Advertising:
First to Suffer, First to Recover?

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Sources and Notes:
The Advertising Association/WARC Expenditure Report (AA/WARC Expenditure Report)
Office for National Statistics and the Office for Budget Responsibility
Kingston Smith W1
AA/WARC Expenditure Report
Institute of Practitioners in Advertising
Internet Advertising Bureau and PricewaterhouseCoopers
Ad Age Media News
HM Treasury
Deutsche Bank
Enders Analysis

Executive Summary

As Spotify celebrates its fifth year, it's worth remembering that the company has only existed during an economic depression. Put another way, the company has not sold adverts during the good times. So, in this edition of Insight, we test the assumed 'first to suffer, first to recover' relationship between advertising and the economy. Get ready for some encouraging new insights on the state of the recovery in both advertising and the UK economy, as well as new tools to better interpret advertising trends.

1. **The state we've been stuck in**
   What makes a 'balance sheet' recession different

   To explain the state we're in, we endorse Deutsche Bank's Credit Impulse theory, which suggests that consumption will grow as the pace of paying off debt slows.

2. **First to suffer, first to recover?**
   Hard evidence of the causal relationship between advertising and the economy

   Rather than tracking GDP, the data suggests advertising has a stronger relationship with both investment and consumption, which sits intuitively with the product life cycle.

3. **Down on the ground, ad agencies are looking up**
   Analysis of four of the big marcomms groups suggest the recovery is underway

   Collaborating with advertising industry experts, accountants Kingston Smith W1, we provide insights on the performance of four of the biggest marcomms groups in the UK in the first half of 2013.

4. **Follow the money, and the volume**
   Changing the way the industry thinks about performance

   The industry often uses deflators when explaining headline trends. This is potentially misleading. We offer two alternative measures using current prices and volume metrics.

5. **Keep on recovering**
   Considering the road ahead for advertising

   Some key media sectors like television are already in recovery mode, but it will be 2014 when we see advertising and the economy return to growth.

Feature: You've never had it so tough
How Spotify innovated during a downturn

As Spotify celebrates its fifth year, we look back at how it innovated during the height of the financial crisis in late 2008.

The state we've been stuck in

What makes a 'balance sheet' recession different

Put two economists together and you get three opinions. No surprise, then, that there are numerous explanations for the fragile state of the UK and global economy. Economists will forever agree to disagree on what got us in to (and will get us out of) this mess. As for the question of when (not if) we will see 'green shoots' of a recovery, one of the most persuasive arguments put forward is the 'Credit Impulse' theory by Deutsche Bank. It describes the 'balance sheet' recession, which makes this cycle different from past recessions, and uses complicated terms like 'deleveraging' but – rest assured – it is incredibly simple.

Put crudely, deleveraging means that money is pumped into paying off debt. Leveraging is the opposite: money is borrowed to increase expenditure. During the recession, firms and households have taken money out of the economy by paying off debt. This means less money is available for consumption, to fuel the economy. According to Deutsche Bank, firms and households who tackled their balance sheet early will now start to see consumption grow. To predict when consumption will grow we need to know when and how balance sheets will move.

The two-period table captures deleveraging for households. In this example, an individual has an income of 100 in period one, and allocates 40 to pay off debt, leaving 60 to spend on goods and services. Paying more debt means less spending, and contributes to the economy entering a recession. In period two, income remains 100, of which only 20 is used to pay off debt, leaving 80 to spend. In period two, consumption has risen by a third and the economy can move out of recession. We offer this as a simple and intuitive explanation of the state we are currently in.

The Credit Impulse: Why paying off less debt leads to economic recovery

	Income	Pay down debt	Consumption spend
Period 1	100	- 40	60
Period 2	100	-20	80

We can be cautiously optimistic about the UK from the Deutsche Bank Credit Impulse work: unsecured borrowing has almost trebled in the last year, and mortgages have also picked up. This is against a backdrop of low inflation, which means more bang for your buck. What will be critical going forward is the level of the borrowing, and the credit terms attached, for households and companies. For now, we can say that this adds to the growing evidence base that a consumption-led recovery is underway.

Elsewhere, Deutsche Bank notes that the US went through deleveraging earlier (and harder) than the UK, and they are seeing the green shoots of a consumption-led recovery much earlier.

This recovery appears to tie in with trends in advertising. Jon Swallen, chief research officer at Kantar Media North America, was quoted in Ad Age recently as stating that "[US] ad spend has now increased for six consecutive quarters and, in reaching 3.5 percent growth for Q2, had its best performance in a non-Olympic period since the end of 2010."

First to suffer, first to recover?

Hard evidence of the causal relationship between advertising and the economy

Economists love assumptions. You could argue that, without them, the discipline could simply be renamed accountancy. One common assumption is that the marketing budget is the first thing to be cut as the economy enters a downturn, and the first to expand as the economy enters a recovery. Some refer to it as a 'first to suffer, first to recover' relationship, or simply, 'first in, first out'. Regardless of word count, what matters is that this assumption has received little scrutiny. Until now.

Surprisingly, we found very few examples of academic literature on this assumed relationship. Little was recently published, and even less was specific to the UK. It's striking to consider how much has changed, especially in online and mobile advertising, and how little of this transformation has been researched in the context of the economic cycle. We offer a reading list at the end of the report. Hopefully this insight will help fill the gap and encourage further research.

The table below sets out the sources of data and analysis used in this study. There are three main existing sources used: IPA's quarterly Bellwether Report, IAB/PwC's bi-annual UK Digital Ad Spend Study and AA/WARC Expenditure Report. Importantly, Kingston Smith W1, an accountancy firm who are regarded as experts in this field, provided us with firm level data of media buyers which helped us establish original insights. Finally, we used official government data and the Credit Impulse analysis put forward by Deutsche Bank.

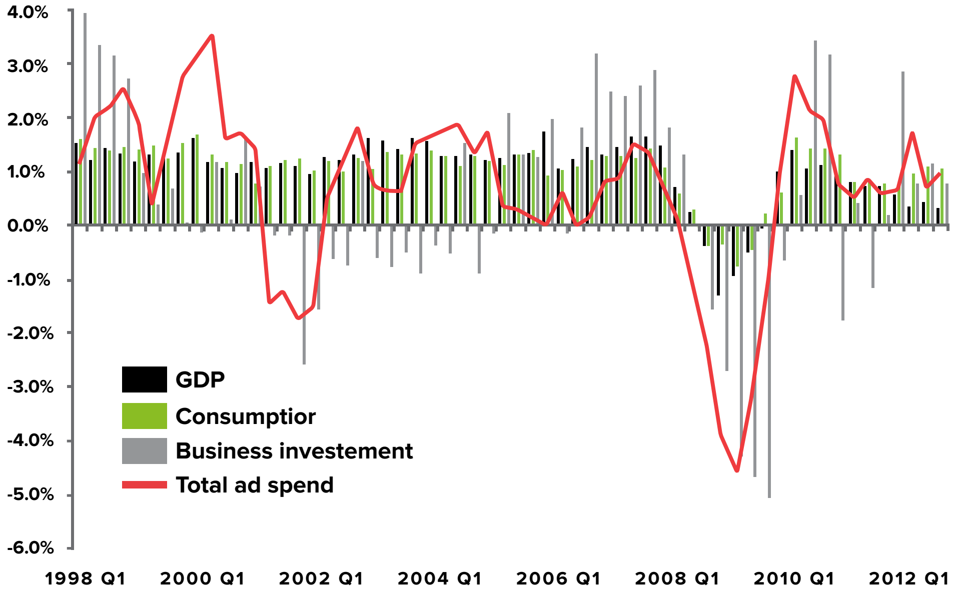
Our toolkit for the advertising industry		
Data	**Source**	**Why is it useful?**
Companies' marketing budgets	**IPA** Bellwether Report (quarterly)	Through survey data, provides firm level ad spend budget changes
Historical and forecast advertising spend	**AA/WARC** Expenditure Report (quarterly) **PwC/IAB** Digital Ad Spend Study UK (bi-annual)	Provides quarterly historical and forecasted ad spend by type Provides annual historical and future online ad spend by type and industry
Current levels of consumption and investment	**ONS** Available online (quarterly)	Given relationship, helps predict ad spend
Forecast of consumption and investment	**HM Treasury** Forecasts for the UK Economy (quarterly)	Given relationship, helps predict ad spend
What we've added		
Credit Impulse	**Deutsche Bank** Credit Impulse Update (quarterly)	Provides insight on impact of debt on consumption and the wider economy
Annual media cost	**AA/WARC** Available online (annually)	Gives forecasted price changes, so it's possible to predict performance (volume)
Ad agency revenue	**Kingston Smith W1** Financial statements (quarterly)	Snapshot of how industry is doing months before industry data is released

So, let's take a look at the link between advertising and the UK economy and test the 'first to suffer, first to recover' assumption. The chart below compares ad spend data from AA/WARC (red line) with GDP, consumption and investment figures from ONS (black, green and grey bars) between 1998 to 2012. To tackle the fact that advertising is a seasonal business we've used a four-quarter moving average. For example, the figure for Q4 2012 will be the average of the last four quarters: Q1 2012 to Q4 2012.

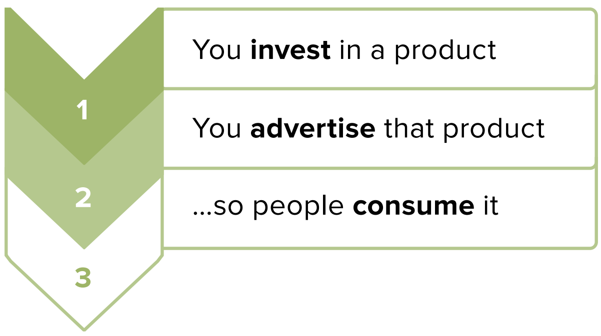
It's noteworthy that ad spend nosedives before the recession hits in 2008, and is the first to recover when the economy rebounds in early 2010. At a glance, advertising appears to be the 'first to suffer, first to recover' during the recent recession.

Percentage Change in Ad Spend to GDP, Consumption and Investment

Source: AA/WARC, ONS



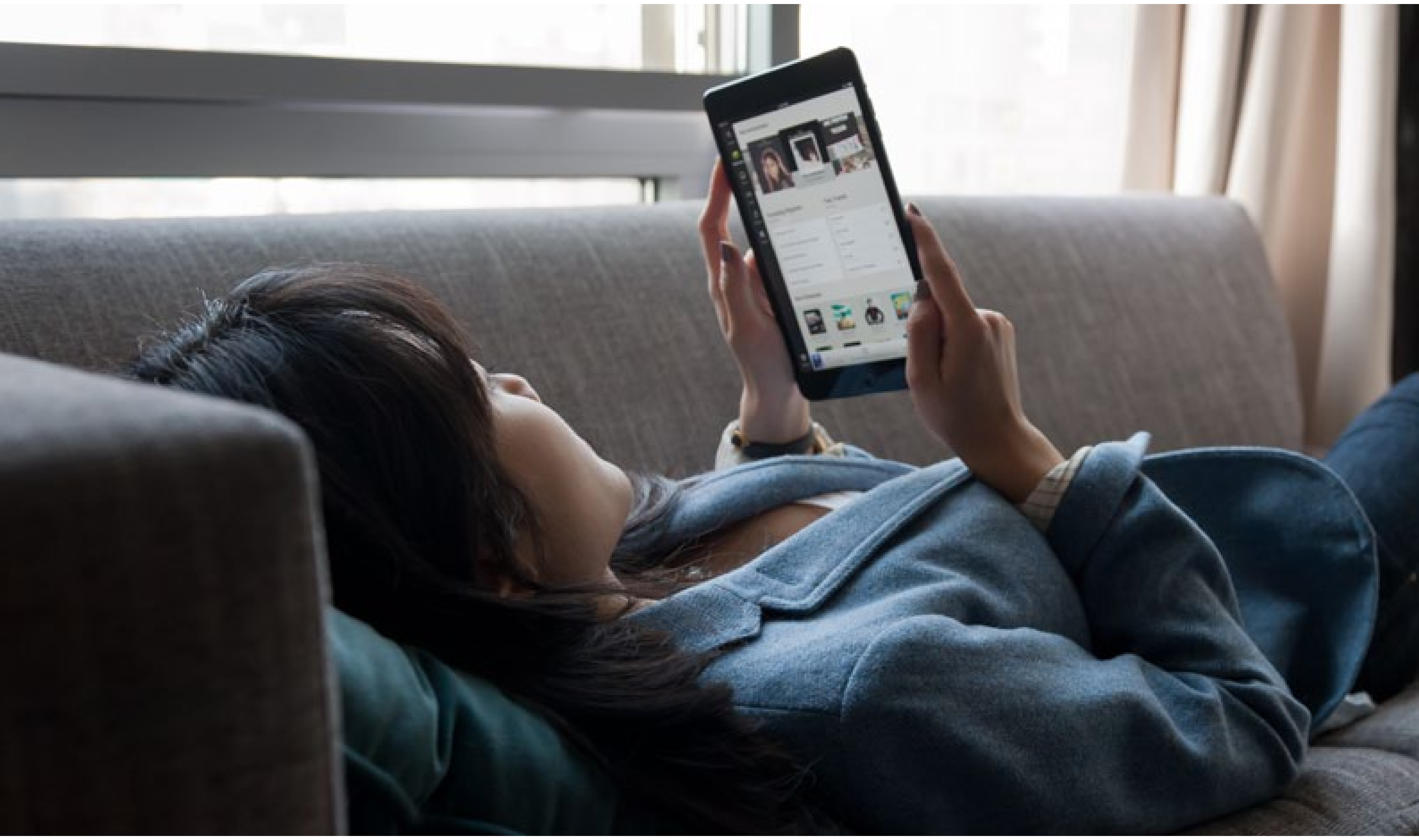
The next question to ask is which of the three bars best correlates with the red advertising spend line? Firstly, consumption and investment are both strongly related to ad spend, GDP less so. This makes sense. It's simply the product life cycle: companies develop a product or service (*investment*), and then market it (*advertising*), so that people buy it (*consumption*).



Taking a deeper dive, consumption has a stronger link to advertising during the good times, investment during the bad times. An example of this is that only investment follows ad spend during the dot-com bubble of 01/02. GDP adds nothing extra to the mix, so lesson number one is that investment and consumption provide a better bellwether for the advertising industry than the assumed GDP. Here's a handy reference table to give you a feel for the pros and cons of using each variable to track ad spend.

Pros and cons of GDP, consumption and investment to track advertising

	Pros	Cons
Consumption	Good when advertising healthy	Happens after advertising in cycle
Investment	Good when advertising not healthy	Capital investment unrelated
GDP	Data readily available	Other two are stronger



Down on the ground, ad agencies are looking up

Analysis of four of the big UK marcomms groups suggest the recovery is underway

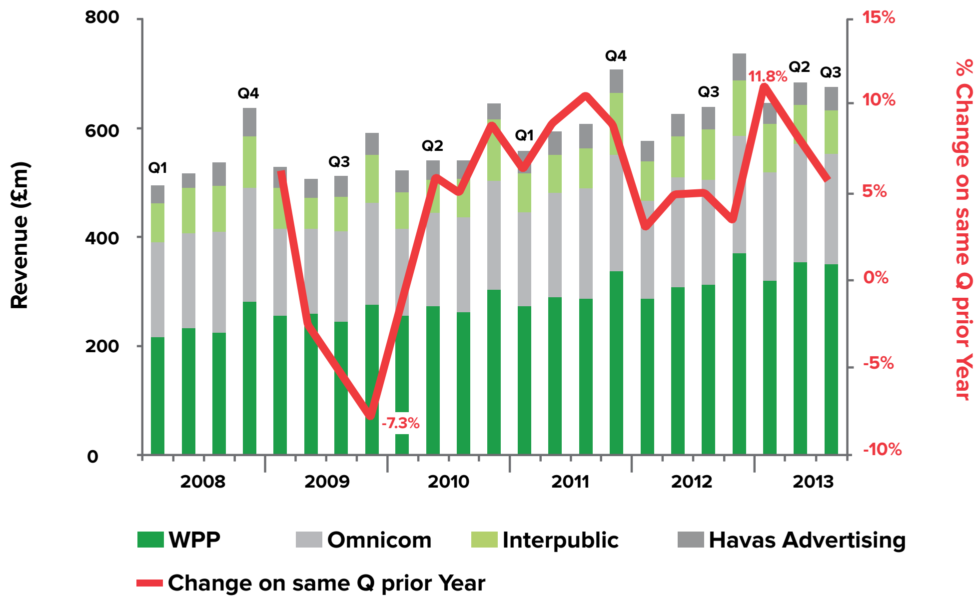
To understand this 'first to suffer, first to recover' relationship further, we partnered with Kingston Smith W1, marketing services and media specialist accountants. We designed a simple and effective estimate for ad spend, by tracking the revenue of four big UK marcomms groups to provide timely and relevant firm level data. We've provided two advantages and two limitations of the work below, to give a feel for how it could be used.

+ The groups capture a significant portion of media buyer activity, suggesting the data is a strong bellwether for the advertising industry
+ Importantly, the data is available almost two months before industry level data, meaning more timely data for identifying turning points
– It doesn't provide a definite split of growth between sectors of advertising, like digital and TV
– Trends in advertising outside of media buyer activity need to be kept in mind

This firm level data allowed us to isolate UK revenue from four major international firms, and present the raw unadjusted figures for 2008 Q1 to 2013 Q3. The chart below shows headline revenue for these four groups recovering well. After posting a sharp 7% fall in the fourth quarter of 2009 as the recession hit, we are now witnessing raw unadjusted growth of 5% to 10%.

Quarterly Revenue Figures and % Change for four of the Big UK Marcomms Groups

Source: Kingston Smith W1



These trends can be driven by new business, but also distorted by acquisition (snapping up other marcomms companies might expand a firm's revenue, but does not expand the size of the pie). However, for the most recent two quarters we were able to separate out organic 'like for like' growth (new business) from acquisition growth (old business). We calculated that, on a like for like basis, ad agency revenue was up 5.1% in 2013 Q2 and 5.7% in 2013 Q3. This evidence of organic growth adds further support to the consensus that the economic recovery is well underway.

This is news. Not only do we have headline growth from the marcomms groups, but much of it is from organic growth, not from acquiring existing business. We can map this back to the macro-economy with the table below, which presents encouraging signs of consumption picking up this year and investment recovering next year. We can be confident that the recovery is underway with investment taking a lead, and advertising soon to follow.

Forecasts for UK economy for 2013 and 2014*

Year	Variable	Growth (%)
2013	Investment Consumption GDP	- 1.7 + 1.4 + 1.1
2014	Investment Consumption GDP	+ 5.0 + 1.6 + 1.8

*Forecasts are from the Treasury's August edition of Forecasts for the UK Economy

Follow the money, and the volume

Changing the way the industry thinks about performance

In researching this topic, we noticed numerous headlines which broadly state 'advertising is up but… if you strip out inflation, it's down'. This is confusing as CPMs – the unit price of adverts – are generally falling, so if we remove inflation when none exists we risk understating performance. To offer a different perspective, we suggest two performance measures:

- Value: we suggest using current prices without deflators.
- Volume: estimating the change in the amount of adverts placed.

Looking first at value, the example below explains why using inflation doesn't always work, and why we should, instead, follow the money. Working from left to right in the table below, we have inflation at 10% and begin in year 1 with 100 adverts being sold. 110 are sold in year 2. An advert costs £1 in both years – there's no price change.

Why using inflation for ad spend doesn't work

	Inflation	Adverts sold	Price of advert	Revenue	If we deflate	Implied volume
Year 1	-	100	£1	£100	£100	100
Year 2	10%	110	£1	£110	£100	100

If we deflate year 2 using inflation of 10%, it implies 100 ads are sold, but we know 110 were sold! Back to reality, CPMs have been falling across the advertising sectors despite above target inflation of 2-3%. Like in the example, the industry should be celebrating more ads being sold (greater volume) – but deflation effectively cancels out the growth. In the example:

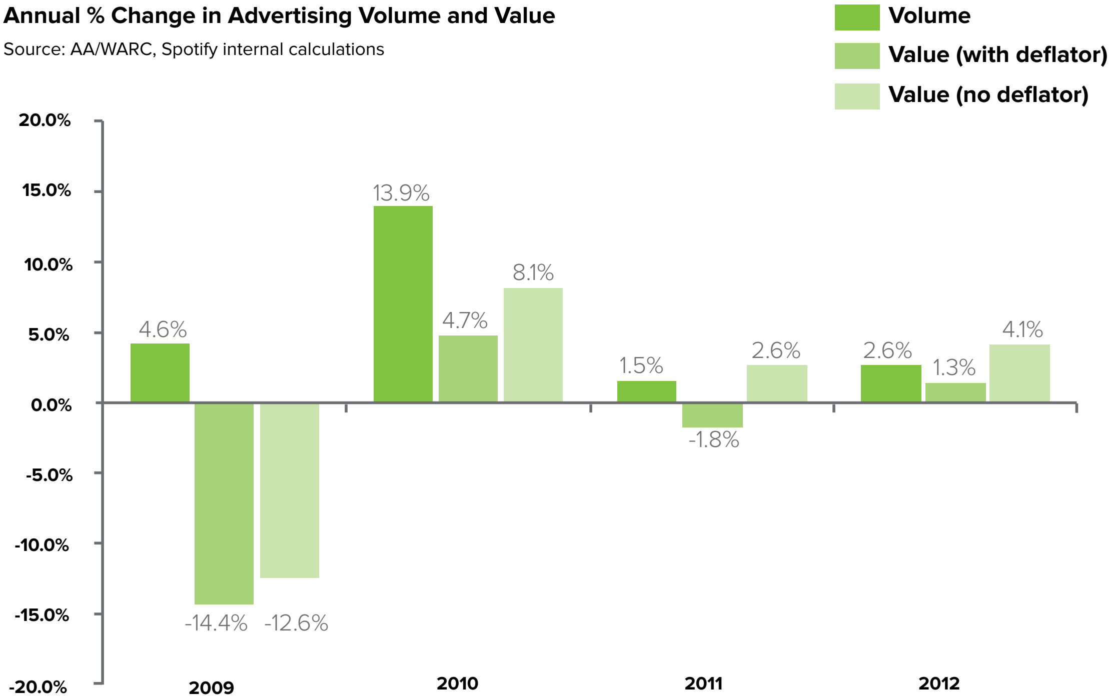
- The number of adverts sold (volume) has increased by 10
- The value of the industry has increased by £10, it isn't flat

What does this suggest when we think about measuring performance? Let's stick with the actual money spent on adverts, with no adjustments for inflation.

We can now turn to the second challenge, that of following the volume. We can estimate the change in the volume of adverts by using AA/WARC's predicted price changes in different types of ads - like a one minute TV slot or an online banner. We can then apply the price changes of each specific advertising sector to the proportion that sector makes up of the overall industry. This creates what we call an Advertising Price Index (API), which gives the change in the volume of adverts placed. This allows us to ignore the effects of price changes and consider whether people have advertised more or less over the last few years, which is a new way to think about productivity.

Annual % Change in Advertising Volume and Value

Source: AA/WARC, Spotify internal calculations



Taking 2009 as an example, the value of the industry fell by over 10%, while volume increased by 5%. The business of advertising grew, whilst the business of ad spend fell. This may be due to fiscal 'belt tightening' by firms, leading to a fall in CPMs and moves to better targeted online ads. If so, it may be that advertisers experienced a productivity gain: more for less.

At the simplest possible level, there could be three types of productivity gains at work:

1. More ad impressions from the same budget
2. Same number of ad impressions from a smaller budget
3. More ad impressions from a smaller budget

One plausible scenario is that the recession has forced the advertising industry to grow out of its "Wanamaker era", named after John Wanamaker who not only invented department stores and price tags but expounded a witticism that has proven timeless and priceless: "Half the money I spend on advertising is wasted," he said. "The trouble is, I don't know which half". The recession has arguably forced advertisers to stop wasting that unknown half, and seek more targeted approaches which would ease Wanamaker's fears. Less branding, and more direct response.

Keep on recovering

Considering the road ahead for advertising

We put forward our toolkit to be considered when thinking about the future of advertising. More strongly, we encourage players in the advertising industry to look at improving the speed with which data is available. For example, we've shown in this study how, by using Kingston Smith W1 firm level data, we are able to present and interpret Q3 2013 data now, in early November. Critically, this is two months before the release of industry data for Q3 by AA/WARC and IPA, which would only become available early in the new year. When it comes to identifying turning points, timely data is just as important as good data.

To offer a forward look, we've incorporated these insights into a forecast for this year and next. By the year end, we expect to see ad spend increase by 3% in current value and 1% in volume for 2013. In 2014, with the economy in full recovery, we expect ad spend to grow an impressive 5% in value and 3.5% in volume.

Forecasts for the advertising industry

	Growth (value)	Growth (volume)
2013	3%	1%
2014	5%	3.5%

Some firms may expand budgets sooner rather than later and other sectors like television are already showing signs of expansion. This adds to recent positive recovery stories coming from Enders Analysis who viewed the outlook as being 'bright with some clouds', and the IPA Bellwether study which reported that a 'strengthening economic climate [has supported the] largest recorded upward revision to marketing budgets'.

Given the insights raised in this study, one final question that merits asking is this: would resurgence in advertising result in traditional media sectors market-growing or market-stealing from the digital ad spend sector? If we take the aforementioned productivity argument forward, traditional forms of advertising will need to compete with the 'more for less waste' productivity gain offered by digital forms of direct response, and as they do the overall industry should grow.

This ability to target adverts to improve performance brings us back to Spotify, which has just celebrated its fifth birthday. Think about this: Spotify launched at the height of the financial meltdown in late 2008 and has been restricted to developing its advertising business during an economic depression since. Spotify, for all of its success to date, has not experienced the good times! One could conclude this report by asking how much more successful digital companies like Spotify will be once the recovery is in full swing. Instead we choose to reflect on how the company has innovated during the tough times to get to where it is now...

You've never had it so tough

How Spotify succeeded during a downturn

Starting an ad-funded music business model with no precedent and and no audience, is no easy task. Doing so during a financial meltdown doesn't help either. To explain how Spotify overcame this challenge, we pass the mic to Zia George, Partnership Director @ Spotify, the company's first UK employee, who joined in 2008, when Spotify had only 2,000 users. Here she reflects on how the company overcame the challenge:

"Before Spotify, my advertising career was in radio. I was faced with not only launching Spotify ad-sales in the UK during a credit crisis, but also with suspicion. People were suspicious about the Spotify product, the lack of audience and the long-term viability. The educational process would dominate the first two years, but it was iterative – after each rejection, we innovated and were able to go back with a solution. We were quick to harness the digital potential of audio and display working well together, but it was still tricky to explain to audiences more used to advertising on radio. In many ways, our Ad-Sales business unfolded back-to-front – the continual process of innovation developed partnerships, and that led to a scalable advertising business.

During a credit-crunch, firms have to deliver more with the same, or produce the same with less – belt tightening was the financial expression at the time, and CFOs were looking for productivity gains. Our Click Through Rate (CTR) for simple banner ads was standing out like a sore thumb with our clients list. We had no idea what the average was because we all came from radio, but we were getting feedback that our CTR was 300 times the industry average! Brand partners kept telling us that it was an uncluttered environment and we were able to innovate our audio ads from those positive results.

Of all the campaigns I've been involved with, my personal favourite was with Citroen DS3. This was the first time we created branded content for the platform. We got six high profile artists, including Zero 7, Faithless and Temper Trap, to record radio shows about the songs they thought were innovative at the time. Instead of the audio advertising spots just promoting a new car, it was Sister Bliss giving you a trail you could hear on a radio station and then click to hear on Spotify – the car was about innovation, the conversation was about innovation. To accompany this, they ran display ads to bring the message home. It felt like we were really entering unchartered waters back then, and I can see how this type of innovation continues to this day, in all of our 32 markets around the world".

Further Reading

As already mentioned, there is surprisingly little literature on the relationship between advertising and the economy, of which only a few papers are recent enough to capture the emergence of digital. To encourage further research, a selected reading list is provided below.

Albert and Reid (2011) The Contribution of the Advertising Industry to the UK Economy: A Creative Industries report, Conducted on behalf of Credos

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