



# THE WATERMARK WIRE

## FACTORS AFFECTING RETURN ON INVESTMENT (ROI)



A question on many CEOs' minds is how to increase their company's return on investment (ROI). While most things have changed considerably in the past few decades, the factors that determine a company's ROI have not. These factors are still the same today as they were 40 or 50 years ago.

This *Wire* summarizes these timeless truths for companies contemplating on ways to increase their ROI. These truths are findings from the Profit Impact of Market Strategy (PIMS) study conducted by the Strategic Planning Institute, a non-profit corporation associated with Harvard Business School. According to it, and as reported in the *Harvard Business Review* (1975), there is a strong positive correlation between ROI and: market share, product or service quality, and investment in research and development (R&D). ROI is also quite strongly correlated with marketing expenditure, but not in the direction one would anticipate.

productivity from employees, and so on.

### Product/Service Quality

The second most important determinant of a company's ROI is product or service quality. When customers are satisfied with a product or service, they return as repeat customers. The best of all possible worlds would be for a company to have both high market share and superior product quality. In the PIMS study, businesses in this category averaged a 28.3% return on investment over the course of the study.

Even when quality was relatively inferior, average ROI for high market share businesses was a respectable 19.5%. On the other hand, superior-quality producers with low market positions earned an average 17.4% on investment, which suggests that high product quality can partially offset low market shares.

### R&D Spending

R&D spending is the third factor affecting a company's ROI. When market share is high, average ROI is highest when R&D spending is also high, typically above 3% of sales. These figures, however, do not identify which is cause and which is effect. One hypothesis offered up is that businesses that are highly profitable—for whatever reason—are inclined to invest more of their earnings in research.

Most likely, the positive relationship between ROI and R&D spending reflects both this kind of "reverse causation"—that is, that high ROI encourages companies

### Market Share

The PIMS study identified market share as the single largest determinant of a company's ROI. Specifically, as a company achieves a higher share of the market, it also tends to have a higher profit margin and higher priced products while experiencing a decline in marketing costs as a percentage of sales. On average, businesses with market shares above 36% earn more than three times as much as businesses with less than a 7% share of their respective markets. There are at least three contributing factors: economies of scale, market power, and management quality.

Economies of scale is the most obvious and cited rationale for companies to engage in mergers. Intuitively it makes sense. If you currently own 20% of the market,

and acquire someone else in your industry, you can significantly increase market share. After the acquisition, your marketing, procurement, and other non-variable costs will be much smaller as a percentage of sales.

In turn, market power enables larger businesses to earn higher profits than their smaller competitors. Large size permits a business to bargain more effectively, "administer" prices, and, in the end, realize significantly higher prices for a particular product.

Finally, management quality increases ROI as high performing managers are successful in achieving large portions of their respective markets; these managers are skillful in controlling costs, getting maximum



# THE WATERMARK WIRE

to invest in R&D—as well a real, positive impact of R&D, in that investments in R&D help drive ROI up.

Interestingly, when market share is low, the relationship between R&D and profitability is exactly the opposite from the above: the higher the level of R&D spending, the lower the profits, on average, for low market share companies.

Sometimes, low profits coupled with high R&D spending is representative of a “transitional time” for a company. Among businesses with low market shares, ROI was higher (11.6%) when new products comprised a relatively high proportion of total sales compared to when new products represented only a small fraction of sales (average ROI, 5.3%). Thus, when and if R&D spending is successfully converted into new products, it can pay off.

### Marketing Expenditure

In contrast to market share, product/service quality, and R&D expenditure, all of which are positively correlated with ROI, marketing expenditure has a negative relationship with ROI. That is, a high level of marketing expenditure diminishes ROI somewhat for businesses with “average” or “superior” relative product quality.

However, for businesses with relatively low product quality—exactly equivalent or somewhat inferior to competition--the negative impact of marketing costs is much larger. This confirms the old adage that “it doesn’t pay to

promote a poor product.” It also suggests that sellers of higher quality products or services could inflict severe short-term penalties on weaker competitors by escalating the level of marketing costs in an industry—and that lower-quality producers should try and avoid such scenarios like the plague.

### Inorganic Growth

Although there is validity to the fact that market share, product/service quality, investments in R&D, and marketing costs correlate with ROI, that argument has lost steam over the past forty years. In many companies, management believes the only way to increase ROI is through inorganic growth, or mergers.

While this is a valid path to grow or retain market share, most acquirers are hasty, have unrealistic goals, and/or have not done their homework. This typically results in acquirers overpaying as management’s hubris kicks in. While the outlook is rosy at the onset, the synergies of the acquisition are

rarely realized or optimized, and the company begins to suffer as the acquisition fails to meet its ROI goals, reducing the company’s market share and overall ROI.

Such patterns highlight the importance for a company to engage in extensive preparation for an acquisition and give thorough attention to the transaction and post-transaction phases. When structured correctly, acquisitions can and should increase market share and ROI. However, a company will need to understand the importance of, and invest time in, the preparation, transaction and integration phases as well as to acquire at the right price.

Watermark Advisors teaches the processes necessary for your team to win in an acquisition through its extensive, one-day Master Class in Mergers and Acquisitions, which includes step-by-step guidance in how to successfully take your company through all the acquisition phases: preparation, transaction, and integration.

### ATTEND WATERMARK’S NEXT 1-DAY MASTER CLASS IN M&A!\*

NOVEMBER 12, 2015 (8:00am-6:30pm)  
Greenville, South Carolina

A comprehensive, interactive class on best practices for corporate acquirers. Intended for C-suite, board members, and line managers—all who would be involved in the acquisition process.

\$1,000 (includes lunch & beer/wine networking)

Full content: [www.watermarkadvisors.com](http://www.watermarkadvisors.com)

Hosted by:



\*3-4 classes offered per year