



the
profitability
triangle

white paper

compensation management in the marketing communications industry

Paper 3 in the Maconomy Profitability Triangle Series on resource optimization, pricing and compensation management in marketing communications organizations





introduction to compensation management

The cost of compensating the people who produce the services sold to clients is by far the biggest cost item to marketing communication businesses – and it is less fixed than most other cost items. Therefore, compensation is clearly in focus when discussing how to improve the performance of the businesses.

Fundamentally, there are two ways of impacting compensation costs:

- Costs per hour
- Number of hours employed to deliver a given service

This paper will focus on the first, which has been frequently debated but so far without resulting in the needed fundamental changes.

Compensation systems of the future

A simple analysis of the mathematical consequence of various arrangements and established habits of a business unit will often not only explain why it is not (sufficiently) profitable, but also spell out why it is never going to be...

Multiplying the total number of annually available hours per individual by that individual's past utilization rate (utilization rate: hours paid for by clients divided by total available hours) will result in an expression of the number of hours likely to be sold for that individual.

The number of hours likely to be sold per year per individual will in itself often be surprisingly low.

Multiplying hours likely to be sold by the hourly sales rate for the individual represents the likely billing per year for that individual.

Likely billing potential per year per individual will typically be an even more surprisingly low number.

Multiplying the total compensation of an individual by the overhead rate for the company will represent the fully loaded annual cost for that individual.

Profitability Triangle Series

Big changes have taken place in the marketing communications industry during the last 10 years. Clients have become extremely conscious about what they get and at what price. Ownership has consolidated into about a handful global holding companies dominating the market. And new performance standards have emerged both for the big groups and the smaller independent agencies.

This paper is the first in a three-part series from Maconomy on the "Profitability Triangle" in the marketing communications industry, which is based on three drivers of profit: Resource Optimization, Pricing and Compensation Management.

By focusing on making these three drivers truly profitable, agencies can survive, and thrive, in their industry.

This paper focuses on resource optimization, in particular, the use of free agents. It should be read together with its companion papers on Pricing and Compensation Management.



Compensation systems of the future

When comparing the likely billing of an individual to the fully loaded annual cost of employing the same individual, the surprise will get even bigger and it will become evident for many why the business suffers from poor financial performance. It simply does not sell its resources for more than it is paying.

Of course such an analysis contains a lot of simplification. You cannot just terminate staff with low utilization. E.g. many “unprofitable” seniors are responsible for profitable staff who are highly dependent on being managed by these seniors. Nevertheless, the analysis should be made and its conclusions acted on.

A very significant contribution to solving such a situation is for marketing communication companies to link the compensation of people to the performance of the business. Stop paying employees salaries using methods and at levels that are solely driven by pressure in the market for employees, and which completely disregards the conditions in the market where businesses need to sell their services to clients.

Previously such a change in compensation levels and methods has been difficult to introduce, simply because the best people went for the positions with the highest possible fixed salary – rather than, for example, a position with the most interesting professional tasks. This has started to change and with fierce competition from the rapidly increasing occurrence of free agents, more flexible compensation systems will become the norm rather than the exception.

The compensation system of the future should be comprised of a significant element of individual performance incentives and a reduction in this commitment if the overall performance of the business fails.

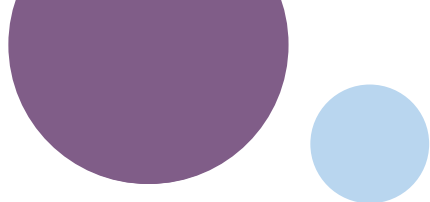
How it will work

Unless the business is performing quite well and just needs a bit of tuning for the future, the recommendation is to declare a fundamental and perhaps even brutal change once and for all up-front. How fundamental and brutal is obviously very individual and dependent on the specific situation.

An example may help illustrate the elements. The chosen calibration is one that would fit a company which produces black numbers, but where things have settled at a rather uninteresting level. This calibration will be deemed tough (not brutal) but also extremely stimulating and encouraging to most employees.

Start out by determining the total compensation per individual. Total compensation means payroll, pension and insurance contribution, total cost of company cars, company-paid private phones, subscriptions, bonus trips – absolutely everything.

Then reduce total compensation for each individual by 1/3 and define the new reduced (2/3) level as the base level which corresponds to a “sloppy” overall performance level at which it is only appropriate that the company protects itself by this overall compensation reduction.



Of course this will be a difficult and unpopular message and therefore it should be served delicately paving the road ahead to the potential for making a lot more money (than ever before):

- Give back the lost 1/3 at the lowest acceptable performance (3/3 of the original level). That is in reality the level corresponding to the performance needed to stay in business, and it should be made clear to everyone that the business needs to move significantly beyond that point very soon.
- Give back another 1/3 at the target level of performance (4/3 of original level). That is the level of performance that should be established as the expectation and that should tie directly into the business planning and budgeting process – with some built-in prudence.
- Give back further 1/3 at the stretch level of performance (5/3 of original level). That is the level of performance to be achieved if all uncertainties turn out to the advantage of the business. It is not the overall performance level that should be planned for, but it may well be achieved by certain individuals.

Of course this is just an example – and a rather unaggressive one as the original compensation level is achieved already at lowest acceptable performance. It could be made a lot harsher if the situation calls for it. However, the central point here is that the creation of a direct link between individual performance and compensation will improve the overall performance of the business.

Due to the consolidation of the industry, local employee ownership becomes a less frequent element of compensation. However, particularly in the local independent businesses it is commonly used as a very efficient motivator. In these businesses, ownership could be designed to be tied into the compensation model, for example by letting the size of individual employee ownership be determined by performance levels. This of course requires that the share prices can be easily fixed and that they are at relatively low levels (such as intrinsic value as per the annual accounts) leaving the real monetary value of ownership to the access to dividends.

The next issue is how to score individual performance. Almost any scoring system can feed the described flexible compensation system. The only important thing is that it suits the business characteristics of the company.

The following will serve as an example.

Most people react positively to the balanced scorecard thinking, but many businesses find it complicated to deploy and find that their performance indicators are less operational than required. However, many of the elements of a balanced scorecard can be achieved in a very simple manner and in a way that overcomes the operational issue.

Obtain mutual agreement between each employee and each manager on 5-7 (maximum 10) goals for the planning horizon. Also, agree on any sub-goals that each goal may be divided into, their prerequisites and their weighting (totaling 100%). Then every 3-12 months, mutually agree on the performance score (0-100) on each goal to which a weighting has been assigned, and calculate the overall performance index (0-100).

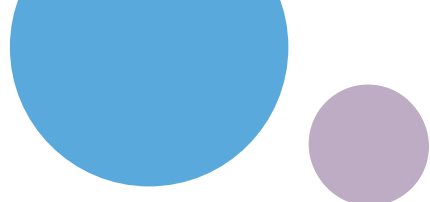
Define what performance index will be required to get back respectively the first, second and third of the 1/3 of previous total compensation that was taken away.

Such a system actually makes up some critical components to a neat but much too often absent closed-loop planning cycle: The overall business- and action plan of the business is broken down to individuals that will now be well informed about their contribution to the overall business performance (cathedral building versus stone chopping). And the periodical reviews with staff will be forced to be focused on topics of prime relevance to the company.

How did the current situation arise and what are the obstacles to changing it?

In many businesses, employee compensation has followed or exceeded any general salary and price index in the market – and the prices charged to clients.

And probably, bonus elements of the total compensation are paid primarily based on relatively soft criteria such as “doing a good job”, “winning a new client”, “using weekends on new business pitches” or just “being a nice bloke” – unrelated to profit or hard fact profitability drivers.



This actually means that the marketing communication industry has detached the market where they buy their “raw materials” from the market where they sell their “finished goods.”

We have got to ask ourselves: “How did that happen?”

Firstly, management has in many situations been very slow to detect and/or adapt to new market signals and have kept on competing with each other by offering higher and higher salaries to employees with no sanity check as to the short term value of the employees as goods sold to clients.

Management is typically very focused on being able to offer the right resources – and less focused on clients’ willingness to pay for them!

Secondly, the general competence level at clients is increasing and in many cases clients employ the same profiles as the marketing communication industry. An example is the tendency for many larger companies to have its own internal resources rather than buying it all from the marketing communication industry. This tendency simultaneously drives up salaries and pushes up the barrier for what the communications companies can sell to their client.

Luckily, there is a shift in attitudes. Managers seem to have become more commercially aware and so has a younger generation of employees – they will more easily accept the need for flexible compensation models.

Nevertheless, introducing fundamental changes in compensation models is a difficult one and a lot of consideration is needed to establish a situation that fits each specific situation. E.g. some excellent people will not be able to afford a big general pay cut. This may be solved by offering a smaller cut against a smaller upwards gearing and/or an on account payment for parts of the gearing, etc. There are all sorts of ways to customize the model and that should be done – rather than giving up the idea of a more flexible compensation model all together.

Companies may fear that they risk paying out a lot of extra compensation without having achieved an overall profitability boost (due to high individual performances not sufficiently related to the profits of the company). It is a valid objection. It is critical that when setting individual employee goals, it should be debated and understood that high individual performance that does not – as directly as possible – lead to higher overall business performance is generally irrelevant

and should to be considered leisure activity. A way of aligning this difficult part of the process is to involve a central HR resource who can ensure consistency in the goal setting across managers and employees of the company.

Also, it should be considered to install a security valve where the underlying prerequisite to paying any individual performance element is an overall company performance above a certain level. In the example used above it could be defined that the EBITDA % will need to be minimum 5% to trigger the first 1/3, minimum 15% to trigger the second 1/3 and minimum 25% in order to trigger the third 1/3.

Another objection will be that systems are not ready for it. That is also quite often true. A dramatic organizational change like this will only deliver full impact if supported by the right IT systems that provide access to performance driven activities/metrics on an ongoing basis. Fortunately such systems indeed exist.

Conclusion

The large regional and less global players will have absolutely no patience with poor performing core markets. The corporate governance standards will ensure that stakeholders will know of the details, ask questions and require action.

The huge investments that have been made acquiring companies include the geographical markets that are not considered core to the acquirer. Nevertheless, for many acquirers these non-core investments have become substantial and therefore they have also become a substantial problem when the non-core markets are poor performers. And they quite often are. The large players have lost their patience with the non-core markets and will demand that they perform up to the same standards as the major markets.

The independent business will in most cases be owned by people who are well informed about the benchmarks of the big players – and they will want to do significantly better because they are able to run lean.

In conclusion, it is unlikely that the marketing communication industry will allow the currently dominating compensation arrangements to prevail much longer.

organic business solutions

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