



A Second Opinion: Compensation Trends

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HISTORICAL BACKGROUND

When media commissions were the prevailing method of agency compensation, it almost always resulted in either over or under payment for advertising services. In theory this methodology rewarded the agency for risking some of their profits for the prospects of future growth in their clients' businesses, based on the premise that advertisers would maintain a constant Advertising/Sales (A/S) ratio.

In practice the large advertisers usually overpaid their agencies, since the costs to service their accounts were seldom proportionate to the agency's income; and the small advertisers usually underpaid, and were subsidized by the agencies' large clients.

It wasn't until the hyper-inflation in media costs that began in the late eighties, that large advertisers began to seriously question the magnitude of their agencies' commissions. These questions lead first to reductions in media commissions from the old 15% standard to 10% or less. But since most national agencies were now parts of publicly traded holding companies, providing a steady and predictable earnings stream for Wall Street had become the paramount issue for agencies as well as their clients. Thus fees became the solution of choice for both parties.

However this decision has had unintended consequences for many advertisers and agencies. Suddenly agency compensation became a line item in marketing and/or advertising budgets. The money was always there but it was "invisible" as media commissions. But now it was out in the open, subject to question and scrutiny from all quarters.

Agencies and advertisers adapted in different ways. Some welcomed the opportunity to put their relationships on a clear value-added scale, and be judged by their contributions to their client's marketing objectives and their financial candor. But many agencies clung to their old ways, acting as though they still had something at risk in their new fee arrangements, arguing that their costs and profits were "none of anybody's business".

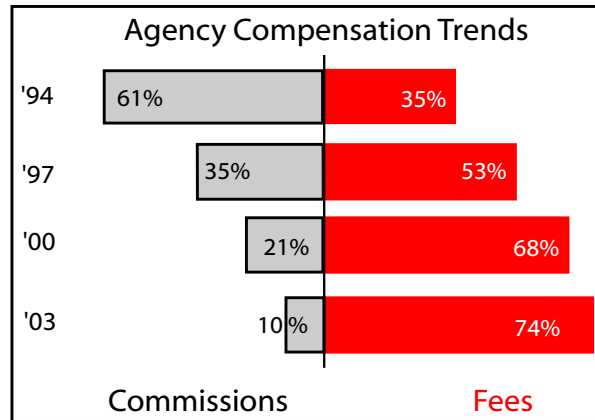
In 2003 the Association of National Advertisers (A.N.A.) probed this subject in some detail for the first time in their thirteenth triennial Survey of Agency Compensation. In this paper we have highlighted the key findings from that survey in an actionable way, plus we've added some more context to the information. One-hundred twelve companies participated in the 2003 A.N.A. Survey. **All of the charts in this document are based on that data.**

DATA SOURCE: 2003 A.N.A. SURVEY

FEES REPLACE COMMISSIONS

Since 1994 there has been a steady shift to fees and away from media commissions. In 2003 74% of the respondents

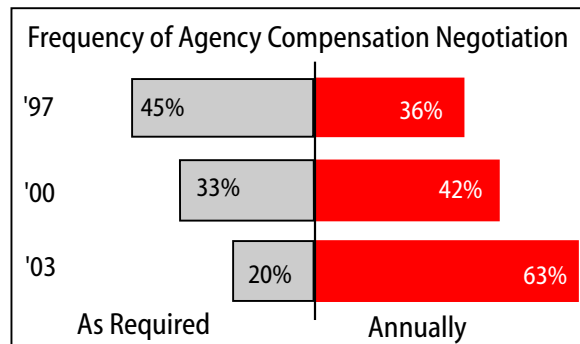
in the A.N.A survey utilized some form of fee as the basis for their agencies' compensation.



RE-NEGOTIATION ANNUAL EVENT?

The table below shows how agency compensation negotiation has become an annual event for 63% of the advertisers that the A.N.A. surveyed. But if 74% of advertisers are using fees, and only 63% re-negotiate them annually,

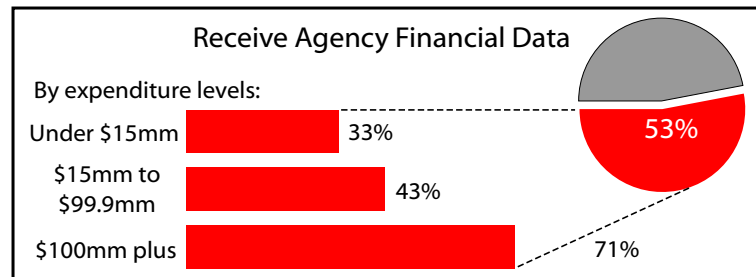
how do the remaining 11% manage them? Do the fees remain unchanged from year-to-year, or do they just accept the agency's annual proposals on faith?



BASIS FOR RE-NEGOTIATIONS

There is also an apparent discrepancy between the total fee users (74%), the annual re-negotiators (63%) and the number who actually receive any financial data from their agencies (53%). As the table below shows, most of the

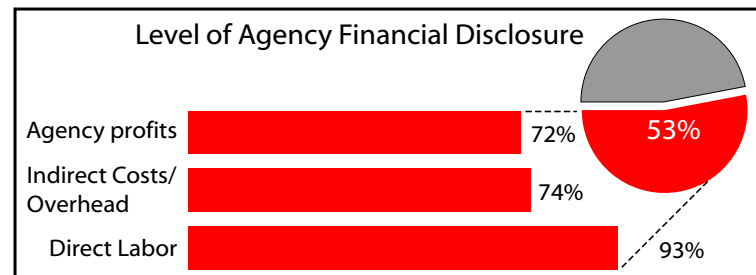
\$100mm plus players, get this information from their agencies. But the smaller advertisers are much less likely to. Is that a question of leverage, or just not understanding their rights and asking the right questions?



FINANCIAL DISCLOSURE

Among those advertisers who do receive financial data from their agencies, nearly all get direct labor information: which is appropriate since this is the basis for the agency's fees. However what is surprising is that one-quarter of the agencies' financial disclosures

don't include any information re: either their overhead or profits on those advertiser's accounts. Since fees include a profit markup, these advertisers are unable to independently judge what's fair and what's excessive. More evidence of faith-based compensation.

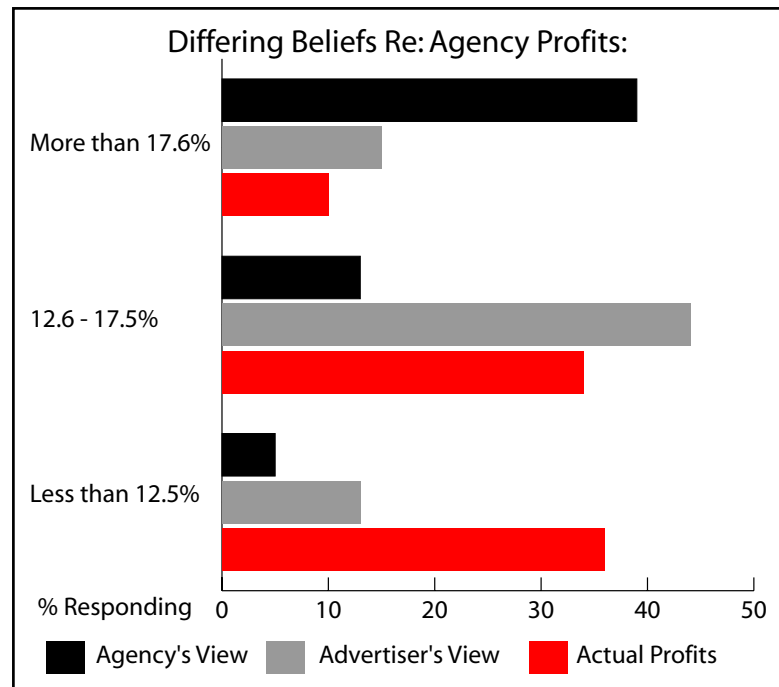


WHAT'S A FAIR PROFIT?

When Advertisers were asked to compare their view of what constituted a fair profit for their agency, and then contrast that with the agency's expectations and their actual profits, there were substantial variances. Most advertisers viewed the 12.6-17.5% range as appropriate while most agencies thought their profits should be higher than 17.5%, according to their clients.

Only 40 of the 112 respondents in the A.N.A. Survey actually professed to know what their agency's profits were on their business, and among that sub-sample, 60% said it was 15% or less.

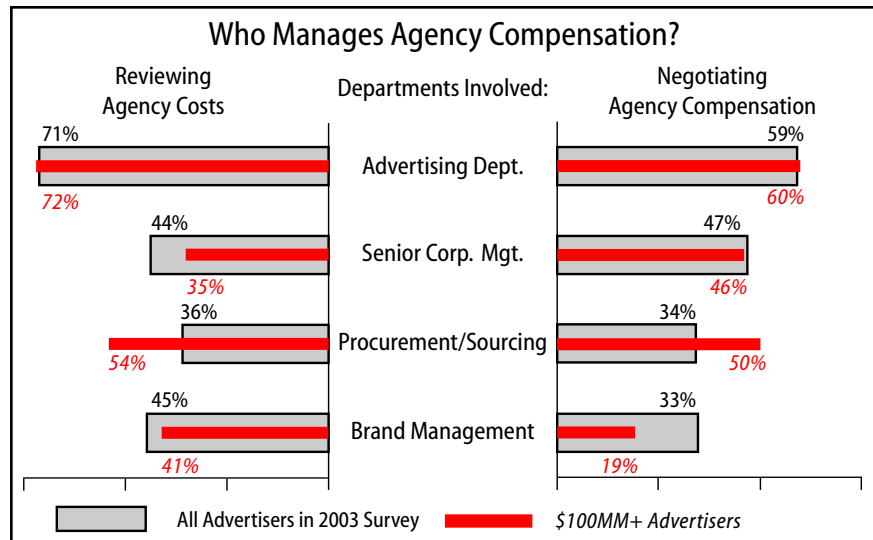
For the record the actual operating profits of the most successful agency holding companies are in the 13-15% range, and this is the range they target most often when speaking to investors.



MANAGING AGENCY COMPENSATION

As expected, the Advertising Department leads the way in compensation reviews and negotiations. However what may be less expected is the importance of the Procurement/Sourcing Departments, particularly among the \$100mm plus advertisers.

The chart below shows that among advertisers spending more than \$100mm annually, the Procurement and/or Sourcing staff are involved in both reviewing and negotiating agency compensation in half of those companies. We expect to see this number increase in future surveys.



SOURCING'S NEW ROLE

In the manufacturing and administrative areas, Strategic Sourcing has become an accepted practice to control costs and improve profitability. Now some companies have extended these same disciplines to their marketing programs.

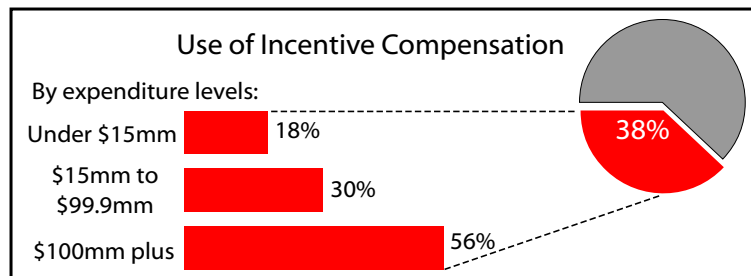
However to take full advantage of their contributions, it means that the Sourcing Staff must be involved in defining requirements, selecting suppliers, negotiating costs and evaluating the vendor's performance after the fact. But many marketing managers resist sharing this responsibility.

INCENTIVE TRENDS

The 2003 A.N.A. Survey reported little change from the 2000 survey in the overall percentage of advertisers using incentives. But it did report a decline in the percentage of incentive usage in the \$100mm plus category from 64% to 56%.

This change can probably be attributed to significant changes in the respondents from 2000 to 2003.

The overall number of companies participating in the survey went down from 136 in 2000 to 112 in 2003. But the actual number of participants in the \$100mm plus category went up from 33 in 2000 to 47 in 2003. So the lower incidence of incentive usage in this segment between 2000 and 2003 could be accounted for entirely by the new participants included in this segment in 2003.



INCENTIVE RESULTS

Only 68% of incentive users said that they resulted in any “improved performance” by their agency. Nonetheless 95% of those same advertisers said that they “will continue to use” incentives. This disparity could be explained in two different ways:

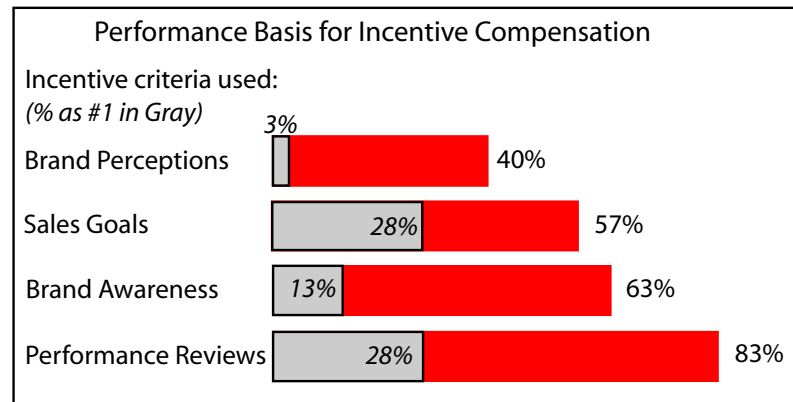
1. It could be a tacit acknowledgment that the criteria may be flawed;
2. Or the incentives could be more of a stick than a carrot.

We have published a 14 page booklet that discusses the options, trends and issues in Agency Incentive Compensation. It describes how we use a special questionnaire to illuminate the dualities in compensation arrangements; plus it shows how we create *what-if* models to mitigate these dualities and make the final agreement more open and equitable for both parties. To obtain a copy of this document go to our web site www.mcb-associates.com. and look in the IDEAS section.

INCENTIVE CRITERIA

Among the sample of 43 advertisers using incentives, 80% used multiple criteria. The leading measures were agency performance reviews (subjective) and brand awareness (objective). These are both areas that the agency can influence more easily than sales.

The most objective measures of an Agency's effectiveness — changes in Brand Perceptions and/or Awareness — were considered by more advertisers in this survey than the last one. But still only 5 out of 32 companies reporting used it as their number one criteria.



INCENTIVE GUIDELINES

When structuring a performance related incentive program for an Agency, here are three points to keep in mind:

1. Set and agree on the goals jointly;
2. Those goals should be attainable, meaningful and--preferably--objectively measurable;
3. The primary goal should be based on some sort of advertising induced effect.

WHAT WE DO

McBride & Associates was formed in 1991 to enable companies to improve the accountability and productivity of their marketing communications relationships. We do this by providing counsel in the evaluation, selection, compensation and management of advertising agencies as well as all other marketing communications resources.

We are distinguished from our competitors by the breadth and depth of our experiences in both advertising and agency management capacities. This paper focuses on Agency Compensation. Visit our web site to obtain similar information regarding our other services: www.mcb-associates.com.

OUR WORK OUR CLIENTS

Since 1991 our firm has been assisting marketers to evaluate, select compensate and manage the full spectrum of marketing resources. Our assignments have involved:

- Mass-media agencies
- Direct marketing
- Sales promotion
- Hispanic marketing
- Public Relations
- Media Buying
- In-store merchandising
- Event marketing
- Relationship marketing
- Exhibit management
- Fulfilment services
- Enterprise marketing management tools

Some of the advertisers we have worked for include:

- Apple Computer (2)
- Bank of America
- Baskin-Robbins (3)
- Hasbro, Inc.
- Hewlett-Packard (5)
- Intel Corporation (2)
- Nvidia, Inc.
- Plantronics, Inc. (2)
- Qualcomm (5)
- SBC/Pacific Bell (5)
- Siebel Systems
- Silicon Graphics, Inc.
- 3Com Corporation (3)
- Universal Studios Hollywood
- Verizon Wireless
- Visa (3)

NOTE: Figures in brackets signify the number of assignments.

ABOUT US

Jack McBride's marketing career began with five years at Quaker Oats in Product Management. Later during 15 years with DDB, he directed many memorable advertising programs for such clients as General Mills and McDonald's.



From 1987 to 1991, McBride was the Vice -President Advertising for the E & J Gallo Winery. Since 1991 he has consulted for many of the leading advertisers in the West.

If you would like to learn more about any of the topics in this paper or about how we manage agency compensation audits covering all sorts of marketing communications resources contact Jack McBride via E-mail jack@mcb-associates.com or call 209-577-1464.