

# ESTIMATING SHORT-TERM RETURN ON CUSTOMER INVESTMENT

Step 4 of the IMC process begins with the estimation of the short-term returns that have been or can be achieved from marcom investment. Unlike traditional models based only on communication effects, the goal of IMC is to clearly determine the returns on the investments that have or will be made by customers and prospects as a result of marcom programs.

In this chapter, we describe a basic approach to calculating return on customer investment (ROCI). We first provide a framework that can be applied to any type of organization. The method is then illustrated in a detailed case history that demonstrates the actual steps one marketing manager took when estimating the potential returns from a proposed IMC program.

## **Marginal Analysis of Business-Building Marcom Investments**

A tangible return on the marcom investment is critical if senior management is to be asked to compare that investment against other uses of

finite corporate resources. For this reason, IMC offers a marginal analysis system through which to value marcom programs. The system is simple: dollars go out in the form of investments in various communication programs that impact customers and prospects immediately and in the long term; dollars come back in, in the form of increased or retained income flows from those same customers and prospects. With this marginal return approach, all current marcom investments, which have short-term measurable results, can be converted into *variable costs* to the organization. In other words, short-term, business-building marcom investments become variable costs rather than fixed expenses. The primary requirement to make this fundamental change is the ability of the firm to know the value of a customer or customer group and have some way to manage and measure changes in the value of that customer or group over time.

The justification for this variable-cost approach is simple: If marketers can determine the economic value of customers or prospects (either individually or as a group), they can determine how much they should invest against those individuals or groups. Recall from Chapter 5 that the value of customers must be calculated at the contribution margin line based on their income flows to the organization. If one adjusts the contribution figure slightly—that is, break out all costs and other charges so that the contribution margin figure includes only marcom expenditures and profits—one can quickly and easily determine the return on investment. This is now being done in many firms through activity-based costing methodologies. In these methodologies, with the contribution figure containing only marcom costs and profits, it becomes clear that money not spent on marketing communication becomes profit, and profits not taken can be used for marketing communication. Thus, marketing communication is converted into a variable organizational cost for accounting purposes. (This is illustrated further in the examples that follow.)

Likewise, other types of marcom investments in customers, such as customer retention, protection of existing customers from competition, and migration of customers through a product portfolio, can be accommodated in the same way. In fact, the marcom manager can estimate or determine the value of any type of marcom investment against any set of customers or prospects based on the marketing strategy being devel-

oped. This planned marcom expenditure against specific customers or groups of customers or prospects forms the core of the value-based IMC measurement system.

Let's illustrate the difference in how business-building marcom investments and returns are treated in IMC compared to traditional marketing budgeting and allocation processes. Table 10.1 illustrates a typical line item budget for a fast-moving consumer goods product. It shows advertising and sales promotion as fixed line expenses. The budget for this product has been based on an organizational budgeting model. In this case, it is a flat 6 percent of gross sales with a built-in inflation factor of 10 percent. That is, it assumes costs of communication activities will increase by 10 percent over last year. Thus, the budget for each of these functional marcom activities has been increased by that amount from the previous year. Using this annual fiscal budget spreadsheet, the brand manager can allocate marketing and communication programs over the coming year, keeping in mind the limits that senior management has established through the budgeting process.

Contrast this with the IMC model in Table 10.2. Note there are no functional communication budget lines. All marcom programs have

**Table 10.1 Line Item Budget for Fast-Moving Consumer Good**

	1995 (millions)	1996 (millions)	1997 (estimate) (millions)
Gross sales	\$1,750.00	\$1,897.50	\$2,108.00
Units	500	550	620
Price per unit	\$3.50	\$3.45	\$3.40
General and administration	\$170.00	\$166.60	\$163.27
Advertising and promotion	\$105.00	\$115.50	\$127.05
Total fixed expense	\$275.00	\$282.10	\$290.32
GMBT and COGS	\$1,475.00	\$1,615.40	\$1,817.68
	84%	85%	86%
COGS	\$525.00	\$550.28	\$590.24
GMBT	\$950.00	\$1,065.13	\$1,227.44
	54%	56%	58%

Note: COGS = cost of goods sold; GMBT = gross margin before tax.

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been included as variable product expenses in the budget sheet. Since expenses will be included as cost of the product, the only requirement of the IMC manager is to reach his or her income flow goal for each customer group. Thus, all marcom investments will be recorded as part of product financials.

From these two spreadsheets, it is obvious that the business-building investment approach is a form of basic economic marginal analysis. Using marginal analysis, the organization could theoretically invest unlimited marcom funds against groups of customers or prospects as long as the return income flows were equal to or greater than the expenditures (and also covered the cost of capital), since marketing communication is being treated as a variable product cost.

## How to Estimate Returns on Business-Building Marcom Programs

As discussed in the last chapter, a key element needed to effectively measure ROI is the ability to separate short-term business-building marketing communication from brand-building communication. While

**Table 10.2 Business-Building Spreadsheet**

	1995 (millions)	1996 (millions)	1997 (estimate) (millions)
Gross sales	\$1,750.00	\$1,897.50	\$2,108.00
Units	500	550	620
Price per unit	\$3.50	\$3.45	\$3.40
General and administration	\$170.00	\$166.60	\$163.27
Total fixed expense	\$170.00	\$166.60	\$163.27
GMBT, COGS, and marketing communication	\$1,580.00	\$1,730.90	\$1,944.73
	90%	91%	92%
COGS	\$525.00	\$550.28	\$590.24
Marketing communication	\$105.00	\$115.50	\$127.05
GMBT	\$950.00	\$1,065.13	\$1,227.44
	54%	56%	58%

Note: COGS = cost of goods sold; GMBT = gross margin before tax

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the line between the two will not always be distinct, the basic separation between short term (returns within the organization's fiscal year) and long term (returns over typically several fiscal years) is critical because of current accounting standards.

The ROI measurement system proposed for IMC planning is based on the premise that all business-building marcom programs will contribute incremental returns to the organization. The planner must, in advance, estimate or account for additional revenue that is or should be expected to be generated by the marcom program. This is important, because almost all organizations have some form of income flow from present customers or expected income flow from prospects. Additional investments in marketing communication should therefore either enhance or protect those revenue streams or, in some cases, alter them to create more cash flows and hopefully a greater profitability.

This incremental revenue approach is possible because some measure of income flows from the customer or the value of a customer group is known prior to executing the marcom program. Thus, the calculation of incremental financial return is the goal, replacing the determination of total sales volume or total profit in traditional budgeting. Also, the incremental revenue approach works just as well for a customer retention strategy—the marketer can estimate what it costs or will cost to retain a customer's income flows, and from that, the level of investment and ROI can be determined. Similarly, a marketing communication manager can estimate or calculate the cost to acquire a new customer from whom the initial income flow to the organization will be zero until a purchase has been made. Thus, the proposed process works equally well with most any type of customer or prospect marketing strategy. This is a critical element in the success of the IMC program.

A key element in the process, explained in more detail in the following examples, is that it is designed to work either with customer or prospect groups or with individuals. If the planner could estimate or calculate the return on every individual customer, that would be the ideal situation for most organizations. However, this is not always practical or possible. Therefore, the focus in this chapter is on customer groups, since that is what the majority of marketers will likely be using.

## How the Incremental Revenue Method Works

The spreadsheets that follow demonstrate how the process works. The same method can be used to calculate either the actual return that has been achieved on a marcom investment program or to estimate potential returns using various “what-if” scenarios.

Table 10.3 provides a standardized overview of a typical ROCI analysis spreadsheet.

In the column headings across the top, customers are aggregated by their behavior. These groups can be as broad or as narrow, as many or as few as needed for the market being estimated or calculated. Along with each customer group, the marcom manager specifies the behavioral objective the plan aims to achieve during the measurement period (acquire new customers, retain existing customers, grow share of business, migrate customers through the product portfolio). Note that there may even be times when the marketer aims to divest high-maintenance, low-profit customers.

The spreadsheet itself is composed of rows divided into the five sections that provide the basic building blocks for the ROCI calculation. Let's look at each one in more detail.<sup>1</sup>

### Category Requirement Assumptions

In this section, the customer's entire demand in the product category, spread across all vendors, is determined. (Note that for organizations that sell through channels, this estimate is based on sales at the factory level.)

**Line 1: Estimated Category Demand** This is based on historical or what-if data about customer purchase behavior and is expressed in dollars rather than units, shipments, or other nonfinancial measures.

### Base Income Flow Assumptions

Basic assumptions are made about the brand's share-of-customer requirements and its cost dynamics. These are factors that are then applied under alternative scenarios calling for differing levels of communication spending.

**Table 10.3 Building Blocks of ROCI Analysis**

		Aggregated Customer Group:		Group A	Group B	Group C
		Behavioral Goal:				
Category Requirement Assumptions		Historical data/estimate		\$	\$	\$
1	Estimated category demand					
Base Income Flow Assumptions						
2	Base share of requirement	Historical data/estimate		%	%	%
3	Base income flow to us	Line 1 × Line 2 =		\$	\$	\$
4	Noncommunication costs (product, fixed, G&A, etc.)	Operating estimate		%	%	%
5	Contribution margin (%)	100% – Line 4 =		%	%	%
6	Contribution margin (\$)	Line 3 × Line 5 =		\$	\$	\$
Scenario A: No Communication Investment						
7	Change in share of requirement	Estimate		+	+	+
8	Resulting share of requirement	Line 2 + (Line 7 × Line 2) =		%	%	%
9	Resulting customer income flow to us	Line 8 × Line 1 =		\$	\$	\$
10	Less noncommunication costs (product, fixed, G&A, etc.)	– (Line 9 × Line 4) =		–\$	–\$	–\$
11	Less marketing communication costs	\$0		–	–	–
12	Net contribution	Line 9 + (Line 10 + Line 11) =		\$	\$	\$

(continued)

Table 10.3 Building Blocks of ROI Analysis (continued)

Table 10.3 Building Blocks of ROI Analysis (continued)						
		Aggregated Customer Group:		Group A	Group B	Group C
		Behavioral Goal:				
Scenario B: Communication Investment						
13	Marketing communication efforts (Lines A–M)	Estimate		\$	\$	\$
14	Total marketing communication investment	Total lines 13A–M		\$	\$	\$
15	Change in share of requirement	Estimate		±%	±%	±%
16	Resulting share of requirement	Line 2 + (Line 15 × Line 2) =		%	%	%
17	Resulting customer income flow to us	Line 16 × Line 1 =		\$	\$	\$
18	Less noncommunication costs (product, fixed, G&A, etc.)	– (Line 18 × Line 4) =		–\$	–\$	–\$
19	Less marketing communication costs	– Line 14		–	–	–
20	Net contribution	Line 18 + (Line 19 + Line 20) =		\$	\$	\$
ROI Calculation						
21	Incremental gain/loss vs. “no investment” scenario	Line 20 – Line 12 =		\$	\$	\$
22	Incremental ROI	Line 22 / Line 14 =		\$	\$	\$

Note: G&A = general and administration; ROI = return on customer investment.

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**Line 2: Base Share of Requirement (SOR)** This is the proportion of the customer's total category requirements that the marketer's brand currently enjoys, based on historical or what-if scenario data.

**Line 3: Base Income Flow to Us** The customer's total category demand is multiplied by the percentage of that demand that comes to the marketer's brand, meaning the dollar income flow to the brand that the customer group represents.

**Line 4: Noncommunication Costs** This line shows all fixed and variable costs of running the business *excluding* marcom costs. For the sake of simplicity, this is shown as a simple percentage of the income flow.

**Line 5: Contribution Margin (%)** This is equal to 100 percent less the percentage used in line 4 to account for nonmarcom costs.

**Line 6: Contribution Margin (\$)** Contribution margin for the brand expressed in dollars is determined by multiplying line 3 by line 5.

#### Scenario A: No Communication Investment

This section establishes a base line of profitability. That is, if the brand made no further communication investment, how much business would it receive from each of its customer groups during the period of analysis? It is, of course, unlikely the brand would lose 100 percent of its customers without any marketing communication in the fiscal year, although one could imagine such a situation for a direct marketing firm. However, chances are some change in demand, share, or requirements would occur. This section of the spreadsheet defines certain assumptions about just what that impact might be. From there, the brand's income flow, costs, and net contribution based on the factors established in the previous section are reprojected.

**Line 7: Change in Share of Requirement** This represents the estimated change in the brand's SOR during the period if there were no marcom investments. In most cases, this will result in a negative number, such as a 15 percent decrease in the SOR.

The key question for many organizations is how to develop an accurate estimate of the change in requirements of their customers or prospects. Companies with a great deal of historical data can extrapolate from past experiences. Others may have done A/B market tests that could provide a starting point. In most cases, all firms have had to cancel, adjust, or redefine their marcom programs at one time or another. The same data provide the basis for this estimate or calculation. In other cases, this estimate may be based on nothing other than the manager's own best professional judgment and insight from experience. In truth, assumptions about what would happen if no communication were done are made by marcom managers every day, albeit they are often done indirectly. The key is that this process forces the manager to focus on the issue(s) to be resolved and to make viable and supportable decisions, not just maintain the status quo or continue the traditional spending patterns as they have been done in the past.

**Line 8: Resulting Share of Requirement** This is the result of adjusting the initial SOR in line 2 by the factor increase or decrease specified in line 7. For example, if the brand's initial SOR were 50 percent, but the manager felt that brand share would decrease by 25 percent without communication support, the resulting SOR would be  $0.50 + (0.50 \times -0.25) = 37.5\%$ .

**Line 9: Resulting Customer Income Flow to Us** The adjusted SOR from line 8 is multiplied by the customer total category demand in line 1. This line represents what would happen to the brand's income flow for the period if no marcom expenditures were made.

**Line 10: Less Noncommunication Costs** Line 4 (the percentage allocated to cover all noncommunication costs and profits) is multiplied by the adjusted income estimate in Line 9.

**Line 11: Less Marketing Communication Costs** In this scenario, this line is \$0 since there will be no marcom expenditures during the period of analysis.

**Line 12: Net Contribution** This shows what remains after the costs associated with lines 10 and 11 are subtracted from the income flow estimate in Line 9 (meaning the brand's contribution level under a scenario where no funds are invested in marketing communication). It is this figure that is the basis for estimating the incremental gain, if any, to be achieved when the firm invests in an IMC program, as in Scenario B which follows.

### Scenario B: Communication Investment

The next step is to estimate how the value of each customer group would change if a planned communication program were directed toward it.

**Line 13: Marketing Communication Efforts** This includes all identifiable expenditures for marcom programs the organization plans to direct to a specific group of customers or prospects.

**Line 14: Total Marketing Communication Investment** This is the firm's total investment in its IMC programs, indicated by all items under line 13.

**Line 15: Change in Share of Requirement** This line estimates what percentage increase (or decrease) can be expected in SOR for the brand as a result of the total communication program.

**Lines 16, 17, and 18** These lines recalculate the revised SOR, income flows, and noncommunication costs based on the percentage obtained in line 16.

**Line 19: Less Marketing Communication Costs** This number is equal to the total IMC communication investment figure in line 14. It is repeated here as a negative so that it can be subtracted from the income flow along with the noncommunication costs.

**Line 20: Net Contribution** This indicates the net income after all communication and noncommunication expenses have been deducted.

**Line 21: Incremental Gain/Loss Versus “No Communication Investment” Scenario** This gives a comparison of the two net contribution estimates obtained in lines 12 and 20. Note that these are incremental gains (or losses) to the brand as a result of the IMC program or lack thereof.

**Line 22: Incremental ROCI** This is the total incremental gain/loss (line 21) divided by the investment made in line 14.

### An Example of the Incremental Revenue Method in Action

Table 10.4 is a walk through the process of developing an actual ROCI analysis for a marcom program step-by-step, using a consumer product example. The example incorporates real-world situations and shows how they fit into the model.

The product illustrated is a consumer brand that is sold through retailers. It is generally purchased three to four times per year by a using household and has a high rate of market penetration. There is limited brand loyalty in the category, so substantial price promotion and discounting by competing brands generally occur. Thus, there is considerable brand switching in the category.

For this example, customers have been divided into four groups based on their relationship with the brand. From previous experience with these groups, the firm has specific behavioral objectives it wishes to achieve through its marcom efforts.

The first group, loyals, consists of long-term customers who give the brand most of their category purchases. Previous analysis has shown that demand from this group is not growing significantly, but the brand obviously needs to maintain the substantial income flow it generates from these customers. Thus, the goal of the brand manager is to retain these customers' income flows at the same level as in the past.

The second group, switchers, are people who switch quite often between the marketer's brand and various competitive brands. While switchers purchase the brand on occasion, this usually happens during a promotion or special offer period. The brand's managers believe they

**Table 10.4 Business-Building ROCI Example**  
CONSUMER PRODUCT

Line #	Aggregated Customer Group:	Loyals	Switchers	New or Emerging Customers	Problem Customers	Total of All Customers Groups
	Behavioral Goal:	Retain	Grow Share	Acquire	Divest	
1	Category Requirement Assumptions	\$1,000.00	\$1,000.00	\$1,000.00	\$1,000.00	\$4,000.00
	Base Income Flow Assumptions					
2	Base share of requirement	75.0%	40.0%	10.0%	15.0%	35%
3	Base income flow to us	\$750.00	\$400.00	\$100.00	\$150.00	\$1,400.00
4	Noncommunication costs (product, fixed, G&A, etc.)	75.0%	80.0%	80.0%	90.0%	78.4%
5	Gross contribution margin (%)	25.0%	20.0%	20.0%	10.0%	21.6%
6	Gross contribution margin (\$)	\$187.50	\$80.00	\$20.00	\$15.00	\$302.50
	Scenario A: No Communication Investment					
7	Change in share of requirement	-20.0%	-25.0%	-30.0%	-20.0%	-22.1%
8	Resulting share of requirement	60.0%	30.0%	7.0%	12.0%	27.3%
9	Resulting customer income flow to us	\$600.00	\$300.00	\$70.00	\$120.00	\$1,090.00
10	Less noncommunication costs (product, fixed, G&A, etc.)	-\$450.00	-\$240.00	-\$56.00	-\$108.00	-\$854.00
11	Less brand communication costs	\$0.00	\$0.00	\$0.00	\$0.00	—
12	Net contribution	\$150.00	\$60.00	\$14.00	\$12.00	\$236.00

(continued)

**Table 10.4 Business-Building ROCI Example (continued)**  
CONSUMER PRODUCT

CONSUMER PRODUCT						
Line #	Aggregated Customer Group: Behavioral Goal:	Loyals	Switchers	New or Emerging Customers	Problem Customers	Total of All Customers
		Retain	Grow Share	Acquire	Divest	Groups
Scenario B: Brand Communication Investment						
13	TV advertising	\$0.00	\$5.00	\$4.00	\$0.00	\$9.00
14	Radio advertising	\$0.00	\$2.00	\$2.00	\$0.00	\$4.00
15	Consumer magazines	\$0.00	\$3.00	\$2.00	\$0.00	\$5.00
16	Direct mail	\$4.00	\$1.00	\$2.00	\$0.00	\$7.00
17	Sales promotion	\$0.00	\$5.00	\$3.00	\$1.00	\$9.00
18	Public relations	\$2.00	\$2.00	\$2.00	\$1.00	\$7.00
19	Special events/sponsorships	\$2.00	\$2.00	\$2.00	\$1.00	\$7.00
20	Custom media	\$4.00	\$0.00	\$0.00	\$0.00	\$4.00
21	Customer service improvements	\$2.00	\$0.00	\$0.00	\$1.00	\$3.00
22	Total brand communication investment	\$14.00	\$20.00	\$17.00	\$4.00	\$55.00
23	Change in share of requirement	0.0%	10.0%	40.0%	3.0%	6.0%
24	Resulting share of requirement	75.0%	44.0%	14.0%	15.5%	37.1%
25	Resulting customer income flow to us	\$750.00	\$440.00	\$140.00	\$154.50	\$1,484.50
26	Less noncommunication costs (product, fixed, G&A, etc.)	-\$562.50	-\$352.00	-\$112.00	-\$139.05	-\$1,165.55
27	Less brand communication cost	-\$14.00	-\$20.00	-\$17.00	-\$4.00	-\$55.00
28	Net contribution	\$173.50	\$68.00	\$11.00	\$11.45	\$263.95

Line #	Aggregated Customer Group: Behavioral Goal:	Loyals		Switchers		New or Emerging Customers		Problem Customers		Total of All Customers
		Retain	Grow Share	Acquire	Divest	Groups				
ROCI Calculation										
29	Net contribution scenario A	\$150.00	\$60.00	\$14.00	\$12.00	\$236.00				
30	Net contribution scenario B	\$173.50	\$68.00	\$11.00	\$11.45	\$263.95				
31	Incremental gain/loss vs. "no investment" scenario	\$23.50	\$8.00	-\$3.00	-\$0.55	\$27.95				
32	Incremental ROCI	168%	40%	-18%	-14%	51%				

Note: G&A = general and administration; ROCI = return on customer investment.

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can strengthen their relationship with these customers with marcom activities and capture a greater proportion of their SORs.

The third group, new or emerging customers, consists of those purchasers just coming into the market. This group is expected to expand rapidly, and even though the marketer's brand now only receives a small portion of the group's business, the goal is to acquire more of its income flows now and in the future.

The last group of customers is called the problem group. In some instances, these customers give the marketer's brand only a small percentage of their business. In others, their general requirements in the category are simply very low. In still other cases, such customers often require a great deal of service and support. Therefore, customer service costs to maintain them are quite high, and product margins for the marketer's brand are squeezed. Demand from this group is also expected to decline in the coming period because of members' changing lifestyles. As a result of this analysis, the marketer would like to reduce the firm's marcom investment to this group and perhaps even divest some of these customers. Note, however, that the marketer can't afford to alienate these customers because this could damage the firm's reputation with other, more valuable customers.

For purposes of this illustration, the projected category demand for each group has been set arbitrarily at the same rate (\$1,000.00) for the measurement period. Most likely, this would never be the case in the real world, but it is done to show the dynamics of the process so that comparisons can be made. Thus, the real data on which this analysis is based have been adapted to fit this example.

With overall category demand established, the next step is to move on to determine the base value each customer group represents to the brand. Line 2 details the base share of requirements each group gives to the brand in question. In this case, the marketer has been receiving 75 percent of the income flows from loyals based on what they spent or will spend in the category. This results in a base income flow (line 3) of \$750.00. Switchers give the brand 40 percent of their business, so the marketer receives \$400.00. Emerging customers provide an income flow of 10 percent SOR, equal to \$100.00. And the problem segment is using the brand for 15 percent of its members' requirements, resulting in \$150.00.

Next, line 4 shows an estimate of all costs other than those for marketing communication. This is the allocation for all fixed and variable costs, such as those related to product manufacturing and distribution, staff salaries, general and administrative costs, and so on. Typically, there will be some justifiable variation in costs attributed to different groups. New customers, for example, generate greater administrative costs as accounts are established, credit checks are run, and so forth. Established customers, on the other hand, are often the easiest and most efficient to serve. They understand the product, require less hand-holding, are acquainted with the firm's staff, and can easily and quickly explain what they want or need.

In this example, 75 percent of the total customer income flow will be needed to cover all these noncommunication costs for loyals. As shown, they cost somewhat less to serve than switchers or the emerging group, both of which have more churn (i.e., temporary or permanent customer defection to a competitor) and therefore greater administrative expense. Lastly, the problem group requires a high level of customer service and support, and often high promotional and retention costs. Thus, a cost factor of 90 percent has been determined for this group.

When deducted from base income flows, these cost factors give the contribution margin percentage available for each customer group (line 5). This is obtained by subtracting each percentage factor in line 4 from 100 percent. Line 6 expresses the gross contribution margin in terms of dollars. (Recall that the contribution margin in this approach includes only funds available for marketing communication and profit.) In this case, the contribution margin ranges from \$187.50 for loyals, to \$80.00 for switchers, to \$20.00 for the emerging group, to \$15.00 for the problem group.

At this point, it is time to recap. So far, the marketer has determined the baseline financial value of each of the four groups of customers at the contribution margin line, based on their estimated income flows to the organization. If the organization could generate these income flows without investing any marcom funds, the communication manager might be able to justify serving each of them. Given some of the group's value based on the calculations, however, even if the firm were able to drive its share of their requirements up substantially—say, getting 80

percent to 85 percent of each group's future business—the company would still have limited funds available for an IMC program. This is the challenge that every communication manager faces when using this type of ROI analysis. There are some customers against whom finite resources simply cannot be invested, or if the investment is made, it must be done through some type of very efficient, low-cost communication activity that commonly limits its power and impact. This is not to say that these types of IMC programs are not possible or useful, but it does suggest that targeting and focusing on best customers or at least those who provide the greatest opportunity for returning income flows to the firm should be the first requirement of any integrated marcom program.

With this analysis of customer value, it is time to take the next step in the process, which is to identify the incremental value that can likely be created through a marcom program. This is done by first estimating the impact on the brand's income flows if no marcom investment were made and then comparing these results with the results the marketer expects to achieve when various marcom programs are developed and implemented. The results are often surprising.

First, it is necessary to create a "no communication investment" scenario in lines 7 through 12. This is done by estimating or calculating how much the brand's share of customer requirements would fall if all marcom programs were suspended for some period of time. In our earlier example, the brand operated in a competitive category with low customer loyalty and a great deal of competitive marcom activity. Here, the manager has estimated on line 7 that the brand would see a 20 percent decline in its SOR from loyals if there were no promotional investments in this group. Among switchers and emerging customers, the drop is even more dramatic, with decreases of 25 percent and 30 percent, respectively. Even the problem group SOR is predicted to decrease by 20 percent if there are no messages or incentives to encourage its members.

In earlier discussions we stated that, in our experience, the customer's total demand or income flow in the category commonly does not change as a result of diminished brand communication activity in the short term. It is, instead, the proportion of total SOR the brand receives that

is impacted. That is, the SOR for the marketer's brand will commonly decline without some marcom support, although customer purchases in the category might continue at the same rate.

Lines 8 through 12 show a recalculation of all the components that lead to the net contribution, which is so critical to the brand. Since the SOR among loyals falls by 20 percent, the resulting SOR declines from 75 percent to 60 percent. When this is multiplied by their base category demand of \$1,000.00, it produces an income flow of \$600.00 to the firm's brand. From this amount, \$450.00 must be subtracted to cover the 75 percent provision for product, administrative, and other noncommunication costs. This results in a net contribution from the group of \$150.00, down from the baseline in line 6 of \$187.50.

The SOR among switchers, as previously stated, falls 25 percent as well. That means an adjusted share of 30 percent and a resulting income flow of \$300.00. With 80 percent of this (\$240.00) required to cover noncommunication expenses, the group thus has a net contribution of \$60.00.

The emerging customer group was impacted even more by the lack of communication from the brand. Its members are newer to the category, have less experience with the various product alternatives, and in some cases are still experimenting with various marketplace alternatives. Without a compelling communication program, their share of requirement is expected to drop by 30 percent, leaving an SOR of only 7 percent and an income flow of \$70.00. Subtracting allocated costs of \$56.00 provides a net contribution of \$14.00 to the marketer's brand from this group.

Finally, a 20 percent decrease in SOR is expected to occur among the problem group if marcom programs are suspended. Thus, the adjusted SOR for these customers becomes 12 percent. This produces an income flow of \$120.00. When allocated noncommunication costs of \$108.00 are deducted, a net contribution of \$12.00 is the result.

The net contribution income flow shown for each group becomes the basis against which the marketer will measure the incremental gain or loss resulting from the brand's IMC program.

The next step in the analysis is to estimate or calculate the alternative scenario of developing and implementing one or more marcom

efforts against each of the groups. In this example, nine marcom efforts are shown on lines 13 through 21. Some are targeted to each group, although the message, incentives, and delivery systems may be different. In some of the programs, only one or two of the communication elements are to be used.

As part of the manager's analysis, the cost of each of these marcom efforts must first be determined. It is not the total invested in each communication method that is important, as much as the determination of how these expenditures are to be allocated across the individual groups. For example, the advertising campaign that has been developed to run on TV, over radio, and in consumer magazines is geared to attract new customers. So, the entire cost of advertising is allocated to switchers and loyals. While it could be argued that even loyals are positively influenced by advertising, the manager has special communication efforts planned for this group, including direct mail, public relations, and custom media.

Line 22 is a summary of the total communication investment made against each customer group. So, a total of \$14.00 was spent against loyals, \$20.00 against switchers, \$17.00 against emerging customers, and \$4.00 against the problem group.

In the previous scenario, the following questions were raised: "What if no marcom investment whatsoever were made? What would happen to the brand's share of requirements? What would happen to its sales volume?" In this scenario, the question is reversed: "What happens to the brand's share of requirements and income flows if these marcom investments are made, through the various communication efforts, against customers and prospects? How much, if any, will the brand's business increase in terms of dollars? Will profits increase as well?"

Just as in the "no communication investment" scenario described earlier, the key is to estimate or calculate any change in SOR that would result from the brand's IMC efforts. This is commonly based on some estimate or analysis, often using historical behavioral data, of the responsiveness of customers and prospects to the brand's message and incentive delivery programs. The goal is not to attempt to value each individual, functionally specific communication effort and then sum

them. Instead, in the IMC approach, the objective is to determine the synergistic effect produced by all the elements in the integrated marcom program.

Once a determination has been made or estimated of how much (or if) the brand's SOR will change as a direct result of the marcom program, all the brand's income, costs, and net contribution for each group can be recalculated. This is shown on line 23 of the spreadsheet.

At this point, a number of observations are possible. Even though the brand invested \$14.00 in communicating with the loyals, there was no impact on their SOR; it stayed the same. However, since the manager's initial goal was to maintain the current SOR level, that objective appears to have been achieved. As shown, the income flow remains at \$750.00, with 75 percent (\$562.50) of this allocated to noncommunication costs. However, the \$14.00 communication expenditure must be deducted to arrive at the net contribution of this group (\$173.50).

The estimated SOR among switchers increased by 10 percent as a result of using the marcom programs shown. That gave the brand a total SOR of 44 percent, producing an income flow of \$440.00. Although income increased, so did costs; 80 percent (\$352.00) of the income was allocated to noncommunication costs. So, after subtracting the marcom investment of \$20.00, a net contribution of \$68.00 remained.

Emerging customers were very receptive to the brand's marcom programs. Thus, the firm was able to increase its SOR for this group by 40 percent, to 14 percent, and increase its income flow to \$140.00. Of this, 80 percent (\$112.00) is required for noncommunication expenses. When the \$17.00 that was invested in the IMC is deducted, the firm will receive a net contribution of \$11.00 from this group.

The problem segment, unfortunately, had a very slight change in SOR as a result of the IMC program. The manager did not want to make a significant investment in communication with the problem customers, but realized that they would be exposed to a certain number of the communication efforts regardless. Thus, a total expense of \$4.00 was deemed to have been spent on this group, with the result that the SOR increased, although only by 3 percent, leaving an overall SOR of

15 percent. Based on this, the brand's income flow becomes \$154.50, from which \$139.05 in noncommunication costs and the \$4.00 in communication investment must be deducted, leaving a net contribution of \$11.45.

Following these calculations, it is now possible to develop the actual ROCI estimation among the four groups. Only three lines are required for that calculation:

- Line 12, net contribution, under the "no communication investment" scenario
- Line 22, total amount of brand communication spending, under the "brand communication investment" scenario
- Line 28, net contribution, under the "brand communication investment" scenario

For each group, the incremental gain or loss in net contribution under the two scenarios is shown (line 30 – line 29). Because a comparison is being made between net contribution value after all communication spending has been deducted, the objective is to look at the change in profitability that each group of customers or prospects contributes during the time of the communication program. To determine the ROCI, the incremental gain/loss (or the "return") in line 31 is divided by line 22, the total brand communication investment.

As a result of these calculations, the following conclusions can be drawn:

- Loyals received the second smallest portion of the brand's communication spending, \$14.00. That investment created no impact on their SOR when compared to their historical level. However, the alternative was to suspend communication, and in that event the brand would likely have lost 20 percent of its SOR among this key group. By spending the \$14.00, the brand maintained its share and added to the company's profitability in the amount of \$23.50 (\$173.50 versus \$150.00). Thus, the calculated ROCI is 168 percent ( $\$173.50 - \$150.00 / \$14.00$ ).

- Switchers increased their net contribution from \$60.00 under the "no communication investment" scenario to \$68.00. This is an incremental gain of \$8.00 that, when divided by the communication investment of \$20.00, produces an ROCI of 40 percent.
- Communication dollars invested against the emerging customer group did not have as great an impact. The net contribution actually fell from \$14.00 to \$11.00. While the brand was able to increase its SOR by 40 percent, the additional income was not sufficient to offset the communication costs. There was a loss of \$3.00, and an ROCI of –18 percent. This illustrates why it is often true that new customers are expensive to acquire and their value often occurs over time, not immediately. In many cases, organizations are better off trying to nurture the business they have established from existing customer relationships before investing significant amounts to acquire new customers. The true value of customer acquisition usually cannot be reflected in a business-building model such as this because the time frame is simply too short. There is, however, long-term value in acquiring new customers. This is discussed in more detail in Chapter 12.
- Communication to the problem group also produced a negative ROCI. While the SOR had a modest increase, net contribution went from \$12.00 to \$11.45, an incremental loss of \$0.55 and generated an ROCI of –14 percent.

While this example is based on a real-world experience, it has been adapted and simplified to illustrate the ROCI process. Thus, the estimates and calculations are for demonstration purposes only. Other firms using this same approach and process may receive greater or smaller returns from their marcom programs.

## Good Versus Bad Return on Customer Investment

A question often raised in this type of calculation is how to determine what level of ROCI is acceptable and what level is not. Obviously,

marketing and communication managers want some sort of comparison with similar organizations or competitors. Unfortunately, such yardsticks do not exist or if used are of little value. All organizations are different. All have different strategies. All have different sets of expectations from management and stockholders. So, the only "good" or "bad" ROCI number is the one that fits (or doesn't fit) the financial or financial expectation requirements of the organization.

We have worked with clients who have set a "hurdle rate," that is, a level of return they would like to achieve, in the range of 20 percent to 50 percent. This is the level of return they believe they can achieve by using their finite resources in other ways. Other firms are more modest in their expectations. They believe a return in the 10 percent to 25 percent range is appropriate. Still others fall in between these estimates.

The true determination of whether or not the ROCI is good or bad is what return could be expected from investing those same funds in other corporate activities. If research and development is expected to return 40 percent, then that is a relevant number for comparison. If a new plant investment will return 9 percent, that is the relevant return on investment to use in comparing a marcom ROCI. Again, it all depends on the organization and its other uses for corporate resources. It is within this framework that marketing communication must function now and in the future.

### ROCI in Action: National American Bank

The example that follows demonstrates how ROCI analysis, as step 4 of an IMC program, assisted marcom planners at a major financial organization, National American Bank (name has been changed to protect confidentiality). The bank's newly appointed marketing and communication manager was asked to determine and justify a marcom budget and to estimate the expected returns for one of the bank's most mature categories, its credit card division. The example shows how he tackled the problem, particularly as it relates to short-term, business-building communication solutions.

### Before the Marcom Effort: National American Bank's Credit Card Portfolio

When the new manager took over responsibility for the marketing and communication programs for the bank's credit card portfolio at the end of 2001, he found a troubled department. Marcom investments had been declining for the past five years. Because the previous manager had been unable to provide senior management with solid evidence that marcom investments could provide measurable returns to the organization, the executive committee had failed to approve that manager's budget requests. Thus, funding had declined and marketing communication had become a minor element in the operation of the unit.

Historically, National American's credit card operation had been highly profitable. Its revenue stemmed from two sources:

- **Interest charged to cardholders on outstanding balances in their accounts.** National American made over \$2.4 billion in interest revenue annually, more than that of any of its primary competitors.
- **Interchange fees charged to merchants who accept credit card purchases.** National American estimated its net credit sales in 2002 would be in excess of \$7.8 billion, placing it second among its major competitors.

In recent years, the bank had benefited from a growing economy and a positive economic outlook. Thus, consumers were willing to take on additional charge card debt. Revenues had grown as a result of the economic good times. In addition, bank management prided itself on having the best financial performance among its primary competitors as measured by such ratios as cost to income, return on assets, and so on.

As a result, management was highly reluctant to increase marketing expenditures. The concern was that a substantial change in spending would, at least in the short term, result in deterioration in the key financial ratios that were closely monitored by the investment community and could influence the bank's stock price.

However, after conducting an assessment of the bank's recent performance and position against half a dozen competitors, the marcom manager spotted several negative trends that, if not addressed, could result in slowed growth and less profitability. He was particularly concerned about the bank's position vis-à-vis its two largest competitors, Worcester Bank and Valley National, as well as one small but very aggressive competitor, Garden City Bank. Highlights of his analysis, including data for these three competitors, are shown in Table 10.5.

Among the issues he identified were the following:

- **Slower growth than competitors.** While the bank's credit card business was growing at about 3 percent, two of its primary competitors were growing at more than twice this rate.
- **Lower levels of marketing investment.** The slower growth seemed to be related, at least in part, to lower spending levels for marketing activities. The competing banks that were growing faster than National American were investing substantially more in marcom activities. In fact, of the four major banks in its area, National American spent the least on marketing communication. For example, National American invested only \$207,000 in above-the-line marketing communication in 2001 compared to the nearly \$535,000 spent by Worcester Bank, \$1,250,000 spent by Valley National, and

**Table 10.5 National American Bank and Its Competitors**

	National American Bank	Worcester Bank	Garden City Bank	Valley National
No. of accounts	1,435,000	1,225,000	950,000	1,515,000
Outstanding balances	\$2.4 billion	\$1.9 billion	\$531 million	\$1.8 billion
Net credit sales	\$7.8 billion	\$6.75 billion	\$1.1 billion	\$11.2 billion
Annual growth	3.0%	2.3%	8.8%	6.3%
Spending on marketing communication	\$207,000	\$535,000	\$4,725,000	\$1,250,000
Spending per account	\$0.14	\$0.43	\$4.97	\$0.83
Share of market	21%	18%	3.3%	27.0%
Share of wallet	62%	79%	85%	71%

a whopping \$4,725,000 spent by Garden City Bank. On the basis of communication investment per cardholder, National American was investing only about \$0.14, substantially less than any of the other banks in the analysis.

- **Declining share of market.** National American's share of revenues from interest and interchange income had declined from 26 percent five years earlier to only 21 percent. The marcom manager estimated that this decline in market share represented over \$45 million in lost interest and interchange revenue.
- **Declining share of wallet.** Among its own cardholders, National American had seen its share of requirement—or "share of wallet"—decline from 69 percent five years earlier to just 62 percent in 2001. Research showed that half of National American's credit card customers had more than one card, sometimes carrying two, three, or even four. The bank closely monitored this share of wallet figure—that is, the percentage of purchases customers put on their National American card as opposed to one of the other cards they carried—as this was believed to be a strong indicator of customer loyalty and future business. At the current interchange rates, the manager calculated that each 1 percent loss in National American's share of wallet was equivalent to a \$5 million loss in bank interchange revenue. Therefore, a decline of 7 percentage points at \$5 million per percentage point per year over the last five years likely amounted to more than \$35 million in lost revenue to the bank.

The issue of declining share of wallet was particularly disconcerting to the new manager. His first step was to determine the amount of revenue that the bank's customers were charging on other cards. He determined that the current share of wallet for National American was 62 percent of its customers' total spending, or \$7.8 billion. That, the marcom manager reasoned, left a 38 percent opportunity for the bank, or about \$4.8 billion that the bank's customers were charging on other credit cards. By applying the standard interchange rate of 1.1 percent per year, he determined there was approximately \$53 million per year in revenue forgone in available but not captured income among National American's existing cardholders.

Additionally, the bank would have been able to earn interest on the \$4.8 billion available but not captured income. The manager estimated the lost interest at approximately \$46.4 million per year. When combined, the interchange fees and the lost interest revenue totaled a whopping \$99.4 million. That is the additional billing that would have been processed on National American credit cards if the bank had captured all the funds in the 38 percent of the available dollars.

Obviously, capturing 100 percent of available funds is not very likely, but it is a good measure of the potential income the bank was leaving on the table for competitors—and just among its own customers. This calculation clearly defines the available potential against which marcom efforts could be directed and a yardstick against which success could be measured.

As the final piece in the puzzle, the marcom manager had to determine why customers were ignoring or not taking advantage of National American Bank's credit card offerings. As previously noted, market research had indicated that 50 percent of the bank's credit card customers held cards from other banks or other card organizations. Additional analysis showed that of the 50 percent who held two or more cards, almost 20 percent had switched their choice of primary card within the last year. Obviously, if this trend was not reversed, National American's share of wallet would continue to decline, as would revenues and profits. The key question was why these customers had ceased using National American as their primary card. Research was again able to provide some insight. The most common response—from half of all customers who had switched from National American as their primary card—stated that the competing bank offered a customer reward program.

At this point, the new manager knew the magnitude of the problem he was facing, what was creating a large portion of that problem, and what he could expect to generate in terms of returns to the bank if he could solve the problem. It is clear to see that everything he had done so far fell within steps 1, 2, and 3 of the IMC process. By going through that process, he began estimating what he might be able to accomplish with a focused marcom solution. Clearly, he felt a well-conceived and

well-implemented IMC program could provide a solution to the declining value of the National American credit card portfolio.

## The IMC Story Line

To gain approval for a strategic solution to the bank's credit card challenge, the marcom manager had to develop a powerful "story line" for senior management. This presentation had to outline the problem, present the recommended solution, provide the supporting documents, illustrate the assumptions on which the solution was based, and, finally, describe the expected returns. The manager recalled that his predecessor had been unable to provide a solid proposal and, therefore, had been unsuccessful in gaining approval for his recommendations. The new manager was determined this would not happen again. He developed his story line in the following manner, summarizing the current situation and then putting forth his recommended solutions.

### Current Situation

The basic premise of the program the manager proposed was to begin treating communication budgets as an investment rather than as an expense. This concept had never been adequately developed nor explained at the bank. In reviewing previously proposed programs, the new manager found that his predecessor had presented his recommendations in a way that avoided any estimate of the return on investment. In fact, the predecessor had argued that it was impossible to measure the return on marketing investments with any precision. He had assumed that, because of the lagged response effect, marketing programs only worked over time and could not be linked to customer behavior. Thus, any measurements that were undertaken were primarily attitudinal and could not be directly linked to overall business objectives, such as increasing cash flows, customer migration, and so on.

The new manager believed if he challenged these assumptions, he might be able to present new approaches that would provide answers to the questions senior management had been asking.

### The Solution

The manager proposed that the bank adopt a new set of principles to guide marcom investments. The bank needed not only to measure and justify its marcom investment, but to determine the areas of business in which it should invest and the returns it could expect from those investments.

The manager set two major objectives for a new IMC-driven approach to developing a marcom program for the credit card division:

- To demonstrate how National American Bank could measure the return on its marcom investments
- To determine the appropriate marcom investment level for the National American Bank credit card programs

The net result of this approach, he believed, would enable senior management to compare alternative investments by weighting likely dollar returns to marcom programs versus the alternative uses available to them for the same finite organizational resources.

The marketing manager then went on to present a three-part program that was based on a consistency of efforts approach to attract new customers as well as increase share of wallet among existing cardholders. The three primary efforts were as follows:

- New customer acquisition for the bank's gold, standard, and special-interest credit cards
- An expansion of credit limits for selected, creditworthy current customers
- Usage offers to stimulate demand among existing customers

Detailed ROCI projections were presented for each of these programs showing the returns that could be expected in both the short and long term.

### How Return on Customer Investment Was Calculated

The basic premise of the proposal was that only customers could provide returns to National American Bank, and those customers could

be influenced through various types of marcom efforts. Thus, the approach the marcom manager proposed was to relate the results of the income generated through marcom programs to the customers influenced, not the delivery systems that took the communication to them. The advertising, marketing, and marcom activities would be considered simply as the tools and techniques by which the bank was able to invest in its credit card customers to influence their behaviors.

This was possible because the bank was in a unique situation with regard to customer knowledge and information; it had a continuing one-to-one relationship with every credit card customer it served. This came about because the bank captured and stored customer-level activity data on each and every credit card customer over time. That quantity and quality of data allowed the credit card marketing team to understand and measure income flows, purchase rates, share of wallet, and product margins. The use of these data contributed substantially to the ROCI model the team developed and in which it had great confidence.

Finally, to meet senior management objectives, the team members needed to calculate the cost-to-income ratios that would result from their programs. Senior management used this evaluation measure to determine what programs met their investment criteria. The guideline was that the cost of any investment by the bank could not exceed 40 percent of the revenue that investment was expected to return. By including this additional calculation on their marcom investment models, the marketers were able to assure management that their programs did not exceed the 40 percent ratio.

The first step in determining the appropriate level of investment in National American Bank's credit card customers was to create an ROCI model, a tailor-made version of the model described earlier in this chapter. The marcom manager assumed that by not investing in current customers, the bank's share of wallet among these customers would continue to fall from the current 62 percent to 60.5 percent in the coming year. On the other hand, by making the recommended investments, he hoped to increase share of wallet by 20 percent among key customer groups, thus giving the bank an average 74 percent overall share of wallet among all its core customers.

Exhibit 10.1 shows a portion of the ROCI analysis he presented to senior management. The analysis was actually conducted over a dozen



customer and prospect segments, but only four are shown here. The objective of the model was to account for the additional revenue the credit card team believed could be generated as a result of the proposed investments in marcom programs.

As shown, the goal was to determine the incremental financial return to the bank based on the communication investments made in customer groups, rather than to determine the total sales or profit for the division. The manager also judged that the incremental value approach he was using for new growth through customer acquisition would work just as well for customer retention. He further surmised it could even be used as a methodology to determine how and when the bank should divest certain high-maintenance, low-profit customers. In short, the ROI analysis process was an excellent basic tool to manage customers—just what the manager was seeking.

The first step in the process was to aggregate the bank's credit card portfolio of customers into four groups, namely gold-card holders, standard-card holders, cardholders who were qualified for an increase in their credit limits, and a special-interest cardholder group. The manager estimated that all groups would, on average, increase their demand for credit card usage at the same rate of 12 percent per year, as shown on line 3. Further, the manager estimated that National American Bank would hold the 62 percent share of wallet it presently enjoyed. Thus, that would be the base case for a calculation of each group's share of wallet (line 5).

The credit card team estimated there would be different noncommunication costs for each group which they determined from previous experience (line 7). Thus, there would be different gross contribution margins (lines 8 and 9) for each group as well. As a result of the "no investment" scenario, it was estimated the change in share of wallet for each group would decline by 2.5 percent (line 10) during the period.

Starting in Scenario B, the manager identified the brand communication programs he was planning and the investments required for each of those activities. We have not shown the detail of the program here; instead, all activities have been aggregated into a total investment figure. This represents the amount that would be invested in communication programs aimed at each group (line 16). Line 17 shows the

### Exhibit 10.1 Credit Card ROI Analysis

Target Segments:		Gold	Standard	Credit Limit	Special Interest
<b>Category Requirement Assumptions</b>					
1	No. of customers in group	1,841	19,676	2,137	6,583
2	Historical category demand	\$895,000	\$4,307,300	\$725,207	\$2,175,621
3	Estimated % increase/decrease in demand	12.0%	12.0%	12.0%	12.0%
4	Adjusted category demand	\$1,002,400	\$4,824,176	\$812,232	\$2,436,696
<b>Base Income Flow Assumptions</b>					
5	Base share of wallet	62.0%	62.0%	62.0%	62.0%
6	Base income flow to us	\$621,488	\$2,990,989	\$503,584	\$1,510,751
7	Noncommunication costs (product, fixed, G&A, etc.)	33.0%	26.0%	28.0%	38.0%
8	Gross contribution margin (%)	67.0%	74.0%	72.0%	62.0%
9	Gross contribution margin (\$)	\$416,397	\$2,213,332	\$362,580	\$936,666
<b>Scenario A: No Communication Investment</b>					
10	Change in share of wallet	-2.5%	-2.5%	-2.5%	-2.5%
11	Resulting share of wallet	60.5%	60.5%	60.5%	60.5%
12	Resulting customer income flow to us	\$605,951	\$2,916,214	\$490,994	\$1,472,982
13	Less noncommunication costs (product, fixed, G&A, etc.)	-\$199,964	-\$758,216	-\$137,478	-\$559,733
14	Less brand communication cost	\$0	\$0	\$0	\$0
15	Net contribution	\$405,987	\$2,157,999	\$353,516	\$913,249

(continued)

Exhibit 10.1 Credit Card ROCI Analysis (continued)

Target Segments:		Gold	Standard	Credit Limit	Special Interest
<b>Scenario B: Brand Communication Investment</b>					
16	Total brand communication investment	\$6,200	\$59,250	\$5,500	\$95,000
17	Change in share of wallet	20.0%	20.0%	20.0%	20.0%
18	Resulting share of wallet	74.4%	74.4%	74.4%	74.4%
19	Resulting customer income flow to us	\$745,786	\$3,589,187	\$604,300	\$1,812,901
20	Less noncommunication cost (product, fixed, G&A, etc.)	—\$246,109	—\$933,189	—\$169,204	—\$688,903
21	Less brand communication cost	—\$6,200	—\$59,250	—\$5,500	—\$95,000
22	Net contribution	\$493,476	\$2,596,748	\$429,596	\$1,028,999
<b>ROCI Calculation</b>					
23	Net contribution scenario A	\$405,987	\$2,157,999	\$353,516	\$913,249
24	Net contribution scenario B	\$493,476	\$2,596,748	\$429,596	\$1,028,999
25	Incremental gain/loss vs. "No investment" scenario	\$87,489	\$438,750	\$76,081	\$115,750
26	Incremental ROCI	1.41%	74%	1.383%	1.22%
27	Cost-to-income ratio	34%	28%	29%	43%

Category requirement assumptions—Gives a total estimate within the category of spending in dollars

Base income flow assumptions—Makes a basic assumption of share of wallet, our share of income, and the share required to cover all fixed and variable costs to run the business other than communication and profit

No communication investment—Establishes a baseline of profitability if we make no further communication investment

Communication investment—Estimates how the value of each customer group would change if we conducted a communication program directed toward them

ROCI calculation—Determines the total incremental gain/loss to the bank as a result of the communication program

manager's estimate of returns on the program. He had projected a 20 percent change in share of wallet for each customer group that would receive the marcom programs. From that, he deducted the brand communication costs as shown on line 21. That gave him the net contribution on his marcom investments as shown on line 22.

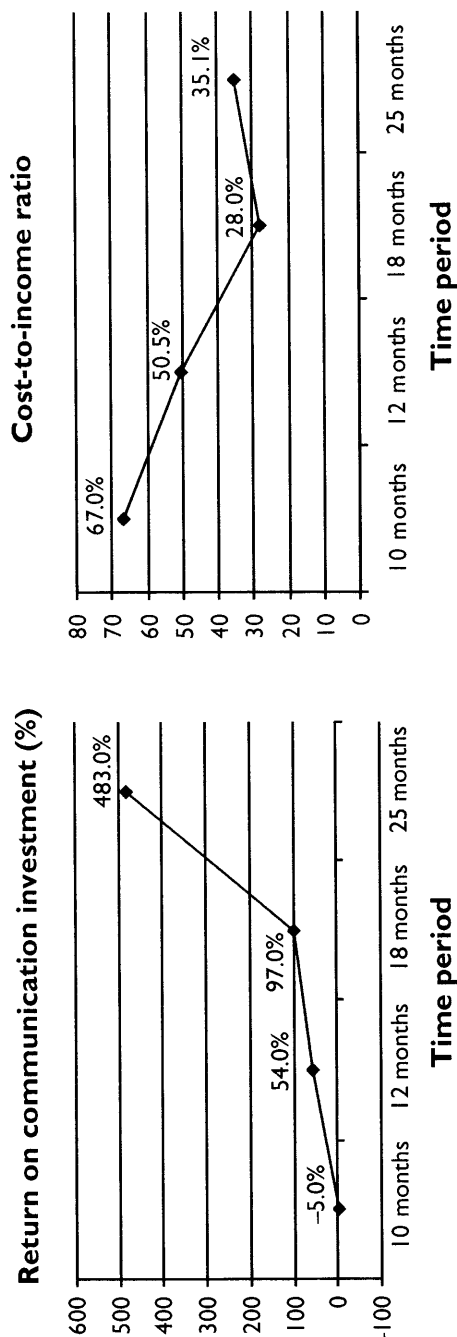
In the final section (ROCI calculation), the manager and his team determined that an incremental ROCI of over 700 percent would be achieved among all groups except the special-interest cardholders (line 26) if the marcom programs were implemented as planned.

Additionally, the manager calculated the cost-to-income ratio for each of the groups targeted in the program. As shown at the bottom of the chart, the estimate for three of the groups was below the 40 percent guideline senior management had set for the entire firm. The guideline would not be met if the program were implemented among the special-interest cardholders. Based on this analysis, the manager and his team determined that, although the special-interest group could be promoted to profitably, there would be greater returns to the bank by concentrating on the first three segments.

To provide additional support for the proposal he was to make to management, the manager developed more detailed long-term and short-term ROCI estimates for each of the three programs he planned to initiate. (These are presented with limited comments since much of the supporting data is confidential.)

- **Acquisition of new customer activities.** Exhibit 10.2 shows the estimated returns on planned acquisition activities. As shown, the ROCI through the customer acquisition program was estimated to be 54 percent after 12 months and was estimated to rise to 483 percent after 25 months. The cost-to-income ratio starts fairly high in the first few months after the customer acquisition, but after 25 months is well within the management directive of 40 percent or less.
- **Increasing selected customer's credit limits.** The plan to increase the credit limits for selected customers shows the best return of any of the planned programs. As illustrated in Exhibit 10.3, the return after 10 months is over 1,000 percent and is still near that rate at the end of the first year. Also important is that the estimated

Exhibit 10.2 ROCI on New Customer Acquisition Efforts



return on the credit limit increase rises to over 2,200 percent after two years. Best of all, the cost-to-income ratio for the program starts below the 40 percent management ceiling and declines to 22.1 percent at the end of nearly two years.

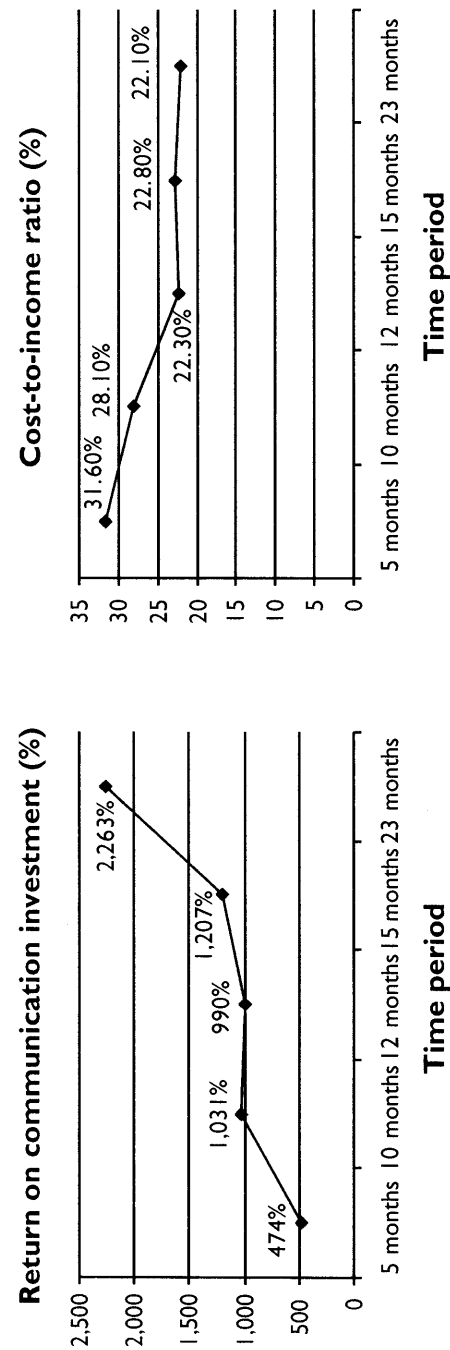
- **Developing customer usage offers.** The third planned marcom program was to develop premiums and merchandising offers for customers who met certain credit card spending or usage requirements. Unfortunately, the manager had little internal data to support his recommendations. Since the decline in communication investment in the credit card division had occurred, data collection programs had been eliminated and thus there were only spotty case histories. As a result, the manager relied on his previous experience with this type of program at other banks, along with some published data from other banks and lending institutions in the country. That provided enough information for him to make some informed estimates.

Based on their review, the team members determined there was considerable evidence from external sources that credit card customers did respond to various merchandising offers. Therefore, that approach appeared to be a good investment for the National American Bank customer base. The marcom manager therefore aggregated the bank's individual credit card customer base into five groups based on the number of merchandising offers they had received during the previous years. These ranged from zero to five offers.

The average outstanding balance was then calculated for each group. (The outstanding balance is the average amount due on the credit card at the end of each month. This is the basis on which interest is charged to customer accounts.) The team then computed the probability that the average balance for any group would exceed that of any other group and by what amount.

Based on two merchandise offers the bank had made to credit card holders in the recent past—a preferred travel service for vacations and excursions and a dining club offer—the team estimated that for every \$4.50 the bank invested in usage offers, it would receive \$11.50 back in interchange and net interest income. Thus, the team members figured that the proposed merchandise offers and usage programs they planned

Exhibit 10.3 ROCI on Increased Credit Limits



to develop would provide an average 255 percent return on each customer investment made in the first 12 months. Based on these estimates and calculations, the new marcom manager was ready to develop the specifics of the proposed program to rejuvenate the credit card division.

### Appropriate Levels of Investment in the Marcom Program

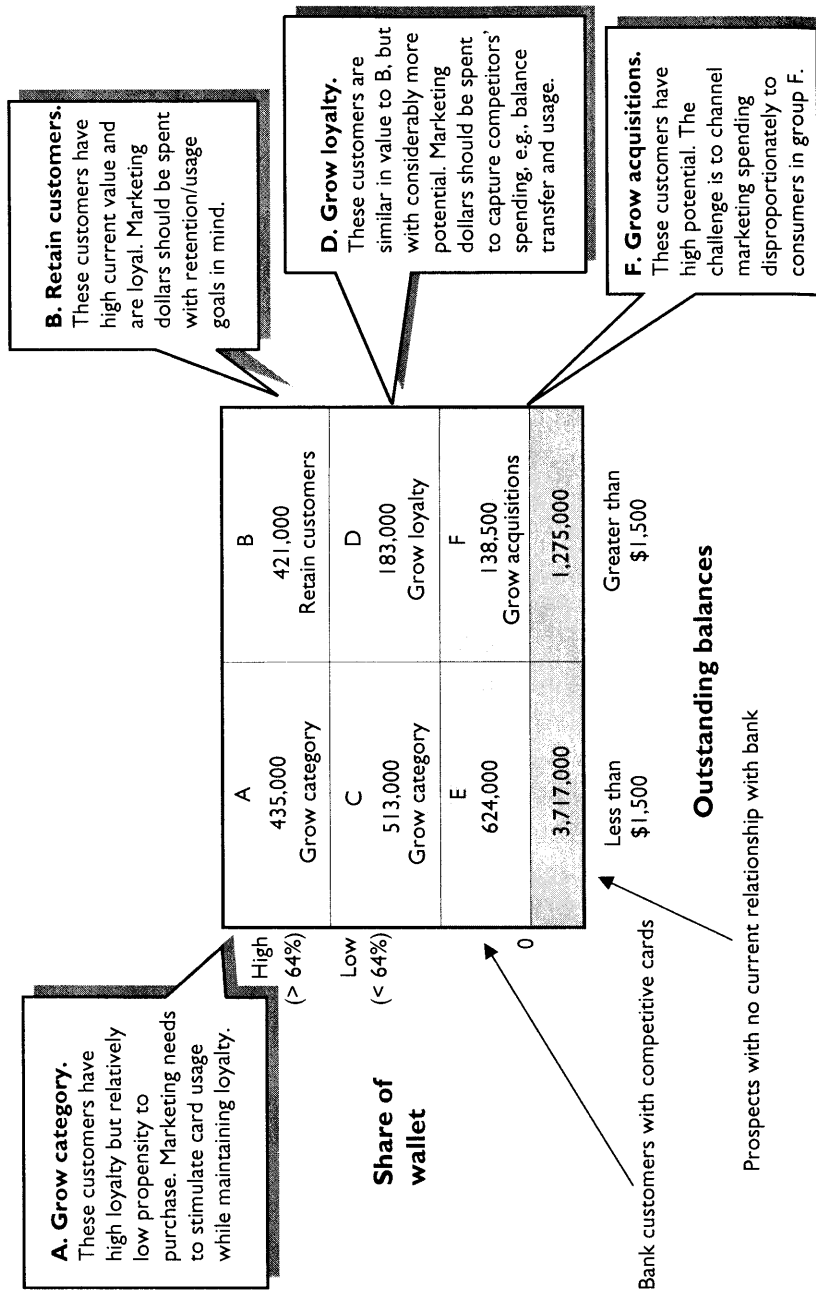
To this point, the estimates and investments requested by the marcom manager had been based on the tactical programs and activities that had been proposed. The next step was to relate these to the customers and prospects against whom the programs would be directed. The manager started by reviewing share of wallet versus outstanding balances. He used this to develop strategies that would reflect the various opportunities that he felt might exist. His approach is illustrated in the six-box matrix shown in Exhibit 10.4.

As shown, the manager allocated all National American Bank credit card customers into one of the six boxes in the matrix. On the x-axis, he plotted outstanding balances. He separated all potential customers into two groups: those with outstanding balances of less than \$1,500 and those with balances greater than \$1,500.

On the y-axis, he plotted the customer share of wallet that was currently being filled by their National American Bank card. These were then divided into three groups: (a) customers with a credit card from another institution, or those with whom National American Bank presently had no share of wallet; (b) customers who held a National American Bank credit card but allocated less than 64 percent of their credit card requirements to it; and (c) those who held a National American Bank credit card and filled more than 64 percent of their requirements with it.

The development of this matrix allowed the manager to create six customer promotional groups. In each box, the number of customers in that category is given and a general marketing and communication strategy is identified. For example, the strategy for groups A and C would be to try and grow credit card usage since they have high loyalty to National American. The strategy for Group B would be to focus on

Exhibit 10.4 Six-Box Matrix



retention. These customers have high current value and are already loyal, so the bank does not want to lose them. Thus, the goal in this segment would be to retain these customers and keep them happy. Group D appears to have substantial unrealized potential. Therefore the communication efforts would aim to (a) capture or recapture customers' spending on competitive credit cards and shift it to National American, (b) try to get their balance shifted to National American, and (c) generally get them to increase their usage of the National American card.

Groups E and F were felt to represent the greatest challenge. The E segment was split into two groups although both had an outstanding credit card balance of less than \$1,500. The top group—approximately 624,000 customers—had a relationship with the bank but also had a competitive credit card. The bottom group—3,717,000 members—had no affiliation with the bank and had no National American credit card. Given the low outstanding balances held among this group, it was felt that the returns would not warrant the investment that would be required to stimulate further penetration into this segment. Thus, no marcom effort was planned against this group.

The F segment was also broken into two groups. The bottom group—1,275,000 prospects—had no current relationship with the bank. The top segment—only about 138,500 customers—represented current bank customers who held and used a competitive credit card. All these prospects, however, appeared to have high potential. Therefore, the manager's plan was to invest marketing resources disproportionately in group F.

Based on the customer valuation scheme shown here, the manager then developed an overall budget and business case for each of the planned marcom investments, which is summarized in Table 10.6. The plan was organized around the key customer segments isolated in Exhibit 10.4. On the left-hand side of the chart the expected ROCI for each effort is listed, with subtotals for each customer segment. The planned activities concentrate on the three efforts the manager isolated as having the greatest ROCI potential—new customer acquisition, credit limit extensions, and offers to stimulate usage of the card. Addi-

tionally, the planned program included some efforts especially designed to increase retention among certain key customer groups.

As shown in the exhibit, credit card customers in segment A would receive three marcom programs—a club offer, an in-store retail offer to be organized with a major department store chain, and a travel insurance offer. The marcom investment in these customers would be approximately \$40,000. These programs were expected to generate

**Table 10.6 Communication Budget by Customer Group**

ROCI	Segment	Effort	Proposed Budget (in \$000s)	Estimated Revenue Growth (in \$000s)
140%	A	Club offer	\$ 10	\$ 14
250%	A	In-store retail promotion	\$ 15	\$ 38
450%	A	Travel insurance	\$ 15	\$ 68
298%		Total group A	\$ 40	\$ 119
225%	B	Credit limit offer	\$ 100	\$ 225
375%	B	Best customer retention package	\$ 50	\$ 188
475%	B	Standard retention	\$ 75	\$ 356
850%	B	Travel insurance	\$ 75	\$ 638
469%		Total group B	\$ 300	\$ 1,406
140%	D	Preferred customer points	\$ 75	\$ 105
225%	D	Club offer	\$ 10	\$ 23
250%	D	Credit limit offer	\$ 50	\$ 125
375%	D	Best customer retention package	\$ 20	\$ 75
625%	D	Recapture effort	\$ 75	\$ 469
800%	D	Travel insurance	\$ 30	\$ 240
399%		Total group D	\$ 260	\$ 1,036
150%	F	Outside list promotion	\$ 750	\$ 1,125
150%	F	Web-based promotion	\$ 10	\$ 15
300%	F	New account promotion	\$ 350	\$ 1,050
500%	F	In-branch acquisition efforts	\$ 500	\$ 2,500
306%		Total group F	\$1,870	\$ 5,726
332%		Totals	\$4,680	\$15,539

Note: ROCI = return on customer investment.

approximately \$119,000 in incremental revenue. That would provide an ROCI of approximately 298 percent for the following year. This was actually the lowest projected ROCI, as groups B, D, and F were estimated to return 469 percent, 399 percent, and 306 percent, respectively. The overall program was budgeted to cost \$4.68 million, but was expected to increase revenues by over \$15.5 million, with an overall ROCI of 332 percent.

Obviously, there are two final questions: Did senior management approve the new marcom recommendations? And if so, did the program work in the marketplace? The answer is yes to both questions. Senior managers approved the requested budget and the proposed investments against credit card users. Their comment was that this was the first time any marcom manager had presented a real business plan, that is, recommended investments in marcom programs and expected returns. Thus, the manager got off on the right foot with his new employer by using the ROCI approach to support his recommendations and estimates.

In the marketplace, the response to the program was even greater than the credit card communication team had expected. Thus, the proof of the approach was demonstrated in financial returns, the key element in any ROCI program.

## Moving On

The ROCI framework illustrated in this chapter works. It does, however, take some time and effort, as well as a new way of thinking—as the National American Bank example shows. The beauty of it, however, is that once the system is in place, the manager can refine and enhance the program quite readily and always be able to prove that the company's investment in customers—via marcom tools—pays off. As we show in the next chapter, those payoffs are not just immediate and short term, but long term as well.