Creating strong brands for the information age

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In a previous article in this journal (Hanssens 2017), I described how the digital information age is changing the practice of marketing across its four major dimensions, i.e. decisions around product, price, distribution and promotion. In what follows I will describe the parallel changes that are happening with respect to marketing's major objectives, i.e. to create strong brands and strong customer relationships.

Creating and maintaining a strong brand has always been a fundamental objective of marketing practice. However, the way in which a strong brand generates value to consumers, along with financial benefits to the brand owner, has changed since the advent of the digital economy. To appreciate this, let's take a look at the evolution of *enterprise value* in this century, i.e. the amount a buyer is willing to pay for a company in a merger or acquisition scenario. Binder and Hanssens (2015) examined the relative importance of brand and customer relationship value for over 5000 such mergers and acquisitions between 2003 and 2013. The data are generated by a branch of the accounting discipline called *purchase price allocation (PPA).* After the transaction price in an M&A is agreed upon, PPA experts determine the fraction of that price that can be attributed to brand strength and to customer relationship strength. The results obtained by Binder and Hanssens are shown in Figure 1. They demonstrate the inverse movement of these two metrics over time: between 2003 and 2013, brand importance has declined from about 19 percent of purchase price (enterprise value) to around 9 percent, whereas customer relationship value increased from about 8 percent to 17 percent over the same time period.

Why is this trend occurring ? Consumers have always appreciated quality and value for their money, but in the digital age, they find it much easier to collect information on product and service quality prior to purchasing. A quick search on one's smartphone or laptop readily reveals competitive product reviews, price comparisons and user testimonials. Thus today's consumer is much better informed about product and service offerings and, as such, attaches more importance to experiential factors rather than the brand name alone. This does not imply that brands have lost their relevance, but rather that consumer expectations on strong brands have risen: they must deliver not only brand recognition but also evidence of high customer satisfaction.

Delivering high customer satisfaction typically has *costs* associated with it, so the logical question is whether or not its net benefit is still positive for the firm. Think of necessary investments in consumer hotlines, information infrastructure, front-line employee training, willingness to accept returns without questions asked, etc.., all of which weigh on the company's bottom line. The best way to answer the net-benefit question is to study *investor behavior*, at least for publicly listed firms. Indeed it is often assumed that investors (and, therefore, the stock market overall) react only to changes in firm's expected future earnings, which sometimes leads to a perception that "only quarterly earnings reports matter." However, careful empirical research into the determinants of stock prices and stock returns have shown otherwise. For example, Fornell et al. (2016) conducted an interesting longitudinal study of the relationship between customer satisfaction levels (as measured periodically by the ACSI, the American Customer Satisfaction Index) and firm value (as measured by stock prices). They document that, over a 15-year period (2000-2014), an investment portfolio based on firms' customer satisfaction scores, would have yielded a cumulative return of 518 percent. By comparison, investing in the S&P500 would have yielded a cumulative return of 31 percent over the same time period. Note that this long sample period includes the major financial crisis that started in 2007.

The key takeaway is that *customer satisfaction movements, even though they are not financial metrics, contain information about the future of a business that is not picked up by earnings and other financial data collected at the same time.* The marketing profession offers, of course, an intuitive explanation for this phenomenon: satisfied customers are more likely to become or remain loyal to the brand, to increase their consumption of the brand and/or to recommend the brand to others, all of which impact future revenue generation in ways that current cash flows may not (yet) reflect. Said differently, customer satisfaction is a *leading indicator* of firms' financial performance, i.e. firms can "do well by doing good."

In technical terms, customer satisfaction strengthens both the *brand equity* and the *customer equity* of the brand. These two firm asset metrics, in turn, have a positive impact on firm value, holding constant other determinants of firm value. This relationship was quantified in an empirical generalizations study by Edeling and Fischer (2016). On the basis of nearly 500 estimates from 83 different scientific studies, the authors derive that the average brand strength→firm value elasticity is **0.33**, while the customer relationship→firm value elasticity is **0.72**. As an illustration, if a firm's actions result in a 10 percent increase in its brand strength, that leads to a 3.3 percent increase in firm value (on average). So, brand matters. If the same firm also manages to increase the strength of its customer relations, that leads to a 7.2 percent increase (on average) in firm value. So, customer relationships matter even more. The immediate implication for senior management is that marketing actions that strengthen the brand and/or the firm's customer relationships should be viewed as *investments*, not merely expenses as they often are.

These principles are beautifully illustrated in an article on the hotel sector by Hollenbeck (2018). Business performance in that sector is typically measured by REVPAR, i.e. revenue per available room. What are the drivers of REVPAR and how have these changed over time? The author analyzed a large database of hotels in the state of Texas. As might be expected, hotels that are part of a major brand chain such as Hilton or Marriott have higher REVPAR than others, i.e. they attract business by virtue of their umbrella brand. That effect still holds, however in recent years another REVPAR driver has become more important: the quality rating of the particular hotel. For example, if a Hilton in San Antonio generates a higher customer experience rating than a comparable Hilton in Arlington, the former enjoys better financial performance, all else equal. Once again we witness that brands matter, but in the age of the informed customer, brands need to strive for high customer satisfaction in order to succeed.

Our overall conclusion is that the information age creates a business environment in which factual, objective information has become more influential than subjective, persuasive information such as that contained in advertising. Again, we see this trend reflected in real data. Consider the meta-analysis on the impact of product reviews on sales, conducted by Floyd et al. (2013). They summarized the findings of hundreds of published scientific studies and estimated that the average product review-sentiment elasticity is 0.69 and the average product review-quantity elasticity is 0.3. So, all else equal, if the review sentiment of a brand increases by 10 percent, then that brand's sales tend to increase by almost 7 percent. Furthermore, even the mere presence of reviews, regardless of sentiment, has a positive impact on sales, i.e. ten percent more reviews results in an average sales increase of 3 percent. We can compare these numbers to the equivalent statistic around advertising spending. The average sales elasticity of advertising spending is around 0.11 (Sethuraman et al. 2011). So, increasing the ad budget by 10 percent increases sales by only 1.1 % on average, much lower than the corresponding effects of review quantity and quality. The comparison becomes even sharper when considering that getting good product reviews does not cost anything extra, unlike increasing ad spend.

The net result of these findings is good news for the future of the marketing profession, so long as marketing is geared toward strengthening brand perceptions and customer relationships. There are, of course, managerial challenges that companies will face. In my view, the principal challenge is to change prevailing attitudes that marketing is an expense that tends to lag financial performance (i.e. if last year's financials are good, then marketing budgets increase for next year, and vice versa), as opposed to leading it. I hope that the numerical summaries above, all of which are based on carefully crafted and peer-reviewed scientific studies, will help in changing these perceptions.

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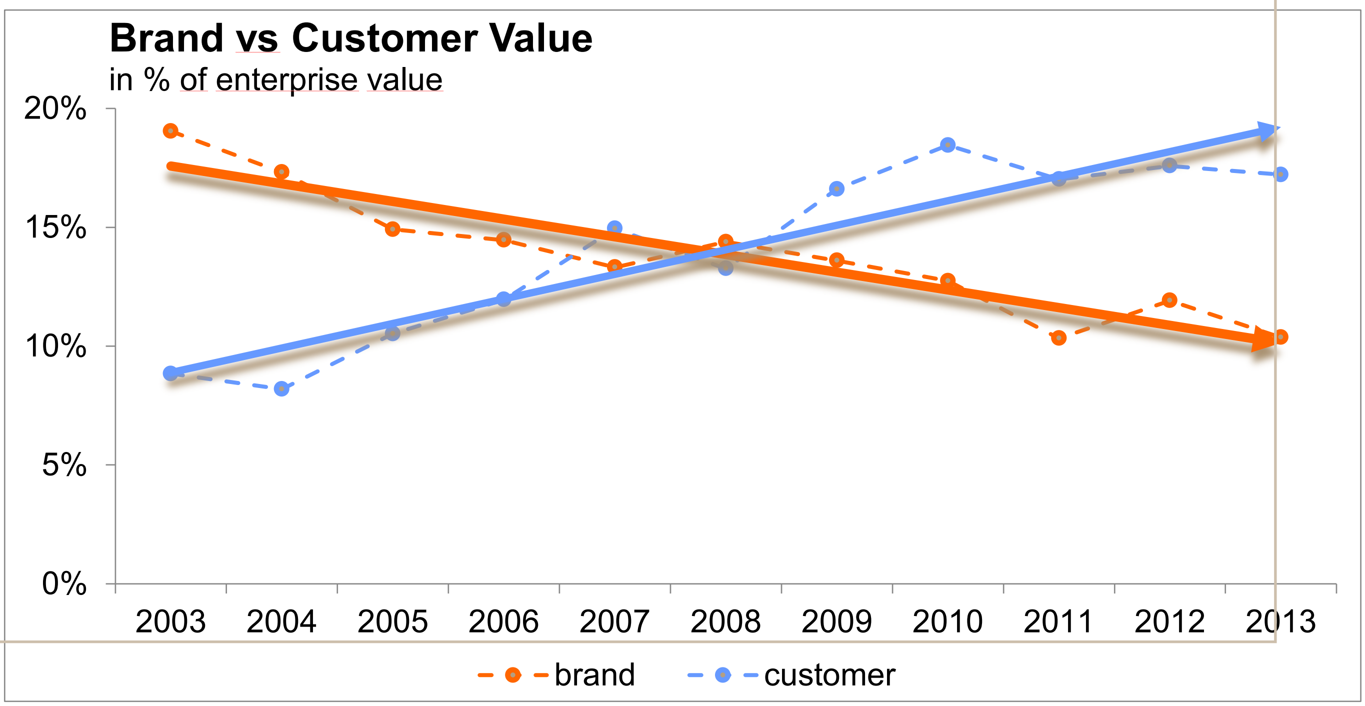
Figure 1

Brand and Customer Value in Mergers and Acquisitions



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