

chapter 2

Market-Based Performance

CommTech is a \$454 million business that manufactures a wide range of imaging and data transmission products for medical, industrial, and business-to-business markets. Five years ago, a new

management team was put in place after several years of disappointing performance. The new management team reorganized the business and designed programs to lower unit costs, control overhead expenses, and facilitate better management of assets. In addition, the new management team put in place an extensive sales training program that enabled the sales force to improve its sales productivity from \$1.4 million to \$2.2 million per salesperson.

The results were sensational! In five years, the new management team almost doubled sales and more than tripled net profits. As shown in Figure 2.1, CommTech's return on sales grew from 6.3 percent to 12.1 percent, and its return on assets increased from 11.3 percent to 26.7 percent. On the basis of this information

- How would you rate CommTech's performance over the last five years?
- What aspects of CommTech's performance were most impressive?
- Should CommTech follow the same strategy for the next five years?

MARKET VS. FINANCIAL PERFORMANCE

Most of us would be quick to conclude that CommTech's performance over the last five years was outstanding. Who would not like to have run a business in which the sales almost doubled and the profits more than tripled over a five-year period? Despite those

Performance (millions)	Base Year	1	2	3	4	5
Sales Revenue	\$254	\$293	\$318	\$387	\$431	\$454
–Cost of Goods Sold	183	210	230	283	314	331
Total Contribution	\$ 71	\$ 83	\$ 88	\$104	\$117	\$123
–Marketing and Sales	18	23	24	26	27	28
–Operating Expenses	37	38	38	41	40	40
Net Profit (before taxes)	\$ 16	\$ 22	\$ 26	\$ 37	\$ 50	\$ 55
Return on Sales (%)	6.3	7.5	8.2	9.6	11.6	12.1
Assets (millions)	\$141	\$162	\$167	\$194	\$205	\$206
Return on Assets (%)	11.3	13.6	15.6	19.1	24.4	26.7

Figure 2.1 ♦ CommTech's Five-Year Performance

impressive increases, it is probably a mistake to evaluate CommTech's performance in such rosy terms when all the criteria used to arrive at this judgment are *financial* measures of performance. Sales revenues, net profits, return on sales, assets as a percentage of sales, and return on assets are all excellent measures of internal financial performance. These measures, however, do not provide an *external or market-based view* of performance. As a result, we do not know how CommTech has performed relative to external benchmarks such as market growth, competitive prices, relative product and service quality, and satisfying and retaining customers. Therefore, following the same strategy for the next five years may or may not be the best strategy for achieving profitable growth.

While using traditional methods of tracking performance, most would judge CommTech to be a real success story. But it can be demonstrated that, in reality, its efforts represent a cumulative loss to the corporation and its shareholders of \$122 million in net income and cash flow over the five-year period. This difference in performance is due largely to a lack of market-based performance metrics and an overreliance on traditional financial measures as a guide to strategic thinking and performance evaluation.

To complement a business's internal financial performance, a business needs a parallel set of external metrics to track market-based performance.¹ Although these measures may not have the additive elegance of financial accounting, individually and collectively they provide a different and more strategic view of business performance. In Figure 2.2 is a set of market-based performance metrics that paints a different picture of CommTech's performance over the past five years.

One can readily see several strategic flaws in CommTech's market-based performance. First, CommTech sales, while showing impressive growth, were increasing at a rate less than the market growth rate. This analysis shows that CommTech was actually losing market share over the past five years. New product sales, product quality, and service quality each eroded *relative to competition*. Declines in relative product and service quality do not necessarily mean that CommTech's actual product or service quality declined.

Market-Based Performance	Base Year	1	2	3	4	5
Market Growth (dollars)	18.3%	23.8%	16.3%	31.4%	24.9%	16.9%
CommTech Sales Growth	12.8%	17.8%	13.3%	24.9%	18.2%	7.7%
Market Share	20.3%	18.8%	17.5%	16.2%	14.4%	13.0%
Customer Retention	88.2%	87.1%	85.0%	82.2%	80.9%	80.0%
New Customers	11.7%	12.9%	14.9%	24.1%	22.5%	29.2%
Dissatisfied Customers	13.6%	14.3%	16.1%	17.3%	18.9%	19.6%
Relative Product Quality	+19	+20	+17	+12	+9	+7
Relative Service Quality	+0	+0	-2	-3	-5	-8
Relative New Product Sales	+8	+8	+7	+5	+1	-4

Figure 2.2 ♦ CommTech's Five-Year Market-Based Performance

In many instances, the competition simply moved ahead in delivering a higher level of product and service quality. On a relative basis, the competition's more rapid progress caused CommTech to lose ground to competitors in these areas.

Declines in quality, along with declines in relative new product sales, made it more difficult to hold customers as customer satisfaction declined and the percentage of dissatisfied customers grew. The net results were an eroding market-based performance, high levels of customer turnover, and a steady decline in market share.

A Market-Based Strategy

What would have been the impact of a strategy to hold market share? To hold a 20 percent share in a growing market, the marketing budget and product R&D would have needed to keep pace with market demand and the competition. At this level of investment and a 20 percent market share, the results presented in Figure 2.3 would have been plausible.

Although the market-based strategy to hold share would have delivered approximately the same return on assets as the internally driven strategy, it would have produced an additional \$122 million in net profit (before taxes). Thus, over the five-year period, the business gave up \$122 million in cash to the bottom line. Furthermore, CommTech's lost income will be even greater over the next five years even if share erosion is halted and market growth completely subsides. If the market continues to grow, and market share continues to erode, CommTech's lost profit opportunity could easily approach \$500 million over the next five years.

Market-Based Performance

The foundation of market-based management is a strong commitment to market-based performance metrics, market-level profitability, and the management of marketing expenses to achieve a high level of marketing productivity. Businesses that are market-based

Performance (millions)	Base Year	1	2	3	4	5
Sales Revenue	\$254	\$312	\$363	\$477	\$596	\$697
–Cost of Goods Sold	183	216	251	330	415	484
Total Contribution	\$ 71	\$ 96	\$112	\$147	\$181	\$213
–Marketing and Sales	18	24	27	32	41	50
–Operating Expenses	37	41	45	52	59	66
Net Profit (before taxes)	\$ 16	\$ 31	\$ 40	\$ 63	\$ 81	\$ 97
Return on Sales (%)	6.3	9.9	11.0	13.2	13.6	13.9
Assets (millions)	\$141	\$172	\$196	\$253	\$310	\$355
Assets (% of sales)	55.5	55.1	54.0	53.0	52.0	50.9
Return on Assets (%)	11.3	18.0	20.4	24.9	26.1	27.3
Lost Income (cash flow)*	\$ 0	\$ 9	\$ 14	\$ 26	\$ 31	\$ 42

* Difference between net profits in Figures 2.1 and 2.3.

Figure 2.3 ♦ Market-Based Strategy to Hold a 20 Percent Market Share

are able to create a business culture in which managers possess strong individual market orientations and work across functions to achieve marketing excellence. However, to fully leverage market-based management and market orientation and attain superior performance, a business needs to manage itself with respect to:

- **Market Performance Metrics:** External measures of market performance.
- **Marketing Profitability:** Measures of profitability at the market level.
- **Market-Based Organization:** Business structure built around markets.

Each of these elements of market-based performance is critical in taking a business to a higher level of marketing effectiveness and overall success.

MARKET-BASED PERFORMANCE METRICS

The CommTech situation underlines the importance of market-based performance metrics. Most business systems are set up to track revenues, costs, factory overhead, accounts receivable, operating expenses, and profits. Yet a business's customers are its most important asset and the only significant source of positive cash flow. Giving up customers in a period of growth simply means that the business has to work harder and spend more in order to replace each lost customer.

Internal vs. External Performance Metrics

To be successful, a business needs both internal and external performance metrics.² As presented in Figure 2.4, internal measures are critical for tracking unit costs, expenses, asset utilization, employee and capital productivity, and overall measures of profitability. Market-based performance metrics are equally important in providing an external view of the business's market-based performance. While CPA firms have done an excellent job in developing procedures for internal measures of a business's performance, the next frontier for either CPA firms or market research firms will be the development of stan-

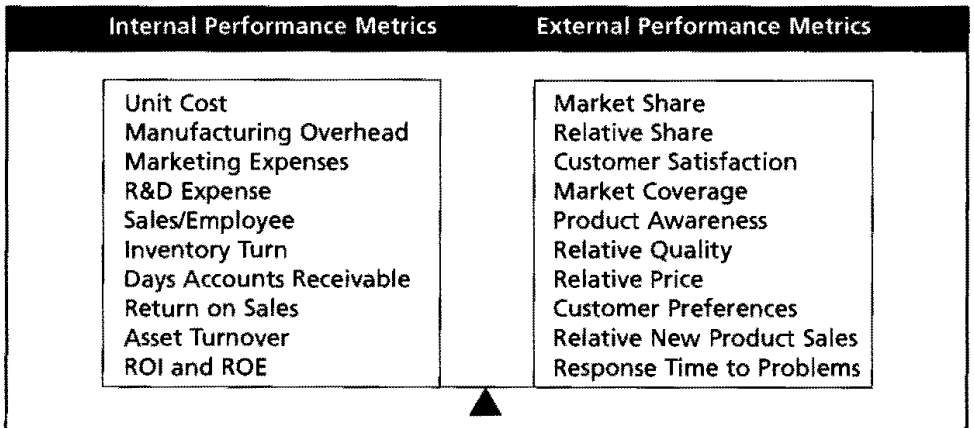


Figure 2.4 ♦ Internal and External Measures of Performance

standardized procedures for external measures of a business's market-based performance. With both sets of performance metrics, managers as well as financial analysts and shareholders will be in a much better position to evaluate a business's marketing effectiveness and business performance.

In-Process vs. End-Result Performance Metrics

The primary purpose of market metrics is to maintain an ongoing measure of market performance. And, because many market metrics precede financial performance, they are critical to strategy implementation and financial performance. However, not all market metrics are leading indicators of business performance. There are *in-process market metrics* and *end-result market metrics*.³ Both are important, but in-process market metrics are particularly important because they are also leading indicators of financial performance. End-result metrics correspond more closely to financial performance.

Product awareness, intention to purchase, product trial, and customer satisfaction and dissatisfaction, along with customer perceptions of relative product quality, service quality, and customer value, all serve as in-process market metrics. Changes in each, positive or negative, generally precede actual changes in customer purchase behavior. As a result, these in-process measures of customer thinking and attitude are important leading indicators of future purchase behavior and, hence, of revenue and profit performance.

For example, perhaps customers are satisfied, but their perceptions of the value they derive from your product, relative to competing alternatives, is steadily diminishing. You may well have done nothing wrong to dissatisfy customers; the competition may have simply improved in delivering customer value based upon a combination of total benefits in comparison to total cost. However, the net effect is that customer perceptions of the value derived from your product have diminished. This change in customer perceptions, in turn, opens the door to competitors' products that your customer may be inclined to try or purchase. With an early warning signal, a market-based business can take corrective action before customers switch their purchase to a competitor. Without in-process market metrics, problems may go undetected and unresolved until after declines in financial performance.

End-result market metrics include market share, customer retention, revenue per customer, and others, as outlined in Figure 2.5. End-result market metrics are likely to occur at the end of a financial performance period. However, each provides a different set of performance diagnostics and insights.

For example, let's assume that sales revenues are increasing and are ahead of forecast, and financial performance is also better than expected. Most businesses would feel pretty good about their performance. However, if end-result performance metrics show that the business is losing market share in a growing market, and poor customer retention is masked by new customer growth, there should be cause for concern. Without end-result market metrics, the business has only an internal perspective of end-result performance.

MARKETING PROFITABILITY

Although market-based performance metrics are essential to understanding external performance, it is also important that a business be managed to grow and to protect profits and shareholder value. Consider, for example, the Santa Fe Sportswear Company. The

Measurement Perspective	Time of Measurement	
	In-Process Metrics	End-Result Metrics
Internal (in-company)	Product Defects Late Deliveries Billing Errors Accounts Receivable Inventory Turnover	Net Profit/Earnings Return on Sales Margin per Unit Return on Assets Asset Turnover
External (in-market)	Customer Satisfaction Relative Product Quality Relative Service Quality Intentions to Purchase Product Awareness	Market Share Customer Retention Relative New Product Sales Revenue per Customer Market Growth Rate

Figure 2.5 ♦ Internal vs. External and In-Process vs. End-Result Performance Metrics

company's sales of \$125 million were built around five product lines. The company was profitable overall, but two of the product lines had not performed well. In response, the senior management team of Santa Fe Sportswear met to review its product line performance. In preparation for the senior management review, the finance manager prepared the product line profitability summary presented in Figure 2.6.

Using this information, the finance manager argued the following:

We are wasting resources on Product Lines P4 and P5. One makes no money and the other loses money. I recommend we drop both product lines and refocus our efforts on Product Lines P1, P2, and P3.

Would this be a good decision? How should the marketing manager present her interpretation of the performance of Product Lines P4 and P5? Before we address those two questions, let's examine the role marketing plays in building net profits.

MARKET-BASED MEASURE OF PROFITABILITY

To create a measure of marketing profitability, we need to examine more closely the elements of profitability and determine which come under the influence of the marketing function. To do this, we need to systematically break down the elements of profitability

Area of Performance	Product Line					Company Total
	P1	P2	P3	P4	P5	
Sales Revenues	\$60.0	\$25.0	\$15.0	\$10.0	\$15.0	\$125
Variable Expenses	37.5	15.5	7.5	8.5	11.0	80
Total Contribution	\$22.5	\$ 9.5	\$ 7.5	\$ 1.5	\$ 4.0	\$ 45
Fixed Expenses	17.0	7.0	4.0	3.0	4.0	35
Net Profit	\$ 5.5	\$ 2.5	\$ 3.5	\$-1.5	\$ 0.0	\$ 10

Figure 2.6 ♦ Santa Fe Sportswear: Product Line Profitability

and marketing strategy to better understand how they interact.⁴ The best method is to start with a very broad definition of net profit and then break down the profit equation into a definition that encompasses a market-level measure of profitability. Thus, in its most basic terms, a business's net profit is simply revenues minus expenses:

$$\text{Net Profits (before taxes)} = \text{Revenues} - \text{Expenses}$$

However, from a marketing point of view, we would want to break down sales revenues and expenses into more meaningful market-based strategic variables. Revenues can be decomposed into unit volume sold times the price per unit, and unit volume can be further broken down into market demand and a business's share of that demand, as shown:

$$\begin{aligned}\text{Sales Revenues} &= \text{Unit Volume} \times \text{Price per Unit} \\ &= \text{Market Demand} \times \text{Market Share} \times \text{Price per Unit}\end{aligned}$$

For marketing purposes, this is a more meaningful expression of revenue because it is based on a particular combination of market demand (units), market share (percentage of market demand), and price per unit. In this manner, we can readily understand three ways in which revenue can change. Market demand can change because of market growth, expanded market definition, or new market entry. Likewise, share of market and price can vary depending on a combination of marketing strategies and changes in competitive conditions.

With regard to expenses, we can break them down into *variable* expenses and *fixed* expenses. Variable expenses are *volume-sensitive* and can be broken down in the same manner as sales revenue:

$$\begin{aligned}\text{Variable Expenses} &= \text{Unit Volume} \times \text{Variable Cost per Unit} \\ &= \text{Market Demand} \times \text{Market Share} \times \text{Variable Cost per Unit}\end{aligned}$$

Changes in unit manufacturing cost, purchased materials, sales commissions, and transportation costs generally determine the variable cost of each unit sold, as described in Figure 2.7. As volume changes, the overall variable expenses will also change.

Fixed expenses (also described in Figure 2.7) are made up of those expenses that are not volume-sensitive and are, therefore, less likely to change in the short run for a given level of production capacity. However, from a market-based management perspective, it is very important that these expenses also be decomposed into two important sources of fixed expense, as shown:

$$\text{Fixed Expenses} = \text{Marketing Expenses} + \text{Operating Expenses}$$

To manage profits at the market level we need to separate fixed marketing expenses from other fixed *operating* expenses.⁵ Operating expenses, as described in Figure 2.7, include R&D and administrative expenses needed to run the business.

NET MARKETING CONTRIBUTION

If we combine revenues, variable expenses, and marketing expenses, we can create a measure of marketing profitability. However, to manage profit at the market level, we need to rewrite the net profit equation based on how we break down revenues and variable and fixed expenses as they are related to the profit impact of marketing strategies. Because the

Variable Cost per Unit	Costs that vary with unit volume sold
Cost of Materials	Per unit cost of products sold to customers that is made up of raw materials, semifinished goods, and component products
Direct Labor	Per unit cost of personnel needed to manufacture and/or assemble products sold
Transportation Costs	Per unit cost of shipping to and holding finished goods for customers
Sales Commissions	Per unit cost of commissions paid to the sales force or sales agents
Sales Promotions	Per unit cost of price discounts or co-op advertising used to promote products
Marketing Expenses	Direct fixed expenses that vary with market strategy
Sales Force Expense	Salaries paid to the sales force and personnel who support the sales force
Advertising Expense	Advertising dollars spent to communicate the business's message to the served market
Customer Service	Fixed expense of providing customer service to the served market
Marketing Support	Market research and administration that supports the efforts directed at the served market
Sales Promotions	Special promotions and public relations intended to stimulate potential or served market demand
Marketing Administration	Fixed cost of the marketing management team and associated administrative expenses
Operating Expenses	Indirect fixed expenses that will not vary in the short run and are independent of volume
Research and Development	Expense of improving products and developing new products
Administrative Overhead	Expenses allocated to business units to cover corporate expenses associated with legal counsel, professional services, corporate communications, and the salaries of senior management and staff

Figure 2.7 ♦ Variable Costs, Marketing Expenses, and Operating Expenses

volume portion of revenues and that of variable expenses are the same, we can express net profit in *marketing terms* in the following way:

$$\text{Net Profit (before taxes)} = \underbrace{\left[\text{Market Demand} \times \text{Market Share} \times \left(\text{Price per Unit} - \text{Variable Cost per Unit} \right) \right]}_{\text{Net Marketing Contribution (NMC)}} - \text{Marketing Expenses} - \text{Operating Expenses}$$

The portion bracketed as *net marketing contribution* is our measure of marketing profitability. These are the components of profitability that are largely under the con-

control of the marketing function. Operating expenses are generally not under the control of the marketing function. Thus, we can rewrite the net profit of a business as shown, where marketing controls the net marketing contribution (NMC) component of net profit:

$$\text{Net Profit (before taxes)} = \text{Net Marketing Contribution} - \text{Operating Expenses}$$

From this perspective, a marketing strategy produces a net marketing contribution.⁶ This net marketing contribution has to cover the business's operating expenses and more in order for the business to make a profit.

Using net marketing contribution as a measure of profitability, the marketing manager can more readily evaluate the profit impact of a marketing strategy. Each product or market should be managed to produce a *positive* net marketing contribution. In this way, marketing decisions can be evaluated with respect not only to revenue and share gains but also to how they will affect profits by the level of net marketing contribution they produce.

Recognizing net marketing contribution as the measure of marketing profitability, we need to reexamine Santa Fe Sportswear's product line profitability. For example, Santa Fe Sportswear's marketing strategy for Product Line P1 currently produces a net marketing contribution of \$15.5 million, as shown in Figure 2.8. This level of marketing profitability is the result of a 12.5 percent share of a 12 million unit market demand, a price of \$40 per unit, a variable cost of \$25 per unit, and marketing expenses of \$7 million.

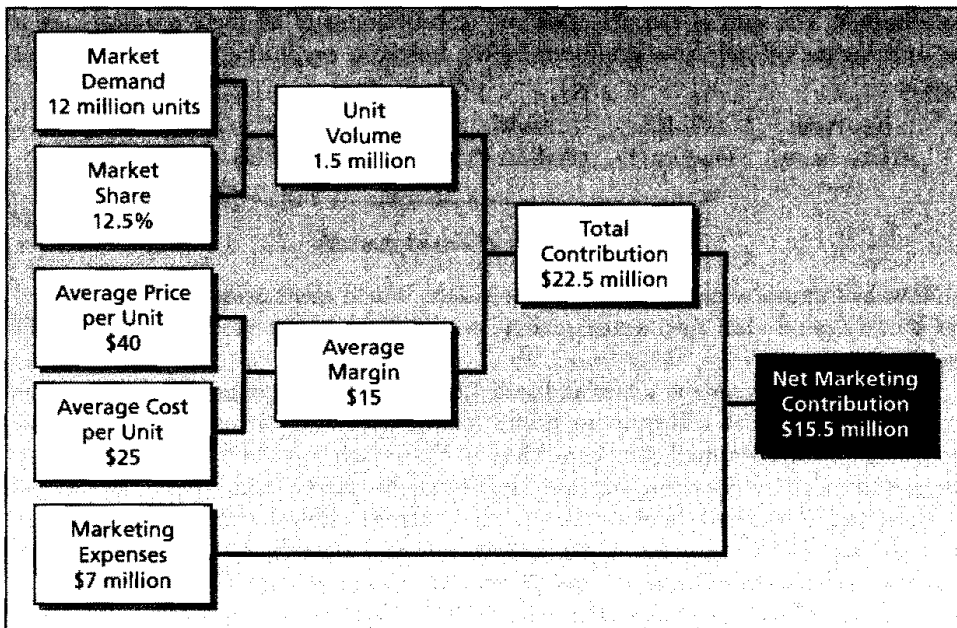


Figure 2.8 ♦ Net Marketing Contribution: Santa Fe Sportswear Product Line P1

$$\begin{aligned}
 \text{NMC (P1)} &= \left[\text{Market Demand} \times \text{Market Share} \times \left(\text{Price per Unit} - \text{Variable Cost per Unit} \right) \right] - \text{Marketing Expenses} \\
 &= [12 \text{ million} \times 0.125 \times (\$40 - \$25)] - \$7 \text{ million} \\
 &= [1.5 \text{ million} \times \$15 \text{ per unit}] - \$7 \text{ million} \\
 &= \$22.5 \text{ million} - \$7 \text{ million} \\
 &= \$15.5 \text{ million}
 \end{aligned}$$

To demonstrate how the profit impact of a marketing strategy can be assessed, assume that the marketing manager of Santa Fe Sportswear's Product Line P1 proposed to cut price by 10 percent in order to grow share from 12.5 to 15 percent. As shown below, this marketing strategy would produce 300,000 more units in sales volume, but at a lower margin (\$15 vs. \$11). The net result of this marketing strategy would be a decrease in net marketing contribution from \$15.5 million to \$12.8 million and, therefore, a decrease in net profits of the same amount.

$$\begin{aligned}
 \text{NMC (P1)} &= [12 \text{ million} \times 0.15 \times (\$36 - \$25)] - \$7 \text{ million} \\
 &= [1.8 \text{ million} \times \$11 \text{ per unit}] - \$7 \text{ million} \\
 &= \$19.8 \text{ million} - \$7 \text{ million} \\
 &= \$12.8 \text{ million}
 \end{aligned}$$

Net Marketing Contribution and Business Unit Profitability

When a business has several product lines, it produces several sources of net marketing contribution. The sum of the net marketing contributions of all these product lines is the only source of cash flow produced by the business; everything else is expense, as shown:

$$\begin{array}{rcccl}
 \text{Net Profit} & = & \text{NMC} & + & \text{NMC} & + & \dots & + & \text{NMC} & - & \text{Operating} \\
 \text{(before taxes)} & & \text{Product (1)} & & \text{Product (2)} & & & & \text{Product (n)} & & \text{Expenses} \\
 & & \underbrace{\hspace{10em}} & & & & & & & & \\
 & & \text{NMCs from all served markets} & & & & & & & &
 \end{array}$$

Now, let's return to the questions raised earlier: Would eliminating Product Lines P4 and P5 be a good idea? And would such a decision improve the net profits of Santa Fe Sportswear?

First, Figure 2.9 presents a market-based view of Santa Fe Sportswear's product line profitability and overall company net profits (before taxes). As shown, each product line produces a positive net marketing contribution. Thus, each product line is making a positive contribution to operating expenses and net profit (before taxes). If we assume that the operating expenses of the business would not change with the elimination of Product Lines P4 and P5, the business would actually reduce net profits by the amount of net marketing contribution Product Lines P4 and P5 were producing. Eliminating Product Lines P4 and P5 would reduce overall sales by \$25 million and net profits by \$2.5 (from \$10 to \$7.5 million), as shown below:

Sante Fe Sportswear Area of Performance	Product Line					Company Total
	P1	P2	P3	P4	P5	
Market Demand (000)	12,000	6,250	5,000	3,750	3,000	30,000
Market Share	12.5%	8.0%	10.0%	8.0%	6.7%	10.0%
Unit Volume (000)	1,500	500	500	300	200	3,000
Sales Revenues (millions)	\$ 60	\$ 25	\$ 15	\$ 10	\$ 15	\$125.0
Average Price (per unit)	\$ 40	\$ 50	\$ 30	\$33.3	\$ 75	\$ 41.7
-Average Variable Cost	25	31	15	28.3	55	26.7
Average Margin	\$ 15	\$ 19	\$ 15	\$ 5	\$ 20	\$ 15.0
Total Contribution (millions)	\$ 22.5	\$ 9.5	\$ 7.5	\$ 1.5	\$ 4.0	\$ 45.0
-Marketing Expenses	7.0	3.0	2.0	1.0	2.0	15.0
Net Mktg. Cont. (millions)	\$ 15.5	\$ 6.5	\$ 5.5	\$ 0.5	\$ 2.0	\$ 30.0
-Operating Expenses	10.0	4.0	2.0	2.0	2.0	20.0
Net Profit (before taxes)	\$ 5.5	\$ 2.5	\$ 3.5	\$ -1.5	\$ 0.0	\$ 10.0

Figure 2.9 ♦ Santa Fe Sportswear: Product Line Marketing Profitability

$$\begin{aligned}
 \text{Net Profit (before taxes)} &= \text{NMC(P1)} + \text{NMC(P2)} + \text{NMC(P3)} - \text{Operating Expenses} \\
 &= \$15.5 \text{ mil} + \$6.5 \text{ mil} + \$5.5 \text{ mil} - \$20 \text{ mil} \\
 &= \$7.5
 \end{aligned}$$

Another way for the marketing manager to demonstrate how each product line contributes to overall net profits is presented in Figure 2.10. As shown, each product line is producing a positive net marketing contribution. As a result, each makes a contribution toward covering operating expenses and producing net profit. Eliminating any of these products without a commensurate reduction in operating expenses would result in a reduction in net profits.

MARKET-BASED MARKETING PROFITABILITY

Accounting systems are generally built around producing something. Revenues and costs are directly associated with the production of something whether it be a product or a service. Costs that are not directly related to production are allocated to products or services using some agreed-upon accounting rules that have nothing to do with satisfying customers or making money. To develop marketing strategies that satisfy customers and

Santa Fe Sportswear Area of Performance	Market Segment			Company Total
	S1	S2	S3	
Market Demand (000 customers)	6,800	3,600	1,600	12,000
Market Share	9.0%	6.3%	10.1%	8.3%
Customer Volume (000)	612	227	161	1,000
Sales Revenue (millions)	\$ 55	\$ 31	\$ 39	\$125
Revenue per Customer	\$ 90	\$137	\$242	\$125
-Variable Cost per Customer	55	80	175	80
Margin per Customer	\$ 35	\$ 57	\$ 67	\$ 45
Total Contribution (millions)	\$ 21	\$ 13	\$ 11	\$ 45
-Marketing Expenses (millions)	6	4	5	15
Net Marketing Contribution	\$15.4	\$ 8.9	\$ 5.8	\$30.1
-Operating Expenses (millions)	8	5	7	20
Net Profit (millions)	\$ 7.4	\$ 3.9	\$-1.2	\$10.1

Figure 2.11 ♦ Santa Fe Sportswear: Customer-Based Marketing Profitability

MARKET-BASED STRATEGIES AND PROFITABLE GROWTH

Recognizing the product or customer as the unit of analysis, we can evaluate different aspects of net marketing contribution in order to gain a better insight into the development of marketing strategies designed to grow profitability.⁷ As shown in Figure 2.12, each element of the net marketing contribution equation offers the potential to create a marketing strategy that will affect profits. In each case, the net marketing contribution of a proposed strategy must exceed the current net marketing contribution in order to grow the net profits of the business. In light of this fact, there are a limited number of fundamental marketing strategies that a business can consider in order to grow net marketing contribution.

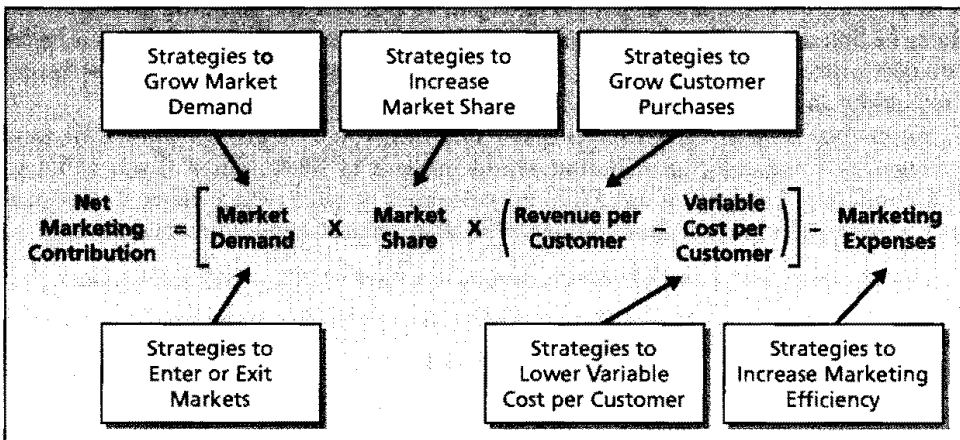


Figure 2.12 ♦ Fundamental Market-Based Strategies and Profitable Growth

Consider, for example, Santa Fe Sportswear's performance in Segment S1, as presented in Figure 2.11. As shown below, Segment S1 currently produces a net marketing contribution of \$15.4 million. This is derived from a 9 percent share of a market demand of 6.8 million customers, revenues of \$90 per customer, variable costs of \$55 per customer, and marketing expenses of \$6 million.

$$\begin{aligned}
 \text{NMC (Segment S1)} &= \left[\text{Market Demand} \times \text{Market Share} \times \left(\text{Revenue per Customer} - \text{Variable Cost per Customer} \right) \right] - \text{Marketing Expenses} \\
 &= [6.8 \text{ million customers} \times 0.09 \times (\$90 - \$55)] - \$6 \text{ million} \\
 &= [612,000 \text{ customers} \times \$35] - \$6 \text{ million} \\
 &= \$21.4 \text{ million} - \$6 \text{ million} \\
 &= \$15.4 \text{ million}
 \end{aligned}$$

Marketing strategies to grow marketing profitability are many. In the remainder of this section, we will discuss the market-based strategies suggested in Figure 2.12 and assess how selected strategies in each area might affect the profits of Santa Fe Sportswear.

Strategies to Grow Market Demand

In many markets, a large part of the marketing challenge is to bring more customers into the market. If you think about the Sony Walkman, cellular telephones, and personal computers, you realize that a good portion of the profitable growth comes from new customers. Thus, marketing strategies to attract more customers and grow market demand offer one way to grow the net profits of a business. If a business is able to hold or grow share while attracting new customers to the market, there is a potential to grow profits. Profits will grow, however, only when the net marketing contribution produced by the proposed marketing strategy exceeds the current net marketing contribution.

For example, the Santa Fe Sportswear's Segment S1 marketing manager believes that segment demand could be grown from 6.8 million customers to 8.0 million customers with a 50 percent increase in marketing effort. If this increase could be achieved, and Santa Fe Sportswear were able to maintain a 9 percent share, volume would increase by 108,000 customers. But would this proposed strategy improve Segment S1's marketing profitability and increase the business's overall profitability?

We can see from the calculations below that this would be a worthwhile marketing strategy. Net marketing contribution would increase by \$0.8 million (from \$15.4 to \$16.2 million). The gain of 108,000 new customers would produce enough additional total contribution to cover the additional \$3 million in marketing expenses required.

$$\begin{aligned}
 \text{NMC (Segment S1)} &= [8.0 \text{ million customers} \times 0.09 \times (\$90 - \$55)] - \$9 \text{ million} \\
 &= [720,000 \text{ customers} \times \$35 \text{ per unit}] - \$9 \text{ million} \\
 &= \$25.2 \text{ million} - \$9 \text{ million} \\
 &= \$16.2 \text{ million}
 \end{aligned}$$

In some instances a business may actually take lower net marketing contributions in the short run in order to build demand and future net marketing contributions.

However, the discounted cash flow from the long-term strategy has to exceed that of the current strategy in order for this approach to be viable.

Strategies to Increase Market Share

Perhaps the most common marketing strategy to grow revenue and profits is market share penetration. For any served market, a strategy is developed to grow the business's share of its served market. The same rules apply; a market penetration strategy is likely to cost money, margin, or both, and the net marketing contribution of the penetration strategy needs to exceed the current net marketing contribution for the business to improve profitability. For example, in Segment S1, Santa Fe Sportswear could consider a strategy to increase its market share from 9 to 11 percent by lowering its prices 10 percent. As shown below, the overall 136,000 customer gain would not be sufficient to offset the lower margin that would result from a 10 percent price decrease. The net result is a projected decrease in net marketing contribution from \$15.4 million to \$13.45 million.

$$\begin{aligned}\text{NMC (Segment S1)} &= [6.8 \text{ million customers} \times 0.11 \times (\$81 - \$55)] - \$6 \text{ million} \\ &= [748,000 \text{ customers} \times \$26 \text{ per customer}] - \$6 \text{ million} \\ &= \$19.45 \text{ million} - \$6 \text{ million} \\ &= \$13.45 \text{ million}\end{aligned}$$

Strategies to Increase Revenue per Customer

In a mature market with a strong share position, a business may not find it feasible or profitable to grow market demand or market share. However, the business's customers still remain its best strategic asset, and an examination of customer needs might reveal new products and services to better serve those needs and grow revenues. To evaluate the overall profit impact of such a marketing strategy, a business would have to project what higher prices could be attained and what increases in the average cost per unit would be required.

Also, to be considered are potential additional marketing expenses, such as the additional advertising dollars that would be necessary to make existing customers aware of product or service improvements. Thus, it is important to examine all aspects of the strategy to ensure that a strategy to increase price per unit leads to an increase in net marketing contribution.

To illustrate the profit impact of a strategy to build revenue per customer, let us consider that, in Segment S1, a major product line improvement would be able to raise average revenue per customer from \$90 to \$100. However, this improvement would also raise the average variable cost per customer by \$5 because of increased materials costs. In addition, another \$2 million in marketing expense will be needed to introduce the improved product line and to communicate its benefits. As shown below, this marketing strategy would produce an incremental gain of \$1.1 million in net marketing contribution when compared with the current net marketing contribution of \$15.4 million.

$$\begin{aligned}\text{NMC (Segment S1)} &= [6.8 \text{ million customers} \times 0.09 \times (\$100 - \$60)] - \$8 \text{ million} \\ &= [612,000 \text{ customers} \times \$40 \text{ per customer}] - \$8 \text{ million} \\ &= \$24.5 \text{ million} - \$8 \text{ million} \\ &= \$16.5 \text{ million}\end{aligned}$$

Strategies to Lower Variable Cost

Another way to grow net profits is by lowering the variable cost per unit. For example, perhaps the transportation costs and sales commissions could be lowered with a new distribution strategy for a given market or market segment. This strategy would lower variable expenses per unit and increase margin per unit, but the business has to be concerned about the level of customer satisfaction that will be delivered by this alternative distribution system. If customer satisfaction lessens, so will customer retention. And, in the long run, net profits will erode even though the business has achieved a lower variable cost and higher margin per unit. Thus, a successful marketing strategy must hold or increase customer satisfaction while growing net profits through increases in net marketing contribution.

Continuing with the Santa Fe Sportswear example, Segment S1's management is evaluating a new customer order entry and billing system that would improve customer satisfaction and lower the variable cost of serving a customer by \$5 per customer. However, this new system will add \$1 million per year in fixed marketing expense. This system would improve customer satisfaction and lower variable costs, but would it improve profitability? As shown below, the proposed order entry and billing system would improve the net marketing contribution by \$2.1 million, improving both customer satisfaction and profitability.

$$\begin{aligned}
 \text{NMC (Segment S1)} &= [6.8 \text{ million customers} \times 0.09 \times (\$90 - \$50)] - \$7 \text{ million} \\
 &= [612,000 \text{ customers} \times \$40 \text{ per customer}] - \$7 \text{ million} \\
 &= \$24.5 \text{ million} - \$7 \text{ million} \\
 &= \$17.5 \text{ million}
 \end{aligned}$$

Strategies to Increase Market Efficiency

Another way to improve the profitability of a marketing strategy is to lower fixed marketing expenses: that is, to be more efficient in the use of marketing expenses to achieve a particular performance objective. The more focused a business is with respect to target customers, the fewer marketing dollars it has to expend in order to achieve a desired marketing objective. Likewise, alternative forms of distribution affect the fixed marketing expenses needed. For example, a business short on financial resources may elect to use a distributor rather than incur the fixed cost of direct selling and distribution.

Santa Fe Sportswear currently uses a direct sales force in Segment S1 and, as we have seen, spends \$6 million in marketing expenses to obtain a market share of 9 percent. The business is considering shifting to manufacturers' representatives as a way to lower marketing expenses. The reps would be paid a 10 percent sales commission, and the business could reduce its marketing expenses by \$2 million. As shown below, the 10 percent sales commission would be too costly in terms of reduced margin. As a result, the business is better off with its current marketing strategy because the current net marketing contribution (\$15.4 million) is greater than the net marketing contribution of the projected marketing strategy.

$$\begin{aligned}
 \text{NMC (Segment S1)} &= [6.8 \text{ million customers} \times 0.09 \times (\$90 - \$9 - \$55)] - \$4 \text{ million} \\
 &= [612,000 \text{ customers} \times \$26 \text{ per unit}] - \$4 \text{ million} \\
 &= \$15.9 \text{ million} - \$4 \text{ million} \\
 &= \$11.9 \text{ million}
 \end{aligned}$$

MARKETING PRODUCTIVITY

Recognizing net marketing contribution as the measure of marketing profitability, a manager can readily evaluate the profit impact of marketing strategies, as has been illustrated. In addition, we can evaluate the efficiency of the marketing budget used to produce a given level of marketing profitability (net marketing contribution) by creating the following measure of marketing productivity.

$$\text{Market Productivity} = \frac{\text{Net Marketing Contribution}}{\text{Marketing Budget}}$$

The ratio of net marketing contribution to marketing budget (marketing and sales expenses) provides a measure of how efficient a given marketing budget is in producing marketing profits. For example, Santa Fe Sportswear produces an overall net marketing contribution of \$30.1 million with a marketing budget of \$15 million. This is a market productivity ratio of 2.0, which means that each dollar of marketing budget produces \$2 of net marketing contribution:

$$\begin{aligned}\text{Market Productivity} &= \frac{\text{Net Marketing Contribution}}{\text{Marketing Budget}} \\ &= \frac{\$30.1 \text{ million}}{\$15 \text{ million}} \\ &= 2.0\end{aligned}$$

We can also assess the marketing productivity of each segment served by Santa Fe Sportswear. Using the net marketing contribution and marketing expenses reported in Figure 2.11, we can see that each segment strategy is producing a good level of net marketing contribution for each dollar of marketing budget. Segment S1 produces the largest sales revenue, and the marketing strategy used in this segment is the most efficient in producing marketing profits. And, while segment S3 is reported to produce an overall loss of \$1 million, the marketing strategy developed for segment S3 is profitable and produces \$1.20 of marketing profits for each dollar of marketing budget.

Market Performance Metric	Seg. S1	Seg. S2	Seg. S3	Overall
Net Marketing Contribution (mil)	\$15.4	\$8.9	\$5.8	\$30.1
Marketing and Sales Expenses (mil)	\$ 6	\$ 4	\$ 5	\$ 15
Marketing Productivity	2.5	2.25	1.2	2.0

This market-based performance metric helps managers evaluate the relative efficiency with which they are growing net marketing contribution. It may be that two marketing strategies yield an equivalent net marketing contribution, but one is more efficient because it has a higher marketing productivity. Put simply, one strategy can produce the same level of marketing profitability (net marketing contribution) but for fewer dollars of marketing budget. This, of course, is an advantage to any business, since those extra dollars can be used for other purposes.

Another benefit to this market metric is that it can be used in comparisons with competitors or benchmark businesses. Figure 2.13 presents the marketing productivity of three

Area of Performance (billions)	Personal Computer Company			Consumer Goods Company		
	Compaq	Dell	Gateway	Ralston Purina	General Mills	PepsiCo
Sales Revenues	\$24.6	\$7.7	\$6.3	\$4.5	\$6.0	\$20.9
-Cost of Goods Sold	<u>17.9</u>	<u>6.1</u>	<u>5.2</u>	<u>2.3</u>	<u>2.4</u>	<u>8.4</u>
Total Contribution	\$ 6.7	\$1.6	\$1.1	\$2.2	\$3.6	\$12.5
Marketing Expenses	<u>2.1</u>	<u>.8</u>	<u>.8</u>	<u>1.6</u>	<u>2.5</u>	<u>9.2</u>
Net Mktg. Cont.	\$ 4.6	\$.8	\$.3	\$.6	\$1.1	\$ 3.3
Mktg. Productivity*	2.2	1.0	0.38	0.38	0.44	0.36

* A ratio of Net Marketing Contribution to Marketing Expenses (marketing, sales, and administrative expenses).

Figure 2.13 ♦ Net Marketing Contribution and Marketing Productivity

competing computer companies. In this case, Compaq is more efficient in generating marketing profits than either Dell or Gateway. Also presented in Figure 2.13 is the marketing productivity of three well-known consumer goods companies. Each of these companies produced a marketing productivity ratio of less than 1. However, in this case, the three consumer goods companies shown have very similar levels of marketing productivity.

MARKET-BASED ORGANIZATIONS

Over time, businesses develop extended product lines. Unfortunately, as these businesses evolve from single- to multiple-product organizations, they rarely alter their organizational structure. What normally emerges over time is a product-driven organization, as illustrated in Figure 2.14. In this example, five separate motor manufacturing operations each serve multiple markets. This arrangement is both expensive for the business and

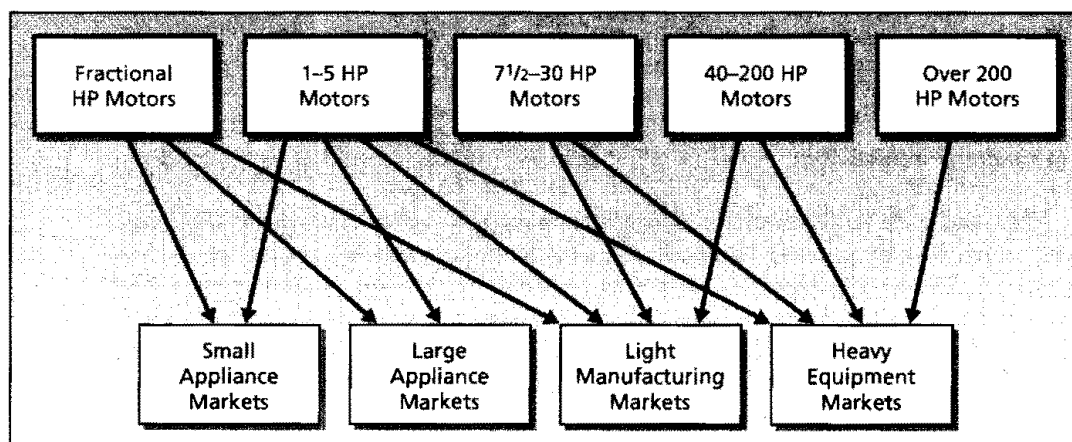


Figure 2.14 ♦ Product-Focused Organizational Structure

confusing for customers. It is expensive for the business because there are obvious marketing redundancies in sales, support, and distribution. For customers, it is frustrating to deal with two or more separate businesses with respect to invoices, service levels, sales coverage, etc. Even worse, each product-focused business is looking to sell only its own products and becomes myopic in its view of the market.⁸ As a result, a product-oriented organizational structure is less likely to see a broader range of customer needs and, hence, market opportunities.

Thus, an important characteristic of a market-managed business is that it will reengineer its marketing organization as more markets are served or as these markets change.⁹ An important element of this characteristic of market-based management is that businesses are built around markets, not around products or manufacturing operations. If customers are the primary focus of a market-based business, then why not start with the customer and work backward with respect to how we design our business and marketing organization to serve target customers?¹⁰ In this way, the organizational focus is on the market where customers buy, and not on the factory where products are made.

To become market-focused, a business needs to formulate a market-based organizational structure. In this structure, the *market unit* is a market-focused entity. It is assigned the task of understanding customer needs and competitor positioning in a given market and developing and implementing marketing strategies to achieve target objectives for that market.¹¹ Hence, the market unit is responsible for all aspects of the marketing and business directed at target customers in its market. For example, consider the motor manufacturer. While the company may have a number of different manufacturing operations to produce a range of motors, it serves several markets through market units. As illustrated in Figure 2.15, this market-based structure provides a much better systems linkage between customer markets and the organization. This structure facilitates more responsive market strategy development, implementation, and market-based performance tracking.¹²

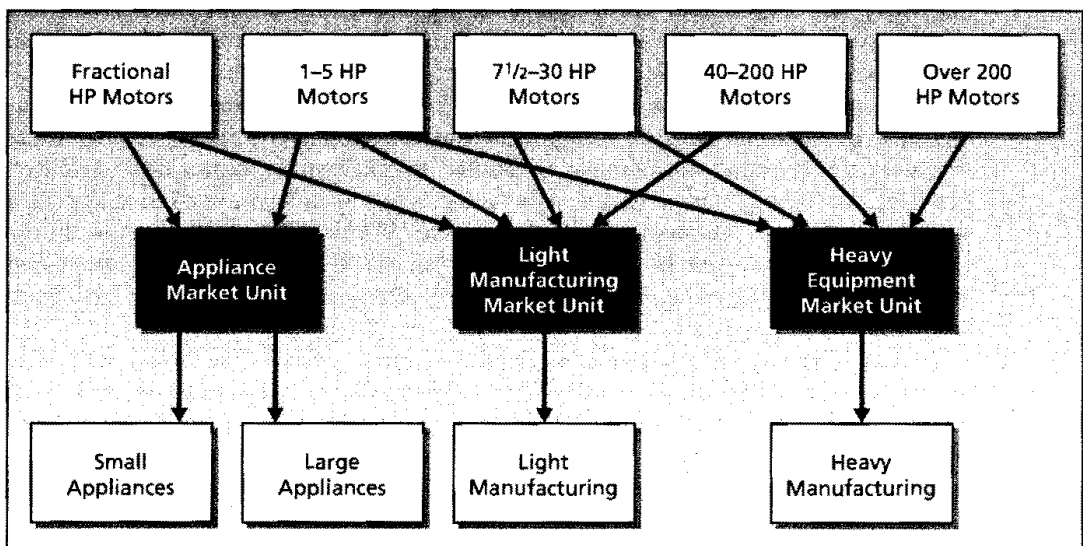


Figure 2.15 ♦ Market-Focused Organizational Structure

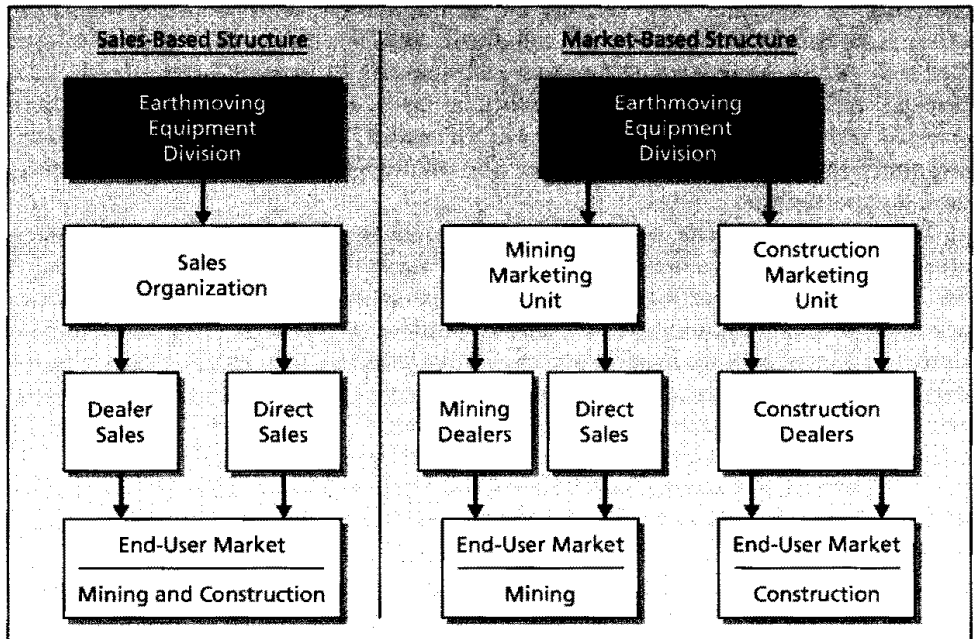


Figure 2.16 ♦ Sales-Based vs. Market-Based Organizational Structure

Figure 2.16 illustrates how a specialty steel manufacturer shifted from a sales-oriented to a market-oriented organizational structure. The business sold products in both the mining and construction markets. It had done well in mining but poorly in construction markets because they were much more difficult to reach. However, the construction market, while very fragmented, was several times larger. The only way to perform better in the construction market was to have a market unit (marketing team) in charge of that market whose sole responsibility was that market. When a construction market unit team was put in place, within a short time they found they had ineffective dealers, an incomplete product line, and the wrong marketing systems to serve the more price-sensitive and delivery-conscious construction market. In other words, a great deal was different from the mining market, and it required a completely different marketing approach to satisfy customers. The results were phenomenal. Within 18 months, the sales in the construction market grew by over 40 percent. Further, this increase was accomplished with no change in personnel, just a reorganization of existing marketing, sales, and product management personnel.

Market units are organized around customer markets such that maximum market focus can be achieved without conflict in developing and implementing market-based strategies that deliver high levels of both customer satisfaction and profitability. Each market unit becomes a marketing team that is solely focused on the needs of a particular group of customers.¹³ This organizational structure makes market-based measures of performance such as customer satisfaction meaningful and actionable. The market units can also be set up as market-level profit centers, enabling the business to evaluate and track profitability at the market level.

SUMMARY

A market-based business engages in three important distinguishing practices:

- It tracks market-based measures of performance.
- It measures marketing profits by product, market, or both.
- It organizes around markets rather than products.

Without an external set of market-based performance metrics, a business will never know its market performance. For CommTech, an overreliance on traditional measures of internal performance cost the business and its shareholders \$122 million in net profits. Thus, an important step in becoming a market-based business is the development of a key set of external market-based measures of performance. These external market metrics can include in-process metrics, which typically precede financial performance measurement, and end-result market metrics, which are more likely to coincide with financial performance measurement.

To develop and implement marketing strategies that are going to increase customer satisfaction and grow profits, a business needs to be able to measure the profitability of a marketing decision. This means understanding the revenues that result from serving a target market of customers and all the costs associated with serving that market. A common problem often arises here in most accounting systems: the need to allocate overhead costs. This has the potential to distort profitability and can lead to decisions that actually reduce profitability. To grow profits, a business needs to grow net marketing contribution. Allocating overhead costs will distort net marketing contribution. If the accountants persist in allocating cost, simply ask that costs be allocated after the net marketing contribution has been computed so that market-level profitability can be clearly observed.

With market-based management, the focus is on the customer. How much revenue does a customer produce? What are the costs of acquiring a customer? What are the costs of serving those customers after they have been acquired? What is the net marketing contribution per customer in different segments of the market? Measures of marketing profitability and marketing productivity help us evaluate the profit impact and spending efficiency of a marketing strategy.

Marketing is manipulation, but what should be manipulated is the business, not the customer. Businesses that are able to reengineer their organizational structures around markets and new market opportunities are in the best position to respond to customer needs and changing market conditions. Thus, a market-based organizational structure is evolutionary. It will change as markets change in order to maximize its ability to attract, satisfy, and retain target market customers.

MARKET-BASED LOGIC AND STRATEGIC THINKING

1. Why are market-based measures of performance critical to achieving profitable growth?
2. How do market-based measures of performance differ from internal measures of performance? Why are both necessary?

APPLICATION PROBLEM: DELL COMPUTER

Dell Computer is a direct marketer of personal computers with sales in 1997 of over \$7.76 billion and net profit before tax of \$705 million. At that time, Dell's product line included desktop computers, portable computers, and servers/workstations. Eighty-five percent of sales were gained through direct marketing and 15 percent via the Internet. Dell planned to derive 50 percent of their sales from the Internet in two years.

The average margin for Dell computer products was 21.4 percent. Marketing expenses ran about 10.7 percent of sales. However, marketing on the Internet was reported to be roughly half as expensive. Dell's operating overhead was among the lowest in the industry at 1.6 percent of sales. The average selling price for PCs had been eroding at roughly eight percent per year. Outlined below are specific details for each of Dell's major product-markets in 1997.

Desktop PC Market

- Market demand was estimated to be 33 million units per year and growing at 16 percent per year.
- Dell's market share is 6 percent, average selling price \$2,250 per unit, and margin 18 percent.
- Marketing expenses in this segment averaged 12.4 percent of sales.

Portable PC Market

- The market was estimated to be 13.5 million units per year and growing at 25 percent per year.
- Dell's share was five percent. Average selling price was \$2,750 per unit, which provided margins of 25 percent.
- Marketing expenses in the portable PC segment averaged 10.2 percent of sales.

Server/Workstation Market

- This (low-end server) market was 5.5 million units per year and growing at 27 percent per year.
- Dell's market share was 6 percent. Dell's average price was \$4,500 with a margin of 27 percent of sales.
- Marketing expenses for the low-end server market segment were 6 percent of sales.

Questions

For Internet discussion, go to www.prenhall.com/phbusiness.

1. What was Dell's net marketing contribution in each major product-market? What were Dell's overall net marketing contribution and net profit?
2. How would Dell's net marketing contribution in portable computers change the next year if the company able to hold market share and margins while average prices continued to erode at eight percent per year?
3. Which of Dell's product-markets had the highest marketing productivity?

3. Why does a business need both internal (financial) measures of performance and external (market-based) measures of performance?
4. What roles do market-based measures of performance play in achieving profitable growth?
5. Why are performance metrics important?
6. What is the fundamental difference between a market performance metric and a financial performance metric?
7. Why are in-process metrics an important part of a successful marketing strategy? What is the relationship between in-process metrics and end-result metrics?
8. What are some of the fundamental differences between product-based accounting and customer-based customer accounting?
9. How does net marketing contribution enable a business to better understand the profit impact of a marketing strategy?
10. What is the difference between a variable cost and a fixed expense?
11. Why are marketing expenses considered semi-variable expenses and cost of goods a variable expense?
12. How can treatment of operating expenses distort interpretations of profitability?
13. How can one assess the profit impact of a specific marketing strategy?
14. Under what conditions would you expect operating expenses to change with changes in marketing strategies?
15. What fundamental marketing strategies can a business pursue to grow marketing profits?
16. Explain how any given marketing strategy might affect different components of net marketing contribution.
17. Why would a business want to measure its profitability by market segment?
18. What does a marketing productivity of 0.5 mean? What does it mean when a competitor with approximately the same market share has a marketing productivity of 1.0?

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SECOND EDITION

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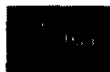
Professor of Marketing
University of Oregon



Prentice Hall, Upper Saddle River, New Jersey 07458

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