



Marketing and Shareholder Value

'If you are not willing to own a stock for 10 years don't even think about it for 10 minutes.'

Warren Buffett, Berkshire Hathaway Annual Report

INTRODUCTION AND OBJECTIVES

In recent years creating shareholder value has become the overarching goal for the chief executives of more and more major companies. As we shall see, both theoretically and empirically the case for managers choosing strategies that maximise shareholder value is almost unchallengeable. Those companies which have achieved this suggest that there should be no conflict between marketing and shareholder value.

The illusion of conflict has occurred because many managers have confused maximising shareholder value and maximising *profitability*. The two are completely different. Maximising profitability is short-term and invariably erodes a company's long-term market competitiveness. It is about cutting costs and shedding assets to produce quick improvements in earnings. By neglecting new market opportunities and failing to invest, such strategies destroy rather than create economic value. Strategies aimed at maximising shareholder value are different. They focus on identifying growth opportunities and building competitive advantage. They punish short-term strategies that destroy assets and fail to capitalise on the company's core capabilities.

By the time you have completed this chapter, you will be able to:

- *Describe the new marketing challenges faced by today's managers*
- *Understand the central role of shareholder value*
- *Assess why marketing has too little influence in the board room*
- *Recognise why marketing is the bedrock of shareholder value analysis*
- *Identify how the profession and discipline of marketing need to change to make it more relevant to top management*

The next section discusses the striking new challenges of the information age: global markets, changing industrial structures, the information revolution and rising consumer expectations. It is shown how these changes have far-reaching implications for the strategies and organisations of all businesses. This leads to a discussion of the shareholder value concept and the market-to-book ratio as measures of the success of a business.

A major problem for marketing is that it has not been integrated with the modern concept of financial value creation. This has handicapped the ability of marketing managers to contribute to top management decision-making. Yet

marketing-led growth is at the heart of value creation. Without effective marketing, the shareholder value concept becomes little more than another destructive technique gearing management to rationalisation and short-term profits. Value-based marketing is presented as a new approach, which integrates marketing directly into the process of creating value for shareholders and thereby for all stakeholders. Value-based marketing makes the shareholder concept more valuable and marketing more effective.

MANAGING IN THE TWENTY-FIRST CENTURY

The enormous changes in the global market environment explain today's pressures for greater management effectiveness. Competitive capitalism is Darwinian in nature. Businesses succeed when they meet the wants of customers more effectively than their competitors. Corporate profitability depends primarily on the company's ability to offer products and services which customers choose to pay for. But what products and services customers regard as attractive is a function of the market environment. What is an appealing computer, retail store or banking service today will not be tomorrow. Technological change, new competition and changing wants make yesterday's solutions obsolete and create the opportunity for new answers.

The result is that most companies do not usually last very long. De Geus calculated that the average life expectancy of a Western company is well below 20 years.^[1] The period over which a successful firm can maintain a profitable competitive advantage is usually even shorter. Normally any innovation in product, services or processes is quickly copied and the surplus profit is competed away. Even where a company endures and grows, its true profitability normally erodes. Studies show that the average company does not maintain a return above its cost of capital for more than seven or eight years.^[2]

While the period over which the average business is successful is short, there are companies that do better. There are a few examples of companies that have survived and maintained successful economic performance over a much longer period. Currently examples would include GE, Coca-Cola, Nike and Hewlett-Packard. But quoting examples of excellent companies is a hazardous venture. Great companies have a tendency to go belly-up when the environment changes fundamentally. Few leaders have the perspicacity, courage or capabilities to overturn the strategies, systems and organisation which created their past achievement.

ENVIRONMENTAL CHANGE

Environmental changes affecting the performance of the business can be categorised as macro or micro. *Macroenvironmental* changes are the broad outside forces affecting all markets. These include the major economic, demographic, political, technological and cultural developments taking place today. The *microenvironment* refers to the specific developments affecting the firm's individual industry: its customers, competitors and suppliers. These developments reflect the impacts of the macroenvironmental changes on the specific industry (Figure 1.1).

Today this macroenvironment is experiencing unique historical changes which are fundamentally redrawing the business and social landscape. These changes have been given various names including the 'post-industrial society', the 'global village', the 'third wave' and perhaps most accurately the 'information age'.

Social scientists describe three periods of economic evolution in the Western world: the *agricultural era*, which lasted from around 8000 BC to the mid-eighteenth century; the *industrial era*, which lasted until the late twentieth century;

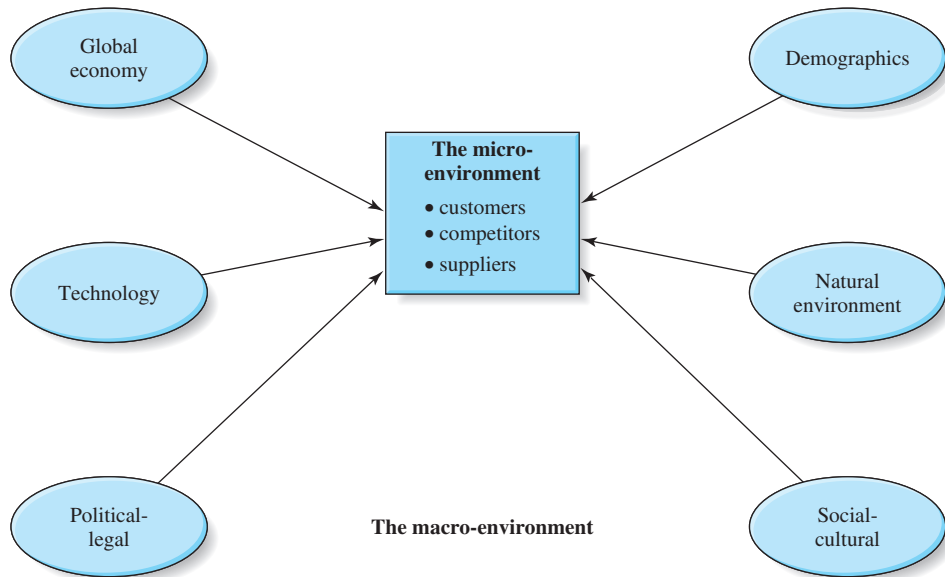


Figure 1.1 The Business Environment

and finally what we will call the *information age*, which began in the 1960s and will last for decades to come.^[3] These dates are of course approximate and overlapping. The first era was based on agriculture, with physical labour being the driver of any wealth that was achieved. This eventually gave way to the second era sparked by the industrial revolution, when machinery replaced muscle power, and factories replaced agriculture as the dominant employer, leading to an enormous growth in both agricultural and industrial productivity.

While the agricultural era lasted for over two thousand years, the industrial age lasted only two hundred. The 1960s began to see the end of the industrial era and the beginning of the new information age. Employment in manufacturing began to drop in all the advanced countries and the service sector became the new focus for growth. Blue-collar workers who operated equipment in crowded factories were increasingly replaced by white-collar workers working individually or in small teams using computers and scientific knowledge in office environments. Today, information technology has replaced factories and machine power as the source of productivity growth and competitiveness.

The transitional periods between the three great waves of change have not been smooth. In Figure 1.2 each wave is represented by an 'S' curve that shows an early period of turbulence, followed by a long spell of maturity, and then its eventual demise as new technologies take over. The last decades of the twentieth century witnessed the period of turbulence marking the birth of the information age and the death of the industrial era. The turbulence included record levels of mergers and acquisitions, the collapse of communism in the former USSR and its satellites, and economic crises in South East Asia. All these reflected old second-wave industries and social organisations being pushed aside in the competitive environment of the new information age.

Four aspects in particular of the new information age require fundamental strategic and organisational responses from management:

1. The globalisation of markets
2. Changing industrial structures

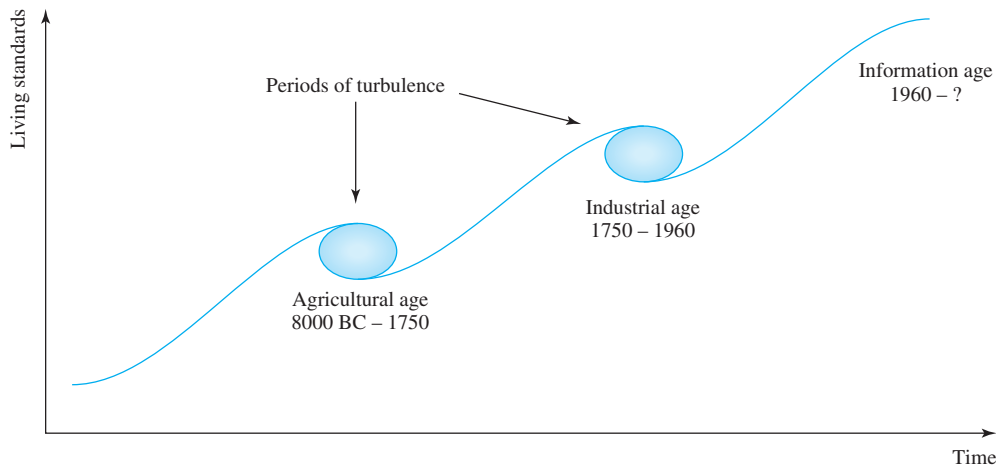


Figure 1.2 The Three Waves of Economic Change

3. The information revolution
4. Rising customer expectations

THE GLOBALISATION OF MARKETS

The new information age has seen a dramatic shift to global markets and competition. Across more and more industries, firms that are not building global operations and marketing capabilities are losing out. Recent decades have seen an enormous growth of international trade in goods, services and capital. The General Agreement on Tariffs and Trade (GATT) and its successor organisation the World Trade Organization (WTO) have been the means of negotiating a general lowering of barriers to trade between countries and an opening up of markets. The stimulus to this liberalisation of trade has been experience. Governments have seen, often painfully, that protecting home industries and markets from competition does not work. It only leads to higher inflation, lower economic growth and domestic companies lacking the levels of efficiency and entrepreneurial skills ever to be internationally competitive. Other stimuli to the globalisation of markets and competition have been faster and cheaper transportation and a continuing telecommunications revolution that has made global communications cheap, simple and effective. Finally, the barriers to participation in world trade have often come down dramatically. Today any business can open an Internet web site and market to customers from the other side of the world, just as easily as to its customers around the corner.

The result has been the emergence of new transnational companies organised to maximise the opportunities to be gained from the new global market-place and to minimise the costs of serving it. Companies like Microsoft, GE, Intel, Merck, IBM, Starbucks and McDonald's are selling in all the key markets. Their supply chains are equally global, with materials and components sourced from the cheapest locations, assembly and logistics organised from the most effective regional bases, and research and development located where relevant knowledge is most accessible.

In most sectors, small domestically-orientated companies lack the economies of scale to remain competitive over the longer run. The scale economies of the transnational companies lie not so much in manufacturing costs but in information and knowledge. Focused transnationals like Intel, Apple, Dell and Cisco win out because they can afford to spend more on research and development, on building brands, on information technology and on marketing. Once new opportunities are identified they can also marshal the resources that are necessary to capitalise and develop the market.

CHANGING INDUSTRIAL STRUCTURES

The information age is changing the nature of the profit opportunities available to businesses. Many markets that were once at the very heart of the economy have ceased to offer profit opportunities for Western firms. Other new markets are rapidly emerging that offer enormous profit opportunities to companies that can move fast and decisively to capitalise on them.

Manufacturing industries can be divided into two types. One type comprises traditional industries such as textiles, coal mining, heavy chemicals, steel and auto manufacturing, which are relatively labour intensive and make heavy use of raw materials. These industries are relocating rapidly to the developing countries, which have a comparative cost advantage. Such industries also generally suffer the problem of substantial excess manufacturing capacity because these new countries have invested too aggressively in seeking to gain market shares. The result has been falling prices and very poor returns on investment.

The second type of industries are the information- and knowledge-based ones such as pharmaceuticals, communications equipment, electronics and computers, aerospace and biotechnology. Here labour costs are typically less than five per cent of total costs. Most of the costs are information-related: research, design, development, testing, marketing, customer service and support. These are where the profit and growth opportunities occur for information-age companies. Contrary to the popular view, in most Western countries, manufacturing output has not declined in recent decades. What has changed is the switch away from traditional labour-intensive industries to those that are information-based. Second, there has been a sharp decline in manufacturing employment – notably blue-collar work, as these jobs have been automated or moved to the developing countries.

Overall employment has been maintained in information-age countries by the rapid growth of the service sector. Service-sector output has been growing at least twice as fast as manufacturing output in recent decades. In advanced countries services now account for two-thirds of economic output. As living standards continue to rise consumers spend relatively more on services rather than on goods. Health, education, travel, financial services, entertainment and restaurants are all growth markets. Informational technology has also become a massive service industry. Another reason why this will continue is that the output of information-based manufacturing industries is increasingly distributed in service form. For example, pharmaceutical companies or book publishers, rather than exporting drugs or books, will license the rights to produce them. Many items such as music and news are already being downloaded from the Internet rather than bought in the form of a physical product such as a CD.

THE INFORMATION REVOLUTION

Rapid scientific and technological changes continue to radically reshape many industries. But the most dramatic and far-reaching changes of the current era result from the revolution in information technology. Initiated by the development of the mainframe and the personal computer in the 1960s and 1970s, its full implications only really became apparent in the 1990s with the explosion in use of the Internet. By 2001, only a decade after the emergence of the World Wide Web, a fundamental change in business and society had occurred – a critical mass of people, over 200 million, at home and at work, were able to communicate electronically with one another at essentially zero cost, using universal, open standards. By the end of 2007, that number had multiplied exponentially to over 1.3 billion.

The Internet, together with the emergence of broadband cellular radio networks, has created an explosion in connectivity that is revolutionising almost every aspect of business. First, it changes the firm's internal value chain – the

way people inside the business organise to design, produce, market, deliver and support its products and services. In the past, businesses had to organise through hierarchies and bureaucracy because information was expensive, difficult and slow to obtain. Today, *intranets*, which instantly and costlessly connect individuals within companies for the exchange of information, make obsolete the need for hierarchical functions. Instead cross-functional teams and informal networking are encouraged, which in turn facilitate flatter, lower-cost organisational structures, faster responses and better customer service.

Second, the information revolution has changed the way the business works with its suppliers. Where partnerships are important, information technology can make them much closer. *Extranets*, which connect companies to each other, can seamlessly integrate buyer and seller into a *virtual business*. A typical example is the jeans maker, Levi. Over the Internet it continuously obtains information on the sizes and styles of its jeans being sold by its major retailers. Levi then electronically orders more fabric for immediate delivery from the Milliken Company, its fabric supplier. Milliken, in turn, relays an order for more fibre to Du Pont, its fibre supplier. In this way the partners take out cost throughout the supply chain, minimise inventory holding and have up-to date information to enable them to respond quickly to changes in consumer demand.

In a similar way, when the bar code of a Procter & Gamble (P&G) product passes across a Wal-Mart scanner, that information is immediately relayed to P&G, which invoices the retailer and makes another, which, in turn, is relayed to the distribution centre. This process has saved Wal-Mart millions of dollars in administration expenses.

On the other hand, where buyers see price as more important than partnerships, the widespread availability of information undermines the suppliers' relationships with customers. For example, component buyers can post their purchasing requirements on Internet bulletin boards and invite bids from anybody inclined to respond. The information revolution has increased the information available to buyers and reduced the cost of switching suppliers. In general, the bargaining power of buyers has been radically increased.

Finally, the information revolution has significantly changed the nature of marketing and the marketing mix (see box, 'Traditional Marketing Meets the Information Revolution'). Traditionally buyers chose suppliers for both the qualities of the products and the information they supplied. For example, retailers like Toys 'R' Us or PC World prospered by offering shoppers a wider selection of merchandise. But such formats are now undermined by search engines on the Internet, which can offer consumers much more choice than any store. This has created many new huge business opportunities for companies able to exploit the informational advantage of the Internet. These include specialist facilitators like Google which assist consumers in their search for information. Others have reconfigured the traditional industry chain to capitalise on electronic communications. Among the most successful in the late 1990s was Amazon.com, which in only four years created the world's biggest book retailing operation, and which had net sales of almost \$15 billion by the end of 2007. Its business has broadened significantly beyond books, and includes third parties selling a range of different products and services globally over the Net.

Traditional Marketing Meets the Information Revolution

For two centuries Encyclopaedia Britannica was one of the strongest and best-known brands in the world. Its large sales force successfully encouraged middle-class parents to view purchase of the 32-volume set of encyclopaedias as offering a genuine advantage for their children. Then the home computer and the CD-ROM came along. By the early 1990s Britannica's sales were collapsing.

What went wrong? First the emerging information age changed consumer behaviour. Now parents who wanted to do the right thing for their children bought them a computer rather than printed encyclopaedias. Once Microsoft and others launched CD-ROM versions of encyclopaedias, the game was lost. The cost of producing a CD-ROM was about £1; the cost of producing a printed set of encyclopaedias was around £250. The result was that Microsoft's Encarta could sell at £50 or even be given away free; a set of Encyclopaedia Britannica sold at between £1300 and £2200. Worse, because of its high cost, Britannica needed an expensive direct sales force to sell the product. The cheap CD-ROM versions were almost impulse items, which could be sold through computer shops or marketed to manufacturers for bundling with new computer sales. Finally, children liked computers and CD-ROMS more; a CD-ROM was easier and more fun to use than searching through a formidable set of 32 large books.

When the threat became obvious, Britannica brought out its own CD-ROM, but to avoid undercutting its sales force it charged £755. Not surprisingly, its sales continued to decline. Finally, in 1997 the company recognised the issue, the sales force was disbanded and, under new ownership, the company sought to rebuild the business around the Internet.

The company now offers its extensive information in a variety of formats, including the original print versions, DVD packages, the online site, which also offers daily features, updates and links to news reports, and a mobile version. However, its pre-eminence continues to be challenged by other online encyclopaedias, such as Encarta and Wikipedia – even though the latter might seem to lack the authority of its older rival since it is written collaboratively by volunteers within certain editorial rules.

Britannica's real problem was that its management – like many others – failed to recognise the implications of the information era. The information revolution has made traditional strategies obsolete, destroyed barriers to entry and stimulated new competitors with dramatically lower cost structures and more effective marketing systems. Management recognised too late that its sales force had become an expensive liability and that the computer had become the real competitor. The complacency of Britannica's management is not unique. It is a predicament that a host of major companies have faced in such industries as cars, insurance, travel, financial services and major sectors of retailing and distribution.

Contrast this with Yellow Pages – now called Yell – which didn't make the same mistake as Britannica and was in the forefront of putting its data into electronic formats alongside the more traditional print version. The result is that Yell remains one of the top organisations in its sector.

Sources: Philip B. Evans and Thomas S. Wurster, Strategy and the new economics of information, Harvard Business Review, September/October, 1997, 70–83; The Economist, Encyclopaedias on CD-ROM, 17 February 1996, p. 67; New York Times, Start Writing the Eulogies for Printed Encyclopedias, 23 March 2008.

In many markets, information technology has led to *disintermediation* – the elimination of agents between the supplier and the consumer. Buyers have found that they no longer need retailers, agents or brokers; they can buy at lower cost, and more conveniently, directly from the manufacturer over the telephone or, increasingly, the Internet. Companies like Dell in computers and Direct Line in insurance rapidly grew to market leadership by exploiting this strategic window. When the seller deals directly with end consumers the opportunity is then created to build databases which record *learning* about individual consumer wants and buying behaviour. The seller can then create added value by tailoring messages and even products for individual consumers. The information revolution has thus begun to change marketing from mass communications and standardised brands to one-to-one customised marketing. For the innovators this has offered the opportunity for higher profit margins, greater loyalty and a bigger share of the customer's spending.^[4]

RISING CUSTOMER EXPECTATIONS

The information age has brought a marked rise in customer expectations. Buyers have grown to expect higher quality, competitive prices, and better and faster service. The most important causes have been the globalisation of competition and the deregulation of markets. Once markets were opened up to today's aggressive international competitors, companies that lacked a customer orientation or that had inefficient cost structures were soon in trouble. The new wave of Japanese exporters such as Sony, Toyota and Matsushita in the 1960s showed Western companies the new standards of quality required to stay competitive. Concepts like *kaizen* (continuous incremental improvement), Total Quality Management (TQM) and such schemes as the US Baldrige Awards and the European ISO 9000 certification had real effects in raising quality standards. During the 1970s and 1980s major excess capacity became a characteristic of more and more industries – for example, cars, steel, chemicals, electrical goods, agricultural products and banking. This further shifted the priority to gaining customer preference in hypercompetitive markets. Finally, the explosion of information technology gave management new tools for serving customers better: tools to continuously monitor customer needs and to improve the internal processes and supply chains that would enable them to meet, and indeed exceed, customer expectations.

Initially the response to meeting customer needs better was *market segmentation*. Companies brought out an increasing number of product variants to meet the diverse needs of their customers. Nike had 347 types of running shoe, Procter & Gamble had 207 brands and sizes of detergent, United Distillers introduced nine line extensions of its Johnnie Walker brand of scotch whisky, credit card companies offered green, blue, gold and platinum versions, each with minor differences in the service offering, and so on. Media too became more segmented: mass-circulation newspapers and magazines were replaced by a proliferating array of specialists. Digital technology also facilitated an explosive growth in the number of radio and television channels.

The problem with market segmentation was that it was expensive and limited in effectiveness. More variants meant higher manufacturing costs and spiralling inventory levels leading to lower profits and asset turnover. By 2000, the information revolution was beginning to offer a better alternative – *mass customisation*. Media and products could be tailored to the individual customer and made to order, using modern high technology communications and manufacturing systems. Information technology allows companies to record all the information they obtain from consumers through their personal, written, telephone or Internet communications with the company. Creating a database allows companies to learn about the buying behaviour and preferences of customers and to communicate individually and directly with them. Direct marketing creates the opportunity for a dialogue, allowing a precise specification of the customer's wants.

Dell Computer Corporation was one of the pioneers in showing how direct marketing could be allied to a fast response supply chain to produce customised products delivered to the customer's door 48 hours after the order.^[5] For the customer one-to-one marketing offers a precise fit to his or her individual requirements. For the supplier it means higher margins and lower investment requirements.

STRATEGIC AND ORGANISATIONAL IMPLICATIONS

Companies survive only if they can adapt to this rapidly changing environment (Figure 1.3). This changing environment determines what products and services customers will find attractive. It also determines the technologies that will be available for companies to produce and market these products and services. By *strategy* we mean the business's

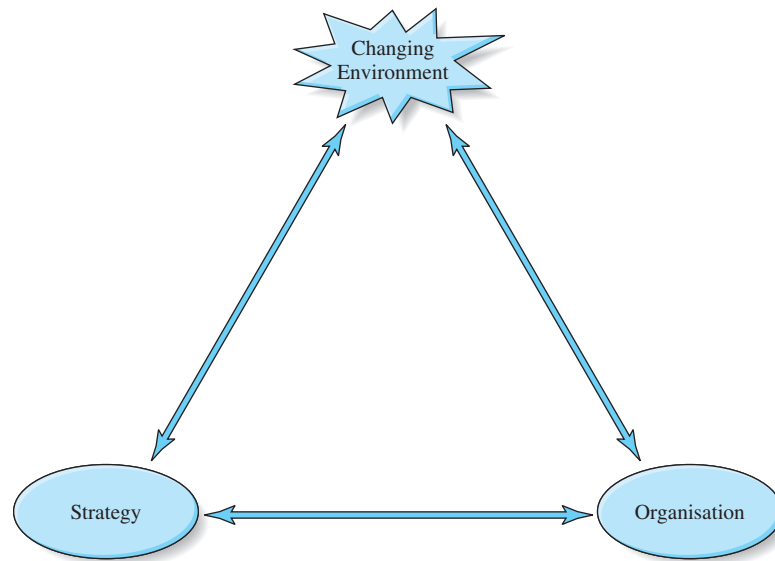


Figure 1.3 Adapting to a Changing Environment

overall plan for deploying resources to create a competitive advantage in its markets. *Organisation* refers to the capabilities the firm possesses and how its staff are led, coordinated and motivated to implement the strategy.

Today the changes in the marketing environment are so momentous that they require radical strategic and organisational change from virtually all companies. Gone are the days when managers could stick to tried and tested formulas to provide continuous growth and profitability. Globalisation, new industrial structures, rapidly changing technologies and new customer expectations are quickly eroding yesterday's markets, while creating phenomenal new opportunities for those that can move fast and decisively to capitalise on the changing environment.

Today five main issues stand out for management:

1. Participation strategy
2. Marketing strategy
3. Operations strategy
4. Global strategy
5. Organisational imperatives

PARTICIPATION STRATEGY

As the environment changes, the opportunities to achieve profitable growth change too. Some markets cease to have potential and should be exited; others offer great opportunities and require high investment, innovative strategies and new organisations. Managers have to decide which markets to participate in. To do this they have to objectively assess, first, the future *attractiveness* of the markets in which they operate. Because they differ in intensity of competition and price pressures from customers, some markets will become much more profitable than others. In general, the greatest opportunities are occurring in services, such as entertainment, education, software and mobile telecommunications. Other markets are extremely unlikely to generate returns for shareholders. Many

of the old labour- and raw-material intensive industries such as textiles, steel and heavy chemicals fall into this category. Second, managers need to assess their *competitive potential*. With today's fierce global competition, unless a business can create a differential advantage, in terms of either low total cost or a superior product or service that can command a price premium from customers, it will not earn an adequate return.

MARKETING STRATEGY

The information revolution is making obsolete the marketing strategies of many traditional industry leaders. It destroys barriers to entry and transforms the structure of many industries. What is the role of a branch network when customers can bank more conveniently on the web? Who needs retailers and distributors when you can sell direct to consumers? Every aspect of marketing comes up for renewal.

The customer and product mix needs to be strategically reappraised. The information revolution has increased the need for firms to focus. Many firms have too many low-value customers who do not want long-term relationships. They also often have too many products bundled together by the classic informational logic of one-stop shopping. But one-stop shopping loses its premium for customers once information is readily available. Specialists can then generally offer lower prices or superior service by focusing their operations around a single product or customer group.

Pricing strategies also need reviewing. The globalisation of markets, the euro currency and information technology have all made prices more transparent and comparable. Businesses not offering value to customers are seeing their market shares eroding at accelerating rates. The information revolution is having its most dramatic impacts on promotion and distribution strategies. The company's web site is increasingly becoming both the first port of call for customers looking for information and a crucial source of knowledge about customers for the company. More fundamentally, the Internet offers more and more companies of all sizes the opportunity to eliminate intermediaries and deal with consumers directly.

OPERATIONS STRATEGY

To implement a new marketing strategy requires the firm to create an operations strategy capable of delivering it. Companies need to construct a supply chain that can produce the right goods and services, at the right price, in the right place, at the right time. With today's global competition and rising customer expectations, this right strategy usually means low prices, rapid delivery, reliable quality and up-to-date technology.

To meet these demanding expectations a new business model has emerged among today's leading-edge companies built around coordination and focus. We will call this the *direct business model* (Figure 1.4). This model fundamentally reshapes the firm's downstream and upstream activities. *Downstream* the business model is built around bypassing the dealer, selling direct to the customer and making to order. Generally the communications take place over the telephone or, increasingly, the Internet. Selling direct has the crucial advantage of enabling the firm rather than the intermediary to control the relationship with the customer. Information from customers enables the firm to add value and develop loyalty by customising the offer and the communications to the customer's exact requirements. Information also gives the firm leverage over its suppliers because it owns the brand and the customer relationships. The direct business model also cuts distribution costs, eliminates inventories and reduces risks by enabling better forecasting of consumer demand.

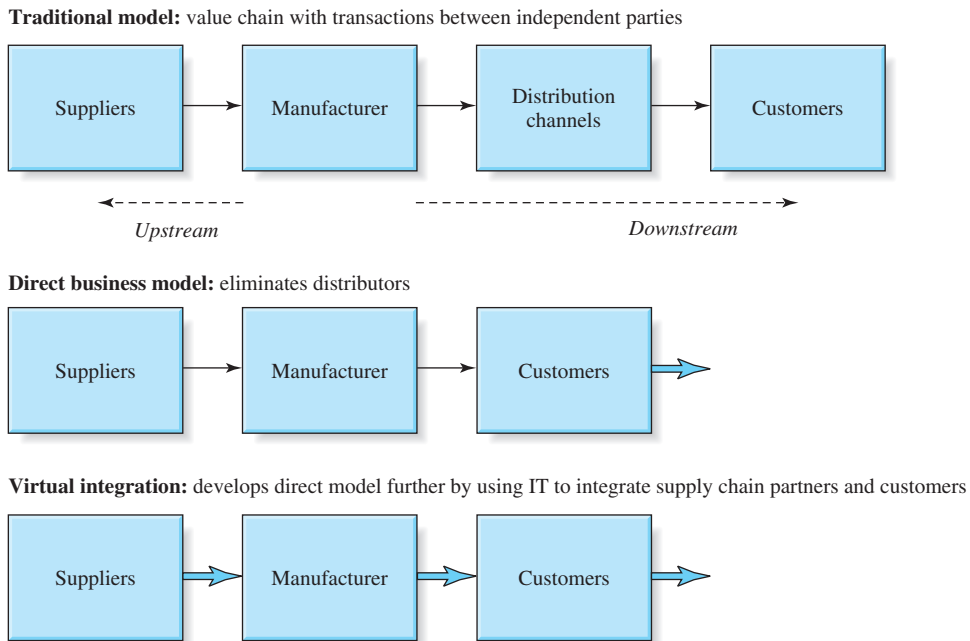


Figure 1.4 The Evolution of a New Business Model

Upstream the model is built around close cooperation with suppliers. Manufacturing and logistics is outsourced to a carefully selected set of partners. These suppliers are linked electronically to the firm and treated like an internal department. Instead of vertical integration – control and coordination through ownership – we have *virtual integration* – control and coordination through information. This reduces the assets required to support rapid growth, minimises financial risk and maximises flexibility. It frees the management to focus on what adds most value today – delivering solutions and systems to customers. The direct business model creates genuine value through customer focus, supplier partnerships, mass customisation and just-in-time manufacturing.

GLOBAL STRATEGY

In today's connected world, every company now needs a global strategy. Industries are globalising at a rush and companies that are not leading, or at least participating, in the new alliances, are becoming non-viable. Manufacturing tended to globalise first but now services are following rapidly. For example, a series of mega-mergers in the 1990s globalised accounting, financial services and most of the advertising industry into a small number of huge global groups. Regional and global groupings have also emerged in telecommunications, banking, contract services and many other areas.

In business-to-business markets – to which most companies belong – the pressure to globalise comes from their customers, which operate across the world. Procter & Gamble and IBM want suppliers and business partners that can interface with their own far-flung geographical operations. The opportunity to spread the costs and lever the investments in research, development and technology also favours global players. Finally, being dependent on a single country market leaves today's local player highly vulnerable. Strategically it is in a weak position to counter-attack

against a strong global player moving into its market and being willing to cross-subsidise its entry from profits earned in other markets.

As in most areas of business today, there are big advantages in speed and decisiveness when it comes to global strategy. The longer management prevaricates, the fewer the options are available and the higher the price that has to be paid.

ORGANISATIONAL IMPERATIVES

To implement new strategies requires new organisations. What is different about organisations in the information age? First, employees are different. Blue-collar workers have given way to knowledge professionals. Part-timers and women make up an increasing proportion of the staff. The skills of the new knowledge workers make them less dependent on the company and more mobile. Motivating them requires different work environments and incentives from the past. Second, information and communications technology now permits new and more effective ways for people within the firm to relate to one another and to relate to others in the supply chain.

Finally, the new strategies ushered in by the information age require different responses from staff. A customer orientation becomes more important since more of the staff are now directly involved in providing customer service and customising products and solutions. The priority consumers now give to convenience and speed of response demands much greater empowerment and commitment from staff. The pressure on prices and the need to provide greater shareholder value also drive management to seek higher productivity and better utilisation of assets.

The direction of organisational changes is clear. Delaying has been one major move. Information technology has enabled companies to reduce the number of levels of middle management, providing for greater customer orientation, lower costs and faster response. Second, enhanced connectivity is breaking down functional barriers within firms, permitting a much greater use of cross-functional teams, which again makes for faster response and greater customer focus. The same forces have increased the flow of information between firms, facilitating more effective networks to lever the firm's capabilities with those of its business partners. The final change has been a greater focus on shareholder value. Investors are putting much more pressures on managers either to deliver superior returns or return the cash to shareholders.

The implications of the changing environment for strategy and organisation – and hence for the firm's ability to achieve longer term growth and profitability – can be summarised in five principles:

1. **Strategy must fit the environment.** Companies can remain competitive only when they have products and services which today's customers regard as offering superior value. Perceived value is shaped by the changing macro- and microenvironments within which the firm and its customers operate.
2. **Successful strategies erode.** Winning formulas eventually lose out because the environment changes. Competitors copy successful products and processes. Changing tastes and new technologies make yesterday's successes obsolete.
3. **Effectiveness is more important than efficiency.** Old formulas cannot be preserved by downsizing and cost reduction. Innovative solutions have a way of coming down in costs to offer superior value across all dimensions of value. Success in the information age is about renewal rather than retrenchment.

4. **Speed and decisiveness.** Being first mover when new opportunities occur can carry great advantages. With no direct competition it is much easier to demonstrate a competitive advantage. But being first is not sufficient; the innovator has to create a critical mass in terms of market share. This requires managers decisively shifting resources out of yesterday's businesses into the new opportunities
5. **Organisational adaptation.** Creating these dynamic, customer-orientated businesses that will be required for the new millennium requires leadership and organisational transformation of a high order.

MEASURING SUCCESS: SHAREHOLDER VALUE

The value of a company measures the views of professional investors about the ability of management to master this changing market environment. When a company is seen to be in an attractive market, pursuing a strategy that has a good chance of building a sustainable competitive advantage, then the value of the company rises (see, box 'Shareholder Values Reflect Perceptions of Winning Strategies'). An attractive market and a winning formula should mean that the company will be able to earn a return on its investment above the cost of capital. In this situation management finds it easy to attract outside funds, to make acquisitions and to grow.

Shareholder Values Reflect Perceptions of Winning Strategies

In the late 1990s investors became alert to the potential impact of the Internet on many businesses. Charles Schwab, a leading US stockbroker, also saw the opportunity. In 1998 it launched a global online dealing service to the public. In the following 12 months it was rewarded by a trebling of its market capitalisation. Investors reacted enthusiastically to the potential attractiveness of the market and to the decisiveness of Schwab management. By 2007 it was managing approximately \$1.3 trillion for more than seven million individual and institutional clients through the telephone, wireless devices, the Internet and physical offices.

In 1990 nobody had heard of Vodafone, a subsidiary of a British electrical contracting company, Racal. In the following years Vodafone aggressively entered and developed the emerging mobile telephone market, first in the UK then overseas. Its share price soared. By 2007, thanks to a raft of acquisitions around the world, it was the world's largest global operator with a stock market value of almost £100 billion.

The stock market clearly recognises that some markets have much greater prospects for generating corporate earning in the future than others. CMG, a small Dutch start-up specialising in computer services, was floated on the stock market at the end of 1995 with a market capitalisation of £185 million. So impressed were investors by the attractiveness of the industry and CMG's strategy that three years later its market value had soared 16-fold to £2 billion. In 2002 it then merged with the UK's Logica. Logica is a major international force in IT and business services, employing around 40 000 people across 41 countries.

In 2000 Amazon.com, the Internet book retailer, had been going for five years. It had never yet made any profit, but it was valued at \$20 billion – more than all the other US booksellers together. Following the dot.com collapse, its value then dropped: in 2004 it was valued at \$14 billion, for example. However, by 2008 it had risen again, to \$34 billion.

Contrast these examples with conglomerates such as GEC, Hanson and BTR, which, in the 1980s, had emerged through a series of acquisitions to become among Europe's largest companies. All three were characterised by financial and strategic conservatism. Investments had to break even within two years and managers were evaluated against quarterly profitability goals. The result was that none developed significant new products, entered new markets or generated a competitive advantage. A decade later the share values of all three had collapsed, BTR was acquired, and GEC and Hanson were broken up.

When investors perceive a company to be stuck in unattractive markets and to be lacking a competitive advantage, they naturally do not want to invest. The value of the company then declines, making the company difficult to attract resources and making it prone to being acquired.

The value of a company is increased by making the business better. But even if the company performs well, it could still be too small to remain independent. It may be worth more to a larger company with global ambitions than it is as a stand-alone business. Good companies as well as bad companies get bought. The difference is that in the former case shareholders are well rewarded in the higher price that the acquirer has to pay. If managers want to be able to control their own destiny in today's global economy – to remain independent – the company has to get bigger as well as getting better.

The stock market's judgement on the expected financial performance of a company is reflected in its market-to-book ratio.^[6] (see box, 'Definition of Shareholder Value'). The main determinant of market value is the ability of management to seize profitable investment opportunities. Company size can be measured by its book value – the accounting value of its equity. The market capitalisation is simply the product of these two components. For example, a market-to-book ratio of 3 and a book value of £10 billion means a market capitalisation of £30 billion.

Definition of Shareholder Value

Shareholder value is created by rising share prices and/or dividends but there are exceptions. If a company buys back its own shares, the individual share price should increase but shareholder wealth is unaffected because the share price times the number of shares stays the same. Likewise, a share price rise may be ephemeral due to rumours or the rise in the market as a whole or otherwise unrelated to the improvement in the underlying business, which is what the shareholder value method of evaluation is trying to track. So in practice we look internally to examine, as a measure of shareholder value increase, the economic value added (EVA) which is defined as the net profit after tax less Weighted Average Cost of Capital (WACC) times capital invested. (EVA is discussed in Chapter 2.)

The implications of this can be seen in Figure 1.5. The management consultants, McKinsey suggest that companies can be mapped into four groups:^[7]

1. **Vulnerable.** Companies like A and B, using relatively small amounts of financial capital and generating relatively low returns, are vulnerable to acquisition. These are often businesses that have been left in mature, unattractive industries and are still focused on the domestic market. They are commonly taken over by larger competitors that can generate higher returns from the same asset base. To have a future, these vulnerable

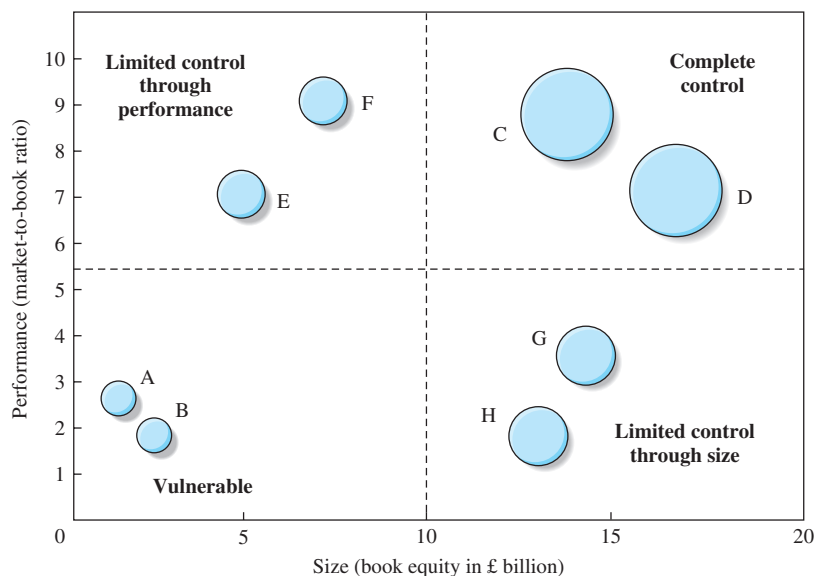


Figure 1.5 Strategic Control as a Function of Performance and Size

companies need either to radically improve the performance of their existing businesses or divest them and reinvest the capital in more attractive industries.

2. **Complete control.** At the opposite extreme are companies like C and D, which are generating high returns from a large capital base. Examples in the late 1990s might be Merck, Intel and GE. Typically these companies are in attractive markets, competing globally and with competitive advantages that give them high market shares. Their high multiples enable them to acquire competitors, and protect them from being acquisition targets themselves. The challenge facing these companies is protecting their positions against the onslaught of new competitors while simultaneously identifying new opportunities to grow sales and profits.
3. **Limited control through performance.** Companies like E and F in the upper left quadrant obtain high returns from relatively small amounts of invested capital. Examples in 2000 might be Cable and Wireless, Reuters and 3Com. They are often specialist niche players in attractive high-tech segments. Their good performance makes them an expensive acquisition. But in the longer run, they are vulnerable to bigger companies that believe they can lever their specialist skills by taking them into global or broader markets. The information technology and service sectors are full of young, successful businesses that fall into this category. To maintain control these companies need to grow aggressively by adding new products and new markets.
4. **Limited control through size.** H and G are large companies producing low returns on capital. Today they include such companies as General Motors, Henkel and Credit Lyonnais. Despite their relatively poor performance they are difficult to acquire because of their sheer size. They are generally older companies, in mature, asset-intensive industries. Their challenge is to improve performance by divesting assets that produce low returns and using the proceeds to capture more attractive opportunities. Should they fail, they are likely eventually to be acquired or merged as part of the cost consolidation process in the industry.

Shareholder value analysis allows management to compare the value of alternative marketing strategies. They can objectively examine which strategy is most likely to increase the market value of the company. They can explore where a particular plan is likely to take them on the strategic vulnerability map (Figure 1.5). Will it move the company towards the area of 'complete control' or towards increased 'vulnerability'?

The key to economic value creation is the company's ability to achieve or maintain competitive advantage in a changing market environment. The inputs into the valuation process are the assumptions about future sales growth, margins and investments that follow from any marketing strategy. For example:

A major European airline believed that deregulation would inevitably lead to greater price competition as new 'no-frills' airlines entered the market. Companies such as Virgin, Ryanair, Easyjet and others had already announced big expansion plans. The airline's review of the industry led it to conclude that its recent market share losses would accelerate unless a new strategy was developed.

Management eventually identified three alternative marketing strategies. The *parity strategy* involved seeking to hold market share by reducing prices towards the level of the new competitors. A major cost reduction exercise would run alongside this plan. The *premium strategy* would refocus the airline around business and first-class passengers. It would include a switch to smaller aeroplanes, with fewer seats for economy passengers. The *dual-brand strategy* envisaged the launch of an entirely new airline codenamed 'Merit'. Merit would be positioned as a no-frills discount airline that would match or even undercut the prices of the new competitors. Here the aim would be to achieve market leadership in both the regular and the discount sectors.

Management made detailed projections of sales, profit margins and investment requirements under the three strategies. On the basis of this analysis they calculated the shareholder value added with each alternative:

Alternative strategy	Shareholder value added
1. Parity strategy	–£40 million
2. Premium strategy	+£70 million
3. Dual-brand strategy	+£185 million

Faced with the analysis, the board of directors had no hesitation in accepting management's radical strategy of dual branding and the new airline was launched ten months later. The parity strategy was demonstrated to be disastrous because, while it stopped the erosion of market share, it led to a huge decline in profitability per passenger. The premium strategy did create value but it was inferior to dual branding because of the effect of the decline in passengers carried.

The board believed that shareholder value analysis had proved its worth. It challenged management to identify and develop new strategies. It encouraged them to think radically, which was necessary with rapid environmental changes increasingly making the status quo a non-viable strategic option. Finally, it provided a criterion for rationally and objectively evaluating strategic choices. All too often in the past, key decisions had been made on the basis of subjective judgements, marketing 'hype' or political wrangling, which had subsequently proved to be wrong.

MARKETING'S LOST INFLUENCE

In today's information age marketing professionals should have become more important in the top councils of business. First, the central issue facing all firms now is understanding and adapting to rapidly changing markets – globalisation, new competition, rising customer expectations and the implications of the information revolution on how companies market. Second, marketing, rather than production, skills have become the key to creating competitive advantage. More and more leading branded goods companies follow the lead of the likes of Coca-Cola, Dell, Nike, Levi's and Armani in outsourcing all their manufacturing to outside suppliers, often in the

developing countries. Others, like GE and IBM, see their future not in selling products, but in providing services that offer tailored solutions to the needs of individual customers. Third, marketing performance is the root source of shareholder value. The firm's opportunity to create cash is based first and foremost on its ability to create a competitive advantage that will enable it to attract and retain customers paying satisfactory prices.

But rather than gaining in influence, marketing professionals, whose expertise is in identifying these market opportunities and building customer relationships, appear to have little influence in the board rooms of industry. A survey by the Chartered Institute of Marketing, for example, found that only 17 per cent of the chief executives of Britain's FTSE 100 companies had experience in a marketing job, with 34 per cent coming from finance, 29 per cent rising up the ranks from operations and 19 per cent from general management. Only 14 per cent of those companies had marketing represented on the board.^[8] Another study in 2008 of chief executives, financial and marketing directors found a harmful lack of a common understanding of the role of marketing.^[9]

Why does the lack of marketing professionalism in the board room matter? It matters because top managers will lack expert guidance on how their customers and competitors' strategies are changing. New market opportunities and threats are unlikely to be recognised speedily and, once recognised, acted upon decisively. If senior management are not focusing on customers and markets, it will mean that other issues fill the agenda. Evidence suggests that managers become preoccupied with short-term budgets, operating rather than strategic issues, and, when difficulties arise, retrenchment rather than renewal. Such myopia is, in the long run, antithetical to genuine value-creating strategies.^[10]

Several factors account for this paradox of the growing importance of marketing with the lack of influence of marketing professionals in top management. Of fundamental importance has been the failure of the marketing discipline to incorporate the concept of shareholder value.^[11] As a result there is no criteria for judging the success of a marketing strategy or comparing alternatives. This in turn means it is difficult to accept marketing recommendations on product policy, pricing, promotions or, indeed, any element of the marketing mix. All too often marketing managers think a strategy is sensible if it increases sales or market share.^[12] But astute top managers know that strategies to maximise market share will very rarely make economic sense. More sophisticated marketing managers will be tempted to use projected profits or return on investment to rationalise their marketing proposals. Unfortunately, this approach has the opposite bias and leads to an under-investment in marketing and a failure to capitalise on opportunities. Modern marketing has not incorporated current strategic valuation techniques and has consequently become marginalised in many board rooms. The marketing discipline lacks the framework for engaging in the strategic debate.

Because the link between marketing strategy and shareholder value has not been made, boards have tended to look at two other more transparent strategies. One has been cost reduction – sometimes disguised by more appealing names such as reengineering, downsizing or right sizing. Unfortunately, in a time of rapid market change, such actions are invariably only palliatives at best. The other common remedy has been acquisition. Acquisitions have broken all records in recent years. They have been seen as a way of generating value by adding top-line growth and by permitting a reduction in average costs. But, again, the evidence is that three out of four acquisitions fail to add value for the acquiring company.^[13] Excessive bid premiums, cultural differences between the businesses and a failure to rejuvenate the company's marketing orientation appear to be the major weaknesses.

The failure to place marketing strategy at the centre of the corporate agenda cannot be laid solely at the door of the marketing profession. Financial management has also failed to bridge the marketing–finance interface. Top management still focuses on company accounts that measure only the historical cost of assets and omit internally developed brands and other intangible assets. Yet these marketing assets are now by far the most important sources

of shareholder value. The market-to-book ratios for the *Fortune 500* average over 4, implying that over 75 per cent of the value of these companies lies in their brands and other marketing-based intangibles. (Note, however, that if a company has hyped its shares – such as Enron – the share price may not be backed by assets, tangible or intangible.) Companies whose goal is maximising shareholder value need a framework for placing the development and management of marketing assets at the centre of their planning processes. It is these marketing assets – brands, market knowledge and customer and partner relationships – that have become the key generators of long-term profits in today's information age.

MARKETING'S NEW OPPORTUNITY

Shareholder value analysis has become the new standard because of increasing realisation of the defects of conventional accounting. As we shall see, accounting profits encourage an excessively short-term view of business. They also encourage an under-investment in information-based assets – staff, brands, and customer and supplier relationships. In today's information age, the accounting focus only on tangible assets makes little sense now that these intangible assets are the overwhelming source of value creation. Shareholder value analysis (SVA) can avoid both these biases. But to achieve its potential, SVA needs marketing. Similarly, marketing needs SVA if it is to make a real contribution to strategy.

SHAREHOLDER VALUE NEEDS MARKETING

SVA is tautological without a marketing strategy. The shareholder value principle is that a business should be run to maximise the return on the shareholders' investment. SVA provides a tool for calculating the shareholder value added from any given growth, profit and investments projections. But what drives these growth, profit and investment requirements is outside the financial model. SVA does not address how managers can develop strategies that can accelerate growth, increase profit margins and lever investments. These are the objectives of marketing strategy. For example, returning to the earlier airline problem, SVA was able to identify which of the three strategies presented was best, but developing the innovative dual-branding plan came solely from an understanding of the market dynamics and a creative approach to serving different customer segments.

The heart of SVA is that economic value is created only when the business earns a return on investment that exceeds its cost of capital. From economic theory we know that in competitive markets this will only occur when it has a differential advantage in cost or product superiority. Without a unique advantage, competition will drive profits down to the cost of capital. Creating shareholder value is then essentially about building a sustainable competitive advantage – a reason why customers should consistently prefer to buy from one company rather than others. Marketing provides the tools for creating this competitive advantage. These are frameworks for researching and analysing customer needs, techniques for competitive analysis, and systems for measuring and enhancing consumer preference. Effective marketing input allows SVA to be dynamic and growth-orientated. Without it, SVA is static, merely focusing on ways of reducing costs and assets to produce a temporary fillip to cash flow.

The inputs to the SVA model are largely estimates about marketing variables. Key inputs are future sales volumes and prices. The other inputs are costs, investments and the cost of capital. Each of these variables depends on careful

analysis and projections of the market. As with all models, the lesson is 'garbage in, garbage out'. Poor judgements about the future behaviour of customers and competitors will make worthless any conclusions from SVA.

SVA only deals with the latter stages of strategic planning. Any decision problem has four steps: (1) perceiving a need to change, (2) identifying alternative courses of action, (3) evaluating the options and (4) making the choice. SVA only provides answers for the last two steps. It does not provide for the continuing analysis of the firm's markets and technologies that is needed to alert management to emerging problems and opportunities. Nor does it suggest alternative strategies – these have to be discovered elsewhere. For example, SVA is not going to alert management to identify great new product or distribution ideas. These are most likely to be generated by staff who are close to customers. Just as marketing needs to be augmented to include developments in finance, so finance needs to be extended and broadened to include developments in marketing.

MARKETING NEEDS SHAREHOLDER VALUE

SVA is a great opportunity for marketing professionals. Traditional accounting, by focusing on short-term profits and ignoring intangible assets, marginalises marketing. In contrast, SVA can bring to the fore the real value drivers in today's globally competitive markets. First, SVA roots marketing in a central role in the board-room process of strategy formulation. The language of the modern board is finance. Actions have to be justified in terms of their ability to increase the financial value of the business. In the past marketing has not been able to measure and communicate to other disciplines the financial value created by marketing activities. This has resulted in marketing professionals being undervalued and sidelined. SVA offers marketing a direct way to show how marketing strategies increase the value of the firm. It provides the framework and language for integrating marketing more effectively with the other functions in the business.

Second, SVA provides marketing with a stronger theoretical base. Traditionally, marketing has tended to see increasing customer loyalty and market share as ends in themselves. But today, top management requires that marketing view its ultimate purpose as contributing to increasing shareholder value. No longer can marketers afford to rely on the untested assumption that increases in customer satisfaction and share will translate automatically into higher financial performance. This dilemma suggests a reformulation of the marketing discipline as about developing and managing intangible assets – customer and channel relationships and brands – to maximise economic value.^[14] We call this value-based marketing. This view of marketing is theoretically appealing and also places marketing activities in a pivotal role in the strategy formulation process.

Third, SVA encourages profitable marketing investments. Conventional accounting has treated marketing expenditures as costs rather than investments in intangible assets. Because the long-term profit streams generated by such investments are ignored, marketing in many businesses is underfunded. SVA, however, is future-orientated; it encourages the long-term effects of marketing expenditures to be explicitly estimated. Brand-building investments that would be discouraged under conventional accounting procedures because they reduce current profits are shown as value-creating under SVA.

Finally, SVA penalises arbitrary cuts in marketing budgets. Management have found marketing budgets an easy target when they need to improve short-term profits. For example, cutting brand support will normally boost profitability without significantly affecting sales in the short run. The fact that such policies invariably lead to longer-term erosion

in market share and price premiums has been ignored. SVA gives marketing management the tool to demonstrate that these short-term cuts destroy rather than build value. Informed shareholders are likely to react to *ad hoc* cuts in brand support by reducing the market value of the company.

THE SHAREHOLDER VALUE PRINCIPLE

In the past fifteen years or so more and more leading companies have shifted to adopt shareholder value as the criterion for evaluating strategies and the performance of their managers. This criterion asserts that business strategies should be judged by the economic returns they generate for shareholders, as measured by dividends and increases in the company's share price.

Companies that adopt the shareholder value approach accept two assumptions drawn from modern financial theory.^[15] The first is that the primary obligation of managers is to maximise the returns for ordinary shareholders of the business. Managers are agents whose task is to act in the interests of the principals – the shareholders with financial ownership rights over the business. The second assumption is about how this is achieved in practice. This states that the stock market value of the company's shares is based on investors' expectations of the cash-generating abilities of the business. This then leads to the definition of the task of management as about developing strategies that maximise the value of these cash flows over time. A company generates cash, i.e. creates value, when its sales exceed its costs (including capital costs).

SVA calculates the total value of a strategy by discounting these cash flows. Discounting reflects that money has a time value. Because cash can earn interest, cash received today is worth more than the same amount received a year or more in the future. Discounting also allows for risk. To take greater risks, investors demand the promise of higher returns. Risk is reflected in the cost of capital used in the discounting formula. The idea of discounting cash flows (DCF) is not new; indeed, it has been the standard for evaluating capital projects for years. But it was not until the 1980s that firms began seriously using DCF for broader strategic planning purposes. It then began to be considered for evaluating marketing strategies.

SVA seeks to identify those strategies that create shareholder value. The stock market's judgement on the expected financial performance of a company is reflected in its market-to-book ratio (see Figure 1.5). If the market value of the shares exceeds the book value of the firm, it has created value. This ratio is a useful insight for measuring how successful management has been in maximising shareholder value.

To evaluate a new strategy proposed by the management team, the future effects of this strategy must be separated from the results of past strategies and investments. The current share price reflects both the values derived from these past decisions as well as shareholders' expectations about what the current management team will do. To judge the current strategy we need to focus on the incremental effect on shareholder value. The essence of the shareholder value approach is that managers create value when their strategy generates a greater economic return than their cost of capital. The cost of capital is what investors would expect to earn if they invested the funds on their own, in businesses with a similar degree of risk.

WHY SHAREHOLDER VALUE?

The spread of value-based management and SVA has been triggered by the changes brought in by the information age. One is the enormous growth of equity markets around the world caused by economic expansion and the

declining role of government investment in industry. While government investment is motivated by complex political concerns, the objectives of private equity investors are much simpler and clearer. Private investors expect the pension, insurance and mutual funds that invest their money to maximise their performance. This in turn causes the fund managers to increasingly demand value from the companies they invest in.

The modern shareholder value movement started in the USA and the UK but, with the globalisation of trade and capital flows, it is sweeping into other major countries. Companies are now competing internationally not only for customers but also for capital. The most important criterion for attracting equity capital is its expected economic return. The information revolution is also making markets more efficient. Computers and modelling software make it much quicker to run SVA methodology and test the implications of a company's strategic thinking. The quantity and quality of information available to investors have also increased exponentially in recent years. Finally, the sophistication of modern telecommunications means that money can now travel around the world in seconds. All these trends mean that managers have come under increasing scrutiny from the people whose money they are using.

Companies that do not manage for value find capital more difficult and costly to obtain, handicapping their growth potential. They also become vulnerable more quickly. Non-executive shareholders and fund managers have become notably more proactive in removing top management when they fail to create value for shareholders. The high-profile collapse of once well-regarded companies such as Enron and WorldCom and the dot.com implosion in the early part of the century have made them even more vigilant. Finally, acquisition is a potent threat. When a weak market-to-book ratio indicates a 'value gap', i.e. a difference between the value of the company if it were operated to maximise shareholder value and its current value, an invitation appears for an acquirer to bid for it and replace the existing management.

CHALLENGES TO SHAREHOLDER VALUE

Recall that value-based planning is based on two premises: one is the philosophical assertion that the primary objective of managers is to maximise the returns for shareholders; the other is the technical assumption that the market value of the company is based on investors' expectations of discounted future cash flows. The latter assumption will be explored in Chapter 2, when the more technical aspects of SVA are presented. Here the rationale of the first premise is discussed.

Many writers have pointed out that a company has social and environmental responsibilities and that shareholders are not the only stakeholders in the business.^[16] It is argued that in seeking to maximise shareholder value managers ignore these social responsibilities and fail to balance the different stakeholder interests. That these stakeholders may have interests which conflict with those of shareholders is clear. It is also true that they often have longer-term relationships with the company than its shareholders. Today's shareholders are normally financial investors rather than individuals with emotional and long-term personal ties to the business. These other stakeholders fall into the following groups:

- **Employees.** *The legitimacy of the claims of employees lies in the long-term commitment many of them make to the firm. In today's information age companies, their special skills also represent intangible assets that are generally more important in creating value than the traditional balance-sheet items. The objectives of employees are normally a combination of employment security, compensation and job satisfaction. Each of these, but particularly security, can conflict sharply with a strategy based on maximising shareholder value. In rapidly changing markets, value-based management will unfortunately often dictate closure or disposals of businesses.*

- *Managers. The separation of ownership and control in the twentieth century increased the ability of top managers to pursue interests that were not aligned to those of shareholders. Managers have often seen growth and short-term profits as more closely linked to personal rewards in terms of salaries and prestige than shareholder value. Managers too are typically more risk averse in searching for opportunities than shareholders would wish. If the company invests in a risky project, shareholders can always balance the risk by portfolio diversification. Managers, however, have their jobs on the line, and so are hurt more by failure.*
- *Customers. Without customer value there can be no shareholder value. Even the most focused financial manager understands that the source of a company's long-term cash flow is its satisfied customers. Many managers, especially those with a marketing background, have therefore gone on to argue that maximising customer satisfaction should be the primary goal. The problem is that providing customer satisfaction does not automatically lead to shareholder value. Delighting customers with lower prices than competitors or superior quality and features cannot provide a sustainable advantage if the cost of delivering all this (including the cost of capital) exceeds the price they are paying. The unconstrained maximisation of customer satisfaction certainly conflicts with a shareholder value orientation.*
- *Suppliers. Today's virtually integrated companies are clearly dependent upon the cooperation and commitment of their network of suppliers. Competition has moved on from competition between individual companies to competition between networks. Suppliers in these networks want long-term security, predictability and satisfactory margins. Again, value management in today's volatile markets will mean that the firm cannot guarantee these relationships. Changing technologies, evolving consumer needs and new sources of supply will bring conflicts between the aspirations of traditional suppliers for stability and the ambitions of shareholders for value.*
- *Community. The local and national communities where the firm is located will also have interests in the firm's behaviour. Social responsibilities can be divided into those arising from what the firm does to the society, and what it can do for it. The former are the negative impacts – pollution and environmental damage – which arise as by-products of the firm's activities, and which communities increasingly want stopped. The latter are tasks which communities often want businesses to take on, such as preserving employment, helping minorities or improving schooling. Social impacts are caused by, and are the responsibility of, the firm. Social problems, on the other hand, are dysfunctions of society. Accepting responsibility for these social problems can bring sharp conflicts with the goal of maximising shareholder value.*

There are a number of objections to the claims made by advocates of corporate social responsibility and the interests of alternative stakeholders. The most fundamental is that social responsibilities are not the job of business. In a market-based economy that recognises the rights of private property, the only social responsibility of business is to create shareholder value, and to do so legally and with integrity. Managers have neither the expertise nor the political legitimacy to decide what is in the public interest. Such choices in our society are the function of elected governments. If the government is unwilling to ask voters to bear the costs of its social goals, why should a company ask its customers, employees and shareholders to pay through higher prices, lower wages or reduced returns?

Fortunately, there are strong market incentives for value-maximising firms to take into account other stakeholder interests. Crucial is the need to attract, retain and motivate the new 'knowledge workers' whose specialist skills and efforts determine the firm's ultimate competitiveness.^[17] Shareholder interest dictates that the firm offers competitive salaries and safe and attractive working conditions. Similarly, it would be suicidal in today's competitive markets not to be dedicated to satisfying customers. Investing in market research, new product development, quality and customer service are central to value management. Sustainability in its broadest sense is also a major concern.

However, when top management eschews shareholder value as the primary goal in favour of 'balancing the interests of stakeholders' the company's strategy loses clarity and focus (see box, 'Getting the Stakeholder Balance Right').

Management can be lured into making investments for reasons of prestige or public relations. They hold on to business units that have no chance of generating economic returns or go on to make ill-considered diversifications. When this occurs a 'value gap' begins to emerge, eventually precipitating a takeover, with all the unpleasant consequences for employees, managers and the community.

Getting the Stakeholder Balance Right

For his book, The Committed Enterprise, Hugh Davidson carried out in-depth interviews with 125 leaders of high-calibre organisations in for-profit as well as in not-for-profit organisations in Europe and the USA. He found that long-term successful organisations actively aligned their stakeholders. He quotes a typical CEO comment: 'To achieve value for shareholders, you must have very satisfied customers and employees' and notes robust linkages are increasingly being established between customer commitment, employee motivation and shareholder value. To manage what can be conflicting stakeholder needs, however, organisational leaders need to unite them through strong vision and value and recognise how they are changing. He found that the long-term successful organisations were committed from post room to board room to assuring the alignment of stakeholder values and had embedded processes for this purpose.

Hugh Davidson, The Committed Enterprise, Butterworth-Heinemann, 2006 (second reprint).

In the long term, shareholder value is the best strategy for all stakeholders. Ultimately all their claims depend on the firm's ability to generate sufficient cash to meet them. This in turn depends on the firm's competitiveness. The share price reflects the firm's competitiveness. The market value of a company is based on the most informed estimates of its ability to create a competitive advantage and to achieve profitable growth in its markets. Goals which undermine this focus increase costs, misallocate investment and reduce the ability of the firm to compete. While in the short run, employees or managers might be better off, in today's global markets, the non-optimal use of resources is not sustainable, as will become evident in the firm's declining profits and growth performance. All stakeholders are vulnerable when managements fail to create shareholder value.

Many critics of value management forget who shareholders are. Often they are demonised as a small group of wealthy, self-serving individuals set apart from ordinary people. Certainly for the USA and the UK, nothing could be further from the truth. One in three households owns shares directly or through unit trusts in the UK, rather more in the USA. But virtually every household owns shares indirectly through pension funds and other institutional savings. These institutions own 50 per cent of all shares in the USA and 80 per cent in the UK and Japan. Almost everyone now is affected by the market value of shares. Losses, whether due to poor management or incurred in the pursuit of other stakeholder interests, come out of the pockets of employees, pensioners and other individuals with savings. As governments around the world shift pension and social security provision from the public sector to individuals, shareholders become even more 'us' rather than 'them'. Self-interest increasingly pressures business executives and fund managers to maximise shareholder value.

There are two other fundamental and related criticisms of the shareholder value objective. The first is that it does not motivate staff to achieve high performance. The second criticism is that it is not operational – it does not tell employees and managers what to do at a practical level. There are several reasons why maximising shareholder

value may not be aspirational. One is that few of the staff will normally be significant shareholders themselves. Another is that they cannot see a direct link between their own specific jobs and the share prices of the company as a whole. Third, share prices often move as a result of macroeconomic factors and market forces unrelated to the performance of management.

Operationally, the problem is that, as noted earlier, while value-based management provides a criterion for strategies to be selected and evaluated, it does not say how these strategies can be constructed. Before a strategy can be put forward for SVA, a method for identifying the need for strategic change must exist. Then there must be a process of constructing strategic options that have prospects of creating competitive advantage and enabling the business to generate cash flows that exceed costs including the cost of capital. If these two prior processes are not well understood SVA can easily become over-focused on downsizing – getting rid of non-performing business units – rather than on exploiting growth opportunities.

To motivate staff and operationalise SVA, managements need a deep understanding of what the value drivers of the business will be in the future. This is why value management should not be thought of as a financial technique: it depends on all the knowledge and skills within the firm. This understanding can be called a *theory of the business*. It is a set of assumptions about what operations will be necessary for the firm to build and sustain a competitive advantage in the industry. These assumptions fall under five headings (Figure 1.6). The first is called the *environmental*

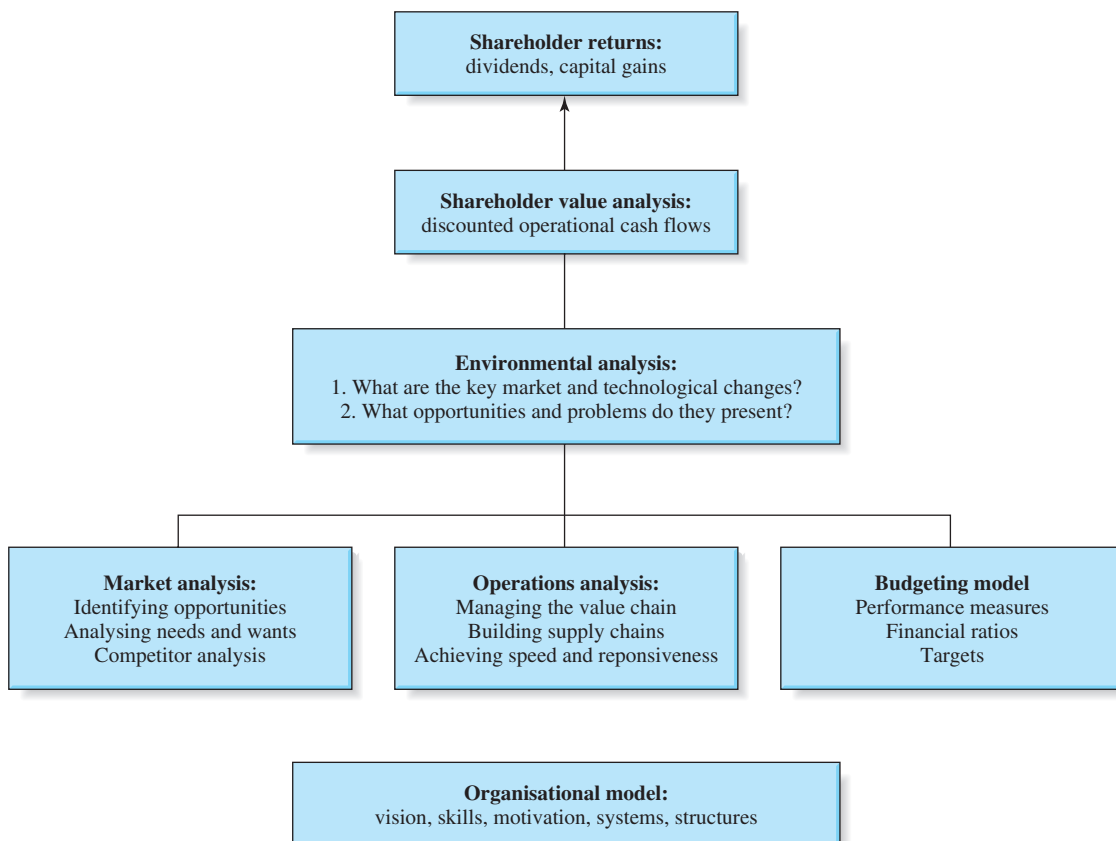


Figure 1.6 Shareholder Returns and the Theory of Business

assessment. It reflects management's analysis of those key developments in the global economy, technology, changing industrial structures and customer expectations that will shape its markets in the future. Changes in this environment should be the triggers that alert managers to the need to reformulate their own business strategy and capability requirements.

The second set of assumptions is contained in the firm's *marketing model*. This contains managers' analysis of which customers the firm can most profitably target and knowledge about what their wants are. It also contains the analysis of the competition: what strategies competitors are likely to follow, what their strengths and weaknesses are, and what capabilities are needed to create a competitive advantage. Next is the *operations model*, which contains the analysis of the best way to structure the firm's value chain to produce and deliver products and service to customers. Then comes the *budgeting model* which contains the key financial ratios management will use to monitor marketing and operations performance. Finally, and of vital importance, is the *organisation model*, which puts together people, leadership, vision and the skills to implement the strategy.

It is only with such a theory of the business that managers can use shareholder value to generate successful growth strategies. And, in an era of low inflation and relatively low overall GNP growth, it is only those companies that can achieve consistent growth that will create substantial increases in shareholder value. A well-grounded understanding of the fundamental value generators also allows managers to overcome the motivational and operational limitations of SVA. It can assign objectives, tasks and resources to measures of marketing, operations and financial performance that automatically lead to increases in shareholder value.

ACCOUNTING-BASED PERFORMANCE MEASURES

PROBLEMS WITH EARNINGS

In spite of the acceptance, in principle, that the task of management is to maximise returns for shareholders, most companies and fund managers still have not adopted value-based management. Accounting earnings rather than cash flows still form the basis for evaluating performance and valuing businesses. The financial press and analysts' reports consistently focus on short-term earnings, earnings per share and price earnings ratios. Despite the clear contrary evidence, the belief still persists that good earnings growth will lead to a parallel growth in the market value of the company's shares. Similarly, managers erroneously believe that if they concentrate on improving return on investment (earnings divided by assets) and return on equity (earnings divided by the book value of shareholder funds), the share price will automatically follow.

There are four reasons why earnings are a poor measure of performance compared to changes in shareholder value. First, unlike cash flow, which underpins SVA, accounting earnings are arbitrary and easily manipulated by management. Different, equally acceptable, accounting methods lead to quite different earnings figures. Prominent examples include alternative ways to compute the cost of goods sold (LIFO versus FIFO), different methods of depreciating assets, and the various choices in accounting for mergers and acquisitions. Different countries have different accounting regulations too, so international companies are frequently quoting different earnings on different stock markets. Not surprisingly, the flexibility of reporting procedures gives management ample opportunity to manipulate reported earnings for their own purposes – opportunities which are commonly taken.^[18] But however managers choose to report profits, none of their manipulations or adjustments have any effect on the company's cash flow or economic value. While profits are an opinion, cash is a fact.

The second problem with accounting profits is that, unlike cash flow, they exclude investments. A growing business will invariably have to invest more in working and fixed capital, so that it could easily have positive earnings, but cash could be draining away. On the other hand, depreciation is deducted in the calculation of earnings even though it does not involve any cash outlay. So for a mature business with assets still being depreciated, earnings could well understate cash flows.

Third, earnings ignore the time value of money. This means that even consistent earnings growth can reduce shareholder returns. The economic value of any investment is the discounted value of the anticipated cash flows. The discounting procedure recognises that money has a time value – money today is worth more to investors than a money return tomorrow. Consequently, shareholder value will increase only if the company earns a return on the new investment which exceeds the cost of capital used in the discounting process. Taking a simple example, suppose a company has current earnings (and cash flow) of £20 million and a cost of capital of 10 per cent. It decides to invest £25 million to increase the future levels of earnings by 10 per cent. Unfortunately, while profits and cash flow rise by an agreeable £2 million, the shareholder value of the company falls. This is because when the increased annual cash flow is discounted, it is valued at only £20 million, or £5 million less than the original investment. Shareholders could have done better investing the money themselves elsewhere.

Finally, and perhaps most crucial from a strategic viewpoint, profits produce a short-term managerial focus. Rising earnings can easily disguise a decline in shareholder value because earnings ignore the future implications of current activities. For example, earnings can quickly be boosted by cutting advertising or customer service levels. In the short run this is beneficial, but in the long run it will erode the company's market share, future earnings and shareholder value. Similarly, many activities that lower short-term earnings such as investing in brands and building customer relationships can increase long-term cash flows and shareholder value. The focus on short-term earnings discourages growth-orientated strategies that increase long-term competitiveness and shareholder value. Taking all these problems into account, it is not surprising that there is little or no statistical correlation between earnings per share growth and total shareholder return as measured by dividends and share price appreciation.

PROBLEMS WITH RETURN ON INVESTMENT

Seeking to link earnings to levels of investment, managers routinely measure performance by looking at return on assets (ROA) and return on equity (ROE). The former tends to be used at the business unit level, the latter at the corporate level. Unfortunately, since both use earnings in the numerator, they are subject to all the previous weaknesses, plus some additional ones.

The main new problem is that assets are valued in an equally arbitrary way to earnings. Different, but equally valid, depreciation procedures or capitalisation policies, will lead to different valuations of both assets and equity. With today's information-age companies the implications of the capitalisation problem are striking. The growing importance of knowledge-based companies makes intangible assets far larger than physical assets. But these intangible assets such as brand names, patents, R&D, training and customer loyalty, do not normally appear on the balance sheet. One implication is that it is impossible to use ROA or ROE to evaluate different types of company. For example, pharmaceutical companies and businesses with strong brands would have higher ROAs than traditional manufacturing businesses even if their economic returns were identical, because the assets of the former do not appear in the denominator. As companies gradually invest more in knowledge and less in physical assets, it also makes comparing a company's ROA overtime a dubious indication of performance.

Studies show that ROA generally overstates the true return on investment.^[19] The bias is greater for mature companies. Mature companies will often have higher ROAs than growth companies because depreciation policies and inflation will have tended to lower the net book value of their assets. Such figures then often deter management from moving away from declining businesses because they wrongly believe that ROA is correlated with value. Only when SVA is conducted using estimates of future cash flows can it be seen that the growth businesses are often immensely more valuable, and that there is often an inverse correlation between ROA and shareholder value added.

Turning to return on equity, this has all the above problems plus another one. ROE is calculated as ROA factored by gearing – the proportion of assets financed by debt rather than equity. Provided that it earns more than the cost of borrowing, more debt increases the ROE. Even if the amount of debt exceeds the optimal level, further borrowings increase ROE even while the value of the company declines due to increased financial risk.

The Problems with Return on Capital

Many fashionable techniques for judging corporate performance are variations of return on capital. While admirable in theory, all suffer from the weakness that, to calculate a return, one first needs to know the value of a company's assets, and historic book values are often irrelevant. Hence, one sees elaborate adjustments: goodwill write-offs and accumulated depreciation may be added back, the replacement cost of assets can be used or the price originally paid can be adjusted in line with inflation. All the wizardry is fair enough. But it can come at the expense of clear thinking about how to use return on capital in assessing performance . . . Such adjustments can simply divert attention from the fact that return on capital employed is not a useful measure for judging operating performance.

Source: The Lex column, Financial Times, 2 January 1997.

Managers and analysts use accounting earnings presumably because they are easy to calculate. But earnings, and all the various valuation measures (P-E ratios, EPS) and performance standards (ROI, ROA, ROE) which utilise them, are subject to fundamental practical, conceptual and empirical weaknesses (see box, 'The Problems with Return on Capital'). Practically their measurement is arbitrary and subjective. Conceptually they are inappropriate because they do not measure changes in value. Earnings are the result of past decisions; value changes are based on future cash flows. Empirically, earnings-based measures do not predict changes in the returns accruing to shareholders. Shareholder value analysis works because it overcomes all three weaknesses. It is fact-based, conceptually robust and highly predictive of actual changes in the market value of businesses. And, unlike accounting numbers, shareholder value calculations are unaffected by the shift from industrial companies to knowledge-based companies built around intangible assets.

THE CHANGING ROLE OF MARKETING

The centrality of marketing in creating growth and shareholder value suggests a new role for marketing both as a discipline and a function (Table 1.1). Traditionally, marketing has been seen as about satisfying the needs of customers more effectively than competitors. The assumption has been that if the company satisfied its customers and won market share, positive financial results would automatically follow. Unfortunately, top management knows

Table 1.1 The Changing Role of Marketing

	Past	Today
Objective of marketing	Create customer value	Create shareholder value
Marketing strategy	Increase market share	Develop and manage marketing assets
Assumptions	Positive market performance leads to positive financial performance	Marketing strategies need to be tested in value terms
Contribution	Knowledge of customers, competitors and channels	Knowledge of how to lever marketing to increase shareholder value
Focus of marketing	Marketing orientation	General management
Skills of marketing	Specialist	Specialist + general
Advocacy	Importance of understanding customers	Marketing's role in creating shareholder value
Concept of assets	Tangible	Intangible
Rationale	Improves profits	Increases shareholder value
Performance measures	Market share, customer satisfaction, return on sales and positive cash flow	Shareholder value: discounted cash flows

that this is not necessarily true. Marketing expenditures, like any other resources, can be wasted, and satisfied customers are not necessarily profitable ones. The concept of marketing that will make it more effective in today's board room is one of contributing to the creation of shareholder value. It can be defined as follows:

Marketing is the management process that seeks to maximise returns to shareholders by developing relationships with valued customers and creating a competitive advantage.

This new concept of marketing shifts it from being a specialist activity to an integral part of the general management process. Where in the past marketing managers were seen as experts on customers, channels and competitors, today they should be seen as experts on how marketing and growth can increase shareholder value. To do this, marketers need to extend their skill base to add expertise in modern financial planning techniques. In the past, marketers have often allowed themselves to be trapped by accounting-orientated management into seeking to justify their marketing strategies in terms of improving immediate earnings. Such a short-term approach is invariably destructive because marketing is primarily about creating and managing assets. Investments in brands and customer relationships – like research and development – rarely pay off in the period in which they occur. They are made to generate and defend cash flows, often for many years ahead. Familiarity with shareholder value analysis has become an essential tool for demonstrating that marketing produces an economic return.

TECHNOLOGY AND THE RESHAPING OF MARKETING

Marketing, like other business disciplines, has to adapt to changing technology. Indeed, the history of marketing can be viewed as a stepwise evolution to a changing technological environment. Over the past century there have been three changes in the orientation of marketing: distribution, selling and brand management. The Internet is consolidating the fourth stage of marketing's evolution: marketing as managing individual relationships with customers.

MARKETING AS DISTRIBUTION

At the beginning of the twentieth century, when marketing began to emerge as a subject of interest, technology was still shaped by the industrial revolution. The companies that succeeded were those that could lever vast amounts of capital to build huge factories that employed mass production techniques turning out standardised products in their millions. Companies that perfected this technology, like Ford, General Motors, Westinghouse and ICI, became the giants of the era. The mass production of standardised products resulted in scale economies that allowed these companies to offer cheap products that small craft-based businesses producing customised products could not match.

In his marketing textbook, Kotler called this business focus the production concept.^[20]

The production concept holds that consumers will favor those products that are widely available and low in cost. Managers of production-oriented organizations concentrate on achieving high production efficiency and wide distribution coverage.

In this era, the task of marketing was to arrange distribution to enable the products to be shipped to as broad a market as possible. It involved logistics and supply chain management, dealing with suppliers and creating an effective channel to get the goods to the consumer.

MARKETING AS SELLING

In the post-War years the problem began to change. Advances in production technology and the industrialisation of the developing countries began to make mass production too successful. Increasing production capacity led to greater competition and declining prices and profit margins. In addition, rising income levels led to customers wanting more than just basic, standardised products. At this stage the priority of firms began to shift from production to selling. Kotler defined this business focus as the selling concept.

The selling concept holds that consumers and businesses, if left alone, will ordinarily not buy enough of the organization's products. The organization must, therefore, undertake an aggressive selling and promotions effort.

In this period, the role of marketing was to organise this aggressive selling effort. Advertising and selling techniques became powerful tools for increasing the appeal of the company's products.

MARKETING AS BRAND MANAGEMENT

During the 1960s, there was an increasing appreciation that a better way of growing the business was not relying on increasingly aggressive and expensive selling and advertising, but instead researching what customers really wanted. The focus began to shift from 'selling what the company produced' to 'producing what the customer wanted'. This led on to the era of branding. Here companies researched the market, grouped customers into market segments sharing similar needs, and designed and positioned brands to these segments. Such companies as Procter & Gamble and Unilever professionalised this brand management concept.

The brand management concept holds that the key to meeting its organizational goals consists of the company being more effective than competitors in developing brands that create, deliver, and communicate customer value to its chosen target market segments.

The focus of marketing in this era was on market research, segmentation, positioning and brands. The arrival of computers and the development of databases allowed increasingly sophisticated techniques for tracking and profiling markets. Until well into the 1990s this concept represented the state of the art in marketing. Yet the technology at the time left marketing with one fundamental weakness: most companies had no direct interaction with individual consumers. A Procter & Gamble brand manager knew nothing about an individual consumer even if it was one of the company's most important and loyal users. At most, the manager knew the average needs of a market segment – though this could include several million customers. As a result, brands were a compromised solution, which would meet the needs of some customers and not others. At its core, the brand concept retained a product rather than a customer focus.

MARKETING AS MANAGING INDIVIDUAL CUSTOMER RELATIONSHIPS

In the mid-1990s the Internet brought in technologies which promised to overcome these compromises and usher in a new, more powerful marketing concept. It offered the opportunity to efficiently build relationships with individual consumers that allowed companies to precisely meet their needs with customised products and services. The first breakthrough was the opportunity for individual communication and interaction between company and consumer that the Net offered. This enabled companies to learn about individual needs and to rank customers by importance. Unlike a Procter & Gamble manager, one from Dell or First Direct is armed with detailed information when talking with a customer.

The second breakthrough was the emergence of mass customisation, where companies could make individual rather than standardised products and services. Again, this was facilitated by Internet technology, which fostered a shift from the inflexible vertically integrated company to the flexible network, or hub-and-spoke organisation. Here, the customer's order over the Internet is immediately transferred to the company's component suppliers through its extranet, who begin building the individualised modules. Information technology then coordinates the modules into a customised product that is quickly despatched.

These new 'virtually integrated' companies offer speed, customisation and economies in cost and assets that traditional companies cannot match. The new marketing concept has been called the individual marketing concept.

The individual marketing concept holds that the key to effective marketing is to use interactive communications to develop individual relationships with consumers based on providing superior value through personalised products and services.

The new marketing concept treats each consumer as unique and aims to match his or her specific requirements. If the company is doing this job well, the consumer will have very little reason to move. Indeed, moving away from the relationship will be unattractive because of the switching costs resulting from another company having to learn about their needs. Individual marketing also enables the firm to acquire detailed information about the value of each customer. The lifetime value of a customer is defined as the discounted net present value of all future cash flow generated by dealings with the individual. A company has a portfolio of customers. It is the increase in the value of the portfolio that is the best measure of how a company is performing.

Table 1.2 summarises the evolution of marketing to the present concept of building value through individual customer relationships.

Table 1.2 Changing Technologies and the Evolving Marketing Concept

Marketing concept	Distribution	Selling	Brand management	Individual relationships
Products	Single product	Few	Many	Huge, customised
Market size	As big as possible	National to global	Target segments	Individual customer
Competitive tools	Price, costs	Advertising, selling	Positioning, segmentation	Dialogue, customisation
Key technology	Mass production	Television, media	Market research	Internet
Key measures	Production costs, volume	Market share, margins	Brand equity	Customer lifetime value

SUMMARY

1. Companies grow and prosper when they efficiently meet the needs of customers. But efficient products and services are soon made obsolete by rapid environmental changes that create new customer needs, introduce new competition and offer new technologies that provide better answers. Maintaining success requires continual change.
2. In the new millennium four particular changes are reshaping the environment of business: the globalisation of markets, changing industrial structures, the information revolution and rising consumer expectations.
3. Increasing shareholder returns is the best measure of business performance. The market value of a business reflects investors' views of the ability of managers to create long-term profits that exceed its cost of capital.
4. Marketing has too little influence in business because marketing strategies are not effectively linked to shareholder value creation. Growth of sales or market share are not reliable measures of operating performance. The real role of marketing is to create and utilise marketing assets to create future cash flows with a positive net present value.
5. In most companies shareholder value has mistakenly come to be associated with downsizing and rationalisation. Such strategies do not create sustainable increases in cash flow or shareholder value. In today's rapidly changing markets, the greatest increases in value accrue to companies that identify new market opportunities and put in place market-led strategies that promise high future earnings growth.
6. Without effective marketing, shareholder value is a trivial concept. Shareholder value analysis allows management to evaluate alternative strategies, but only marketing insight and investment can create worthwhile strategies in the first place.
7. Marketing, like other business disciplines, has to adapt to changing technology. The history of marketing can be viewed as a stepwise evolution to a changing technological environment. Over the past century there have been three changes in the orientation of marketing: distribution, selling and brand management. The Internet is consolidating the fourth stage of marketing's evolution: marketing as managing individual relationships with customers.

REVIEW QUESTIONS

1. What are the characteristics of the information age, and how do these affect business?
2. How does the 'direct business model' contrast with the traditional business model?
3. What does the market-to-book value ratio indicate?
4. How does marketing contribute to a more effective shareholder value orientation?
5. What are the weaknesses of traditional, accounting-based measures of performance?
6. How can marketing managers use the shareholder value concept?

NOTES ON CHAPTER 1

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