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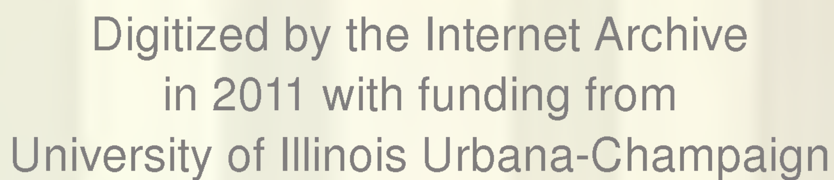
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An Earnings-Return Model for Strategic Market Planning

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May 1982

An Earnings-Return Model for Strategic Market Planning

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Abstract

Few models currently exist which aid managers in their strategic market planning. The models or frameworks which do exist have a variety of shortcomings, a major one being an inadequate linkage to a business organization's dominant goals for existence -- earnings and return on investment. This paper develops a planning model based on a firm's present levels of earnings and return designed to provide a partial foundation on which its managers can base their strategic market planning. Depending upon the firm's placement in the model, different organizational objectives and strategies exist for improving future performance.

INTRODUCTION

A number of models or conceptual frameworks have recently emerged as tools for strategic market planning. These include the market share-growth matrix, the industry attractiveness-business strength screen, the PIMS analyses, and the strategic intelligence system approach (cf., Day 1977; Abell and Hammond 1979; Montgomery and Weinberg 1979; Wensley 1981). Although these models and frameworks are highly interesting and useful as diagnostic tools, they all suffer from two major weaknesses. First, they are not adequately related to the primary corporate goals of earnings and return on investment either due to questionable assumptions and use of surrogate relationships (the market share-growth matrix and the industry attractiveness-business strength screen) or methodological problems (the PIMS analyses and the strategic intelligence system approach). Second, and perhaps more significantly, these models or frameworks provide strategic recommendations that are either too general (e.g., harvest, grow, divest) or often difficult to implement (e.g., disinvest dogs). In the process, unfortunately, utilization of these methods often results in the "tail wagging the dog;" rather than becoming the strategic instruments to achieve the corporate objectives of earnings and return, their implementation and utilization become the corporate objectives.

The basic proposition of this paper is that strategic market planning decisions must be directly based on their relevance and impact on corporate financial criteria. Rather than look first at varying strategies and speculate on their relationship to financial criteria, it is best to work backwards from these criteria. As suggested above, the

corporate performance criteria most commonly sought and used to evaluate the financial standing of the firm are earnings and return on investment. A company attempts to achieve through its strategic market plan the dual objective of satisfactory earnings and satisfactory returns. Whenever there is an imbalance such as satisfactory return but unsatisfactory earnings or *vice versa*, the company should try to bring about a balance by utilizing all corporate resources and functions. Being marketing is but one resource and function of the firm, marketing strategies should be examined only within the context of major corporate objectives and processes designed to achieve satisfactory earnings and return.

The purpose of this paper is, therefore, to develop a model for strategic market planning which begins with the corporate goals of earnings and return on investment, and attempts to show under different earnings-return scenarios how different strategic objectives should be sought and different marketing strategies should be utilized to achieve the ultimate earning and return goals of the firm. First, the basic nature as well as the strengths and weaknesses of the current strategic planning models or frameworks are reviewed in greater depth in order to place the current research in proper perspective. The "earnings-return" model is then presented and discussed. The model is restricted to a discussion of marketing strategy rather than include strategy development for other functional areas of the organization.

EVALUATION OF PRESENT MODELS OR FRAMEWORKS

The Market Share-Growth Matrix

The market share-growth matrix was developed to address the problems that a multidivisional, multiproduct company faces in its strategic

market planning. Products, strategic business units, or divisions of corporations are classified as "stars" if they achieve high market share and high growth, "cash cows" if market share is high but growth is low, "question marks" if they are high growth but low share, and "dogs" if neither growth nor share is satisfactory. The classification of products and/or businesses is used in planning resource allocations within the company.

> Some products may need cash to finance growth or competitive battles while others may be generating more cash than they need. Somehow the organization must display its limited financial resources among these products so as to achieve the best performance possible (Abell and Hammond 1979, p. 173).

The market share-growth matrix approach has met with considerable criticism. The model assumes that all competitors have the same overhead structures and experience curves with their position on the experience curve corresponding to their market share position (Day 1977, p. 31). Economies of scale are also assumed to be important. Day (1977), Abell and Hammond (1979), and Porter (1980) question these assumptions and the general applicability of experience curves and scale economies for all costs (manufacturing, marketing, and management costs), products, business units, and industries. For example, Abell and Hammond (1979) indicate that a competitor may have a low cost source of purchased materials unrelated to relative share position; a low share competitor may be on a steeper experience curve than high share competitors by virtue of superior production technology. Abell and Hammond (1979) and Porter (1980) also question the assumed relationship between market growth and required cash investment while Wensley (1981) indicates that this approach ignores the capital market as a

source of funds, inappropriately viewing the corporation as an independent cash recycling entity.

Perhaps the major weakness in the model is its use of market share as a proxy for profitability. Day (1977), Hamermesh, Anderson, and Harris (1978), Abell and Hammond (1979), Porter (1980), Kotler (1980), Wensley (1981), and Woo and Cooper (1981) all indicate that the assumed relationship between relative market share and cash flow may be very weak because strategic factors other than relative share will certainly influence profit margins (e.g., product quality or other forms of competitive differentiation). Depending upon the strategic plan followed, "...a number of possible relationships between market share and profitability" may exist (Porter 1980, p. 42). Further, Wensley (1981) indicates that empirical evidence does not support the contention that, on the average, the payoff is better from investing cash in gaining market share in rapid growth markets (c.f., Kijewski 1972).

Day (1977) indicates that even when the assumptions of the model hold, if objectives other than balancing cash flows take priority or there are barriers to implementing desired strategies, the model will not be very useful. Cash flow may be viewed as less important than return on investment in making many strategic decisions. Conclusions drawn from the approach may not work out well. For example, divesting the firm of a so-called "dog" may be inappropriate if it is still profitable. Porter (1980, p. 364) further elaborates, "The advice to harvest or grow into a star is far from sufficient to guide managerial action."

The Industry Attractiveness-Business Strength Screen

The basis for this approach involves expanding the dimensions of the market share-growth matrix so that market growth becomes a part of a composite measure of industry attractiveness and market share becomes part of a composite measure of business strength. Aside from market growth, an evaluation of industry attractiveness involves such criteria as size, market diversity, competitive structure, and industry profitability. The business unit's strength is based on such criteria as size, growth, profitability, margins, and technological position in addition to its market share. The industry attractiveness and business strength dimensions are subsequently split into each of three categories whether high, medium, or low resulting in a three-by-three matrix. "Depending on where a unit falls on the matrix, its broad strategic mandate is either to invest capital to build position, to hold by balancing cash generation and selective cash use, or to harvest or divest" (Porter 1980, p. 365).

This model also has a considerable number of problems. Abell and Hammond (1979) and Wensley (1981) indicate that the main weakness of the approach is the subjectivity involved in developing measures of an industry's attractiveness and the product's or business firm's position.

> Analysts using this approach must rely heavily on management judgment and experience and avoid easy generalizations about what particular factors are relevant. For the same reason, upper level management must take care to understand why certain factors are included in the analysis and why others have been excluded (Abell and Hammond 1979, p. 217).

Additionally, the direction and form of the relationships have to be determined and each of the contributing factors has to be weighted by its relative importance in deriving the composite measures of

attractiveness and position. In most cases, managers must simply make educated guesses about the variable relationships and the relative importance of each factor.

Further, Wensley (1981) indicates that the model provides little in the way of valuable information for a firm's managers, that it simply leads the analyst to the tautological position of recommending preferential investment in those areas of highest market attractiveness and strongest business position. Hussey (1978) concludes that use of the model results in no surprises and that there is a direct correlation between the discount rate shown by projects via a typical financial analysis and those predicted by the model. Because such variables as growth and profitability are included in an evaluation of both industry attractiveness and business strength, a serious dependency exists between these dimensions which may, in part, help to explain these viewpoints.

The model does little to guide the manager in the selection of appropriate strategies; the build, hold, or harvest strategies are certainly not sufficient and the question of how to implement each strategy still remains. Porter (1980) indicates that the criteria for building the model are inadequate to determine industry attractiveness, company strength, or the appropriate strategy; "It is difficult to see, for example, how the screen could lead to a recommendation to invest in a declining industry" (Porter 1980, p. 366).

The PIMS Data Base

As indicated previously, three problems associated with the industry attractiveness-business strength screen include identification of the factors that impact attractiveness or position, the direction of

their relationship with ROI, and each factors relative importance. The PIMS (Profit Impact of Marketing Strategies) project attempts to address these difficulties by collecting and analyzing data from a large number of businesses in a variety of industries. Seeking participation from mostly large manufacturing firms, current membership includes more than 150 companies operating more than 1,000 businesses. Two separate regression equations have been formulated, one which attempts to explain ROI and the other cash flow.

The main assumption the proponents of PIMS generally make is that "general laws" exist throughout the business community, that certain regularities exist across countries, industries, and businesses. This assumption is highly questionable, especially in regard to marketing strategy and strategic planning. Porter (1976) and Bass, Cattin, and Wittink (1977, 1978) find that an aggregation of firms across industries can bias regression coefficients; variable relationships can vary by industry. As Porter (1980, p. 3) explains, "Industry structure has a strong influence in determining the competitive rules of the game as well as the strategies potentially available to the firm." What is important for a consumer product's manufacturer to consider in developing its strategic market plan can be very different from that of a capital equipment manufacturer; consumers' customs, needs, and values and their reactions to varying strategies differ across cultures, countries, and product areas.

Perhaps recognizing the existence of such problems, "sector" models are being developed for the PIMS data base in an attempt to determine if variations in variable relationships exist across industries. For example, Farris and Buzzell (1979) report results for the entire sample

as well as individually for capital goods, raw materials and components, supply, and consumer businesses. While such a procedure disaggregates the data one step further, empirical results in Frazier and Howell (1982a, 1982b) clearly suggest that further disaggregation may be needed. They find that aggregation of firms _within_ an industry can also bias parameter estimates if different strategic groups (based on customers and functions served with a given technology) exist within it. Thus, an inspection of strategic groups within each industry may be a necessity in many situations.

A number of other methodological problems with PIMS also exist. The firms involved in the project are generally _large_ raw material or manufacturing firms and, therefore, not representative of the majority of business organizations. Each observation in the data base is not independent considering the data were collected from a number of divisions or strategic business units within each participating corporation (Woo and Cooper 1981); effects of synergy are, therefore, ignored for the corporation as a whole (Anderson and Paine 1978). A key informant methodology is used in collecting the data which may involve considerable measurement error (Phillips 1981) while some of the informants are reportedly lower level personnel who are not "qualified" to provide the required information. The reliability and validity of the measures utilized in the study have not been established. When measuring market size and market share, PIMS uses the "served market" concept, acknowledging that a business may elect to serve only certain customers in certain markets. While this measurement may be very useful if comparing firms within one industry, this approach can, in part, explain the strong positive correlation between market share and profitability in the cross-section of firms within the

data base. Surely, if a firm selects a narrow customer focus, it must effectively dominate this segment, in a relative sense, to reap adequate returns. As Porter states (1980, p. 146):

> Ascribing the higher profits of specialized, small-share firms to specialized market definition begs the question we are seeking to answer; namely, under what industry circumstances can a firm select a specialist strategy (to take just one strategic option) without being vulnerable to economies of scale or product differentiation achieved by broader-line firms?...The answer will differ by industry, depending on the array of mobility barriers and firm-specific features.

Some variables included in the PIMS regression model appear to have a significant impact due to their construction rather than to a true causal relationship. For example, investment intensity will be significantly correlated with ROI by definition considering the former variable is used to calculate the latter.

Finally, as Abell and Hammond (1979) suggest, the equations to explain ROI and cash flow involve mostly general, high level variables which provide little direction to the manager in what specific actions or strategies should be undertaken. For example, manager perceptions of product quality (however defined) are positively related to ROI. What strategic implication does this relationship hold for the manager? For a firm on the lower end of the quality spectrum, should product quality be improved at a high cost? Or, would this merely serve to disgruntle their current customer base? Could the firm handle the competition in the high quality market? Additionally, a retrospective analysis of past performance and strategy cannot be applied with validity to all environmental conditions, especially those where significant discontinuities occur or change is commonplace (Anderson and Paine 1978).

Therefore, although the PIMS project may be beneficial in raising questions, it offers few if any answers.

The Information System Approach

An alternative to using models such as the market share-growth matrix or the industry attractiveness-business strength screen or belonging to PIMS is the development of a strategic intelligence system. Montgomery and Weinberg (1979) discuss the need for firms to collect and analyze data on their competitive, technological, customer, economic, political, and social environments in guiding their strategic market planning. As they emphasize (p. 41), "A strategic plan can be no better than the information on which it is based." Porter (1980) discusses the wide variety of data which managers should consider including in such an information system, stressing that a structural analysis centering on basic competitive forces in the industry (e.g., threats to entry, bargaining power of buyers and suppliers, entry and exit barriers, opportunities, current as well as potential competitors) lies at the heart of a successful strategic plan.

The major weakness with the information based approach to aiding strategic market planning at the present time is that it lacks focus; questions concerning what specific data out of the total available should be collected and how should it be subsequently utilized remain unanswered. Montgomery and Weinberg (1979, pp. 41,44) recognize this problem as well as its possible solution:

> Some method is needed to avoid collecting vast quantities of meaningless data, while simultaneously preventing a focus so narrow that crucial information is missed...The problem is not to generate data, but to determine what information is

> relevant and actionable. The emerging tools of strategic planning and analysis...provide a framework for ascertaining what information is needed and how it might be used if obtained (also see Rothschild 1979).

Thus, the key to devising a beneficial strategic intelligence system is to have valid and reliable planning models guiding the collection of data and its subsequent utilization and analyses.

AN EARNINGS-RETURN MODEL FOR STRATEGIC MARKET PLANNING

The previous discussion clearly indicates that frameworks or models for strategic market planning must be developed which are directly anchored to major corporate financial objectives. Unless specific marketing strategies can be directly linked to the financial objectives of the firm, it is likely that their relevance and importance may go unappreciated in the organization. Furthermore, without this direct link, specific marketing strategies may be used inappropriately resulting in a suboptimization of corporate goals and objectives.

The two most common financial objectives of all for-profit corporations are earnings and return on investment. The performance of a company on the first criterion is typically summarized in the company's annual or quarterly income statement whereas its performance on the second criterion is summarized in the balance sheet.

The earnings criterion reflects the company's financial performance on specific business activities. It is directly related to the efficiency of the company's purchasing, manufacturing, distribution, and marketing operations. Perhaps the most important aspect of earnings is that it reflects the company's cash flow position. The most common method of calculating earnings or the net profit margin is the percent of sales

revenue still remaining with the company after payment for all variable and controllable costs associated with its level of sales such as cost of goods sold, operating expenses, short term interest expenses, and corporate tax. In short, the earnings criterion reflects the financial impact of the firm's short-term tactical and operational decisions.

The return on investment or assets criterion, on the other hand, reflects the financial impact of the company's longer term strategic decisions and commitments. First, it reflects the company's investment and capitalization policies, and it is generally indicated by the extent to which the company has decided to sink capital into manufacturing, distribution, warehousing, and human resources relative to its level of sales. Second, it also reflects the company's financial leverage decisions on issues such as its debt to equity ratio and the combination of various paper portfolios including common or preferred stocks, convertibles, bonds, and debentures. Finally, it reflects the long-term financial viability of the corporation to sustain targeted growth and diversification objectives. In essence, the return criterion reflects company attempts to declare and stake out its future mission and objectives whereas the earnings criterion reflects the company's present performance on strategic decisions made earlier in time.

The most common approach to measuring return on investment is the percentage recovery of capital assets (earnings divided by net worth) on an amortized basis (net present value). It is directly anchored to the present life cycles and depreciation schedules of imbedded assets in manufacturing and distribution, manpower, and the property holdings of the company.

Unlike the criteria utilized in the market share-growth matrix and the business screen analysis, the threshold levels for satisfactory performance on earnings and return are generally well-established and fairly consistent over time. Most companies tend to set a target level of net profits as a percentage of sales to reflect operations efficiency and similarly a target level of return as a percent of the capital asset base to reflect cost of capital and dividend policies. In other words, there is generally less ambiguity and a higher degree of management consensus about the satisfactory levels of earnings and return objectives. Unfortunately, this is not always true for the other planning models. Often a company interested in implementing the market share-growth matrix or the business screen approach experiences a considerable degree of disagreement among its managers in setting the cut-off points for the company growth and market share objectives as well as in dividing the industry attractiveness and business strength indices into high, medium, and low categories.

The earnings-return model is presented in Table 1. Based on the firm's targeted levels for the earnings and return objectives, the firm, a corporation's strategic/natural business units, or its products can be placed within the model. As evident, distinctively different management objectives exist for each quadrant. The company can ask each functional area of the business such as marketing, personnel, and manufacturing to identify specific strategies that would achieve the managerial objectives. In this paper, the discussion is limited to marketing strategies and, therefore, strategic decisions related to the four P's of the marketing mix (product, price, place, and promotion).[1] Certainly, other

nonmarketing strategies may be equally relevant to achieve the managerial objectives set in each quadrant. Each quadrant will now be examined in terms of the relevant managerial objectives and their corresponding marketing strategies.[2]

[Place Table 1 About Here]

Satisfactory Earnings and Return Situation

This is, of course, the ideal situation for a company; it is above the targeted threshold level in its short-term operations efficiency as well as in its long-term strategic objectives. Unfortunately, too many companies tend to become myopic over time if they remain in this ideal situation. While the company enjoys the benefits of good performance with respect to operations and strategy, it should also plan to ensure its continued viability. This can be achieved by setting and attempting to reach two management objectives.

The Market Entrenchment Objective. The immediate managerial objective should be market entrenchment where the firm attempts to maintain and solidify its current position in the marketplace. When a company is enjoying satisfactory earnings and return on its investment, there is a very strong likelihood that this will invite relatively high competitive pressure. Competition may come from a variety of sources including new entrants, substitute products, forward integration by suppliers of raw materials and component parts as well as from large buyers who are tempted to engage in backward integration (Porter 1980). It is, therefore, vital for the company to set the market entrenchment objective with which to minimize competitive vulnerability from any of these sources.

There are two specific marketing strategies that can be used in an attempt to achieve the market entrenchment objective. The first is the share protection strategy. Defending the company's market share can be achieved based on overall cost leadership and/or differentiation while focusing efforts on its major customers. Personal relationships can be stressed while emphasizing the benefits received by doing business with one another over time. For example, companies like Mennon (after shave), Bic (ball point pens), and Campbells (canned soups) have successfully defended their market share over time by engaging in overall cost leadership so that no company can offer the same product at a cheaper price without substantial financial losses. On the other hand, Monsanto (agricultural products) has instituted a differentiation program for its successful but mature herbicide called Lasso to protect its market share. This is reflected in its advertising positioning with large farmers (1000 acres or more) while providing rebates on purchases of 55 gallon drums of the herbicide. Similarly, Fieldcrest Mills which manufactures bedspreads, sheets, blankets, rugs, etc. instituted an "account management" program with major department stores and mass merchandisers in which its salespeople are trained to build personal working relationships with several members in each of its key accounts. Finally, IBM has always successfully minimized competitive inroads by creating industry specialization in its sales force and account management activities.

A second and slightly longer term strategy to achieve market entrenchment is the repositioning strategy. In light of changing market needs and societal life styles, the firm attempts to enhance the position of its current product lines by changing and extending their image through

mass advertising and/or personal selling. Some minor additions to the firm's product lines can also occur. While its current customer base may be emphasized, a slight extension to other target markets is also possible. A good example of a repositioning strategy unfolding in front of us is Campbells switch from an emotional appeal of good tasting soups to a nutritional appeal. As a consequence of declining birth rates, an increase in working spouses, and emergence of single adult households, Campbells hopes to entrench its dominant market share by repositioning the soups from a meal supplement to a meal substitute product. A similar repositioning is currently being practiced by Kelloggs to broaden and increase the consumption of cereals among adults.

The Market Expansion Objective. The market entrenchment objective to ward off potential competition is extremely useful in the short run. Unfortunately, competitive pressures tend to remain high due to the firm's satisfactory earning and return performance. Ultimately, the company must think strategically to convert a competitive (zero-sum) game into a coexistive (positive-sum) game. This can be achieved by setting the managerial objective of market expansion. A company in this quadrant likely has the money, resources, and borrowing capacity to fund a relatively costly expansion program.

There are again two fundamental strategies associated with this objective. The first strategy is to redefine the market boundaries from the domestic to worldwide markets, a multinational strategy. This may include both marketing and manufacturing operations. For example, Coca-Cola has remained a profitable company by deciding several decades ago to locally bottle and distribute its soft drinks on a worldwide basis.

Today, more than half of its sales and profits come from foreign markets. Similarly, many department and discount store chains such as K-Mart have learned they can continue to expand the market by buying and manufacturing products in foreign countries. In general, if a company belongs to an industry that is anchored to universal needs and wants, it is relatively easy to implement the multinational strategy. Examples include pharmaceuticals, heavy engineering, and electronics.

The market expansion objective can also be achieved by expansion of the firm's product lines. This is referred to as the <u>full line strategy</u>. As the name implies, the full line strategy means expanding the range of products and services offered by the company. In high technology industries, it is usually associated with product line stretching. Improvements to present products can also be emphasized. In the process, the firm should seek out and serve each desirable target segment in the industry through a differentiated marketing approach (Kotler 1980). For example, Rolm Corporation after its successful entry into the medium sized, digitial PBX market has stretched its product line over a much larger continuum of the number of telephone lines its digital switch can integrate and manage. It now offers a full line of PBX equipment appropriate for a wider range of businesses from small to large. A more recent illustration of line stretching strategy is IBM's manufacturing and marketing of personal computers.

A second mechanism of the full line strategy is to offer product assortments. Different products and services capable of satisfying different market needs are offered to the same target segment. The classic example, of course, was the emergence of Sears as the one stop shopping place for practically everything that middle America needed and wanted.

The market expansion objective is clearly more risky than the market entrenchment objective because it requires significant changes in the manufacturing, distribution, and marketing operations in addition to greater capitalization of resources and manpower commitments. If a company is not careful in its expansion efforts, it can easily over-extend itself and, as a result, move from quadrant one to another quadrant in the earnings-profit model. There are several classic examples of this in the retail and service industries. For example, the failure of W. T. Grant Company is often attributed to a very rapid expansion policy. Numerous fast food chains have gone bankrupt in trying to expand their market coverage. We are also witnessing similar problems with many commercial airlines such as People's Express and Laker Airlines.

Since market expansion is directly tied to longer term capitalization of assets, a major factor in its critical success rests on long term interest rates and the country's monetary policies. If the interest rates tend to fluctuate wildly and are often unpredictable, it is even more risky for a company to engage in the market expansion objective.

<u>Satisfactory Earnings but Unsatisfactory Return Situation</u>

A company in quadrant two has a satisfactory net profit margin. However, due to heavy capitalization relative to sales volume, it is still below the threshold level in terms of a satisfactory return on investment. In general, this situation is most common among companies in the early stages of their life cycles and companies which have undertaken major expansion programs.

The Volume Improvement Objective. One objective for a company in this quadrant is, of course, to increase asset turnover through volume improvement since each incremental dollar of sales revenue will contribute toward reaching the targeted return objective. There are two basic marketing strategies available to the firm to achieve its volume improvement objective.

The first marketing strategy is sales stimulation through aggressive selling and promotion to both intermediaries and end users. On one hand, it can utilize the push strategy with resellers of its products and services through sales contests and other sales incentive plans. On the other hand, it can also utilize the pull strategy by strong advertising and sales promotions addressed to the end users. A good example of the sales stimulation strategy is the Bell System's recent promotional campaign, "Reach out and touch someone," for its profitable long distance service. Up until recently, the Bell System was restricted by regulation to make less than ten percent of return on investment which was satisfactory only when long-term interest rates were less than five to six percent. With the sharp increase in long-term interest rates in the late seventies, the Bell System's regulated return could not guarantee sufficient reserves to maintain its capitalization policy. McDonalds is currently attempting to increase traffic in its fast food franchised outlets through use of a "sweepstakes" sales promotion.

Another marketing strategy to improve volume is systems selling in which the company sells a group of related and complementary products to the same customer (Kotler 1980). In this context, system selling does not involve new product development or additions to the product line; the

firm attempts to sell existing products as a group. Systems selling has become common in the office equipment business. Burroughs has implemented such a strategy in selling business forms. Recently, the Bell System has also implemented a systems selling program in its business marketing division. The Bell System account executives specialize in the customer's total communication needs and write proposals which include a number of telecommunication products and network services.

System selling, however, is not limited to industrial products. For example, Cole National Corporation's consumer products division consists of four major product lines: brass keys, colored keys, knives, and plastic letters, numbers, and signs. In 1974, only four percent of its retail customers carried all four lines. To improve its asset turnover, Cole instituted a systems selling approach which encouraged the salespeople to engage in cross-selling. Each product line was related to the others in terms of special displays and relatively high margins for the retailer.

The Capital Restructuring Objective. Unfortunately, there are situations where the volume improvement objective simply does not work due to temporary economic conditions. For example, the recent efforts by the American automobile companies to stimulate sales through rebates and lower interest rates have been unsuccessful mostly because of high unemployment and a deep recession. It is also possible that the industry may be at a mature stage in its life cycle and, therefore, stimulating sales may be more difficult. This is generally true of the appliance industry because it mostly consists of the replacement market.

In this situation, a company can hope to improve its return on investment by instituting a capital restructuring program. Capital restructuring entails abolition of some of the firm's fixed, noncontrollable costs of doing business. In the marketing area, this objective can be carried out by focusing on the company's physical distribution, channel relationships, and value added services.

First, a company can attempt to restructure its capital through promoting distribution efficiency, a distribution productivity strategy. Here, the emphasis is on decreasing the firm's level of current assets by effectively managing inventory and accounts receivable. Adopting improved inventory control procedures while coordinating the ordering process and cycle with associated firms would decrease resources tied up in inventory. Through better buyer selection while communicating with existing customers on the need for quick payment of accounts (perhaps providing additional inducements), the amount of assets tied up in accounts receivable could be decreased.

For example, Japanese automobile manufacturers are achieving significant savings in inventory costs by utilizing the "just in time" system of assembling the automobiles and shipping them to the marketplace (a policy since joined by domestic manufacturers). Some American companies in agri-business such as Archer-Daniel Midland (ADM) are reducing inventory as well as transportation costs through development of computerized software programs for shipment of grains through trucks, railroads, and barges. Eli Lilly's physical distribution group recently instituted a material requirements planning inventory control system to lessen inventory levels within its distribution channel and, therefore, improve the firm's return.

A second way to achieve capital restructuring is the reseller alignment strategy where the firm centers its efforts on decreasing levels of its fixed assets in the distribution channel. If the firm currently has a direct distribution system, some trucks and warehouses could be sold while using independent distributors, trucking firms, and some public warehousing. By streamlining its sales organization through the use of manufacturers representatives and agents, or by instituting telemarketing programs, a company can significantly reduce its uncontrollable selling costs. Similarly, if a company has a corporate vertical selling system, it can convert it to a franchised selling system so that its capitalization in retail locations can be restructured. Some companies such as IBM have even gone so far as to give up its traditional vertical integration and district selling policy to end-users by adopting third party selling agreements with dealers such as Sears and Computerland for its personal computer line. To avoid a large amount of capital invested in distributing its products, Heinz uses food brokers to contact wholesaling estalishments.

In some cases, it is also possible to consolidate distribution and selling functions by joint agreements between two or more companies. For example, at one time, Whirlpool Corporation and RCA had a joint selling and distribution program to minimize capitalization in the distribution and selling areas. Similarly, Pillsbury currently utilizes Kraft Foods' sales force and refrigerated trucks for its dough line instead of buying and maintaining its own fleet of trucks.

Finally, in the past, companies have tended to provide a number of support services to the marketplace free of cost to the customer. This

may include free delivery and installation, scheduled maintenance, liberal return or exchange policies, and credit float through its own credit cards. More and more firms are realizing that the hidden costs of these support services are often staggering. For example, the Bell System discovered that the cost of installing the phone in the homes was prohibitive and it could not afford to charge nominal fees as part of this support service. It has now instituted a program of designing modular jacks so that consumers can plug in their own telephones. Furthermore, it now encourages the customer to pick up and drop the telephone sets at any of its phone service centers.

Capital restructuring is decidedly a much more risky corporate objective than volume improvement. First, it requires some reorganization and, therefore, there is generally strong resistance from all the parties impacted by the decisions. Second, the impact of strategies implemented to achieve capital restructuring is long-term: top management must have patience and confidence to sustain implementation. The temptation is often high to back away from continued support and sustenance of capital structuring programs in the face of mounting opposition from all types of stakeholders and watchdogs. Third, capital restructuring strategies are inherently more risky since they require greater long term capital commitments. For example, the jury is still out whether Levi-Strauss Company will be able to survive and grow by its decision to align with convenience stores such as J. C. Penny and Sears in selling jeans. Much depends on the marketplace decision whether Levis is a specialty or convenience product within the clothing business. Finally, the firm's level of fixed costs should not be decreased beyond a safe range as this will

mean an exorbitant increase in variable expenses. While risk is lowered as uncontrollable costs are decreased, so are earnings in a prosperous economy.

Satisfactory Return but Unsatisfactory Earnings Situation

In the third quadrant, a company is experiencing satisfactory return on investment but an unsatisfactory level of earnings. In general, this can be true of mature industries or companies, partly due to depreciated book values of its capital assets, partly due to its lower interest rates on long term debts secured in more favorable times, and partly due to erosion of margins and a consequent profit squeeze created by intense price competition in the industry. A classic example of this is the present financial situation of the supermarket chains where the net profit margins are generally less than two percent of sales, but where most of them are still able to achieve a satisfactory return due to favorable mortgage rates and depreciated book values of buildings and fixtures. The company in this financial situation should set the following two objectives: margin improvement and product improvement.

The Margin Improvement Objective. This short-run objective refers to increasing the gross margins as well as net profit margins of products and services. The first strategy that should be considered is the repricing strategy, centering on attempts to improve the company's gross margins. The price charged per unit by the firm may be too low on certain products relative to the firm's cost of goods sold. Thus, tighter controls on pricing may be required along with a revision in pricing strategy. Buyer selection and the evaluation of present customers becomes a relatively important consideration; current customers should be dropped if they are

unwilling to buy the firm's products at acceptable prices. For example, in an attempt to ensure adequate gross margins, a number of wholesalers in the medical supply and equipment channel do not allow their salespeople to deviate from list price unless they receive prior approval from upper management (Stephenson, Cron, and Frazier 1979).

Repricing can also be achieved in other ways. For example, one can change the packaging size or shape or form of the product and improve the margin. Nowadays, this is very commonly utilized by the beverage industry. It tends to charge different prices for soft drinks in cans as opposed to disposable plastic bottles. A more interesting repricing mechanism is the switch from selling to leasing automobiles. The dealer tends to improve his margin by performing scheduled maintenance, as well as by providing property and casualty insurance as part of his lease price. With the significant increases in interest rates, many savings and loan institutions have developed "creative financing" programs such as variable term mortgages.

A second strategy to be used in reaching the margin improvement objective is the <u>cost control strategy</u>. This concerns increasing the firm's net profit margin by reducing variable and controllable costs associated with the manufacturing and marketing of products and services. The focus of this strategy is on the productivity of functional areas within the business. By increased efficiency in the firm's inventory control and logistics systems, ordering, warehouse, inventory carrying, and delivery expenses can be decreased. Increases in fixed costs (e.g., purchase of computer control systems, newer delivery vehicles) may be incurred in the drive to decrease variable costs. Because increasing sales volume, in

itself, is not a primary goal here, promotion costs may be kept at relatively low levels. For example, Stern and El-Ansary (1977) report that Marcor Corporation (formerly Montgomery Ward), in an attempt to improve its earnings, achieved significant cost savings in its distribution center operations by utilizing computerization and automated handling equipment which reduced labor costs for order processing and picking while reducing the number of special orders. W. H. Brady Company in the pressure-sensitive identification business is using more over-the-phone selling in low potential sales areas in an effort to lessen selling expenses. Atlantic Richfield Company (ARCO) recently announced that it will abolish its credit card operations associated with its gasoline stations. They hope to improve their profit margin and still remain competitive in the marketplace by the cost control strategy.

The Product Improvement Objective. A second longer term objective to seek in an attempt to improve the firm's earnings is product improvement. While the emphasis is again on improving the gross margins and net profit margins of the firm's products and services, implementation of this objective involves alterations in the company's product and market mix as well as it vertical relationships with suppliers, wholesalers, and retailers.

First, the migration strategy should be considered. It entails assessment of margin contributions of each product or service, and adding or deleting products and services to improve the overall margin. For example, Federal Express in the early seventies decided to focus on its Courier Pak overnight delivery business and gave up its standard air freight business to improve its profit contribution. Many supermarkets

have added higher product lines such as L'eggs panty hose, delicatessans, and even luncheon counters to improve their earnings. In fact, major supermarket chains such as Jewel and Kroger are literally blurring the boundaries between grocery shopping and department store shopping through offering a wide assortment of nontraditional products such as housewares, cosmetics, clothing, cameras, and electronic products. The Bell System has such a vast product/market combination that it is in virtually all quadrants of the earnings-return model for different product/market situations. It has recently instituted a migration strategy which involves replacing old electro-mechanical PBX switchboards with more modern and electronic Dimension PBX switchboards. The latter peform more functions and, therefore, the customer is willing to upgrade even though it is much higher priced terminal equipment. Libby, McNeill, and Libby stopped marketing frozen vegetables and Libbyland children's frozen dinners in 1974 because of poor earnings. It has recently sold some of its well-known canned fruit and vegetable lines because of low margins.

In addition, the markets the firm is currently serving should be carefully evaluated. Customer selectivity should be the rule of the day so that unprofitable market segments are abandoned or given to competition by product pruning and selective selling approaches. Recently, many commercial banks have raised the minimum balances in interest bearing checking accounts to discourage very small depositors.

Similarly, some companies have learned to unbundle their offerings and eliminated many peripheral products or services that have low margins. For example, some supermarket chains have begun to offer highly selective products in "no frill" stores such as Aldi or Jewel T. Likewise, many

commercial airlines such as U.S. Air and Ozark Airlines have abolished first-class sections in their planes.

The migration strategy means many things depending on the industry. It is often referred to as the planned obsolescence strategy in durable goods businesses. For example, in the automobile industry, it is used to pass on the incremental costs associated with engineering improvements and regulatory requirements. It is also referred to as the cannibalization strategy in nondurable goods such as soaps and detergents, cosmetics, and personal care products. In general, the marketer is interested in retaining loyal customers while motivating them to buy a better product which also has a higher margin. Finally, the migration strategy is sometimes referred to as a "moving up the ladder" strategy. In many retail stores, a customer for replacement of durable goods such as automobile tires, furniture, residential homes, and cars is "steered" by salespeople to buy higher priced items which have higher margins and commissions.

Another way to achieve the product improvement objective is through the vertical integration strategy, whether forward or backward, in hopes that it will provide economies of scale, increased control of sales and distribution activities, and overall cost efficiency in manufacturing and marketing operations. For example, many fast food franchised companies tend to engage in backward integration as a way of controlling costs of raw materials, supplies, and cooking equipment. It is this vertical integration which gives McDonalds its greatest strength in french fries and hamburgers. Likewise, several packaged food companies have attempted forward vertical integration by buying restaurants and fast food chains.

Examples include Pillsbury's successful acquisition and marketing of Burger King and Quaker Oats' development of Magic Pan restaurants. Holiday Inn in an attempt to ensure satisfactory earnings is evolving into a self-supply network that includes a carpet mill, a furniture manufacturing plant, and numerous captive redistribution facilities.

Once again it should be kept in mind that the product improvement objective is generally much more difficult and longer term as compared to the margin improvement objective. First, it requires significant changes in manufacturing and marketing operations. Second, it takes a considerable longer time period to either innovate new products or to vertically integrate operations. Finally, the strategies involved in product improvement often entail a considerable degree of capitalization. Therefore, any wrong decision may literally push the company to the fourth quadrant of unsatisfactory earnings and unsatisfactory return on investment. In that sense, the product improvement objective is similar to the capital restructuring and market expansion objectives of quadrants one and two.

<u>Unsatisfactory Earnings and Return Situation</u>

When a company finds itself in the fourth quadrant of the matrix, it has neither the margin nor the capital leverage to fall back on. Under such financial conditions, more extreme measures are normally required. It is, therefore, not uncommon for a company in this situation to manifest crisis management. Furthermore, marketing as well as other business operations such as manufacturing or purchasing are relatively less useful in this situation. Instead, the company must focus on its management practices and procedures.

There are once again two corporate objectives a company can establish to survive and bounce back to a more desirable financial position. The first is corporate retrenchment and the second longer term objective is corporate restructuring. Both are highly painful and unpleasant and require strong leadership at the top management. In fact, it is not unusual for many companies in this situation to hire a chief executive officer from outside the organization who can effectively act as a "hatchet man."

The Corporate Retrenchment Objective. This objective refers to organizational pruning and shaping so that it becomes a "lean and mean" organization. In the process, all the excess fat in operations and management should be systematically cut and eliminated.

One strategy for corporate retrenchment is one of overhead reduction. It requires systematic analysis of both controllable and noncontrollable costs and finding ways to eliminate them. Reductions in personnel may represent a critical need as witnessed by recent actions by Sears. Support systems such as consumer affairs may be eliminated or at least drastically reduced in funding. It may entail closing a number of branches or outlets which are highly unprofitable as A&P has done in the last several years. On the other hand, it may require closing certain manufacturing plants and consolidating operations into fewer factories as Firestone has recently done. Finally, it may require tougher negotiations with labor unions and seeking major wage and benefit concessions as has been recently done by all the three major automobile manufacturers as well as International Harvester.

A second strategy to achieve corporate retrenchment is reorganization. In general, it entails a greater degree of centralization, increased span of control, reduction in the number of hierarchical levels, and instituting incentive compensation plans. For example, Chrysler Corporation implemented a reorganization plan which consolidated its manufacturing to a much narrower product line by eliminating marginal or unrelated products. This included large cars as well as their military products division.

The general emphasis in the reorganization strategy tends to be one of focus and specialization. This may also cause divesting of manufacturing or marketing operations to concentrate on the strengths of the organization. For example, many American companies in the textile and consumer electronics industries have opted for outside sourcing especially in Korea and Taiwan, and have instead concentrated on domestic marketing operations.

The Corporate Restructuring Objective. The corporate restructuring objective refers to major decisions which impact the corporate mission and definition. This entails issues related to divestiture and diversification.

Especially in cases where the corporate retrenchment objective is not effectively reached and a worsening financial picture exists, a divestment strategy needs to be considered. In cases where management feels a redefinition of the business can make the firm profitable but where the funds required for such a move are unavailable, a merger may be particularly appropriate. Selling the firm to another business organization represents another possibility, although the market and

intrinsic value of a company with unsatisfactory earnings and return would be relatively low. If all else fails and financial conditions further deteriorate, the liquidation procedures of assignment or bankruptcy may be the only recourse. For example, a number of small breweries have been acquired by larger breweries in the face of increased competition and declining market shares. In the process, Heilmann has become the third largest brewery next to Anheuser-Busch and Miller Brewing Company. Similarly, a number of famous retailers such as A&P and Korvettes have been sold to foreign concerns. The Wickes Corporation recently filed for bankruptcy under Chapter 11.

If a firm is careful and engages in strategic planning, it is possible for it to initiate a <u>diversifaction strategy</u> early enough to revitalize itself from impending financial disaster, especially if a high level of financial reserves still exist. Here, the firm can (1) acquire other business organizations and/or (2) reallocate resources from one group of products to another group that will facilitate movement to its desired position in the marketplace. For example, several years ago Gould Inc. decided to diversify its business from industrial batteries to industrial electronics by acquiring another company. On the other hand, Zenith Corporation has successfully reallocated resources to make a partial switch from consumer electronics to microprocessors. Perhaps the best example of what looks like a very successful diversification program is the recent acquisition of Dean Witter (a financial brokerage firm) and Caldwell Bankers (a real estate firm) by Sears to position itself in the emerging financial services industry.

DISCUSSION AND IMPLICATIONS

In our view, the earnings-return model serves many useful functions in strategic market planning. First, it clearly subordinates all other functional goals and objectives such as market share, productivity, and growth to the more fundamental and essential corporate financial objectives. Since companies must be financially viable to survive and grow, this model is more realistic and reflects the concerns and philosophies of top management.

Second, the model enables the management to priortize its corporate objectives and consequent marketing strategies. For example, the model clearly discourages a company with poor reserves to engage in market expansion programs. Similarly, the model recommends short term and long term strategies for each financial situation with a clear logic that a company should engage in the short term strategies first.

Third, the model strongly suggests that the role of strategic marketing is far more critical in the off-diagonal quadrants where there is at least one financial leverage available to the company. By the same token, strategic marketing is least relevant when the company is in a poor financial condition and has to embark on a major coprorate retrenchment and restructuring program.

Four, it is interesting to note that the traditional elements of the marketing mix (promotion-selling and distribution) are most appropriate when the company has satisfactory margins but unsatisfactory return on investment. On the other hand, the other elements of the marketing mix (product and price) are more appropriate when the firm is experiencing a satisfactory return but unsatisfactory earnings. In another light,

the role of selling and distribution (push-pull strategies) is extremely critical at the early stages of the corporate life cycle. However, at the maturity stage, it is important to shift focus onto product-price elements of marketing. These are traditionally controlled by the manufacturing and accounting functions in a company.

Finally, the model is capable of business portfolio analysis for a large, highly diversified organization. Since each division or strategic business unit can be measured in terms of targeted earnings and return, it is possible to classify them into the traditional star (quadrant one), question mark (quadrants two and three), and dog (quadrant four) categories.[3] Business units in quadrant one should have relatively high levels of excess funds and borrowing capacity and, therefore, would represent a major source of funds for units in the other quadrants. However, the model also provides clues as to what to do within each quadrant besides how to allocate resources across the four quadrants. For example, it suggests how to plough back financial resources within the "star" businesses with the use of market entrenchment or market expansion objectives.

Any planning model should be used only as a guide to management; no model should be straightforwardly followed. This is certainly the case here. Indeed, some managerial judgment is necessary if the firm is near the boundary of two or more quadrants. On one hand, the firm could attempt to achieve the recommended objectives in its present quadrant. On the other, it could follow a preemptive strategy by seeking the objectives in the quadrant in which it is in danger of falling. At times, it may be necessary for managers to be selective in implementing the

recommended strategies. For example, for a firm in quadrant two, perhaps the market is saturated or a poor economy exists making increases in sales unattainable. In this case, the firm could mainly strive to decrease its current and fixed asset levels. Finally, there will always be some situations where the recommended behaviors and strategies may not apply or have primary importance. For example, in a certain industry for a company in quadrant two, seeking the volume improvement objective may invite a severe competitive reaction; management could decide to forego short-run improvements in return for the long-run welfare of the firm and industry.

A variety of extensions can be made to the earnings-return model. The objectives and strategies exhibited in the model are certainly not exhaustive. Other relevant organizational objectives and marketing strategies must be identified that are appropriate under varying earning-return scenarios. In some cases, adding more dimensions to the model may be relevant, including an explicit evaluation of other dominant organizational goals. For example, if growth is a primary goal for an organization, for whatever the reasons, it could be included as a third dimension in the model along with earnings and ROI. The model can also be applied to individual product lines or products given an adequate disaggregation of accounting data.

Among functional areas, only marketing was stressed in the model. An identification of strategies that can be implemented by other functional areas in the attempt to achieve organizational objectives would represent an extremely important contribution to the strategic market planning area. Certain functional areas would appear to take relatively

high prominence in each quadrant in the model. For example, marketing, finance, and production are functions of dominant importance in quadrant two (where revenues, turnover, and leverage are important) while, in quadrant three, marketing, purchasing, and cost accounting are prominent in an attempt to increase gross margins and decrease costs. By extending the model to include strategy development in other functional areas, the interdependence among the various functional areas of the firm could be more clearly identified. An evaluation of which functions should dominate the firm's operations and receive precedence in terms of resource allocations would be facilitated as a result.

CONCLUSION

An "earnings-return" model to aide the manager in his firm's strategic market planning is developed within the paper. Based on whether the firm is currently reaching both its targeted earnings and return levels, varying organizational objectives and marketing strategies are recommended. While the model can provide a foundation for a firm's strategic market planning, further refinement of the model and the development of other planning models and frameworks are clearly required to further promote the effectiveness and efficiency of the strategic planning process in modern business organizations.

FOOTNOTES

[1]Contrary to the modern definition of marketing, most companies still organize their operations separately for each element of the marketing mix. For example, the product variable is often associated with manufacturing and engineering, price with the cost acocunting function and place with the distribution function, with only promotion linked to the sales or marketing group. In that sense, our discussion is related to most operations within the firm.

[2]In most cases, a firm should seek the objectives and follow the strategies for the quadrant in which it is currently placed. However, where a firm is in danger of moving into a less desirable quadrant in the model (that is, it is near the boundary of two or more quadrants), a preemptive strategy may be most appropriate to follow.

[3]Care must be taken in making return on investment comparisons across divisions or business units within a corporation. Transfer pricing, varying depreciation schedules and industry conditions, the book value of assets, projects requiring heavy investments with long gestation periods in certain units, and a variety of other factors can make one unit's return look very different from the returns of other units in the corporation (Weston and Brigham 1972).

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Table 1

The Earnings-Return Model

	Targeted Return: Satisfactory	Targeted Return: Unsatisfactory
Targeted Earnings: Satisfactory	quadrant one 1. Market Entrenchment a. Share protection strategy b. Repositioning strategy 2. Market Expansion a. Multinational strategy b. Full line strategy	quadrant two 1. Volume Improvement a. Sales stimulation strategy b. Systems selling strategy 2. Capital Restructuring a. Distribution productivity strategy b. Reseller alignment strategy
Targeted Earnings: Unsatisfactory	quadrant three 1. Margin Improvement a. Repricing strategy b. Cost control strategy 2. Product Improvement a. Migration strategy b. Vertical integration strategy	quadrant four 1. Corporate Retrenchment a. Overhead reduction strategy b. Reorganization strategy 2. Corporate Restructuring a. Divestment strategy b. Diversification strategy

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