes. Brand strength tangibly translates to share price through brand valuation - the cash-flow to the corporation that can be uniquely identified as coming from the brand when discounted by the cost of capital to maintain and build the brand, and by the volatility of those brand-based earnings.

The marketing group will use brand differentiation and brand strength as essential elements of diagnosing relevant courses of action to develop strategies, consumer communication, and efficiently allocate and gauge the often multi-millions of media dollars placed against these segments.

The finance group will use brand strength and brand valuation in assessing the actionability of marketing proposals and linking activities to shareholder value. Thus, brand strength is the crucial link between marketing and finance.

Armed with a common language, and relevant linkages, it is possible to articulate the business objectives of marketing, advertising, segmentation, customer intimacy programs and loyalty programs and to rationally allocate budgets or evaluate proposed budget allocations to marketing, product development, diversification, portfolio management, merger and acquisition strategies or divestment strategies.

There is a framework for the board to direct the business of brands and seek accountability. As a director, you probably do have lots of people looking after your customers and your brands. But the board is ultimately responsible for the value of the brand and its growth. ■