CUSTOMER MANUFACTURING GROUP

HOW MUCH SHOULD I SPEND ON MARKETING?

TO GAIN COMPETITIVE ADVANTAGE

In this increasingly competitive market, how much should a company spend on marketing? It depends what you mean by marketing. (Now there's a typical consultant's answer!) Since most people who ask that question are referring to the promotion side of marketing, let's focus there. We'll rephrase the question to "How much money should I spend on marketing promotion activities?" This paper provides useful insight to help you create your own real world answer.

If you don't work to make your effective marketing messages more efficient, you can still spend too much money on effective marketing and suffer a competitive disadvantage.

What can you afford? Well 'afford' is an interesting word.

The promotion side of marketing includes activities designed to create awareness and/or move customers further along the buying cycle until such time as the sales force or channel (e-commerce, distributor, or retail store) takes over. It also includes activities that are designed to retain existing customers.

These activities can include advertising, public relations, trade shows, brochures and other collateral materials, premiums and give-aways, social media, and some portion of the cost of your Web site.

Creating New Customers

If we start by looking only at spending to create new customers, one answer to this question of how much should you spend is: you can afford to spend up to the net present value of the life-time profit contribution of all new customers created by the promotion. (Huh?)

OK, let's explain that another way. A new customer has some value to your business. What is that value? Realistically it's the sum of the profits that the customer generates over the time they do business with you, discounted[1] to its present value today.

To determine how much money that is, you have to be able to answer some key questions. First, how much does the "typical" new customer buy from you? What is the marginal profit contribution[2] of that added customer? Clearly the contribution to profit from a new customer is greater since all other fixed costs are already being incurred regardless of this additional purchase.

[1] Discounting is a financial term and technique used to convert the future value of a sum of money to its present value. Since money today can be "put to work" to earn a return in at least the form of interest, then money today is "worth more" than the same amount of money tomorrow. That difference in value can be calculated using a discount formula based on interest rate assumptions.

[2] Marginal profit contribution is the added profit generated by an additional sale. Once you have covered your fixed costs of operations from the necessary level of sales, the profit available from an additional sale is usually greater than the profits available from those first sales since overhead and other costs don't increase just because of that one more sale. This added profit is called the marginal profit contribution. It is usually the sales price minus the actual cost of goods sold without further burdens of overhead or sales and administrative expenses.

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Second, how long are they likely to be your customer. One year? Five years? Longer? Again, the longer they are your customers, the more valuable they are to you. There is probably a promotion cost associated with keeping existing customers, and with getting existing customers to buy more. If you want to create a complete model, you'll need to factor in those costs and the related benefits as well. So you need to think in terms of what is the on-going cost of retaining the customer. How does that affect their continued profit contribution?

If you can accomplish the first and second item above, you know the actual profit stream available from the "typical" new customer. Then what is the present value of that profit stream? Well, once you calculate the profit stream . . . ah, that's the hard part . . . then the present value calculation is math and can be performed by a computer or calculator.

So, reviewing our first answer, which was to determine "how much can I spend on promotional marketing to create new customers," requires that you understand the profit value of a new customer.

Value From Existing Customers

You can make a similar calculation for promotion designed to increase the buying frequency of — or amount from — existing customers, and the retention value of existing customers. Any or all of those calculations probably requires a better understanding of your customer than most companies have. Does that excuse you from not knowing? . . . We don't think so.

What Can You Afford?

But what if you do know that profit value, should you really afford to spend up to that total amount on marketing? Well 'afford' is an interesting word. As the father of one of us taught him when he was very young, "can't afford" doesn't necessarily imply a lack of money, but rather a lack of desire to spend it on a particular item. Just because you can afford to spend that much money on marketing promotion, doesn't mean you should.

Efficient and Effective

If you have found a marketing message that can "create valuable new customers on purpose" (borrowing from sales guru, Ted Steinberg's *Ultimate Selling Machine*), you have found an effective marketing message. Now you must work to make this message more efficient.

To be sure we're communicating; effectiveness is doing the right thing, efficiency is doing things right. First do the right thing, then do things right.

The wrong message, no matter how efficiently delivered, does no good at its best and damage at its worst.

If you don't work to make your effective marketing messages more efficient, you can still spend too much money on effective marketing and suffer a competitive disadvantage. In other words, just because you have a good message, if you spend too much money delivering that message because you don't know how to do it efficiently, then your competitors, who may also have their own effective message, gain a competitive advantage if they can be more efficient at message delivery than you are.

Now being effective is obviously better than spending too much money on an ineffective marketing message (as United Airlines did with its ineffective, Rising message), and it's still a problem. The wrong message, no matter how efficiently delivered, does no good at its best and damage at its worst. So, again, you must first develop an effective message then work on efficiently delivering that message.

Long-Term vs. Short-Term

There's also the complex issue of "short-term" versus "long term." In today's instant gratification financial markets, it may not be practical for you to try to afford to spend much of tomorrow's profit stream getting customers today. This time-frame focus issue is at the heart of many practical decisions . . . no matter how misguided . . . that we must live with in the real world.

Assuming you have an effective message, how can you tell if you're being efficient. You need the ability to measure efficiency. So what are some efficiency measures?

Efficiency boils down to increased profitability. A calculation of the profitability of a promotion can be made using the following formula[3]:

(# of leads generated)

x (% who buy from someone)

x ($ profit from the average sale)

x (# of sales over the customer's lifetime)

x (% of leads you will follow-up)

x (your usual closing rate)

- (incremental cost of sales follow-up and promotion required to sustain the customers' business)

This formula can be made more complex by adjusting for the net present value of the profit stream. It can be simplified by removing the lifetime calcula-

[3] This does not include issues of marketing-mix modeling, which are beyond the scope of this paper

tion. Only the fully complex formula can give you absolute assurance that a promotional program is profitable, but once a program is profitable, the simplified formula is usually sufficient to track increased efficiencies.

Increasing marketing promotion to generate more leads that are not followed up, is a waste of money no matter what.

Promotion Is Not A Stand-Alone Tactic

Several sales management opportunities to increase sales and lower net promotion costs per sale are available in this process of using marketing to develop more business, but those are beyond the scope of this article.

Regardless of the above discussion, marketing promotion is an activity within a larger framework. If you consider the marketing-to-sales process as essentially a manufacturing process to produce valuable customers on purpose, then, like any manufacturing process, to increase output (profitable sales) you must focus first on the manufacturing bottlenecks. For example, increasing marketing promotion to generate more leads that are not followed up, is a waste of money no matter what.

Therefore to answer the question, "How much money should I spend on marketing?" requires an understanding of the profit contribution of that spending, and where the results of that spending are going to affect the process of manufacturing customers.

A well understood manufacturing principle states that to increase production you must first identify the primary constraint in the process. Increasing throughput anywhere but at the most constrained point will not necessarily increase output.

In the manufacturing of customers, this principle is equally valid. Increasing promotional marketing spending will not increase sales if the activities that result are not a constraint in your current Customer Manufacturing system.

Final Thoughts

The answer to the question, "How much money should I spend on marketing promotion?" is therefore:

(1) None, if the results of these promotional activities are not the constraint in your Customer Manufacturing process; or

(2) No more than the profit contribution available from the business generated, and then you must work diligently to use that money efficiently or suffer potential competitive disadvantage.

More Information About Customer Manufacturing Group

If you would like more information about how to apply a process to improve your marketing/sales function, simply contact us and we'd be happy to help you get started. From sweeping marketing/sales management process strategies to specific branding or product launch services, Customer Manufacturing Group can help.

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We have offices in major cities in the United States, and our experts travel extensively throughout the world. If you'd like to schedule a meeting when we're in your area, just let us know.