Agency Profit: The Rules of the Road

A User's Guide to Agency Profit
Parameters & Targets
Frequently Asked Questions (FAQs)

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4A's

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Overview

When the marketing service industry moved away from agency compensation based on media commissions, most industry practitioners shifted to fixed fees, labor-based fees, cost-based and, in some instances, cost-plus remuneration methodologies. In conjunction with the evolution of cost-based and cost-plus compensation, many agencies began to justify their fees and labor rates by deconstructing agency compensation into labor, overhead and profit components.

Over time, there has been extensive discussion within the marketing services and client communities related to agency profit. Much of the agency profit discussion has been in response to client compensation consultants' and client procurement groups' efforts to benchmark and, in some instances, cap or limit the agency profit component of cost-based compensation arrangements.

Members of the 4A's Finance committees believe that it is in the best interest of both the agency and client communities to provide information on agency profit, including predominant industry profit parameters and targets.

Frequently Asked Questions

Agency management and agency financial executives are frequently asked questions relating to agency profit by client marketing and procurement, compensation consultants, search consultants and other industry participants. This document provides rules of the road for agency profit and references predominant industry perspectives.

The information is structured in a Frequently Asked Questions (FAQs) format, i.e., questions followed by answers that contain information and best practices.

FAQ #1, Industry Profit Expectations

Question: Is there an industry-standard profit ratio or expected "norm" for agency profitability? How is the agency profit ratio calculated?

Answer: There is no singular industry standard agency profit ratio. Agencies independently develop profit targets, which they update from time to time and from situation to situation.

Agency profitability is generally expressed as a margin percentage of the agency fee (i.e., Profit Margin), however, unlike agencies, some parties think of profitability as a markup on costs multiplier (i.e., Profit Markup).

Understanding Differences in Agency Profitability Definitions Is Important
The difference between Profit Margin and Profit Markup is significant.

Profit Margin expresses profit as a percentage of Agency Client Revenue.
Profit Markup is an expression of agency profit in terms of operating expenses (costs).

The terms Profit Margin and Profit Markup should not be confused. The following calculation illustrates that a frequently referenced industry Profit Markup of 25% yields the same result as a 20% Profit Margin.

The following example illustrates the calculation of these terms using the following values:

- $100 Agency Client Revenue (Client commissions, markups, fees or other forms of client compensation)
- $80 Agency Operating Expense (Client Direct Labor plus Overhead)
- $20 Profit (Profit represents the difference between Agency Client Revenues and Agency Operating Expenses)

Example 1—20% Profit Margin
$20 Profit/$100 Agency Client Revenue = 20% Profit Margin

Agency Profit Margin is normally calculated by looking at operating profit (client revenue less all reasonable and customary agency operating costs) divided by Agency Client Revenues (commissions, fees, incentives and other client remuneration)

Example 2—25% Profit Markup
$20 Profit /$80 Agency Operating Expense = 25% Profit Markup

An agency profit markup is normally applied to all reasonable and customary agency operating costs, i.e., payroll costs (W-2 and 1099 items), plus payroll-related costs (payroll taxes, contributions to employee benefit and savings plans, and payment into retirement plans) plus other agency overheads. Markup is not normally applied to financing costs or income taxes.

FAQ #2, Agency Profit Tiers

Question: Do agencies differentiate between Profit Margin targets for specific service arrangements and tiers of the business? For example: Client level profitability? Agency office and agency brand level profitability? Agency group or holding company level profitability?

Answer: Agencies often develop different Profit Margin targets for different business tiers.

Client Profitability

Within an agency's portfolio of clients, profitability on individual client business can and does vary from period to period, as well as in conjunction with the nature of the client assignment. While many agencies have profit targets for different levels of business, aggregate client profitability is generally benchmarked at a 20% margin.

Business Unit Profitability

It should be noted that for an agency office or agency brand, in order to achieve an aggregate Profit Margin level of 20% across the portfolio of clients, the agency will have some clients making less and some clients making more than a 20% Profit Margin, often related to either the volume of client business or the nature of services provided.

Holding Company Profit

A Holding Company may provide its agencies with varying degrees of centralized services that can include; Payroll Administration, Employee Benefits, Real Estate, Legal/General Business, Legal/Ad Copy Clearance, Travel, Procurement, Financial Reporting, Audit, Tax, Treasury, Insurance and Marketing Intelligence.

Some Holding Companies provide a high level of centralized service, as they believe it is less expensive. Others believe that Holding Company centralized services allows agency management to focus on clients and growth and not on day-to-day administrative matters/support, and still others may leave most services to operating company management. There is no right or wrong method.

For a variety of tax and other reasons, not all of Holding Company service costs can be charged back to the agencies. Under this circumstance, the operating company/agency is getting service at no cost that inflates or misrepresents its true operating profit level. For this reason, the agency profit target must be higher to reconcile the overstated operating profit level and so the Holding Company can achieve a competitive profit level.

Recognizing that business entity targets and actual performance vary from period to period, frequently referenced Profit Margin benchmarks for industry business tiers are noted in the chart below:

	Illustrative Profit Margin Ranges
Individual Client Profitability	15%–25%
Agency Business Unit Benchmark	20%
Holding Company Consolidated Benchmark	13%–17%

FAQ #3, Agency Profit and Pricing Dynamics: Individual Project Assignments versus Annual Retainer Assignments

Question: Some clients work with agencies on a project-by-project basis (PxP), while other clients commit to annual scopes of work and retainer arrangements. How does predictability of work activity and fee commitments impact agency profitability and pricing?

Answer: Most agencies price project assignments differently than they price retainer assignments. Project-by-project arrangements have inherent built-in inefficiencies for an agency. For example, the cost of planning and selling-in the project, higher costs of indirect labor, lower and inconsistent levels of staff utilization, the risks of a project being terminated and because project uncertainties make it difficult to plan for long term commitments (e.g., commitment to fixed costs such as real estate, equipment, technology), most agencies elevate their labor rates and apply higher Profit Margin requirements for many projects.

PXP Arrangements

Pricing agency services in a project environment requires agreement on agency compensation for upfront planning, discovery and project estimation in addition to payment for back-end project execution.

Structuring PxP assignments with existing clients or prospective clients results in added burdens for an agency. Because agency revenues are less predictable on PxP assignments, resource planning is more difficult and risky. Speculative strategy development, planning and budget estimation are often required in advance of bidding on the execution of a project that requires agency resourcing for which the agency is often paid a consultative fee.

Agency Profit Margin targets vary from project to project and may often vary within the phases of a project, for example, many agencies apply a higher profit level to strategic, planning and ideation than they do to day-to-day execution.

Retainer Relationships

Predictability of retainer relationship service activities (annual scopes of work) and client commitment to an annual agency fee allow an agency to efficiently allocate staff, enter into more cost-effective service options and allows the agency to more accurately plan for revenues and expenses. Both agency and client benefit from these efficiencies. Agencies will consider revenue predictability and operations efficiencies when costing and pricing client assignments and calculating the Profit Margin.

Best-in-class agencies have screening criteria that incorporate the agency's business principles, operations requirements and profitability parameters. Agency screening criteria recognize the reality that not all clients and not all projects are worth pursuing.

FAQ #4, Agency Profitability Compared with Marketer Profitability

Question: How does agency profitability compare with the profitability of client marketers?

Answer: It depends on how you calculate profitability and what business category or sector is used for comparison.

Profitability Calculation Methodology
Agency profitability, if viewed as a percent of agency gross income, might be 20%, however, if agency profitability is viewed as a percent of client marketing spend, the ratio is likely closer to 3%, or if viewed as a percent of the client's brand sales, the agency profit ratio is likely less than 1%.

Consider the illustrative example provided below:

Illustrative Client Financial Statements

Assume that a client has a brand with sales of $10 million and advertising expenditure of $1 million ($850K net media/production/billable OOP and $150K agency fee)

	Client	
Sales	$ 10,000,000	% Sales
COGS	(4,000,000)	
Gross Profit	6,000,000	60%
Advertising Expenditures	(1,000,000)	
Other Marketing Expense	(1,000,000)	
Other Operating Expenses	(2,000,000)	
Client Operating Profit	$ 2,000,000	20%

Typical Client P&L at the Agency

Now assume that the agency that is working on the client's business is paid a fee of $150K and earns a 20% profit margin on that fee (i.e., $30K).

	Agency	
Revenue (Commissions, Fees)	$150,000	% Revenue
COGS (Agency Operating Expense)	(120,000)	
Agency Operating Profit	$30,000	20%

“Grossed Up” Agency Financial Statement

When publicly traded agency holding companies report financial results, they report agency revenues (they do not report client billings) and express profit as a margin on agency revenues. However, as illustrated in the chart below, if you were to view agency profit ($30K) in the context of the client’s advertising expenditure (i.e., billings, $1 million) or the client’s sales ($10 million), the agency profit ratios are very modest (3% of ad spend and only .3% of the client’s brand sales).

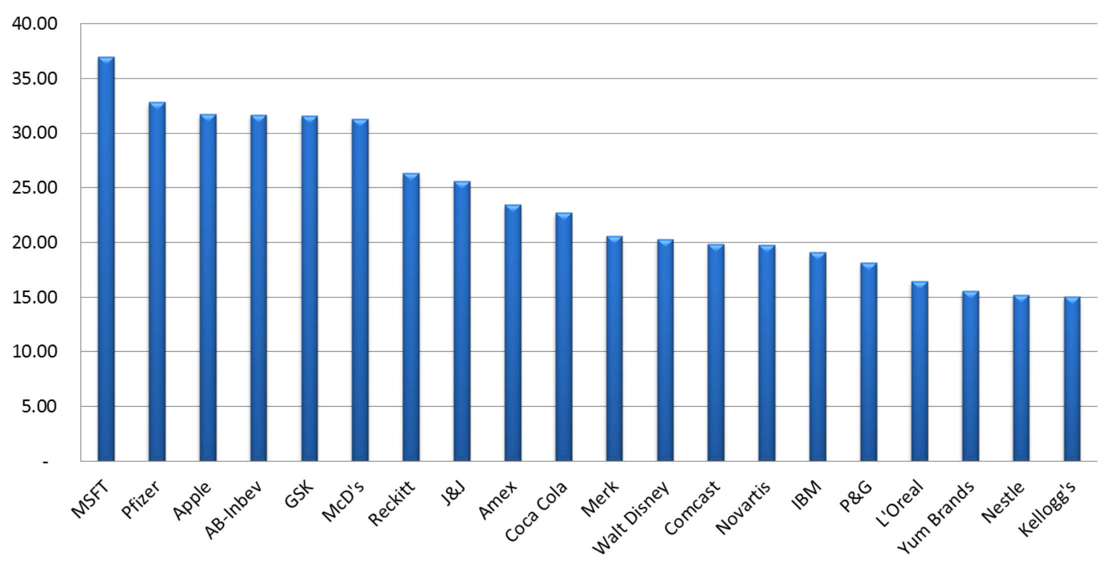
		% Client Sales	% Client Ad Spend	% Agency Revenue
Client Brand Sales	$10,000,000			
Agency Billings (Client Ad Spend)	1,000,000			
Media/Production/Billable OOP	(850,000)			
Gross Profit (Agency Revenue)	150,000	1.5%	15%	
Agency Operating Expenses *(Salaries, rent, etc.)*	(120,000)			
Agency Operating Profit	$30,000	0.3%	3%	20%

Client Business Sector Profitability Compared with Agency Industry Profitability

Marketers leverage their intellectual property and brands in order to create premium positions in the marketplace. Sectors like software, healthcare, financial services, media, entertainment and packaged goods are renowned for maintaining relatively high profit margins. Advertising agency profit margins are significantly lower than tech and pharmaceutical companies.

Client business sectors such as retail and manufacturing have low profit margins but enormous scale. Advertising agencies do not have the same scale as those sectors, consequently, agency profit margins need to be targeted to be higher than client business sectors such as retail and manufacturing.

Corporate Margins for Large Marketers Are Very Healthy



Source: Bloomberg 2011-2013 Average Operating Margins

FAQ #5, Investor Expectations for Agency Profitability

Question: How do investors and lenders look at agency profitability? What profitability targets do they expect from advertising agencies?

Answer: Investors monitor industry trends, assess public agency guidance forecasts, consider agency organic growth trends and evaluate M&A activities. Knowledgeable investors recognize that advertising agency growth and profitability are impacted by economic cycles—they expect base levels of profit performance in down cycles and they expect upside profit margin leverage in up cycles. Speaking of leverage on incremental agency business revenues, it is relevant to note that there is tension between client leverage expectations and investor leverage expectations—both expect agency “operating leverage” on incremental agency revenue. However, while agency investors expect to see higher agency profit margins on incremental client revenues, clients seek to realize efficiencies as they increase their business with an agency. The challenge for agency management is when a client endeavors to press beyond operations synergies from incremental business and endeavors to negotiate lower agency profit margins.

Investors recognize that agencies need to be sufficiently profitable in order to invest in the business (talent, technology, acquisitions, capex, etc.) while concurrently delivering predictability of revenue, good dividend yield and positive shareholder return on investment. The major publicly traded agencies have communicated margin expansion goals to investors. Resultantly, investors are expecting profit improvement from the agencies so long as there is revenue growth. These are consistent expectations by the client-side investor community when evaluating a client’s financial performance.

Another tension that exists is between clients and agency talent. Clients don't want their agencies to make too much money, while agency talent expects to be paid well when the agency performs well for its clients. Retention of talent is difficult when profitability on a client is not sufficient to reward agency talent. This is further complicated when payment by results (PBR) compensation does not achieve adequate profit levels, even when 100% of the PBR compensation is earned.

Consensus Forecasts

Profit margins for the S&P 500 were 14.2% for 2013 and are projected to be about the same in 2014. Advertising agency holding company profit margins are projected to be below the S&P for 2014 and are not expected to equal the market until 2015 or 2016.

Industry forecasts through 2016/17 project improvement in the big five holding company profit margins and double-digit revenue growth.

Profit Margin	2016/17
Havas	14.9
Publicis	21.5
Omnicom	13.6
Interpublic Group	12.8
WPP	15.0
Average	15.3

Profit % Growth	2016/17
Havas	10.4
Publicis	5.0
Omnicom	7.5
Interpublic Group	21.0
WPP	6.9
Average	10.1

FAQ #6, The Agency Profit Imperative

Question: Why do agencies need to be profitable? Is it in the client's best interest to work with a profitable agency?

Answer: Agencies need to be profitable in order to invest in talent, technology, new services and global coordination capabilities, which ultimately benefit the clients served by a profitable agency.

- Talent Investment
  Two-thirds of the marketing services industry's operating cost structure is tied to talent and talent-related expense. In order to attract and retain premier quality talent, agencies must pay competitively. In order to motivate talent to excel, agencies must provide performance incentives and career growth opportunities. In order to stay ahead in an increasingly complex industry, agencies must invest in training and personnel development. Over time, the agencies with the best talent will produce the best work for their clients.

  Profitable agencies can invest in talent to the benefit of their clients—unprofitable agencies cannot.

- Technology
  It takes time and money to investigate, experiment, assess, acquire and optimize new and emerging technologies. Clients need agencies to identify new marketing technology opportunities and curate transformative business platforms.

  Profitable agencies can invest in technology to the benefit of their clients—unprofitable agencies cannot.

- New Marketing Services
  The accelerating proliferation of the marketing services and media ecosystems requires new agency services and specialist agency expertise to deal with the complexity, sophistication and integration of multifaceted real-time marketing innovation.

  Profitable agencies can invest in new services to the benefit of their clients—unprofitable agencies cannot.

- Global Coordination Capabilities
  Today many markets are global. In the not-too-distant future, all significant markets will be global. Agency investment in global infrastructure systems, management leadership and communications platforms is mission critical for an agency as well as for the clients served by the agency.

  Profitable agencies can invest in global coordination capabilities to the benefit of their clients—unprofitable agencies cannot.

FAQ #7, Capped Agency Profit

Question: Some clients and many compensation consultants strive to dictate or cap agency profitability, even when the compensation arrangement is not a true cost-plus agreement. How are agencies responding to clients' efforts to micromanage agency profitability?

Answer: Deconstruction of agency cost and profit components is a generally accepted methodology in true cost-plus agreements with clients where the agency profit factor is negotiated and all costs are actualized (up or down, as the case may be) at the end of the engagement or fiscal year. The reality in the marketing services industry is that there are very few true cost-plus agreements and those that exist are usually found in the government sector. The reason that cost-plus arrangements are rare is that they are complex and costly to administer. Furthermore, differences between estimate and actualized costs create uncertainty risks that are problematic for both clients and agencies.

Customer oversight of a supplier's profit is appropriate for regulated utilities, which have quasi-monopoly exclusivity. Customer oversight of a supplier's profit is not optimal for professional services industries, which do not have monopoly exclusivity and do not produce identical services or output quality.

Advertising agencies are for-profit businesses. Responsibility for pricing agency services and profitably managing the agency's business is the domain of agency management, not client procurement. Many agency practitioners feel that client arrangements that dictate agency profitability are inappropriate.

Agencies can and should provide clients with information to allow the client to have reasonable reassurance that the compensation that they are paying their agency is fair and appropriate. Most agencies have credible information on market-based labor rates and fixed fees for defined scopes of work that allow client and agency to negotiate equitable agency compensation without the need to micromanage agency profitability.

FAQ #8, Agency Profit and Risk—"Skin in the Game"

<u>Question:</u> Some clients endeavor to squeeze the agency to reduce even basic levels of profitability and put "skin-in-the-game" in return for the possibility of earning back "at-risk" or incremental profit. How are agencies responding to client-initiated performance compensation overtures?

<u>Answer:</u> The 4A's Agency Performance Incentive Compensation Payment by Results (PBR) survey reported that slightly more than one-half (53%) of the 2013 PBR arrangements were structured as "skin-in-the-game" arrangements, where the agency put some base compensation at risk in return for the potential to earn performance compensation.

<u>Risk/Reward</u>

Some Agency Base Revenue at Risk - 53%

Incentive Is a Bonus —All Upside - 47%

Slightly less than one-half (47%) of the 2013 arrangements were structured as bonuses above and beyond the base fee (none of the agency's base compensation was at risk), which provided agencies with the potential to earn incremental compensation beyond the base compensation amount, predicated on performance.

The 4A's Survey on Agency Performance Incentive Compensation Payment by Results (PBR) also provided information on the prevalence and economic impact of incentive arrangements. Relative to risk-reward dynamics on "skin-in-the-game" arrangements, the survey report indicated that agency earned incentives, in aggregate, did not fully recover the amount of base compensation that agencies put at risk.

The approximate correlation between the 2013 amount of base compensation that agencies put at risk and the amounts actually earned (as reflected in the results below from the 4A's PBR survey) seems to reinforce the mindset by some agency executives that many performance incentive arrangements are self-funded by the agency rather than by the marketer.

Skin-in-the-Game Arrangements	% Responses	
% Base Compensation	At-Risk Compensation	Actual Earned Incentive
Don't Know		19%
Less than 5.0%	24%	31%
5.0% to 9.9%	41%	28%
10.0% to 14.9%	19%	13%
15.0% to 19.9%	6%	3%
20.0% to 24.9%	4%	1%
25.0% or More	6%	5%

Most agencies and clients embrace the theory of aligning the agency's and advertiser's economic interests via evolving mutually beneficial performance-oriented compensation. However, the industry has struggled with structuring and effectively implementing ongoing performance compensation.

Best practices for structuring beneficial performance incentive compensation include:

- Align agency incentives with client senior management incentives
- Simple to administer. Simple to understand
- Mutually agreed-upon criteria – Helps deepen the relationship
- Realistic, achievable calibration of thresholds and performance scales
- Prudent logical weighting of relevant metrics
- Full transparency of historical performance, current goals, metrics and tracking of performance
- Interim checkpoints to gauge performance + course correct (results shouldn't be a surprise)
- Incremental rewards for incremental improvement (avoid all-or-nothing structures)
- Ensure funding is available

The most important aspects of evolving fair, mutually beneficial performance compensation are based on relationship dynamics and client culture:

(1) Build trust in the relationship by inculcating a robust, formal two-way performance evaluation process

(2) Explore performance compensation primarily with clients that culturally embrace pay-for-performance, view the agency as a partner rather than a vendor and legitimately embrace a "We-Win-You-Win" philosophy.

FAQ #9, The Industry Risk Environment—Agency Profit Implications

Question: The agency business has become a high-risk business. What are the profit-margin implications associated with the industry's risk profile?

Answer: The marketing services industry entails material investments to succeed and a relatively high degree of risk; therefore, it is essential for agencies to achieve threshold levels of profitability from client servicing activities.

Marketing services industry participants are required to make significant investments in talent, technology and systems as well as the costs related to pitching new business. Marketing services industry risks also include economic downturns, relatively short client engagements and minimal relationship termination protections.

The agency business is high risk:

- Often first to feel the impact of pending economic declines
- Often one of the last sectors to turn around in an economic recovery
- If the agency isn't able to sell its time, it loses the opportunity cost
- Compliance with mutually agreed-upon master service agreement (MSA) terms are treated as mandatory requirements for the agency (i.e., the client requires the agency to adhere to all terms in the agreement), however, at times, the client's contractual commitments are treated as discretionary or subject to unilateral change by the client (i.e., agency efforts to require client compliance with their contractual obligations are met with client resistance or client threats that could damage or potentially truncate the relationship).
- Contracts are typically cancelable on 90 days' notice, in spite of investments made by the agency on behalf of the client in people, technology and real estate
- Client relationships are fragile. Relationship tenure is shorter, and many clients are gravitating to short-term project-by-project arrangements
- Agencies must make longer-term commitments in real estate and technology that are difficult to adjust to in response to swings in client business.
- Recently, agencies are experiencing more risk being shifted to their business in the form of aggressive contractual terms in the advertising services agreement.
- Some marketers seek to limit an agency's ability to work with other clients through exclusivity (competitive conflict) policies. It stands to reason that for marketers seeking agency exclusivity, in any significant category, the economic arrangement with the agency needs to be sufficiently compelling and the profit potential sufficiently attractive to warrant the agency even considering limiting its potential growth options in the category.

When you consider that relationship tenure is often three to five years in duration, the cost of amortizing pitch costs can effectively erode the frequently referred-to industry profit margin target of 20% by two to three points per year.

FAQ #10, Additional Information on Agency Profit

Question: Where can I access additional information about agency profit?

Answer: The 4A's has complied information and materials related to agency profit. Titles and links to much of the available 4A's agency profit and agency compensation information are provided below:

4A's Compensation Summit 2012

The Profit Imperative
Dana Perry, EVP, CFO of BBDO NY, emphasizes the importance of being profitable and reminds the industry that profit is not discretionary and that being profitable is essential for our shareholders, employees and clients.

"First Research," a database of industry profiles that can be accessed online by 4A's members through 4A's Research Database ProQuest, provides updates on a quarterly basis. Information reported includes; Industry Indicators, Industry Forecast, Industry Drivers, Critical Issues, Business Challenges, Business Trends, Industry Opportunities, Executive Insights and Financial Information.

4A's Analysis of Agency Cost
4A's publishes information on agency operating expense ratios and profitability. The 4A's Analysis of Agency Cost (AAC) looks at agency ratios for different-sized agencies. The AAC report information is available to 4A's members.

4A's Agency Performance Incentive Compensation Survey Report
The survey report provides information on many aspects of incentive compensation, including prevalence, structure and amount; correlation with business relationship and base compensation; agency/client relationship management; and performance-incentive criteria.

4A's Labor Billing Rate Survey Report
The data collected in this survey provide relevant parameters to help the industry frame labor rates that were utilized in context of service types, size groups and geographic regions.

4A's Agency Billing Practices and Client Payment Terms Survey
The report provides information on the billing and payment arrangements of 4A's members. The report contains robust, statistically sound information that provides the agency and advertiser communities with a mechanism for understanding predominant agency-advertiser practices and terms.

Public Agency: Annual Reports & Investor Analysts Reports
Information on agency profitability, for publicly traded agencies, can be obtained from publicly available annual reports and investment analysts reports.