

Is There a Silver Metric for Marketing Accountability? (Pt. 2)

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My [last article](#) discussed whether any single financial indicator provided an adequate measure of marketing performance. We reviewed return on that investment (ROI) or some variant on the incremental discounted cash flow (DCF), which can be expressed in various ways, e.g. increased net present value (NPV), customer equity, brand valuation, shareholder value*, or customer lifetime value. ROI aside, these are all different labels for the same thing, namely incremental cash flow in future years, discounted by the time costs of waiting for the money and added together. Risk factors are sometimes included. For simplicity, we will refer to this group as “NPV.”

Marketing metrics are merely tools. Like all tools, they are suitable for their intended tasks but not for other uses. ROI is suitable for comparing alternative one-off capital investments, yet most marketing costs are ongoing, repeat expenses, so ROI is unsuitable. NPV methods are valuable for considering future alternatives when market planning, for example, but not for considering the past. NPV looks to the future, not to the past, nor to performance to date.

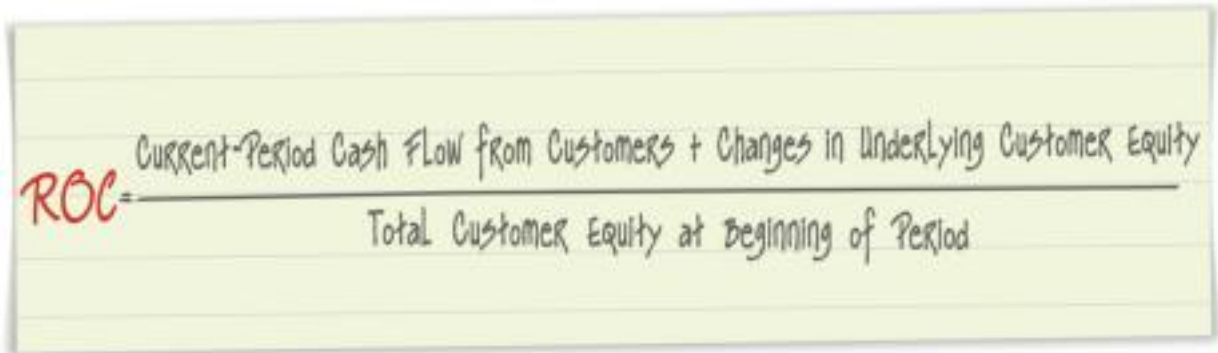
Return on Customer SM

Recently, another metric, “Return on Customer” (ROC), has been proposed as a silver metric that can be used to judge marketing performance. In their book *Return on Customer*, Don Peppers and Martha Rogers have proposed that ROC can be used as the ultimate marketing performance indicator because maximizing ROC also maximizes both current period and future profits. The concept has attracted some attention from business analysts: Larry Kudlow, host of CNBC’s “Kudlow and Company,” enthused, “Finally! A business metric that can drive better management and a higher stock price. I predict soon you’ll be hard pressed to find a company that isn’t tracking ROC.”

The Peppers and Rogers definition is: “ROC equals a firm’s current-period cash flow from its customers plus any changes in the underlying customer equity, divided by the total customer equity at the beginning of the period.” Looking at the changes in short-term cash flow and the marketing asset is valid and corresponds with my view of performance measurement. Whether they can be added together to create a silver metric is another matter. The questions, therefore, become how can we measure the change in the marketing asset and is it correct or even reasonable to use a single measure of it rather than many.

Customer equity is, in line with Rust, Lemon, and Zeithaml, taken to be the NPV of future cash flows from customers. The concept is clear, but one very practical problem is predicting who all the future customers will be, and what cash flows will be contributed in response to the infinite permutation of marketing activities that the firm may undertake in future. In other words, this “silver metric” depends on crystal-balling the immeasurable future. As Peppers and Rogers themselves concede in a slightly

different context, “No one really knows what any company’s discounted cash flow is going to be in the future.” In reality, then, DCF and customer equity are just different labels for the same thing.



$$\text{ROC} = \frac{\text{Current-Period Cash Flow from Customers} + \text{Changes in Underlying Customer Equity}}{\text{Total Customer Equity at Beginning of Period}}$$

ROC, based on the Peppers and Rogers definition, is another matter. In plain language, if one replaces the current year’s customer equity (NPV) calculation by the equivalent calculation made a year earlier, the top line of their formula becomes the difference between the actual and forecast cash generated for the period under review plus the difference between the two forecasts for the same outward years. Thus, if the forecasts are accurate, the return is zero. In other words, this ROC formula does not measure return on the value of the marketing assets so much as the excess of the return for the current period (compared to forecast) plus any increase in forecast, both taken as a ratio of customer equity.

We are measuring the accuracy and consistency of forecasts, not marketing performance.

The Peppers and Rogers calculation of ROC is positive when the firm is doing better than was previously expected. This may be both sensible and practical. On the other hand, ROC might just measure the accuracy of the forecast for the period just completed and the consistency of out-years rather than actual marketing performance, which was the object of the exercise. Those who forecast low before and high now will appear better than those who did the reverse. In actual performance terms, either one could have been more successful than the other.

This relative performance aspect of ROC indicates that it can be susceptible to “gaming,” i.e., low budgeting and/or fattening short-term cash flow at the expense of the longer term, while maintaining the high forecasts for the out-years. This is a problem for all DCF techniques but becomes compounded in the calculation of ROC.

Competitor performance might be a useful yardstick for comparison, but that is not considered by ROC.

We also need to consider differences arising from year-to-year changes in the discount rate used. An increasing customer equity (NPV) may be due to real changes in future marketing prospects based on good marketing work in the current period, or it may have nothing to do with marketing performance but rather changes in discount rates or other “environmental” factors. In the end, ROC leaves us subject to all the problems of using NPV as a performance indicator mentioned above. The technical interest rates and year shifts are not what we are examining. Worse still, the new forecast may have changed due to external factors, such as the political situation, which have nothing to do with the marketing performance being evaluated.

ROC brings NPV and ROI together but does not appear to provide a silver metric for assessing marketing performance. NPV can be a valid technique for comparing alternative future marketing activities, partly because they are simultaneous and therefore the external factors are the same for both. Time-shifting NPV calculations makes them less valuable for comparison because other factors are much less likely to be identical between the different years of estimation.

Remarkably, Peppers also claims that ROC equals total shareholder return (TSR), the increase in shareholder value as a ratio of the assets. Since ROC is zero whenever the forecasting is accurate and consistent, shareholders might not be happy with this TSR. In summary, ROC appears to measure little beyond the current discount rate used by the firm, which is hardly useful, and the accuracy and consistency of forecasting from one year to the next. In other words, the skeptic would see ROC as measuring forecasts rather than performance, but the supporter would see ROC as measuring performance relative to forecast. Neither would be totally wrong or totally right, and the debate over marketing performance would continue unresolved.

Which Metrics Deserve a Place on Your Dashboard?

Eliminating silver metrics leads to the conclusion, which others (like your editor Pat LaPointe in his book *Marketing by the Dashboard Light*) have reached by other means, that management needs multiple metrics to help drive the business. Since business problems arise unpredictably, a range of

tools, metrics, or indicators is needed to cover likely market issues. The “dashboard,” which may be on a sheet of paper or a computer screen, describes the way the indicators should be collected together to be seen as a whole.

Big companies need more metrics than small ones, and they have the resources to collect and process them. All companies need to include the key attributes of brand health and probably some kind of NPV metric. Some metrics should be behavioral, such as loyalty or market share, and some intermediate, such as customer satisfaction or intention to purchase. Some should be absolute, like distribution, and some should be relative to competition, such as share of voice or relative price. All should be compared with the plan and have long- and short-term trends.

In complex groups, top management will want also to monitor the top brands or countries or business units, but these typically will need the separate dashboards used by the top managers of those units. Even without this subunit analysis, just a few metrics can soon outstrip the space available on a page or computer screen. A dashboard, just like the one in your car, has a further option: indicators like the fuel gauge are permanently on view, while some, like the oil level warning light, are only visible when that problem arises. Having top management debate which metrics should always be visible and which should only light up when the variance warrants it will teach them quite a bit about their own business. How the business works, what the business model is, and what you should measure are much the same.

Conclusion

One of the NPV metrics — customer lifetime value, customer equity, or brand valuation — deserves a place on the dashboard both to evaluate alternative plans and to track how circumstances drive expectations. NPV techniques help develop the business model by observing the way performance differs from plan. But a firm needs a dashboard of key market metrics, not just one. Each metric has particular uses, strengths, and weaknesses. Thus, a dashboard needs a variety of metrics to cope with the different circumstances it encounters. Return on Customer is heavily dependent on forecasts. It appears simply to compare the cash flow for the year completed with the forecast for that year and the consistency of last and this year’s forecasts for future years. As such, its value as a dashboard metric, never mind as a “silver metric,” is dubious.

Managers must go below these single summary measures to the few key drivers of the business that may be moving interdependently, but provide a full view of the state of the business.

Analysis of the ROC Formula

Peppers and Rogers have defined ROC in various but equivalent ways. Slide 42 of their presentation (see References below) has:

$$ROC_i = \frac{\Pi_i + \Delta CE_i}{CE_{i-1}}$$

where Π_i is the cash flow for period i and CE is customer equity.

This is equivalent to:

$$ROC_t(t^*-1) = \frac{C_t(t^*-1) + CE_t(t^*) - CE_{t-1}(t^*-1)}{CE_{t-1}(t^*-1)}$$

where $C_t(t^*)$ is cash flow during the period t^* as estimated at time t and $CE_t(t^*)$ is customer equity starting with period t^* as estimated at time t . t^* relates to a time period (usually one year and taken as such here), whereas t stands for the moment at which the estimate is made; otherwise they are the same. We only need the $*$ notation to clarify which is the forecast date and which is the period. ROC looks at the cash flow for the period just completed (the period (t^*-1) takes us to time t) and the customer equity looking forward.

Note that cash flows are in contemporary money: $CE_{t-1}(t^*)$ is the same as $CE_t(t^*)$ except that the date of the forecast is a year earlier. $CE_t(t^*)$ does not need to be discounted by a year in money terms. This treatment is consistent with marketing planning practice.

Therefore $CE_{t-1}(t^*-1) = C_{t-1}(t^*-1) + CE_{t-1}(t^*)$, i.e. the cash flow for period t plus customer equity with the calculation starting a year later. Residual values are assumed to be trivial and years are treated as units.

Substituting for $CE_{t-1}(t^*-1)$ in the ROC formula above gives:

$$ROC_t(t^*-1) = \frac{\{C_t(t^*-1) - C_{t-1}(t^*-1)\} + \{CE_t(t^*) - CE_{t-1}(t^*)\}}{CE_{t-1}(t^*-1)}$$

In other words, ROC adds the actual to forecast variances for short-term cash flow and customer equity respectively and divides them by the prior year's customer equity. If the prior forecast of the period's cash flow was accurate and the two estimates of customer equity consistent, ROC is 0, which is hardly the result Peppers and Rogers can have intended.

Thus ROC does not measure return on the value of the marketing assets so much as the variance of the cash flow for the period just ended plus any change in forecast cash flows, both taken as a ratio of customer equity. This is directly analogous to abnormal earnings growth used to value performance changes in other equities.

A difference is that this formula scales it by taking the ratio to incoming customer equity at time t-1, $CE_{t-1}(t^*-1)$. Of course, doing so introduces many of the problems of ROI, not the least of which is that maximizing ROC does not correspond to maximizing the value of marketing to the firm.

References

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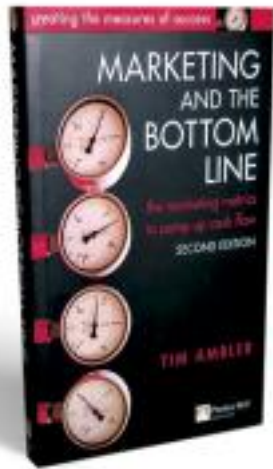
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* Shareholder value can also be measured as the cash return to shareholders plus the increase in share value, but changes in share values are commonly held to anticipate future cash flows.

Return on Customer is a service mark of Peppers & Rogers Group, a division of Carlson Marketing Group, Inc.



Adapted from London Business School working paper 05-709: "Choosing Marketing Dashboard Metrics" by Tim Ambler and John Roberts. [Click here](#) to read Part 1 of this article.

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