Kingston Smith

Marketing Monitor

DIGEST OF THE ANNUAL SURVEY

Introduction

The results of this year's Kingston Smith annual survey were characterised by improved growth but translating this into increased profit margins was, for many agencies, a struggle. Of the eight sectors surveyed, five saw their operating profit margins fall, despite most reporting better growth in fee income compared to last year.

The marketing services landscape continues to change with rapidly developing technology presenting both opportunities and challenges. The need to make communications interesting and relevant in order to stand out against the noise has never been more important or difficult.

Change, however, generally requires re-evaluation of strategy and continual investment in talent, which makes it expensive. The shortage of talent remains, especially amongst those with digital expertise, inevitably putting pressure on wages. This cost pressure is exacerbated by the increasing need to use freelancers, which in turn are even more expensive. This, combined with the continued trend away from retainer fees to more project orientated work and increased property costs, does not make it easy to generate the sort of profit margins that agencies aspire to and this is reflected in many of the results that we have seen.

In the Kingston Smith annual survey, we reviewed the financial performance of eight distinct sectors: six individual disciplines – advertising, branding & design, digital, marketing & sales promotion (MSP), media buying and public relations (PR), as well as the UK quoted and independent marketing services groups (whether individual or mixed discipline). The accounts that are reviewed are those that were filed at Companies House on, or before, 30 September 2016 and, in the majority of cases, cover the calendar year to 31 December 2015.

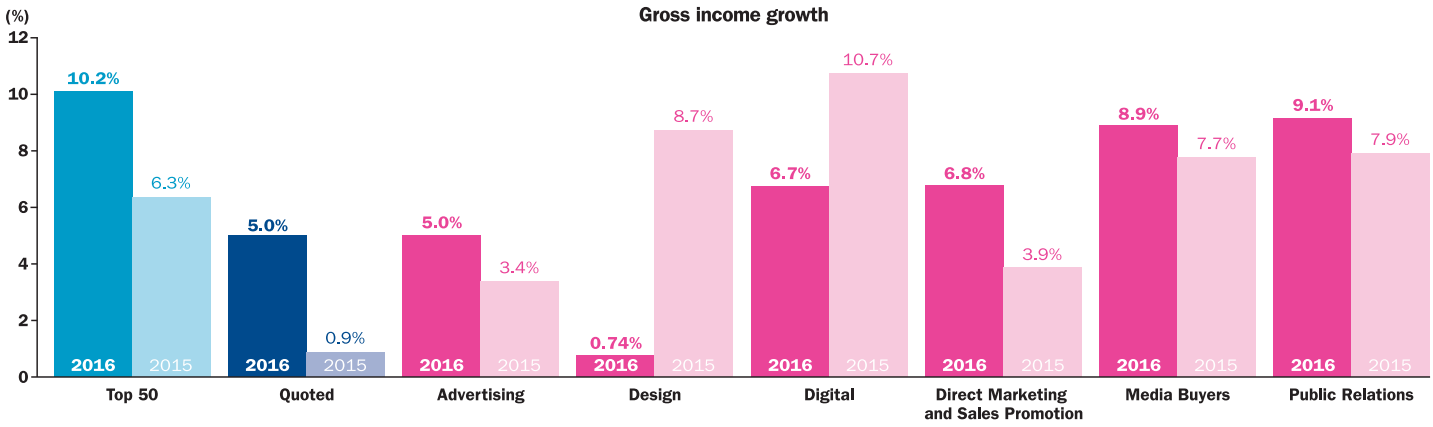
As the chart overleaf shows, every sector managed to grow total income when compared with the results of the same companies last year. Apart from Design and Digital, all the other sectors reported stronger growth than the previous year, which is encouraging. The average growth across all the sectors was 6.6%, which was just slightly more than last year's average 6.2%.

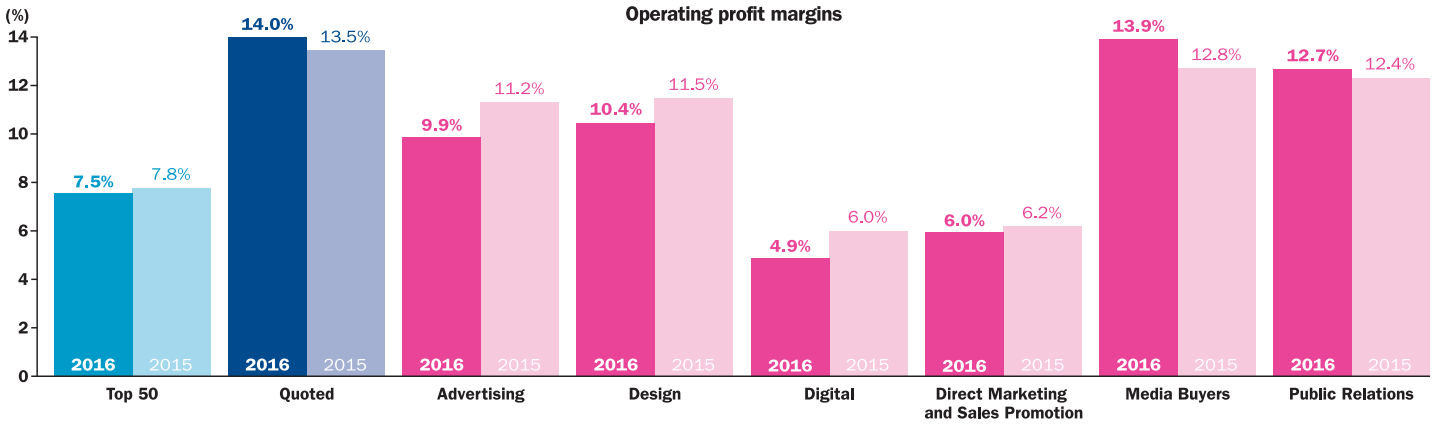
In contrast to last year, the digital specialists did not report such high fee income growth as one might have expected. It was in fact the media buyers and PR consultancies that showed the strongest growth as individual sectors. The **Top 50** independent mixed discipline groups were the only sector to show growth in excess of 10% and, whilst some of this was due to acquisitions, a healthy amount was organic.

MEDIA BUYERS AND PR CONSULTANCIES SHOWED THE STRONGEST GROWTH AS INDIVIDUAL SECTORS.

One of the key ratios for any agency to monitor is the proportion of fee income spent on staff costs. The Kingston Smith target ratio has historically been 55%, although a more realistic target in the current climate including freelancers would be 60%. The amount of fee income spent on staff costs reached a record high, averaging 60.7% across all the sectors surveyed.

This is no surprise, given the continued pressure on staff costs caused by skills shortages. Across the **Top 50** independent





mixed discipline groups, spend on staff costs remained extremely high at 62.1% of fee income. However, they were not alone, as this was a key theme across many of the individual disciplines; six out of the eight sectors surveyed spent more than 60% of their fee income on staff costs, with Advertising and Design both reporting record highest post recession ratios, and Media Buyers reporting nearly joint record high ratios.

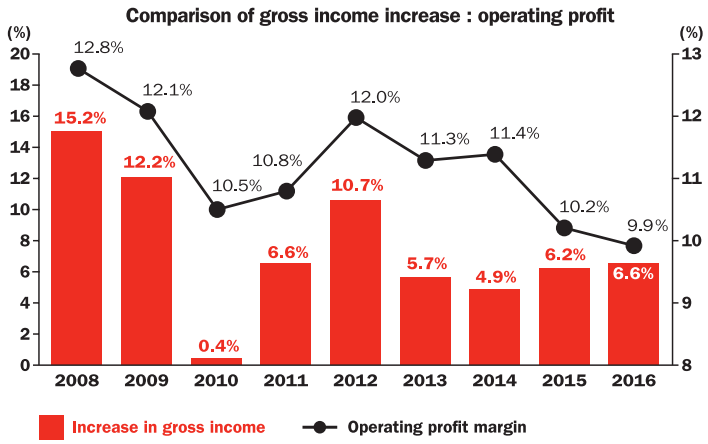
All those sectors showing a worsening of this key staff costs ratio also saw their operating profit margins fall, with a disappointing five out of the eight sectors in total seeing margins worsen. On average, margins across all the sectors fell from 10.2% to 9.9%.

The **Top 50** independent mixed discipline groups saw margins fall to a record low of 7.5% – very disappointing considering they all have fee income of around £10 million or more and so have the economies of scale required to be able to generate good margins. This demonstrates that size is by no means the key to profitability.

Typically, average operating profit margins have shown an upward trend when growth in fee income has improved. However, for the last two surveys, this has proved not to be the case. The average profit margin fell to 9.9% despite an average income growth rate improving on last year to 6.6%. This shows the tough times that agencies are operating in and just how necessary a combination of both income growth and a close control of costs is to achieve good profitability.

What is worrying is that the financial data surveyed pre-dates two of the most potentially challenging events of modern times; Britain's decision to leave the European Union and the astonishing result of the US election, both of which will undoubtedly have an impact on the economy.

The marketing services industry is traditionally robust, however, and has already weathered the storm presented by the 2008 financial crisis. A dampened economy will be something that most agencies have already lived through. Unfortunately, tough seems to be the new normal and there is no indication that things will get any easier any time soon.



Launch of the Kingston Smith annual Survey

30 November 2016

Monitoring the Markets

The Marketing Services Share Price Index tracks the share prices of marketing services groups listed on the London Stock Exchange's Main Market or AIM, tracking prices against the performance of the leading 100 shares on the FTSE. As with our last edition of Monitoring the Markets, the starting point for our comparison is January 2010, with marketing services groups based against the FTSE 100 from that date.

The index and the FTSE 100 have followed similar paths over the past six years, with the highs and lows of the Marketing Services Index being more extreme. The index closed in December 2016 7% above the FTSE 100, compared to 8% below the FTSE 100 in June 2016.

The six months to December 2016 have seen growth in both the FTSE 100 and the Marketing Services Index, with the index rapidly overtaking the FTSE. Both indexes were at a low in June 2016, following the result of the EU referendum. However, the fall in the value of sterling has made the UK more attractive to overseas investors and, along with rising commodity prices, has been a major reason for the growth over the past six months.

Although there has been an overall trend of growth in both the Marketing Services Index and the FTSE 100, a slight dip can be seen in November. This can be explained by the results of the US election on 8 November and the uncertainty that followed, combined with a fall in oil prices as OPEC's member states struggled to agree on a new output deal.

However, the FTSE 100 recovered in December as a result of an upswing in the mining industry, economic recovery in China and OPEC's eventual agreement to cap their oil output. Trump's pledge to spend $1 trillion on infrastructure has helped to restore hope to the US economy but, with the Federal Reserve's plans to raise interest rates still on standby, there is uncertainty over whether this will continue. The dollar has strengthened as a result of this and, due to the effects of Brexit being unclear, the pound has weakened. This has meant that the FTSE 100 has continued to reap the benefits from the exchange rates and it closed the year at a record high, whilst the Marketing Services Index was back at a level which hadn't been seen since May 2014.

The Marketing Services Index mirrored the FTSE 100's dip from September to November 2016, as a number of companies (such as **Porta Communications**, **Huntsworth**, and **Matomy**) announced losses for the first six months of the year. A rise in the pound in September took away the exchange rate advantage and contributed to the dip in the index.

Similarly to the FTSE 100, the Marketing Services Index recovered again in December 2016. In the five months to May 2016, prior to the EU referendum, the Marketing Services Index outperformed the FTSE 100 by 7%, which is the same at the closing position in December 2016. Whilst these companies initially felt the uncertainty in the market caused by the vote to leave the EU, they have since greatly reaped the benefits of a falling exchange rate; this was further compounded by an overall increase in international sales for many of the major marketing agencies.

As ever, the marketing services sector is dominated by the performance of **WPP**. The world's largest advertising group mostly followed the performance of the FTSE 100 during the period; following a slight dip at the end of June, it had a runaway recovery and achieved an all-time-high share price twice during the year, resulting in an overall increase

in share price of 17% since our last edition of Monitoring the Markets in June. The falling exchange rates caused WPP's revenue to rise in their last quarter by 23%, bringing the growth in their current year up to 16%. In November 2016, they acquired Promotion Execution Partners, a US shopper marketing promotions agency, and have been continuing their programme of share buybacks.

Creston plc saw a steady increase in share price during the period, with a 23% rise since June. This was sparked by a takeover bid by Isle of Man offshore fund manager DBAY Advisiors for £75.8 million. The deal was announced on 17 November and Creston subsequently delisted and will no longer be included in the index. Barrie Brien, group chief executive of Creston, commented, "as the business and our clients' requirements continue to develop, and in light of uncertain market conditions, the board of Creston has given careful thought about how best it pursues this strategy to deliver value for shareholders, clients and staff." Following on from Chime Communications in 2015, it is another example of a mid tier marketing communications group deciding it will have a better future under private ownership.

M&C Saatchi enjoyed an increase in US revenue of 93% over the past six months, meaning they hardly felt the effects of this summer's downturn but joined in the renewed optimism across the Atlantic, closing the year with its share price at an all time high. Partly this was due to exchange rate changes, but they have also increased their US presence in the period; having acquired a controlling share in both MCD Partners and SS+K, they were also in a good position to benefit from US growth.

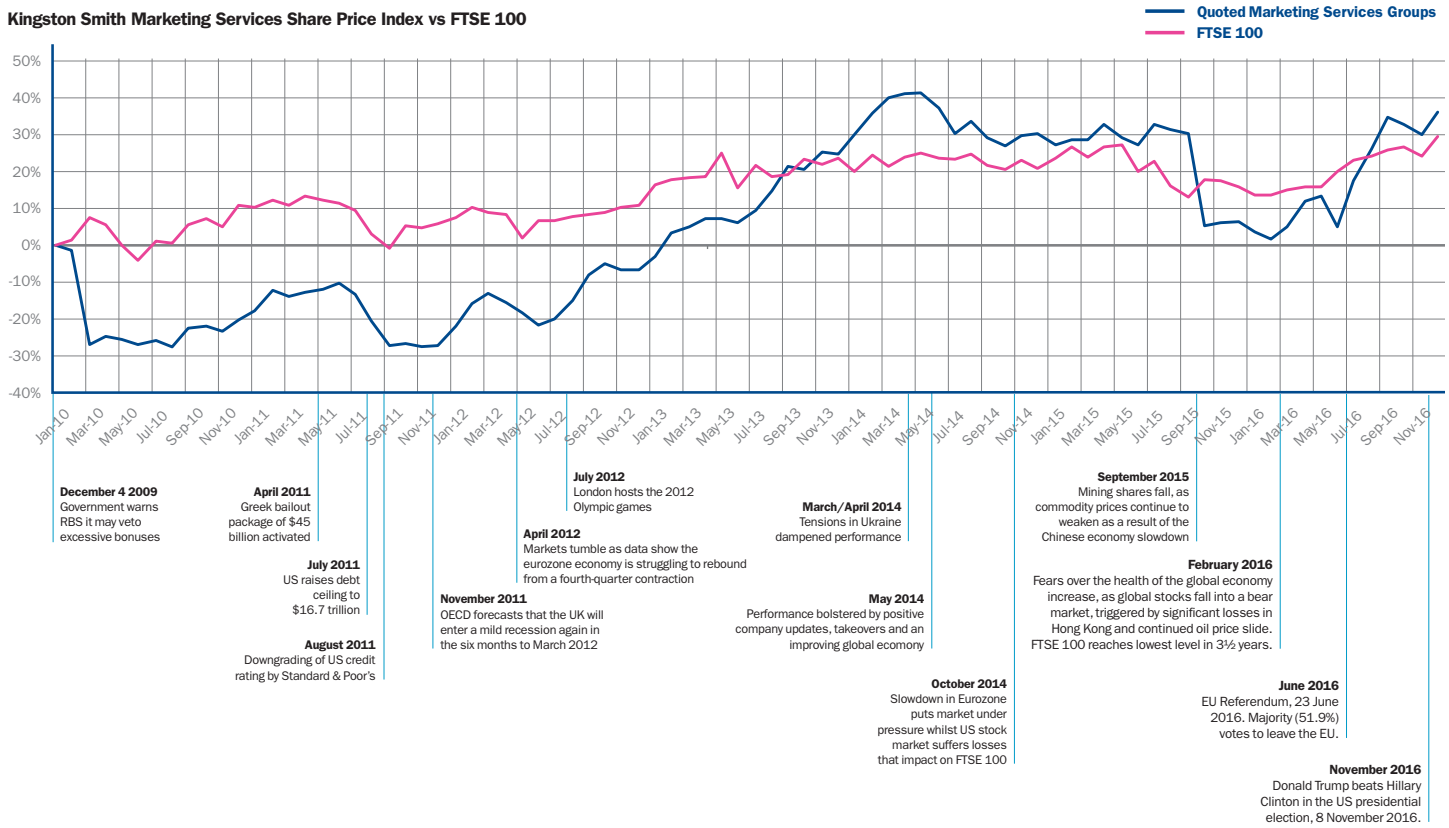
Porta Communications Group's share price fluctuated through the period due to internal turmoil, as well as several announcements made throughout the year. Porta changed accountants for the sixth time in as many years. In July 2016, it became public knowledge that nine failed companies were connected with their Chairman and CEO. They subsequently resigned, resulting in their shares hitting an all time low in early October. In September, it was announced that, despite revenue increasing by 3% for the first half of the year compared to the first half of 2015, EBITDA had decreased by 16%. In December 2016, the share price saw a welcome boost after the group announced that they would increase their interest in Newgate Australia and Hong Kong.

reach4entertainment announced a return to profitability when publishing half year results to June 2016; revenue increased by 15% and operating profit more than tripled to just over £1 million. At the same time, they announced that there were fewer shows in the second half of the year and that it was likely to be more challenging. As a result, the share price dipped. They have since acquired a new subsidiary, German sports entertainment advertising giant Dewynters and reduced their debt to AIB Group by almost £10 million. In October, reach4entertainment raised £2 million in additional capital. However, it was announced in December that they had breached their loan covenants, prompting a reduction in share price.

Matomy Media suffered a post tax loss of £3.8 million for its half year results to June, and a decrease in gross profit of 11%. As an Israeli company, it was by and large independent of UK market trends; their issues arose due to strategic failure - desktop and display advertising plummeted in value with the rise of mobile and video advertising at a rate which directors simply did not anticipate. An extraordinary general meeting was called to address Matomy's strategy and its "disappointing" results, whilst the chairman opted not to stand for re-election at the start of the year.

In contrast, mobile advertisers and fellow "Silicon *Wadi*" company **Taptica International** performed strongly in the final six months of 2016. The opening of a new office in Korea contributed to this, as well as the announcement in July that Taptica International had partnered with Adways with the aim of targeting the Asian market. In September, Taptica announced spectacular six-month results, reporting a 55% revenue increase and nearly doubling its gross profit. Overall, the share price increased by 149% in the six months to December, by far the largest increase of any of the groups included in the marketing services share price index.

Kingston Smith Marketing Services Share Price Index vs FTSE 100



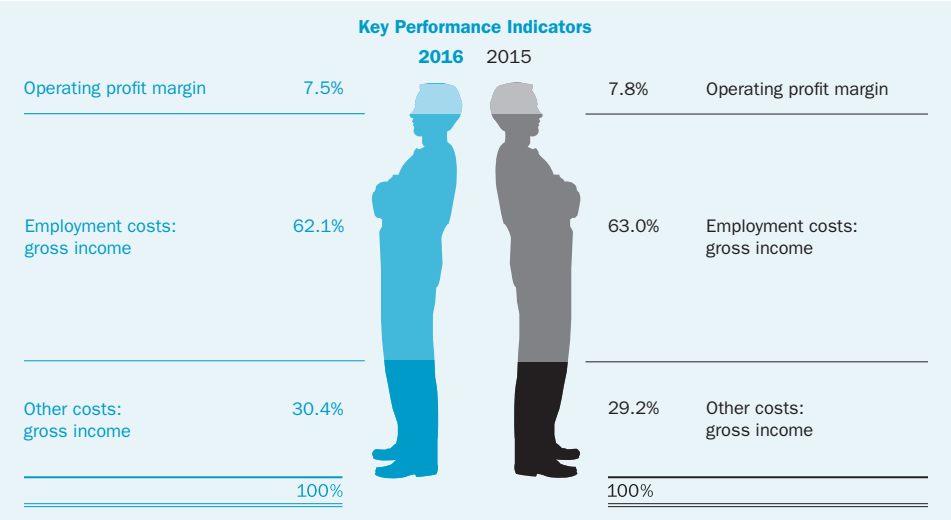
Top 50

Fee income increases by an impressive 10.2% year on year

Profit margins decrease slightly to 7.5% – an historic low

Employee numbers up 8.5%

Employment costs to fee income KPI improves to 62.1%



The results of this year's Top 50 Independent Marketing Groups present an interesting, and somewhat challenging, contrast. Growth in fee income of 10.2%, back into double digits for the first time since 2012, recorded alongside an increase in operating profits of 5.2% year on year, finds itself set against the lowest operating margins recorded in the history of the Annual Survey, at a lowly 7.5%.

The growth in fee income of 10.2% is impressive, with 39 of the **Top 50** agencies recording an increase, up from 33. Encouragingly, this is not solely attributable to mergers or acquisitions – strong organic growth appears achievable for those agencies with the right strategic offering, and demonstrates that confidence amongst those in control of marketing spend (albeit pre Brexit and pre-Trump) remains strong.

Well informed industry analysts may suggest the finger of blame for the erosion of operating profit margins should point squarely at increasing employment costs, reflecting continued talent shortages, and the disruptive effect of digital.

However, this has not been the case. Whilst employee numbers across the **Top 50** have increased by 8.5%, total employment costs have only risen by 7.8% year on year (falling short of the increase in gross income of 10.2%). What this means, therefore, is that employment costs expressed as a percentage of gross income generated have in fact fallen to 62.1%, down from 63.0% the year before and down further still on the all time high recorded in 2014 of 63.8%. Whilst this ratio is improving, it is still some way above our recommended maximum of 55%.

It should come as little surprise that those agencies spending over 60% of their fee income on staff costs are generally those recording lower operating profit margins.

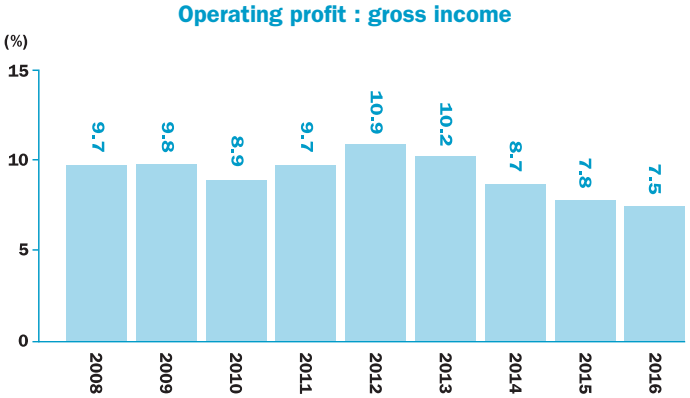
Productivity amongst the **Top 50** has also improved. On average, the **Top 50** agencies are generating £89,165 of fee income per employee, up on £87,569 in the previous year.

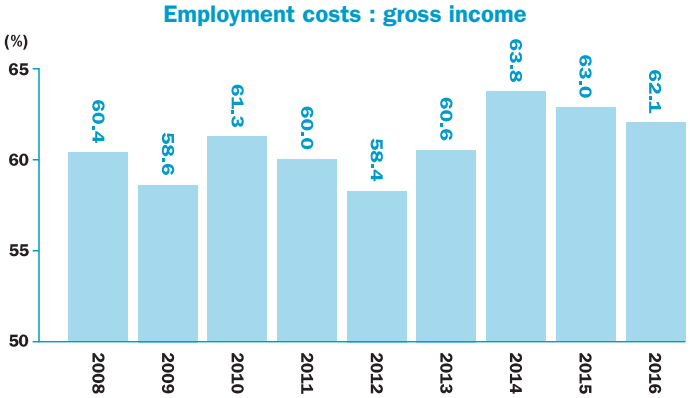
Unlike previous years, however, staff costs incurred by the **Top 50** groups are not the primary driver behind the decreasing operating profit margins. Indeed, the results surveyed reveal that 'other costs' have increased by some 16.7% year on year.

A significant component of these other costs is likely to be property based, with both rent and rates subject to unprecedented increases, particularly for those agencies headquartered in London and the South East. Any increase in property costs resulting from lease re-negotiation, renewal, or even office move will come directly off an agency's bottom line, and hence negatively impact upon operating profit margins achieved.

A further factor that will have a direct impact on the **Top 50** agencies' operating profit margins is their use of freelance labour. These freelancer costs are not included within an agency's disclosed employment costs – unfortunately there is no requirement to do so. However, in recent years the flexibility afforded by freelance labour has outweighed the increased cost; combine this with agencies' increasing need to secure specialist talent in order to service client accounts, and it is no surprise that margins are squeezed ever further. As such, the ratio of revenue spent on people is likely to exceed 62.1%.

Over the coming months, if not years, where the only certainty across the industry is likely to be the presence and effect of uncertainty, those agencies that are best able to manage the quality and utilisation of their freelancer pool, whilst controlling property costs, are those agencies likely to achieve the most substantial operating profit margins and therefore thrive.





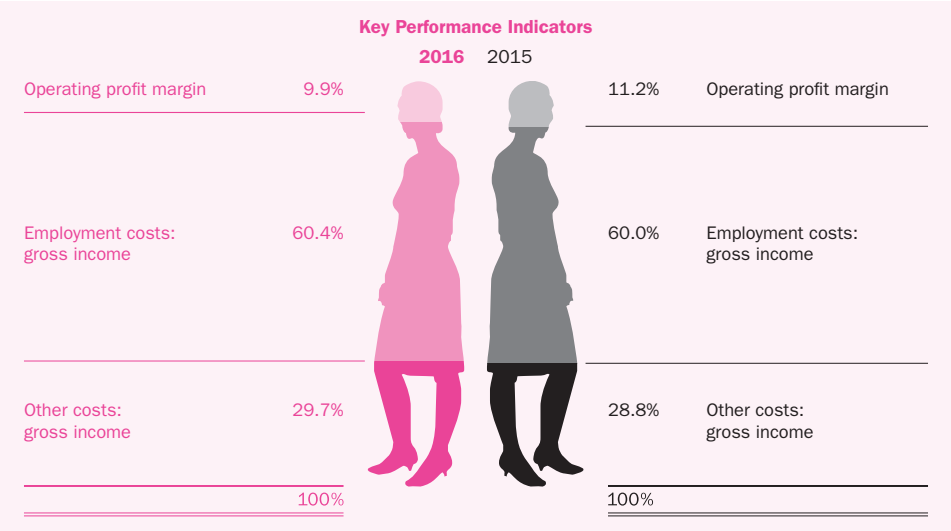
Advertising

Gross income growth of 5%

Profit margins deteriorate to 9.9% – the lowest since 2003

Employment costs to gross income increases to all time high of 60.4%

Group agencies win on both profitability and productivity



The latest results for the Top 50 advertising agencies are disappointing but not unexpected. The sector remains very competitive so, despite employment costs already being at an all time high, agencies are having to continue to invest in new talent to ensure they are able to deliver exceptional work.

Gross income across the **Top 50** advertising agencies increased by 5% to a combined total of £1.4 billion this year. Whilst the overall growth in the sector is encouraging, disappointingly only 33 of the 50 companies reported individual increases in their income levels. The average operating profit margin for the **Top 50** fell further to 9.9% (11.2% last year), the lowest since 2003, as it remains difficult for agencies to charge properly for work delivered and manage staff costs. With Brexit on the horizon, the pressures felt this year are unlikely to ease. As a consequence, agencies will need to be flexible and ensure they are not over reliant on key clients in order to prosper.

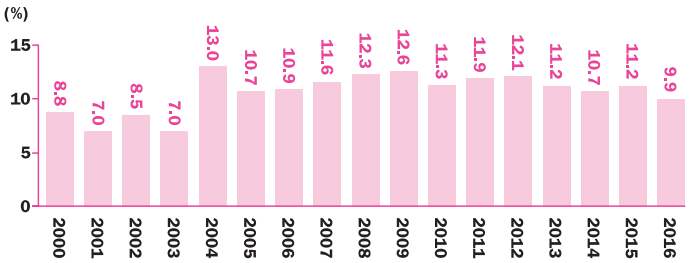
Since we started compiling the data we have seen the spend on employment costs as a percentage of gross income rise across the sector, as there has been significant pressure to invest in new talent to service changing client demands. This year was no different, as agencies reported an all time high of 60.4% (60.0% last year) of gross income spent on staff costs. At this level it is difficult to achieve a respectable operating profit margin.

Agencies reported an increase in other costs of 3.5% this year. Increasingly, a larger proportion of other costs relate to freelancer costs. As work becomes more intertwined with digital, mobile and technology, the broad range of skill sets that are required to service this work becomes ever wider and the demand for flexible talent is likely to continue. Agencies based in London also continue to face rising rents and rates, and so control over other costs going forward will be critical to remaining profitable.

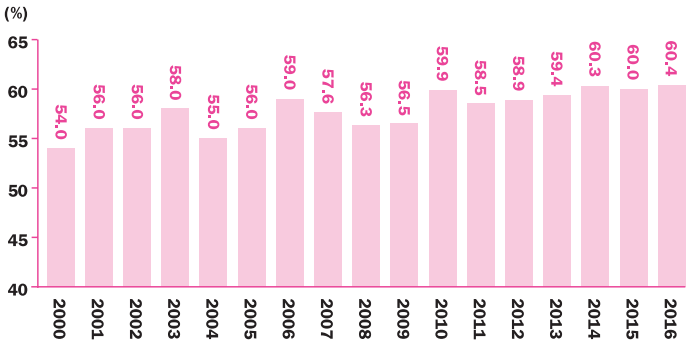
Operating profit per head fell further from our target of £15,000 to £10,908. This key indicator measures both the productivity and profitability of a business and gives us a good overall sense of the financial position of the sector.

In an industry where talent and creativity are the differentiators, it is becoming increasingly challenging for agencies to deliver excellent financial performance with the unrelenting staff cost pressure. This year's results confirm that the **Top 50** advertising agencies are continuing to struggle with changing demands, as clients expect a creative offering supported by digital and technology. Regrettably, it looks as if 2017 could bring further pressures for agencies, as reservations around Brexit are likely to fuel further staff cost pressure and weakening market confidence on a global level could curb demand. That said, there will no doubt be opportunities and it will be the agencies that adapt their offering to capitalise on those that will thrive.

Operating profit : gross income



Employment costs : gross income



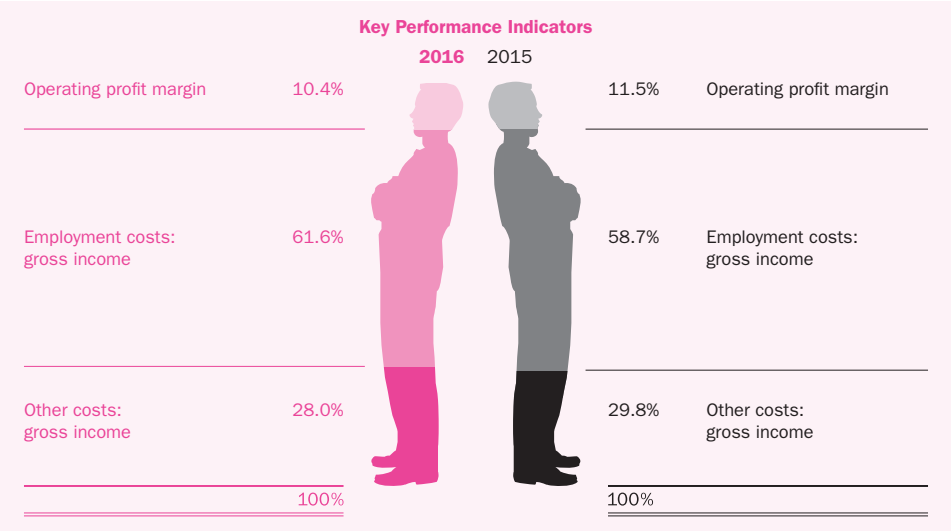
Branding and Design

Gross income flat with 0.7% increase

Operating profits decrease by 12%

Employment costs to gross income ratio increases to 61.6%

Levels of cash held consistent, but current assets decrease by 5%



It has been a tough year across the design sector. The Top 30 design agencies' total gross income increased by only £2 million but this small increase hasn't translated to any growth in operating profits, with agencies reporting a decrease in profit of 12%.

Unfortunately this meant that profit margins fell to 10.4%. A well run agency would typically be able to generate operating profit margins of at least 15% of gross income, and ideally 20%. Some 12 of the **Top 30** managed to achieve this lower target, with only five achieving in excess of 20%.

The average employment costs to gross income ratio across the **Top 30** has increased this year to 61.6%, which remains well in excess of the Kingston Smith target ratio of 55%. However, this doesn't include freelancers; if they were included, the average people costs to gross income ratio for the **Top 30** would be higher still.

We see those agencies that better manage their employment costs to gross income ratio also report healthier operating profit margins. Of the 10 agencies containing staff costs to within 55% of their gross income, six achieved margins in excess of 15%, demonstrating the importance of this ratio.

Average gross income per head, the key measure of productivity, has decreased significantly to £98,000, which is below the range of £100,000 and £120,000 where we think an agency ought to be. Group-owned agencies fared considerably better, earning £106,048 per head compared to the £93,903 generated by independents.

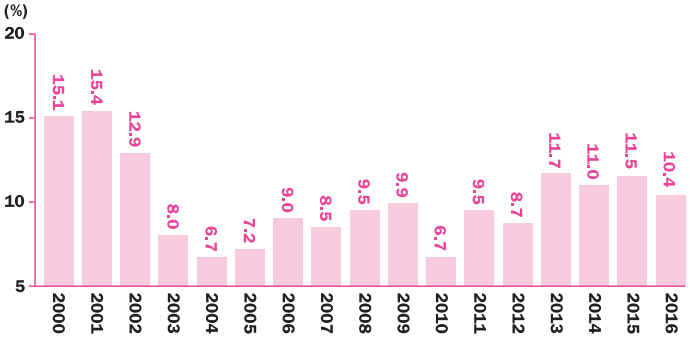
The average employment cost per head for this year's **Top 30** has been maintained at approximately £60,000. As the general economic climate continues to improve, there are likely to be further pressures on agencies to increase rates of pay to ensure that they attract and retain talented individuals, particularly those with digital expertise.

Given the decreases in gross income and productivity, the key operating profit per head figure has declined markedly on last year to £10,163. A well run design business should aim to generate £20,000, but only nine achieved this.

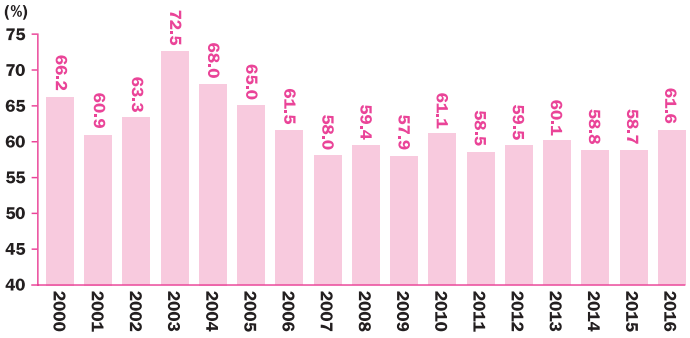
The **Top 30**, collectively, have continued to retain significant cash reserves of £84 million. However, net current assets decreased from £131 million to £125 million. Overall, this year marks a point where the growth seen over the last few years in the Design sector has ceased and, while the more agile agencies were able to cope with this slowdown, others were caught out and suffered. Unsurprisingly, the negative effects have hit the larger groups harder, with their heavier infrastructure and chains of decision making, meaning it is more difficult for them to adapt quickly. By comparison, independent agencies were largely unaffected.

The continuing challenges of providing marcoms in this digital age continue to make profits harder to generate so this, combined with the slow down in gross income growth, makes for an unsavoury combination. It is therefore not surprising that agencies in the main are retaining significant liquid assets. Given that long term survival is likely to involve continued reinvestment, perhaps at the expense of profit margins, these reserves are likely to stand those agencies that are sensible with them in good stead.

Operating profit : gross income



Employment costs : gross income



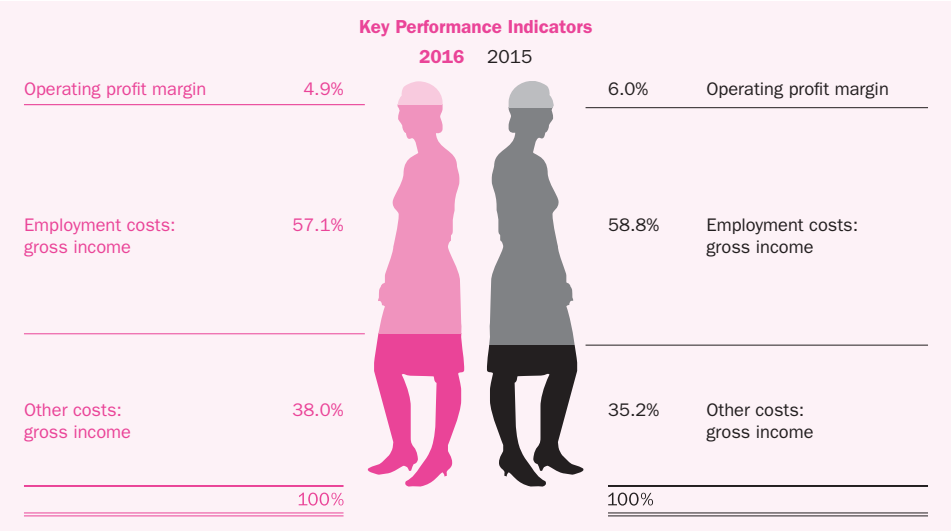
Digital

Gross income growth slows to 6.7%

Employment costs to gross income ratio improves further to 57.1%

Operating profit margin falls again to 4.9%

Group-owned agencies more productive, while independent agencies grow faster



Total gross income generated by the Top 30 digital agencies is up by 6.7% on last year. This represents a return to steadier growth following the impressive 10.7% growth seen in the previous year.

Individually, 21 agencies reported increases in gross income, with 10 achieving growth of over 20%, suggesting significant client wins. However, unfortunately, the **Top 30** digital agencies were once again unable to convert this revenue growth into profits. Total operating profits shrunk by a further 4% this year. However, this is a slow down on last year's 33.5% plunge.

This combination of increased income but decreased profits led to a disappointing decrease in profit margin to 4.9% - nearly an all time low!

Once again, the increase in employment costs of 9.5% outpaced the increase in staff numbers across the **Top 30** of 7.3%. This meant that average employment costs per head rose some 2% to £54,953, compared with £53,855 last year, reflective of the pressure on salaries in this sector.

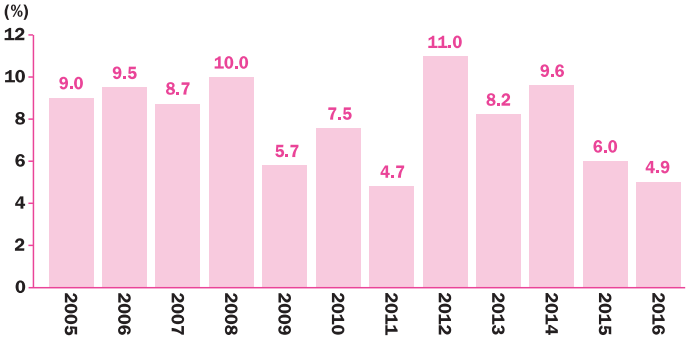
The decrease in profit margin was despite an improvement in the ratio of staff costs to gross income. However, one can be sure that this was more than compensated for by an increased spend on freelancers, which has pushed the total spend on people costs way above our target of 60%. Once again, the top five performers in the employment costs to gross income ratio were group-owned agencies. This is unsurprising, as there is likely pressure from parent companies to keep costs under control.

Operating profit generated per employee saw a reduction to £4,759 compared to £5,322 last year. Nine agencies exceeded the Kingston Smith target of £15,000 per head and just three exceeded £20,000.

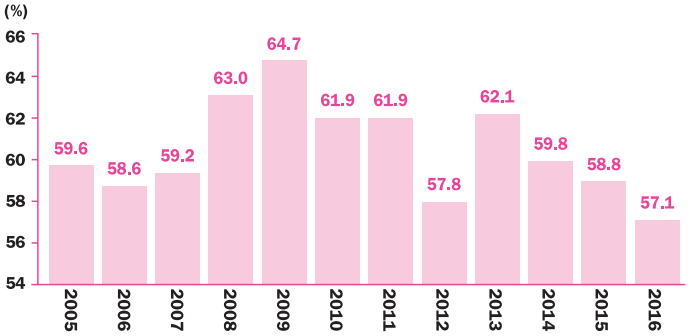
Whilst we continue to see solid growth in gross income both as a whole and individually, this progress is beginning to slow down. This is likely because the growth in digital is now more spread across other marcomms disciplines, since digital has become ingrained in most marketing campaigns. Whereas in previous years, as Digital was rapidly picking up momentum, we had noted that companies needed to become more efficient with their overheads; now there is a real pressure to do so. Whilst it is therefore encouraging to see many agencies meeting our recommended targets, the importance of keeping to these can never be over-emphasised.

*(One point of concern is the fact that six agencies of the **Top 30** had not filed their 2015 accounts when the annual survey went live – this is an unusually high number and these companies are more likely to be hiding bad news than good).*

Operating profit : gross income



Employment costs : gross income



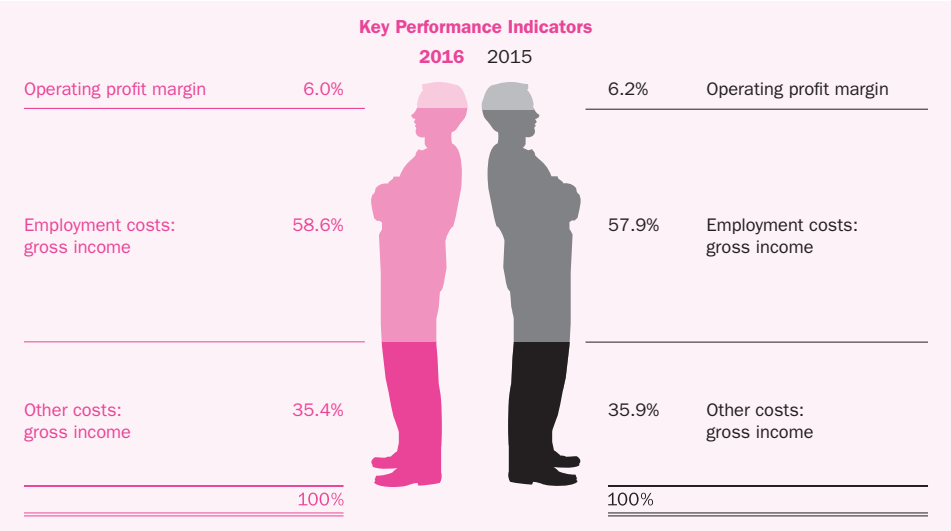
Marketing and sales promotion

Gross income improves by 6.8%

Operating margins at record low of just 6%

Other operating costs continue to erode margins

Group agencies continue to outperform their independent peers



The ability to convert fees into profit remained a challenge for a number of the Top 40 Marketing and Sales Promotion (MSP) agencies. Whilst fee income across the sector increased by 6.8% to almost £460 million, profits fell. Individually, half of the Top 40 reported a decrease in their fee income, although it was good to see that growth amongst the other half outweighed these declines. However, on a less positive note, once two major group reorganisations are factored out, the overall increase in fee income reduces to just over 1%, which is more in line with what one may expect as the sector continues to struggle.

Despite the increase in income, operating profit fell to £27.5 million, which represented an average profit margin of just 6% and, perhaps more significantly, the second consecutive year that a record low has been achieved by the **Top 40**. Margins were generally suppressed across the board with only nine agencies achieving a margin of 15% or more and only six agencies generating premium margins of 20% or more. A staggering 25% of the sample reported an operating loss.

On a positive note, agencies were able to better utilise staff and the income generated per head increased to approximately £93,500, an improvement in productivity of roughly 2.5%. Meanwhile, the average employement cost per head increased by 2.1% to approximately £54,800. As a result of this, employment costs as a proportion of fee income remained broadly in line with the previous year at 58%. We recommend that agencies maintain their employment costs within 55% of their income or no more than 60% once freelancer costs are included.

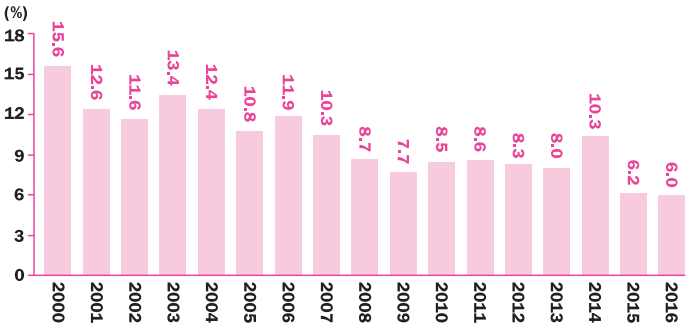
The crippling factor for agencies in the last annual survey was other overhead costs and, sadly, this year is no different, as they increased by more than 10% and consumed more than 35% of income. With the vast majority of the **Top 40** being either London based or having a London presence, premium property prices in the capital will form part of this. However, the larger contributing factor is likely to be that many freelance costs are included in overheads.

The key ratio for assessing the financial success of an agency remains the average profit generated by each employee. We believe that an accomplished agency should target a minimum of £15,000 with £20,000 being the stretch target, which six agencies managed to achieve.

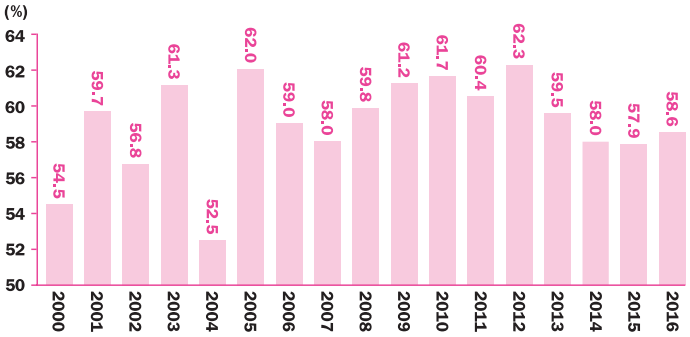
There was a noticeable divide between the performance of group and independently owned agencies. Continuing the trend of recent years, the difference in the productivity of group-owned agencies in comparison to their independent counterparts widened, as gross income per head at group agencies increased to a respectable £106,906. Independent agencies, on the other hand, have seen little growth in productivity, as gross income per head remained relatively stable at £69,712. This is far too low and no doubt partly responsible for the very low margins at independents, where increases in other costs meant that margins slipped from 3% last year to a very disappointing low of 1%. In comparison, the group-owned agencies generated an average operating profit margin of 7.8%.

Overall then, it was a poor year for MSP agencies, with the continued squeeze on profits clearly a cause for concern. Agencies need to evolve to keep pace with technological changes, which demands investment in people; that combined with escalating property costs means that the pressure on margins may not lift for some time. The effects of Brexit will no doubt also contribute to their woes with a general dampening of the economy expected, which will no doubt affect marketing spend.

Operating profit : gross income



Employment costs : gross income



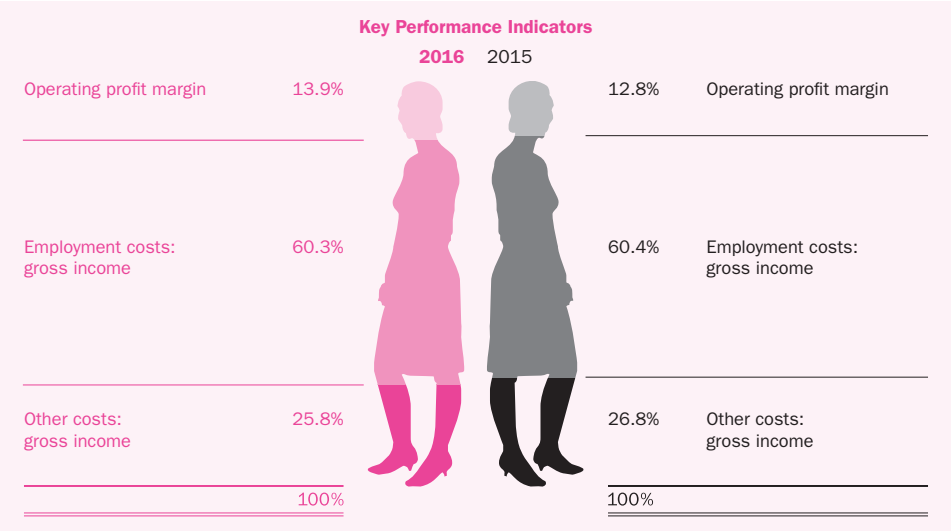
Media buyers

Gross income rises by 8.9% overall

Operating profit margin recovers slightly at 13.9%

Average salary costs stabilise with an increase of 1.2%

Employment cost to gross income ratio exceeds 60% for the second year



Media buying agencies continue to try to find their way in the ever increasing digital world. The advent of programmatic and the shift in consumer behaviour are driving agencies to explore new business models that will allow them to adapt to the revolutionary changes. With expectations for efficiency being pushed ever higher by advances in technology, agencies continue to research and develop new approaches to differentiate themselves from the competition - and this requires a significant amount of investment.

The gross income of the **Top 30** media buying sector has continued to grow in the period, increasing by 8.9% overall compared to last year. This is a very positive result given the continued difficult trading environment for companies in this sector in terms of competition to win and retain clients. The average gross income per head over the entire **Top 30** has stabilised, being £101,431 this year compared to £101,807 last year, suggesting that gross income is broadly increasing in line with employee numbers. However, only six agencies achieved gross income per head of over £120,000, which is our target figure, compared to 10 in the 2015 survey.

The effort and cost that goes into winning new work is immense, so it has never been more important that agencies retain and develop existing clients. Talented staff are integral to building strong, enduring client relationships, so nurturing and retaining those individuals is also crucially important.

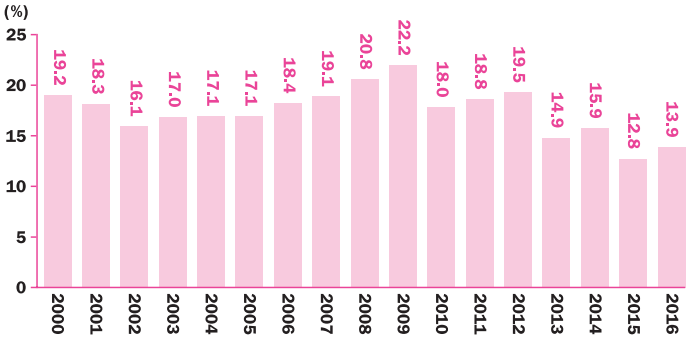
The landscape for media buyers is changing and becoming increasingly technical, highlighting the importance of having an engaged team with the right skillset. This will impact both staff costs and use of freelancers in the years to come as agencies work to find the right balance.

Average salary costs per head have stabilised in the period, increasing by a reasonable 1.2% to £61,138. However, in percentage terms, the average employment cost is over 60% of gross income for the second year in a row, having increased from 52% over the past six years. Our benchmark is that employment costs should be a maximum of 55% gross income and 19 companies in our sample managed to keep costs at this level, a slight improvement compared to 18 last year.

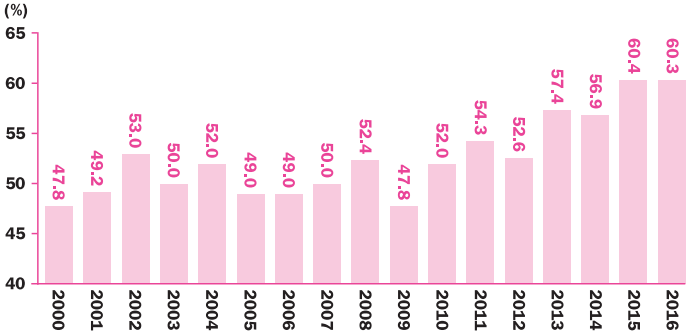
Stabilisation of salary costs means that agencies are able to focus on their bottom line. Some 23 of the **Top 30** companies increased their operating profits in the year and only two reported losses this year. Operating profit margins have recovered slightly at an average 13.9% compared to 12.8% last year.

We have been reporting for the past few years that agencies have been investing in people and technology to remain competitive in the new programmatic world. The investment really needs to start converting into increased top-line efficiency, and therefore profits, soon if media agencies have any hope of returning to the higher margins they traditionally experienced. It will be interesting to see what happens in the next few years to come.

Operating profit : gross income



Employment costs : gross income



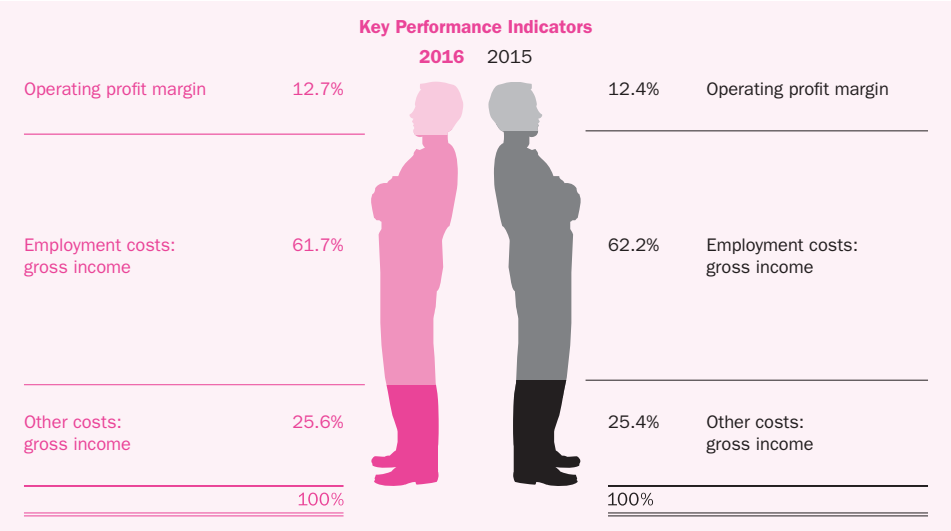
PR

Gross income growth accelerates to over 9%

Operating profit margin remains consistent at 12.7%

Half of the agencies report margins of more than 15%

Financial PR still leading the way in terms of gross income per head



PR continues to be one of the more profitable marketing disciplines and saw margins rise from 12.4% to 12.7%. The range of profit margins achieved was very similar to the previous year, with exactly half of the Top 40 agencies achieving margins in excess of our target minimum of 15%. Disappointingly, the number of loss making agencies increased to eight.

The reported operating profit margins continue to underline our long-held belief that a well-run agency that keeps good control of its people costs will generate healthy bottom-line profits. In fact, of the 11 agencies reporting a margin over 20%, all but one managed to keep employment costs below our target ratio of 55%.

The PR sector also continued to achieve top line growth, generating an additional £45 million of fee income, an 8% increase. Individually, 26 consultancies reported an increase, of which 14 achieved an increase of more than 10%. With overall positive growth in the sector, only four agencies saw significant falls in gross income, the main reason cited being the loss of client budgets as they were taken in-house.

Gross income per head has seen an increase of 2% to just under £106,000. Employment costs and other operating costs per head have risen by just over 2% and 0.5% respectively. This has therefore led to an improvement on the bottom line, with operating profits rising to £13,100 per head.

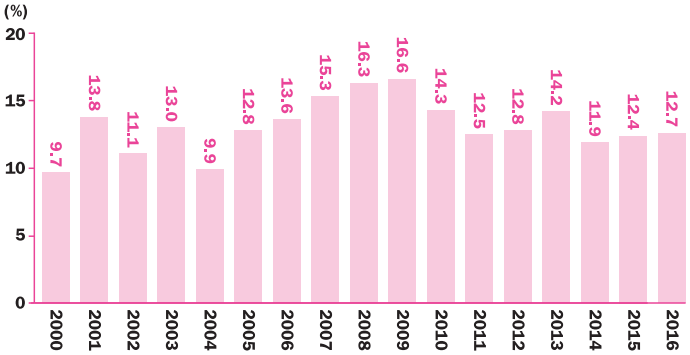
Financial PR agencies fill the top four positions in terms of gross income per head, with the majority also being in the top half of the margins table. In terms of the operating profit margin, those tech and financial focussed businesses filled four of the top five positions, mostly as a result of generating over £110,000 gross income per head whilst managing to control their staff costs to within about 55% or less of gross income.

Whilst this year's results are an improvement, they are still significantly short of the impressive margins of over 16% achieved prior to the financial crisis and recession of seven years earlier. In recent years margins have begun to be squeezed as a result of a move to more project-based work (coupled with continued salary and premises cost pressures), a trend that a number of agencies were already anticipating.

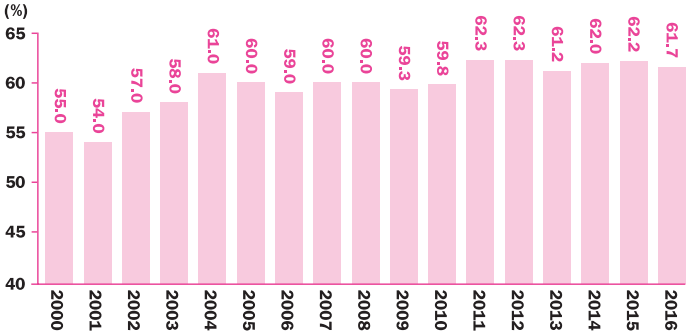
We reflected in 2015 that those agencies that can move with the times and broaden their offering to include digital services and rich content will be those more likely to prosper and stay ahead of their rivals. Agencies need to ensure they are at the forefront of this change, developing content and branding skills within the business to ensure they can deliver the value-added services that clients are demanding. That they have in the main managed to do this has contributed to healthy margins.

Interestingly, what we are seeing is agencies having to balance the requirements of clients to offer these more wide-ranging skills while retaining focus on the key specialisms and reputations that have laid the foundation for previous success. We predict that a greater specialism, combined with a broader range of services, is likely to give consultancies the edge going forward.

Operating profit : gross income



Employment costs : gross income



About Kingston Smith

Kingston Smith LLP is one of the UK's top 20 audit and accounting firms, and a founding member of Morison KSi, a worldwide association of independent accountancy firms.

Kingston Smith's West End office, with its team of six partners and 60 staff, specialises in advising media businesses. We are able to provide a full range of audit, accountancy, tax and corporate finance services, as well as specialist ad-hoc advisory services on all financial issues. Such specialist areas of advice include employee incentive schemes, benchmarking, succession planning, exit planning, business valuations, profit improvement reviews, business plans, preparing for sale, pre sale tax planning, mergers and acquisitions.

Our clients are spread across the media sector, covering all the key disciplines within marketing services, TV and commercial production, media technology, publishing, consulting, live entertainment and music.

Our services have been developed to advise growing, successful businesses at every stage of their growth, with our clients ranging from start ups and sizeable independents through to multinationals and AIM listed groups.

International expansion is of increasing significance to businesses' growth plans. At Kingston Smith, we support our clients as they move into new markets, providing commercial and timely advice throughout the transition and using our Morison KSi network to assist you locally. As part of our international focus, we are also commercial partners of www.thecreativeindustries.co.uk. Developed by industry and government, this portal aims to celebrate UK successes globally and increase international trade and inward investment in the creative sector.

For more information on Kingston Smith's services to the media sector, visit www.kingstonsmith.co.uk/media

Kingston Smith's 2016 M&A Highlights

Our corporate finance team is proud to have advised on the following media transactions in 2016:

Digital
Sale of majority stake in Code Computer Love to Mediacom, part of WPP
Lead Adviser

PR
Sale of House PR to W Communications
Lead Adviser

Media
Management Buy Out (MBO)
Corporate Finance Advisers

Digital
Sale of Flipside to Weber Shandwick, part of the Interpublic Group
Corporate Finance Adviser

Media
Growth Capital Fundraising
Lead Adviser

Marketing Services
Acquisition of The Brooklyn Brothers by Golin
Transaction Tax

PR
Sale of 3 Monkeys Communications to Zeno Group
Transaction Support

Marketing
Sale of 4Ps Marketing to NetBooster Group
Transaction Tax

Contact us

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

Kingston Smith
Charlotte Building
17 Gresse Street
London
W1T 1QL
T 020 7304 4646

Amanda Merron, Partner
amerron@kingstonsmith.co.uk

Esther Carder, Partner
ecarder@kingstonsmith.co.uk

Graham Tyler, Partner
gtyler@kingstonsmith.co.uk

Ian Graham, Partner
igraham@kingstonsmith.co.uk

Nicola Horton, Principal
nhorton@kingstonsmith.co.uk

Peter Smithson, Partner
psmithson@kingstonsmith.co.uk

Val Cazalet, Partner
vcazalet@kingstonsmith.co.uk

More information about Kingston Smith and our services to the media sector can be found at: **www.kingstonsmith.co.uk/media**

Kingston Smith