Linking Market Strategy Risk to Shareholder Value

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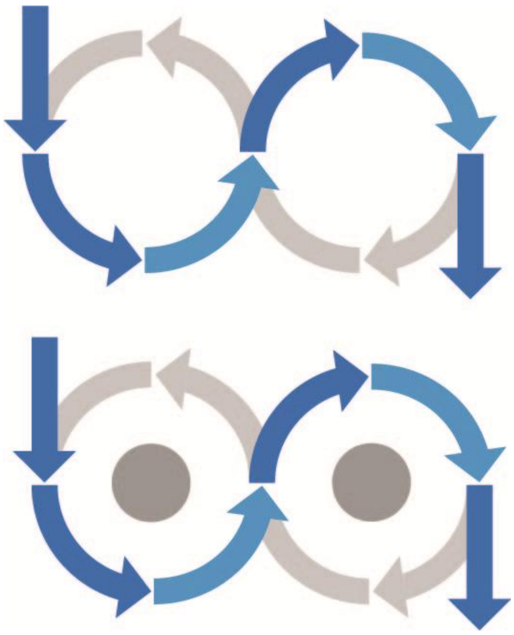
The most common financial objective of modern commercial corporations is the sustainable creation of shareholder value. This can be achieved only by providing shareholders with a total return that exceeds their risk-adjusted required rate of return for the investment.



However, the share price for most companies already reflects some expected future growth in profits. Current shareholders and, more importantly, potential future investors want to assess whether the company's proposed business strategies will produce sufficient growth in sales revenues and profits to support both the current share price and existing dividend payments, as well as to drive the capital growth they want to see in the future. Alongside this, external stakeholders also need a method of assessing the risks associated with proposed strategies as these have a direct effect on the rate of return.

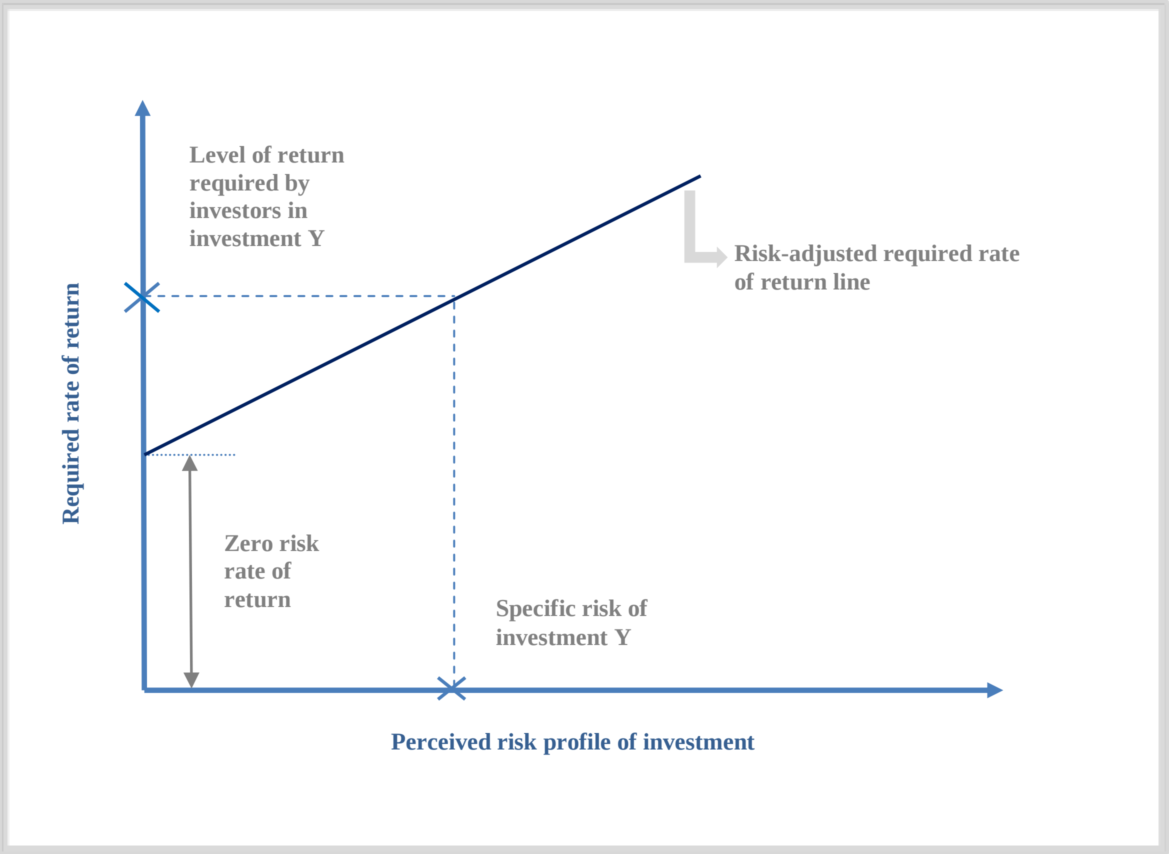
In today's highly competitive environment, the major sources of shareholder value creation are intangible marketing assets such as brands, customer relationships and channels of distribution. This accounts for 80% of the company's value that does not appear on the traditional balance sheet. To reflect the importance of intangible marketing assets, future marketing strategies should be subjected to a rigorous review process.

Unfortunately this is not the case and, even more worryingly, there are few rigorous internal evaluations of how marketing strategies will impact on shareholder value. This is surprising as these same companies would undoubtedly have created formal, board-level audit committees responsible for reviewing all the major business risks they face. They would never think of failing to conduct comprehensive financial due diligence processes on their acquisitions or investments, so why should this differ for marketing strategies?

Following four years of company-sponsored research at the UK-based Cranfield University School of Management, this paper is able to set out Marketing Due Diligence (MDD) process to address the marketing strategy review process gap.

The MDD process subjects any proposed marketing strategy to a structured, sequential process that will indicate the probability of a marketing strategy leading to increased shareholder value. The whole basis of shareholder value is the direct linking of the level of risk to the level of financial return that is required. As shown in Figure 1, the perceived risk profile of the investment drives the level of return required by investors.

Figure 1 Risk-adjusted required rate of return



But what is the methodology around the MDD process and how does it assess the risks associated with planned marketing strategies?

The process of MDD

Despite what many non-marketers think, marketing is much more than just promotion. It is much more, even, than designing and delivering the 'marketing mix' of promotion, product, pricing, place (distribution), process, people and physical evidence.

Methods for measuring the effectiveness of these more obvious marketing activities have been in place for years. Whilst they have their place, they tell us little about the effectiveness of the marketing strategy - the part of the marketing process that concerns itself with understanding the market and deciding what parts of it to focus on and with what value propositions. This is where the MDD process comes in.

Looked at through the lens of business risk, as investors do, a strong strategy reduces the risk associated with a promised return. To investors, it is the risk-adjusted rate of return that matters and managing risk is as important as managing returns, sometimes more so.

In essence, all business plans say the same thing. They make three basic assertions, which can be summed up as:

1. The market is 'this' big.
2. We're going to take 'this' share of the market.
3. 'That' share will make 'this' much profit.

Each of these carries a level of risk that it may be wrong or may fall short of its stated promise. Business risk, therefore, is the combined risk of these three things and can be said to have three components:

Market risk	The risk that the market may not be as big as promised in the plan
Share risk	The risk that the strategy may not deliver the share promised in the plan
Profit risk	The risk that the strategy may not deliver the margins promised in the plan

Table 1 sets out the contributing factors to each component of the strategic business plan.

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Table 1

Overall risk associated with the business plan

Market Risk	Strategy risk	Implementation risk
Product category risk which is lower if the product category is well established and higher for a new product category.	**Target market risk** which is lower if the target market is defined in terms of homogeneous segments and higher if it is not.	**Profit pool risk** which is lower if the targeted profit pool is high and growing and higher if it is static or shrinking.
Segment existence risk which is lower if the target segment is well established and higher if it is a new segment.	**Proposition risk** which is lower if the proposition delivered to each segment is segment specific and higher if all segments are offered the same thing.	**Competitor impact risk** which is lower if the profit impact on competitors is small and distributed and higher if it threatens a competitor's survival**.**
Sales volumes risk which is lower if the sales volumes are well supported by evidence and higher if they are guessed.	**SWOT risk** which is lower if the strengths and weaknesses of the organisation are correctly assessed and leveraged by the strategy and higher if the strategy ignores the firm's strengths and weaknesses.	**Internal gross margin risk** which is lower if the internal gross margin assumptions are conservative relative to current products and higher if they are optimistic.
Pricing risk which is lower if the pricing assumptions are conservative relative to current pricing levels and higher if they are optimistic.	**Uniqueness risk** which is lower if the target segments and propositions are different from those of the major competitors and higher if the strategy goes 'head on'.	**Profit sources risk which** is lower if the source profit is growth in the existing profit pool and higher if the profit is planned to come from the market leader.
	Future risk which is lower if the strategy allows for any trends in the market and higher if it fails to address them.	**Other costs risk** which is lower if assumptions regarding other costs, including marketing support, are higher than existing costs and higher if they are lower than current costs.

Turning MDD into a financial value

Given the focus on aligning the MDD process with the creation of shareholder value, it should come as no surprise that the MDD diagnostic process adjusts the expected cash flows generated by proposed marketing strategies. It does this by using the probabilities assessed through the structured risk analysis process.

This first stage of the MDD diagnostic

process should result in an adjusted set of forecast sales revenues, profits and cash flows from the proposed marketing strategy.
The adjusted expected cash flows are then assessed to see whether they are shareholder value-enhancing. This is done by putting them into the context of the capital employed in implementing the marketing strategy and the required rate of return on the capital employed.

Essentially the formula is as follows:

Probability-adjusted cash flows	-	Value of capital employed	x	Required rate of return	-	Potential loss from capital at risk

A detailed explanation of how these calculations are made can be reviewed in the book nearing publication: "Marketing and Finance—Creating shareholder value" (McDonald M. Wiley 2013).

Not surprisingly, the capital employed that we use for this computation is the genuine capital that is required in the business in order to implement the marketing strategy. In other words, it includes the value of the relevant intangible assets owned and used by the business and is not limited to the historically-based, tangible asset-oriented balance sheets published by most companies.

When MDD becomes a routine process for assessing the strategic decisions of company directors, the flaws it detects and the challenges it throws up may be fewer and more routine. In the meantime, MDD will have many important implications for the board.

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The full reference for this study:
Professor Malcolm McDonald; Linking Market Strategy Risk to Shareholder Value, Journal of Digital Asset Management, volume 5 June 2009.

Editor; Hannah McGivern