Theme of the Book

“Marketing as a discipline has failed during the past 50 years by concentrating on promotion rather than on developing world-class marketing strategies…..The result of this sad lack of marketing leadership is the demise of our erstwhile famous organizations.”

All of this happened against a background of three major challenges that industry was facing during this period and still faces i.e. maturity in demand in many markets, globalization, and a massive shift of power away from suppliers to customers.

*The crux of the matter is failure to align marketing with the fundamental shareholder value objective.*

Most marketing plans do not explicitly take account of the risks associated with proposed marketing strategies. What CEOs and Boards need is a way of measuring those risks and hence the likely shareholder value creation of marketing strategies. This is the aim of Marketing Due Diligence, a new process that has emerged from years of research at Cranfield.
Key Learning Points

- Marketing Due Diligence, unlike other measures of market performance, measures specifically at the most fundamental strategic level rather than the tactical or promotional level. Its objective is to improve the marketing strategy in terms of its ability to create shareholder value i.e. a rate of return in excess of the cost of capital employed.

- The focus of the Marketing Due Diligence process is explicitly to take account of all the risks associated with marketing strategies and to highlight the likely impact of the key risk factors on shareholder value creation.

- Most marketing plans tend to focus on predicting outcomes and do not explicitly take account of the risks associated with proposed marketing strategies.

- The Marketing Due Diligence process has two phases. The diagnostic phase identifies the critical risks associated with the proposed marketing strategy which have the greatest impact on the predicted financial outcomes. The therapeutic part of the process concentrates on these critical risks and assesses whether modifications to the originally proposed marketing strategy could significantly reduce them and, as a result, increase the shareholder value created.

- Marketing Due Diligence disassembles business risk into three discrete but interlinked risks categories viz. market risk, share risk, and profit risk, each of which is further subdivided into five sub-components.
1. Introduction

CEOs need a way of holding marketing accountable. Methods for measuring the effectiveness of the more obvious marketing activities (i.e. promotional activities and design and delivery of the ‘marketing mix’) have been in place for years. While these tactical measures have their place, they tell us little about the effectiveness of the marketing strategy, that part of the marketing process that concerns itself with understanding the market and deciding what parts of it to focus upon and with what value propositions. In effect the same rigour fails to be applied to the real issue, which is marketing’s strategic role of creating shareholder value by ensuring returns on investment over and above the cost of capital, having taken proper account of the risks associated with the strategy.

2. The Connection between Marketing and Shareholder Value

The traditional view of a great leader comes from the ‘born to lead’ school. However there has been a move away from this towards the self-development school of leadership as the 20th century progressed. Complex national and international organisations point to a required emphasis on the self-development school. The reason is complexity, and also diversity. The complexity arises from the constantly changing nature of organisation: numerous mergers, acquisitions, divestments that take place today and the knowledge that you can realise capital gain by buying and selling bits of businesses or whole businesses.

The diversity arises from governance, laws, ethics, different morals across the world which require individuals and corporations to behave in varying ways on a global basis.

So on this premise, where you have so many people, requiring so much of the corporation, plus governments intervening with the corporation, how can one man or one woman successfully lead the organisation? So the response to cope with both
complexity and diversity is to have high performing, sophisticated leadership teams.

Added to complexity and diversity is sophistication, with an educated population, where you have an interested and all consuming market, no one person can drive that. The required leadership strength has to be drawn from a number of people at senior level and they need to behave as a team. In this situation, it is clear that organisations need high-performing teams; but establishing leadership teams is not the final solution, teams need to be developed to succeed.

3. A Process of Marketing Due Diligence

Marketing Due Diligence, unlike other measures of marketing performance, measures at the most fundamental strategic level rather than the tactical or promotional level. Its objective is to improve the marketing strategy in terms of its ability to create shareholder value.

The process involves the following steps viz.

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<th>Step 1</th>
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<td>Explicating the strategy</td>
<td>Assessing the risks</td>
<td>Assessing shareholder value creation</td>
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<td>Uncovering the strategy from written and unwritten sources.</td>
<td>Assessing the business risk of the now explicit strategy</td>
<td>Calculating the shareholder value creation of the plan after allowing for risk.</td>
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Step 1: Explication of the marketing strategy

It is reasonable to assume that marketing strategy is laid out in the business plan. In practice, however, this is not the case. The important detail of the strategy, which reveals its inherent risk, is, for instance, often held in the heads of the executives as implicit and unspoken strategy decisions that have important ramifications for the probability of the plan working.

Explicating the strategy not only provides the basis for assessing the risks associated with its key assumptions but also serves to identify the gaps, inconsistencies and errors that can result from even the most rigorous strategic planning process.

Stage 2: Risk assessment of the marketing strategy

The whole basis of shareholder value is the direct linking of the level of risk to the level of financial return that is required. Financial markets assess risk through the volatility in the financial returns generated by a business. Thus, any increase in volatility results in an increased risk perception which leads, inevitably, to the compensating requirement for a higher return on the part of the external investor. The ability to respond to potential volatility so as to mitigate its impact will reduce the risk perception of a marketing strategy and thus increase the potential shareholder value creation of the expected financial outcome.

Whilst it will never be possible to eliminate business risk entirely, it is possible to reduce it to a practical minimum. In doing so, what risk remains is identified, located and most importantly understood so that it can be actively managed. Business risk is the combination of the following three risks viz.

Market Risk

Market risk arises from the possibility that the market may not be as large as hoped for in the business plan. It is to a large extent a function of the novelty of the business plan. Strategies involving new customers and/or new products are more likely to have higher market risk than those involving existing products and customers.
Assessment of market risk involves an objective judgement of the probability that the market may not be as large as expected. The research that underpins this book revealed that market risk was accurately quantified if five sub-components were assessed and combined into an aggregate value for market risk viz.

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<th>Product category risk</th>
<th>The risk that the entire product category may be smaller than planned. It is higher if the product category is novel and lower if the product category is well established.</th>
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<tr>
<td>Market existence risk</td>
<td>The risk that the target segment may be smaller than planned. It is higher if it is a new segment and lower if the segment is well established.</td>
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<td>Sales volume risk</td>
<td>The risk that sales volumes will be lower than planned. It is higher if sales volumes are ‘guessed’ with little supporting evidence and lower if the sales volumes are well supported by evidence such as market research.</td>
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<tr>
<td>Forecast risk</td>
<td>The risk that the market will grow less quickly than planned. It is higher if forecast market growth exceeds historical trends and lower if it is line with or below historical growth.</td>
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<tr>
<td>Pricing risk</td>
<td>The risk that the price levels in the market will be lower than planned. It is higher if pricing assumptions are optimistic and lower if they are conservative.</td>
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Together, the five components represent all of the significant assumptions made and risks taken regarding market size.

Share Risk

Share risk arises from the possibility that the plan may not deliver the hoped for market share. It is the corollary of the competitive strength of the strategy. Share risk is reduced when homogeneous segments are targeted with specifically tailored value propositions which leverage strengths, negate weaknesses, avoid direct competition and anticipate future trends.
Whilst market risk is a function of both market choice and strategy design, share risk flows solely from the strategic decisions on which the plan is based. A strong strategy has a high probability of delivering the planned share, whilst a weak strategy has a high probability of failing to meet its promises. The challenge, therefore, is to understand what constitutes a strong strategy compared to a weak one.

Again the research foundations of this book considered the issue of strategy strength and share risk and again a pattern of consistent factors emerged which clearly differentiated strong strategies from weak, risky ones. This pattern revealed that the choice of target markets and value propositions can be objectively assessed against five criteria again representing five sub-components of share risk viz.

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<th><strong>Target market risk</strong></th>
<th>The risk that the value proposition will appeal only to a minority of the customers targeted. It is low when each target segment is homogeneous in its needs and high when each segment is heterogeneous in what it seeks</th>
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<tr>
<td><strong>Proposition risk</strong></td>
<td>The risk that the value proposition will not be quite right for any of the customers targeted. It is low when the strategy involves making specific offers to each of the customers targeted and high when the strategy involves a single offer to the whole of a segmented market</td>
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<td><strong>SWOT risk</strong></td>
<td>The risk that the strategy does not make good use of the company’s strengths and does not compensate for its weaknesses. It is low when the targeting reflects the distinctive competences of the company and high when it fails to understand them</td>
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<td><strong>Uniqueness risk</strong></td>
<td>The risk that the strategy competes ‘head-on’ with the competitors. It is higher if the choice of target market and the value proposition are very similar to the competition and lower if they are very different.</td>
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<td><strong>Future risk</strong></td>
<td>The risk that the strategy fails to take proper account of changing needs in the market. It is higher if the strategy ignores market trends and lower if it assess and allows for them.</td>
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An objectively moderated view of the probable share can then be combined with the expected market size to calculate the likely future revenue. The next task is to see if that revenue will deliver the planned profit.

**Profit Risk**

Profit risk arises from the possibility that the plan may not deliver the intended profits. It is a function of the competitive reaction engendered by the plan and of the aggressiveness of the cost assumptions.

Whilst share risk flows from strategic decisions about which customers within the market to target and what to offer them, profit risk arises from assumptions about the implementation of the strategy. In particular profit risk arises from assumptions made about competitor response and from planned versus actual costs and prices.

Again, by looking at the detail of why some strategies deliver their promised margins, five sub-components of profit risk can be discerned viz.

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<th><strong>Profit pool risk</strong></th>
<th>This is the risk that profit will be less than planned because of competitors’ reaction to the strategy caused by a combination of the strategy and the market conditions. It is higher if the profit pool is static or shrinking and lower if the targeted profit pool is growing.</th>
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<tr>
<td><strong>Profit sources risk</strong></td>
<td>This is the risk that profit will be less than planned because of competitors’ reaction to the strategy. It will be higher if the profit growth comes at the expense of competitors and lower if the profit growth comes only from growth in the profit pool.</td>
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Competitor impact risk

This is the risk that profit will be less than planned because of a single competitor reacting to the strategy. It is higher if the profit impact on competitors is concentrated on one powerful competitor and that impact threatens the competitor’s survival. It is lower if the profit impact is relatively small, distributed across a number of competitors and has a non-survival threatening impact on each of them.

Internal gross margin risk

This is the risk that the internal gross margins will be lower than planned because the core costs of manufacturing the product or providing the service are higher than anticipated. It is higher if the internal gross margin assumptions are optimistic relative to similar products and lower if they are relatively conservative.

Other costs risk

This is the risk that net margins will be lower than planned because other costs are higher than anticipated. It is higher if assumptions regarding other costs, including, marketing support, are less than current costs and lower if those assumptions are more than current costs.

Profit is generally threatened when assumptions about costs are too optimistic, ignoring experience with other similar products, or those about prices are too naïve, assuming benign and passive competitors.

The risk of not delivering the promised margins is high when the total profit pool available in the market is small and shrinking, the strategy impacts heavily on a single powerful competitor and assumptions about costs are overly optimistic.

This three-part structure, simplistic as it sounds, captures all of the hundreds of possible reasons why a business plan can fail to deliver its promises.
**Stage 3: Assessing shareholder value creation**

Significant levels of market, share or profit risk, or some combination of the three, suggest that the returns delivered by the plan are likely to be less than promised. The third stage of the process is therefore to calculate whether these risk-moderated returns represent the creation or destruction of shareholder value. Only if the likely return is greater than the cost of this capital is shareholder value created.

The Marketing Due Diligence process involves both diagnostic and therapeutic stages. Whilst the first evaluates business risk and assesses whether the plan creates or destroys shareholder value. The second, building on the outcomes of the first, adapts the business plan to improve its risk profile and enhance shareholder value creation.

The assessment of shareholder value creation begins in the diagnostic phase by identifying the sensitivity of the plan to business risk. Such risk is not a monolithic entity but rather the sum of market, share and profit risk, and the relative proportions of these three risks vary between markets. Strategies, for example, are sensitive to market risk if they involve fast growth and high market share; to share risk if they involve fast growth in the face of strong competition; and to profit risk if they involve fast growth and operate on low margins.

The therapeutic part of the Marketing Due Diligence process concentrates on those critical risks as they have been identified in the diagnostic phase and assesses whether modifications to the originally proposed marketing strategy could significantly reduce them and, as a result, increase the shareholder value created. This focused, detailed approach to altering a marketing strategy is only possible because the overall risk profile has been disassembled into its constituent parts so that the critical areas of risk are highlighted. For example:

- **Market risk** can be reduced by better understanding of the risks inherent in growth strategies and in poorly characterized markets. It can be reduced in practice by intelligent use of market research, understanding the implications of Ansoff’s matrix and the predictive power of life cycle analysis.
• **Share risk** can be reduced by improving the choice of target customers and the value proposition offered to them. It can be reduced in practice by understanding market structure, market segmentation and the difference between a product or service and a value proposition. It can be further reduced by insight into strengths and weaknesses of the company and how they align to the market.

• **Profit risk** can be reduced by understanding the impact of strategies on competitors. It can be further reduced in practice by the use of game theory to predict and avoid aggressive responses. Profit margin risk can be further reduced by making better informed assumptions about the costs of implementing the strategy.

Taken together, the end-result is a revised profit figure for the returns reasonably expected from the plan.

In assessing whether or not the strategy delivers shareholder value the revised profit figure, as a return on capital employed, is compared with that which would represent the cost of capital. It is important to be realistic about the value of the capital employed to realize the profits. It should include the value of intangible (e.g., brands) as well tangible assets, since they are all 'at risk' in the investment.

The critical issue is whether the expected profit represents a return on the capital employed greater than the cost of capital. The simple comparison of profits and required return results in one of two conclusions viz, the strategy is either likely or unlikely to create shareholder value.
4. Conclusion

The outcome of the Marketing Due Diligence process is a strategy and plan for the business that is stronger and much more likely to succeed than prior to the detailed examination of the strategy.

Marketing Due Diligence, then, is a much more challenging test of a business plan than other approaches. The rigour of this challenge means that few firms emerge from the process without revealing some weakness in their business plans.

About the Authors

Malcolm McDonald is Emeritus Professor of Marketing at Cranfield University School of Management and the author of over fifty books, including the best seller "Marketing Plans; how to prepare them; how to use them" and many of his papers have been published. Until recently, Malcolm was Professor of Marketing and Deputy Director Cranfield School of Management with special responsibility for E-Business. He is Chairman of six companies and spends much of his time working with the operating boards of the world’s biggest multinational companies.

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