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How To Tell If An Advertisement Costs Too Much

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If I've heard it once, I've heard it a thousand times: "This advertising costs too much!" Our clients frequently go into cardiac arrest when they see how much the advertising for media in certain markets will cost them. I'll admit it's pretty easy to get sticker shock when you see that a sixty second radio commercial on a popular Los Angeles station could cost you a thousand bucks. Each. Ouch. Or when you realize that all the dot com businesses in Silicon Valley have made radio spots on top stations in the San Francisco market cost as much as \$2,500. A minute. Or when you realize that a newspaper ad barely bigger than a Hershey Bar in your city will cost a couple grand. It's easy to automatically think that's a lot of money. Now here's the important question for you, the advertiser: Does the ad actually cost too much?

So what's the answer? The savvy advertiser will tell you the cost of the ad is not the issue. What's important is the return the ad will bring. Think about it this way: if I charged you even as much as \$40,000 for a sixty-second radio commercial that generated enough sales to make you a profit of \$50,000, then would the \$40,000 be A LOT? The answer is NO! Of course not! You'd be a fool not to beg, borrow or steal the \$40,000 so you could make the \$50,000 profit! Try getting that kind of return in the stock market!

How do you think these big companies can afford to spend over two million bucks for a thirty second TV commercial during the Super Bowl? They know that an enormous amount of people will see it - enough to make the return on investment a good deal. Well, at least they hope it will.

The point is simple: you've got to figure out how much money an ad will make you before you draw a conclusion of whether or not it costs too much. So how do you do that? It's actually pretty easy. Here's a simple process for determining the Return on Investment (or ROI) of an ad. First, you've got to know how much profit you make on

each sale. For instance, if you buy whatever it is you sell for \$50 and sell it for \$100, your gross profit is \$50. That's easy enough. Figure out your gross profit. Step two is to figure out what your closing ratio is. If, on average, you close one sale for every four people who inquire, that's a 25% closing ratio. If 9 out of 10 end up buying, then your closing ratio would be 90%. This is simple math. Now figure out what your break even is. Do this by taking cost of the advertisement and divide it by the amount of gross profit per sale. Remember, we already figured out what your gross profit is a second ago. So how much do the ads cost? If the ads cost \$1,000 and your average gross profit is \$50, that means you've got to make 20 sales to make back the \$1,000 - that's your break even point - in this example, it's 20 sales. Fourth and last, figure out the number of leads you need to generate from the ad if you are to break even. To do this, you've got to know your closing ratio, which we just figured out also. Let's say it's 25% - meaning you close one out of four people who inquire - so if you close 25% and you need 20 sales to break even, that means that your \$1,000 worth of advertising needs to generate 80 leads to break even.

Now I know it sounds kind of complicated, but it's actually really pretty simple. We just calculated in the example that if the \$1,000 ads can generate 80 leads, you would break even. That's a return on investment of 0. I'm not saying that your goal is to break even. I realize that you're in business to make a profit. But let's start with breaking even; that's the bare minimum you can accept when running an ad. Hey, at least you didn't come up with a NEGATIVE return on investment! So let's say your goal was to double your money. What would have to happen to your numbers? That's right, you'd have to double your lead flow or, in this case, generate 160 leads instead of just 80. That means if you generated 160 leads you would generate a profit of \$1,000 - again, on \$1,000 spent. In other words, you've doubled your money. Your return on investment is 100%. That's pretty easy to follow, isn't it? By way of review, what we're trying to do is calculate your return on investment for your advertising. As you go through these, think about your numbers in your business. Here are the four steps again:

1. What's your gross profit per sale?
 2. What's your closing ratio?
 3. What's your break even...in terms of number of sales needed?
 4. How many leads does your ad need to generate enough sales to break even?
- What's your return on investment on any given number of leads you generate?

Now realize something important here. In this exercise, we've just figured out how many leads you need to generate to break even on the cost of the advertisement and then calculated the ROI for how many leads your ad ends up generating. That's a good piece of information to have, but now I want to take it a step further. Let's figure out what's known as the Lifetime Value of a Customer. What if your average customer brings you a \$50 gross profit per sale like in the example we just went through? Is that the only time that customer will ever buy anything from you? I hope not! How many times does that average customer come back in the course of a month or a year? If your average customer shops with you once a month and makes you \$50 of gross profit every time, that customer is now worth \$600 a year - in profit. And if you know that your average customer stays with you for 3 years, now that \$50 a month client is worth a tidy \$1800. So now how much would you be willing to spend on marketing and advertising to accrue that client? What if those were your average numbers, \$50 a month for 3 years? Remember where we broke even in the example earlier with 80 leads and just 20 sales? Now those 20 customers would be worth an astounding \$36,000 over the next three years. And it only cost you a thousand bucks worth of advertising. Now your break even looks a lot better doesn't it? If you could accrue a \$36,000 annuity every time you ran a thousand dollars' worth of

ads - all things being equal - I'd tell you to mortgage your house and spend as much money as possible on advertising!

Here are a couple of words of advice when figuring your return on investment for advertising. First, always estimate your numbers conservatively - in other words, on the low side. Always figure on getting a lower number of leads than you're hoping for and expecting. Always count on a lower closing ratio than you're used to. If you calculate your numbers using conservative figures, then you'll do fine if your results are actually lower than projections and in the event you do as well as you had initially hoped, you'll just make more money than you expected.

Let's take a real life example to give you a little better idea about this ROI stuff. We worked with a client who was promoting seminars where they would attempt to sell a service that cost \$8,000. They hired us to do their advertising for them to promote these seminars and the question of how much budget should they allot came up. They wanted to start filling seminars within a week of when they hired us, so we decided that fax broadcasting would be the best way for them to quickly get the message out about the seminars. We could do faxing for as little as 7 per page in some major metropolitan areas, so they came back and said they thought they would want to send 25,000 faxes a week for the 5 weeks they would be doing seminars. So we asked them, how many sales were they planning on generating? They said because of a unique financing plan that allowed them to sell their package on a low monthly payment basis, they thought they could sell at least 100 packages in that 5 week time period.

Well, 100 packages is a lot and we told them that they would have to do at least 100,000 faxes a week for the 5 week period to get the number of leads required to sell that many packages. The guy got his calculator out and did some quick math and realized that I had just told him that he had to spend \$35,000! 7 times 100,000 faxes times 5 weeks! That number - \$35,000 - sounded so huge, it caught him off guard. His idea was to spend just under 2 grand a week or a total of less than \$9,000. Big difference. That's called "sticker shock."

So what we did was figure out the ROI according to the steps I just gave you. Remember the steps? They are: First, figure out your gross profit per sale. He said his was about \$3,250. Second, figure out the closing ratio. He thought his would be about 20%. We thought that sounded awfully ambitious, so we cut the numbers in half. So then, how many sales would he need to break even on a \$35,000 advertising expenditure? Well, 35,000 divided by \$3,250 gross profit per sale is about 11 sales - just 11 sales to break even. So if his closing ratio was just 10%, he'd have to generate about 110 leads to break even. 110 leads on 500,000 faxes? I'll tell you right now, that's a laughable number. Easily attainable. The last thing to do would be to figure out how many leads he has to have to reach his goal. His goal was 100 sales and his closing ratio was 10%. That means he'd have to generate about 1,000 leads. On 500,000 faxes sent out, that's like a two-one-thousandths of a percent response. A very doable deal. He'd generate a total gross profit on the deal of \$325,000 and if you subtract out the \$35,000 advertising cost, that's still a healthy gross profit. His attitude toward the \$35,000 changed instantly.

Do you see how that works now? Just run through your numbers and you'll know how much money is a lot of money when it comes to advertising.

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