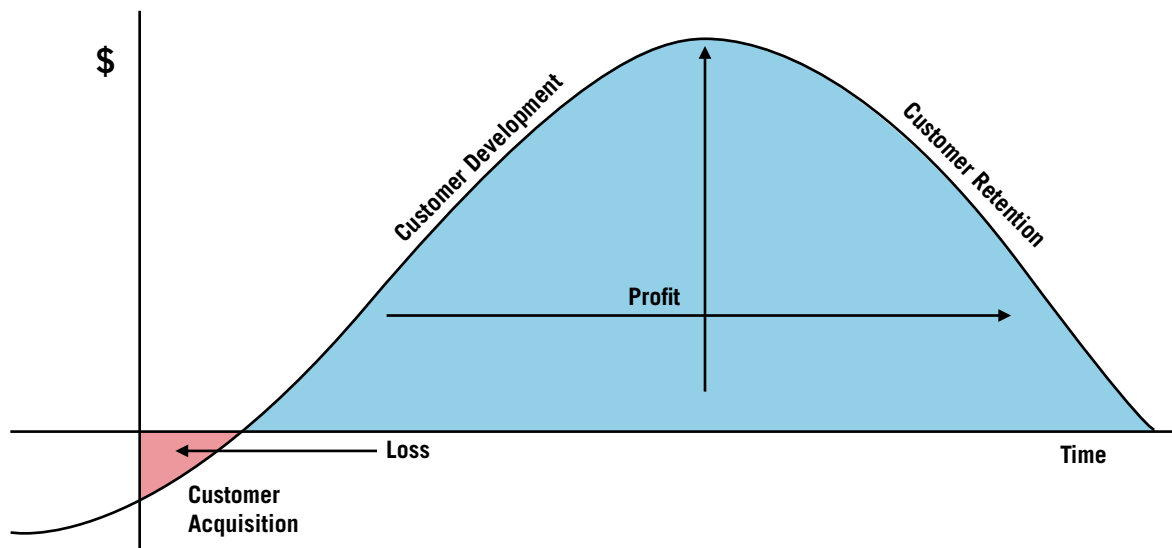


MARKETING METRICS

ROI DIAGNOSTIC

SEAN^M
DOYLE



The Eight Measures
of Marketing
Performance - A
Whitepaper
Diagnostic

Today's marketers are more results-driven than ever, attributed largely to the rise in digital marketing initiatives. More technology brings more outcomes and data. From click-through rates, website visitors, email opens, Facebook shares, to conversions – we're awash in information. Marketers are comfortable with an array of complex campaign metrics, but aren't always so confident with the big-picture measures of marketing performance. More marketers should know how to measure their department's impact on the bottom line.

This whitepaper diagnostic will teach you eight valuable calculations that will help prove accountability and pursue improvement. It will also identify opportunities across the usual organizational silos where you can collaborate with sales, finance, accounting and operations.

You will be able to show your bosses (and their bosses) you are capable of setting the right priorities and the right boundaries.

Layers of
Sophistication

Evaluating your department's performance requires looking beyond the usual measures of campaign and customer engagement. You'll have to spend some time delving into your company's financials. Moreover, you might have to work with your accountants and CFO to peg down the cost structure of your products, both fixed and variable costs. This might be a bit ambiguous for professional services firms. As you'll see in a bit, it is still a worthwhile exercise.

Over several years of helping clients gauge the performance of their marketing departments, we've identified three tiers of client sophistication. Sophistication has nothing to do with dedication or smarts. It's more about the accessibility of detailed product and financial data.

1. *Intermediate*- These organizations look at simple, broad snapshots of marketing performance and evaluate impact accordingly. The focus is on averages: average customer acquisition cost, average retention cost and so on. While average measurements can tell us a lot, they often give an incomplete picture of performance. In reality, outcomes can vary from customer to customer and offering to offering.

Because averages are measurements of central tendency, they aren't always good for making decisions amidst wide dispersion. B2B purchases are unique because of the variations in buying habits. Think of the long, complex sales cycles, the layers of decisions makers and the way offerings are often customized to make everyone happy. All of the variety makes a sole focus on averages a bit dangerous.

2. *Advanced*- The next great leap in sophistication occurs when marketing, finance (or accounting) and operations work together to implement some kind of "activity-based cost model" that assigns and tracks a specific cost of service to each unique customer. Accomplish this, and you will have access to more information than most of your peers when making big decisions about customer acquisition, development and retention. You will know the difference between a "good" customer and a "bad" customer and will have the departmental performance to prove it.

3. *All-Star*- The real legends are able to solicit enough information from customers to calculate "Share of Budget" – how much customers spend with you to fulfill all of the potential needs you can meet. Whether this is a useful calculation or not will hinge on your offerings and the industry you serve. Either way, it's a good way of evaluating the depth of your relationship from the customer's perspective and loyalty over time.

1. Average Customer Acquisition Cost (CAC)

The greatest leap is the distance between "Intermediate" and "Advanced." An "activity-based cost model" will drive better decisions with focus. For now, let's work through these seven measurements with the information you currently have at your disposal. You have to start somewhere, after all!

Average Customer Acquisition Cost is a simple measurement of sales and marketing efficiency.

To calculate this measurement:

$$\text{Average Customer Acquisition Cost} = \frac{\text{(Sales Costs + Marketing Costs) in a given period}}{\text{New Customers over the exact same period}}$$

As marketing measures go, this one is super simple yet extremely important.

However, like any statistic, resist the urge to read too much into any one number. You can't evaluate whether a particular average acquisition cost is "good" or "bad" on its own merit. Average acquisition cost only becomes a powerful measure of efficiency when compared, in plain terms, with other numbers.

One obvious way to evaluate acquisition cost is to compare it to the projected gross margin you can expect from a customer over their usual lifespan (we'll talk later about Customer Lifetime Value). It's also a great baseline for assessing growing (or shrinking) acquisition costs over time. The baseline will tell you whether your marketing and sales apparatus is becoming more or less efficient over time. Marketing should be about accountability and improvement!

2. Retention Rate

Retention rate isn't hard to calculate and, in of itself, it's a good thing to know. But, having a sense of retention will also help drive the more complex measures of performance.

$$\text{Retention Rate} = \frac{\text{Number of Customers Retained}}{\text{Number of Customers at Risk of Not Being Retained}}$$

If 10,000 subscriptions to *The New York Times* are set to expire in June and 8,000 of those customers renew, the retention rate is 80%. Any new subscribers added during that time frame are irrelevant. The retention rate of the cohort will be evaluated when their subscriptions are scheduled to expire.

The two most important things you should know about retention are:

1. *For a customer to count as "retained," they must be at risk of leaving to begin with. They can't be on the second year of a four-year agreement. Factoring newly acquired customers into the numerator will artificially inflate the retention rate.*
2. *There is a difference between measuring retention in the past and predicting it in the future. The retention rate of a particular cohort will improve over time unless something catastrophically bad happens, like a major product or service breakdown. For example, a seller of commercial alarm monitoring services that offers annual contracts sees a lower retention rate (e.g. 70%) in a customer cohort's first year than in their fourth (e.g. 92%).*

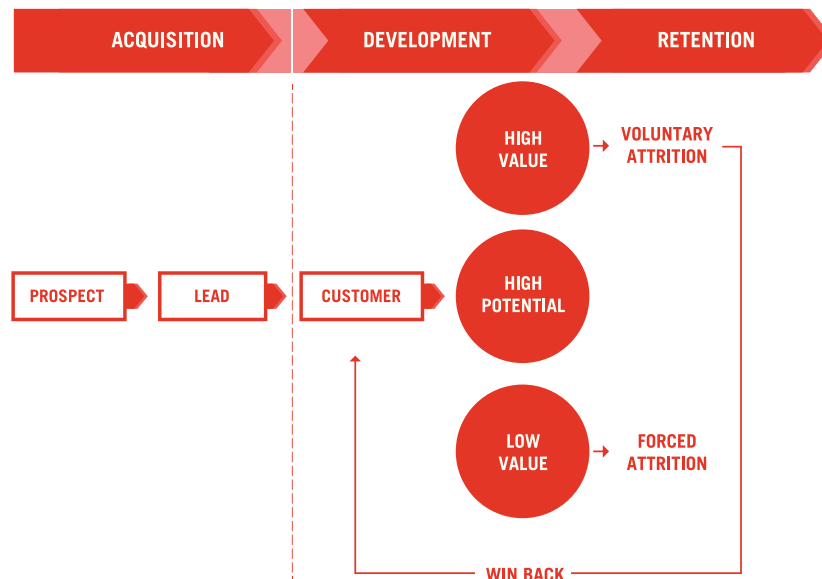
3.) Customer Lifetime Value (LTV)

As with a great many things in our culture, marketing has evolved from something transactional to something relational. Our work isn't done when the deal is closed!

Developing and retaining current customers is how marketers perfect all the effort that went into landing a new customer to begin with. Understanding how much to invest in retention and development, otherwise known as "engagement," is an absolute necessity.

LTV forecasts the revenue you can expect from a customer over the duration of the relationship. These calculations will help you shift your company's focus from short-term profits to long-term growth.

Customer Lifetime Value drives decision making across the customer lifecycle.



LTV helps you decide...

ACQUISITION

- How much should you spend on a gift or discount for a new customer? Should you offer free shipping?
- What's the right commission for your sales force?
- How much should you invest in onboarding new customers?

DEVELOPMENT

- How much should you spend on incentives for current customers to increase order sizes?
- Is free customer training affordable?

RETENTION

- How much should you invest in a customer loyalty program?
- Does it pay to reduce service response times?
- How much can you spend to retain an at-risk customer? Should you ever proactively fire a customer?

To calculate LTV, there are some things you will need to know (average annual customer profit margin, discount rate) and others that you will need to predict (average retention rate). The simplest LTV calculations occur when customers are locked into fixed contracts. Otherwise, you'll have to expend a little bit of effort to identify the values for each variable.

One quick caveat – we're going to assume profit margins and retention rates will be constant over time. You should recalculate LTV on an ongoing basis as margins, cost structures, retention rates, acquisition costs and other factors change.

It's time to fire up Excel. You've got some spreadsheeting to do.

Four Year LTV Forecast	Year 1	Year 2	Year 3	Year 4
Number of Customers	37	26	20	17
Annual Retention Rate	70%	78%	82%	
Annual Operating Profit Per Customer	\$1,000	\$1,030	\$1,061	\$1,093
Profit Growth Factor (Annual)	3.00%			
Annual Profit	\$37,000	\$26,677	\$21,432	\$18,102
Total Customer Acquisition Cost	\$27,000			
Net Profit (After CAC)	\$10,000	\$26,677	\$21,432	\$18,102
Discount Rate	2.50%			
Aggregate LTV:	\$71,448.94			

Step 1: In an Excel sheet, build out a few columns for each year of your forecast. In the rows, create fields for:

- Number of customers
- Annual Retention Rate (then add a projected annual retention rate for each year)
- Annual Operating Profit Per Customer
- Annual Profit Growth Factor
- Annual Profit
- Total Customer Acquisition Cost
- Profit after Customer Acquisition Cost
- Discount Rate

Present-day information should populate the column under Year 1. Years 2 through 4 are projections.

The line item detail can certainly vary, particularly when it comes to the components of profit. You might create more rows for extra flexibility in factoring different revenue and cost scenarios into your model. This calculation can be as simple or thorough as necessary.

- Step 2:** Calculate number of customers for each year by multiplying the number of customers from the year before by the retention rate from the year before.
- Step 3:** Calculate each year's annual operating profit per customer by multiplying annual operating profit from the year before by the profit growth factor (3.00%).
- Step 4:** Calculate Annual Profit by multiplying Number of Customers in each column by the corresponding Annual Operating Profit per Customer in each row.
- Step 5:** Calculate Net Profit (After CAC) by subtracting Total Customer Acquisition Cost from Annual Profit. This will only make a difference in Year 1. This is normally when you realize these acquisition costs.
- Step 6:** You can use the NPV function in Excel to calculate Aggregate LTV. When you type in =NPV, a prompt will ask you to plug in a Rate. Just click the cell with your discount rate. For Value1, click the Net Profit (After CAC) cell under Year 1. For Value2, click the Net Profit (After CAC) cell under Year 2. Repeat until all four net profit values have been plugged into the NPV function. When done, just hit "Enter."

The answer in Aggregate LTV is the value of the batch of customers acquired in Year 1, considering retention, growths in profit, and acquisition cost. You will notice that calculating LTV isn't something as simple as adding up net profits for Year 1, 2, 3 and 4. Again, money tomorrow is inherently less valuable than money today because of inflation.

Here are some quick tips to help make your measurements a little more reliable:

- The discount rate is useful for calculating the value of tomorrow's revenue today (because of inflation and other factors, \$5 tomorrow won't be as valuable as \$5 today). Your finance team can help you determine a proper discount rate.
- Acquisition costs can vary across years, products, campaigns or segments. Build a specific LTV model for each unique group. For example, don't use the same assumptions for customers acquired in different years.
- Unless your customers sign extended contracts, don't forecast LTV any longer than five years out (IBM uses a three-year window).
- Be conservative! Overly optimistic retention rates or revenue growth factors will result in forecasts that are unrealistically high. Even small changes can have a major impact on the final calculation. Tempering your expectations will ensure you don't justify overspending with rosy predictions of LTV.
- With the right accounting methods and database tools, you can actually measure and track LTV for each individual customer. You can narrow the aperture from groups to individuals. This is really what one-to-one marketing is all about.

4. Ratio of LTV to CAC

This simple calculation is one of the capstone measurements of the value generated by your marketing and sales departments, as well as operations.

$$\frac{\text{Average Customer Lifetime Value}}{\text{Average Customer Acquisition Cost}}$$

Two important caveats:

1. This calculation will only be as precise as the model you used to forecast customer lifetime value. So, to that extent, this ratio can be a little tricky.
2. Resist the urge to look at this ratio as good, bad, amazing, horrible, or perfect. As a stand-alone ratio, the only thing this calculation will tell you is whether or not you're creating value (you likely are). The benefit of this measurement is realized in comparisons over time. Shoot for improvement through gains in customer value and marginal enhancements of sales marketing and sales efficiency through stable or lower customer acquisition costs.

5. Return on Marketing Investment (ROMI)

Most marketing department ROI calculations take a lot for granted. After all, while marketing is a key driver of results, it is not solely responsible for results. Operations, finance, and product development are internal contributors to success.

Moreover, investments in marketing aren't like investments in capital or inventory. The latter can be expensed through accounting techniques. They aren't as nimble or flexible as investments in marketing, which can be reallocated on the fly.

The ROMI calculation is used to measure the rate at which marketing expenditures and investments actually contribute to profits. To do the math, you'll need at least two years of marketing campaign and sales results data.

First, some quick definitions:

- *Revenue Attributable to Marketing:* This is the increase in sales that can be attributed to your entire marketing budget. This will be based on what you think your baseline sales would be without any marketing support. Yes, baseline sales can be very hard to estimate. The finance team can apply some of their statistical modeling skills to help you come up with a reliable estimate.
- *Contribution Per Unit Sold:* This is the selling price of each unit MINUS the variable cost per unit. Your accounting or finance team can provide you with this number.

- *Contribution Margin*: This is the contribution per unit sold DIVIDED BY selling price per unit.

Once you have an understanding of these numbers and the actual numbers in hand, you can perform a simple ROMI calculation to measure the impact of your department's efforts on profits and sales. The formula for ROMI is:

$$\frac{[(\text{Revenue Attributable to Marketing} \times \text{Contribution Margin}) - \text{Marketing Budget Spending}]}{\text{Marketing Budget Spending}}$$

6.) Marketing Percentage of Customer Acquisition Cost (M%-CAC)

Marketing Percentage of Customer Acquisition Cost is a barometer for evaluating whether or not your customer acquisition efforts are too heavily weighted, or not weighted enough, toward marketing initiatives. To compute this figure, divide the value of your marketing expenditures by the entirety of your sales and marketing budget.

$$M\% - CAC = \frac{\text{Marketing Budget}}{\text{Customer Acquisition Cost}}$$

The M%-CAC is interesting to watch over time. Changes to this ratio will occur as your marketing strategy and its effectiveness evolve. For instance, an increase in M%-CAC either means 1) you are spending too much on marketing, 2) sales costs are lower because they missed quota, or 3) you are trying to raise sales productivity by spending more on marketing and providing more, and higher quality, leads to Sales.

For a company focused on outside sales with a long and complicated sales cycle, M%-CAC might be only 10-20%. For companies that have an inside sales team and a less complicated sales process, M%-CAC might be more like 20-50%. Companies that have a low cost and simpler sales cycle where sales are humanless, the M%-CAC might be more like 60-90%.

7.) Marketing-Originated Customer Percentage

This ratio shows what % of your new business marketing drives. To compute it, take all of the new customers you signed up in a period, and look at what % of them started with a lead Marketing generated.

$$\frac{\text{Marketing - Generated Leads in a Given Period}}{\text{New Customers in the Same Period}}$$

This is much, much easier to do when you have a closed-loop marketing analytics system. It is possible to collect the necessary data manually, but just know it will be time consuming.

This metric is useful because it directly shows what portion of the overall customer acquisition originated in Marketing. The figure is often higher than Sales would lead you to believe.

In our experience, this ratio will vary from company to company. Marketing-Originated Customer Percentage might be pretty small (anywhere from 20-40%) for companies with an outside sales team supported by an inside sales team with cold callers. For a company with an inside sales team supported by lead generation from Marketing, it might be 40-80%. Companies that rely on humanless sales will see their Marketing-Originated Customer Percentage in the range of 70-95%.

Note: You can also compute this percentage using revenue, not customers, depending on how you prefer to look at your business.

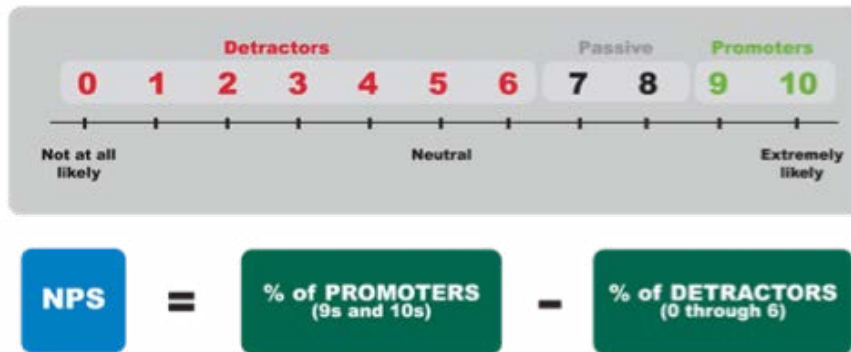
8.) Net Promoter Score

The Net Promoter Score, or NPS®, is based on the fundamental perspective that every company's customers can be divided into three categories: Promoters, Passives, and Detractors.

By asking one simple question — “How likely is it you would recommend [_____] to a friend or colleague?” — you can track these groups and get a clear measure of your company's performance through your customers' eyes. Customers respond on a 0-to-10 point rating scale and are categorized as follows:

- **Promoters** (score 9-10) are loyal enthusiasts who will keep buying and refer others, fueling growth.
- **Passives** (score 7-8) are satisfied but unenthusiastic customers who are vulnerable to competitive offerings.
- **Detractors** (score 0-6) are unhappy customers who can damage your brand and impede growth through negative word-of-mouth.

To calculate your company's NPS, subtract the percentage of Detractors from the percentage of Promoters.



The most successful companies using Net Promoter build out a complete operational model with NPS as its centerpiece. Real breakthroughs in performance are achieved only when a company moves from a research model to an operational model embedded in their company culture.

In their book, *Answering the Ultimate Question*, Richard Owen and Laura Brooks describe the Net Promoter Operating Model that captures the elements necessary for a successful customer-focused program. It provides a best practice framework for how companies collect, evaluate, and act on customer feedback to optimize financial benefits.

What Now? When sharing the results of this diagnostic, it is important to keep the following economic principles in mind. These will hold true regardless of the situation.

1. The relationship between org-level marketing/sales budgets and performance is rarely ever linear. A reduction or increase in budget won't generate a clean, proportionate shift in outcomes. This isn't just due to the function of the relationship between the two, but because of the carryover effects from prior marketing and sales efforts.

While profits and performance are measured and reported in discrete increments (annually, quarterly, monthly), the drivers of profit and performance are continuous. They play out over time.

2. When you understand that marketing often has a non-linear effect on performance, it tempers your desire for ever-expanding budgets and resources. You will focus instead on incremental improvement over instant gratification. When assessing your department's performance, you will look for opportunities to shore up the things that might not be working as well, instead of just blindly abandoning them altogether.
3. Good leaders in marketing focus on incremental improvement because they know every driver of performance will eventually encounter diminishing marginal returns. There comes a point when each additional dollar in spending will result in lower and lower incremental gains. While the first four hours of studying for an exam might raise

your grade from a 60 to an 80, the next four hours might realize a gain of only five points.

4. Another note about improvement – these measurements are not ends to themselves. That an airplane has an altimeter isn't a reason to fly at the highest altitude possible. This will always end in disaster. ROI is a balance between investment and return. Just as it would be foolish to slash marketing budgets with an eye toward higher ROI (which will surely cripple performance and profits), idly throwing more money at something just because we need more of what works isn't a sustainable budgeting strategy. Sensible budgeting can often produce a bit of a drag on ROI while increasing overall profits in the future.