1 – BUDGET SIZING

Combine multiple lenses to right-size your marketing budget

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Why does budget sizing matter?

How much should you spend on marketing? It's the biggest question of all, and yet many companies settle on an easy answer. Most years, they spend whatever they spent the previous year. If they make adjustments at all, these are often a function of overall company performance: if the company is prospering, the budget goes up – sometimes beyond what is necessary or effective. And in times of stagnation or decline, marketing budget cuts are as certain as death and taxes, even if reduced marketing support is the last thing a troubled company needs. This is because a lot of companies still define their marketing budget as a percentage of past sales. In effect, budget sizing is decoupled from business requirements. Budgeting inertia is further aggravated by the fact that many companies buy media many months – if not years – in advance.[1] If you are serious about turning the marketing function into a profit centre that contributes to the company's bottom line, put an end to these wasteful practices and introduce zero-based budgeting. First conceived in 1970 by Peter Pyhrr[2] – a controller at Texas Instruments at the time – zero-based budgeting is about "reviewing every dollar in the annual budget",[3] taking nothing for granted, and only signing off on budget positions that promise

sufficient returns. Applied to marketing, this is nothing short of a paradigm shift – from a cost item to an investment opportunity.

The role of marketing is not a constant, nor is your mandate as the CMO. Markets change, and so does your company's competitive position. Even your brand profile and your business model are bound to evolve over time. Such changes need to be reflected in the size of the marketing budget. Consider, for example, the case of an insurance company that depends on frontline excellence. If sales force performance is lagging, you may have to intensify your marketing communication to drive short-term consumer pull while your peers in sales do their homework to fix the underlying issues. Now fast-forward five years into the future. Aggressive new market entrants have declared a price war, and your competitors are launching secondary brands to secure their share of the lower end of the market. In this new situation, you will want to invest in brand building to strengthen your brand, justify your price premium, and protect the profitability of your company.[4] Now fast-forward 20 years into the future. Your brand is the top dog, and you are the market leader. You are finally able to decrease the marketing budget and allocate funds to other functions without putting your business at risk.

Whatever happens, we encourage you to put an end to "budgeting as usual." The size of your budget should reflect your ambitions for future growth, rather than the past performance of the company. Start treating budgeting as a profitability driver and build your budget as an investment case rather than as a cost item.

How to drive marketing performance with fact-based budget sizing

A few years ago, an electronics retailer embarked on a radical experiment. For an entire month, the company cut its ad spend by 60 percent. It was a top-management decision, just to see what

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would happen. Revenues plummeted. Store managers felt betrayed by the corporate centre, and their motivation dropped to an all-time low. But while the experiment substantiates the direct sales impact of advertising, it doesn't say much about the appropriate budget level. Indeed, 40 percent of last year's budget may be too little, but how much is enough?

Cause-and-effect relationships between the marketing budget level and market success are notoriously difficult to establish. There are simply too many other influencing factors: the creative quality of your campaigns, your mix of marketing instruments (see Chapters 5 and 6), prices, promotions, distribution, weather, seasonality, consumer confidence, competitors, financial markets. In light of this complexity, no tool or algorithm can give you the right budget level at the push of a button.[5] Historic relations between cause and effect should not be the only driver of sizing decisions anyway. Your company's objectives for the future and your own perception of market dynamics are equally important. Instead, we propose a multi-lens approach to budgeting that is both systematic and pragmatic. It starts with transparency creation and moves on to combine three perspectives on overall budget size (Exhibit 1.1).[6]

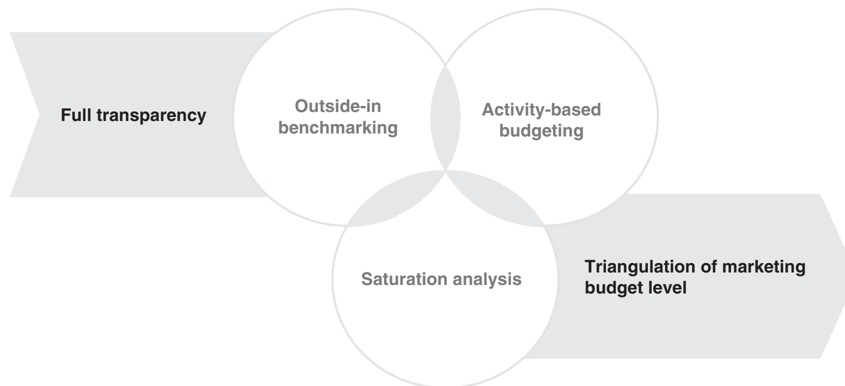

Exhibit 1.1 Five elements of budget sizing.
Source: McKinsey

Create full budget transparency; you will be surprised by what is hidden in the cracks and crevices of your organization

Transparency creation – it's easy to say and hard to do. This is because the marketing budget is scattered across so many different business units, functions, and departments at most companies. While most CMOs are in charge of all advertising, responsibility for activities such as co-op campaigns, sales support, public relations, owned media, and sponsorships often resides elsewhere in the organization. Yet all these activities affect your target audience in some way or another, and they should all contribute to your overall marketing objectives. A substantial share of the budget can also be hidden in the P&L of local subsidiaries, franchise partners, or affiliate companies.

So, before you even think about sizing, compile a comprehensive list of all the buckets in your current budget. Obviously, the number and granularity of budget positions will vary from company to company. Conceptually, taking stock should include all investments that are made to advance customers – current as well as prospective – towards your company on their purchase decision journey from awareness and consideration to purchase and loyalty. You don't need us to tell you that marketing is so much more than advertising. But in some industries – such as retail or B2B – traditional advertising typically only accounts for a relatively small share of the total budget. Make sure your transparency effort also captures point-of-sale activities, direct marketing, sales support, events, sponsorships, and indirect costs, such as agency fees and production expense. Compare our discussion of the "total cost of ownership" of a given touch point in Chapter 5.

The structures of most organizations – and the respective decision rules – are often the products of history and politics rather than business requirements. Typically, the marketing budget mirrors this

internal view. As a result, the building blocks of the budget are often departments and business units, rather than products, channels, or target groups. But the budget should be a function of the market you are serving, the objectives you are pursuing, and the instruments you are using to reach these objectives. To promote an investor's mindset, we recommend you create transparency in two respects:

- Which objective is a given investment meant to support – brand building, customer acquisition, or sales support for a specific product or service?
- Which instrument, or combination of instruments, are we using to reach that objective in our target group?

This will lay the foundations for optimizing the allocation of funds to business units (see Chapter 2) and instruments (see Chapters 5 and 6). Ideally, investments should be split according to where and how they reach your audience: on TV, in a print ad, online, as a leaflet that is delivered to their homes, in a store, in the form of an addressed direct mailing, or as part of a loyalty programme. This will help you take on a consumer perspective, rather than worrying about budget ownership. Keep in mind that costs incurred at the same touch point may be split between multiple departments. For example, your company's website may be co-funded by the IT department, corporate PR, and your own function. Some marketing activities may not be treated as marketing expenditure at all. For example, co-funded sales stimulation campaigns are often managed as stand-alone profit centres. While this is good news from a return on investment perspective, it can turn transparency creation into a nightmare. Depending on the size and the complexity of your organization, transparency creation can take several weeks, but it is worth the effort. It will not only help you quantify the total "I" (investment) in "ROI" (return on investment), but often also triggers a productive debate among executives about appropriate allocation keys and accountability assignments.

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Systematic transparency creation is imperative not only at the corporate level; it should be a matter of course for all your direct reports and their teams – be it to allocate funds to investment units (Chapter 2), to quantify the true cost of each touch point (Chapter 5), or to apply advanced analytics and optimize the mix of marketing instruments (Chapter 6). In each of these respects, transparency is the prerequisite of reliable, fact-based decision making. In this chapter, we will focus on the total size of the budget.

Outside-in: Conduct benchmarking analyses to find out what it takes for your voice to be heard

Your marketing activities don't take place in a void. You are in constant competition with other companies for customer attention. In a noisy environment, it isn't always easy to make sure your voice is heard. Of course, volume isn't the only way to get your audience to listen. A relevant message, a creative campaign, and a compelling story are equally important to engage your target group. But it's all for nothing if your messages never break through to them.

Marketing expenditure as a percentage of revenues is perhaps the most common indicator of relative marketing intensity. While this metric varies greatly with industry and country, it is a quick and easy way of determining whether you are spending in a healthy range. Typical ad-to-sales ratios range from 1 to 17 percent (Exhibit 1.2), but there is a wide spread within each industry.[7] In any case, you should have a good reason to spend either significantly below or above the average for your industry.

Of course, marketing as a percentage of sales is a highly aggregated figure, and it can easily be distorted. For example, if you are a B2B2C company selling to intermediaries, your ad-to-sales ratio will look disproportionately high. This is because sell-in to retailers is lower than sell-out to end customers. Because of such

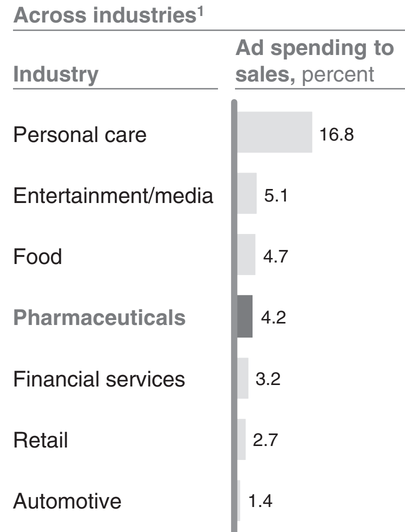

Exhibit 1.2 Average ad-to-sales ratios for different industries.
Source: Advertising Age, Capital IQ

distortions, you should use ad-to-sales ratios for rough orientation only. For benchmarking purposes, we recommend plotting your share of spending (SoS) against your share of market (SoM).

The textbook opinion is that your share of spending[8] should roughly match your market share to sustain your position relative to competitors.[9] In general, our experience corroborates this rule of thumb. But as the disguised example in Exhibit 1.3 shows, the "fair share of advertising" is not normally a linear function of revenues. If your market share is relatively low, you will have to overspend to get noticed (Players 1 and 2). Conversely, if your market share is very high, you are able to underspend (Player 3). This is a pattern we observe consistently, across countries, various industries, and many companies. Other reasons to deviate from the SoS/SoM equilibrium may be derived from specific strengths or weaknesses in sales performance, brand equity, or promotion intensity. For example, a high-performing sales force or a strong brand can compensate for

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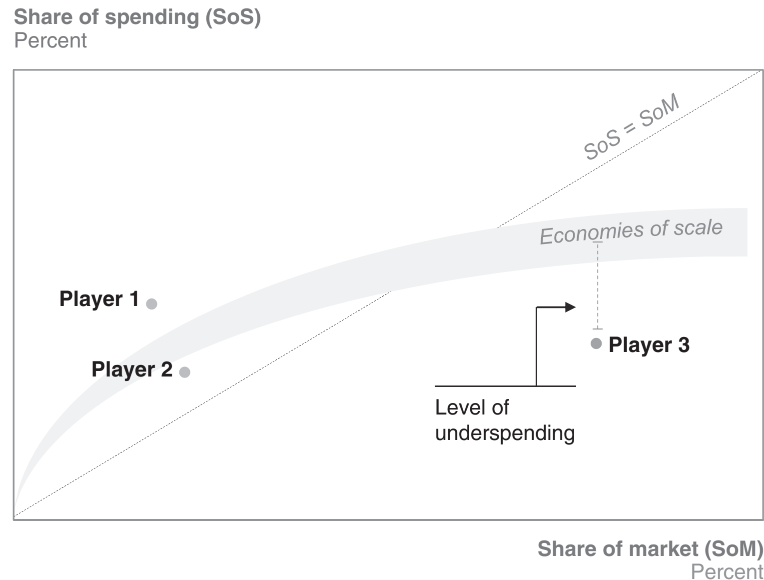

Exhibit 1.3 Outside-in benchmarking: Share of spending versus share of market.
Source: McKinsey

part of the marketing communication investment that would normally be required to reach a share of spending in line with your market share. But if you are launching a new brand, or setting out to conquer a new market segment, you may need to overspend in relation to your market share. In general, marketing communication should always be managed as one of multiple interdependent commercial levers, such as prices, promotions, brand, and sales.

When you conduct this kind of analysis, only include companies you actually consider your competitors according to your definition of the relevant market. Separate rounds of analysis may be required for different countries and categories. Note that the share of spending in our example is limited to gross media expense, the only figure that is easily available in the public domain. For deeper insight, the share of spending analysis should also include major below-the-line positions – such as leaflets – especially for retailers. The trouble

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is that this data is hard to come by, at least for competitors. Once you have gone through a transparency creation effort, you will know your own expenditure. There are different approaches to quantify the equivalent for competitors. Some providers of advertising data – such as AC Nielsen and Ebiquity – also track non-classical media. Alternatively, you can approximate below-the-line spending by deducting observed above-the-line spending from total marketing expenditure as given in a competitor's annual report. But keep in mind that reported ad spending is usually based on gross rate cards. In reality, most companies are awarded substantial discounts on those rates. A hundred "observed" advertising dollars might actually have cost the advertiser only 50 dollars or less in cash-out. Accounting for these rebates, which vary greatly across countries, is particularly important when you combine marketing spend data from multiple sources. We recommend that you conduct this type of analysis for the last three years to reflect the dynamics in the market. Typically, changes in SoM trail changes in SoS.

There is no wrong or right when it comes to your position in the SoS/SoM scatter plot. It's all about good reasons and conscious choices. If you are big enough or have other advantages over your competitors – such as a superior, patent-protected product or exclusive access to a key distribution channel – you may get away with underspending. Apple, for example, spends less than 1 percent of sales on advertising.[10] This is due to a combination of brand strength,[11] superior products, and lock-in effects that make it unappealing for many customers to even consider any other brand. From the perspective of many users, the perceived switching cost of transferring their music, photos, and contacts to another platform is simply too high to bother. Conversely, you may have to spend more than your fair share if your competitors have some such advantage over you. But be aware that focusing solely on SoS can lead to an unhealthy budgeting spiral that leaves all competitors worse off. This is why we encourage you to approach budget sizing from additional angles, namely inside-out and in terms of saturation effects.

Inside-out: Clarify your targets and build your budget on the activities required to reach them

The outside-in perspective afforded by competitive benchmarking is helpful to give you a sense of the right magnitude of your marketing budget. Your budget level should be high enough to get noticed in the marketplace, but it should also reflect what you are trying to achieve as a company. Because of the differences in marketing strategy and overall business objectives, benchmarking alone is insufficient to determine the appropriate budget level. The high variation we see both in ad-to-sales ratios and positions on the SoS/SoM scatter plot testify to the fact that companies differ in their growth ambitions, in their short-term versus long-term orientation, in the scale effects they benefit or suffer from, and in the operational marketing objectives they pursue.

Your budget should take into account both your general strategic direction and your market share targets. Building on these foundations, you can define specific activities and estimate the funds required for each. Ranked according to typical budget need in ascending order, examples include:

- Ongoing support for an established brand
- Launch of a new model or product range
- Organic growth with existing products
- Brand extension – to a new category, for example
- Introduction of a new brand.

Put yourself in the shoes of a consumer goods executive. Assume you have set out to build a new non-food brand for the Chinese market. Once you have outlined the structure and the size of your target group (e.g., all female consumers in big cities aged 19 to 45) and quantified your perception and preference targets (e.g., 50 percent aided brand awareness and 25 percent purchase

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consideration), your media agency can help you calculate the required reach and investment – for example, by using utility models as pioneered by von Neumann and Morgenstern.[12] Repeat this process for all the major marketing objectives you seek to achieve in a given year and sum up the individual investments to arrive at a total activity-based budget figure. To reduce complexity, you may want to go through this exercise brand by brand, country by country, or target segment by target segment, depending on the structure of your organization and the business priorities of your company.

In our experience, many companies will readily invest in highly visible above-the-line campaigns that drive awareness, but tend to neglect activities that drive purchase and loyalty. This is because such activities are often less spectacular than classical campaigns, and because they can be more cumbersome in terms of planning and steering. One consumer electronics company, for example, used to invest the bulk of their budget in classical media campaigns to promote their brand, partly spurred on by their creative agency that was desperate to win a Cannes Lion. But an analysis of consumer attitudes (see Chapter 3) revealed that lagging purchase consideration was actually the company's biggest issue. Subsequently, they included a range of activities in their marketing plan that would drive consideration, such as a new campaign featuring innovative products – rather than just the brand – and a set of activities targeting sales personnel at major electronics stores. In this case, the resulting budget was actually lower than before, but much more in tune with what the company needed to achieve in the marketplace to close the gap to its key competitor.

Saturation analysis: Review your budget in light of the expected return it will generate

Your competitors are going overboard with advertising spending. The noise they create calls for massive investments on your part

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as well, as do your ambitious growth targets for the company. And still it can be a bad idea to increase the marketing budget. Why? Because it may not pay off. Even if both outside-in benchmarking and inside-out activity planning lead you to believe a higher investment is required, the figure you arrive at may actually be beyond the efficient range. The disguised case in Exhibit 1.4 shows how the marginal ROI declines as the size of the budget increases.

As you can see from the shape of the curve, saturation is not a black-and-white affair. Long before your total budget reaches the saturation point, incremental returns generated by additional marketing investment begin to level off. In other words, your budget becomes less efficient the more you spend. As you get close to the tipping point, we encourage you to assess every new marketing activity, every additional instrument, and every request for a budget increase from one of your direct reports or product managers in light of the expected return. If your current budget already exceeds the saturation point, consider decreasing the budget to increase the relative return on marketing investment.

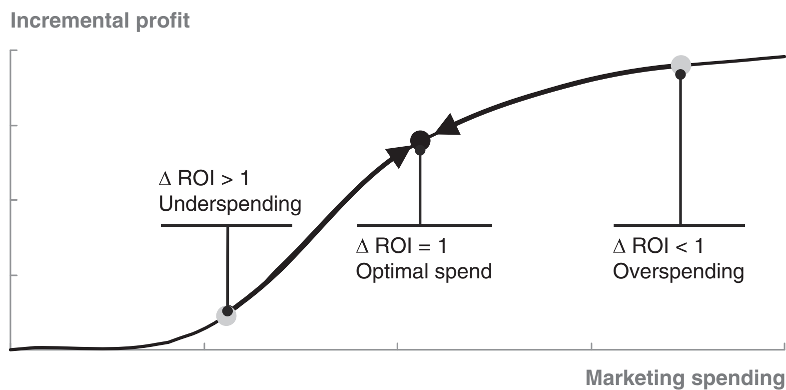

Exhibit 1.4 Saturation analysis.
Source: McKinsey

Additionally – or alternatively – you may also want to change the way you spend, based on this "marginal benefit" mindset. In this book, we will present a wide range of approaches you can apply to quantify and optimize the expected return on a given marketing instrument or activity. Granular growth analysis will help you find the investment units in which your budget is bound to have the biggest impact (Chapter 2). Insights derived from purchase funnel analysis will point you to the stages in a consumer's decision journey at which marketing investments are likely to be most worthwhile (Chapter 3). A common currency will help you compare different marketing instruments in light of their real reach per cost (Chapter 5). Creative storytelling is a great way to engage with consumers, often at very little cost because of the viral effects and free editorial coverage it generates (Chapter 4). Advanced analytical approaches let you optimize your mix across instruments (Chapter 6). Smart activation allows you to get the most out of your investments in specific instruments (Chapter 7). Don't hesitate to ask your trusted agencies for ROI estimates, and by all means have your team challenge their assumptions. Tying agency remuneration to marketing ROI can be a great way to motivate service providers to help you make your budget more efficient (Chapter 8). Screen the marketing technology landscape for solutions that enable you to monitor and manage marketing performance on a continuous basis (Chapter 9), and build an organization that is sufficiently agile and adaptive to react to relevant changes in market dynamics, competitor moves, instrument availability, and consumer behaviour (Chapter 10).

Combine all lenses for a holistic view on budget sizing and submit the result to practical, tactical, and strategic pressure tests

Each of the three perspectives described above – benchmarking, objective-based budgeting, and ROI analysis – will provide you with

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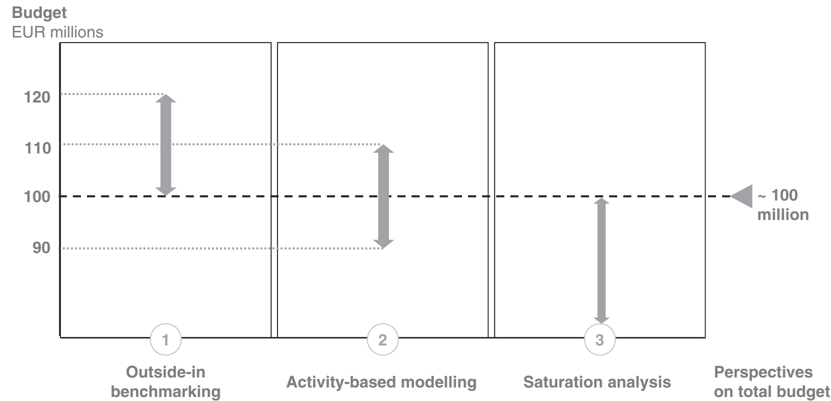

Exhibit 1.5 Triangulation of marketing budget level.
Source: McKinsey

a budget figure or, more commonly, a budget range. These ranges should show a fair amount of overlap. The company in our fictitious example (Exhibit 1.5) would have to spend EUR 90 to 120 million to achieve a share of spending in line with its market share and business objectives. But in the example, the saturation point for an ROI-positive investment is EUR 100 million. This is how much this company should spend.

Is that it? Not quite. The common ground defined by the combination of multiple budgeting lenses is only the starting point for real-life budget sizing. Before you actually submit your budget to the board for approval, you should perform a series of sanity checks and adjust the budget as needed:

- Have I considered all instruments? Make sure the three budgeting lenses have been applied to all marketing instruments. If you have missed out on any instruments, increase or reshuffle the budget accordingly. For example, your share of spending analysis may have been restricted to traditional advertising because of a lack of data for other instruments. Use objective-based

planning to quantify other parts of the budget, such as below-the-line activities.

- Have I accounted for non-working spending? Activation is wasted unless you have something worth activating. Make sure you include sufficient funds for indirect cost in your budget, such as creative agency fees, production, licences, testing, and research.
- Can I turn to others for co-funding? If third parties share your marketing objectives, they may be willing to share the burden of your budget as well. As a retailer, turn to vendors. As a consumer goods company, turn to distribution partners. As a big spender, ask agencies and media owners for discounts.
- Have I taken discounts into consideration? Some analyses, such as outside-in benchmarking, are typically based on reported gross spending, rather than actual cash-out. You may be able to reduce the affected budget positions – such as ad buying – by whatever discounts your media agency – or the media owners you buy from – are prepared to grant you. Make sure you take a "net" perspective.
- Is the company ready for the new budget? Some changes may overtax the capabilities of your current organization. For example, running campaigns as profit centres might necessitate structural adjustments and require training for the managers in charge to succeed. Consider introducing changes to your budgeting approach step by step, rather than all at once.

When all that is said and done, lock yourself in a room with the brightest minds on your team and at your lead agencies. Have everyone come up with at least one idea for how to make your budget even more efficient. What about spending against the trend? Matching competitors' activities is often a very inefficient use of marketing funds. Companies that maintained their spending levels during the world financial crisis, for example, consistently outperformed their peers on the stock market.[13] Last but not least, make sure to set aside an emergency fund to react to unforeseen competitor moves, potential scandals, unexpected opportunities, and other surprises.

Budget sizing should neither be an automated process nor a black box. The systematic approach presented in this chapter is most powerful when you use it to initiate a fact-based discussion among your executive peers in other functions, brand owners, product managers, and country-level managers. Lay bare your reasons why, let them challenge your assumptions, and ask for their advice. If you have the big debate before the fact and make budget sizing a joint exercise, you will have a much stronger case against requests for midstream budget changes. And you will have your hands free for next year's budget planning.

Key takeaways

- Create full budget transparency. You will be surprised by what is hidden in the cracks and crevices of your organization.
- Outside-in: conduct benchmarking analyses to find out what it takes for your voice to be heard.
- Inside-out: clarify your targets and build your budget on the activities required to reach them.
- Saturation analysis: review your budget in light of the expected return it will generate.
- Combine all lenses for a holistic view of budget sizing and submit the result to practical, tactical, and strategic pressure tests.

NOTES

1. Jonathan Gordon and Jesko Perrey, "Boosting returns on marketing investment," *McKinsey Quarterly*, June 2005, http://www.mckinsey.com/insights/marketing_sales/boosting_returns_on_marketing_investment.
2. Peter A. Pyhrr, "Zero-base budgeting," *Harvard Business Review*, November/December 1970, Volume 48, Number 6, pp. 111–121.
3. Matt Fitzpatrick and Kyle Hawke, "The return of zero-base budgeting," *McKinsey Quarterly*, August 2015, http://www.mckinsey.com/insights/corporate_finance/the_return_of_zero-base_budgeting.

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4. This is actually happening in many commoditized industries, from personal finance and airline travel to telecommunications and energy.
5. Advanced analytical approaches are required to control for external factors and isolate the business impact of marketing investments. See Chapter 6 for details.
6. The main section of this chapter is based on Tobias Karmann et al., "Budget sizing," pp. 117–128, in *Retail Marketing and Branding – A Definitive Guide to Maximizing Marketing ROI*, by Jesko Perrey and Dennis Spillecke, Second Edition, John Wiley & Sons, 2013.
7. Kate Maddox, "Capital IQ debuts first ad campaign," *Advertising Age*, October 20, 2008.
8. In an ideal world, you should measure and manage effective share of voice (i.e., the *output* that reaches your audience), rather than the share of spending (i.e., your *input* relative to that of your competitors). But in the real world, you will normally not have the data to quantify the share of voice you actually generate with your spending, except for a few instruments, such as TV.
9. John Philip Jones, "Ad spending: maintaining market share," *Harvard Business Review*, January/February 1990 (https://hbr.org/1990/01/ad-spending-maintaining-market-share).
10. YCharts, "Who spends more on ads—Apple or Microsoft? Another lesson in quality vs. quantity," *Forbes*, August 2, 2012, http://www.forbes.com/sites/ycharts/2012/08/02/who-spends-more-on-ads-apple-or-microsoft-another-lesson-in-quality-vs-quantity/.
11. According to Interbrand, Apple is the most valuable brand in the world, currently valued at USD 170 million http://interbrand.com/best-brands/best-global-brands/2015/ranking/ (retrieved 28 December 2015).
12. Glen L. Urban, "Direct assessment of consumer utility functions: von Neumann-Morgenstern utility theory applied to marketing," MIT Working Paper 843-76, January 1977.
13. Credit Suisse.

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