Must Finance and Strategy Clash?

Marketing and finance are complementary —when the analysis right

by Patrick Barwise, Paul R. Marsh, and Robin Wensley

Marketers and finance people seldom see eye to eye. The marketers say, "This product will open up a whole new market segment." Finance people respond, "It's a bad investment. The IRR is only 8%." Why are they so often in opposition?

The financial criteria used to decide if a project will be profitable are entirely consistent with the tenets of competitive marketing analysis. Correctly applied, good financial analysis complements rather than contradicts good marketing analysis. In practice, though, the analysis usually falls short. That explains why a strategic investment's projected returns are so often out of line with the marketing and strategic logic.

From a financial perspective, a good investment is one with a positive net present value-that is, one whose value exceeds its costs. While marketers often think a project's NPV is merely the result of financial arithmetic, in reality, it is derived from strategic marketing issues. To have a positive NPV, a project must pass two tests[1]: Does the product or service have enough value to enough customers to support prices and volumes that exceed the costs of supplying it – including the opportunity cost of capital? This question is central to postwar marketing and the "marketing concept." Second, does the company have enough sources of sustainable competitive advantage to exploit, develop, and defend the opportunity? This reflects marketing's more recent emphasis on competitive strategy. The trick, then, is to encourage an investment decision-making process in which the financial analysis highlights rather than masks these two fundamental marketing questions.

Consider Fashion Bathrooms, a disguised but real division of a diversified engineering company that makes traditional cast-iron bathtubs. The CEO and her senior managers were considering new investments. One option was to adopt a novel proprietary casting process to make lighter bathtubs that could compete better against plastic ones. The $20 million investment seemed wise from a marketing perspective, but the investment's NPV came to a negative $2 million.

Good analysis ties the details of strategy to the financial implications

A debate ensued. Some top managers put their faith in the numbers. They believed that although the project would produce a superior product in many respects, its capital requirements were excessive. To the CEO and some others, however, Project Lightweight still made intuitive sense. They wanted to go ahead with it despite the negative returns. As the marketing director put it,

[1] Patrick Barwise, Paul Marsh, and Robin Wensley, "Strategic Investment Decisions," *Research in Marketing*, vol. 9, 1987, pp. 1-57.

"There are some investments you have to make simply to stay in business-regardless of their rate of return."

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In the end, what was good for Fashion Bathrooms in a marketing sense was also good for it financially. The initial analysis simply failed to reflect that reality. To sharpen the financial analysis, the managers returned to the marketing strategy and delved deeper into it. Now the financial analysis helped clarify the marketing issues to be reconsidered.

Good project evaluation considers *all* the relevant factors, including hard-to-quantify costs and benefits. It also takes into account the more neglected consequences of *not* investing. It recognizes the value of opening up options and, by not arbitrarily restricting the time horizon or setting discount rates too high, avoids undervaluing long-term projects. Understanding project evaluation is easy. Doing it is the real challenge.

Use the right base case

Finance theory assumes that a project will be evaluated against its base case, that is, what will happen if the project is not carried out. Managers tend to explore fully the implications of adopting the project but usually spend less time considering the likely outcome of not making the investment. Yet unless the base case is realistic, the incremental cash flows— the difference between the "with" and the "without" scenarios—will mislead.

Often companies implicity assume that the base case is simply a continuation of the status quo, but this assumption ignores market trends and competitor behavior. It also neglects the impact of changes the company might make anyway, like improving operations management.

Using the wrong base case is typical of product launches in which the new product will likely erode the market for the company's existing product line. Take Apple Computer's introduction of the Macintosh SE. The new PC had obvious implications for sales of earlier generation Macintoshes. To analyze the incremental cash flows arising from the new product, Apple would have needed to count the lost contribution from sales of its existing products as a cost of the launch.

Wrongly applied, however, this approach would equate the without case to the status quo: it would assume that without the SE, sales of existing Macintoshes would continue at their current level. In the competitive PC market, however, nothing stands still. Competitors like IBM would likely innovate and take share away form the earlier generation Macintoshes-which a more realistic base case would have reflected. Sales of existing products would decline even in the base case.

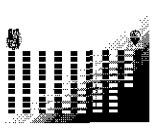
Consider investments in the marketing of existing brands through promotions, media budgets, and the like. They are often sold as if they were likely to lead to ever-increasing market share. But competitors will also be promoting their brands, and market shares across the board still have to add up to 100%. Still, such an investment is not necessarily wasted. It may just need a more realistic justification: although the investment is unlikely to increase sales above existing levels, it may prevent sales from falling. Marketers who like positive thinking may not like this defensive argument, but it is the only argument that makes economic sense in a mature market.

In situations like this, when the investment is needed just to maintain market share, the returns may be high in comparison with the base case, but the company's reported profits may still go down. Senior managers are naturally puzzled at apparently netting only 5% on a project that had promised a 35% return.[2] Without the investment, however, the profit picture would have looked even worse, especially in the longer term.

Some projects disappoint for other reasons. Sometimes the original proposals are overoptimistic, partly because the base case is implicit or defined incorrectly. That is, if managers are convinced that the investment is sound and are frustrated because the figures fail to confirm their intuition, they may overinflate projections of sales or earnings. But misstating the base case and then having to make unrealistic projections are unlikely to cancel each other out; they merely cloud the analysis.

The base case against which Fashion Bathrooms first compared Project Lightweight implicity assumed that sales would stay the same without the investment.

[2] Joseph L. Bower, *Managing the Resource Allocation Process* (Boston: Harvard Business School Press, 1986), p. 13.



In fact, sales were declining. When managers reevaluated the project using the correct base case, the negative NPV disappeared. The finance director also began to question the discount rate. He had at first used a high rate because the volumes and therefore the cost savings seemed very uncertain. At the time, Fashion Bathrooms had two plants, both running below capacity. Project Lightweight would upgrade one, so only products made at that plant would benefit from the new efficiencies. The finance director realized, however, that Fashion Bathrooms could shift all production to the upgraded plant until it hit full capacity. That way, the company would be sure to get the full savings. The second plant would handle only the overflow.

Other managers at Fashion Bathrooms thought that exiting the business was a more relevant base case. This alternative proved to be unattractive. The company would face heavy closure costs, and its plants had few alternative uses and therefore very low resale value.

Define the project boundaries

Advising managers to get the base case right is like telling them to get the project right. Obviously, the advice is grossly simplistic. One difficult task, for instance, is defining the project's boundaries: What is the correct without case-exiting the business, carrying on as things are now, improving distribution and marketing? And what is the right version of the project? Usually, there are several quite different ways of implementing it.

The project's boundaries tend to shift during the course of the analysis. Different players view the investment differently. For the CEO of Fashion Bathrooms, the without case was the dismal prospect of soldiering on in a declining market, while the investment was a way to improve morale and signal a commitment to stay in business. The manager of the plant that would not be upgraded saw things differently. While the without case would allow his factory to maintain its production level, the with case was a sure route to reduced output and diminished personal status—or even the loss of his job.

In principle, managers should take a corporate perspective when considering incremental costs and benefits. In practice, this is unrealistic. Unit managers' own responsibilities and self-interest will influence their perception of the project and color the way they define and analyze the proposal.

A project may look good at the business unit level because it shifts costs or steals share from another unit. From the corporate perspective, such a project would be less appealing. Fashion Bathrooms' parent company had a minimal share of the plastic bathtub market, so management ignored any erosion that Project Lightweight might cause. Had the plastics division been larger or more important, corporate management would have wanted the analysis to include the loss for the plastics division as well as the gain for the cast-iron bathtub division.

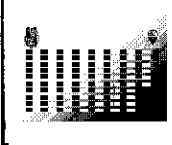
One might expect the boundaries of a project to be defined more broadly at the corporate level than at the business unit level. This is not always the case. The CEO of Fashion Bathrooms, for instance, proposed the ambitious idea of combining marketing for the plastic and cast-iron divisions. The parent company board discouraged her from pursuing this course. It wanted her to narrow her focus and first sort out the operating and marketing problems at Fashion Bathrooms.

Choose an appropriate time horizon

Project boundaries are also defined in terms of time. A project's financial analysis often extends over whichever is shorter: the assets' physical economic life or some arbitrary time horizon, like ten years. In the final year, the analysis may include minimal salvage values for the largest tangible assets. But financial appraisals seldom explain why a particular time horizon was chosen, even when the numbers are sensitive to the project's assumed life.

Strategic projects seldom have short or even easily defined lives. A plant built to manufacture a new branded product will eventually have to be replaced, but the product's value to the company, if successful, may easily outlast the plant. Or the plant's replacement date may extend beyond the time horizon used to appraise the project. None of this matters as long as the financial appraisal includes full economic terminal value rather than salvage amounts. The terminal value should reflect the eash flows over the remaining life of the existing plant or the value of the brand when the plant is replaced.

Some managers argue that it is pointless to look beyond ten years since cash flows will have only a small



present value when discounted and since no one can accurately forecast that far ahead. But if terminal values are large, as they are for many strategic investments, they will be significant even when discounted. And that such values are notoriously hard to forecast is little reason to ignore them. Many strategic investments are designed to build a market position, a research capability, a reputation, or a brand name. Assuming that these assets are worthless beyond some arbitrary horizon fails to reflect the strategic reality.

The bathtub managers were fully aware that they had chosen an arbitrary time horizon for evaluating Project Lightweight. Their choice of ten years was purely pragmatic: there were ten columns on the company's capital-budgeting appraisal form. Since ten years was also the standard life over which plant and machinery were depreciated, they inserted no terminal value for the upgraded plant. In reality, however, the upgraded plant would last longer than ten years, and the market for cast-iron bathtubs was projected to continue well into the future.

Evaluate options

Strategic investments usually go beyond exploitation of a particular opportunity. They open up options that extend even further into the future than the original project. When, for instance, Nestlé was considering its take-over of Rowntree, it paid close attention to the intangible assets. Nestlé was particularly interested in Rowntree's brands because of the marketing and distribution options they provided, especially in Europe in the run up to 1992.

Obviously, options stemming from investments in R&D, know-how, brand names, test markets, and channel developments have value beyond the initial investment. Less obvious is the value of the options to create subsequent products that complement or are based on existing ones.

Financial theorists and professionals have long been interested in valuing financial options like puts and calls, warrants, and convertible bonds; valuation models for these options are well-known. More recently, however, theorists and practitioners have acknowledged the importance of options on real assets[3] But quantitative models for valuing these kinds of options are almost impossible to apply in practice, since truly strategic options are so vague and often depend on a manager's vision of what might happen.

A product brand may outlast the factory. Do you give it a terminal value?

Financial appraisals of strategic investments therefore usually focus on the opportunity at hand and seldom try to value market opportunities that the investment may create. Businesspeople try to compensate for this when it comes to making the real decision. As Richard A. Brealey and Stewart C. Myers wrote, "Businesspeople often act smarter than they talk... They may make correct decisions, but they may not be able to explain them in the languaje of finance."[4]

Fashion Bathrooms was well aware of the options that Project Lightweight could open for its cast-iron bathtub business. First was the possibility of modernizing the company's second plant by introducing the casting process there as well. The attractiveness of this action would depend on the sucess of the company in reversing the market decline. Second, Fashion Bathrooms could use the same brand name to produce complementary products like washbasins and shower trays. The company made no attempt to value these opportunities, partly because they were just ideas with a small chance of being implemented and partly because Project Lightweight already appeared financially worthwhile.

Unbundle the costs and benefits

Almost any strategic investment can be regarded as a bundle of component subprojects, each with different costs and benefits. It is useful to recognize this and unbundle the subprojects. Doing so simplifies the analysis and helps managers make forecasts and assumptions explicit. It may also help the proposers come up with a better alternative.

[3] See Stewart C. Myers, "Finance Theory and Financial Strategy," *Interfaces*, January-February 1984, pp. 126-137.

[4] *Principles of Corporate Finance*, 3rd edition (New York: McGraw-Hill, 1988), p. 258.

Take an investment in a highly competitive market, like a Main Street retailing operation. The investment is a combination of two things: an investment in real estate and an investment in retailing skills. Yet financial evaluations normally lump these together, showing the total project as an initial investment in real estate plus shop-fitting costs, a stream of retailing profits, and a terminal value for the real estate and retailing business. A common problem with this formulation is that an overoptimistic terminal value for the real estate can make a bad retailing investment look good; a pessimistic value can make an efficient retailing operation look like a loser.

An alternative analysis would view the investment as two related projects. The first is a straight real estate investment, which includes the initial cost, a stream of rental receipts, and a terminal value. The second is a retailing investment, which involves the initial shopfitting costs, the stream of retailing profits net of the rental, and the terminal value of the retailing operation.

Unless the company has a genuine competitive advantage in real estate, the NPV of the investment in real estate in the highly competitive Main Street market will probably be zero. Using the assumption of a zero NPV and given the purchase price and market rentals, managers can find the terminal value of the property. This shifts the focus to the second project, where the company may indeed have a competitive advantage. By stripping out the initial cost and the terminal values of the real estate and replacing these with the market rental, that is, with the opportunity cost of renting the space to another tenant, the company can evaluate the pure retailing project without the bias of an optimistic or pessimistic assumption about future real estate prices.

Performing the analysis this way clarifies the investment decision and avoids misleading forecasts. It also raises questions that might otherwise go unasked. In the Main Street deal, for example, it raises questions like: Would it be better to rent rather than buy the real estate? Or is it better to forgo the retailing project and invest in the real estate only?

Many strategic investments come packaged with investments in highly competitive and risky markets: overseas investments in manufacturing facilities may come with investments in foreign currency, investments in natural resource extraction may come with an investment in the resource itself, and so on. The best approach is to separate the investments in which the company has some competitive advantage from those in a highly competitive market and for which the NPV is likely to be zero.

Projects are also often bundled for political reasons. Proposers may include under the project umbrella a smaller project that would be hard to justify by itself. In one packaged-goods company, the executives buried in a large cost-saving investment a staff and office space upgrade and an investment in a new computer system. Although related to the costsaving project, these additions were not essential to it. In such cases, project evaluators should proceed with caution. Unbundling is a useful analytic discipline, but it may be counterproductive to do it too explicitly. In our experience, managers often indulge in this kind of bundling to gain approval for genuinely worthwhile projects that are hard to justify in their own right. If they are forced to quantify the benefits of each subproject separately, some good projects may never see the light of day.

What gets included in or excluded from a project also depends on the proposers' need to end up with financial forecasts that are good enough to gain acceptance but not so good as to become an embarrassment later. It is often assumed that managers use optimistic revenue and cost projections if the project doesn't look profitable enough and do the opposite if it looks too profitable. According to our research, managers are in fact more likely to influence the numbers by redefining the project's boundaries.[5] They realize this is less likely to give hostages to fortune.

Some investments are really two. Do you analyze them separately?

A highly profitable project will tend to be justified on the basis of its direct benefits but may also carry many indirect costs for such things as new computers or site refurbishment. Conversely, the proposer of a marginal project will tie in as many direct, quantifiable benefits as he or she can and exclude all indirect costs. This way, managers get corporate support for most of their

[5] Paul R. Marsh, Patrick Barwise, Kathryn Thomas, and Robin Wensley, "Managing Strategic Investment Decisions," in *Competitiveness and the Management Process*, ed. Andrew Pettigrew (Oxford: Basil Blackwell, 1988).

projects without seriously compromising the decision-making process.

The management team at Fashion Bathrooms recognized the importance of project unbundling. Project Lightweight offered cost savings through a reduction in raw materials costs. On the other hand, it also promised quality improvements that would lead to increased sales. The CEO asked the finance director to rework the figures to determine if the project could be justified on the basis of cost savings alone-a benefit much easier to measure than incremental sales growth.

Unfortunately, cost savings alone were not enough. The project made sense only if the quality improvements could boost sales. This realization provoked further soul-searching. The managers reevaluated the quality improvements and asked themselves what evidence they had that sales would in fact benefit.

The quality improvements were twofold. First, the new bathtubs would be thinner and 35% lighter, making them easier to transport and install. Since plumbers and builders often make the buying decision, this feature was important. Second, the new casting process would create a smoother, shinier finish. But would these improvements really lead to more sales?

Fashion Bathrooms responded to this classic marketing problem by conducting market research. The results were revealing. Some people found many advantages in cast-iron bathtubs: they didn't flex and pull away from the wall, they looked better than shiny plastic, and they were more durable. But some complained of having to choose between a white cast-iron bathtub and a 20-week wait for a colored one. Others didn't even know that cast-iron bathtubs were available and that they had some advantages over plastic.

Would customers value the planned quality improvements? A lighter tub might seem less solid; a shiny finish might make it look just like a plastic tub. The evidence was shaky.

Ultimately better investments

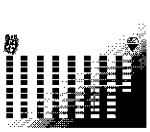
In the end, Fashion Bathrooms shelved Project Lightweigt. When managers scrutinized the analysis itself - not just the numbers it produced – they considered a new set of questions: Does Fashion Bathrooms have a sustainable competitive advantage? Why do people buy a particular type of bathtub? Was the company delivering what the market wanted, when it wanted it? And was Fashion Bathrooms helping to create a strong brand image for quality cast-iron bathtubs? These are the issues that are most important to strategic marketing.

When Fashion Bathrooms answered the questions and redid the financial analysis, things fell into place. The numbers demostrated the benefits of investing in intangible assets like brand image, market position, customer franchise, and distribution channels, and of investing to improve factory organization, styling, production control, color mix, and, above all, delivery.

When finance and marketing conflict, retrace the analysis

The Fashion Bathrooms story illustrates that in marketing and operations, detail matters. Good investments come from a detailed understanding of both the market and the company's operating and competitive capabilities. Used sensibly, finance helps bring these into the open. Financial analysis also helps clarify the project's boundaries by addressing issues like the base case, the time horizon, and future strategic options-all of which are as much strategic and market based as they are financial. Finance gives them a common language and framework.

Unfortunately, the financial analysis is all too often "pinned on" afterward, rather like the tail on the donkey in the children's game. An interactive process that relates the product-market specifics to the wider financial implications is not only a requirement for sound strategic investment decisions but also a powerful source of organizational learning.



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