How can a shareholder value approach improve marketing’s strategic influence?

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Abstract

For many marketers, the world of corporate finance, and shareholder value in particular, remains a peripheral issue. Accordingly, marketing’s influence at the top management and board level continues to languish. A more synergistic marketing–finance relationship, we argue, rests on answers to two questions: What can marketing do for shareholder value; and what can a shareholder value approach do for marketing? Some valuable work on how marketing contributes to shareholder value has been conducted. But marketing’s failure to incorporate current financial valuation techniques and properly demonstrate its contribution to financial market performance suggests that the latter question remains open. We address this question and set out a framework for understanding the contribution shareholder value can make to marketing. Particular emphasis is placed on the opportunities that arise for marketing from embracing and incorporating shareholder value principles and metrics.

Keywords: Marketing–finance interface; Marketing metrics; Marketing strategy; Marketing management; Shareholder value; Financial valuation techniques; Net present value (NPV) of future cash flow

1. Introduction

Increasingly, the rhetoric used by top managers and boards is that the primary task of management is to maximize returns to shareholders (Black et al., 2001). There is growing acceptance by today’s executives that unless they demonstrate their ability to enhance shareholder value, they will be replaced, new capital will be difficult to obtain, and their business will be put at risk. Day and Fahey (1988) and Srivastava et al. (1998) have shown that marketing can greatly enhance shareholder value. One might therefore expect, given the pivotal importance of creating shareholder value, that marketing has a powerful influence on strategic policy. There is in fact no evidence that this is happening.

Many authors argue that marketing’s influence on business strategy is at best marginal. They claim that marketing does not shape the way businesses are run, is given insufficient attention at the board level, and the few business decisions over which it does exercise strategic influence are limited in scope. Indeed, Webster (1997) maintains that marketing has surrendered its strategic responsibilities to other organizational functions that do not prioritise the customer. Serious concerns about marketing’s strategic role, and even its identity and organizational impact, have also been expressed by Day and Montgomery (1999), Varadarajan and Jayachandran (1999), Srivastava et al. (1998), Hunt (1992), and Day (1992). Such has been the decline in marketing’s strategic influence that marketing is even claimed to be experiencing a “crisis” (e.g., Brown, 1995; Brownlie et al., 1994).

We contend that marketing’s lack of strategic influence within organizations will continue to happen until marketing has a better understanding of what shareholder value is and how it provides opportunities for the discipline to engage in a meaningful performance dialog with top management. The quality of, and motivation for, such a dialog depends on fully understanding the marketing–finance interface, which is centered on the interdependence between the marketing function and shareholder value (Day and Fahey, 1988;
Doyle, 2000; Srivastava et al., 1998, 1999). This understanding, we believe, rests on answers to two questions: What can marketing do for shareholder value; and what can a shareholder value approach do for marketing?

Regarding the first question, we now have a better understanding of what marketing can do for shareholder value. The analysis of shareholder value is based on a well-founded body of financial theory (see Black et al., 2001; Copeland et al., 2000; Martin and Petty, 2000; Rappaport, 1998), which states that the value of a business is increased when managers make decisions that increase the discounted value of all future cash flows. Srivastava et al. (1998, 1999) developed a framework that makes more explicit the contribution of marketing to shareholder returns. The framework demonstrates how marketing accelerates and enhances cash flow.

Marketing has failed, however, to consider the importance and implications of the second question: what can shareholder value do for marketing? Modern marketing’s reluctance to fully incorporate current financial valuation techniques and, thus, properly quantify its contribution to financial market performance has made it a bystander in many boardrooms. The criteria used by marketing for judging the true financial success of a marketing strategy, or comparing strategic alternatives, remain incomplete and inadequate (cf. Day and Wensley, 1988). This, in turn, means it is difficult to accept marketing recommendations on product policy, pricing, promotions, or, indeed, any aspect of the marketing function.

The purpose of this article is to set out a framework for understanding the contribution of shareholder value to marketing. Particular emphasis is placed on the opportunities that arise for marketing from embracing and incorporating shareholder value principles and metrics. We propose that if these opportunities are seized, then marketing can begin to exercise strategic and managerial influence within the firm commensurate with its importance.

We begin with an explanation of shareholder value analysis, including its philosophical underpinnings and components, followed by an evaluation of its metrics. We then present a framework that uncovers five opportunities that a shareholder value approach offers marketing. The article concludes by recognizing some of the potential pitfalls of shareholder value analysis, but it also argues that marketing can play a role in reducing the impact of these concerns. We also provide a discussion of some of the key research issues that emerge from our framework.

2. Overview of the shareholder value approach

Before we explore the contributions of a shareholder value approach to marketing, we need to be clear on what the approach entails. A shareholder value approach to marketing entails the utilization of shareholder value analysis to create and utilize marketing assets to generate future cash flows with a positive net present value. We do not have the space in this article to provide a detailed analysis of the techniques of shareholder value analysis. A more elaborate examination of these techniques can be found in studies by Black et al. (2001), Copeland et al. (2000), Martin and Petty (2000), and, from a marketing perspective, Day and Fahey (1988) and Doyle (2000). Here, we concentrate on the essence.

The starting point is that shareholders are the owners of the firm. From the shareholders’ perspective, managers are their agents, acting on their behalf. Shareholder value analysis recognizes that the implementation of strategic decisions generates a stream of cash flows over a number of years. A company generates cash, i.e., creates value, when its sales exceed costs, including capital costs. Shareholder value analysis emphasizes the importance of cash flow because this determines how much is available to pay shareholders and debtors. Particular attention is paid to long-term cash flows; one of the tenets of shareholder value analysis is that, contrary to what many managers believe, most investors have a long-term perspective. They acknowledge, for example, that a strategy that yields considerable long-term gains may have a negative impact on both short-term earnings and cash flow, and factor this into their evaluation.

The shareholder value approach typically is associated with publicly listed companies, but it can also be used by private companies. The situation becomes more complex, but techniques are available for estimating the necessary metrics when market prices for the company’s stock are not observable (see Erhardt, 1994). These techniques essentially involve the use of a proxy capital structure and are based on an analysis of what the company would look like if it were publicly listed.

There are a variety of approaches to measuring shareholder value. Accordingly, the marketing manager, trying to understand the nature of shareholder value, encounters a variety of competing terms. Metrics that measure shareholder value directly include free cash flow, shareholder value added, economic value added, market value added, cash flow return on investment, and cash value added. Despite the plethora of different labels and approaches, each shares a common conceptual heritage—the critical importance of the present value of the future cash flows that a company is expected to generate. The approaches can differ, however, in terms of their views as to how cash flow is best measured and/or the period for which it is to be measured.

The marketing manager is also likely to encounter a number of proxy measures purporting to measure shareholder value. These involve accounting measures, such as earnings (profits), earnings per share, price earnings ratios, return on investment (earnings divided by assets), and return on equity (earnings divided by the book value of shareholders). Despite the clear contrary evidence, the belief still persists that good earnings growth will lead to a parallel growth in the market value of the company’s shares. Similarly, managers erroneously believe that if they con-
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