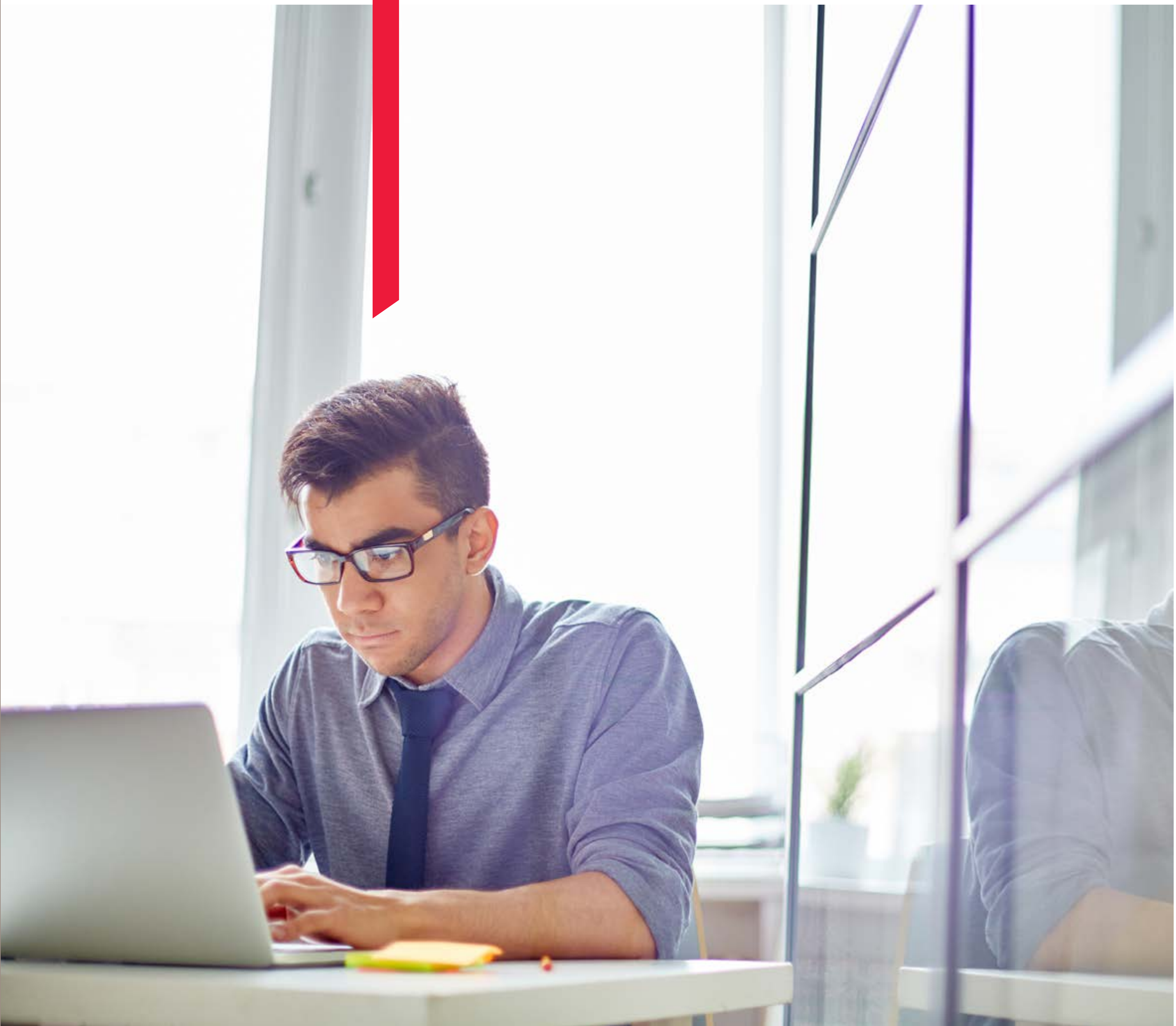


TACKLING RISK HEAD ON

MARKETING SERVICES RISK FACTOR REPORT 2015

BDO

THRIVING IN A DISRUPTIVE MARKET

BDO'S MARKETING SERVICES RISK FACTOR REPORT 2015

SIGNIFICANT AND DISRUPTIVE CHALLENGES LIE AHEAD FOR THE MARKETING SERVICES INDUSTRY.

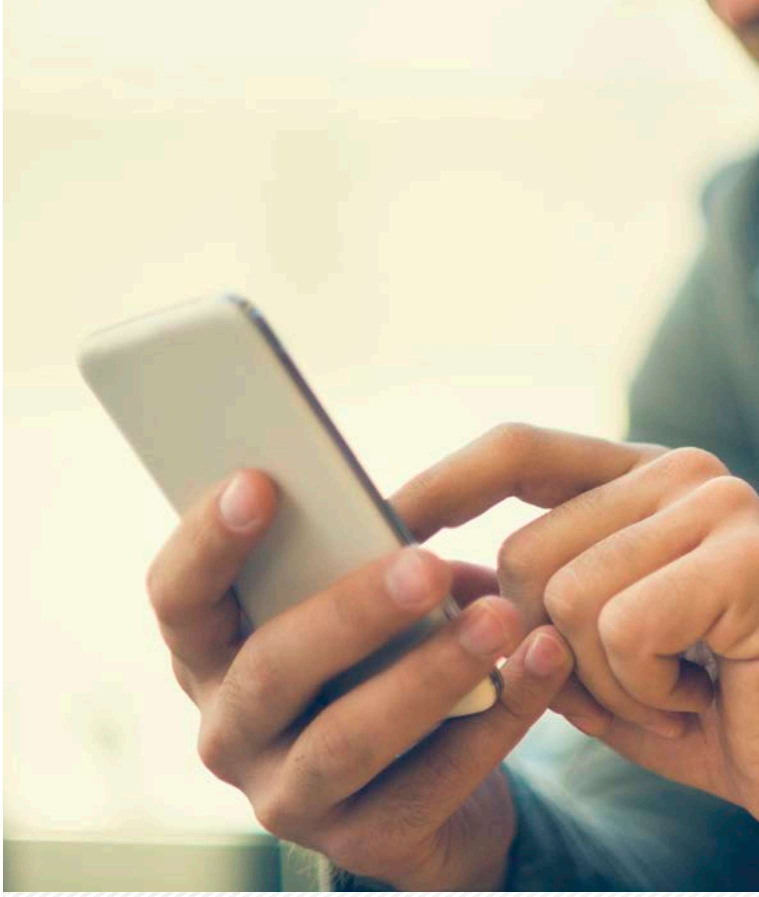
Taken together these challenges have the potential to fundamentally alter the way that companies in the sector do business with their clients, and how they generate future income. A decline in traditional advertising channels in favour of new technologies, relentless pressure from clients on price and more aggressive, global competition are some of the issues weighing heavily on the minds of leaders of marketing and advertising businesses the world over.

Given added pressure from regulatory change, currency fluctuation and an escalating war for talent, it is easy to understand why WPP, one of the world's leading marketing companies has defined the market as one of 'caution and conservatism' dominated by a 'confidence-sapping sense of uncertainty'[1].

The businesses best placed to win in this more complicated environment will be finely tuned to the risks ahead. A deeper understanding of these risks will help marketing services companies adapt their strategy, operations and financial model to ride out future shocks and retain the competitive advantage they need to thrive. But which risks should be top of the agenda for marketing services companies? Which will have the most disruptive impact? And which risks lie undetected on the radar that companies need to give more attention?

To answer these questions BDO has investigated the risks self-reported by 50 of the largest marketing services and digital media companies across 10 different global markets in their most recent annual results statements. This research has been combined with insights from in-depth interviews with executives at marketing services companies in the UK, Germany, Canada and South Africa to gain a global perspective on their risks and opportunities for the year ahead and the longer term.

1. WPP, Annual Report and Accounts 2014: www.wpp.com/annualreports/2014/



CATEGORISING THE RISK FACTORS FOR MARKETING SERVICES

Our analysis reveals many common concerns among the 50 leading companies included in the research. Figure 1 highlights the top 20 risks identified by marketing services companies. It shows, for example, that almost three quarters of marketing services companies (72%) highlight risks around future cash flows in their most recent annual statements, while just under half of companies (48%) point to the emergence of new competitors as a major risk to their future growth prospects. Other significant risks identified include foreign exchange fluctuations (68%), data privacy (34%) and a too highly-concentrated client base (42%).

To help make sense of this long list of issues, we have segmented the risks into five categories as outlined in Figure 2. These categories represent five broad areas of concern that marketing services executives need to devote sufficient time and attention to in order to ensure their company is fit to tackle risk head on.

Below we examine how each of these five risk categories has an impact on the strategy and day-to-day management of marketing services companies. We include BDO's view about the major developments to watch out for in each of these risk categories, and conclude with a series of questions that executives can use to hone their current thinking on these issues.

FIGURE 2:
The five main categories of risk for marketing services companies.

ONE
FINANCE AND MACRO-ECONOMIC RISK

TWO
CHANGING CUSTOMER DEMAND RISK

THREE
REGULATORY RISK

FOUR
COMPETITION RISK

FIVE
TECHNOLOGY AND SKILLS RISK

FIGURE 1: The top 20 risks identified by marketing services companies (% citing in their most recent annual report)

1.	Liquidity and cash flow	72%	**11.**	Too highly-concentrated client base	46%
=2.	FX fluctuations	68%	**12.**	Poorly executed M&A deals	42%
=2.	Access to growth financing	68%	**=13.**	Maintaining data privacy	34%
4.	Interest rate fluctuations	60%	**=13.**	Political risk in region of operation	34%
5.	Changing demand / reduction in client spending	58%	**=15.**	Technological innovation	32%
6.	Dependence on key personnel	56%	**=15.**	Disruption to services / IT network	32%
7.	Unfavourable regulatory environment	54%	**17.**	Cyber attacks	26%
8.	Macroeconomic uncertainty	52%	**=18.**	Lack of infrastructure investment	22%
9.	Attracting and retaining talent	50%	**=18.**	Reputational risk	22%
10.	New sources of competition	48%	**=18.**	Unfavourable litigation	22%

ONE

FINANCE AND MACROECONOMIC RISK

UNCERTAINTY IN A GLOBALISED ECONOMY

MARKETING SERVICES IS ONE OF THE INDUSTRIES MOST EXPOSED TO MACROECONOMIC CHANGES.

The sector is often hit early during a macroeconomic downturn because marketing budgets are among the first places that CFOs usually look to make savings when faced with a challenging external market. In spite of this, many success stories abound: among the 50 companies surveyed are a group of high performers who have grown rapidly over the last three years through a combination of organic and acquisitive growth.

Although global economic conditions are now generally more favourable than they have been for most of the last decade, the pressure on the marketing sector remains intense. Macroeconomic shocks still have the power to limit the sector's growth potential. Warc, a global body representing the advertising and media industry, has recently revised down its global adspend forecast for 2015; it now estimates an annual global rise of 3.8% down from the 5.1% anticipated at the beginning of the year. It attributes this reduction to less promising growth prospects, particularly in emerging markets such as Russia, Brazil and China[2].

While there remains many reasons to be optimistic about the future, significant finance risks need to be properly considered. The first is managing cash flows, reported as a major concern by 72% of the companies investigated. Increasingly debtors – often large multinational clients – insist on longer payment terms which puts pressure on cash flows. "We have found that some of our first tier clients do have slower payment terms," explains the CEO of one of South Africa's leading digital agencies. "We incur third party costs in the media space: whereas our suppliers expect to be paid within 45 days, our clients sometimes stretch this to 90 or 120 days. Increasingly we are asking our clients to pay some of the media costs themselves to mitigate this risk," he says.

[2] Warc, 'Global adspend forecasts cut' (September 2015): http://www.warc.com//Content/News/Globaladspendforecastscut.content?ID=3ac3cdee-98ec-4c72-8b9c-139669416b62&CID=N35444

Another critical risk is fluctuations in foreign exchange rates, noted by seven in ten (68%) of the marketing services companies investigated.

Of particular concern is the strengthening of the dollar and euro against currencies in emerging markets across Africa, Asia and Latin America. This creates uncertainty: when companies win one year from a positive exchange rate, they may lose out the following year. Small and mid-sized companies with global operations may find they need to devote additional management time and resource to repatriating profits and to deal with the tax and currency issues arising.

THE BDO VIEW

THREE FINANCE AND MACROECONOMIC RISKS TO WATCH OUT FOR.

1. DEBT FINANCING WILL BECOME MORE EXPENSIVE

Interest rates in western economies are at historically low levels and are generally expected to rise during 2016. The UK may see a rise within six months, and in the US a rate rise may come even sooner. This means bank financing will become less attractive and marketing services companies may need to seek alternative sources of finance.

2. M&A ACTIVITY ON THE RISE

Over the last year M&A activity has remained relatively muted as companies await the outcome of seismic economic events such as the Chinese slowdown or the European immigration crisis. As M&A activity picks up in 2016 this will eat into the warchests that companies have built up. A consequence of this is likely to be further margin pressure as clients of marketing services companies look to make cost savings to sustain short-term profitability.

3. GEOPOLITICAL RISK SHOULD NOT BE UNDERESTIMATED

For companies with offices in emerging markets, uncertain political situations make for more challenging market conditions. The end of 2015 has witnessed risks in countries such as Egypt, which was becoming a fast-growth market for many marketing services companies. Further geopolitical shocks are likely in 2016.

TWO

CHANGING CUSTOMER DEMAND RISK

NEW BUYING PATTERNS NECESSITATE NEW BUSINESS MODELS

IN ORDER TO ACHIEVE SUSTAINABLE, LONG-TERM GROWTH MARKETING COMPANIES INCREASINGLY CHOOSE TO WORK WITH GLOBAL BRANDS WHO HAVE THE SCALE, STRATEGIC NEEDS AND FUNDS AVAILABLE TO ESTABLISH LONG-TERM PROFITABLE RELATIONSHIPS.

However, this has become increasingly difficult in an environment where corporates are bringing more of their work in-house and consolidating their buying power among external agencies. Consumer products company Proctor & Gamble, for example, has recently cut the number of agencies it works with globally by 40% resulting in savings of $300m[3]. It is unsurprising, therefore, that six in ten (58%) of the marketing companies we investigated report changing client demand as a major risk to their future performance.

As consumers' habits evolve in response to new technologies, corporates need to find new ways to engage their customers across multiple platforms. To meet these changing demand patterns, marketing services companies need to adapt by bundling their solutions to fit clients' complex and specific needs. "The future of the marketing services industry will be much more about areas such as branding, PR and corporate affairs, which have higher margins than more traditional advertising services," predicts the UK CEO of one global media agency.

Other companies are responding to demand risk by developing new strategic advisory propositions. "Ten years ago we were much more focused on web development, whereas today we are doing lots more work in strategy and transformation," says the CEO of a major North American company that provides marketing strategy, design and technology services to its clients. "Our clients' main challenges cluster around customer experience and content strategy, as well as platforms and digital integration; at the same time they are looking to lower the cost of delivery and find new ways to interact with their customers," he says.

3. 'P&G Cuts Agencies 40% in First Wave of Consolidation Drive', Advertising Age (July 2015): http://adage.com/article/ad-age-research/p-g-cuts-agencies-40-wave-consolidation/299750/

However, innovating an organisation's business model to maintain margins can be challenging.

Careful thought needs to be given to how changing customer demand will impact future revenue streams. According to the CFO of one of Germany's largest digital media companies, it is important not to cannibalise existing revenue streams too quickly during the innovation process: "Although we have been shifting to a video and mobile-based strategy, we have found that there is still a lot of potential to grow our existing assets. Premium display won't fully substitute television. The attractiveness of mobile channels for consumers will be difficult to monetise, and as more and more traffic comes from mobile we will need to focus on developing high-quality content to maintain margins."

THE BDO VIEW

TWO CHANGING CUSTOMER DEMAND RISKS TO WATCH OUT FOR.

1. BRINGING MORE SERVICES IN-HOUSE

With balance sheets under scrutiny from investors, companies will want to keep tighter control on discretionary spend. This is likely to result in further pressure for marketing functions to bring more work in-house and reduce their dependency on external providers.

2. GLOBAL SPENDING PATTERNS WILL DIVERSIFY

As marketing services companies become more global they will need to look at how to offer more joined-up services to international clients. While some clients will welcome a global approach, others will prioritise a local touch. An in-depth knowledge of local markets will be essential in 2016 and beyond.

THREE

REGULATORY RISK

OVERCOMING REGULATORY BARRIERS TO GROWTH

MORE THAN HALF (54%) OF MARKETING SERVICES COMPANIES IN OUR RESEARCH CITE THE CHANGING REGULATORY ENVIRONMENT AS A SIGNIFICANT RISK TO THEIR FUTURE GROWTH.

The regulatory risks they cite are multiple and various, but often cluster around a concern that the public health agenda may limit the ability of their clients to promote their products, and hence impact on revenues from clients in these segments. For example, the most recent annual report from global public relations group Publicis cites 'strict regulations governing the advertising and marketing of certain products, in particular tobacco, alcohol, pharmaceuticals and foodstuffs' as a having an 'adverse impact' on the group's operations[4].

Our research reveals a perception among some marketing services companies, particularly those in Europe, that regulation hasn't created a level playing field to do business. Rather than create a more competitive market, marketing companies highlight that regulation has actually allowed overseas companies, such as Google and Facebook, to dominate local markets.

One area where this poses a major risk to marketing companies is data security. The CFO of a major European marketing company argues that the current regulatory regime puts European companies at a disadvantage: "We are not allowed to gather as much data from the end customer as companies in the US are. Customers have to opt-in to cookies in order for us to gain more valuable intelligence from them, whereas American companies are allowed to track a lot more customer data." Given that data poses a huge opportunity for marketing companies to expand their services to clients, the regulations around data security need to be carefully balanced to ensure ongoing compliance without limiting growth potential.

4. Publicis Group, Annual Yearbook : 2014 Highlights (2015): http://www.publicisgroupe.com/en/media/display/id/7786/theme/36-Annual-Reports

THE BDO VIEW

The regulations around data security need to be carefully balanced to ensure ongoing compliance without limiting growth potential

TWO REGULATORY RISKS TO WATCH OUT FOR.

1. THE DIGITAL SINGLE MARKET WILL HAVE TO BE EMBRACED

The EU's Digital Single Market agenda, designed to help companies, brings increased challenges of understanding and complying with new regulations. With further EU reform on the agenda, including a possible "Brexit", marketing services companies in this market need to keep a close eye on regulatory developments.

2. DATA COMPLIANCE IS NO LONGER A "NICE TO HAVE"

Recent high profile data breaches highlight the importance of data security and integrity. Given data is the backbone for many new marketing services, further regulation or restriction could have wide-reaching implications for marketing services companies. In 2016 companies may need to set aside additional resource to cover the costs of ensuring compliance with enhanced data security standards.

FOUR

COMPETITION RISK

ADAPTING TO DISRUPTIVE COMPETITORS

ACCORDING TO THE UK CEO OF ONE MARKETING COMPANY INTERVIEWED FOR THIS RESEARCH, THE MARKETING SERVICES INDUSTRY IS HIGHLY SATURATED WITH QUALITY ADVERTISING.

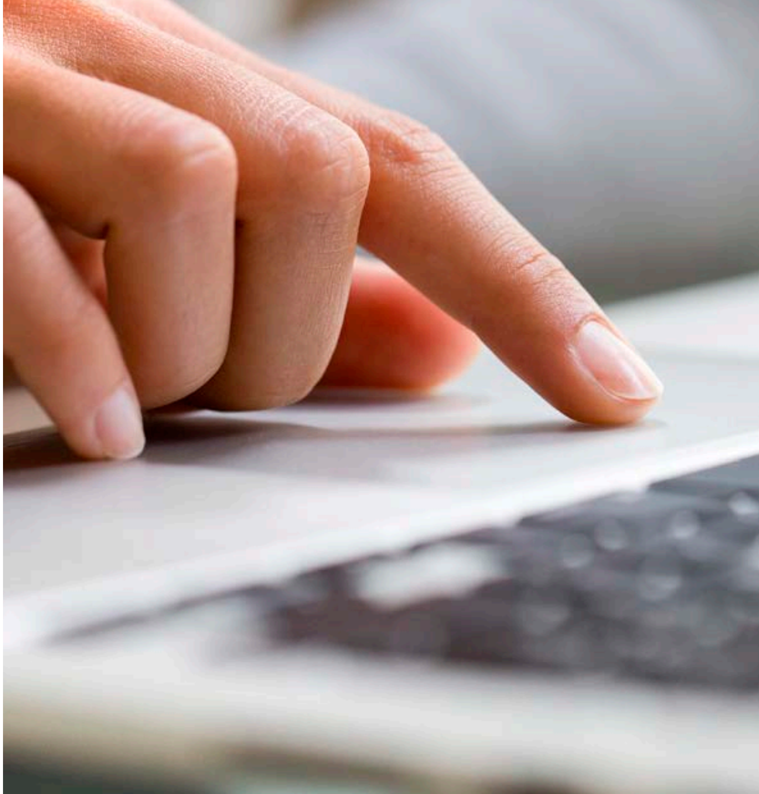
"There are almost too many great advertising agencies out there fighting over decreasing marketing budgets," he says. The wider market concurs: 48% of companies agree that the emergence of new competitors is major risk to their growth strategies. As Chinese advertising and communications company ChinaNet Online Media notes in its annual report, "Increased competition could result in a loss of market share. It could lead to lower prices and decreased revenues, gross margins and profits"[5].

A consequence of the over-supply of advertising and marketing agencies is that companies have become increasingly reliant on a small number of clients for a high proportion of their revenue. This risk is noted by just under half (46%) of companies, and is common to agencies the world over. Interpublic, a US marketing group, notes that its top ten clients account for 20% of total revenue, while German SYZYGY Group says its ten largest clients constitute 61% of sales. Aimia, a Canadian marketing and analytics company, highlights that its four largest accumulation partners accounted for 52% of billings in its latest financial year[6]. Overreliance on a small number of clients amplifies the risk of short-term swings in profitability should any clients launch a competitive retender or unexpectedly reduce their overall marketing spend.

5. ChinaNet Online Media, Annual Report (2015): http://investor.chinanet-online.com/secfiling.cfm?filingID=1171843-15-1980&CIK=1376321

6. Interpublic Group, Annual Report 2014 (2015): http://phx.corporate-ir.net/External.File?item=UGFyZW50SUQ9Mjc5MzA0fENoaWxkSUQ9LTF8VHlwZT0z&t=1; SYZYGY Group, Annual Report 2014 (2015): http://www.syzygy.net/images/AR2014_EN_web.pdf

Aimia, Annual Report 2014 (2015): http://www.aimia.com/content/dam/aimiawebsite/financial_reports/2014/Annual/AnnualReport2014EN.pdf



48% of companies agree that the emergence of new competitors is major risk to their growth strategies.

THE BDO VIEW

TWO COMPETITION RISKS TO WATCH OUT FOR.

1. A NEW ERA OF "MEGA MERGERS" IS LIKELY

The disparate nature of the marketing services sector means that further consolidation is likely. The changing landscape will put huge pressure on companies who want to be acquired to demonstrate their value as a potential acquisition target. Companies who have failed to build up a sufficient warchest may miss out on the best acquisitions and could be left behind.

2. SPECIALIST AGENCIES ARE EMERGING IN NICHE AREAS

The fast growth of areas such as mobile marketing has led to the emergence of niche providers, some of which have enjoyed triple digit growth rates in recent years. In the coming years these companies are likely to be chased by large marketing services conglomerates, often for higher than expected multiples.

FIVE

TECHNOLOGY AND SKILLS RISK

REMAINING FIT FOR THE FUTURE

TECHNOLOGY PRESENTS SIGNIFICANT OPPORTUNITIES FOR MARKETING COMPANIES: BY 2017, FOR EXAMPLE, 90% OF INTERNET USERS WILL BE ABLE TO ACCESS ONLINE CONTENT VIA THEIR MOBILE PHONE[7].

According to the CEO of one of South Africa's leading digital agencies, "most global companies, and even strong local companies, haven't even begun to really tap into the value that the digital space represents to them. There is still much more value that technology can deliver".

Given the size of this opportunity, why do a third (32%) of marketing services companies in our research see technological innovation as a risk? One answer is that the fast pace of technology creates barriers to growth almost as quickly as it creates opportunities. An example is ad blockers, software that users can install on their devices to limit the display of digital adverts. New research from industry body the Internet Advertising Bureau has recently shown that almost one in five (18%) UK adults now uses ad blocking software[8]. This is one technology innovation that is changing the game for the negative.

Another answer is that technology rapidly changes the skills and competencies needed by marketing services companies. The need to attract and develop talent with the right technological skills is one of the most significant risk facing companies in the sector today; 50% of companies cite it in their annual report as a major risk, while 56% acknowledge they are dependent on a small number of key personnel to deliver core competencies.

The supply of high-skilled talent is failing to keep up with demand. The CFO of a leading German marketing company notes that his company is having to look further afield to find the right skills: "To access the skills we need we are now recruiting from places

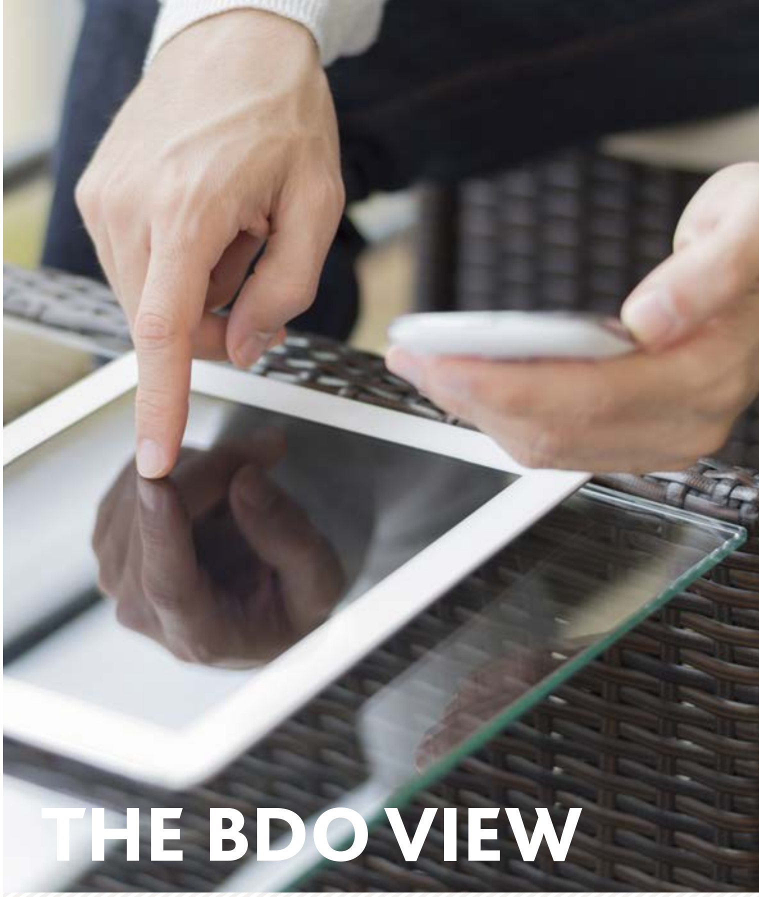
7. http://www.statista.com/topics/779/mobile-internet/

8. Internet Advertising Bureau, 'New IAB UK research reveals latest ad blocking levels' (November 2015): http://www.iabuk.net/about/press/archive/new-iab-uk-research-reveals-latest-ad-blocking-levels

> The need to attract and develop talent with the right technological skills is one of the most significant risks facing companies in the sector today.

as far afield as Brazil, Ukraine and India. If you are studying computer science in Western Europe you can immediately find five to ten different employers all after your skills. You need to be very attractive as an employer to get people on board," he says.

The executives we interviewed expect this risk to intensify. According to the CEO of a leading North American marketing company, one consequence of continued macroeconomic and political turmoil is that it will be harder for small and medium-sized companies to hire skilled workers from overseas necessary to grow their business: "I foresee that governments will become more protectionist of jobs and of trade. They will close borders and it will make it harder for a company like ours to do business in a global economy. We are competing against companies who – if they are able to move more rapidly in hiring skilled workers – have a critical advantage."



THE BDO VIEW

THREE TECHNOLOGY AND SKILLS RISKS TO WATCH OUT FOR.

1. DON'T GET LEFT BEHIND IN THE TECHNOLOGY RACE

Investing in the right technology has become essential for marketing services companies to retain competitive advantage. Companies that fail to re-invest a sufficient proportion of earnings in technology and product development are at risk of being left behind.

2. THE COST OF TECHNOLOGY IS LIKELY TO FALL DISPROPORTIONATELY ON SMALLER COMPANIES

Larger marketing services companies are likely to have capital to invest in new technology, whereas smaller companies may find the cost of new technology has a detrimental impact on margins. Additional sources of financing are likely to be required to fund significant technology projects.

3. THE WAR FOR TALENT IS SET TO INTENSIFY

The bid to attract the best talent is always a challenge, but this pressure is likely to intensify. Companies need to keep their compensation and benefits under review to ensure their benefits package enables them to attract and retain the best staff.

CONCLUSION

KEY QUESTIONS FOR YOUR COMPANY TO CONSIDER

Executives in the marketing services industry need to be aware of the various risks on the agenda and should act on them accordingly. How confident are you that you can adapt to disruptive market conditions ahead to ensure your company thrives?

Consider the following questions about the most significant risks facing your company:

1. FINANCE AND MACRO-ECONOMIC RISK

- How significant is the impact of fluctuations in interest rates and currency markets for your company?
- How resilient is your company against macroeconomic or geopolitical shocks? How might these shocks impact short-term profitability and cash flows?
- How easy will it be be to gain access to the capital required to fund your growth strategies?

2. CHANGING CUSTOMER DEMAND RISK

- What strategies do you need to adopt to counter the trend of clients reducing their external marketing spend?
- How can you bundle existing services to sell more complete solutions to clients?
- Where are the opportunities to create new propositions to meet changing customer buying patterns? How will this impact your operating model?

3. REGULATORY RISK

- How secure is your IT infrastructure against potential data breaches or cyber threats?
- What will be the impact of the Digital Single Market on your business? How well prepared are you for this regulatory overhaul?
- What other regulatory developments may impact your business during 2016?

4. COMPETITION RISK

- Are you too over-reliant on a small number of clients for a large proportion of your revenue? How can you diversify your client base further?
- How well positioned are you to take advance of merger and acquisition opportunities?
- How much of a risk does the rise of specialist competitors pose to your business?

5. TECHNOLOGY AND SKILLS RISK

- Do you re-invest a sufficient proportion of your revenue in technology and product development?
- What skills will be critical for your business as it adapts to the changing needs of customers in the short and long term?
- Does your current remuneration and benefits package allow you to compete for the best talent?

FOR MORE INFORMATION:

AUSTRALIA

CRAIG MAXWELL
+61 2 9240 9865
craig.maxwell@bdo.com.au

BELGIUM

BERT KEGELS
+32 027 753 018
bert.kegels@bdo.be

CANADA

SCOTT RODIE
+15 149 315 796
srodie@bdo.ca

CHINA

JESSICA WU
+86 21 63 39 01 61
jessica.wu@bdo.com.cn

DENMARK

PETER RASBORG
+45 39 15 52 00
ras@bdo.dk

GERMANY

NICOLAS VON WESTBERG
+49 8955 168 242
nicolas.vonwestberg@bdo.de

INDIA

ZULFIQAR SHIVJI
+91 22 24 39 36 02
zulfiqarshivji@bdo.in

IRELAND

JOHN O'CALLAGHAN
+353 1 470 0000
jocallaghan@bdo.ie

RUSSIA

IRINA SMIRNOVA
+74 957 975 665
i.smirnova@bdo.ru

SINGAPORE

PHILIP AW
+ 65 6828 9169
philipaw@bdo.com.sg

SWEDEN

JOHAN PHARMANSON
+46 8120 116 00
johan.pharmanson@bdo.se

UNITED KINGDOM

ANDREW VINER
+44 207 893 2373
andrew.viner@bdo.co.uk

UNITED STATES OF AMERICA

KASHIF HUSSAIN
+1 310 557 8261
khussain@bdo.com

www.bdointernational.com

HB008105