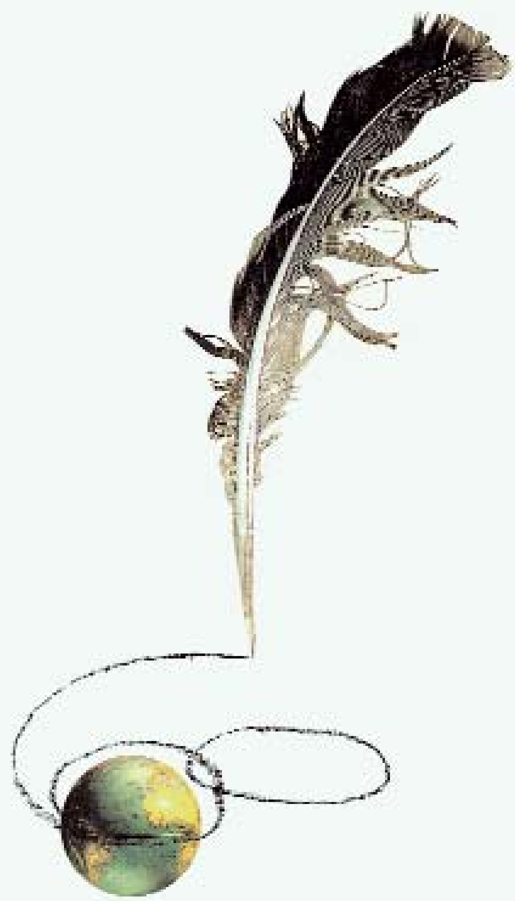
The Advertising and Marketing Services Industry:

Complete recovery from the internet bust of 2000 and strong base for growth

WPP CEO Martin Sorrell reports



2004 marked the full recovery from the internet bust of 2000. It was WPP's best year ever measured by most metrics – with the exception of margins and then only by a small amount. 2005 has already shown more improvement. It should, in theory, be the weakest of the next four-year cycle to 2008.

2006 should be an even better year – a "mini-quadrennial" boosted by mid-term Congressional elections in the US, the Winter Olympics in Turin and soccer's World Cup in Germany.

And 2007 will be the platform for 2008, when a "maxi-quadrennial" year will be dominated by the US presidential elections (Hillary Clinton vs. Condoleezza Rice?), the blockbuster Beijing Olympics and the European Football Championships in Austria and Switzerland.

In the longer term, advancing Americanisation and the growth of Asia Pacific, overcapacity and the shortage of human capital, the web, the demand for internal alignment and as a result internal communications, and retail concentration should together underline and assure the importance of our industry and its constituent parts – advertising and marketing services.

Worldwide communications services expenditure 2004 $bn

	Advertising	Market research	Public relations & public affairs	Specialist communications	**Total**
US	161.5	8.0	2.7	446.0	**618.2**
UK	18.4	2.0	0.9	65.2	**86.5**
France	13.2	1.4	0.1	24.3	**39.0**
Germany	21.7	1.7	0.2	36.8	**60.4**
Japan	40.6	1.3	0.1	47.6	**89.6**
Rest of the world	114.3	5.0	0.1	151.7	**271.1**
Total	369.7	19.4	4.1	771.6	**1,164.8**

Sources: Veronis Suhler Stevenson, ZenithOptimedia, ESOMAR, WPP estimates

What we think

The advertising and marketing services industry

Projected GDP: BRIC vs G6 $bn

	2000	2005	2010	2015	2020	2025	2030	2035	2040	2045	2050
Brazil	762	468	668	952	1,333	1,695	2,189	2,871	3,740	4,794	6,074
China	1,078	1,724	2,998	4,754	7,070	10,213	14,312	19,605	26,438	34,799	44,453
India	489	604	929	1,411	2,104	3,174	4,935	7,854	12,367	18,847	27,803
Russia	391	534	847	1,232	1,741	2,264	2,980	3,734	4,467	5,156	5,870
France	1,311	1,489	1,622	1,767	1,930	2,096	2,267	2,445	2,668	2,898	3,148
Germany	1,875	2,011	2,212	2,386	2,524	2,604	2,687	2,903	3,147	3,381	3,603
Italy	1,078	1,236	1,337	1,447	1,553	1,625	1,671	1,708	1,788	1,912	2,061
Japan	4,176	4,427	4,601	4,858	5,221	5,567	5,810	5,882	6,039	6,297	6,573
UK	1,437	1,688	1,876	2,089	2,285	2,456	2,648	2,901	3,201	3,496	3,782
USA	9,825	11,697	13,271	14,786	16,415	18,340	20,833	23,828	27,229	30,956	35,165
BRIC	2,720	3,330	5,442	8,349	12,248	17,346	24,416	34,064	47,012	63,596	84,200
G6	19,702	22,548	24,919	27,333	29,928	32,688	35,916	39,667	44,072	48,940	54,332

Source: Goldman Sachs

US advertising spending 1998-2008 $m

Year	Television	Radio	Newspapers	Consumer magazines	Business-to-business magazines	Consumer internet	Yellow pages	Outdoor	**Total**
1998	46,437	15,430	49,325	10,518	11,647	1,920	12,119	4,413	**151,809**
1999	49,375	17,681	52,189	11,433	12,682	4,620	12,952	4,832	**165,764**
2000	55,482	19,817	54,971	12,370	13,507	8,229	13,961	5,235	**183,572**
2001	49,993	18,363	50,724	11,095	10,848	7,223	14,693	5,193	**168,132**
2002	53,770	19,405	50,776	10,995	9,042	6,048	14,854	5,232	**170,122**
2003	56,063	19,592	51,894	11,193	9,036	7,267	14,933	5,504	**175,482**
2004[1]	**61,641**	**20,902**	**54,846**	**11,674**	**9,199**	**8,415**	**15,629**	**5,756**	**188,062**
2005[1]	**64,398**	**22,170**	**57,530**	**12,351**	**9,585**	**9,267**	**16,545**	**6,005**	**197,851**
2006[1]	69,457	23,642	60,317	13,154	10,085	10,452	17,564	6,274	**210,945**
2007[1]	72,984	25,096	63,497	14,075	10,706	11,378	18,626	6,568	**222,930**
2008[1]	79,852	26,788	67,124	15,131	11,403	13,264	19,698	6,871	**240,131**

[1] Estimated

Source: Veronis Suhler Stevenson

US growth in advertising spending 1999-2008 % growth

Year	Television	Radio	Newspapers	Consumer magazines	Business-to-business magazines	Consumer internet	Yellow pages	Outdoor	**Total**
1999	6.3	14.6	5.8	8.7	8.9	140.6	6.9	9.5	**9.2**
2000	12.4	12.1	5.3	8.2	6.5	78.1	7.8	8.3	**10.7**
2001	-9.9	-7.3	-7.7	-10.3	-19.7	-12.2	5.2	-0.8	**-8.4**
2002	7.6	5.7	0.1	-0.9	-16.6	-16.3	1.1	0.8	**1.2**
2003	4.3	1.0	2.2	1.8	-0.1	20.2	0.5	5.2	**3.2**
2004[1]	**9.9**	**6.7**	**5.7**	**4.3**	**1.8**	**15.8**	**4.7**	**4.6**	**7.2**
2005[1]	**4.5**	**6.1**	**4.9**	**5.8**	**4.2**	**10.1**	**5.9**	**4.3**	**5.2**
2006[1]	7.9	6.6	4.8	6.5	5.2	12.8	6.2	4.5	**6.6**
2007[1]	5.1	6.2	5.3	7.0	6.2	8.9	6.0	4.7	**5.7**
2008[1]	9.4	6.7	5.7	7.5	6.5	16.6	5.8	4.6	**7.7**
Compound annual growth									
1998-2003	3.8	4.9	1.0	1.3	-4.9	30.5	4.3	4.5	**3.0**
2003-2008	7.3	6.5	5.3	6.2	4.8	12.8	5.7	4.5	**6.5**

[1] Estimated

Source: Veronis Suhler Stevenson

Improving prospects, even in the shorter term

In 2004, spending on worldwide communication services – or advertising and marketing services – grew by 2-3% to more than $1.1 trillion, putting WPP's market share, including Grey Global, at about 10%. This year the industry should again grow at around 2-3%. As a proportion of worldwide GNP, it probably fell during the recession of 2001-03, but stabilised in 2003 and 2004. It will continue to grow thereafter.

Advertising and media investment management – which concentrate on traditional media such as television, radio, newspapers, magazines, outdoor and cinema – have grown well historically and led the industry out of the recession. But its share has declined as supposedly less sophisticated, less global and less developed marketing services have gained share. These are the so-called below-the-line areas, such as information, insight and consultancy, public relations and public affairs, branding and identity, healthcare and specialist communications – particularly direct, interactive and internet communications.

Consumer price inflation year-on-year % change

	00 v 99	01 v 00	02 v 01	03 v 02	04 v 03
France	1.7	1.7	1.8	2.1	2.3
Germany	1.4	2.0	1.4	1.1	1.7
Italy	2.5	2.8	2.4	2.6	2.3
Japan	-0.7	-0.7	-0.9	-0.3	-0.1
UK	2.9	1.8	1.6	2.9	1.4
USA	3.4	2.8	1.6	2.2	2.6
Brazil	7.1	6.8	8.5	14.7	7.3
Russia	20.7	21.5	15.7	13.7	10.9
India	4.0	3.7	4.4	3.9	3.5
China	0.3	0.5	-0.8	1.2	4.0

Source: ZenithOptimedia

The rise and rise of marketing services

Marketing services have grown more quickly, for two reasons. First, network television pricing has risen faster than inflation, to the disquiet of big advertisers. Procter & Gamble, the world's biggest advertiser (even bigger with Gillette), Unilever, Coca-Cola and American Express have registered voluble protests in recent times. They are sick and tired of paying more for less. In 2003, in the up-front network buying season, cost per thousand rose by an estimated 15-22% against an expected 7-12% – and this against general price inflation of 3%. In 2004, up-front pricing continued to outpace inflation, cost per thousand rising by 6-7%. 2005 should see further softening, but prices will still probably grow faster than general price inflation at around 4-5%.

The analogy is to imagine what would happen in the car industry if the price of steel rose consistently by 10% against general price inflation of 3%. Manufacturers would use less steel or find a substitute. That is what is happening in our industry, too. Marketing services and other traditional media such as radio, outdoor and cinema advertising are becoming more acceptable substitutes. Network television will, however, remain an important medium. It will not disappear. It still reaches the largest number of consumers in the shortest time, at the lowest cost per thousand. If we were starting a multi-national package goods company from scratch, we would still use network television to reach the largest number of people in the shortest time at the lowest cost.

Clients also need reach. In the US, for example, prime-time network television used to reach 90% of households. A few years ago it was 50%; today it is perhaps only 33%. There are, of course, still programmes with significantly increased reach, like the Super Bowl or Academy Awards. But they remain in relatively fixed supply and their prices are bid up as a result. That is why a 30-second Super Bowl ad costs $2.4 million and an Academy Awards slot $1.5 million. This is not a situation that can last, particularly when significant segments of the population seem to go missing. For instance, US audience ratings indicate that young men have disappeared on Monday nights – perhaps gaming on the internet or watching out-of-home in bars – and housewives have defected from soap operas.

The Super Bowl line-up 1985-2005

Year	Price $	Network	Household rating	Share
1985	500,000	ABC	46.4	63
1986	550,000	NBC	48.3	70
1987	575,000	CBS	45.8	66
1988	600,000	ABC	41.9	62
1989	675,000	NBC	43.5	68
1990	700,000	CBS	39.0	63
1991	800,000	ABC	41.9	63
1992	800,000	CBS	40.3	61
1993	850,000	NBC	45.1	66
1994	900,000	NBC	45.5	66
1995	1,000,000	ABC	41.3	62
1996	1,100,000	NBC	46.0	68
1997	1,200,000	FOX	43.3	65
1998	1,300,000	NBC	44.5	67
1999	1,600,000	FOX	40.2	61
2000	2,300,000	ABC	43.3	63
2001	2,000,000	CBS	40.4	61
2002	1,800,000	FOX	40.4	61
2003	2,100,000	ABC	40.7	61
2004	2,200,000	CBS	41.3	63
2005	2,400,000	FOX	41.1	62

Source: MindShare

Moreover, media fragmentation has increased significantly as the old media become more sophisticated and the new media proliferate. Technology has improved the effectiveness and development of cable and satellite television, newspapers and periodicals, radio and outdoor, while spawning new media in direct, interactive and the internet. Many of these new media are more measurable and more targeted.

At the same time, media consumption habits are changing with every generation. Just look at what a four-year-old can do with a computer in a few hours or what bloggers and hackers do with different value systems. Decision-makers in media owners and agencies tend to be in their fifties and sixties; their sons and daughters and grandchildren are shifting in ever greater numbers to multi-tasking on the web, personal video recorders (PVRs), video-on-demand, mobiles and internet gaming.

Many leading executives are in denial. They believe – or hope – that such changes will not happen on their watch. Yet I know that my own consumption habits have altered radically over the past few years – more daily newspapers,

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fewer periodicals. More cable and satellite television, less network. More web use for information and Blackberry® e-mail. I am less willing to wait for detailed analysis in weeklies or fortnightlies. I want commentary now. Why should I wait for 10 days or so for in-depth analysis of the Procter/Gillette merger announced on a Thursday night?

Similarly, the US has hitherto accounted for about half of worldwide advertising and marketing services spending, with the most prominent non-US markets being Japan, Germany, the UK, France, Italy and Spain. That is changing. Asia Pacific, Latin America, Africa, the Middle East, and Central and Eastern Europe are becoming more and more significant, as multinational corporations build their businesses where populations are growing.

Non-US markets will be increasingly important. Extrapolate WPP's current revenues in the BRIC countries (Brazil, Russia, India and China) at the rates of GNP growth predicted in recently published Goldman Sachs research documents and assume moderate rises in advertising to GNP ratios. The result is that Asia Pacific, Latin America, Africa, the Middle East, and Central and Eastern Europe will take a growing share of our business: possibly 38% by 2015, excluding acquisitions. Perhaps we should look at our activities on a network television and non-network television basis, and a US and non-US basis. Increasingly, the marketing world is becoming two-paced, geographically and functionally. The US, Asia Pacific, Africa and Middle East and Central and Eastern Europe are outpacing Western Europe; the internet is outpacing network television, newspapers and periodicals.

In any event, WPP was founded some 20 years ago by two people in one room to try to capitalise on these two trends and provide co-ordinated advertising and marketing services throughout the world.

In the short term it's been tough

We were spoiled in the 1990s. All you had to do was come into the office. With a tightly controlled Rubin/Greenspan US economy and Friedmanite economics driving the global economy it was relatively easy – despite the world's second largest economic engine, Japan, being out of order for 12 years or so. Strong growth, low inflation and high, but not full levels of employment, drove a 10-year bull market, such as we have not seen since the 1920s.

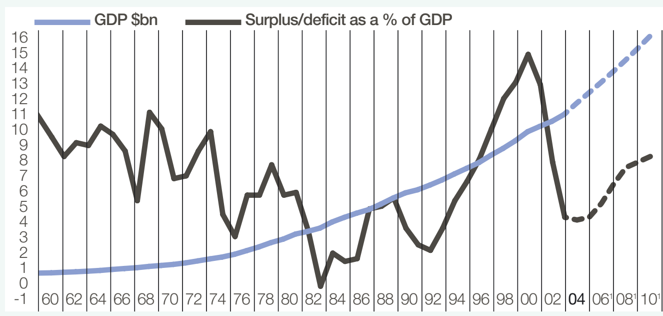
The speculative blow-out around the internet was perhaps inevitable and, given its size, a lengthy correction was necessary. Overall, the past four years have been painful. After growing consistently through the 1990s, culminating in organic growth of 15% in 2000 (20% using the yardstick of our competitors), WPP shrank, on a like-for-like basis, in 2001 and 2002. It resumed modest growth in 2003 and 2004. Ten fat years, three lean ones and a return to modest growth in a lower inflationary environment in the last one – mostly due to quadrennial events. It seems our business is becoming increasingly event-driven, particularly by political events. President Bush wanted a strong economic background to his re-election and Prime Minister Blair wanted a similar background to his.

One worry: fiscal over-stimulation

The US economy was in a political cycle in 2004, as the government used fiscal spending to stimulate the economy. Rates of growth in US government spending were back to where they were 35 years ago at the height of the Vietnam War. It is no accident that governments in many countries are the largest advertising spenders: ministries use marketing spending to reinforce their policies and build electoral popularity. The problem is that the US economy is almost entering another Reagan era with huge fiscal deficits, a weak dollar, trade imbalances and the threat of inflation. Isn't the country's currency really its stock price?

President Bush may have to deal with the deficit and the weak dollar by raising interest rates and taxes and thus curbing growth. To date, the recession has hit the business-to-business arena, leaving the consumer relatively untouched. Spending has been stimulated by negative real interest rates and discounting. The issue remains whether increased corporate profitability and liquidity will stimulate a capital expenditure-led increase in activity, as the consumer is hit by monetary correction. 2005 has so far seen a relatively soft landing, but corporate capital spending remains sluggish, not filling the void caused by more sensitive debt-ridden consumers and reduced consumer spending. Perhaps a Sarbanes-Oxley, Eliot Spitzer-dominated world, where CEOs last on average less than four years and are constantly pressurised to return cash to share owners and hedge funds, themselves pre-occupied by short-term performance targets, is not an environment where anybody wants to take risks or focus on the long-term. Why take chances and be fired?

US Government spending since 1960

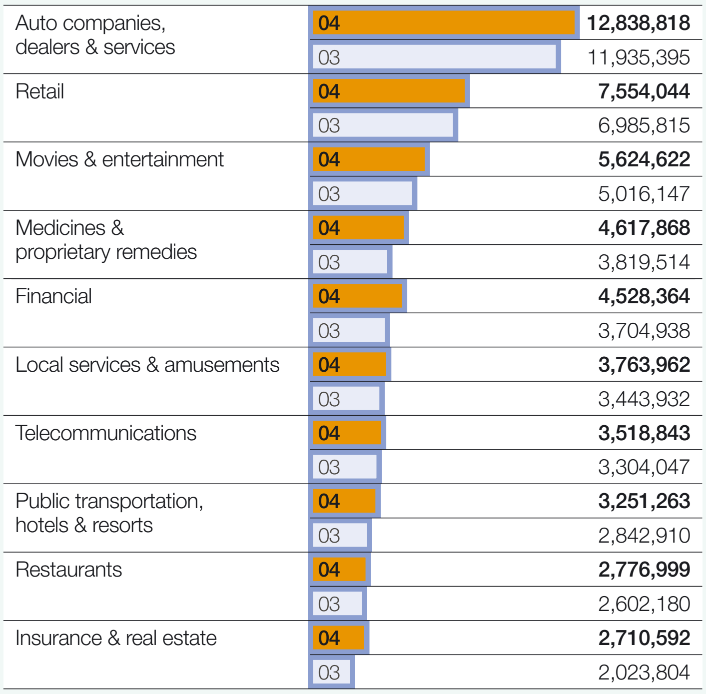


¹ Estimate

Source: Budget of the US Government 2005

Top 10 US advertising spenders by category $000

Industry	Jan – Aug 2003	Jan – Aug 2004	% change
Auto companies, dealers & services	11,935,395	12,838,818	8
Retail	6,985,815	7,554,044	8
Movies & entertainment	5,016,147	5,624,622	12
Medicines & proprietary remedies	3,819,514	4,617,868	21
Financial	3,704,938	4,528,364	22
Local services & amusements	3,443,932	3,763,962	9
Telecommunications	3,304,047	3,518,843	7
Public transportation, hotels & resorts	2,842,910	3,251,263	14
Restaurants	2,602,180	2,776,999	7
Insurance & real estate	2,023,804	2,710,592	34
Other	29,543,717	32,078,479	9
Total	**75,222,399**	**83,263,854**	**11**



Source: CMR (excludes out of home advertising)

Merger & acquisition activity*

Year	Volume	Value
US deal flow		
2005	3,159	$418,508.6
2004	3,783	$361,896.6
2003	3,033	$134,955.2
European deal flow		
2005	3,780	$251,588.8
2004	4,172	$258,392.7
2003	3,380	$249,401.6

*Comparative YTD numbers for period of 1 Jan – 6 May
Source: Mergerstat.com (6 May 2005)

Meanwhile, consolidation continues...

In parallel with this short-term weakness, other pressures persist. Consolidation continues apace. Among clients, Procter takes Wella and Gillette, Interbrew takes AmBev, Telefonica takes Bell South's Latin American interests, Cingular takes AT&T Wireless, MCI chooses Verizon, Pernod Ricard tries to take Allied Domecq. And this at a time when merger and acquisition (M&A) activity is meant to be at lower levels.

Consolidation among media owners also continues unabated. NewsCorp takes DirecTV, Comcast tried to take Disney, Carlton and Granada merge to monopolise ITV. Legislation favours more consolidation in the US and the UK. Even in Brazil, which has been fiercely protectionist, you could now buy 30% of Globo or Editora Abril. Germany allows foreign ownership of TV channels. Italy concentrates further though the Gasparri Bill.

Clients and media owners are not alone. Retail consolidates, too. Morrison takes Safeway. In Latin America, Wal-Mart enters the North East of Brazil by acquiring part of Ahold's interests, Lider consumes Carrefour, Jumbo buys Disco in Argentina, and rumours surround Wal-Mart and Carrefour, and Home Depot and Kingfisher. In line with the laws of big numbers, the challenge to Wal-Mart, Tesco and Home Depot will be how they can successfully manage expansion outside their home markets. It will not be easy; the demands are different.

As a result, it is no surprise that agencies are also consolidating. Certainly in the one area where there are big economies of scale – media buying – consolidation is significant. To negotiate with a Murdoch or Sumner Redstone or Mel Karmazin or Michael Eisner or Bob Iger or Bob Wright, larger scale is essential. Media planning or buying, or what we call media investment management, is one of WPP's fastest-growing businesses, driven by clients looking for media buying efficiencies – rather than reductions in agency's commissions. Often savings on gross media budgets of 5-10% are achievable. Media savings are driving client centralisations and are a quick kill in showing efficiencies, as Nestlé and Unilever have shown. But even on the creative side, voracious procurement departments and ill-judged price competition by agencies themselves are driving consolidation (the $100 million pitch win headline in *AdAge* or *Campaign* is more satisfying than real revenue). No surprise, then, that Publicis dismantled D'Arcy, itself a consolidation of three agencies – D'Arcy, Masius Wynne-Williams and Benton & Bowles. We ourselves consolidated Cordiant, an amalgamation of Bates and Dorland, among others.

...And so do price and trade promotion

In a low-inflation, over-capacity market with little or no pricing power, many manufacturers have turned to price promotion and discounting. Probably the best example is the car and truck industry. General Motors still seems to believe it has a balance sheet advantage over its competitors, particularly in Detroit. Why else would it introduce heavily price-based competition such as five-year zero-coupon financing or discounts of $4,000 to $5,000 a unit. Probably, the most extreme case was Hyundai in Korea offering negative interest rates on financing – a form of cash giveback. One dealer in America offered a buy-one, get-one-free deal on sports utility vehicles (SUVs). Luckily it was a failure.

If you give cars away it is only to be expected that consumers buy them. No surprise, then, that the American auto market has remained at 16 million units in this environment, or that housing markets and house prices show similar buoyancy, when fixed-term money is being given away at such low interest rates.

The problem is that consumers become used to such discounting and wait for new car or truck introductions and the discounting that goes with them. The auto manufacturers face profitless prosperity and break-even economics at full capacity. Interestingly, the Japanese and Korean manufacturers, and some German ones too, have tended to resist the temptation of excessive discounting, offering lower levels of $1,000 or $2,000. Instead they concentrate on design, new products and branding to build a price premium. If you focus on price, you build commodities. If you focus on innovation and product and differentiation, you earn a price premium and build brands. Conclusive evidence of the inadvisability of this strategy came when General Motors had to lower its earnings forecast for 2005 by 80%. Price promotion just does not work. The product is key.

A similarly unfortunate trend is occurring in the food industry. Package goods companies continue to try to build share by discounting and price competition, particularly as distribution concentrates. They pay higher trade discounts and slotting allowances, and fund increased promotional activity. One package goods company has $80 billion of annual sales, $10 billion of operating profits and spends about $2 billion on above-the-line advertising. Guess what its broadly-defined trade promotions budget is? Around $10 billion, equivalent to its operating profits and rising by 1% of revenues or $800 million a year. The CEO described it as the biggest crisis facing the company.

Interestingly, there is not the same phenomenon in the health-based or well-being segments of the package goods industry. Here, companies are more focused on product innovation, research and development or science, along with branding to build stronger market shares. As a result, brands and margins are more robust, and volumes greater.

Recent accounting changes in the US have forced companies to show gross and net sales, at least temporarily. As a result, more data is available on the balance between advertising and promotional spending. Many CEOs know what they spend on advertising, but not on trade promotion. Often the latter exceeds the former, even in heavy-spending above-the-line companies. It may well be that manufacturers will seek to cut trade spending and boost brand spending, particularly at a time when the trade is consolidating at such a rapid rate. Bribing customers for distribution is a recipe for ruin.

Fees, procurement and outsourcing bring opportunities as well as threats

The days of 15% gross commissions, 17.65% on cost, are long gone. Commission levels have receded to around 12% gross for full service, including media planning and buying. Production commissions have largely been reduced or eliminated, although there are interesting procurement opportunities for agencies themselves in television production, as we have seen at WPP in Australia.

While commissions persist, fees are becoming more popular with clients, although that momentum seems to have slowed recently. They now represent at least 75% of our business. Usually time-based, with incentives, they are used exclusively in our marketing services business, which accounts for 54% of our revenues. In advertising, they account for over half of our business.

Fees have a number of advantages and on balance we prefer them. They are not seasonal, in a business where spending tends to be concentrated in the second and fourth quarters. January has become a profitable month. If clients cut or do not spend or continually re-brief us, we still get paid. Finally, when fee-driven, we tend to plan our annual business better.

Fees have also tended to dampen volatility in our operating margins. In the most recent cycle our margins peaked at 14.5% and bottomed at 12.3%. In the previous cycle in the early nineties, they peaked at 10.5% and bottomed at 5.6%.

I cannot remember a time, in the 25 or so years I have been in the industry, when clients have been so focused on cost, although in 2004 there were signs of a growing focus on top-line growth, and innovation and branding – as opposed to costs. Given overcapacity, low inflation and lack of pricing power, and high management turnover, that is perhaps understandable.

However, the question remains whether the procurement process can successfully purchase creative services in the way that door handles or widgets are bought. The emphasis on procurement seemed to start in the pharmaceutical industry and then moved elsewhere. It may work in media buying, where there are economies of scale, but not necessarily in media planning or other creative areas.

It is true that we must improve our processes and eliminate waste, but can you buy ideas or our people's creativity in such a mechanical way? Increasingly, pressure on price will drive our best creative resources to those clients and categories where they feel their services are appreciated and rewarded appropriately. Many marketing

Hours per person per year using consumer media in US

	1998	1999	2000	2001	2002	2003	2004	2005†	2006†	2007†	2008†
Total broadcast television	881	867	866	833	787	769	782	785	790	794	800
Total cable & satellite TV	670	720	769	843	918	975	1,010	1,042	1,068	1,093	1,131
Broadcast & satellite radio	911	939	943	955	990	1,002	1,035	1,040	1,070	1,080	1,120
Cinema	13	13	12	13	14	13	13	13	13	13	14
Home video/DVD	51	48	51	56	65	70	78	85	94	103	110
Interactive TV	–	2	2	2	2	2	3	3	4	4	5
Recorded music	275	281	258	229	200	184	180	176	174	170	167
Video games	45	53	59	60	64	69	71	75	81	86	98
Consumer internet	39	64	107	139	158	176	189	200	213	225	236
Daily newspapers	186	183	180	177	175	171	169	168	165	165	164
Consumer books	118	119	109	106	109	108	107	106	106	105	104
Consumer magazines	134	134	135	127	125	121	118	116	113	111	110
Total	**3,323**	**3,423**	**3,491**	**3,540**	**3,607**	**3,660**	**3,755**	**3,809**	**3,891**	**3,949**	**4,059**

Source: Veronis Suhler Stevenson

† Estimated

clients still appreciate that great advertising ideas and copy deliver outstanding results. Reducing marketing costs indiscriminately, particularly in industries with heavy fixed production costs, will only result in having to spread those costs over fewer unit sales.

The procurement process seems to be based on the idea that what we provide is low value-added, and that because we are dependent on significant revenues from large clients, we can be squeezed. This thinking may well be flawed. First, what we do is critical. There is a limit to how far costs can be reduced; but there is almost no limit (apart from 100% market share) to how far you can grow revenues. Second, in an increasingly undifferentiated world, what we do – differentiate products and services, tangibly and intangibly – is becoming more and more important.

Finally, growing consolidation in our industry is reducing the potential resources for clients. It is ever more difficult to find co-ordinated resources that can deliver what they require, particularly if the client is an international, multinational or global company. Smaller, country or city-based operations cannot offer the depth of coverage.

One interesting recent development is the growing interest in outsourcing parts or all of the marketing function. Clearly this is an opportunity for us and is being driven by CEOs' focus on costs and their analysis of their investment in marketing services. Instead of concentrating solely on amounts spent outside the organisation, closer examination is being made of amounts spent inside the company. WPP has become involved recently in outsourcing projects in the car and internet services industries.

In a number of other areas, including advertising, direct marketing and research, there is interest in what can be done in outsourcing costs. Clearly this tends to make internal marketing departments more defensive about their functions.

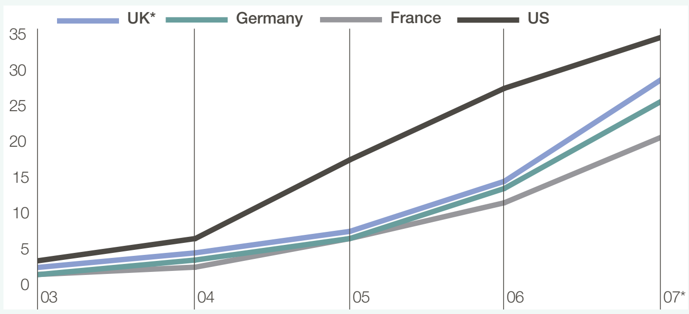
Media fragmentation

Another significant short-term pressure is media fragmentation. This has been driven by television price inflation and falling audiences, as media consumption habits change. Developing technologies have given birth to new media such as personal computers, the internet and interactivity. They have also altered the economics of traditional media such as newspapers and magazines, while minority media such as radio, outdoor and cinema have improved their offerings through better marketing and research. Few newspaper or periodical publishers have mastered the connection with the new internet platforms; hence Rupert Murdoch's recent conference speech with his editors, as well as his decision to re-examine NewsCorp's new media approach with McKinsey engaged to look at it.

As a result, clients are re-examining the absolute levels of their advertising and marketing services investment. Does it make sense to shift their portfolio of media investment away from network television to cable, satellite, radio, outdoor, cinema, direct, public relations, interactive, internet or whatever? The econometric analysis of media investment is becoming increasingly important. How much should we spend and through which media, have become the critical questions – the Holy Grail of advertising. The answer to which half of advertising is wasted.

Among the latest media innovations are PVRs, which enable viewers to download television programmes on to a hard disk. The PVR enables you to build your own television channel, recording programmes for screening when you want to see them, and to build a library, as an Apple iPod does with music. A PVR also allows you to time-shift programmes as you watch, stopping for breaks whenever you wish. Forrester Research predicts that 50% of US households will have PVRs by 2007. Others are less bullish, but even the least enthusiastic forecast 25% penetration by then. It cannot be long before they are standard equipment in television sets.

Projected PVR penetration in parts of Europe and US
%



Source: Jupiter Research

* MindShare estimates only 32% penetration by 2010

What has made observers particularly excited about the PVR is its ability to fast-forward or skip commercials altogether. Market research in the US indicates that consumers like to fast-forward advertisements – though they stop at beer commercials for fun and car commercials for information. We could do most of this previously with television video recorders, of course, and the key question remains the amount of time viewers will continue to devote to television viewing. In some PVRs, the skip button has been omitted and fast-forward speeds are limited. In others, little boxes on the PVR screen will contain details of the ads being fast-forwarded. Whatever the outcome, such devices will exert more pressure on network television and on agencies to develop stronger programming and sponsorship opportunities, along with even more creative advertising ideas. The same will be true of video-on-demand, another new and fast-developing technology. The premium on creativity will grow.

Super-agencies – trend or fad?

Formed initially in response to the pressures of consolidation and to house conflicting accounts, the super-agencies – or what we at WPP prefer to call the parent companies – really represent the full-service agencies of the 21st century.

In the 1960s if you visited, for example, JWT in Berkeley Square you would find a creative department, a marketing department, an account handling department, a media department, a public relations department, a merchandising department, a direct mail department, a packaging department, a production department, an experimental film department, a market research department, a conference department and even a home economics department with two fully equipped kitchens – plus an operations research department designing a factory for Mr Kipling's cakes. Long before the phrase integrated communications came into common use, integrated communications were exactly what such full-service agencies provided.

Over time, and as a result of two pressures, these departments became unbundled. Clients sought to reduce costs – and the media and craft specialists within agencies, feeling under-recognised as members of a mother agency's department, looked for greater recognition and reward in free-standing, specialist companies of their own.

Importantly, this involved a split between the brand agency and the media agency, reducing costs from approximately 15% of gross media costs to about 12%. Good media people left and started independents such as Carat, Media Planning Group, CIA and Western International, which grew organically and by acquisition. The same pattern was seen among packaging, merchandising, PR and other specialist skills. Many such companies have now been re-absorbed into the super-agencies, but in an inter-dependent or autonomous form. Strong media or marketing services functional specialists do not like, understandably, to be subsumed under advertising professionals.

Today, the new super-agencies have a big opportunity. Clients still require, first and foremost, creativity and great creative ideas. Secondly, but increasingly, they want better co-ordination (although it is no good co-ordinating a lousy idea). Finally, they want it at the lowest possible price. The challenge is therefore to provide the best ideas in the best co-ordinated or integrated way at the lowest price. To respond to this, the super-agencies will in turn need to focus on attracting, retaining and developing the best talent, structuring their organisations in the most effective way and incentivising their people successfully – qualitatively and quantitatively.

While only a year ago this might have been seen as a fad, the concept may now be taking root. Three major multinational clients – all three coincidentally, perhaps, with their origins or significant parts of their business in Asia – invited the four or five largest holding or parent companies to present for their global advertising and marketing services business. In all cases the presentations included advertising and media investment management, and direct – and in one case research. All three clients were looking for an integrated global solution to their needs and for groups that can offer alternative solutions – potentially a weakness of the single network.

In all three pitches, a group or parent company solution was selected. WPP tribes were successful in two of them. In the third, we were unable to field our strongest line-up because of conflict issues in one of the tribes. The CEO of one eliminated parent company in the first round of the first pitch declared that this was not a trend. Now that at least three pitches have taken place, he has changed his mind. In addition, many other group pitches have taken place – particularly in pharmaceuticals – that have been under the trade papers' radar. The only issue preventing this from being a trend is whether clients can be convinced of the benefits. The middle of the road is becoming an increasingly difficult place to be, with traffic coming from both directions. Those agencies excluded from the super-agency pitches because they lack the scale and resources must be feeling uncomfortable. Our business is increasingly polarising between the very big at one end and the small at the other.

Further down the line, a much brighter picture

Five key factors underpinning longer-term growth

Strategically, a better future

While the internet bust of 2000 has clouded the short-term outlook, the long-term future for advertising and marketing services, for innovation and branding, remains very rosy. There are five key reasons why the services we provide will become increasingly relevant.

1. Globalisation or Americanisation

Certainly, commercial life has not quite worked out as Professor Theodore Levitt predicted it might some 21 years ago in the *Harvard Business Review*. The world has not been globalised to the extent he predicted, where consumers around the world consumed similar products, marketed in the same way everywhere. Indeed, Levitt admitted as much in an interview to celebrate the 20th anniversary of his article. He was exaggerating to make a point.

Truly global products only account for around 10-15% of our worldwide revenues. Consumers are probably more interesting for their differences than their similarities. Recent political developments support this – the collapse of the Soviet Union, Yugoslavia, devolution in Scotland and Wales, and Basque nationalism. Indeed, the European Union is really a supply-side led phenomenon, harmonising production and distribution, rather than demand. On January 1, 1993, a Euro consumer was not born.

What has been going on may well not be the globalisation of world markets, but their Americanisation. Not in the sense that upsets the French or the Germans and results in the banning of Americanisms from French commercial language, an objection to the cultural imperialism of Coke, the Golden Arches or Mickey Mouse. But more in the sense of the power and leadership of the US. In most industries, including our own, the US accounts for almost half of the world market. And given the prominence of US-based multinationals, you could argue that almost two-thirds of the advertising and marketing services market is controlled or influenced from there. If you want to build a worldwide brand you have to establish a big presence in the world's largest market – the US.

At WPP, 22 of our top 40 clients are headquartered in the US, 17 in Europe and one in Asia Pacific. Moreover, they are almost all located in the north-east corridor created by Chicago, Detroit, New York and Washington.

Failure to understand the importance of North America can be life-threatening. Take the case of the investment banking industry. Fifteen to 20 years ago, strong brands in Europe included SG Warburg, Morgan Grenfell, Schroders and Flemings. Today they have virtually disappeared and the industry is dominated by large American banks like Goldman Sachs, Morgan Stanley, Merrill Lynch and Citigroup. While strong European talent might have had misgivings about working in American multinationals a few years ago, today these businesses are more sensitively run and offer interesting, intellectually stimulating global opportunities and challenges. The European-based businesses that remain, such as Deutsche Bank, UBS and CSFB, still face the challenge of establishing a good market position in the US.

Neither is it easy to find European-based global companies. BP and Shell certainly get it, as do Unilever and Nestlé. So does DaimlerChrysler, although Jurgen Schrempp's strategy is still under attack. Vodafone, GlaxoSmithKline, AstraZeneca, L'Oreal and Sanofi are other good examples. There are not many more.

American strength is based on three factors. First, the size and power of the American market; 295 million people in a relatively homogeneous market. Despite the European Union being almost twice the size, it is much more heterogeneous. Second, the power and size of American capital markets. If you want to raise debt or equity capital, it still is the cheapest place to go. Finally, because of their strength in technology. I am hard pressed to think of many areas where they do not lead. Third-generation mobile phone technology is one, but given the prices that European companies paid for the privilege, the distinction is a dubious one.

At various times in history, when a country or empire seemed to have total political, social or economic hegemony, the situation changed and the vacuum was filled by another power. At this point in time, it may well be China that takes this role, in the context of the growth of Asia Pacific. Although this development was delayed by the tragic events of 9/11, as the US and China grappled with trying to understand actions in the Muslim world, this trend is now in full swing.

Top 100 brands by location

Location	2001 %	2002 %	2003 %	2004 %
USA	63	65	62	58
Germany	7	6	6	9
France	3	5	7	9
Japan	6	6	7	7
UK	7	5	6	5
Switzerland	3	3	3	3
Italy	2	3	2	3
Netherlands	2	2	2	3
Finland	1	1	1	1
Sweden	3	2	2	1
South Korea	1	1	1	1
Bermuda	1	1	1	0
Denmark	1	0	0	0

Source: Interbrand/Business Week

What we think

The advertising and marketing services industry

Top 10 global advertisers 2003

Rank 2003	Rank 2002	Advertiser	Headquarters	Worldwide advertising spend $m 2003	2002	% change	US measured media spending $m 2003	2002	% change	Spend by region 2003 $m Asia	Europe	Latin America
1	1	Procter & Gamble	Cincinnati	5,762	4,466	29.0	2,684	2,160	24.3	718	2,081	141
2	3	Unilever	London/Rotterdam	3,540	3,124	13.3	572	704	-18.8	826	1,861	207
3	2	General Motors Corp.	Detroit	3,412	3,278	4.1	2,367	2,399	-1.3	98	551	112
4	6	Toyota Motor Corp.	Toyota City, Japan	2,669	2,444	9.2	1,014	936	8.3	1,090	398	31
5	5	Ford Motor Co.	Dearborn, US	2,537	2,440	4.0	1,445	1,456	-0.8	98	738	95
6	4	Time Warner	New York, US	2,378	2,165	9.8	1,847	1,743	6.0	52	391	64
7	7	Daimler Chrysler	Auburn Hills, US/ Stuttgart, Germany	2,230	1,926	15.8	1,608	1,410	14.0	29	350	31
8	10	L'Oreal	Paris, France	2,180	1,588	37.3	636	574	10.8	98	1,363	30
9	9	Nestlé	Vevey, Switzerland	1,737	1,453	19.5	520	502	3.6	157	962	69
10	16	Sony Corp.	Tokyo, Japan	1,684	1,431	17.7	1,004	897	11.9	183	395	47
				28,129	24,315	15.7						

Source: Ad Age Global Marketing Report 2004

Worldwide advertising expenditure US vs non-US

Major media*	2003	2004	2005[1]	2006[1]	2007[1]
North America	158,383	167,869	174,823	183,938	193,483
Year-on-year growth	1.9%	6.0%	4.1%	5.2%	5.2%
Europe	89,985	94,839	99,144	104,164	109,925
Year-on-year growth	1.4%	5.4%	4.5%	5.1%	5.5%
Asia/Pacific	69,646	75,564	80,100	85,442	91,467
Year-on-year growth	5.0%	8.5%	6.0%	6.7%	7.1%
Latin America	14,238	15,896	16,664	17,700	18,999
Year-on-year growth	3.7%	11.6%	4.8%	6.2%	7.3%
Africa/Middle East/ROW	13,922	16,022	18,070	20,155	22,126
Year-on-year growth	19.1%	15.1%	12.8%	11.5%	9.8%
World	345,720	369,705	388,268	410,813	434,456
Year-on-year growth	3.0%	6.9%	5.0%	5.8%	5.8%

*TV, Print, Radio, Cinema, Outdoor, Internet

[1] Estimated

Source: ZenithOptimedia

Advertising expenditure as a % of GDP

	2003	2004	2005[1]	2006[1]	2007[1]
France	0.61	0.60	0.60	0.60	0.60
Germany	0.75	0.74	0.74	0.75	0.75
Italy	0.60	0.62	0.64	0.67	0.70
Japan	0.84	0.85	0.86	0.86	0.87
UK	0.95	0.98	0.98	0.99	0.99
USA	1.38	1.37	1.36	1.39	1.40
Brazil	0.75	0.76	0.76	0.76	0.76
Russia	0.61	0.73	0.84	0.91	0.9
India	0.35	0.42	0.40	0.39	0.38
China	0.54	0.57	0.59	0.63	0.67

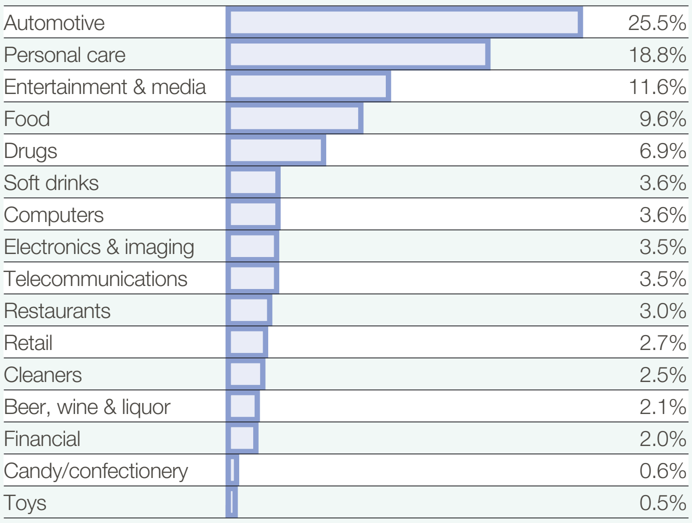
[1] Estimated

Source: ZenithOptimedia

Top 100 global marketers spending by category

by measured media bought in 2003 and 2002

	2003 $m	2002 $m	2003 % change	% total	Advertiser count
Automotive	20,928	19,234	8.8	25.5	17
Personal care	15,294	12,456	22.8	18.8	10
Entertainment & media	9,431	8,623	9.4	11.6	8
Food	7,786	6,640	17.3	9.6	9
Drugs	5,599	4,869	15.0	6.9	7
Soft drinks	2,916	2,791	4.5	3.6	3
Computers	2,904	2,439	19.1	3.6	5
Electronics & imaging	2,860	2,341	22.2	3.5	6
Telecommunications	2,822	2,149	31.3	3.5	6
Restaurants	2,471	2,417	2.2	3.0	3
Retail	2,210	1,764	25.3	2.7	6
Cleaners	2,063	1,772	16.4	2.5	3
Beer, wine & liquor	1,682	1,705	-1.3	2.1	5
Financial	1,624	1,253	29.6	2.0	4
Candy/confectionery	474	469	1.1	0.6	1
Toys	426	364	17.0	0.5	2
Total Worldwide	**81,490**	**71,286**	**14.3**	**100.0**	**95**



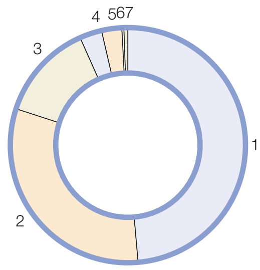
Source: Ad Age Global Marketing Report November 2004

Top 100 global marketers spending by region

by measured media bought in 2003 and 2002

	Measured advertising expenditures				
Region	2003 $m	2002 $m	2003 % change	% total	Country count
Africa	306	197	55.3	0.4	4
Asia	11,223	9,866	13.8	13.5	16
Europe	26,040	23,061	12.9	31.4	36
Latin America	2,490	2,214	12.5	3.0	11
Middle East	293	487	-39.8	0.4	11
Canada	2,118	1,117	89.6	2.6	1
US	40,363	37,305	8.2	48.7	1
Total worldwide	**82,833**	**74,247**	**11.6**	**100.0**	**80**

1	**US**	**48.7%**
2	**Europe**	**31.4%**
3	**Asia**	**13.5%**
4	**Latin America**	**3.0%**
5	**Canada**	**2.6%**
6	**Middle East**	**0.4%**
7	**Africa**	**0.4%**



Source: Ad Age Global Marketing Report November 2004

Asia Pacific: a giant opportunity unfolds

It is difficult for those of us in the West to comprehend the scale of Asia Pacific's potential development. China is not just one country; it consists of more than 30 provinces, with so many languages and dialects that Mao Tse Tung needed an interpreter. But it is equivalent to four or five Americas. It is true also that currently only 150-200 million Chinese can afford the goods and services we are trying to market to them. However, this is already equivalent to over half an America and this is a dynamic situation, one that will change rapidly in the coming years. Furthermore, India – itself equivalent to three to four Americas – seems to have been stimulated into more rapid growth, driven perhaps by neighbourhood envy and the Chinese model of state directed capitalism. Do not underestimate the potential of the region as rapprochement spreads even to cricket, with the Indian-Pakistani test and one-day series representing as important a political, economic and social signal as the Beijing Olympics.

Asia Pacific will dominate again. This really is back to the future. In 1820 China and India generated around 49% of worldwide GDP. In 2025, these two countries are forecast to be headed for the same level again, having bottomed out at 8% in 1973. Currently, China and India represent over one-third of the world's population. Asia Pacific represents one-half. By 2014, Asia Pacific will represent over two-thirds. Greater China is already WPP's fifth largest market in which we have a dominant 15% share. In India, our market share is almost 50%, with a 25% share in South Korea. In Japan, it is almost 10%, behind the dominating Dentsu and HDY, but the largest gaijin firm.

China's development has been rapid and will continue. The Chinese government is conscious of potential over-heating and an imbalance in regional rates of development between the coastal regions and the hinterland. There has already been a soft-landing slow down in growth, which

What we think

The advertising and marketing services industry

US/non-US revenue splits for top 25 S&P 500 companies 2004

Company	Market value $m	US sales $m	US sales %	Non-US sales $m	Non-US sales %
General Electric Co.[1]	381,597	80,101	60	54,086	40
Exxon Mobil Corp.	381,652	88,302	30	209,725	70
Microsoft Corp.	264,171	25,046	68	11,789	32
Citigroup Inc.	233,625	50,889	47	57,386	53
Wal-Mart Stores	214,284	208,908	81	47,421	19
Johnson & Johnson	202,982	27,770	58	19,886	42
Pfizer Inc.	194,527	29,929	57	22,188	43
Bank of America Corp.	180,103	46,156	94	2,738	6
IBM	148,814	35,637	37	60,656	63
American International Group Inc.[1]	146,633	45,315	56	35,988	44
Intel Corp.	146,210	6,563	19	27,646	81
Procter & Gamble	133,671	25,703	50	25,703	50
Altria Group, Inc.	132,226	37,729	42	51,881	58
J.P. Morgan Chase & Co.[1]	124,502	24,118	73	9,138	27
ChevronTexaco Corp.	122,815	79,929	47	90,315	53
Cisco Systems Inc.	116,092	12,233	55	9,812	45
Wells Fargo	100,150	n/a	n/a	n/a	n/a
Coca-Cola Co.	98,861	6,643	30	15,319	70
Verizon Communications Inc.	96,948	69,173	97	2,110	3
Dell Inc.	95,138	32,940	67	16,265	33
PepsiCo Inc.	87,264	18,329	63	10,932	37
Home Depot	83,556	64,167	99	649	1
Time Warner Inc.[1]	81,898	32,123	81	7,442	19
UPS	81,333	28,035	77	8,547	23
Average	**160,377**	**46,771**	**57**	**34,676**	**43**

[1] 2003 figures

Sources: Standard & Poor's, company annual reports, Bloomberg, Hoovers

World's 10 most valuable brands

Rank	Brand	2004 brand value $m	2003 brand value $m	% change	Industry	Country of ownership
1	Coca-Cola	67,394	70,453	-4	Food & beverages	USA
2	Microsoft	61,372	65,174	-6	Software	USA
3	IBM	53,791	51,767	4	Technology	USA
4	GE	44,111	42,340	4	Industrial	USA
5	Intel	33,499	31,112	8	Technology	USA
6	Disney	27,113	28,036	-3	Travel & leisure	USA
7	McDonald's	25,001	24,699	1	Retail	USA
8	Nokia	24,041	29,440	-18	Technology	Finland
9	Toyota	22,673	20,784	9	Automotive	Japan
10	Marlboro	22,128	22,183	0	Leisure goods	USA

Source: Interbrand/Business Week 2004, Bloomberg

Overview of world economic outlook projections GDP growth %

	2001	2002	2003	2004[1]	2005[1]
World	2.4	3.0	3.9	5.0	4.3
Advanced economies	1.2	1.6	2.1	3.6	2.9
USA	0.8	1.9	3.0	4.3	3.5
Euro area	1.6	0.8	0.5	2.2	2.2
Germany	0.8	0.1	-0.1	2.0	1.8
France	2.1	1.1	0.5	2.6	2.3
Italy	1.8	0.4	0.3	1.4	1.9
Japan	0.4	-0.3	2.5	4.4	2.3
UK	2.3	1.8	2.2	3.4	2.5
Canada	1.8	3.4	2.0	2.9	3.1
Other advanced economies	1.7	3.0	2.3	3.8	3.1
Other emerging market & developing countries	4.0	4.8	6.1	6.6	5.9
Africa	4.0	3.5	4.3	4.5	5.4
Sub-Sahara	3.9	3.6	3.7	4.6	5.8
Developing Asia	5.5	6.6	7.7	7.6	6.9
China	7.5	8.3	9.1	9.0	7.5
India	3.9	5.0	7.2	6.4	6.7
Middle East	3.6	4.3	6.0	5.1	4.8
Western hemisphere	0.5	-0.1	1.8	4.6	3.6
Brazil	1.3	1.9	-0.2	4.0	3.5
Central & Eastern Europe	0.2	4.4	4.5	5.5	4.8
CIS & Mongolia	6.4	5.4	7.8	8.0	6.6
Russia	5.1	4.7	7.3	7.3	6.6
Excluding Russia	9.4	7.0	9.0	9.6	6.5

[1] Estimated
Source: IMF 2004

presents more opportunity for investment. 2008 represents a huge opportunity. No self-respecting multi-national company bent on expanding into China or national company seeking to grow inside or outside China will miss out on the branding opportunity presented by the Olympics in Beijing. The Chinese government is already committed to $45 billion of investment around the Games, in a year that will also be stimulated by a US Presidential election that may feature a contest between Senator Hillary Clinton and Secretary of State Condoleezza Rice. 2008 should be a whopper. And it will not end there. The Municipality of Shanghai will be investing $3 billion in Expo 2010.

Watch out for growing Chinese military influence. Recent economic contact with Fidel Castro in Cuba counterbalances Taiwanese tensions. Chinese investment in Galileo's GPRS systems drew a coruscating response from the Pentagon. Beijing will not be prepared to rely on America to defend its vital and growing energy supply interests in the Middle East and Russia.

The other challenge to American dominance may well come from the Muslim world. Already, Muslims number 1.5 billion people or a quarter of the world's population. By 2014, Muslims will number 2.1 billion or 30% of the projected world's population. The recent struggles in Afghanistan and Iraq really only continue the conflicts of the 1950s in Suez, the oil price increases of the 1970s and the invasion of Kuwait in the 1990s. Westerners have made little attempt to understand the Muslim mind and assume they have the same value systems and beliefs. They are different and it will be increasingly necessary to make a serious and sincere attempt to understand them.

These events may demand new thinking from the world's multinational companies. As US-centric companies, for example, seek to develop their businesses and extend their reach into more heterogeneous markets, it may well be that the balance of organisations will shift. There will continue to be a focus on global, max or core brands, with sales of more than $1 billion, particularly to counterbalance the power of global retailers and as companies become less dependent on the US markets. Coca-Cola's geographic coverage of a third in North America, a third in Europe and a third in Asia Pacific and Latin America will become more the norm, rather than Pepsi-Cola's 63% in the US.

A local approach to more heterogeneous markets

However, given this geographic expansion, there will also be a need to develop more sensitive, local organisations that respond to national opportunities and challenges more readily. The past 10 to 15 years have seen, quite rightly, a diminution of power of country managers, as companies sought to reduce needless duplication and stimulate the sharing of knowledge. Eradicating geographic silos and fiefdoms made sense. However, as country-based organisations have become more complex and sizeable, there may be a need to develop more focus at a country level. Several clients have started to re-build country organisations and re-appoint country managers or ambassadors.

As a result, regional management has been scrutinised. With the development of technology and communications, organisational span-breakers may not be so necessary. In addition, given the complexity of regional tasks, regional managers really become glorified financial directors. The average agency regional director in Europe, for example, may have to cover 100 offices in a 250-day working year. Difficult to add significant value spending an average of one to two days in each office a year, even if he or she travelled all year.

At WPP, we are experimenting with two new organisational responses. First, Global Client Leaders to manage big clients across WPP on a worldwide basis. Second, WPP Country Managers focusing on three key issues – people, local clients and acquisitions. Both responses cause angst to our operating company or tribal leaders. Both cut across the traditional organisational structures. Both demand new ways of working together, denying turf, territory and ego. But, both are necessary, responding to client needs and developments. Organisations are becoming more and more networked and less and less pyramidic. Perhaps the 21st century is not for tidy minds.

2. Overcapacity and the shortage of human capital

The single biggest long-term issue facing our clients in most industries is overcapacity. In fact, it is difficult to find many cases where the opposite is true; Tequila, perhaps, where it takes seven years to grow the herb, or watches or high fashion companies like Rolex or Hermes where supply is limited. It is also true that commodity-based industries, like oil and steel, no longer face over-capacity issues, being overwhelmed by Indian and Chinese demand. But most industries face situations similar to the car and truck industry, where companies can make 80 million units and consumers consume 60 million.

Overcapacity issues are particularly difficult to deal with in politically sensitive industries like automobiles. Governments are not enthusiastic about shutting down capacity and increasing unemployment. They also like to increase capacity by offering inducements to locate new production facilities in development regions. Thus the best thing for the European car industry would probably have been for GM to absorb Fiat's production capability. But Italian Prime Minister Silvio Berlusconi could not countenance more unemployment in the Mezzogiorno. The same issue faces the British government with Rover particularly during an election campaign.

The critical issue in the 19th and 20th centuries was how to produce goods and services, and to make sure they reached the consumer. In the 21st century, it is convincing the consumer to purchase your product, service or brand in the first place.

In such circumstances differentiation becomes critically important, and differentiation is what our business is about. Historically, maintaining technical or product differences was easier. Today keeping a technological lead is difficult. Product life-cycles are being shortened and brand cycles lengthened. Again, an example from the car industry; less than a decade ago it took five years to design, produce and market a car. Today, it can be done in 18 months. Led by the aggressive Japanese, South Korean and German manufacturers, the Americans have followed. (Hyundai may well become the Samsung of the automotive industry.)

Intangible differentiation is, then, becoming more important. Psychological, life-style and emotional differences are significant. The suit or dress you wear, the car you drive, the holidays you take, how you spend your leisure time – all say a lot about your personality and preferences. Some find such intangible appeal immoral or at least unsavoury. Preying on people's vulnerabilities, it is said, is unethical. However, we believe that fulfilling people's desires or dreams is almost always justifiable and satisfying for the consumer – and it is a key role for the advertising and marketing services industry.

While there is certainly too much production and capacity in general, what specific resource in the 21st century is in ever shorter supply? The answer is human capital. Every demographic statistic points to a reduction. The slowing birth rate, declining marriage rates, higher divorce rates, more single parent families, smaller families, ageing populations – all these factors are reducing the supply of talent. Even countries with strong, younger demographics, such as Mexico, will face similar situations by 2020. There are examples of government campaigns trying to stimulate the birth rate. Western Europe and Japan face significant economic growth issues as a result of the declining proportion of young people and an overall population decline.

All this points to the growing importance of attracting, recruiting, developing, training, motivating, incentivising and retaining human capital. In a less differentiated world, it will become more and more important for companies to stand out through the quality and responsiveness of their people. Making sure that your people buy into your strategy and structure will be increasingly important. Living the brand – operationally – will be critical.

3. The web: not dead, growing fast

Since the dotcom implosion of 2000 it has become fashionable to dismiss the web. However, WPP's smarter clients and those who missed out on opportunities in the 1990s have taken advantage of depressed values and a contrarian position. Web activity, broadly defined, currently accounts for more than $1.5 billion of WPP Group revenues, or more than 15%, and it is growing rapidly.

There seem to be three reasons why. First, there is still the threat of disintermediation. A horrible word; perhaps some explanation is needed. Let's take an example from our own business. More than $1 billion of WPP's revenues come from market research. Traditionally, research has been done on the phone and through the post. The process is long and cumbersome. A questionnaire has to be designed, distributed and filled in by consumers or interviewers. Then data is collected, analysed and conclusions developed. It can all take three to six months. Many CEOs despair that by the time the solution has been identified, the problem has changed. Using the internet, however, the research process can be transformed and responses obtained almost instantly. WPP's Lightspeed panel interrogates more than six million consumers globally and can deliver answers inside 24 hours.

Second, you continue to be disintermediated by lower-cost business models that are evaluated by investing institutions in new and different ways. Despite the recent vicious compression in valuations and consequent losses, the financiers of new media and technology companies still focus on sales, sales growth and market share, rather than on operating profits, margins, earnings per share and return on capital employed.

Finally, the internet and new media companies still steal your people. After the bankruptcies and failures, many young people returned to the more traditional businesses they had left. WPP lost a number of such bright talents and later welcomed some back to the fold. I myself conducted a number of so-called re-entry interviews and hoped to see and hear that the returnees were relieved to have their jobs back. Far from it: few grovelled. Instead they admitted that, given the opportunity again, they would take it or seize a similar one.

Clearly, the age of apprenticeship inside large corporations is finished. It was weakened by the corporate downsizing of the 1980s and 1990s, and the final nail in the coffin was the internet boom of the late 1990s. Young, bright talent will always seek out new, flexible, un-bureaucratic, responsive companies. Staying with one company for 40 years or so – as my father did and advised me to do – no longer seems the best career choice. However, some recent polling and attitudinal analysis in the UK shows younger people want a better work-life balance. Hedge funds, for instance, are more attractive than investment banks, offering fixed work times and not demanding all-night toil.

4. Internal communications: more important than external

Given the scale of strategic and structural change going on inside most companies, one of the most important challenges facing CEOs is to communicate that change internally. Internal communication to secure internal alignment is, perhaps, a polite way of putting it. Probably the biggest block to progress for our clients – and perhaps ourselves – is internal politics. Turf, territory and ego prevent productive change. If the chairmen or CEOs of our clients saw what we saw, they would be horrified. If they and we devoted 50% of the time that they or we spent on internal politics on the consumer, client or competition, they and we would be considerably more successful.

You could argue that most of the communication we co-ordinate is aimed at internal audiences rather than external ones. As some people, such as Allan Leighton when he was at Asda (now Wal-Mart), have maintained, making sure your internal constituencies are on side is often more important than external ones. Only when internal communications are working can your company talk positively to customers, suppliers, potential customers, potential employees, journalists, analysts, investors, government and NGOs.

Building such virtuous circles in a uni-branded company is one thing. Inside a multi-branded company such as WPP which has grown by acquisition, where our tribes operate independently to deal with dis-economies of scale and client conflict, it is far more complicated. Trying to ensure 84,000 people face in the same direction at the same point in time is not easy. On the other hand, once achieved, internal unison and common focus make up a very, very powerful army.

Most of our companies develop internal communications through advertising, media investment management, information, insight and consultancy, public relations and public affairs, branding and identity, and healthcare and specialist communications. However, no single operating entity exists within WPP to execute internal communications on a worldwide basis. Still an opportunity for the future.

5. The concentration in distribution – CEOs' most pressing issue

Whenever we ask CEOs what keeps them awake at night or worries them when they get up in the morning, they almost always give the same answer: distribution. Some 18% of Procter & Gamble's worldwide sales (pre-Gillette) go through Wal-Mart. The figure is probably 25-30% in US sales. Henkel recently bought Dial Corp, 30% of whose sales go through Wal-Mart. Clorox, another Henkel-connected company, sells 30% of its US products through Wal-Mart. One of WPP's media partners sells 10% of its cover sales through Wal-Mart. To the media owner, this is life or death. To Wal-Mart it is a rounding error and the province of the third or fourth level of procurement, making the publisher's life a misery. More people visit Wal-Mart in the US in one week, than go to church on a Sunday. Indeed, some say Wal-Mart is the new religion. Wal-Mart, with $285 billion of sales, is the seventh largest 'country' by retail sales, not far behind China. Wal-Mart accounts for 8% of US retail sales, Tesco for 11% of UK retail sales and 24% of the UK grocery market.

Influence over and control of distribution is not a new issue. In a sense, it is back to the future. After all, advertising was developed in the 19th century by manufacturers to appeal over the heads of wholesalers or retailers direct to consumers. Increasing retail concentration – not only in the US but also in Europe and Latin America in particular – will only emphasise the importance of focusing on product innovation and branding, along with better understanding of point-of-purchase consumer behaviour and emphasis on packaging, point-of-purchase display and retail design. After all, as one senior Asia Pacific Procter & Gamble executive said recently, depending on which P&G brand you are talking about, something between 30% and 80% of purchasing decisions are made at the point of sale. Procter terms it "the first moment of truth".

WPP believes that an understanding of distribution and retail is essential and it is one of our core practice development areas. The Store, our virtual retail agency, links more than 900 retail professionals around the world, updating them on the latest developments and trends – subject to client confidentiality. Management Ventures in Boston – with more than 50 global retail analysts – along with Cannondale and Glendinning Associates, both experts in channel management, supplement and consolidate our knowledge of global retailing.

In addition, 141 Worldwide gives the Group an even broader distribution offer with its focus on product categories that have been denied access to traditional media.

Conclusion

With recessionary forces abating in 2003 and quadrennial forces driving the industry to new highs in 2004, the short-term picture for the communications services industry has improved. The next quadrennial cycle of 2005-2008 looks stronger.

The immediate issues of government overspending, consolidation among clients, media owners, retail and agencies, increasing trade and price promotion, fees, procurement and outsourcing, media fragmentation and super-agencies all bring opportunities as well as threats. 2005 should show more improvement.

In the longer term, advancing Americanisation and the growth of Asia Pacific, overcapacity and the shortage of human capital, the web, the demand for internal communications and retail concentration should together underline and assure the importance of our industry and its constituent parts, advertising and marketing services. The latter as a proportion of GNP will burst through the cyclical high established at the peak of the internet boom in 2000. ■