

 Major marketing industry associations have been polling their membership to gauge how marketing budgets have been impacted by the severe economic conditions. The feedback demonstrates that very few remained unscathed by the downturn and that most are seeking a variety of cost-cutting measures.

However, best practice that works in the good times will also work when the going gets tough. And while there needs to be an acknowledgement of the difficulties – a sharing of the pain – what is most important is preserving the spirit of open dialog and partnership, so that both parties are properly prepared for a return to normality and the eventual upturn.

Fair compensation for agencies

So how has the concept of compensation for marketing service providers fared during these difficult times?

The small number of agencies that are perceived to be clearly above the competition can still command practically whatever fees they want. For them, there may not be any real change. For the vast majority, however, pervasive client budgetary pressures and lower agency revenues have altered both parties' views of appropriate remuneration.

Buyers, especially those whose industries have been hit the hardest, such as automotive, financial services and retail, face difficulty in preserving existing packages when their own company profitability or employee payrolls have been hit. More and more, dialog has been around 'sharing the pain' and finding further cost efficiencies and savings.

It is reasonable for agencies to scale back their scope of services as a result of fee reductions. However, there may be other opportunities the parties can explore, such as agency volume rebates for increased commitments in the ensuing upturn, either in the form of increased services or actual monetary rebates. If agencies form part of a larger holding company, additional savings may be gained by bundling work across their network. No matter, the key to fairness in any agency concession is that it be clearly identified and documented, within a specified time frame and with appropriate and proper recovery at such time as the situation improves. Open dialog between the parties can pre-empt and address many problems before they surface.

Agency profitability/bellwether models

At a major marketing industry conference in Spring 2009, Coca-Cola and Procter & Gamble, unveiled their new agency compensation models. Both of these were radical departures from conventional labor-based arrangements and clear deviations from traditional agency profit expectations, with innovative applications of pay-for-performance and value-based incentives.

Coke's compensation model

Initial compensation is based on historical cost and value perception of the planned scope of work or selected deliverables, without margin. All margin is paid as an incentive, contingent upon an evaluation of the work, which consists of a mix of qualitative and quantitative criteria. The maximum payout is a 23% agency profit.

Although touted as value-based compensation (VBC), this model could fall short for the following reasons:

- Value is determined by the buyer without obtaining input from the seller.

SUMMARY

By looking at the advanced agency remuneration systems employed by Coca-Cola and Procter & Gamble, J Francisco Escobar provides a deep and practical analysis of the often-strained relationship between procurement functions, internal marketing teams and external agencies. As these innovative, profit-based remuneration models gain more traction, CPOs must be well versed in the benefits and potential problems that valuing intangible spend categories can pose.



- Internal spreadsheets have replaced a collaborative dialog with agency partners
- Agency profit capped at 23%, with a qualitative component, results in a maximum payout of between 15% and 20%.
- It presents cash-flow problems for agencies as they do not receive any profit until incentive pay-outs are determined.

P&G's brand agency leader (BAL) model

For a number of P&G's billion-dollar brands, the BAL involves strategic staff across all marketing disciplines, except media buying. The BAL agency serves as a lead contractor with responsibility for allocating the entire agency remuneration and recommending agencies within P&G's approved list. The initial value point (IVP), inclusive of agency profit, is jointly determined with the BAL based on the sum of historical fees and taking into account the projected scope of work. Final agency compensation is adjusted upwards or downwards 10% depending upon performance, 75% of which is quantitative and 25% qualitative. Subsequent annual compensation is adjusted from the IVP based on BAL feedback and the revised scope of work.

This model is a better version of VBC, but requires the following elements to be successful:

- It must be funded appropriately and not merely become a cost-reduction program.
- The BAL agencies must be empowered as decision makers. ➤

- It could be improved by eliminating the 10% downward penalty and enhancing the upside value incentive.
- It requires continuous communication and buy-in from all P&G internal stakeholders.
- Feedback must be gained from all parties to make necessary corrections and improvements.

When industry leaders such as Coca-Cola and P&G deploy these types of remuneration methodologies, the ripple effect will be felt throughout the entire marketing spend world.

However, any compensation arrangement must acknowledge that the service provider is entitled to a fair profit margin above and beyond the recovery of reasonable cost to service its clients. Historically, this has been presumed to be a 20% margin or a 25% mark-up on agencies' costs. Irrespective of the recent economic meltdown, a 15% agency base profit has, in the minds of major clients, replaced the 20% standard.

What helps mitigate this gap is the increasing use of incentives and enhanced profitability arrangements in marketing services relationships. These arrangements, if properly implemented and deployed, provide a forum for critical discussions around the significance of value and how best to match incremental agency remuneration to measurable and meaningful business outcomes.

Payment terms

To properly address the issue of payment terms, it is important to step back and understand the difference between marketing services providers and most other suppliers with whom major companies do business.

Suppliers of marketing services, for the most part, do not hold a repository of real assets as collateral from which they can borrow. As a result, most require monthly remuneration. Additionally, because agencies rely on their clients' business for survival, whose consistency may be tenuous at best, they can be vulnerable in their ability to fight back and counter their clients' demands and mandates.

Irrespective of a buyer's company-wide practices, the financial state of certain industries or the global economy as a whole, the subject of payment terms is a critical commercial discussion that needs to be tailored to the requirements of the parties involved.

Other considerations include the way in which agencies treat third parties and how disputed invoices are handled. Agencies must be fair to their own contractors and be truthful about when they are paid, if they expect clients to be fair with them. It is unreasonable for buyers to withhold an entire invoice, when only a portion of it is in question. The overriding issue with payment terms is one of fairness and equitable business practice.

Agency audits

Procurement departments, in particular, have heightened their focus during the downturn on overall risk-assessment activities, on ensuring that good fiduciary standards are in place and on confirming that the initial understanding and assumptions with major agency partners are still valid. Audits have become increasingly useful exercises for monitoring a service providers' general financial health and specific performance with respect to the agreement between the parties.

Most contracts that cover major relationships include an audit provision. This may specify the organization which is eligible to conduct such an audit, such as the marketer's internal audit

staff, major accounting firms, and/or specialized third parties. These audit clauses, the negotiation of which has become increasingly contentious in recent years, can vary widely regarding the parameters of the audit and its implications.

Best practice in agency audits must remove potential contractual ambiguity and bring all the parties together to jointly determine objectives, establish reasonable timelines, and define the appropriate process for communicating findings and recommended corrective action to address deficiencies. However, a properly managed relationship, particularly in challenging economic conditions, could eliminate the need for conducting a formal audit altogether.

Agency relationship management

Much like a personal relationship – where arguments about money are often destructive – a continuous and honest dialog about the most important issues at hand can prevent small challenges from becoming major problems that lead to irreconcilable differences. Agency relationship management must follow a cyclical process, defined yet adaptable and flexible. This is established by the buyer and shared upfront with agency partners for potential customization and corresponding buy-in.

Someone with appropriate authority on each side needs to 'own' their respective party's behavior and, most importantly, manage both the expectations and communications that flow across and within their organizations. It is advisable to conduct formal agency evaluations and hold regular meetings among key stakeholders, preferably face-to-face, to monitor progress and make necessary adjustments when circumstances change.

The manner in which information is shared by both organizations cannot be over-emphasized. It is critical that key conversations about scope of services and available budgets take place at the highest levels and then cascade down each side with appropriate transparency.

Correspondingly, ongoing dialog between a company's marketing, procurement and finance departments, as well as between relevant agency personnel – including the CFO – fosters the appropriate bridge to ensure alignment between the parties and the opportunity for trust to grow. Staff turnover is a major challenge, as is the possibility of changes in business models and industry consolidations. But having best practice tools firmly in place provides the necessary emergency response system to address these challenges with a continuous feedback loop.

The test of any relationship is a significant economic or industry-specific downturn such as the one we continue to experience. But, with a proper foundation and a commitment by the owners of the relationship, especially the day-to-day clients, the storm can be weathered. **PL**



J Francisco Escobar is president and founder of JFE International Consultants, a business management advisory targeting major advertisers and service providers in the marketing communications industry. He spent 23 years at Texas Instruments in financial, marketing and procurement management and authored an Association of National Advertisers' 2005 report *Marketing communications procurement: Building value through best practices* as well as a 2008 Council of Public Relations Firms whitepaper on agency compensation trends.