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# Is advertising for losers? An empirical study from a value creation and value capturing perspective

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## ABSTRACT

Does advertising lead to higher profits? This question has preoccupied company executives and academic researchers for many decades. Arguments have been put forth in both directions, and evidence is mixed at best. In this article, we re-examine the question from a value creation and value capturing perspective, which allows us to re-interpret and reconcile the different views and empirically validate the resulting hypotheses. Using a database of the top 500 brands of established companies during the 2008–2015 period, we find that advertising spending has no significant impact on profitability, while both brand value and research and development (R&D) spending have a clearly positive effect. In addition, we observe a positive interaction effect between advertising spending and R&D spending and a negative interaction between brand value and R&D spending on profitability. These findings corroborate the view that advertising in and of itself does not improve profitability; rather, its effect is positive only when it acts in support of customer value creation as a result of R&D.

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## 1. Introduction

Does advertising increase or decrease company profits? For decades, marketers and financial analysts in both academia and the corporate world have asked this question (e.g., Rust, Ambler, Carpenter, Kumar, & Srivastava, 2004). Marketing directors often express their lingering doubt with the popular conundrum that “though roughly half the marketing budget might be wasted, they do not know which half.”

Rarely have alternative views on the relationship between key economic and business variables been so divergent, on both theoretical and empirical levels. More than 50 years ago, the *Journal of Marketing* published an article titled “What about the Relationship among Sales, Advertising, and Earnings?” (Tweedt & Knitter, 1964); yet, so far, a universal, crystal clear, and undisputed answer has not been achieved.

During the years, the discussion on the effectiveness of advertising has become rather polarized, with the two opposing views

labeled “advertising as market power” and “advertising as information” (e.g., Mitra & Lynch, 1995; Wilcox, Kang, & Chitek, 2015). The latter view treats the customer receiving or seeing the advertisement as the main beneficiary because advertising provides knowledge about the company offering and increases price sensitivity by stimulating competition; conversely, for the former, the beneficiary is the company spending the money because advertising persuades customers to consume more products or services from that company while decreasing their price sensitivity (Wilcox et al., 2015). Most prior research has focused on developing one of these views, rather than building bridges between them (e.g., Bahadir, Bharadwaj, & Parzen, 2009; Erickson & Jacobson, 1992; Taylor, 2013). Some studies have tried, at least indirectly, to combine both, by considering the effect of advertising and brand value on firm performance, because “brand equity represents the added value the product garners as a result of past investments in the marketing activity for a brand” (Eng & Keh, 2007, p. 92). Other studies suggest that the diverging results are the product of different research purposes and methodologies used (Peterson & Jeong, 2010).

In an attempt to bridge the gap, we analyze the issue from a different angle, more specifically by distinguishing between the concepts of value creation (for the customer) and value capturing

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(for the shareholder), also referred to as value appropriation or value claiming as introduced in the strategic management field (e.g., Aspara & Tikkanen, 2013; Bowman & Ambrosini, 2000; Lepak, Smith, & Taylor, 2007) and, to a lesser extent, in marketing literature (e.g., Mizik & Jacobson, 2003; Kotler & Armstrong, 2013). We develop and test a model that analyzes the influences of advertising, brand value, and research and development (R&D) on profitability. The advantage of this angle is that the different beneficiaries of the traditional views are reunited into one model. The value creation–value capturing approach thus allows us to reconcile some of the apparent contradictions in previous research and to develop relevant and better-specified hypotheses that are empirically supported. By explicitly distinguishing the value creation and the value capturing dimensions, we also attempt to address previously stated concerns, such as that of Eng and Keh (2007, p. 91), who observe “While brand value creation is generally regarded as a ‘good thing’, we need to have more concrete measures of brand value appropriation.”

The structure of this article is as follows: We begin with a review of the literature, after which we develop our hypotheses, provide the model to be tested empirically, and describe the data in detail. Then, we report the empirical results. We conclude with implications for theory and practice, research limitations, and avenues for further research.

## 2. Literature review and hypotheses development

### 2.1. Background

Stemming from industrial organization theory, two major “schools” of thought on advertising spending emerged in the second half of the 20th century. First, the “power school” treats advertising as a tool to increase market power (Comanor & Wilson, 1972) by convincing customers to choose a certain brand, increase loyalty, and reduce price elasticity (Wilcox et al., 2015). In line with this view, advertising is considered a tool to shift market share among existing competitors while creating barriers to enter for new competitors (Carlton & Perloff, 1990). Recent research even shows that in mature markets, the revenues of the firm drive the advertising spending, rather than the reverse (Darrat, Wilcox, Funches, & Darrat, 2016).

If this notion is valid, just the mere size of a company and its total advertising spending should yield economies of scale because of fixed costs, access to more effective media, and the impact of repetition. Marshall (1919, p. 199) described the third point as follows: “The chief influence of such advertisement is exerted, not through the reason, but through the blind force of habit: people in general are, for good and for evil, inclined to prefer that which is familiar to that which is not.” Thus, it is no surprise that followers observe several benefits of this school, including increased sales and market share (Bahadir et al., 2009), increased profits (Eng & Keh, 2007), and increased market value (Erickson & Jacobson, 1992). The benefits of advertising also reach beyond the boundaries of the firm in that “advertising can also act as a signal of financial well-being or competitive viability of the firm” (Joshi & Hanssens, 2010, p. 22) and, as such, can increase the salience among investors (Srinivasan & Hanssens, 2009).

The second major school, called the “information school” (Nelson, 1974), refers to the benefits that advertising can generate for consumers. Advertising informs consumers about (new) products and services, reduces search costs, and, as such, expands demand (at the brand or category level) but also stimulates competition within the industry (Ali Shah & Akbar, 2008). Moreover, research predicts that advertising facilitates entry of new competitors (Taylor, 2013). Because advertising information also

contains pricing data, customers become more price sensitive, and prices are lowered. Part of the advertising industry (e.g., Deloitte, 2013), as well as some academic literature (e.g., Taylor, 2013) embraces this school of thought. The positive effect of advertising on total demand in established markets is questioned when it leads only to a shift in market share from one player to another (Wilcox et al., 2015).

Overall, conclusions of the research stemming from both the first and second schools have rarely led to a uniform answer, and the outcomes depend largely on environmental variables at the market and brand levels (as well as the particular data sets used). Recent research concludes that in mature markets, the main purpose of advertising is to defend or increase market share rather than stimulate overall demand (Darrat et al., 2016), which is in line with an alternative school of thought on which we focus in this article.

The alternative school of thought, which has emerged in the past decade, is based on the distinction between value creation and value capturing and is further referred to as VC<sup>2</sup> (Hawawini, Subramanian, & Verdin, 2004; Verdin & Tackx, 2015). This view derives less from the advertising domain and more from the strategic management and marketing fields. According to this view, to create long-term shareholder value (or value capturing), a company’s primary focus should be on developing a compelling and valuable offer to customers (or value creation), resulting in the so-called value proposition. It is then up to customers to decide whether the proposed offer creates value for them and thus is worth paying for (as the basis for the appropriate pricing or value capturing).

Companies following this approach need to offer (consistently better) value to customers (consistently lower prices or consistently better products and services), for which both R&D and advertising (to publicize these offerings to existing and potential customers) are necessary. This framework deems R&D an important basis for value creation, because its outcome is superior products or services and distribution processes (Mizik & Jacobson, 2003), despite uncertainty and risks (O’Brien, David, Yoshikawa, & Delios, 2013). If offerings are not compelling enough, companies may resort to advertising spending in an attempt to “compensate” for the lack of attractiveness (Larreche, 2008). Conversely, companies whose products or services are convincing in their own right may be able to decrease their advertising spending and capture superior value for shareholders. Table 1 summarizes the different views of the impact of advertising according to the different schools and serves as the cornerstone for hypotheses development.

### 2.2. Advertising

The traditional view (as represented in the power school) goes as follows: a company takes an action (advertising) that has an impact on the customer (change in perception of needs and/or expectation), such that he or she takes a subsequent action (purchase) that modifies the firm’s position in the market (e.g., increased market share; Chaudhuri, 2002), thus affecting its financial metrics (i.e., profit; Sriram & Kalwani, 2007) and, in turn, eventually influencing the value of the firm (Rust et al., 2004) and reducing its systemic risk (McAlister, Srinivasan, & Kim, 2007). Attempts to quantify and measure this process, however, have faced the major challenge of various intangible factors (Mittal, 1999) that influence the overall customer perception. At the end of the process, it is up to customers to judge the usefulness of the communication (Mittal, 1994), but marketing activities are supposed to increase the performance of the firm (Peterson & Jeong, 2010).

Advertising can play a key role in value creation and capturing.

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