What Makes Marketing Tick? A Chain-of-effects Perspective

Abstract

This paper combines the 'chain-of-effects' framework for marketing productivity with agency theory to explore the underlying mechanism that drives the effects of marketing decisions (measured by marketing expenditure and relative compensation for executive directors with marketing experience) on firm value (Tobin's Q) via firm performance (market share). Data from 491 Chinese listed companies over the 2010-14 period shows that marketing expenditure positively affects firm value but not through market share. In contrast, relative compensation positively affects firm value, both directly and through market share. Moreover, the positive effect of relative compensation on market share appears to be stronger in an organization with more severe agency conflicts. Besides extending current research on the effects of marketing decisions on financial outcomes, this study highlights the importance of having executive directors with marketing experience and paying them relatively better compensation compared to the industry, to increase both market share and firm value.

Keywords: chain-of-effects; marketing expenditure; relative compensation

Citation

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Introduction

Recent trends indicate a continued decline in the importance and status of marketing within organizations (Homburg et al. 2015), as reflected by marketing budget cuts (Rust et al. 2004), no clear evidence about the impact of chief marketing officers (CMOs) on firm performance (Nath and Bharadwaj, 2020), marketing executives' shorter tenure relative to other executives (Nath and Mahajan 2017; Srinivasan and Hanssens 2009), and lack of credibility and legitimacy for marketing function (Park et al. 2012). A major reason for the continuing uncertainty about marketing's impact on firm performance is the inability to demonstrate direct contribution of marketing to firm value, possibly because marketing creates intangible assets, such as brand equity, customer equity and market-sensing capability, which have long-term impact and are difficult to measure reliably and objectively (Srinivasan and Hanssens 2009).

As a result, most studies simply focus on the direct relationships between marketing decisions and financial outcomes, without providing much evidence about the mechanism underlying these effects (e.g., Abernathy et al. 2013; Frennea et al. 2019; Kim and McAlister 2011; Xiong and Bharadwaj 2013). In this context, Rust et al.'s (2004) 'chain-of-effects' framework provides a comprehensive understanding of the contribution of marketing to an organization, by showing that marketing activities lead to immediate marketing outcomes, and the marketing outcomes in turn affect financial results (Stewart 2009). In this paper, we extend this literature by comparing the impact of marketing expenditure and relative compensation

Theoretical Background and Hypotheses

According to Rust et al. (2004), the chain of marketing productivity starts with marketing tactics and strategies (e.g., marketing activities and associated marketing expenditure) which are expected to enhance customer attitudes and satisfaction, and create marketing assets such as brand equity and customer equity. The customer impact and marketing assets then lead to market outcomes (such as market share), financial impact (such as return on investment), and firm value impact (such as market capitalization), respectively (Rust et al. 2004). Moreover, the non-linear market response models (e.g., Hanssens et al. 1990; Lilien et al. 1992) suggest a diminishing return on marketing investments. Accordingly, we posit as follows:

H1: Marketing expenditure has a) positive U-shaped effect on market share, and b) positive effect on firm value.

Past studies also highlight the importance of motivational programs to encourage marketing executives to perform better, such as incentive pay (e.g., Segalla et al. 2006), especially under high competition intensity (Banker et al. 1996). We combine these perspectives with agency theory, efficiency wage theory and gift exchange theory, to argue that paying higher relative compensation (compared to the industry average) to senior executives (e.g., directors and board members) with marketing experience will motivate them to act diligently to improve the firm's market position by managing all the available resources in the most efficient manner.

H2: Relative compensation has a positive effect on a) market share, and b) firm value, and c) it positively moderates the positive effect of marketing expenditure on market share.

Past research also shows that chasing market share can be harmful for financial performance, and the main goals of business organizations should be self-oriented, such as profit maximization and shareholder wealth creation rather than competitor-oriented, such as beating competitors and wining market share (Armstrong and Collopy 1996). Adoption of competitor-oriented strategy can lead to lower shareholder return and value destruction rather than value creation (Slater and Zwirlein 1992). Firms driven by market share objectives are found to have lower profits and lower survival prospects (Armstrong and Collopy 1996). In addition, some "diseconomies of scales" may also arise if market share exceeds the capacity level and a firm is unable to cope with the high demand (Hellofs and Jacobson 1999), which may result in further deterioration of the firm's performance. Hence, we hypothesize as follows:

H3: Market share has a positive U-shaped effect on firm value.

Methodology

We use data from China Stock Market and Accounting Research (CSMAR) database for 491 non-financial firms listed on the Shanghai and Shenzhen stock exchanges, who have executive directors with marketing experience (224 state-owned and 267 privately-owned). We control for several firm characteristic variables that may affect market share and firm value, such as *R&D to Sales*, *Firm Age, Firm Size* along with industry dummy variables (Fabrizi 2014). We use moderated multiple regression analyses to test all our hypotheses.

Data Analysis and Results

$MEXP_{t-1}$ has a significant negative effect on MS_t ($\beta = -0.18$, $p < 0.05$) but $MEXP^2_{t-1}$ has a significant positive effect on MS_t ($\beta = 0.04$, $p < 0.05$). Thus, relative marketing expenditure has a positive U-shaped effect on market share, supporting H1a. $MEXP_t$ has a significant positive effect on firm value ($\beta = 0.51$, $p < 0.05$) but $MEXP^2_{t-1}$ has no significant effect on firm value ($\beta = -0.08$, $p > 0.10$). Hence, relative marketing expenditure has a positive effect on firm value, supporting H1b. Next, both MRC_{t-1} ($\beta = 1.55$, $p < 0.01$) and MRC^2_{t-1} ($\beta = 2.10$, $p < 0.01$) have significant positive effects on MS_t, showing a positive exponential effect of relative compensation on market share, supporting H2a. Interestingly, $MEXP_{t-1}{}^*MRC_{t-1}$ interaction has a non-significant negative effect on MS_t ($\beta = -0.07$, $p > 0.10$) but $MEXP^2_{t-1}{}^*MRC_{t-1}$ has a marginally significant positive effect on MS_t ($\beta = 0.03$, $p < 0.10$), supporting H2c. Both MRC_{t-1} ($\beta = 1.26$, $p < 0.01$) and MRC^2_{t-1} ($\beta = 0.83$, $p < 0.05$) have significant positive effects on firm value, hence relative compensation has a positive exponential effect on firm value, supporting H2b. Finally, MS_{t-1} has a significant negative effect on firm value ($\beta = -0.19$, $p < 0.05$) but MS^2_{t-1} has a significant positive effect on firm value ($\beta = 0.28$, $p < 0.05$), hence market share has a positive U-shaped effect on firm value, supporting H3.

Discussion and Conclusion

This study shows that pay premium (high relative compensation) can be used as an alternative to equity-based compensation to incentivize marketing managers to work diligently to improve financial performance. Together with Fabrizi (2014), this study confirms that executives with marketing experience contribute to firm value, especially when their compensation contracts are designed properly to motivate them to translate their human and social capital into shareholder wealth. By showing the performance implications of pay premium, this study also adds new evidence to the literature on efficiency wage and gift exchange theories. Hence, firms who pay their executive directors with marketing experience relatively higher compensation compared to the industry, are likely to improve their market share as well as firm value.

Limitations and Future Research

Our findings confirm the impact of marketing decisions on firm value, especially when the compensation contracts for marketing managers are properly designed to motivate them to expend their efforts and resources in the right direction. While this study shows that focusing marketing effort and resources on competition may not always be beneficial to the shareholders, it does not fully address the broader question of how marketing effort and resources should be allocated among various tasks to enhance shareholder value. Marketing functions and marketing outcomes are multifaceted (Rust et al. 2004) and marketing tasks are synergistic (Nath & Bharadwaj, 2020), which provides a possible avenue for future research.

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