

Would've, Should've, Could've: Why It Makes Sense to Go Offshore Now

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Client/Agency Engagement?

Summary

- Growing interactive agencies face increasing overhead expenses and client pricing pressures which prevent margin growth. Actual diseconomies of scale come into play.
- To thrive, agencies must seize the strategic, creative and account servicing high ground. They must differentiate through superior work or an innovative business model, or both.
- An innovative model, which promises margin expansion, may be found by partnering with a new breed of offshore production resource. A relatively new phenomenon, a Digital Advertising and Marketing Production Partner (DAMPP) is typically made for marketers by marketers and employs experienced agency staff.
- It seems to have ameliorated many of the difficulties agencies ran into when they tried outsourced solutions from IT oriented providers the first time around, and may help to increase profit margins by up to 50%.

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When I was part of the team running Modem Media in 1997, we were growing revenues from 20 to 45 million dollars year over year. (By 2001 they would reach \$135mm). Our margins were in the over 20% range and I figured as we grew, we'd find more economies of scale and really make some serious dough. As we were about to sign a new lease on a large 60,000 square foot office, one board member, Rick Braddock (if you don't know who Rick is, it's worth time to Google him) took me aside and said it was a BAD idea. He told me "G.M., you think you have economies of scale in your business, but I think you actually have diseconomies of scale." **What?!**

Rick went on to say "The more you grow, the more office space you fill up, the more supervisory management you will add, the less efficient you will be and the more clients will negotiate for lower fees. And when all that happens you will see tons of staff working in a large building not as a symbol of success, but as a big fixed cost fat albatross."

At least that's what I remember from our talk, and he was right. As we grew, managing staff allocations and billability ratios became as important as great ideas and great work. And our office space did indeed hang around our necks as the business contracted during the dot-com downturn.

Lesson: More people, especially on the non-client facing side, leads to more overhead and hidden costs than you can imagine. *The average mid to large size agency can base its total operating costs at around 2.1 times its total salaries.* These costs expand at a linear rate; if anything the multiple goes up, not down, as your grow.

A couple years later we were reviewing our office in Sao Paulo, Brazil. Our Brazilian manager, Fernando Tassinari, took us through client work. I remember a website and promotional work for Peugeot that was innovative, clever and well executed. At the time, we were selling comparable work to clients in the states for over a million dollars. In Brazil, Fernando was only able to charge \$150,000 – and still made a decent margin!

Lesson: You didn't have to be a genius to realize that the real opportunity in Brazil was not getting 20% on \$150,000. **The real opportunity was getting \$600,000 on each \$1,000,000 worth of work sold in the States, but crafted in Sao Paulo.** Early days, but the outsourcing opportunity was clear.

Realizing something that's obvious and doing something about it are two very different things. And because our margins were still very good in the states, and because we got our work done fairly easily with a process that worked well and people who were well trained, and because we had hired HR staff to obtain the ability to hire more and more quality creative, technology and production folks ... and because we had an office building to fill, we did nothing.

Lesson Not Learned: We could have made enormous margins by doing our work in a much lower cost office with people we knew, liked and trusted. But we did not. We left money on the table, and became less competitive and less profitable.

Common Traits to Thriving Agencies

Both at Modem and in working with several up and coming interactive agencies, We've noted a few consistent traits that strong and growing agencies share.

First, growing agencies must be able to **invest** in absolutely outstanding creative and account strategy leaders. You can't do great work -- standout work -- without great creative, and you can't lead accounts to super profitable size -- more than \$6mm --- without great account leaders. And you must be able to make this investment out of current cash flow.

Second, the growing agency must **differentiate** itself. A point of difference is key for prospective clients, employees and potential acquirers. There are two ways to do this. One is to do Agency Defining Work -- innovative

stuff on breaking platforms, such as mobile or social commerce. Two, is to distinguish the agency financially, either through rapid revenue growth or margin expansion, or both. An innovative model, such as a technology services platform (see Aquantive) can do it, or **an innovative operating model** can, as well.

Third, thriving agencies **have great margins from inception**. In other words, agencies **can't grow their way out of low profitability models**. It's those nasty diseconomies of scale. What it means (and I lived it) is as you grow, your average fully loaded cost per employee will rise, and the amount you can charge for work trails. If you are stuck in a low (sub 18%) margin, you're going to have to change your model.

Changing the Model: Lower Production Costs

The challenge, of course, is that it's really hard to find clients that are willing to pay premium rates, no matter how good the work is. Achieving big distinguishable margins based on demanding high prices. So, bias noted, one alternative is to attack the cost side. To produce work for less, while mitigating the risks and headaches that have traditionally been linked with outsourcing interactive marketing and advertising work. This is the reason we set up Tango Modem. **We believe there is room for off-shore outsourcing partners that know marketing and know how agencies work.**

As we saw 10 years ago in Brazil, it is possible to get great work done at a very low price. Our office in Brazil had a few things going for it. First, it was an agency, run by marketing people who knew the business. It had great talent. And it had a very low cost structure in terms of U.S. dollars.

As a low cost resource it had additional benefits: English was well spoken, the time zone was 2 hours east of our main east coast office, and the office already used a modified version of the Modem Media process.

These same attributes continue to be the keys to successful interactive digital *advertising and marketing* production. Many agencies tell us they have been burned by outsourcing work. And it's true. But 90% of those failures can be traced to working with resources that have not worked within an agency structure or on marketing programs. They have little experience in true U.S. customer facing work. The time zone may have been disastrously far away. Language problems were awful. Or there were very incompatible processes on both sides. Or all of the above.

The Case for Digital Advertising and Marketing

Here is a conservative view on costs and prices at typical agency and an Digital Advertising and Marketing Production Partner (DAMPP).

	AGENCY	DAMPP
FTE Fully loaded cost billable/hr @ 75% utilization	\$106 ¹	dna
Price to Client (from agency) vs. to Agency (from DAMPP)	\$120/hr ²	\$45 – 60/hr ³
Freelance hourly cost (before hidden costs)	\$70/hr ⁴	dna

¹ FTE rate of \$106 is based on a salary of \$67,000, Benefits of 1.3x salary and Overhead factor of 1.6, 1,750 annual hours and a 75% utilization rates. Based on our conversations with many agencies \$106 per utilized hour may be low, but we err on the conservative side.
² \$120/hr is an average blended billable rate earned by an agency from a client, based on internal survey.
³ This is a range of rates charged by DAMPP to agency clients in the U.S. The lower end will generally reflect the rates charged for a monthly retained team. The higher end reflects what an agency might expect to pay on a firm bid basis, and thus is used to generate the firm bid price (i.e.) 100 hrs x \$60/hr = \$6,000 on a firm bid.
⁴ There is no doubt that you have supervisory, coordination, set up/training, space and overhead costs associated with that freelancer. It is multiplied greatly if you need to put together a larger team of freelancers for a project that will take a few onths or more.

When comparing in house FTE's to a fixed price project done off-shore, with a cost difference of \$46 per hour (\$106 - \$60), it makes huge sense to ship production work to a DAMPP.

A comparison between hiring more freelancers, while still advantageous, appears to be less of a no brainer. We estimate hidden costs (see footnote) to be on the order of \$10 – \$15 per hour.

Furthermore, in this comparison the freelancer may be working by the hour and not on a fixed fee basis.

How Does It Work in Real Life? (See chart Page 5)

You win an assignment that would keep 5 employees busy for a year (or justify hiring 5 new employees). That's 5 x 1760 annual hours or 8,800 hours x .75 "true utilization" or 6,600 hours. You charge \$125 per hour. You bill the client \$825,000. Now there are two typical outcomes.

First you hire 5 new full time employees. You pay an average of \$67,000 in salary. Benefits and overhead increase the annual cost to \$139,360. Factoring in 75% utilization the fully loaded cost per FTE hits \$105.58 per hour. Your total cost is \$696,800. Profit is \$128,200 and margin is 16%.

Second you are use freelancers to do the work. You pay freelancers \$70/hr (and pretend hidden costs and inefficiencies don't exist). You pay the freelancers \$462,000 for the whole project, yielding a profit of \$363,000 or a net pre tax profit margin of 44%.

But in either case, nothing has really changed. For reasons you've been trying to figure out for years, it doesn't make a huge difference in profitability whether you hire staff or freelancers. You still make the same margin on the new work as you do on existing work, let's say 14%, which equates to a pretax profit of \$114,500.

We commonly see agencies hire more employees or a team of freelancers to produce incremental projects. But it's a slippery slope. Agencies think they are turning the profitability corner and then look back at year's end and realize margins are stuck in the low to mid teens. Unless you change the model, it's near impossible for an agency to grow out of a low profitability.

Making It Work with a DAMPP

Three Scenarios: How to Execute \$825,000 Worth of New Production Work:

	Hire 5 people	Hire 5 Freelancers	DAMPP
Revenue	\$825,000	\$825,000	\$825,000
Fully Loaded Cost	\$696,800	\$462,000	\$396,000
Utilized Cost/hr	\$106	\$70	\$60
Other Cost		<i>Exists but Ignored</i>	\$160,000 for supv.
Total Cost	\$696,800	\$363,000	\$446,000
Profit	\$128,200	\$429,000	\$269,000
Margin	16%	44%?	33% +
Problems	Small margin lift, model remains the same	Does not take into account many costs. Fully loaded: +/- \$90/hr + space	Initial learning and process and communication curve costs. Distance
Risks	Estimating risk	Availability and estimating risks	No estimating risk
Likely Outcome or Not?	Likely to slightly optimistic	Over optimistic to delusional	Proven

Now, let's say you carved out that work and sent it to a DAMPP. It is a professionally run organization, stocked with available project management, development and creative resources. That keeps your organizational and managerial tasks down. The bid is fixed and you have no estimating or overage risks. Assuming all the hours are apples to apples, they'd charge you 6,600 hours by \$60 per hour or \$396,000. **You'd have a profit of \$429,000 on \$825,000 in revenue for a margin of 52%.** It could be that simple.

But let's be aggressive and say that you'll need a full time person to coordinate all that work. So take away \$160,000, assuming an \$80,000 salary. Even though this level of supervision is excessive, you are still making \$269,000 or a margin of 33% -- more than double your current margins (assuming our intuition is correct). You can build in even more inefficiencies and still get to a significant margin lift for your agency.

Hire High Value People. Differentiate Your Work and Your Business Model. Make More Money.

We're sure what we are doing at Tango isn't the answer for everyone, but we do think it is the answer for the mid to larger size shop which seeks to concentrate on strategic and creative services and superior client management. The agency that seeks to conceive and direct Agency Defining Work. Because if that agency owns the high ground it will be able to price production work at a premium and utilize a DAMPP to execute it inexpensively. We know it is possible to expand margins dramatically, but to do so you will have to change the way you produce your work.

The reality is that everybody has also heard about an off-shored project gone wrong. And getting started is not easy. The answer: well, you've got to find a firm that is in the same time zone. That is run by marketers. That has worked with many agencies and has agency people working there. And it must have bullet proof project management skills. Then you've got to test them out, and the best way to do that is to carve out a project for a firm bid. Get a few projects under your belt. It gets easier as you go. In the meantime don't lease more space.

G.M. O'Connell and Bob Allen are co-founders of Tango Modem, a leading digital advertising and marketing production partner for U.S. based agencies. Tango is based in Buenos Aires, with offices in Mexico City and Madison, CT. Prior to founding Tango, G.M. and Bob were Chairman and CEO and President and COO, respectively, of Modem Media. Founded in 1987, Modem Media was the world's first online interactive advertising agency. After successfully operating as a public company, Modem was ultimately purchased by Publicis Groupe in 2006. For more information, feel free to contact either G.M. or Bob at gm.oconnell@tangomodem.com or bob.allen@tangomodem.com.