THE CAMPAIGN ESSAY

PAYBACK TIME

PricewaterhouseCoopers' Andrew Sharp looks at the intrinsic benefits adspend can have on a brand's profitability and value

It should come as no surprise to readers of *Campaign* that brands are very valuable, but sometimes it is hard not to be impressed by the numbers. A few months ago, I worked on a project where it was estimated that the value of a particular brand was somewhat more than $1 billion. This was not the total company value, but the value of the brand reputation alone. It was that company's most significant asset. Several things had contributed to creating that brand value: commercial ability, design expertise (but not manufacturing, that was outsourced). But the main driver, as far as we could see, was years of sustained investment in advertising. The implied ad payback was enormous.

Advertising is persuasion. Advertising is selling. But above all, advertising is an investment. If it doesn't pay back, advertisers won't do it. Collectively, it appears that "UK plc" believes it works. Advertising in a form we would recognise has existed for well over 100 years, and for the ten years up to the end of 2005, the amount spent grew consistently by 5 per cent a year to reach a sum just shy of £19 billion, according to the Advertising Association. The last quarter has shown the fastest growth for three years, according to the IPA's *Bellwether Report*.

But anyone involved in the setting and management of any individual ad budget will tell you that the task is often an uncertain one. The most extreme example I have been involved in was with a major US retail bank, whose ad budgets swung from $200 million to $400 million, then down to $100 million in consecutive years. The bank wasn't completely sure what the right level was, because it wasn't completely sure what the return was.

Even where there is some initial conviction that the ad budget has been set at the right level, it can become vulnerable to being used as the rescue fund if the business is not meeting its numbers. As one senior marketing director once said: "You can't cut people in a hurry, you can't cut your trade bonusing, but you can raid the ad budgets (and research budgets) in an instant."

This presents something of a conundrum. If there is such a pot of gold at the end of the rainbow, why is advertising expenditure often so hard to come by? Why are there so few marketing directors on main company boards? This was echoed in the recent IPA Effectiveness Awards – the genesis of this article – where several of my co-judges noticed two curious things.

Even in what is the longest-running, and arguably best, advertising effectiveness competition in the world, the concept of payback hasn't yet settled down; it seemed to vary from case study to case study. It was not wrong, just different. Second, and this may be connected, there was at times a disparity between the collective intuition of the judges that, in the best cases, something very significant had occurred – a shift in opinion that would result in almost a reinvention of the business, benefiting it for years to come – and the ad payback numbers which, while positive, were not so emphatic.

So what is happening here? PricewaterhouseCoopers' contention is that the problem stems from how we normally think about ad payback. Typically, we look for short-term sales gains. There is nothing wrong with sales gains, unless they have been bought at a loss by, say, price reductions. But they do not tell the whole story, and often do not, in themselves, seem to produce enough payback to justify the ad investment, even on brands that have been built up by ad investment over the years.

The full returns from ad investments occur in two ways. First, from longer-term effects and, in some cases, perhaps very long-term effects. One of the "games" we sometimes play in training sessions is to ask finance executives to attach brand names to taglines. They are unsurprised to achieve an accuracy of about 90 per cent. They are surprised, however, when we tell them these taglines haven't been used for about 20 years.

> "The benchmark to work out the brand benefit, and thus the right brand investment budget, is not last year's sales"

Second, and more important, the benefit comes from sales not lost and price discounts not made. What this double negative is attempting to convey is that spend should be justified not just by what has been gained, but also by what would have been lost if it had not been spent. If you withdraw investment from brands, they may wither and decline, so in many cases, investing just to stay in the same place produces more profit than by not investing. In many cases, advertising is, in effect, the membership fee to the market – and the profits it yields.

But long-term effects take time to reveal themselves, and invisible effects are hard to see. It is for these reasons among others that, in my view, advertising is the hardest investment of all to evaluate. So how should you think about payback?

At PricewaterhouseCoopers, we take an economic approach. All investments – and that includes advertising – should always be measured against the best alternative use of the money. The alternative case for investing in brands is keeping the money in the bank and selling a product or service as a commodity.

But most businesses today usually choose to sell as a brand, and, if successful, the result is more sales or a higher price or, most likely, a combination of both.

Multiply the extra sales by the extra price and you have the brand incremental profits.

These brand profits also have some duration. If we don't invest this year, we don't revert back to commodity position overnight. The brand achieves momentum – and that has a cash value, too. Today's brand incremental profits can be used to calculate brand value. This involves forecasting tomorrow's brand incremental profits across several years and discounting them back to a net present value (NPV). This is a complex subject in its own right, but briefly, it is this extrapolation of brand profits which produces the big prices that have to be paid to acquire one of these brand-owning companies – to acquire the cash-flow generators these brand reputations have become.

So, the true measure of payback is the distance travelled from the commodity in volume and value terms – and the ability to keep that distance.

COLIN STOUT

Sharp… 'We have discovered something of an arc – where some of the most basic and some of the most luxurious brands have the highest-brand profits'

Easy to say, harder to do. Our new approach involves surveys (vital since brand values ultimately only exist inside consumers' heads), and it also involves a bit of economic analysis.

The early results are intriguing. We have discovered something of an arc – where some of the most basic and some of the most luxurious brands have the highest-brand profits (as a percentage of revenues), whereas for products or services in the middle, choices are often driven by more functional considerations.

It is just a hypothesis at this stage, but it could be that at both ends of the markets, functional differences are slight or hard to detect, and reputation thus becomes the main criterion on which to choose. This applies to fashion products, but even services like hotels are, to our surprise, often found at the luxury end of the arc, with large apparent brand incremental profits.

Does this mean that brands are unimportant in categories such as consumer electronics or mobile telephony, where functional considerations predominate? Definitely not. In competitive markets, price and function can often be quickly emulated, which leaves brands, harder to copy overnight, as the residual "swing vote". But it does mean that in those kinds of markets, a brand reputation could be quickly overwhelmed by a competitive, but exclusive, innovation.

Some of the most dramatic results show up when good product innovation is combined with strong branding. The Apple iPod would be the obvious example, but another less obvious one would be Nespresso, combining innovative technology and branding. According to data in Nestlé's February 2007 investor roadshow document, Nespresso was its fastest-growing major brand last year.

Of course, the market everyone has an opinion on is cars. PricewaterhouseCoopers has constructed a car brand value game, which has been used repeatedly across the UK, Europe and the US. There has never been a session where the participants did not disagree with each other and the results, or taken issue with the precise model combinations, or cited evidence of local quirks that supported their view or even introduced new car brands and models into the discussion. Inadvertently, we have found a neat way of releasing the inner petrolhead. Unsurprisingly, in a market of such passionate opinions, brand profits are considerable. But more surprising is by how much the choice preferences, expressed in cash terms, vary by individual. Any individual car brand can be worth thousands more to one individual than to another. But what seems to be consistent is that the highest values are registered by those car marques with a long history of both excellent products and excellent advertising.

This is corroborated by this year's Volkswagen Golf IPA Effectiveness Award-winning work. It showed consistent quality advertising, but also that it was a quality product delivered over years, and which has created an almost unique franchise.

The second observation is that some very big and famous companies don't necessarily have big brand profits. Companies can be famous and sell a lot of their product, but may not be doing that much better than a commodity supplier or near-commodity supplier might in its market. So beware simplistic approaches which show brand values are closely related to the market value of companies.

Finally, we have noted some thoughts about pricing. Everyone agonises about how to price their products – will cutting prices boost volume enough to boost profits? Have they charged enough? Initial findings are that truly strong brands may be under-pricing. The opposite – over-pricing and its impact on profits – is harder to determine without knowing the underlying cost structure of any particular business.

Why does PricewaterhouseCoopers care about this? As objective valuers, we have to understand the increasing share of company value that is "intangible", and brands can be a significant part of this. We need to know this when companies are up for sale or have just been bought. We also need to know values when brands are being licensed, either to set the right price or to evaluate the tax exposure. So what practical lessons does this have for marketing and advertising executives?

First, sometimes ad investments contribute far more value to companies than is recognised. Second, always try to think about brand profit achieved and not just sales – think about the total difference made versus the alternative investment case of doing nothing. The benchmark to work out the brand benefit, and thus the right brand investment budget, is not last year's sales. Next, think about how you are supporting the price as well as how you are supporting the volume. Finally, think about the longevity added to the product or service by the brand investment and what that means in incremental profits.

If you are fortunate enough to think that you might have a big IPA Award-winning success on your hands, you probably have a very big business story to go with that as well. It is worth looking into this. Finally, if you are writing an IPA Award paper, read the payback chapter in *Advertising Works 15*, it could help your chances of securing a prize. My guess is the focus on payback is increasing, not decreasing.

Andrew Sharp was a judge for the 2006 IPA Effectiveness Awards and a contributing author to the recently published Advertising Works 15, *available from www.warc.com*