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Building and Leveraging Market-Based Assets to Drive Marketplace Performance and Value

Managers must understand that marketing initiatives generate market-based assets – which have considerable value in and of themselves. These assets also have enduring value-in-use. They can be leveraged to provide marketplace results that fit with company strategy. Positive market performance, in turn, positively impacts cash flow dynamics and shareholder value. Companies must invest time, money, and energy in developing valuable market-based assets – a perspective that is often at odds with the accounting classification of most marketing activities as "expenses." It is important to recognize that what is considered "expense" is rarely nurtured. Therefore, senior managers must maintain internal books and metrics that recognize and catalog these assets as well as their benefits. Failure to do so will result in sub-optimal market performance, destruction of these assets, and reduced shareholder value.

Introduction

Metrics such as sales growth and market share typically measure the success of marketing initiatives in product marketplace performance, but ignore the impact of marketing decisions on such variables as inventory levels, working capital needs, and financing costs that need to be managed for the well-being of the enterprise. As noted by Anderson (1979), "to assume such factors are purely the responsibility of finance is to be guilty of a kind of marketing myopia not less damaging as that originally envisioned by Levitt" (p. 328). Because most marketing actions are treated by "expenses" rather than "investments," support for market-building programs is inherently short-term and chimerical.

But there is a quiet revolution in the way that marketing activities like CRM and branding are now viewed by marketing professionals, enlightened senior managers, and innovative managers in other functions, particularly in finance. In the "hottest" markets, the "dot-com" businesses, investments in

developing customer bases, value-chain/partner networks and brands are running at 200% to 400% of gross margins. Over 60% of investment capital goes toward such expenditures. Indeed, the value of dot-com's such as Yahoo! and Amazon.com depends on the size and growth rate of their buyer, vendor, content provider, and referral networks. Given switching costs and inertia within networks, the result of such network-building investments is the development of "market-based assets" that are off the balance sheet.

Managers must accordingly adopt the perspective that customers, channels, and strategic partners are not simply marketing objects, but are, in fact, assets that must be cultivated and leveraged. These market-based assets arise from the commingling of the firm with entities in its external environment. Leveraging such assets to enhance corporate performance requires managers to go beyond the traditional inputs and outputs of marketing analysis, to also include an understanding of the financial consequences of marketing decisions such as their impact on cash flows.

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While top management increasingly requires marketers to see their ultimate purpose as contributing to financial returns (Day and Fahey 1988), the marketing community has historically found it difficult to identify, measure, and communicate the value created by marketing activities. Thus financial appraisals of marketing strategy seldom try to value long-run marketing strategies with uncertain outcomes (Barwise, Marsh and Wensley 1989).

There is a growing recognition that a significant proportion of firm market value lies in intangible, off-balance sheet assets such as brands, market networks, and intellectual property, rather than in tangible book assets. With “market-to-book” ratios for Fortune 500 firms averaging over 4.0, more than seventy-five percent of the market value of companies lies in intangible assets that are typically not measured (Capraro and Srivastava 1997). But, as Lusch and Harvey (1994) observe, little has been done in the last 20 years to more accurately project the “true” asset base of the corporation in the global marketplace.

To develop a conceptual theory that makes explicit the contribution of marketing to shareholder value, we advance a framework where marketing inflows (investment in activities such as Customer Relationship Management) result in cash flow and relationships that can be accumulated as market-based assets. Although internal processes (superior product development or customer intelligence) can also be leveraged to enhance shareholder value, our focus in this paper is exclusively on external, market-based assets.

First, we define and describe what we mean by market-based assets. Next, within the context of discussing financial valuation approaches, we discuss methods of asset valuation, and identify the key drivers of shareholder value. Following this, we draw the linkages between market-based assets and the drivers of shareholder value, and discuss investments required to nurture market-based assets and how these can be leveraged to drive shareholder value. We conclude with a deliberation of the implications and potential applications of the framework for the practice of marketing.

Market-Based Assets

In order to define, categorize and leverage market-based assets (Sharp 1995), it is essential to clarify the meaning, importance, and principal characteristics of the base construct – assets, which can be any physical, organizational, or human attribute that enables the firm to improve its efficiency and effectiveness in the marketplace (Barney 1991). Assets can be tangible or intangible, on or off the balance sheet, and internal to the firm or external. Regardless of type, the value of any asset ultimately is realized, directly or indirectly, in the external product marketplace.

But which assets contribute to winning strategies? Which assets create and sustain value for customers and for shareholders? What makes an asset valuable? The resource-based perspective on competitive success (cf. Itami 1987) suggests that an asset is more likely to contribute to value generation when it satisfies the following four tests:

- It is convertible; if the firm can use the asset to exploit an opportunity and/or neutralize a threat in the external environment, then the potential to create and sustain value is enhanced.
- It is rare; if the asset is possessed by multiple rivals, then its potential to be a source of sustained value is considerably diminished.
- It is imperfectly imitable; if it is difficult for rivals to imitate the asset, then the potential to sustain value is considerably enhanced.
- It does not have perfect substitutes; if rivals do not possess, and it is difficult for them to develop strategically equivalent convertible assets, then the potential to sustain value is considerable enhanced.

Market-based assets must, if they are to contribute to customer and financial value, to some extent, satisfy these four tests:

Types of Market-Based Assets

Market-based assets arise from the commingling of the firm with external entities. They are principally of two related types: relational and intellectual. Such

assets are primarily external to the firm, generally do not appear on the balance sheet, and are largely intangible. Yet stocks of these assets can be developed, augmented, leveraged, and valued. And, as we shall see, because of their characteristics, they are particularly suited to meeting the resource value tests noted above.

Relational market-based assets are outcomes of the relationship between a firm and key external stakeholders, including distributors, retailers, end-customers, other strategic partners, community groups, and even governmental agencies. For example, brand and channel equity reflect bonds between the firm and its channels and customers; the former is the result of extensive advertising and superior product functionality, while the latter may be a result of long-standing and successful business relationships between the firm and key channel members. Both require market investments and supporting infrastructure such as call centers and Web sites.

Intellectual market-based assets are the types of knowledge a firm possesses about the environment, such as the emerging and potential state of market conditions, and the entities in it such as competitors, customers, channels and suppliers. This knowledge can lead to superior management of key business processes such as new product introduction, supply-chain management, and customer relationship management – and better financial performance.

The development and evolution of relational and intellectual market-based assets intertwine in many ways, i.e., customer service personnel. Both relational and intellectual market-based assets are intangible; they cannot be inventoried or physically divided into specific portions. Yet, both can be assessed in terms of their stock and flow. Stock refers to a specific amount or extent of brand equity, or knowledge of customer's purchasing criteria, possessed by a firm. Flow refers to the extent to which a stock of a particular asset is augmenting or decaying.

Market-based assets have three important implications. First, the greater the value that can be generated from market-based assets for external entities such as customer and channels partners,

Property	Balance Sheet Assets	Off-Balance Sheet Assets
Type of Asset	Largely tangible	Off-Balance Sheet Assets Largely intangible
Examples	Plant and equipment	Market-based assets such as customer/brand and channel relationships
Can be bought and sold?	Yes. Tangible property has salvage value.	Yes. For example, AT&T's acquisition of McCaw Cellular.
Can be leveraged to lower costs?	Yes. By enhancing productivity.	Yes. Lower sales and service costs due to superior knowledge of customers and channels.
Can be leveraged to command higher prices or share?	Yes. Superior product quality or functionality can be used to justify higher prices.	Yes. Brand and channel equity lead to higher perceived value that may be tapped via price or share premiums.
Generate entry barriers?	Yes. Others must make similar investments to be competitive.	Yes. Customer switching costs and loyalty reduce competitive vulnerability.
Provide a competitive edge?	Yes. Can make other assets such as employees more productive.	Yes. By making other resources more productive (e.g., satisfied buyers are more responsive to marketing efforts).
Create options for managers?	Yes. If plant and equipment can be shared across products.	Yes. Satisfied customers are more likely to try brand and category extensions.
Asset acquisition costs capitalized?	Yes. Plant and equipment can be paid for over several years.	No. Marketing costs are "expensed" and must be justified in the short-run.

FIGURE 1.0 Attributes of Balance Sheet and Off-Balance Sheet Assets

the greater their satisfaction and willingness to be involved with the firm, and, as a consequence, the greater the potential value of these marketplace entities to the firm. Second, market-based assets generate and sustain greater value for external entities the more they satisfy the four asset tests noted earlier. Third, shareholder value depends on how a firm taps or leverages these market-based assets to improve its cash flows.

Market-Based Assets: Generating Customer Value

The concept of market-based assets can be refined and extended through comparison with the more familiar notion of tangible, balance sheet assets. Typically, the value of any assets to any organization ultimately is not just their market or trade value, but also their value-in-use. Unless they possess some value-in-use, they fail the critical initial test of potential contribution to competitive

success noted above; they are not convertible. Table 1 summarizes the value-in-use of both internal, tangible, balance sheet assets (such as plant and equipment, raw materials, supplies, inventory, and finished products) as well as intangible, off-balance sheet assets (such as brands, and customer relationships). Both types of assets can be leveraged by an organization to:

- Enhance productivity (e.g., by lowering production and sales/service costs, respectively)
- Enhance revenues through higher prices (e.g., by enhancing product quality and brand preference, respectively).
- Serve as a barrier to entry or mobility barrier (e.g., because others must make similar investments in plant and equipment and because customer switching costs and loyalty reduce competitive vulnerability, respectively)
- Provide a competitive edge to the extent

they make other assets more valuable (e.g., superior plant and equipment can enhance throughput per employee and satisfied customers are more responsive to marketing efforts, respectively)

- Provide managers with options (e.g., plant or equipment can be shared across products lines and satisfied customers are more likely to respond to brand and category extensions)

Unfortunately the value of market-based assets is harder to measure and is less likely to be recognized. Furthermore, marketing expenditures to acquire and retain customers, develop brands, and create channel and other partnerships are most often "expensed"—i.e., cannot be depreciated over time. Therefore, it is not surprising that market-based assets are often not valued and nurtured in the same way as assets that are deployed for, by way of example, supply-chain effectiveness and efficiencies.

Interestingly, not only can market-based assets be used for much the same purposes as tangible, balance sheet assets, they are more likely to serve as a basis of long-run, sustained customer value for three specific though related reasons. First, market-based assets are more likely to satisfy resource-based tests noted above. Second, they add to the value generating capability of physical assets. Third, they are ideally suited to exploit the benefits of organizational networks.

Resource-Based Tests

Unless such assets are convertible into customer value, the remaining resource-based tests are irrelevant (Barney 1991). Knowledge is perhaps the ultimate source of opportunity (Drucker 1993): it is embedded in research and development; it guides product innovation; it energizes marketing and sales. Relationships with end-users can be exploited in building relationships with other entities (e.g., distributors). The intimacy of relationships with channels and customers attained by some firms such as Home Depot, Nordstrom and Johnson Controls, has proved almost impenetrable by many rivals (Treacy and Wiersema 1995). This presents profound difficulties to rivals seeking to

develop direct substitutes, i.e., assets that allow them to pursue a similar strategy.

Add Value to Tangible Assets

The role and importance of market-based assets is further augmented when we recognize how often they add to the value generating capability of physical assets (Lane and Jacobsen 1995). For example, knowledge of customers' changing tastes

Networked Value

Finally, market-based assets underlie benefits that can be derived from "networks" or product ecosystems. As individual firms increasingly become the node in an interconnected web of formal and informal relationships with external entities (Quinn, 1992), their capacity to generate, integrate and leverage knowledge and relationships extends considerably beyond the resources

Little has been done in the last 20 years to more accurately project the "true" asset base of the corporation in the global marketplace. And, assets that are not measured are likely to be under-funded. Thus, a failure to understand the contribution of marketing activities to shareholder value continues to diminish the role of marketing thought in corporate strategy.

and buying criteria allows a firm to adapt its manufacturing and engineering processes to customize products with the functionality and features demanded by customers (Pine 1993). Strong customer relationships, manifested in channel and brand equity, allow human resources to be committed to entrepreneurial activity such as developing new products and extending existing product lines (Leonard-Barton 1995).

Indeed, it seems that relational and intellectual assets are necessary to invigorate and unleash the customer value-generating potential embedded in tangible assets such as plant, machinery, people, and products. Without knowledge of and relationships with external entities such as customers, channels, suppliers, and other strategic partners, marketing capabilities inherent in business processes such as new product development, order fulfillment, and customer service (Day 1994) can be neither created nor leveraged. Knowledge and market-based relationships are essential sources of these capabilities; they are in turn extended and augmented by the successful execution of these capabilities.

they own and control. For example, Intel's Pentium microprocessor's successful defense against both DEC's Alpha and the IBM/Motorola/Apple PowerPC chips is in part related to its network of end-users, OEM's, and software vendors. Each network link allows customer value generation beyond what could be created by the nodal firm alone or any other network entity operating on its own. Consequently, networked market-based assets help a firm create value over and above that created by market-based assets individually. Thus, the value of a network of market-based assets can be greater than the sum of its individual components.

Networks of relationships across several types of customers facilitate the development of scope economies and increasing returns that otherwise would be impossible. For example, a shift away from vertical integration to horizontal alliances reinforces the need to move from stand-alone competition to networked rivalry. The "best" products do not necessarily win. The best-networked firms usually do. Thus marketing strategy requires that one be in

the right product system and then to ensure mechanisms to get a fair share of the alliance (network) value created. Further, horizontal alliances require a focus on greater collaboration, information sharing and trust across value chains.

The market value of dot-com startups can in part be attributed to the size and growth rate of interconnected networks. Take the case of Travelocity. The larger the size and growth rate in installed bases of subscribers or users, the greater its value as both a media and transaction channel to the vendor network (airlines, hotels chains, car rental agencies, travel package providers, global financial services, facilitators, and the like) and vice versa. This value is further enhanced by linkages to the network of content providers (e.g., purveyors of travel and weather information) as well as the affiliate/referral network. Naturally, such market-based assets do not come free. An organization such as Travelocity must invest in developing and nurturing this multiplicity of networks, grow its capabilities for both transaction and service management (via Web site and call center), and concentrate on market network (as opposed to just marketing) management as a core competence.

Linking Market-Based Assets to Marketplace Performance and Shareholder Value

In order to assess the value of market-based assets, we present a conceptual framework (Figure 1.0) that links the contribution of these assets to the financial performance of the firm, and begins to suggest ways in which the value of marketing activities can be identified, measured, and communicated. Briefly, investments in CRM and value chain relationships lead to development of market-based assets. These can be leveraged to enhance marketplace performance (flow measures) that can be translated into components of shareholder value.

The first column in Figure 1.0 presents two types of market-based assets: customer and partner relationships. These relationships are formed on the basis of value derived from enhanced product functionality (superior performance, greater reliability and

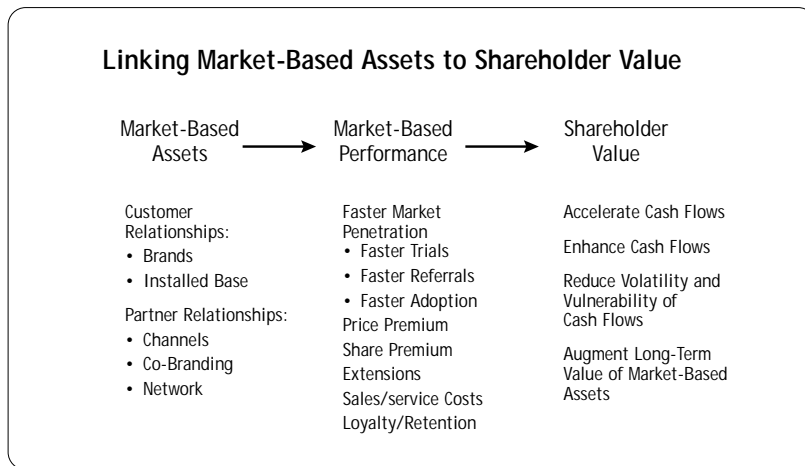


FIGURE 2.0 Linking market-based assets to shareholder value

durability), unique features, better product and service quality, wider availability, greater ease-of-use, lower levels of perceived risks, higher levels of trust and confidence, and better reputation and image. These customer-value elements are nurtured via a CRM process that addresses all aspects of identifying customers, creating customer knowledge and offerings that meet and exceed customer requirements, shaping their perceptions of the organizations, its product and brands, cross-selling and up-selling, and providing support services.

This customer value is the basis for customer satisfaction. If customers are end-consumers, satisfaction is directly linked to brand equity, which is linked to the installed base of users.

The second column summarizes the consequences of customer behavior that are considered desirable by firms. For example, research over the past decade shows that marketing activities such as advertising can lead to more differentiated, and therefore more monopolistic products characterized by lower own-price elasticity. Brand equity can be tapped in a variety of ways. It allows firms to:

- Charge higher prices (Farquhar 1989),
- Attain greater market shares (Boulding, Lee and Staelin 1994),
- Develop more efficient communications programs because well differentiated brands are more responsive to advertising

- and promotions (Keller 1993),
- Command greater buyer loyalty and distribution clout in the marketplace (Kamakura and Russell 1994),
- Deflect competitive initiatives (Srivastava and Shocker 1991),
- Stimulate earlier trial and referrals of products (Zandan 1992), and
- Develop and extend product lines (Keller and Aaker 1992).

The consequences of customer satisfaction include payoffs such as buyer willingness to pay a price premium, to use more of the product, to provide referrals, as well as lower sales and service costs, and greater customer retention (Reichheld 1996).

While market-based assets can be expected to boost market performance and lower risks, little is known about how the stock market values the ability of market-based assets to enhance current and potential market performance. We will next attempt to alleviate this shortcoming.

Asset Valuation Methods and Drivers of Shareholder Value

It is now widely accepted that the difference between the book value and the market value of the firm is accounted for by intangible assets that are not recognized by the standard accounting practices of today (Lowenstein 1996). To the extent that the market value of a firm is greater than the book or replacement values, the

differences can be attributed to intangible assets not captured by current accounting practices (Lane and Jacobsen 1995). With "market-to-book" ratios averaging over 4, and "market-to-replacement cost" ratios (or Q-ratios) substantially above 2 for the Fortune 500, it is clear that a substantial portion of a firm's market value is in intangible assets.

That financial markets are willing to pay price premiums in excess of book values for most firms leads to the question of how intangible assets are valued. According to Lane and Jacobsen (1995), intangible assets such as brand names, channel dominance, or the capability to innovate should enhance the ability of the firm to create earnings beyond those generated by tangible assets alone. The need to value intangible assets has resulted in methodologies such as the "Price-Earnings Multiple" approach used for brand valuation by the InterBrand Group (Penrose 1989). Here, the value of brands is estimated based on incremental earnings associated with brand names multiplied by a brand strength and product category attractiveness based PE multiple (higher for strong brands in more desirable categories). Intuitively, PE multiples, and hence valuation of today's earnings, increase with mitigation of risk and enhancement of future growth potential.

While the PE Multiple is an oft-quoted valuation measure, its use is controversial. Scholars in the finance area have argued that approaches based on cash flow (Economic Value Added (EVA), Cash-flow Return on Investment (CFROI) beyond cost of capital, and Shareholder Value (SHV) based on cash flows expected to accrue to the firm), are more relevant. In particular, EVA with attendant value based management (VBM) approaches that link compensation and incentive systems to factors that help create EVA, has gained popularity in recent years.

Unfortunately, while EVA is relatively easy to measure from current performance information (it is equal to net operating profits after taxes (NOPAT) less the cost of capital employed in creating NOPAT) it has been criticized for its short-term focus and under-valuation of growth potential and

intangible assets (Leuhrman, 1997). On balance, the dominant financial perspective is that of Shareholder Value (SHV) where the value created by strategic initiatives is best reflected by the net present value of all future cash flows expected to accrue to the firm (Martin 1999). The SHV approach is becoming increasingly important in strategic decision-making for purposes of resource allocation among options that offer growth but are inherently risky; this leads to basing much of a firm's value on future performance. The implications of this for marketing and CRM are immense. If resources allocated to marketing strategies cannot be demonstrated to be investments (assets that enhance performance or growth), then marketing initiatives are likely to be perceived as marginal by corporate decision-makers. The challenge then is to demonstrate and measure the value created or driven by marketing investments and strategies.

Market-based Assets and Shareholder Value

While measurement difficulties abound, the principles of SHV value creation are simple. Because of the time value of money (discounting for risk), earlier cash flows are preferred. Reduced risk is valued as well. As discussed by Rappaport (1986), "shareholder value drivers" include:

- 1) Acceleration of cash flows; earlier cash flows are preferred because risk and time adjustments reduce the value of later cash flows
- 2) Enhancement of cash flows by increasing revenues and reducing costs, working capital and fixed investments
- 3) Reduction in the risk associated with cash-flows by decreasing their volatility and vulnerability and hence, indirectly, the firm's cost of capital
- 4) Augmentation of the long-term value of the business (at the end of a planning horizon) via investments in processes that result in tangible and intangible assets.

Typically, the last value driver is simply an outcome of a finite planning horizon. If we define a finite planning horizon over which

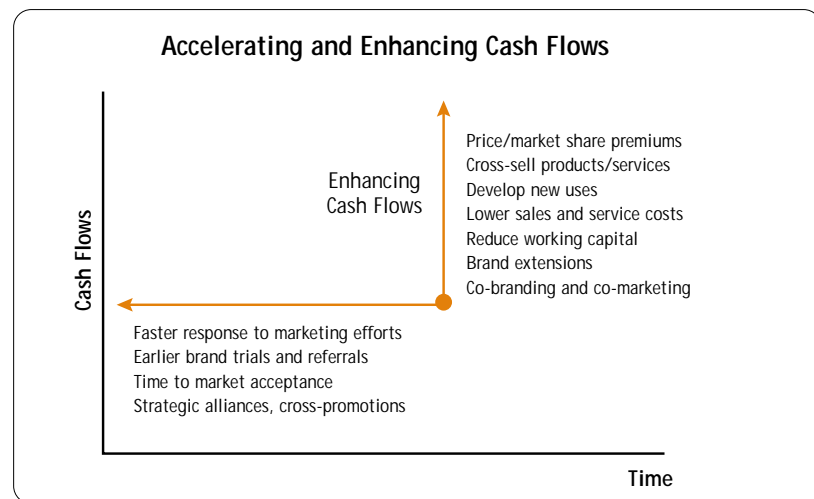


FIGURE 2.0 Accelerating and enhancing cash flows

to project cash flows, then the long-term value at the end of the horizon should be discounted back to the present. But, if we adopt an infinitely long time horizon, the last of the four drivers is automatically incorporated into the valuation and is an outcome of the first three.

Market-Based Assets: Influence on Accelerating Cash Flows

Market-based assets can enhance shareholder value by allowing the firm to generate or accelerate cash flows. As shown in Figure 2.0, the faster the receipt of cash flows, the higher their net present value. To the extent that market-based assets can help accelerate the receipt of cash flows, such assets can positively influence the shareholder value of the firm. There is considerable evidence in the marketing literature that market-based assets can accelerate cash flows by increasing the responsiveness of the marketplace to new product marketing activity. Zandan (1992) found that brands with the strongest image in the personal computer industry, such as IBM, Compaq can typically expect customers to adopt their next generation products more quickly than brands with a weaker image. Furthermore, his study also suggests that customers are generally willing to refer these brands to others much earlier than in the case of weaker brands. These earlier

purchases and faster referrals speed up the innovation adoption process, leading to the acceleration of cash flows, and hence greater shareholder value.

While there is universal recognition in the marketing and new product development practice that speed-to-market is a crucial variable, Robertson (1993) notes the lack of attention paid to reductions in time-to-market acceptance for new products. He argues that being quick to market is only half the battle. The other half is the ability to penetrate the market quickly with mechanisms such as "seeding" the market (i.e., using promotions to establish an installed base), and then leveraging these early adopters to facilitate word-of-mouth advertising to accelerate product life cycles and cash flows.

In addition, market-based assets also have network level effects on market penetration cycle times. Robertson (1993) points out that few firms have the ability to penetrate all markets around the world before a new product loses its innovative advantage. If so, alliances with partners can accelerate cash flows by penetrating a greater portion of the global market in the same time frame. This strategy is especially valuable when there is a competing product group (e.g., VHS versus Beta), when the pace of technology development is rapid, or where the technology pioneer has a short window in which to establish the product. The appropriate use of partnerships also

allows firms to respond faster to market needs by taking advantage of existing networks. McDonald's arrangement with Wal-Mart to place restaurants in Wal-Mart Supercenters, allows the chain to penetrate new markets with greater speed, albeit at the cost of sharing margins with Wal-Mart.

Network externalities lead to "increasing returns" with the growth of the installed base and have been used to justify marketing activities that focus on licensing and standardization as a way of developing and leveraging the buyer installed base (Besen and Farrell 1994). Indeed, while economists have typically focused on network externalities due to buyers' expectation, evidence from Internet-based communications and markets suggests that interaction between different network types serves to multiply the importance of external, market-based drivers.

Marketing programs such as advertising, money-back guarantees, product sampling, and co-marketing alliances geared towards speeding up market acceptance have been neglected in favor of R&D efforts that reduce time-to-market. Companies often balk at spending amounts for channel and market development that are an order of magnitude lower than product development costs. Indeed, Cooper (1993) found that in the case of industrial new product development, 78% of total effort as measured by person-days went to technological and production activities, as compared to only 16% for marketing activities. This can be an expensive mistake: what if you threw a new product party and nobody came? A better balance of resource allocation between time-to-market and time-to-market penetration can lead to faster time-to-volume and time-to-money (Meredith 1998). Senior management should understand and support the impact of marketing initiatives and investments on shareholder value (as measured by "velocity metrics" linked to accelerating cash flows).

Market-Based Assets: Influence on Cash Flows

As shown in Figure 2.0, market-based assets can be leveraged to increase shareholder value by enhancing the level of cash flows

via a variety of means such as price/share premiums, cross-selling, and up-selling activity, finding new uses for products, brand extensions, co-branding, and reduction in working capital requirements. Additionally, branded products lead to "imperfect" markets with monopolistic power that supports higher prices and margins.

A great deal of evidence in the marketing literature suggests that brand extensions are an important mechanism for enhancing revenues (cf. Srivastava and Shocker 1991). Well established and differentiated brands can charge a price premium based on their monopolistic power attributable to customer switching costs and loyalty (Boulding, Lee and Staelin 1994). Brand equity is also associated with a customer base that is more responsive to advertising and promotions (Keller 1993). Therefore, the marginal costs of sales and marketing are lower for higher equity brands. It has also been shown that better customer management results in lower sales and service costs and higher buyer retention, and, therefore, lower customer replacement expenditures (Reichheld 1996).

Brand extensions allow firms to fill out their product lines, to expand into related markets, and to increase revenues by licensing brand names for use in other product categories. Smith and Park (1992) demonstrate the positive impact of brand extensions on market share and advertising efficiency, and show how brand extensions lower the cost of introducing new products; brand extensions can be interpreted as a firm's use of its accumulated investment in the brand, and future cash flows from other products affiliated with the brand, as a "bond" or collateral for the quality of the extension.

The trend toward relationship marketing has created, in many instances, closer relationships between suppliers and customers (Sheth and Parvatiyar, 1995). These relationships have allowed both parties to achieve efficiencies by linking their supply chains. For example, the relationship between Procter & Gamble and Wal-Mart has led to efficient and cost-saving order placement, order processing, cross-docking, and inventory holding. Similarly, the virtual integration of the supply-chain spanning

Dell and its customers and suppliers has led to a dramatic reduction in investments as well as cycle times, reducing the level of working capital and fixed investments.

Networked market-based assets also influence shareholder value by positively impacting cash flows. Anderson and Narus (1996) highlight the usefulness of channels in which members collaborate by pooling inventories to deliver improved customer service levels, while at the same time lowering the investment required in inventories by 15-20% for each member of the network.

Finally, cooperative ventures such as co-branding and co-marketing alliances also allow firms to enhance cash flows (Bucklin and Sengupta 1993). The essence of co-branding and component branding is that both partners gain access to each other's customer base. Cooperation that involves sharing brands and customer relationships allows firms to (i) lower the cost of doing business by leveraging others' already existing resources, (ii) increase revenues by reaching new markets or making available others' products, (iii) avoid the fixed investment of creating a new brand altogether.

While researchers in marketing have addressed the issue of how marketing activities enhance revenues and to a lesser extent lower costs, they have paid little attention to how market-based assets help reduce working capital and fixed investment needs. Where such a recognition has occurred, the willingness to invest in customer and partner relationship building activities is apparent. However, the vast majority of top managers have yet to develop an appreciation of the role of marketing in influencing the capital allocation process.

Market-Based Assets: Influence on the Vulnerability and Volatility of Cash Flows

Market-based assets can also increase shareholder value by lowering the vulnerability and volatility of cash flows. Lower volatility and vulnerability reduce the risk associated with cash flows, which results in a lower cost of capital or discount rate thereby enhancing shareholder value (see Figure 3). The vulnerability of cash flows to

competitive activity is reduced when customer satisfaction, loyalty and retention are increased. As a relatively rare and inimitable asset, the loyalty of the customer installed base represents a significant entry barrier to competition. A variety of marketing programs are geared toward increasing customer loyalty and switching costs by increasing benefits to more loyal customers (e.g., American Airlines' AAdvantage program), reducing their risks (e.g., via unconditional money-back guarantees), and by bundling products and services (e.g., auto leasing programs result in substantially higher repurchase rates). Additionally, cross-selling of multiple products and services can also increase switching costs.

While marketers do focus on how to generate customer loyalty, they often fail to communicate its value. One way to do this may be by looking at the consequences of disloyalty. For example, the average retention rate in the automobile insurance industry is 80 percent. San Antonio based USAA is reputed to have a retention rate of over 99 percent. So while the average insurance company has to replace approximately 50 percent of the customers after three years, USAA has to replace less than 3 percent. With customer acquisition costs running at least five times retention costs, the mathematical justification of a marketing focus on customer loyalty and retention is not difficult (see Reichheld 1996 for detailed analyses and arguments). Additionally, companies such as General Electric, Hewlett-Packard and Kodak have followed the leasing approach pioneered by Xerox. They subsidize equipment sales and subsequently reduce volatility in cash flows by cross-selling consumables (e.g. toner and ink for printers in the case of Hewlett-Packard) and services that are then less vulnerable to competitive actions.

Stable operations between a firm, its customers, and channel partners can reduce cash flow volatility. Customer and partner relationships allow firms to coordinate activities across the value chain, leading to greater sharing of information, automatic ordering and replenishment, and lower inventories, which can help reduce and better manage supply-chain cash flows and risk.

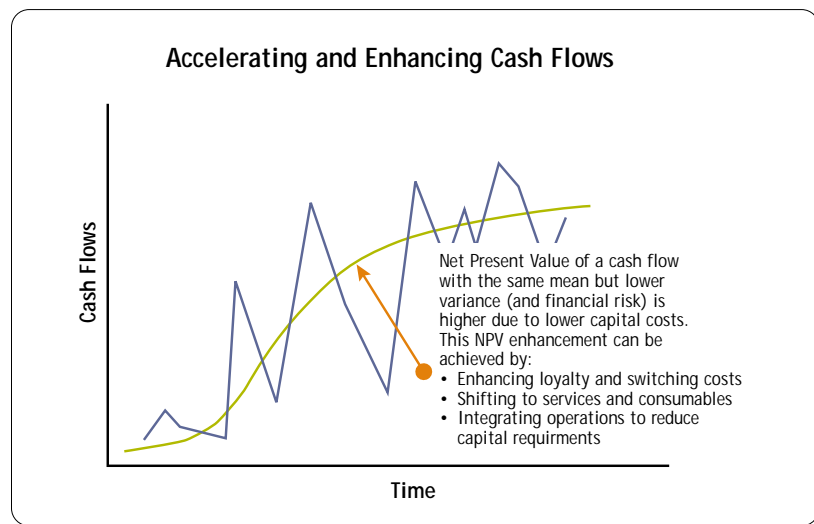


FIGURE 4.0 | Reducing volatility in cash flows

Strategists have long understood the importance of barriers to entry such as investments in R&D and manufacturing systems. However, the barrier to entry that is hardest to overcome might be customer loyalty. Typically, both the vulnerability and volatility of cash flows are under-valued when a short-term transaction perspective displaces a longer-term relationship mentality. One irony is that customer retention strategies and the role of marketing are likely to gain greater recognition as their implications for the vulnerability and volatility of cash flow gain wider appreciation and as one examines long-term value of customer purchases compounded over time (Srivastava, Shervani and Fahey 1997).

Market-Based Assets: Investing to Augment Long-term Value of the Business

Investment in R&D of new technology platforms results in tangible assets such as superior products and intangible ones like intellectual property. Similarly, manufacturing infrastructure investments such as electronic channels and plants and equipment can be viewed as leading to largely tangible assets that support the supply-chain. CRM process investments nurture brand development and customer support. They enhance the size and quality of the customer base result in largely intangible market-based assets.

Because CRM investments lead to less tangible assets, they are typically harder to justify. But they create sustainable competitive advantages and capabilities. These market-based assets represent "resources" that firms can "tap" in driving shareholder value. Differentiated brands are more responsive to advertising and promotions. Brand loyalty can be tapped to reduce marketing expenditures in times of cash flow crunch. The customer base can be leveraged to provide new product ideas as well as the target market for brand and category extensions.

As depicted in Figure 5.0, a strong case can be made for the link between market-based assets and the long-term value of a business. For example, users of earlier versions of product/services typically upgrade and buy related products and services. They also contribute to growth by referring products and services to potential users and, therefore, facilitate product adoption process across multiple generations of the product platform. Microsoft's Windows 95 launch process is a classic case of leveraging market-based assets to drive shareholder value (Clark 1995; see sidebar).

In many industries where cash flows can be directly linked to customers (e.g., magazine subscriptions, cable TV, cellular telephone services), the market value of the business is linked very closely to: (1)

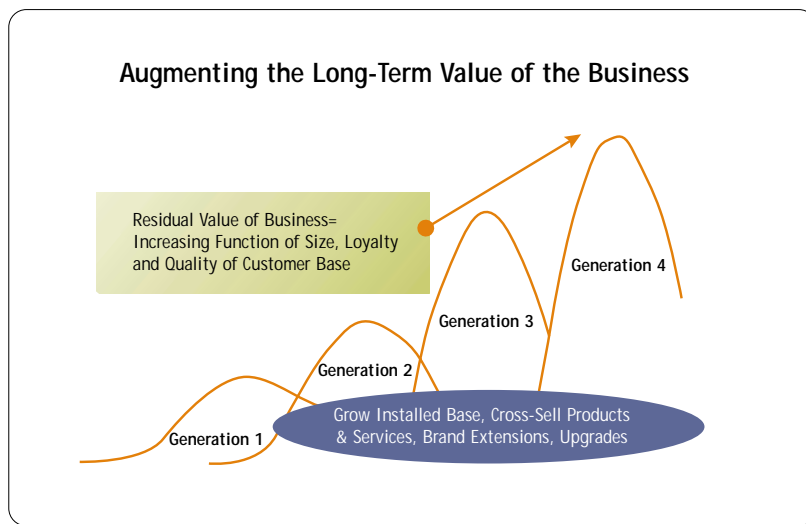


FIGURE 5.0 | Augmenting the long-term value of the business

the size, (2) quality (as measured by usage volume, willingness to pay a price premium, and lower sales and service costs) and (3) loyalty (and, therefore, the lower the risk or vulnerability) of the customer base (Kim, Mahajan and Srivastava 1995). Hence, we not only have to grow the customer base to create customer value, but we have to refine it (i.e., eliminate less profitable customers). Further, a longer-run goal of less vulnerable cash flows would suggest a higher priority for customer retention versus acquisition, because customer loyalty is associated with higher revenue, lower sales and service costs, and lower risk. Finally, it is important to recognize that sustained, long-run customer loyalty results in more stable businesses and, therefore, a lower cost of capital. This further enhances the long-term value of businesses.

The recognition of customers, distributors and brands as market-based assets raises the question as to whether marketing expenditures should be treated as operating expenses or capital investments (Srivastava, Shervani and Fahey 1998). For management purposes, treatment of marketing expenditures as capital investments could provide brands with a defensible claim when competing for resources with other capital expenditures – especially in technology-driven industries such as software and communications where off-bal-

ance sheet assets represent a large proportion of market value of firms.

Implications for the Future of Marketing Practice

Marketing practitioners have historically found it difficult to measure and communicate the value created by investments in marketing activity to other functional executives and top management. The framework presented here (Figure 1.0) has important implications for assessing the success of CRM initiatives and for justifying resource allocations with long-term payoffs. An appreciation of market-based assets and shareholder value parameters may enable market and product managers to communicate more effectively with managers in the top echelon and other functional areas. Managers must move towards assessing the impact of CRM activities on building and nurturing market-based assets as well as leveraging them to achieve desired market performance ends. They must learn to communicate the impact of these marketplace performance metrics such as brand loyalty and quicker adoption of new products in terms of measures that directly communicate financial value such as reduced risk and accelerated cash flows, respectively. At the same time, accounting and finance professionals must learn to work backwards and ask how marketplace performance measures

affect desired shareholder value metrics, and how CRM activities contribute to those performance metrics.

A new challenge for many marketing managers at the strategy input end is the identification and cataloguing of market-based assets. Cross-functional teams can aid in cataloguing existing assets, identifying additional assets needed to attract, win, and retain customers, and begin a dialogue across organizational boundaries about market-based assets and their impact on financial performance. Consideration of how these assets might be leveraged in developing new products or solutions, reaching new customer sets, and establishing new modes of differentiation, may lead managers to identify new opportunities or to better exploit existing opportunities. Managers can ask whether the stock of each market-based asset is being fully exploited. For example, some organizations will discover that their strong relationships with specific channels are underutilized; the channel could take more through-put; they could do a better job of detailing and pushing the firm's products to customers.

At the output end, marketing managers must assimilate and use the concepts and vocabulary of financial and accounting managers. They can begin by carefully identifying how a marketing strategy or individual marketing programs such as a sales promotion program or a new advertising campaign might affect cash flows. Indeed, the few organizations (e.g., Microsoft, see box) that do leverage their market-based assets well provide excellent guidelines for how other firms can also create and utilize market-based assets. At a minimum, additional marketing decision levers will be added to the arsenal of marketing managers. Examples of these additional levers are those related to value-creating factors that marketers impact but for which they typically do not garner credit such as risk (reduced by brand loyalty and customer retention) and speed (enhanced by more rapid market penetration).

In summary, managers must understand that marketing initiatives lead to market-based assets. These assets have considerable value in and of themselves.

Launching Windows 95

The role of market-based assets in building and sustaining a competitive advantage in the marketplace can be illustrated by examining the strategy and tactics of Microsoft Corp. in its launch of Windows 95. Consider the roots of Microsoft's reputation – and the basis of its competitive strength – illustrated in Figure 6.0 and demonstrated by answers to the following questions:

- Would a software publisher first develop a new (version) of their product for a potential market two million users (OS/2), 10 million (Mac's System 7) or 100-plus million (Windows 95)?
- Would a user buy an operating system with say (17,000) applications (Windows 95), 1,700 (Mac's System 7) or 17 (OS/2)?
- Are consumers more prone to buy products with the largest installed base (be it VHS videocassette recorders or spreadsheets, graphics presentations and word-processors) to be compatible with their friends and with other software products?
- Did the "pre-loading" of Windows by PC-makers and driven by clever OEM pricing by Microsoft (lately ruled unfair after the damage was done), help Microsoft?
- Do incentives targeted at retailers, and brand equity with the consumer installed base, help secure additional shelf-space, point of purchase advice and ultimately market share and long-run installed base?

Answers to explain why Microsoft Windows 95 was able to set an aggressive target of 30 million copies during the first 12 months after introduction – a target equivalent to 10 times OS/2's installed base! Interestingly, some of the same software vendors that complained of Microsoft's monopolistic behavior in the marketplace contributed to Windows 95's success by not only writing applications software on that platform, but actually advertising it as "designed for Windows 95." According to industry reports, applications software and complementary hardware producers more than matched Microsoft's advertising and promotion budget for the introduction of Windows 95. Indeed, each of the roots of

Driving Shareholder Value at Microsoft

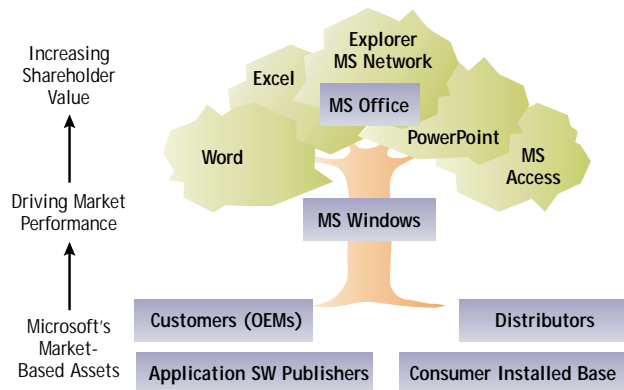


FIGURE 6.0 Driving shareholder value at Microsoft

Such value is recognized by the stock market and reflected in market-to-book value ratios as well as companies that have paid high earnings multiples in buying customer installed bases or access to supply/value networks. These market-based assets also have enduring value-in-use. They can be leveraged to provide marketplace results that fit with company strategy (e.g., some managers might leverage brand equity to support a price premium, others might prefer the longer terms profits often associated with share premiums in markets with customer learning and switching costs). And, positive market performance contributes to cash flow dynamics and shareholder value.

Companies must invest time, money and energy in developing market-based assets. This perspective is at odds with the accounting classification of most marketing activities as "expenses." While senior managers might even prefer this classification because it supports an immediate tax write-off and avoids asset-based taxes, it is important to recognize that what is not measured is rarely nurtured. Therefore, senior managers must maintain internal books and metrics that recognize and catalog these assets as well as their benefits. Failure to do so will result in sub-optimal market performance and destruction of these assets and shareholder value. Finally, as a word of caution, one might remember

that assets can turn into liabilities as the world turns. Compaq's distribution network, and its knowledge and skill in managing this network, proved to be a millstone around its neck when it tried to shift to direct distribution. Indeed, brick and mortar enterprises are discovering the same as they struggle against nimble dot.coms and must co-opt selected distributors in co-branded distribution strategies.

Note

This article draws from two articles published earlier by the authors:

"Market-Based Assets and Shareholder Value: A Framework for Analysis," *Journal of Marketing*, January 1998, Vol. 62, #1, 2-18 (Recipient of the 1998 Maynard Award (Best Theoretical Paper) as well as the 1998 MSI/Paul Root Award (Best Practice Paper) and "Marketing, Business Processes and Shareholder Value: An Organizationally Embedded View of Marketing Activities and the Discipline of Marketing," *Journal of Marketing*, Vol. 63, Special Issue on Fundamental Issues and Directions for Marketing, October 1999, 168-179

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Microsoft's reputations – consumers/end-users, independent software vendors, OEMs and distributors – can be viewed as market-based-assets. They are assets that Microsoft, in a strict sense, does not "own," but they are assets that Microsoft can influence and leverage with other parties and with each other. For instance, when Microsoft serves consumers/end-users, its total offering includes the products, services and expertise of software vendors, distributors, and OEMs. So, how have market-based assets driven shareholder value for Microsoft? They have helped:

Accelerate product adoption and cash flows.

Windows 95 adoptions were aided by the advertising and promotional support of affiliated software and hardware vendors. Users of Excel are likely to try Microsoft Money (developed to fill in the void when the Justice department disallowed the Quicken acquisition). And Microsoft Explorer will have an easier time against Netscape's Navigator riding on top of Windows than it would have had on its own.

Enhance cash flows.

Microsoft has leveraged its market-based-assets to the Windows operating system as well as its applications software. Microsoft software is likely considered more compatible with other Microsoft applications than another brand. This allows the software giant to bundle and cross-sell applications software. Larger market shares lead to larger installed bases, revenues, and cash flow.

Reduce vulnerability and volatility of cash flows.

By cross-selling multiple, compatible products and services, Microsoft has increased the number of bonds with, and hence switching costs for, its customers. This has made it less vulnerable to competitive actions and may also result in scenarios where customers are more willing to wait if a firm is late to market. While Apple (Macintosh) loyalists are right when they say "Mac 88" in response to "Windows 95," Apple is in trouble – not Microsoft. Upgrades sold to a loyal user-installed base