Satisfy your CFO by completing a thorough risk assessment of your business plan.

Marketing Due Diligence and Risk Assessment - will a business plan deliver the shareholder value it promises?

By Malcolm McDonald, Emeritus Professor at Cranfield School of Management, Professor at Warwick, Henley, Aston, Bradford Business Schools and the Sino-British College USST Shanghai, and Chairman of Malcolm McDonald Consulting

The Marketers dilemma

Marketers are torn between two groups whose wants are contradictory:

a. Customers who want the most value and utility for the least cost.

b. Shareholders who want the biggest return on the lowest investment and risk.

Neither group is loyal if they can do better elsewhere. The skill shareholders pay us for is the ability to use their funds better than other marketers. These skills manifest themselves when customers see our offers as meeting their shifting needs better than competing offers. The trick is to do this continuously.

Marketing Due Diligence has important implications for four groups:

1. Investors and their proxies
   - ✓ A way to see through the smoke and mirrors of "investor relations"
2. For Boards and equivalents
   - ✓ A way to prove your value creation to financiers
3. For strategy makers
   - ✓ A way to prove your value to the board
4. For strategy implementers
   - ✓ A way to prove your value to your boss!

What CEOs and the Board need is a way of measuring the risk associated with a marketing strategy and hence its likely shareholder value creation.

This is the aim of Marketing Due Diligence.

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Marketing Due Diligence and Risk Assessment (continued)

1. Where is the Risk in the Business Plan?

Where Does Risk Come From?

Marketing due diligence begins by looking for the risk associated with a strategy. Evaluation of thousands of business plans suggests that the many different ways that companies fail to keep their promises can be grouped into three categories:

a. The market wasn't as big as thought.

b. The company didn't get the market share it hoped for.

c. The company didn't get the profit it hoped for.

Of course, a business can fail by any of these routes or a combination of them. The risk inherent in a plan is the aggregate of these three categories, which we have called, respectively, market risk, share risk and profit risk. The challenge is to accurately assess these risks and their implications for shareholder value creation.

Research has found that most estimates of business risk were unreliable because they grouped lots of different sources of risk under one heading. Since each source of risk is influenced by many different factors, this high-level approach to assessing business risk is too simplistic and inherently inaccurate. A better approach is to sub-divide business risk into as many sources as practically possible, estimate those separately and them recombine them.

This has two advantages.

Firstly, each risk factor is "cleaner", in that its causes can be assessed more accurately.

Secondly, minor errors in each of the estimations cancel each other out. The result is a much better estimate of overall risk.

How Risky is a Business?

Marketing Due Diligence makes an initial improvement over high level risk estimates by assessing market, share and profit risk separately. However, even those three categories are not sufficiently detailed. We need to understand the components of each, which have to be teased out by careful comparison of successful and unsuccessful strategies.

Our research indicated that each of the three risk sources could be sub-divided further into five risk factors, making fifteen in all. These are summarised in the next table.

Armed with this understanding of the components and sub-components of business risk, we are now half-way to a genuine assessment of our value creation potential. The next step is to accurately assess our own business against each of the fifteen criteria and use them to evaluate the probability that our plan will deliver its promises.

This gradation of risk level is not straightforward. It is too simplistic to reduce risk assessment to a tick-box exercise. However, a comparison of a strategy against a large sample of other company's strategies does provide a relative scale. By comparing, for instance, the evidence of a market size, or the homogeneity of target markets, or the intended sources of profit against this scale, a valid, objective, assessment of the risk associated with a business plan can be made.

Table: Factors contributing to risk

Overall Risk Associated with the Business Plan		
Market Risk	**Share Risk**	**Profit Risk**
Product category risk, which is lower if the product category is well established and higher for a new product category.	Target market risk, which is lower if the target market is defined in terms of homogenous segments and higher if it is not.	Profit pool risk, which is lower if the targeted profit pool is high and growing and higher if it is static or shrinking.
Segment existence risk, which is lower if the target segment is well established and higher if it is a new segment.	Proposition risk, which is lower if the proposition delivered to each segment is segment specific and higher if all segments are offered the same thing.	Competitor impact risk, which is lower if the profit impact on competitors is small and distributed and higher if it threatens a competitor's survival.
Sales volumes risk, which is lower if the sales volumes are well supported by evidence and higher if they are guessed.	SWOT risk, which is lower if the strengths and weaknesses of the organisation are correctly assessed and leveraged by the strategy and higher if the strategy ignores the firm's strengths and weaknesses.	Internal gross margin risk, which is lower if the internal gross margin assumptions are conservative relative to current products and higher if they are optimistic.
Forecast risk, which is lower if the forecast growth is in line with historical trends and higher if it exceeds them significantly.	Uniqueness risk, which is lower if the target segments and propositions are different from that of the major competitors and higher if the strategy goes "head on".	Profit sources risk, which is lower if the source profit is growth in the existing profit pool and higher if the profit is planned to come from the market leader.
Pricing risk, which is lower if the pricing assumptions are conservative relative to current pricing levels and higher if they are optimistic.	Future risk, which is lower if the strategy allows for any trends in the market and higher if it fails to address them.	Other costs risk, which is lower if assumptions regarding other costs, including marketing support, are higher than existing costs and higher if they are lower than current costs.

<u>What Use is this Knowledge?</u>

Marketing due diligence involves the careful assessment of a business plan and the supporting information behind it. In doing so, it discounts subjective opinions and side-steps the spin of investor relations. At the end of the process the output is a number, a tangible measure of the risk associated with a chosen strategy. This number is then used in the tried and trusted calculations that are used to work out shareholder value. Now, in place of a subjective guess, we have a research based and objective answer to the all-important question: *Does this plan create shareholder value?*

Too often, the answer is no.

When risk is allowed for, many business plans create less value than putting the same money in a bank account or index-linked investment. Such plans, of course, actually destroy shareholder value because their return is less than the opportunity cost of the investment. An accurate assessment of value creation would make a huge difference to the valuation of the company. The result of carrying out marketing due diligence is, therefore, of great interest and value to both sides of the capital market.

For the investment community, Marketing Due Diligence allows a much more informed and substantiated investment decision. Portfolio management is made more rational and more transparent. Marketing due diligence provides a standard by which to judge potential investments and a means to see through the vagaries of business plans.

For those seeking to satisfy investors, the value of Marketing Due Diligence lies in two areas. Firstly, it allows a rigorous assessment of the business plan in terms of its potential to create shareholder value. A positive assessment then becomes a substantive piece of evidence in negotiations with investors and other sources of finance. If, on the other hand, a strategy is shown to have weaknesses, the process not only pinpoints them but also indicates what corrective action is needed.

For both sides, the growth potential of a company is made more explicit, easier to measure and harder to disguise.

2. An overview of the Marketing Due Diligence Process

The Marketing Due Diligence process is shown in three steps below:

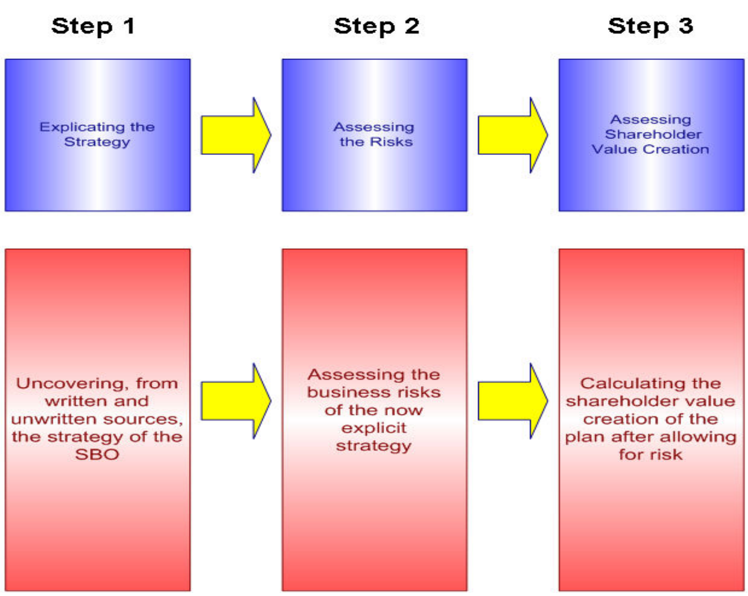


Figure 1: Factors contributing to risk

Step 1 – Explicating the strategy

It is important to surface all the strategic issues and for the management team to identify the gaps, inconsistencies and errors in the business plan. Uncovering the unwritten, often explicate, elements of the strategy requires that a structured set of questions are answered. In simple terms, these are:

a. What is the business of the SBU?

b. Where will its growth come from?

c. How will it achieve that growth?

Step 2 – Assessing the risks

Having explicated the strategy and made it clear what the SBU is about, where it is looking for growth and how it intends to realize it, we have to assess objectively the business risk inherent in the strategy.

This step is achieved by working through the fifteen risk factors and assessing the probability of them occurring.

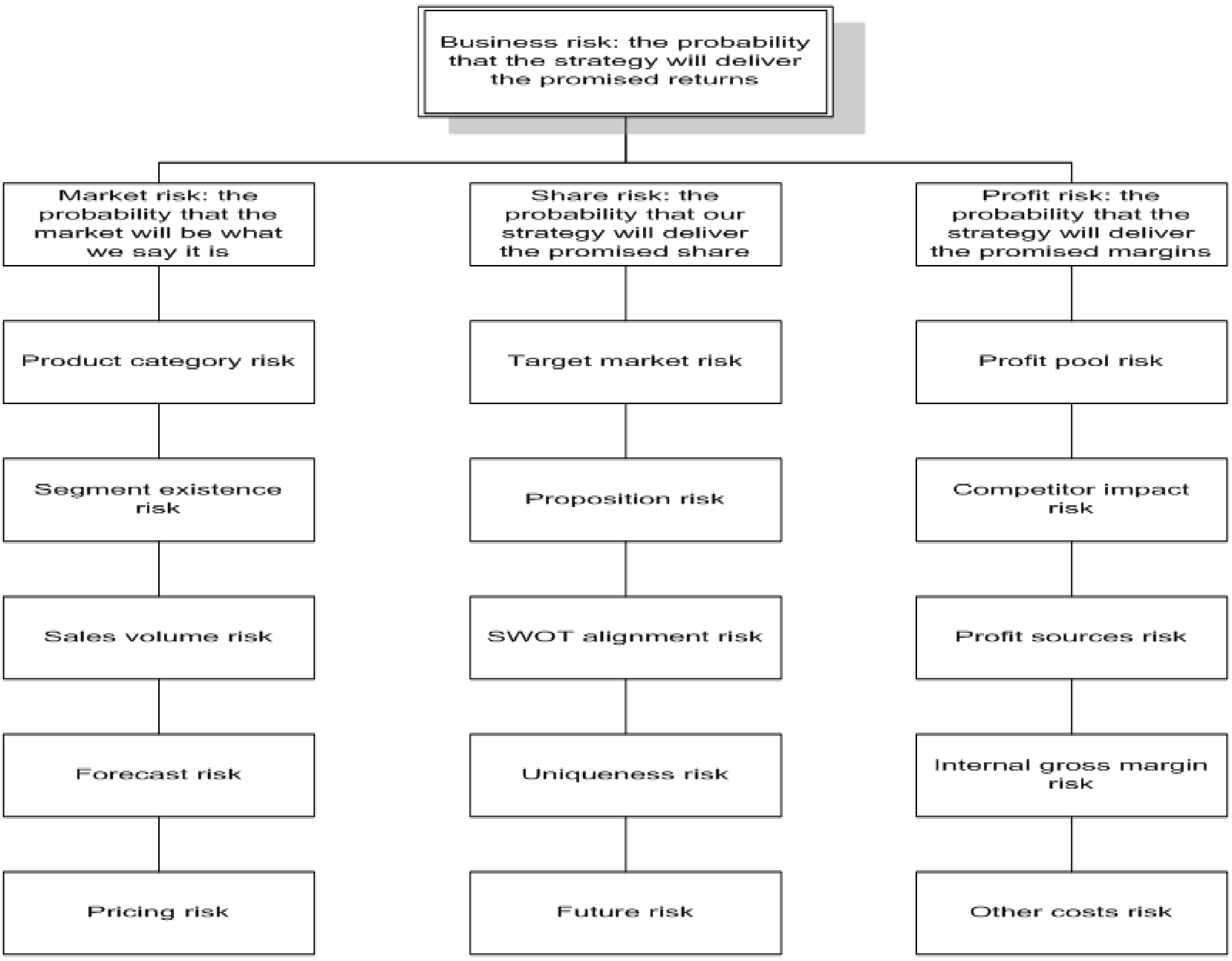


Figure 2: Business risk

Step 3 – Assessing Shareholder Value Creation

The final step is to assess whether or not the SBU's strategy delivers shareholder value and to compare the revised or confirmed profit figure with that which would represent the cost of capital

So the final step is a relatively simple calculation and this results in one of two of two conclusions:

a. The profit generated by the SBU's business plan, when assessed for and adjusted for all the three areas of business risk, exceeds the cost of capital. The strategy is likely to create shareholder value;

b. The profit generated by the SBU's business plan, when assessed for and adjusted for all three areas of business risk, falls short of the cost of capital. The strategy is unlikely to create shareholder value.

To conclude, all too often, marketing strategies are prepared without paying sufficient attention to the associated risks. Marketing Due Diligence is a tried and tested process for doing this.

Reference

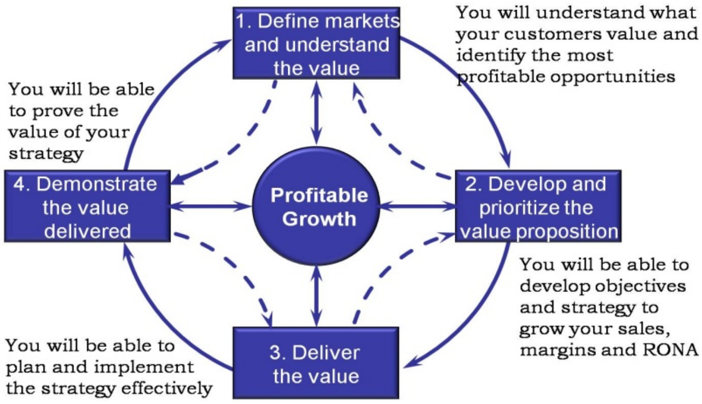
McDonald M, Smith B and Ward K, Marketing and Finance, Wiley 2013

About Malcolm McDonald Consulting

Malcolm McDonald Consulting Ltd. is a strategic sales and marketing consulting business.

With our end-to-end interactions, from Board level to internal project team, we help companies create value through getting the fundamentals right in strategic sales and marketing, all within budget and the agreed deadline.

Professor McDonald and his team of consultants work with the Boards and internal teams of executives from a number of the world's leading multi-nationals on all continents.



Malcolm McDonald is Emeritus Professor of Marketing at Cranfield University, and Visiting Professor at Henley, Warwick, Aston and Bradford Business Schools. He authored over 40 books on marketing and key account management.

Coming from a background in business which included a number of years as Marketing Director of Canada Dry, Malcolm has successfully maintained a close link between academic rigour and commercial application. He has consulted to major companies from the UK, Europe, USA, Far East, South-East Asia, and Africa, in the areas of strategic marketing and marketing planning, market segmentation, key account management, international marketing and marketing accountability.

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