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New Value-Based Comp Model Needed

Mutual Benefit: A True Value-Based Model Aligns Economic Incentives of Marketer and Agency

By Tim Williams and Ronald Baker

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The current cost-based compensation model for advertising agencies is flawed for a simple reason: It misaligns the economic incentives on each side. The client pays whether the agency adds value or not, and the agency is paid a fixed amount regardless of the value it creates. Clearly, this model is not in the best interests of the client or the agency.



Value pyramid: Displays the dynamics of the agency-client relationship.

Even more perniciously, the existing compensation model focuses entirely on the wrong things: efforts, activities and costs. It does this at the expense of the right things: output, results and value.

Agreement on both sides

A recent national survey our firm conducted on behalf of the Association of National Advertisers and the American Association of Advertising Agencies attempts to understand how both agencies and clients define value. What we found was a high degree of interest in "aligning the economic interests" of agencies and clients. We also found significant agreement between agencies and clients regarding the activities each side believes create value.

We evaluated 24 possible areas where agencies could create value and identified the [top-rated agency value drivers](#), according to marketers.

By and large, agencies agreed these are the key value drivers agencies should deliver in a relationship.

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Answers suggest an overarching theme: Marketers are looking to agencies for campaign integration, media neutrality, creative innovation and "holistic communication and marketing plans independent of any agency discipline."

We then turned the spotlight on marketers and asked agencies what their clients could do to create the most value. From a list of 16 choices, we identified [the highest-rated responses](#).

Openness, clarity

Overall, agencies believe clients can add the most value by providing clear direction concerning strategy, timing and objectives. They also believe value would be created by much broader sharing of information, access to decision makers and "engaging the agency as an extension of the client team." Marketers mostly agreed that these are the areas where they can add the most value to the relationship.

As expected, both parties cited significant obstacles to moving to a value-based relationship, including different definitions of value, lack of willingness to share risks and reward, agencies' lack of control over business results, lack of information sharing, insufficiently defined metrics and lack of mutual trust.

To some extent, both sides are locked in a sort of stalemate, thinking there is no better way to enhance value on each side.

There is obviously intense interest among clients and agencies in moving from a cost-based to a value-based compensation model. But how to get there, especially in light of the objections and obstacles mentioned above? If value is like beauty — in the eye of the beholder — how are we to define it? What factors create it? How can agencies be paid if they cannot fully control how clients create it? What happens if value isn't created?

These questions require that new models be developed for true value-based relationships. In our work with both agencies and clients, we have come to believe that an effective approach to value-based compensation must include characteristics such as shared risk and shared reward; evaluation of both parties (not just the agency); and, perhaps most important, the use of leading (not lagging) indicators as metrics of success.

Effectiveness vs. efficiency

To develop meaningful indicators, clients and agencies need to define the chief value drivers—those things customers care the most about.

For instance, the airlines focus on three leading indicators: on-time arrival, lost luggage and customer complaints. Notice that all of the indicators define the success of the airline the same way the customer does. We measure these things because the customer cares about them, not simply because we can.

None of these indicators would appear on a financial statement, but, as the airlines have learned over the years,

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they have predictive causation with profitability — that is, they will drive the numbers that ultimately appear on the financial statements. The correct leading indicators will predict the lagging indicators.

Value-based agency-client relationships must focus on effectiveness rather than efficiency. A business does not exist to be efficient; it exists to create wealth outside of itself. An obsessive compulsion to increase efficiency -- doing things right -- reduces the firm's effectiveness at doing the right things. The relentless pursuit of efficiency can hinder the client and agency from focusing on the things that truly matter, as the survey data demonstrate.

To add insult to injury, the efficiency measures being used tend to be lagging indicators that measure efforts and activities —the past — at the expense of leading indicators that measure results and define success the same way customers do.

Imprecise, but more useful

Effectiveness means that imprecise measurements of the right things are infinitely more valuable than precise measurements of the wrong things. It is more important to be approximately right rather than precisely wrong.

Of course, an advertising agency cannot completely control business results, which was a recurrent comment in the survey. However, this should not dissuade agencies from defining the elements they can influence. These elements are the influencers of value, a key component in establishing value-based relationships.

In effect, influencers of value are the behaviors, skills and activities of both the agency and marketer that form the basis of an effective value-based relationship. The influencers directly affect the leading indicators. Such things as project management, collaboration and unconventional thinking are just a few examples of agency influencers. For the marketer, clear and consistent communication, direction and approval processes are examples of its influencers. These are, in effect, the dimensions of the agency-client relationship that were studied in our survey.

From the top ...

All of these dynamics can be displayed as a value pyramid: At the apex of the value pyramid are the lagging indicators that are the definition of success from the marketer's viewpoint. Lagging indicators can be such things as market share, sales volume, stock-price appreciation, market penetration and so on. Ultimately, these indicators tell us whether value has or has not been created.

One level down are factors such as brand awareness, favorability ratings, search-engine rankings, web-page visits, etc. — the things that directly impact the lagging indicators. These are the leading indicators of value. They are predictive. If they show a positive change, they create the value that eventually shows up as a lagging indicator.

The base of the pyramid contains the influencers of value, which are applied to both the agency and the client. They are the behaviors that produce positive changes in the leading

indicators of value. The brand stakeholders on the marketer's team rank and decide the most important influencers based upon the objectives of the relationship. The agency side does the same for the marketer.

These influencers are graded over a predefined period of time and compared with the goals established at the beginning of the relationship. The scores will influence agency compensation.



Tim Williams is founder of marketing consultancy Ignition and author of 'Take a Stand for Your Brand.'

Playing fair

How will you know if each side is grading fairly and not just abusing its power to negatively influence the compensation? This is an issue of trust, not pricing. The beauty of the influencers on each side affecting compensation is the alignment of the incentives to do the right thing and to relentlessly communicate.

Once the indicators and influencers have been identified, the expected outcomes are benchmarked and the financial impact of achieving the objectives is quantified. This quantification answers the question, "If we accomplished these goals, what would be the value to the client?" The answer to that question will form the basis for a value-based price and a value-based compensation agreement.



Ron Baker is founder of VeraSage Institute, a think tank focused on value pricing, and author of five books, including 'Pricing on Purpose.'

Among other things, the price can be determined by the difficulty of the desired outcomes, ownership and use of intellectual property, the amount of risk-reward the agency assumes, service guarantees and other permutations of value propositions the agency could present to the marketer. The number of possible pricing points is limited only by the imagination on each side, bowing to the reality that value is subjective and there is never going to be one "best" model. This approach to value-based compensation provides a framework so each side can search for the price that is commensurate with the value being created.

A true value-based model, like the one we're describing here, aligns the economic incentives of both marketer and agency, putting each into a value-based mind-set with the ultimate goal of creating ever-increasing value on each side. Rather than allocating resources to solve problems, it pursues opportunities.

How marketers believe agencies create value

We evaluated 24 possible areas where agencies could create value. Here are the top-rated agency value-drivers, according to marketers:

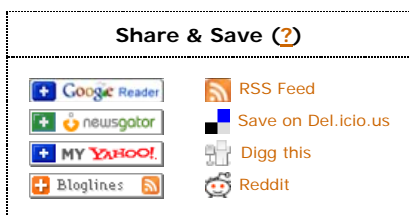
1. Working in a collaborative way with the client by creating an environment of mutual respect.
2. Ensuring that agency functions are integrated and agency divisions collaborate on behalf of the client.
3. Developing and producing creative ideas that are fresh

- and unexpected.
- 4. Developing ideas and programs that can be integrated into multiple communications channels.
- 5. Developing solutions that go beyond traditional approaches and reach consumers in new ways.

How agencies believe marketers create value

We then turned the spotlight on marketers and asked agencies what their clients could do to create the most value:

1. Giving the agency the necessary time and resources to do its best work.
2. Working with the agency in a collaborative manner that puts a premium on mutual respect.
3. Identifying and articulating the outcomes the agency's work is expected to produce.
4. Providing clear, complete direction to the agency.
5. Providing constructive, timely feedback to the agency.



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