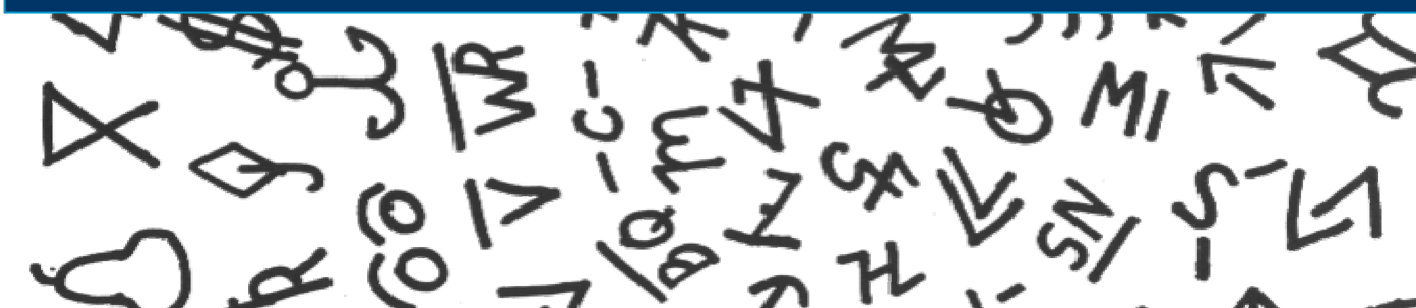
The Executive's Guide to Branding

Corporate Performance and Brands:
The Risk and Return Effects of Branding



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The Executive's Guide to Branding

Everything must have a value proposition. This is especially true for evaluating the use of business practices, such as branding. What exactly is the value proposition of branding? What are the benefits of branding? How does branding affect risk and return in corporate performance? Let's explore this topic with the top 10 burning questions about branding.

This manuscript is based on a seminal article titled "Market-based Assets and Shareholder Value: A Framework for Analysis" published in the *Journal of Marketing* by Rajendra Srivastava (Executive Director, Zyman Institute of Brand Science), Tassaduq Shervani and Liam Fahey in January 1998. This article received the Maynard and Paul Root/MSI Awards for contributions to both the theory and practice of marketing—the only manuscript to receive both awards simultaneously. Interested readers are referred to the original article for greater details.

The top 10 questions executives want to know:

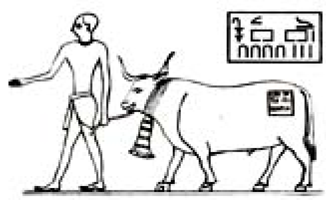
10. What are brands anyway?
9. Why bother with branding?
8. Do strong brands lower customer churn?
7. Do strong brands manage customer selection?
6. Do strong brands engender greater loyalty when the purchase decision is perceived as high risk?
5. Do strong brands lead to lower information costs in the purchase process?

4. Do strong brands result in “imperfect” markets and provide their owners monopolistic powers?
3. Do strong brands increase the liquidity of a firm’s stock?
2. Do strong brands reduce risk associated with future cash flows?
1. Do strong brands result in growth and acceleration of cash flows?

10. What are brands anyway?

What is the origin of branding? The word brand is derived from Old English meaning “burning stick” (and ultimately from the Indo-European word meaning “to be hot”). Livestock branding was used by the ancient Egyptians as early as 2700 BC as a theft deterrent, as stolen animals could then be readily identifiable.

Egyptians ‘Branded’



Around the 10th century merchant marks, formed from simple linear designs, increased in usage. These marks were known as the ‘signa mecatorium’ in Roman-Dutch law. Merchant marks were used to prove ownership of goods that were missing due to shipwrecks, pirates, or other mishaps. They were also useful for the tracking of goods by people who were illiterate.

The first recorded brands in the Western Hemisphere were the Three Latin Crosses of Hernán Cortéz, who landed in Mexico in 1519. Additionally, brands are easily recognized patterns that are used for identification purposes. Livestock being driven across an open range necessitate an easy method of identification to prevent ownership disputes when the animals were commingled with other stock. Brands were subsequently used in the American west as a promise on part of a seller to “make good” on defective livestock sold to buyers.

Craftsmen in Europe and Japan formed guilds that affixed “production marks” to their products. These marks were used as a method to insure quality, as defective goods could be traced back to its origin. These marks allowed the guild warden to fine or expel a craftsman from the guild for faulty craftsmanship. Whereas this guild mark was a personal mark the industrial revolution fostered the growth of commerce and the brand mark became a more generalized legal instrument.

As trade grew consumers were less likely to deal directly with the artesian that made the crafts. Special laws were enacted that were related to forgery, counterfeiting and fraud laws. Courts in France, England, Germany and the US prevented the “passing off” by a third party as being genuine goods of the trademark holder.

Today, brands are still protected by trademark. In the US, according to the 1946 trademark law, commonly called the Lanham Act, the fundamental purpose of the trademark is identified as a measure “to protect the public from deceit, foster fair competition, and…to secure to the business community the advantage of reputation and good will.” In essence brand is used by an organization to identify and distinguish goods sold or manufactured from one individual from that from another.

9. Why bother with branding?

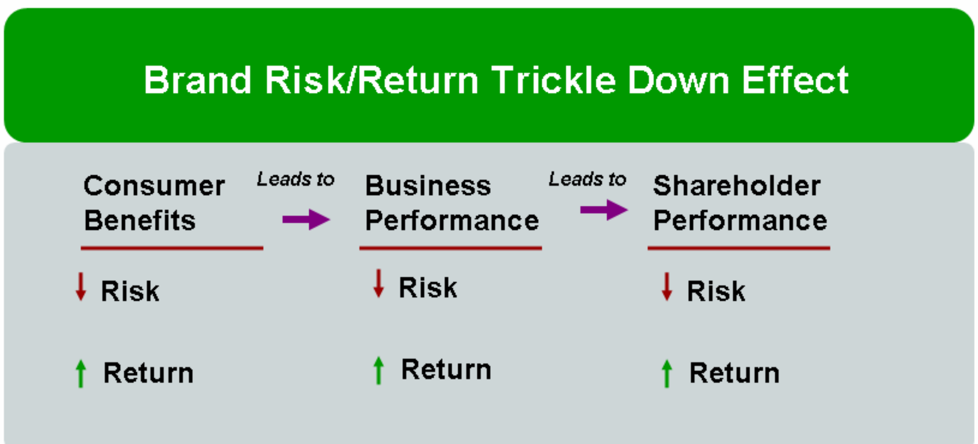
From the consumer viewpoint, the brand is a signal of quality. They trust manufacturers to stand behind their brands. Their positive experience with brands helps establish both a preference for the brand as well as an emotional attachment. In essence, brands reduce risk. For consumers, there are many potential risks involved in a purchase. These include:

- Functional risk: will the product perform to expectations?
- Physical risk: does the product pose a threat to the health?
- Financial risk: is the product worth the price?
- Social risk: will the product result in embarrassment?
- Time risk: will there be associated opportunity costs with a product failure?

A strong brand authenticates the source of the goods, and also promises the value of goods sold. By providing a promise of value the consumer is assured in the purchase decision process that the risk-to-reward ratio of purchasing a strong brand is higher than that of purchasing a similar unbranded good. Why does this matter?

While the brand promise reduces risk for buyers, it creates an uneven playing field among competitors vying for their business. Owners of well-regarded brands enjoy an advantage relative to competition. That is, consumer preference and loyalty for brands enable pricing flexibility and, on the margin, monopolistic powers.

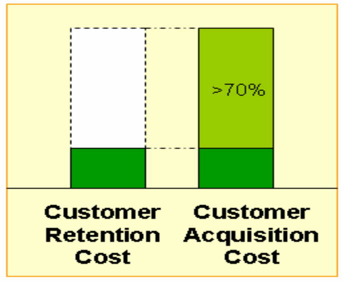
There is a trickle down effect for the business. Strong brands lead to lower risks (e.g., lower vulnerability and volatility of revenues and cash flow) and higher returns (i.e., higher levels of profits due to the ability of dominant brands to extract price premiums, command larger market shares, or negotiate lower distribution costs with retailers) for shareholders. Brands, much like investments in manufacturing infrastructure, are therefore business assets. Yet they have greater advantages than standard manufacturing equipment since brands are legally protected and therefore shielded by an isolation mechanism that prevents diffusion throughout the industry. In that respect brands are relatively valuable, rare, imperfectly imitable, and non-substitutable. By that definition brands enable their owners to enjoy sustainable competitive advantages—and therefore superior financial performance.



8. Do strong brands lower customer churn?

The customer churn rate (or its inverse the customer retention rate) is an important metric used in marketing. It is estimated that the cost of acquiring customers is at least five times greater than that of customer retention. It doesn't take a rocket scientist to figure out that selling to a stable customer base (low churn) is more profitable than selling to a customer base with a high-turnover rate (high churn). Does strong branding help reduce customer churn? Customer loyalty is a function of switching costs, differentiation, and brand preference. Branding takes the core benefits of a product and extends them into a source of greater value through the accretion of intangible benefits (like lower perceived risk and added emotional benefits). By adding these additional benefits the brand earns a higher degree of differentiation. And relevantly differentiated brands lead to lower customer churn.

"It takes several times the cost and effort to gain a new customer as it does to keep an existing customer"



Effect = Lower Costs To Serve

7. Do strong brands manage customer selection?

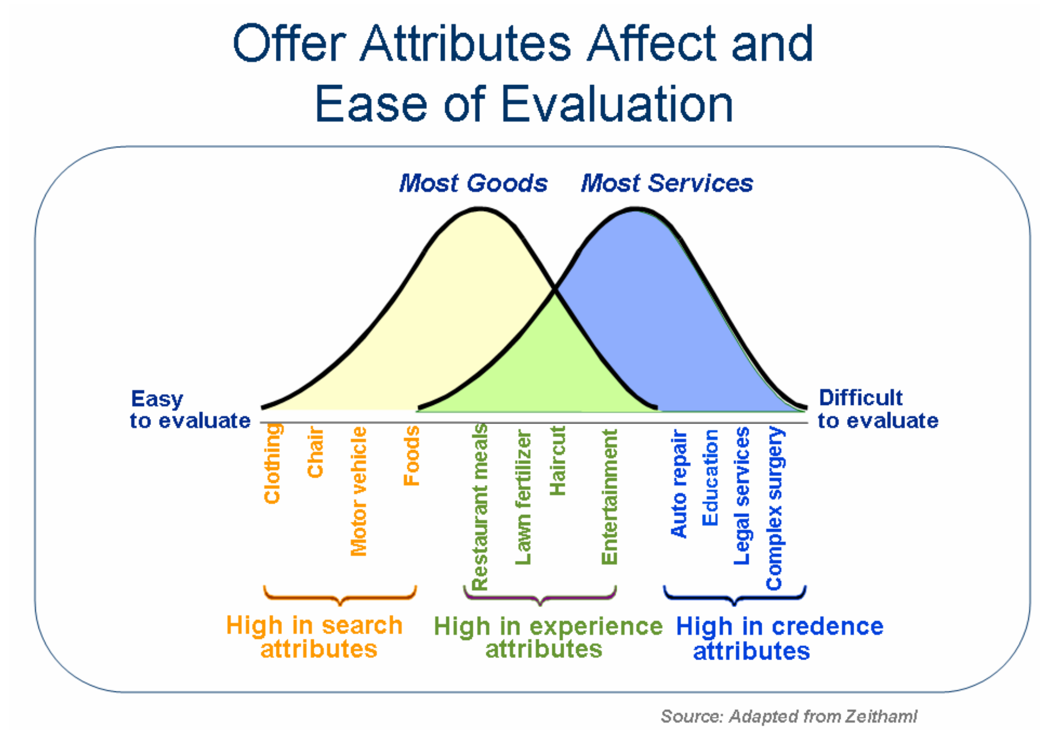
Selecting the right customers leads to lower performance risk for a business. The best customers to target include those that exhibit the greatest returns for the business, either in a lower cost to serve, greater revenue capture, or both. Strong brands have both a retention component and an attractant component. A brand well positioned on the price/performance matrix helps potential customers self-select based on desired segmentation. A strong brand can convey specific user imagery that speaks to the target market. And once the customer self-selects they become familiar with the brand. Their positive experience with the brand reinforces their trust in complimentary offers from the brand's owners.

Thus, by acquiring the 'right' customers one can decrease the volatility of earnings because the customer base will exhibit lower churn, and the customer self-select process lowers the costs of customer acquisition for complimentary products. Strong family brands help introduce a customer to related products within and across product lines, which in the long run supports a lower cost of doing business. Customers introduced to a family brand are strong candidates for cross-selling and solutions selling. Since customer acquisition cost is lowered by using brand extensions to launch related products, the profit of the business across product lines is enhanced. For example, a customer already familiar with Microsoft Word is more likely to try Microsoft Excel when the need for a spreadsheet arises.

6. Do strong brands engender greater loyalty when the purchase decision is perceived as high risk?

Some purchases are more risky than others. The risk associated with purchasing a candy bar is lower than that of purchasing a mutual fund. There simply is more to lose in the latter. The higher the risk the more important the brand becomes in the purchase criterion. For "search" goods, one can evaluate the qualities of the product before the purchase. Many consumer packaged goods fall into this category. The risk associated with the purchase is quite low since the quality can be examined before the purchase, or tried at a low cost. As the goods become more intangible it becomes harder to discern the quality of the offer and that makes the brand more prominent. For experiential or credence goods, product quality is often difficult to discern even after consumption, and you might need extensive experience before arriving at such an assessment. After all, you do not drive a car for a week and become convinced of its overall reliability!

In such cases, the consumer's *brand perceptions* of intangibles such as implied reliability, quality and image of product innovation and expertise play a critical role in determining customer loyalty. Experience with a brand lowers perceived risk and enhances loyalty. Lack of experience with a product leads to higher risk perceptions reducing the likelihood of that option being tried by consumers. Thus, in "experience" goods consumer often rely on the sellers' expertise. In this case the sellers brand associations lead the consumer's choice.



Interestingly, while brand management practices are common in the consumer packaged goods industries, they can be expected to be even more valuable in product markets where experience and reliance on brand associations are even more critical in reducing risk and influencing choice. Thus firms offering high-risk "experiential" goods and firms in services industries should find branding very attractive. Service offerings (like finance, real estate, insurance, travel) and technology-based offers are great candidates for benefiting from superior brand management practices. For technology-based industries the rate of innovation is high and subsequently this makes the rate of uncertainty in the purchase decision high (such as risk of functional performance). And, that in essence makes branding fundamentally vital.

5. Do strong brands lead to lower information costs in the purchase process?

Lower information costs in the purchase process results in lower perceived risk. One approach to measuring brand equity is to decompose it into two components: (1) a liking/emotional component, and (2) an information cost component. Because costs associated with making a choice among competing options include search and evaluation costs, strong brands that are more familiar and that have positive associations (e.g., quality) that are important in the purchase situation effectively lower information costs for prospects. The lower information costs reduce perceived risk, and result in enhanced purchase likelihood and, therefore, enhanced market share.

4. Do strong brands result in “imperfect” markets and provide their owners monopolistic powers?

The two extreme forms of market structure are monopoly and perfect competition. Perfect competition is characterized by many sellers, each selling similar products. In perfect competition there are few barriers to market entry, and prices reach equilibrium. Producers in perfect markets are price takers. Prices are set by the market and the seller has no leverage. Price elasticity is high and that means a small increase in price will be met with a large decrease in demand. In a perfectly competitive market the low cost producer wins.

Market Structure Attributes

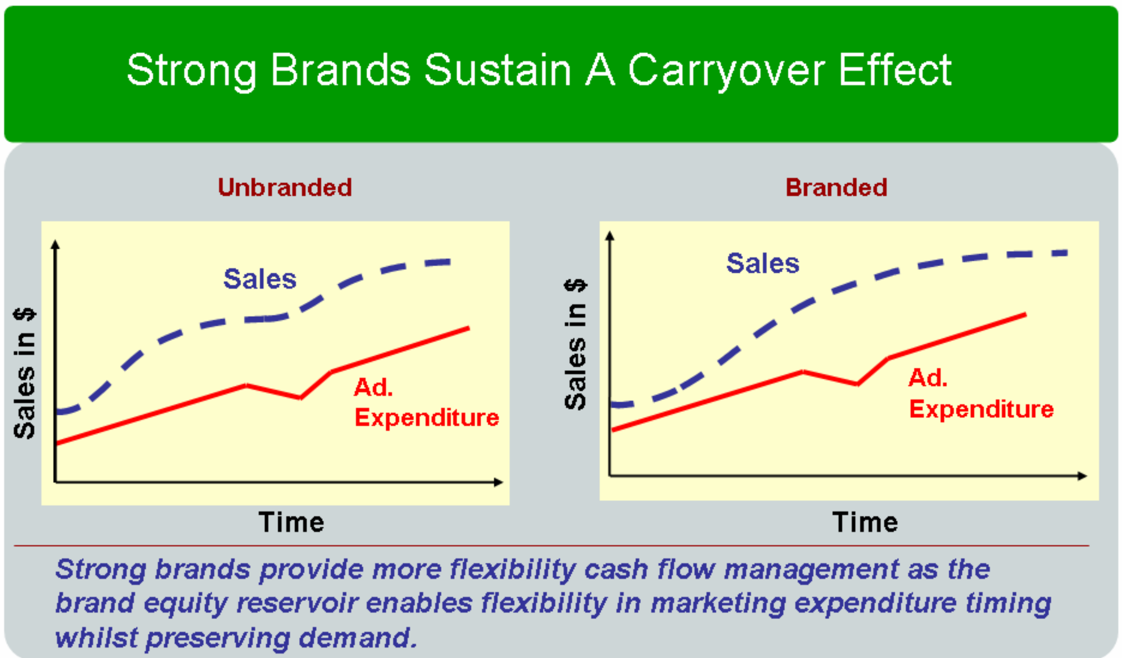
	Perfect Competition	Monopolistic Competition	Oligopoly	Monopoly
Example	Wheat	Movies	Crude oil	Tap water
Number of Competitors	Many	Many	Few	One
Barriers to Entry	Low			High
Competitive Intensity	Fierce	Depends on differentiation	Depends on firm aggression	Light
Products	Identical	Differentiated		
Pricing	Price takers			Price makers
Long Run Profit	Zero			May be high

Unfortunately, as most economics textbooks will demonstrate, the optimal price under perfect competition is characterized by the condition "marginal revenue = marginal cost". Thus, under perfect competition profit margins are at a level that is less than desirable.

The central role of marketing strategy is to make markets imperfect. Here brands play an important role. Brands are differentiators. Brand loyalty (or customer retention) is evidence that customer preferences are not determined by the lowest price. Brands, by influencing consumer preferences, make markets imperfect. They reduce price competition, and doing so lower price elasticity. And, as provided by the protection of trademark law, a brand is a legal mini-monopoly. Brand management is therefore a legally protected method of making markets imperfect.

3. Do strong brands increase the liquidity of a firm's stock?

Liquidity risk is a concern for investors. Liquidity refers to the ability to get into and out of an investment. A liquid stock is one that is easy to buy and sell. The liquidity is closely linked with the bid-ask spread and the volume sold. Bids are the buyers' acceptable price, and asks are the sellers' acceptable price. The bid and ask must meet for a transaction to occur. Consistently large bid-ask spreads imply low liquidity, while small bid-ask spreads imply high liquidity. Part of the bid-ask equation is about supply, while the other half is about demand. Firms with strong brands are associated with higher awareness levels. That high awareness not only helps support sales of the firm's goods, but also creates awareness of the firm as an investment, thus increasing the demand for the stock. Broader ownership of stock enhances liquidity and thus enables a firm with strong brands to convert assets into cash.

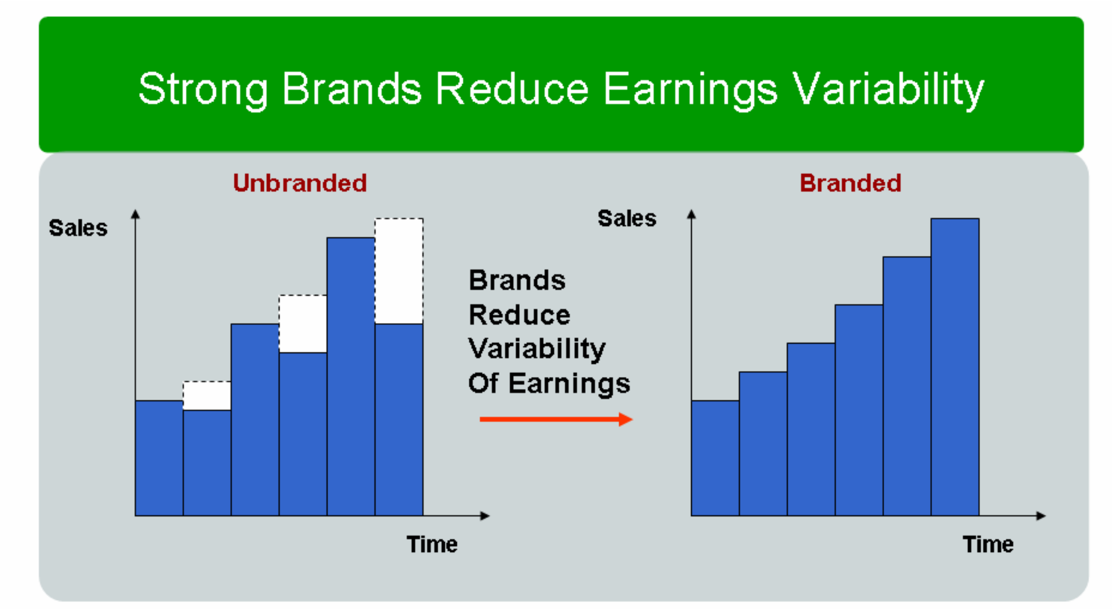


Additionally, brand equity is like a latent asset or a “cash reserve” for a firm. When facing a near term cash shortage a firm can pare back on its marketing communication expenses. The decay rate of sales and market share for strong brands during the periods that their marketing communications support is reduced (or even eliminated) can be quite slow. This allows the firm to increase its short-term cash flow, but not indefinitely. Brand equity will decay over time without reinvestment, but the short term sustain rate provides flexibility that helps smooth variances in cash flows.

For some brands the reservoir of brand equity remains for years after the brand looses marketing support, or even after the brand is taken off the market. Black & Decker’s DeWALT brand was one such brand that was rejuvenated after its withdrawal from the market. Often unused brand names can be sold as they provide access to valuable customers. The venerable German brand “Singer” (of sewing machines fame) was sold for several million dollars as it was recognized globally and had a worldwide distribution network that could be leveraged to sell household products.

2. Do strong brands reduce risk associated with future cash flows?

In general, investments expected returns are estimated on the fundamental risk of the investment vehicle. If one reduces a risk associated with future cash flows (as exhibited by the volatility and vulnerability of cash flows) of an investment the cost of capital is reduced. Volatility is defined as any occurrence that creates fluctuations in cash flow. Vulnerability is simply as any occurrence that negatively affects cash flow.



Strong brands reduce the volatility of revenues by relevantly differentiating the offers of the firm, thereby enhancing loyalty. Enhanced loyalty lowers the long-term investments associated with maintaining a customer base. Enhanced loyalty also reduces the volatility of cash-flow as the customer base is less likely to switch, keeping demand more stable.

While brand loyalty is expected to result in lower volatility and vulnerability of cash flows and therefore corporate risk, can this be also be expected to reduce the cost of capital?

The firm's total cost of capital is expressed as the WACC (Weighted Average Cost of Capital). The WACC combines the cost of debt with the cost of equity. Both components can be expected to decrease with a reduction in business risk associated with the firm's operations. Several factors suggest that companies with strong brands will face lower business risk. Persistence of lower business risk should lead to lower cost of capital. Contributing factors include:

- Demand variability - the more stable, the lower the business risk.
- Sales price variability - the less variable the lower the business risk.
- Input price variability - the less variable the lower the business risk.
- Market pricing power – elasticity of demand – higher brand loyalty implies lower price elasticity and therefore lower business risk

Therefore, lowering the risk in the firms' cash flows reduces the cost of capital to the firm.

Some recent findings suggest that trust and lower perceived risk associated with branded products may carry over into securities. That is, consumers who have a positive ownership experience with GE appliances just might think that the General Electric Company is a good (higher return, lower risk) bet. This suggests that, ceteris paribus (all other things being equal), for firms with better corporate reputations, investors should be willing to accept:

- Higher financial risk (Beta) for same return
- Lower return for same Beta

Either of these will reduce the cost of capital and therefore increase market capitalization. Using the Fortune Corporate Reputation Index as a measure of corporate brand equity, recent studies have shown that the cost of capital difference between the "best" and "worst" reputation firms can be as much as 0.5 percent, depending on the industry.

1. Do strong brands result in growth and acceleration of cash flows?

A dollar in the pocket today is better than one a year from now. Earlier cash flows are preferred because risk and time adjustments reduce the value of later cash flows. Strong brands lead to cash flow acceleration due to more rapid market penetration (enhanced diffusion of innovation). Strong brands improve market penetration because brands reduce the perceived risk for the customer. When the brand is a trusted source there will be a faster new product trial rate, higher referral rate, and faster time-to-adoption.

For example, in high tech (hardware and software) industries tier-one brands exhibit a faster rate of diffusion than tier-two or tier-three brands. Strong brands also provide additional risk reduction by promoting faster market penetration. Brands with strong brand and channel power have the luxury of being able to enter markets late without hindrance to subsequent market dominance. This allows the firm to reduce risk by letting other industry participants bear the risk of market experimentation. Firms like Microsoft, Proctor and Gamble, and Coca-Cola use market scanning 'radar' to seek new opportunities. Microsoft was not the first to launch a word processor, spreadsheet, presentation application, personal information manager, media player, graphic operating system and the like. Yet it currently dominates the market for these applications.

About the Authors

Rajendra Srivastava is the Executive Director of the Zyman Institute of Brand Science, and Professor of Marketing at Emory University's Goizueta Business School. Contact him at raj@zibs.com.

Greg Metz Thomas is Director of Programs at the Institute. His experience is firmly grounded in driving business results based on innovation in marketing management. Contact him at greg@zibs.com.

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Contacts:

For further information, please visit www.zibs.com or contact:

Zyman Institute of Brand Science
Goizueta Business School

Emory University
1300 Clifton Road
Atlanta, Georgia 30322 USA
Main: +1 (404) 727-9172

Web: www.zibs.com

Raj Srivastava
Executive Director
Professor of Marketing
Phone: +1 (404) 727-4858
Email: raj@zibs.com

Academic Facing Contacts

Sundar Bharadwaj
Director of Academic Programs
Associate Professor of Marketing
Phone: 404-727-2646
Email: sundar@zibs.com

Doug Bowman
Director of Academic Programs
Associate Professor of Marketing
Phone: 404-727-4613
Email: doug@zibs.com

Sriram Venkataraman
Director, Analytics
Assistant Professor of Marketing
Phone: +1 (404) 727-5275
sriram@zibs.com

Business Facing Contacts

Greg Thomas
Director of Programs
Phone : +1 (404) 727-4613
Email: greg@zibs.com

Craig Stacey
Director of Research
Phone: +1 (404) 727-4601
Email: craig@zibs.com

Our Mission

The Zyman Institute of Brand Science pursues the advancement of brand driven business performance.
Founded in 2004, the Zyman Institute of Brand Science is driven to become the definitive source for cutting-edge knowledge and thinking about brands. The Institute is an independently managed organization within the Goizueta Business School at Emory University.

Who we work with
The Institute works with top management teams to solve pressing issues in brand strategy.

What we do
The Institute's lauded scholars lead the development of new knowledge and insights for building, maintaining, enhancing, and revitalizing persistently profitable brands. We help companies link brand equity to business and shareholder value. We help management make decisions in managing brands to accelerate cash flows, enhance cash flows, and reduce vulnerability and volatility of cash flows, and optimize the long-term value of the organization.

How we do it
The Institute works collaboratively with its sponsors, other universities, research organizations, and its members to devise cross-disciplinary solutions for managing real world problems in brand strategy. We play an integrative role in problem solving, and capability building. We focus on viable actions