

Chapter 4

Demonstrating payback



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The main purpose of the IPA Effectiveness Awards, and what sets them apart from other awards, is that they clearly set out to encourage marketers and marketing services companies to prove that investing in communications is good business. This doesn't mean 'was it a famous campaign?' (*although it often was*); nor does it just mean 'did sales go up?' (*although they would have had to*). It means 'was it profitable?' Did it 'make more money than it cost to do'? Or, in other words, did it provide positive payback? Because if it didn't, well, nobody summarised it better than Mr Micawber, in Dickens' *David Copperfield*:

Annual income twenty pounds, annual expenditure nineteen nineteen six, result happiness. Annual income twenty pounds, annual expenditure twenty pounds ought and six, result misery.

Or, in our case, increased uncertainty, reduced budgets and troubled career prospects.

Reviewing the papers submitted this year (and some earlier ones), we found that payback clarity was often lacking. Whilst all of the papers unquestionably showed that something significant had happened, not all demonstrated conclusively that true payback had occurred. In fact, there seemed to be a wide variation in understanding about what demonstrating real payback required.

Does this matter? It depends on who we think the ultimate audience for the Awards are. The marketing community itself may be reasonably convinced of the efficacy of communication investment, but even they have their concerns. If, however, it is the wider business community, and within that especially the narrower, specialised community of financially trained executives, that is the intended audience, then they are likely to be both more sceptical and more numerate. Higher standards are required.

What all good effectiveness papers should have, therefore, is clear proof of profit. So the purpose of this chapter is to list the most common problems that seem to arise when 'proving profit', and propose a simple scheme that will enable future judges and readers to understand more precisely what has happened. This will include some simple suggestions as to what can still be said whenever

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important financial information has to be withheld for reasons of commercial sensitivity.

Please note that throughout this chapter I am going to use the phrase ‘marketing communications investment’ to describe the money spent in order to avoid, in this modern integrated communications world, any apparent retro bias by just talking about ‘advertising investment’. I am also going to use, in this case, the term ‘payback’ as being synonymous with return on investment, or ROI.

So, I now turn to the review of the problems we encountered.

Deducting costs

At a very basic level, it appeared that in several cases it was apparently being proposed that if the increased sales revenue value simply exceeded the marketing communications investment cost then that campaign had achieved a positive payback. Would that this were true! Unfortunately, positive payback occurs only when the sum generated after deducting retail margins, sales taxes, cost of extra goods, etc., exceeds the expenditure on marketing communications investment.

A good analogy might be the buying and selling of property. Few of us would think that if we bought a house for £500k, and rapidly sold it for £510k, that it would be likely we had made a profit. We would know that you have to deduct agents’ fees and legal fees, etc., from your sale income – and also add legal fees plus stamp duty to your purchase costs. Net result: you would have lost money.

Defining sales

In some cases, there was uncertainty as to what was actually meant by the term ‘sales’. In one case a business that effectively acts as an agent was claiming £5 extra sales for every £1 invested in marketing communications (the actual numbers were different but not wildly different). But what was not clear was what these sales were: the total retail value of items sold, or their ‘agent’ income? If the former, then the company would need to have had a 20% cut of total sales just to break even on the campaign investment – and this is assuming it had no extra costs arising from those extra sales. Unlikely. On the other hand, if it really was £5 extra actual fee income (their share of the total sale) per £1 invested, then they had probably got a payback rate of several hundred per cent! Sadly, I suspect it was the former case, and this campaign may have – on the basis of the evidence produced at least – actually lost money. In any case, a lack of clarity at a very basic level.

A useful analogy here might be the actual business of ad agencies themselves (or indeed retailers) that can quote revenue at the level of billings, income or net margin. The first is the amount of cash that passed through their hands, the second the amount that they earn in the process and the third the amount left after their costs (e.g. labour) are deducted from the sum earned. Thus you can win a piece of business that increases your turnover (billings), but if it nets you less than you paid to win it, you have lost not gained.

Best practice: demonstrating payback

Timing of revenues

The third problem with revenues, even if they are recognised at the right level, was that of choosing the right time interval to count the revenue over. In most cases the papers choose a simple 12-month timeframe – the normal planning period. But obviously if you choose a longer time period the chance of apparent payback improves dramatically. A simple analogy here is if you are given longer to hit your sales target, it becomes easier to achieve. There are nevertheless often good arguments that returns should be counted over a longer period – customers satisfied or persuaded in one year return in subsequent years, and so forth. In several papers this argument has been advanced – but a number of problems arise, as outlined below.

Lifetime values

The first, and most common, problem with the extended payback argument is the treatment of all customer acquisitions being valued at their ‘lifetime value’. In other words, this is an assumption of likely loyalty times expected revenues, usually discounted at some interest rate. This is typical in contract-based industries like mobile telephony, financial services or even health clubs. It is also often used in public policy cases: cost of lives saved, accidents avoided, etc. Whilst it is a common practice – with the numbers probably being provided by the brand owners themselves – it is also an assumption about the future, and since that is a forecast, it can come unstuck.

In one case, we were presented with a paper that used ‘lifetime’ revenue values to prove payback when, at the time we were judging, we knew the business was being wound down! Perhaps no one was to know this when the paper was being written or the calculations were being made. The important point is that just being provided with such a single large revenue number as a fait accompli, with no explanation of the detail that went into the sum, does not allow the judges, or indeed the actual people we want to convince, the financial community, to exercise proper judgement, and thus have total confidence in what is being shown to them.

Selective time periods

The second, but much less common, problem is the use of selective time periods for assessing revenue return. In one paper, the authors removed the investment months from the payback calculation, analysing only subsequent months’ revenues, which were, unsurprisingly, more profitable – especially since the product was in a growing market. Creative accountancy indeed!

Use of adstocks in econometrics

The third timing problem can arise with the use of econometrics. Those of you who are allergic to econometrics should skip this section and move to problem four now!

In principle, econometric analysis is to be highly encouraged; modelling permits a huge reduction in uncertainty as to what caused what in any situation. But there are potential abuses as well as uses. A discussion of these probably deserves its own

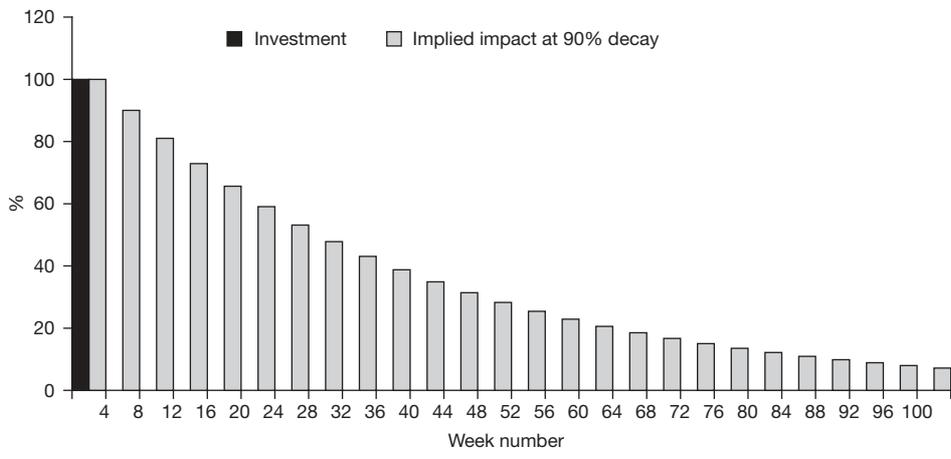
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chapter; suffice to say for now that models should be supplied with all key outputs – coefficients, t-tests and diagnostics – before anyone can draw safe conclusions from them. A little econometrics is a dangerous thing ...

The specific revenue payback time period problem involving econometrics stems from the use of adstocks in modelling. This, again, is a common and correct procedure in principle. If you model advertising, or most marketing communications investment, you will find you get a better ‘fit’, or explanation, if you adjust the investment to ‘flow’ over a longer time period beyond the original period in which it was actually made. The principle is that marketing communications effects persist much longer than in just the initial period; there is a carry-over, or echo, effect. Most people would accept this is probably how marketing communications work – we don’t immediately forget marketing communications, or good marketing communications at least. The normal technique is to ‘flow’ the effect by using a decay rate – an assumption that the effect loses a fixed percentage of its effect for each time period measured – say four-week periods.

Some of the models in the papers ‘fitted’ a very slow decay rate, which implies the investment effects were very long lasting. This increases the amount of sales volume that can be attributed to the investment, and thus improves the apparent payback. There is nothing necessarily wrong with that – but when it was pointed out to less technical judges that a 90% decay rate across four-week periods implies that, by the end of two years, 90% of the total marketing communications investment benefit being counted as payback lay outside the actual period when the marketing communications were being broadcast or distributed (see Figure 1), then there was some doubt. It was rightly seen as an aggressive conclusion – and perhaps an expedient way of multiplying your imputed revenues. I can foresee debate about this issue, but what cannot be argued with, I believe, is that, once again, the fait accompli is not enough – large multiplied revenues need careful explanation.

Figure 1: Effect of decay rate on marketing communications benefits



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Returns come from price as well as volume

A fourth problem is that of a possible bias to new product launches caused by measuring increased revenues only from increased sales. Most papers illustrate the benefit of marketing communications investment in terms of revenue gained from share or volume gained. Yet in highly competitive markets, this can be either impossible or just transient. But marketing investment remains worthwhile. A trip to any supermarket will show many successful brands selling at a considerable price premium to the own-label brands. Some of the best returns (incremental profits) from marketing investment come from price premium growth or protection – yet few papers make that case. It is more tempting to prepare stories of dramatic sales growth, which are typically associated with innovation and launches. This creates its own dilemma. If you invented a cure for the common cold, you would presumably have a highly successful product on your hands – but only as long as people knew about it. So after it inevitably became a massive success, how would you attribute the relative contributions to success made by either the actual product innovation or the marketing of it?

A paper based purely on price premia creation and its protection might be politically difficult for both agencies and clients – but the issue needs to be addressed in papers that seek to demonstrate that investing in marketing communications pays back.

Integrated communications cost base

A final, newly emergent problem prompted considerable debate: accounting for integrated communications, particularly when some kind of ‘knock-on’ effect is being counted. In some cases, free publicity really is free publicity, and the extra exposure generates more communication impacts and thus raises sales. Payback stemming from a small initial ‘seed’ investment can then appear very large indeed. But there can be difficulties in properly allocating the cost base. If a PR initiative leads to a TV programme and the programme actually delivered the result, then was it ‘free’? Should the cost of both activities, PR and TV programme, be netted off the income before declaring positive payback? There is disagreement over this, but no clear answer yet. This field will generate a lot of payback discussion over the coming years.

So, having dwelt on the problems, did anyone get it right? Of course. Several entries demonstrated unambiguous profit from marketing communications investment. One packaged goods entry proved that its campaign was profitable even if you took the worst assumption possible on gross margin. A famous car manufacturer (with a history of effective advertising) was quite open about its profit margins, and thus could prove a very healthy marketing communications investment ROI (in fact it might have been even higher than stated if price premia were also taken into account).

A few simple suggestions

In this section, I present a few simple suggestions on how best to present the data relating to payback.

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Separate out the 'P&L'

First, I would advocate that a separate campaign profit and loss (P&L) is laid out on a separate page in the paper. This is where the analysts will start their reading!

Clarify revenues

Second, on that page, start by sorting out the amount and definition of the incremental revenues.

- Define revenues clearly. Or, in the case of not-for-profit cases, define the returns carefully. Describe in words, and not just in numbers, what kind of revenue we are talking about: retail level? income into company? And so on.
- Consider that revenue gained or retained due to marketing investments comes from two sources: volume *and* price.
- Specify the time period used for the analysis, and explain why it is the right period for the specific market (i.e. something better than 'it is the length of the financial year'). It is legitimate to argue for longer time period effects – but the case should be made explicitly.
- Lifetime values. If they are the currency of the industry in question, then use them – but not in an uncritical way. Find out and quote the assumptions that lie behind these large values in order that judges and business audiences can make their own judgements about the underlying payback.
- Using high adstock decay rates in econometric models of marketing communications effectiveness is also acceptable. But you will need to be prepared to explain in plain English the financial implications of these models, and to argue the case very well for them to be believed without question, given that it will inflate the apparent payback.

Clarify costs

Third, sort out the incremental costs associated with the marketing investment.

- Net off retailer margins and taxes (e.g. VAT) – if in doubt, use average values.
- Net off the cost of goods for the extra sales – use an estimated cost if necessary.
- Arrive at the contribution before deduction of marketing expenses. In other words, of every £1 sold at consumer/high-street prices, how many pence does the company keep before it spends money on the communications investment?

Calculate payback

Fourth, subtract the marketing investment cost from the above contribution. Divide the remainder by the marketing investment cost – and (ta dah!) you have your marketing communications payback percentage.

Make it clear

Fifth, lay it out as a table. Without wishing to be ultra-prescriptive, and accepting that each business situation is unique, the kind of layout that would be clear and useful might look like this:

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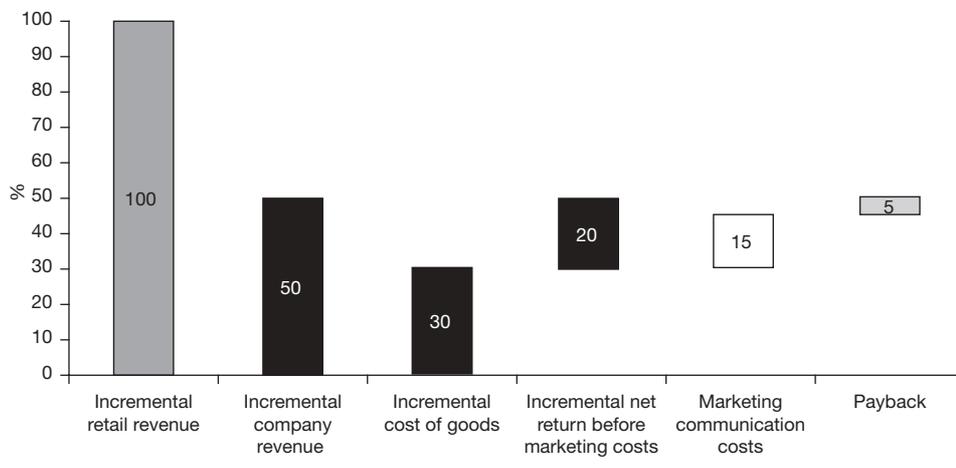
Table 1: Separating profit and loss

Campaign 'P&L'	£-Nominal amounts	Percentage	Commentary
Incremental retail revenue	100	100%	
Incremental company revenue	50	50%	Deductions from retail revenue for VAT, retail margin, etc.
Incremental cost of goods	30	30%	Not directly known but estimates – see analyst report X
Incremental net return before marketing costs	20	20%	Estimate
Marketing communication costs	15		
Payback	5	33%*	

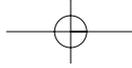
* Denotes return on 'marketing communications' investment

Alternatively, another clear and quick way of showing the same information could be to graph it. Figure 2 displays the same key information as the table above.

Figure 2: Marketing communications payback



Even if you cannot show this level of information, you can still nevertheless work out the break-even point for the investment. In the case above, it would require an incremental net return before marketing costs of £15 before the marketing communications investment broke even (or a break-even margin – at this level – of 15%, i.e. below the 20% shown). If you can get your client to say that the actual margin is (a) higher and (b) they are currently planning to repeat such investments, then a convincing business argument will have been made without divulging any confidential data.



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Involve the FD

The sixth and final idea is to get your finance director to have a look over your calculations. Don't just prepare your paper as a planning document; prepare it as a business document.

Finally ...

The bottom line – literally – is that marketing communications payback is what's left after the right incremental costs have been deducted from the right incremental revenues. Simple to say, a little bit harder to do properly – but not impossible.

