Kingston Smith W1

Helping clients succeed

Agency business model survey

The agency business has been revolutionised over the last 40 years. The heady days of advertising portrayed in the infamous TV series "Mad Men" is unrecognisable to the industry in today's market. The introduction of social media, digital and more recently the effects of the recession, have meant that agencies have had to adapt to new ways of working to remain competitive in an ever-changing and challenging workplace.

Having experienced such radical changes over the last few years, the question that remains is whether the current model is sustainable in the medium or even in the short term.

Kingston Smith have recently undertaken a survey canvassing the views of over 80 FDs and CEOs of agencies across all disciplines to determine how the current model is standing up in today's climate and whether the agencies themselves believe that change is needed.

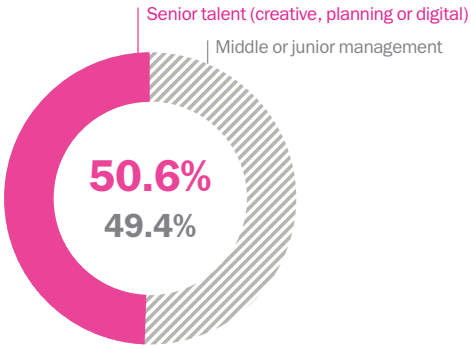
Margins and profitability

Over half the respondents reported that profitability was being maintained or increased. We asked those taking part in the survey if their company's margins were increasing or decreasing. The response here was mixed with 18.6% saying that margins were increasing and a further 34.9% stating that they were maintaining margins. Of the remaining 46.5% who felt margins were decreasing, the overwhelming response was that the decline was due to pressure on revenues rather than overheads.

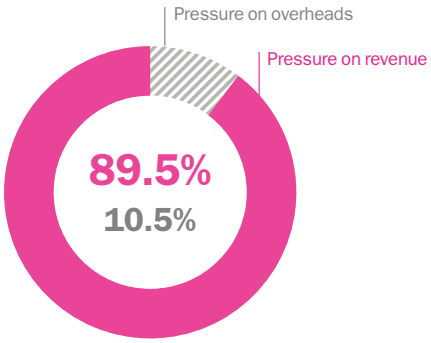
Margins recovery rates

When asked whether there was any distinction between margin recovery rates for those in senior talent (i.e. creative, planning or digital) and those in middle or junior management, the response was roughly equal with 50.6% of respondents citing better recovery in senior talent and 49.6% having better recoveries in junior and middle management.

Where is the greater % charge out recovery from



If margins are declining, is that due to:



Fees: Retainer v project

Pressure on fees was given as the reason by 89.5% of our respondents for declining margins.

In recent years there has been a significant shift from retainer based fees to project based fees. Whilst project work can be more profitable, it makes budgeting and forecasting that much more difficult, as agencies are often unable to predict revenue more than a few months ahead. If not properly addressed, it can impact on service and delivery if staffing levels are not adequate to meet any peaks of work.

Conversely, it can have a significant impact on margins if the agencies are overstaffed.

As agencies income streams have become more variable they have had to replace fixed costs with variable costs where possible.

Increasing employment costs are denting profits and agencies are trying to manage this by increasing the use of freelancers.

89.5%

of respondents gave pressure on fees as the reason for declining margins

Fixed costs v variable costs

Fixed employment costs

Over the last ten years our target ratio for a well run agency for full time salary overhead v income has been 55%. However, increasing pressure on fees and rising salary costs have meant that these ratios have gradually been increasing over both the last 48 months and the last 24 months. In the last 48 months 53.7% said the ratio had increased and 56.1% reported the ratio had risen in the last 24 months.

It is no wonder therefore that the majority (64%) of those who took part in the survey thought that this target ratio was not sustainable to protect margin performances going forward.

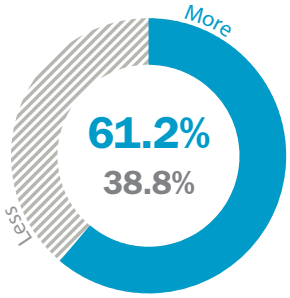
Variable freelance costs

Given the responses above it is not surprising that given the uncertainty of the current economic climate, (and the move from fixed retainer fees to more variable project based fees) agencies are choosing to employ more freelance labour (i.e. variable cost) to deliver on specific projects with 61.2% of respondents agreeing that they have increased the amount spent on freelancers.

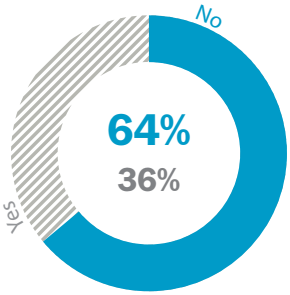
When these responses are broken down even further to look at those companies which are maintaining or increasing margins combined, this % increases even further to 67 %.

Companies are opting to employ more freelance labour.

Are agencies employing more or less freelance (variable) resources to deliver against specific projects



Over the last 10 years the target ratio for full time salary overhead vs. income has been 55% - Is this sustainable to project margin performances?



Who is in demand?

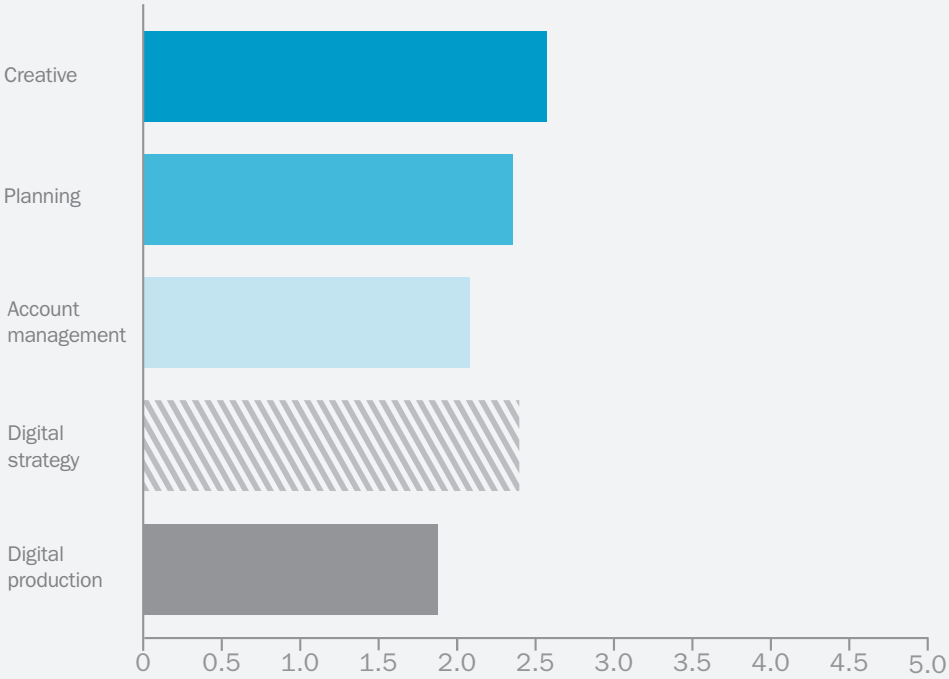
Despite difficult trading conditions, recruiting and keeping the right talent continues to be one of the main priorities. We asked those surveyed to rate five specialist skills and grade them as to which they thought was the most important in terms of margins.

It is reassuring to note that despite the growing prominence of digital, creative skills were still felt to be those that were the most important and delivered the highest margins.

Perhaps as expected, digital strategy came a close second with the core skills of planning and account management coming in 3rd and 4th place respectively. Digital production came in at 5th place.

Creativity is still the most highly prized skill set.

On a scale of 1-5 (1 being unimportant, 5 being very important) please rate the specialist skill that deliver the higher margin returns:



Are clients on the same page?

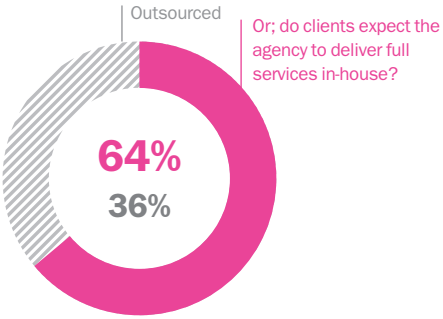
Clients are very aware that the market place has changed. They demand that their agencies are forward thinking and innovative and that also means being at the forefront of technology and new media. They expect that their agencies will be able to cover all aspects of their needs.

For 64% of respondents their clients expected them to be able to cater for all of their needs and provide services in-house rather than have to engage directly with individual specialists themselves.

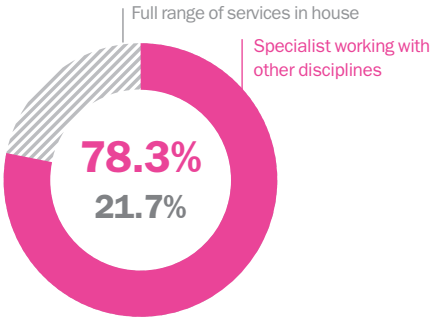
However, when a similar question was asked from the agencies' point of view as to whether they thought it better to provide a full in-house service (where the full range of services are retained in house) or to specialise in integrated marketing (where agencies work with other disciplines to meet client needs), the response came out overwhelmingly in favour of specialising in integrated marketing with 78.3% of respondents agreeing this was the better model.

What is clear is that clients' "wants" and what the agencies would like to provide need to be more closely aligned. Whether agencies are brought round to the clients' view point or whether agencies reconcile themselves to providing more in-house services remains to be seen but the differences need to be addressed.

Are more services being:



Are agencies:



All change?

A huge 72.3% of those surveyed thought that their current overhead to income business model had changed over the last 5 years. Even over the last year this still stood at 57.6% demonstrating just how much change has occurred and that change is still happening.

When asked whether their current business models were sustainable in the short term, 89.4% of respondents agreed that the model was sustainable for the next 2 years, with this reducing to 62.7% of respondents agreeing it was sustainable over the next 4 years.

When questioned about whether the model was sustainable over the next 6 years, the pendulum had swung the other way so that the majority (54.2%) thought that the model was not sustainable over that period of time.

What next?

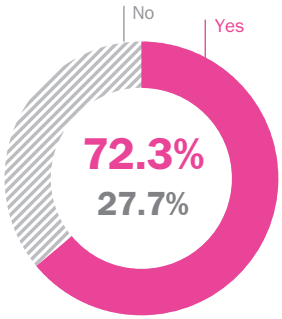
The question that remains is what will be the next big change? There was no clear theme here – the ideas were diverse. Some respondents believed agencies would provide more in-house services whilst others believed clients would take more of the lead themselves. Others thought there would be increased outsourcing to lower cost economies.

Amongst others, the increasing importance of digital, the impact of data and a shift in the way agencies are paid with an increase in payment by results was also suggested. Likewise an increase in profit related pay to agency staff was also suggested. The only thing that most respondents agreed on was that further change was inevitable.

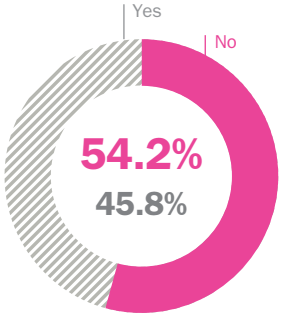
And with change comes opportunities for those companies willing and able to take advantage of that change.

Further change is inevitable.

Has the overhead to income business model changed in the last 5 years?)



Is the current overhead to income model sustainable for the next 6 years?



About us

Kingston Smith W1 is based in London's West End, and the six partners specialise in advising creative, communications and consulting businesses on all aspects of finance, audit, accountancy and tax. Kingston Smith W1 is a specialist division of Kingston Smith LLP, one of the UK's top 20 audit and accounting firms.

Our clients comprise those in marketing services such as advertising, digital and PR as well as TV and commercial production companies, consulting firms, live entertainment and music agencies. Our clients range from start ups and sizeable independents to multi-nationals and AIM listed groups, where we advise on a range of financial and business issues.

By working with businesses with similar challenges, we are able to understand our clients better and can advise on a wide range of accounting, tax, other financial and commercial issues to a greater depth. Specialist areas where we regularly advise include employee incentive schemes, succession planning, exit planning, business valuations, profit improvement reviews, business plans, grooming for sale and pre-sale tax planning. Through Kingston Smith W1 Corporate Finance we are also able to offer a wide range of services such as M&A, fund raising, due diligence and MBO's.

Through the data we collate in our annual survey "Financial Performance of Marketing Services Companies" and biannual "*Marketing Monitor*" we are also able to give invaluable benchmarking advice on numerous key performance indicators.

People are the main asset for most of our clients and as part of Kingston Smith we are also able to provide recruitment services through Balanced People, HR consultancy through HR Insight, and employee benefits advice through Kingston Smith Financial Advisers. (HR Insight and Kingston Smith Financial Advisers Ltd, an appointed representative of Argentis Financial Management Ltd are authorised and regulated by the Financial Services Authority (FSA)).

Contact us

If you would like to discuss any of the matters arising in this edition or how we can we help you, please contact one of the Kingston Smith W1 partners by email or on 020 7304 4646.

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