

Digital Marketing Services Transaction Activity: Transforming the Marketing Landscape

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Executive Summary

"Digital, digital digital. It is the future of all media."

— Steve Ballmer, Chief Executive Officer, Microsoft Corporation

Whether you think it hyperbole or prophecy, Ballmer's perspective reinforces one truth: digital marketing services are in exceedingly high demand, simultaneously representing the single greatest execution challenge and pocket of opportunity throughout the entire marketing engagement.

Transaction activity in the digital marketing services industry (including the full range of execution-oriented online marketing applications) has never been more fervent. During 2007, 225 digital marketing services transactions were completed, representing over \$16 billion in aggregate value—more than the total value of all digital deals completed in 2004, 2005 and 2006 *combined*. The motives behind such ferocious deal making reflect a similarly profound array of changing dynamics: the advent of the Internet as a primary marketing tool, a cluttered media environment, channel proliferation, growing consumer sophistication and demand for analytically-driven marketing solutions being foremost among them.

But key questions remain unanswered: *Does this torrent of activity reflect true value creation for the marketing service providers, marketers and consumers that are parties to the transformation? Are record-breaking transaction multiples justified by substantial, attainable future profit streams? And, given the rise of a select few digital behemoths, what opportunities are left to the vast middle market of digital service providers?*

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This white paper—the first in a series of reports on transaction activity sponsored by Petsky Prunier, LLC—examines the transformative impact that M&A continues to impart upon the broader marketing community. Developed through a comprehensive research effort (including analyses of over 200 digital marketing services transactions, interviews with nearly 50 senior marketing industry executives and an online survey of 100 other key decision makers), the study will demonstrate that:

- Digital marketing services transaction activity has promoted the growth of both service providers and their marketer clients, engendering a broader addressable sales opportunity and providing access to superior tools that more effectively meet client demand
- Marketplace factors, including the institution of marketing standards, the achievement of "critical mass," and greater potential for monetization, must be overcome to allow for consolidation in certain emerging digital segments
- Several common obstacles continue to challenge would-be digital acquirers, including a paucity of sufficiently-sized acquisition opportunities and an inability to incorporate and price newly acquired services into a bundled solution set.

Transaction Activity Overview and Key Findings

Robust transaction activity has virtually transformed the digital marketing services landscape during the past few years. In particular, M&A activity—driven by a frenzy of deal making in the interactive agency and ad network/exchange segments—has accelerated markedly over the last year. Although the majority of transaction activity has been initiated by strategic acquirers, financial sponsorship has become especially pronounced in certain areas, such as ad networks/exchanges. Several emerging segments, such as mobile marketing, online video and online lead generation, have benefitted from significant amounts of early-stage investment and are poised for acquisition-driven growth in the future.

Digital Marketing Services Transaction Activity Accelerating								
<i>(\$ in millions)</i>								
<i>Segment</i>	2004		2005		2006		2007	
	# Trans	Trans Value	# Trans	Trans Value	# Trans	Trans Value	# Trans	Trans Value
<i>Ad Networks / Exchanges</i>	24	\$1,112	30	\$2,221	47	\$1,153	70	\$6,437
<i>Digital Video</i>	2	\$20	1	\$16	2	\$31	17	\$290
<i>E-mail Services</i>	17	\$245	9	\$326	14	\$185	7	\$76
<i>Interactive Agencies</i>	20	\$492	27	\$406	26	\$1,426	46	\$7,099
<i>Mobile Marketing</i>	7	\$86	7	\$75	18	\$667	27	\$846
<i>Online Lead Gen</i>	7	\$166	21	\$1,117	27	\$687	44	\$1,017
<i>SEM / SEO</i>	15	\$224	11	\$124	9	\$91	14	\$427
Total	92	\$2,345	106	\$4,286	143	\$4,241	225	\$16,192

Analysis of this deal activity reveals a correlation between macro drivers of M&A and certain impacts of consolidation as felt by both marketing service providers and their clients.

What's Driving Digital Marketing Services Consolidation?		
What's Driving Consolidation?	How Does Consolidation Impact Marketing Service Providers?	How Does Consolidation Impact Marketers?
<p>Changing marketer demands, resulting from their:</p> <ul style="list-style-type: none"> • Need to manage more (and more complex) channels • Inability to build internal capabilities (i.e. develop in-house talent and platforms) 	<p>Increases overall addressable market, given broader array of challenges to address and capabilities with which they may be addressed</p>	<p>Makes available a deeper and more sophisticated set of capabilities to solve execution challenges</p>
<p>Heightened competition in the marketing services industry, driven by the entrance of new players and moves by others to become scale and/or vertical leaders</p>	<ul style="list-style-type: none"> • Protects against price compression • Allows for deeper reach into marketplace • Provides more attractive marketplace positioning, with ability to command higher valuation multiples 	<ul style="list-style-type: none"> • Potentially lowers cost base with reduced number of vendors utilized • Allows for expansion of geographic footprint, with greater access to local market coverage across the US and internationally
<p>The emergence of new marketing technologies, demanding service providers who are adept at applying these tools for the benefit of their clients</p>	<ul style="list-style-type: none"> • Enables development of thought leadership platform • Provides for enhanced operating efficiencies 	<p>Optimized technology utilization offers greater ability to understand and efficiently address the needs of target customers</p>

The Two Phases of Digital Marketing Services Consolidation

Drilling deeper, one may consider the lion’s share of digital marketing services M&A activity to represent one of two major “phases”—each represented by distinct macro themes, time frames, representative buyers/targets and common execution challenges.

Phase I (“Web 2.0”): Foundational execution capabilities—including Web development and optimization, e-mail distribution, search, display advertising and analytics platforms—have been the focus of aggressive buying as large players sought to gain rapid entry to the online marketing segment. With basic toolsets in place, focus shifts to monetizing online marketing by integrating complementary channels and data sources. Interactive agencies, paid search (SEM), ad networks/exchanges and online lead generation continue to grow in popularity as marketers rely upon coordinated acquisition and retention campaigns based on consumer demand.

<i>Phase I:</i> Status & Timing	Key Target Capabilities	Typical Buyers	Representative Transactions (Buyer / Target)
Currently Integrating; expected to continue for the next 12-18 months	E-mail execution services	<ul style="list-style-type: none"> • Data owners • Database management providers • “Integrated” marketing service providers • Marketing technology developers 	<ul style="list-style-type: none"> • Epsilon / Bigfoot • Acxiom / Digital Impact
	Interactive agency services	<ul style="list-style-type: none"> • Agency holding companies • Database management providers • General, direct and interactive agencies • Search engines / portals 	<ul style="list-style-type: none"> • Microsoft / aQuantive • Digitas / Medical Broadcasting
	Search engine optimization (SEO) and search engine marketing (SEM)	<ul style="list-style-type: none"> • Ad networks / exchanges • Agency holding companies • General and interactive agencies • Online lead generation providers • SEM providers 	<ul style="list-style-type: none"> • AKQA / SearchRev • iCrossing / Spannerworks
	Ad networks / exchanges	<ul style="list-style-type: none"> • Ad networks / exchanges • Agency holding companies • General and interactive agencies • Search engines / portals 	<ul style="list-style-type: none"> • Yahoo! / Right Media • WPP Group / 24/7 RealMedia
	Online lead generation	<ul style="list-style-type: none"> • Ad networks / exchanges • Interactive agencies • Marketers • Media conglomerates • Search engines / portals 	<ul style="list-style-type: none"> • Hearst / RealAge • New Motion / Traffix

Phase II (“Next Generation”): The convergence of services, content and technology continues, driven overwhelmingly by changing consumer behaviors and commensurate demand. Several nascent segments—including social networking, digital video and mobile marketing—will become active in the consolidation landscape during late 2008 and early 2009, made possible by both strategic and financial investment. Among *Phase II* segments, investments comprised over 65 percent of transaction volume during 2007—closely resembling the developmental stage of *Phase I* segments earlier this century. A prerequisite for consolidation then and now, investment must continue, driven by the following forces:

- Their demonstrated ability to monetize diverse content and unique campaign delivery tools, thus improving overall marketing economics
- An increase in consumer receptivity, driving adoption rates
- The achievement of “critical mass,” commonly recognized as a \$10 million annual revenue threshold
- Technological improvements in underlying platforms, allowing for enhanced usability.

<i>Phase II:</i> Status & Timing	Key Target Capabilities	Typical Buyers	Representative Transactions (Buyer / Target)
Currently Undergoing Investment; expected to continue through late 2008 / early 2009	Blogs, podcasts and RSS feed services	<ul style="list-style-type: none"> • Ad networks / exchanges • E-mail service providers • Specialty search engines and portals 	<ul style="list-style-type: none"> • Google / FeedBurner • AOL / Weblogs
	Digital video services	<ul style="list-style-type: none"> • Digital video service providers • Interactive agencies • Media conglomerates • Multichannel retailers • Web content managers 	<ul style="list-style-type: none"> • Blockbuster / Movielink • NDS Group / CastUp
	Mobile marketing services	<ul style="list-style-type: none"> • Experiential marketing service providers • General, direct, interactive agencies • Media conglomerates • Search engines / portals • Web content managers 	<ul style="list-style-type: none"> • AOL / Third Screen Media • Nokia / Enpocket

Leading Trends for the Near-Term Period

The following have surfaced as key trends surrounding *current and near-term (through the next 18 months)* transaction activity within digital marketing services:

- Despite the holding company-led consolidation of many of their peers, small, nimble interactive agencies continue to thrive as incubators of cutting-edge offerings and remain well-equipped to handle evolving marketplace demands
- Interactive agencies have already incorporated *search engine optimization* into their strategic and creative mix, driven by its entanglement in the campaign launch process. As *search engine marketing* providers expand their offering scope, they become prime acquisition targets for interactive agencies seeking to enhance their media buying and planning capabilities
- Continued acquisition activity in the ad network/exchange segment is being fueled by a confluence of factors, including the need to build scale, reduce client friction and promote better consumer targeting
- Online lead generation providers—confounded by the shrinking gap between the cost of driving traffic and marketplace lead pricing—seek out acquisition targets in order to combat margin compression and improve competitive positioning
- Database management companies have aggressively acquired e-mail service providers in a move to enhance their retention-oriented execution capabilities. This consolidation has precipitated resurgence among surviving independents, spurring them to develop stronger technological foundations in support of their own growth initiatives.

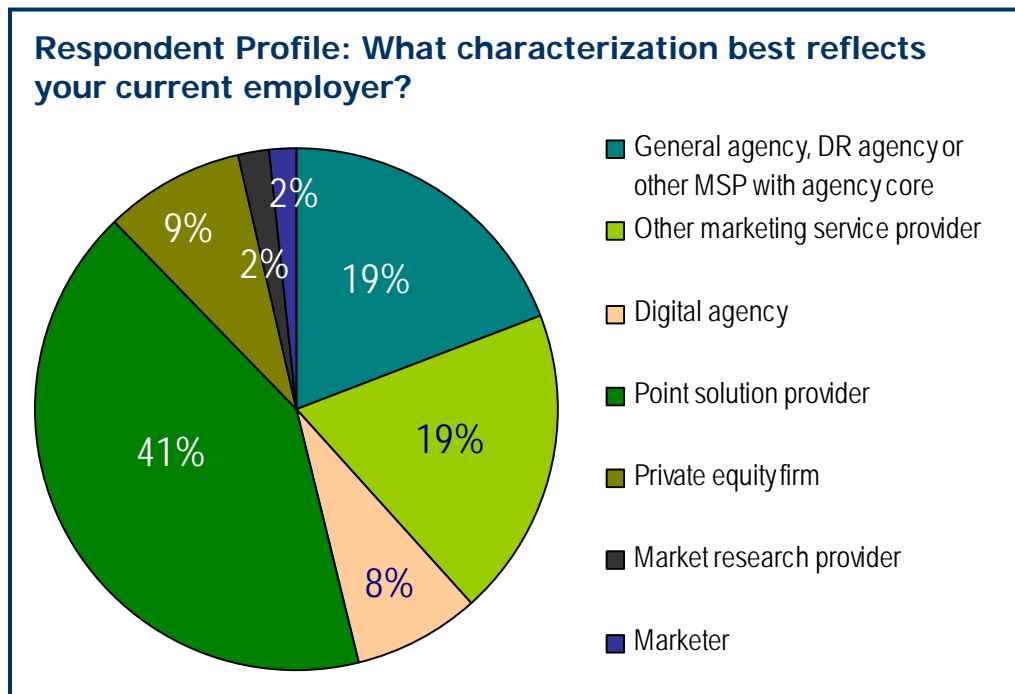
Looking Ahead to the Future

The following are key trends expected to drive *future digital marketing services M&A activity (in late 2008 / early 2009 and beyond)*, facilitated by both financial and strategic investments during the next 12 months:

- Despite the impressive potential of the mobile medium as a *messaging* tool, mobile service providers will not present scalable acquisition opportunities until the medium demonstrates its usefulness as a practical, replicable *marketing* application
- Online video content *enablers*—including video search providers and video ad networks—will become prime acquisition targets, while online video *aggregators* (i.e. “destination sites”) will assume a secondary role
- Strategic consolidators will see brand monitoring and measurement providers as attractive means to protect and promote their clients amidst the explosion of potentially disruptive user-generated content.

Methodology

Relying upon Petsky Prunier’s database of industry transactions and leaders, Winterberry Group conducted an extensive series of interviews and surveys with nearly 150 senior marketers and marketing services industry executives throughout the United States—including a roster of founders, presidents, CEOs and CMOs. This research panel encompassed representatives from “integrated” marketing service providers (those offering more than one primary marketing service), general and direct response agencies, interactive agencies and specialty (or “point solution”) providers, as well as market research companies, investors and other industry constituents. Participating respondents represent companies of virtually all sizes, including those with annual revenues ranging from less than \$10 million to over \$10 billion.



Note: “Point solution providers” include those that offer ad networking, blog/podcast/RSS feeds, digital video, e-mail, online lead generation, rich media production, search, video game advertising and Web analytics services

Throughout the research process, participants were asked to comment on the trends, challenges and emerging platforms that are impacting M&A activity in the digital marketing services segment of the marketing sector, touching upon those services mentioned above (other digital segments of the marketing sector, including Internet/e-Commerce technology platforms and digital content and commerce, may be addressed in future studies).

Ultimately, this study aims to address the following questions pertaining to digital marketing services:

- What factors are influencing current transaction activity?
- What are the downstream impacts of recent transaction activity?
- What is the outlook for future transaction activity?

M&A and Today’s Marketing Services Landscape

Marketing services companies are in high demand. Whether online or offline-focused, the industry is currently enjoying an unprecedented degree of M&A and investment attention—over 385 transactions (collectively accounting for \$35 billion in deal value) were completed during 2007.

Of those deals, the digital marketing services segment constituted nearly 60 percent of transaction volume and nearly 50 percent of value. But why is digital activity so pronounced—especially considering online marketing only commands, even according to the most optimistic projections, less than 4 percent of total U.S. advertising and marketing budgets?

The single most telling reason, said our respondents: marketer demand.

On a scale of 1 to 5 (with 5 being “very important” and 1 being “not important”), please rate the extent to which the following factors have driven transaction activity in the digital marketing services industry:

Digital Marketing Services Transaction Drivers	Extent of Impact
Internal marketer needs—resulting from the need to manage more channels and the inability to build internal capabilities	4.2
Competitive pressures (i.e. defensive moves to combat threats posed by new entrants, as well as scale and vertical plays)	4.1
Advent of new, disruptive technologies (hastening need to add new tools / capabilities)	3.8
Changing consumer behaviors (e.g. widespread adoption of Internet as tool for both communications and commerce)	3.7
Pressure to improve operating margins (by reducing costs, combating price compression and / or driving efficiencies)	3.6
Reaction to consolidation among marketers	3.3
Effort to enhance reach through geographic expansion	2.8

Reflecting on recent transaction activity, respondents noted the most successful deal making has taken place among mid-tier providers, especially interactive agencies and digital point solution providers. And though 59 percent of those surveyed characterized recent transaction valuations as being “overvalued” from a multiples perspective, 82 percent felt that this activity has translated into at least some degree of benefit for marketing service providers and their clients.

On a scale of 1 to 5 (with 5 being “a major benefit” and 1 being “not a benefit”), please rate the extent to which you believe digital marketing services transaction activity has generated the following benefits for buyers and sellers:

Benefits	Respondent Rating
Has grown overall addressable market, based upon better ability to meet customers’ needs through new and enhanced capabilities	4.1
Has enabled more attractive marketplace positioning and ability to command higher valuation multiples	3.8
Has generated greater operational efficiencies, leading to margin enhancement	3.4
Has provided ability to combat price compression, leading to margin enhancement	3.2
Has improved geographic penetration	3.0

When asked to consider the downstream impact that transaction activity has had on the marketing industry, respondents noted that marketers have likewise benefitted from recent deal making.

On a scale of 1 to 5 (with 5 being “a major benefit” and 1 being “not a benefit”), please rate the extent to which you believe digital marketing services transaction activity has generated the following benefits for marketing clients:

Benefits	Respondent Rating
Has provided access to a broader and more sophisticated range of services to support marketing execution	4.1
Has allowed for greater ability to understand and address specific needs of ultimate consumers	3.5
Has helped reduce cost base (i.e. efficiencies derived from fewer vendors)	3.3
Has provided access to local market coverage (i.e. broader geographic footprint)	2.9

Despite the holding company-led consolidation of many of their peers, small, nimble interactive agencies continue to thrive as incubators of cutting-edge offerings and remain well-equipped to handle evolving marketplace demands.

Having plowed their way through the ranks of the offline advertising and marketing services segments, large agency holding companies—champions of the “one-stop-shop” model, whereby clients are intended to benefit from the range of capabilities offered by a single service provider—have now focused their sights on the digital landscape.

Their chief motive: follow the money. With explosive growth expected to continue in digital marketing—up a whopping 19 percent from last year and expected to grow at nearly 15 percent compounded annually through 2011—the scale of the addressable opportunity is obvious. More telling, though, is that spending analysis and anecdotal evidence indicate the vast majority of new digital spending is flowing directly from less-measurable, less-accountable “above-the-line” advertising, which typically constitutes just under *half* of the holding company revenue mix. For the handful of large conglomerates now dominating the media world, expanding their digital exposure may be considered as much a defensive move as one intended to engender cross-channel innovation.

In line with those two priorities, acquisition activity has been intense. “No indie digital is safe from Sir Martin,” read an October 1, 2007 *Advertising Age* headline, in response to WPP Group’s recent acquisition led by chief executive Sir Martin Sorrell. The headline is apropos as WPP has been among the industry’s most prolific buyers, snapping up interactive agencies 24/7 Real Media (for search and ad networking), Schematic (for content development and distribution) and Blast Radius (for social networking expertise) within a six month timeframe. Not to be outdone, WPP’s competitors have been similarly active: Publicis Groupe, for example, dramatically enhanced its digital footprint with the purchase of leading interactive agency Digitas, then added French agency WCube and mobile marketing agency I-Shop. Publicis Groupe’s Chairman and Chief Executive Officer Maurice Lévy echoed the sentiment gaining prevalence among agency holding companies when he told *Adweek* “This is about owning the space and taking on a lot of different initiatives in digital communications.”

Perspectives differ, however, with regard to how well the holding companies will manage the integration of digital marketing services into their branding-dominated service mix. As one respondent reflected, “Buying adjacent

“Digital is far trickier than most mainline agencies initially think. Smaller, dedicated interactive shops can create more effective digital solutions than full service agencies because the former have more familiarity with converting consumer insights into the program architecture, user experience and ongoing optimization to really engage the brand’s most valuable consumers.”

— **Chris Kuenne**
President
Rosetta Marketing Group

services and simply hoping that cross-sell will work is not a beneficial strategy for agency holding companies. Clients demand solutions that help attract and retain end users better; they are not interested in the cross-sell concept itself but rather in the results they can derive. The reality is that the groups within holding companies compete with one another for marketing dollars and are actually beating the heck out of one another on pricing instead of achieving synergies.” Others mentioned that holding companies simply fail to allocate the appropriate dollars to infrastructure development and have not been willing to invest in cross-agency account managers who understand emerging technologies and applications. All of those elements, respondents assert, are critical ingredients in digital marketing success.

In the wake of the agency holding companies’ M&A sprees, smaller independents continue to thrive as breeding grounds for unique application development and creativity. Often achieved through partnership with larger agencies, these boutiques cater to small and medium-sized clients with restricted marketing budgets, providing specific point solutions. The number of specialized digital agencies (usually to be found in the \$2-\$10 million annual revenue range) prospering today stands as a testament to small providers’ success in exploiting this young and fast growing medium. Respondents took note of the largest “last men

“Although holding companies’ intentions are correct, they regard integration as merely a *structural* issue, so you see these companies initiate change by simply seating people from various divisions together. The reality is that it’s also a *behavioral* issue, which is much more difficult to change and requires significant investment.”

—Alan Schanzer
Managing Partner
MEC Interaction, unit of WPP
Group

standing” among digital independents, speculating that AKQA and iCrossing are likely do some small, selective acquisitions—probably driven by geography expansion opportunities—before being acquired themselves.

Interactive agencies have already incorporated *search engine optimization* into their strategic and creative mix, driven by its entanglement in the campaign launch process. As *search engine marketing providers* expand their offering scope, they become prime acquisition targets for interactive agencies seeking to enhance their media buying and planning capabilities.

Search engine optimization (SEO)—the management of Web site content to ensure optimal placement within organic search rankings—has emerged as the single most demanded digital marketing application and is poised to grow at upwards of 40 percent per year. Driven largely by cost efficiencies, higher click-throughs and the rising price of keyword alternatives, the practice has quickly achieved its position of importance in marketing execution—83 percent of advertisers prefer organic to paid search, according to the Search Engine Marketing Professional Organization. Despite the existence of numerous SEO providers—e.g. EngineReady, Fathom SEO, Aegis

Group's iProspect, Prominent Placement and SEO, Inc.—approximately two-thirds of marketers say they handle or plan to handle their organic search needs entirely in-house.

As a result, the majority of search-oriented marketing service providers are offering paid search in addition to SEO, usually as a complement to other digital or offline marketing services associated with brand and campaign launches, which typically include direct mail, public relations and market research. The role of this most-important marketing service has been so diminished as a core service focus, in fact, that the majority of today's pure-play SEO firms are "mom and pop shops." And those few large SEO providers (generating more than \$10 million in annual search revenues) have emerged as primary acquisition targets for general and interactive agencies.

By contrast, the paid search engine marketing (SEM) segment is still undergoing consolidation. As opposed to SEO engagements, which can be run with little or no day-to-day management involvement, SEM services depend upon long-term, consultative client relationships and are finding the M&A integration process much more challenging as a result. In particular, they are confronting an acute need to retain the owners and senior managers of acquired companies, presenting an additional integration hurdle in certain situations.

For the first time in the relatively short history of their industry, the providers of paid search services also now find themselves confronting significant market pressures as keyword prices have grown progressively more expensive and the marginal return on an average keyword investment is under risk. But unlike their counterparts in the agency holding company model (who have looked to M&A as a means of growing scale and enabling client efficiencies), SEM providers are adopting a different

"The very definition of 'search' is expanding. If you ask marketers whether contextual inventory is "search," they think so because it's bucketed in the same invoice from Google, Yahoo! and Microsoft. As behavioral targeting grows, marketers will call that "search" also. The same applies to targeted inventory that's keyword or content-specific. This expanding definition will be the key driver of spending growth."

— Kevin Lee
Executive Chairman
Didit.com

"We bought PFP Advertising, where one hundred percent of the business is derived from SEO—the owner went away, but the business continues! With paid search, you need a more intensive short-term strategy and you must be more nimble. In order to do so, you generally need to keep the person who started it, who has the ideas."

— Michael Platt
President and CEO
Platform Advertising

approach: in a move to foster innovation, consolidate special-interest audiences and reestablish the position of differentiation they once enjoyed, SEM providers are developing complementary digital “fee for service” offerings, propelled by contextual search technologies.

As SEM providers thus broaden their scope, respondents expect they will soon become prime acquisition candidates for interactive agencies hoping to enhance their media planning and buying capabilities with differentiated technology platforms. Likely to be the first of many moves to expand the independent digital agency’s range, study participants noted that AKQA’s August acquisition of SEM provider SearchRev is an effort to better compete with agency rivals like iCrossing—bolstered by effective SEM technologies that deliver paid search within particular niches and optimize post-click conversion rates.

Although promising, SEM acquisition does not come without its share of challenges. Consolidated companies must typically confront a bizarre bifurcation between online and offline work, as well as daunting platform integration issues. What’s more, preliminary sales efforts are typically stifled by the misaligned sales approaches—more proactive in the agency environment, more passive in SEM—that characterize those two businesses. As one respondent noted, “Merchants are *sold* interactive media, they don’t just *buy* it—there needs to be a ‘body’ or long distance rep that caters to different verticals and phraseologies.”

Continued acquisition activity in the ad network/exchange segment is being fueled by a confluence of factors, including the need to build scale, reduce client friction and promote better consumer targeting.

In many respects, the M&A environment defining near-term ad serving opportunities reflects two pathways. On one side of the business, the story is all about retreat. Ad serving technologies that were considered “hot” just a few years ago are growing so commoditized, respondents remarked, that they will likely go “open source” soon—making their source code available for free to the development community. Already, providers like Tribal Fusion and DoubleClick are announcing their intention to literally give away ad serving technology, a practice that is expected to become pervasive.

“Owning the direct relationship with the publisher is not as important because real-time exchanges essentially disintermediated that strategy... As more content is developed and traffic spreads across multiple players, ad targeting technologies become more and more important.”

— Jim Womble
Global Development Leader
Acxiom Corporation

On the other side of the business, the story is one of advance. Large players are aggressively moving forward with scale plays in ad networking as they look to offer all classes of inventory through a common sales infrastructure. What binds these developments together is a theme that sets the ad network

segment apart, in one respect, from the rest of the digital marketing services landscape. As one respondent noted: “The ad network marketplace is not so much *consolidating* as it is simply *acquiring*.”

Recent acquisition activity validates that notion, suggesting that the need to enable advanced, user-level ad targeting is overshadowing any attempts to develop a position of scale within a relatively immature marketplace. As such, deals are increasingly focused on the “nuts and bolts” of the ad network infrastructure, allowing for the development of sophisticated algorithms and taxonomy that has the power to leverage Web site, user and ad inputs for serving purposes. One example of this push is AzoogAd’s acquisition of Bizarre’s proprietary algorithms and bidding models, which have enriched the company’s core data set, allowing for the integration of both Web and search inputs. On a much broader scale, AOL, Google, Microsoft and Yahoo! are effectively building “mega-networks,” providing a combination of ad networking, serving and yield-optimization technology.

Ad networks are also extending their models for the addition of complementary services, such as e-mail list management, to cross-sell their clients. Many marketers fail to monetize e-mail list data, opening the door for ad networks to supply this offering in a move to consolidate service delivery and gain greater wallet-share. This practice is especially compelling, given the fact that e-mail leads have a high life time value and can greatly enhance the quality of traffic generated.

Online lead generation providers—confounded by the shrinking gap between the cost of driving traffic and marketplace lead pricing—seek out acquisition targets in order to combat margin compression and improve competitive positioning.

While the cost of media has increased significantly over the past few years, the online lead generation market—beset by heightened competition and a growing broker channel that is consuming a higher proportion of available margins—has not been nearly as successful at implementing price increases in line with adjacent channels. At the same time, providers of incentivized leads, those using free ringtones and other forced offers, are facing backlash.

“There is a crack in the incentivized space, and privacy issues are really coming to a head. The players that produce the highest quality leads, aiming to protect consumer data in doing so, will prevail in this environment.”

— Jere Doyle
President & CEO
Prospectiv Direct

Despite these setbacks, respondents agreed that permission-based marketing still represents an effective method for generating customer relationships, noting that bigger lead gen providers are now acquiring small-to medium-sized targets to generate economies of scale and diversify the media through which they can drive traffic.

Middle market players, in particular—like ARG, MediaWhiz, Prospectiv Direct, Q Interactive, and Quinstreet—have been expanding their distribution

capabilities, both organically and via acquisition. However, on many of the occasions when a provider is acquired, a branch-off of very small companies splinters out, slowing the pace of consolidation despite many acquisitions in the segment. Providers pay special attention to Web developer drop-outs from companies like BlueLithium and TribalFusion who are writing code and are considered off-shoot acquisition targets.

In an effort to enhance margins, certain providers have taken an “audience-centric” approach, whereby they purchase media with the primary intention of “maximizing towards yield”—working with publishers in search of a broader audience and serving up similar demographic groups. Given today’s focus on relevance and personalization, pure “content plays” also represent attractive growth opportunities for those interested in acquiring vertically-oriented lead generation providers and ad networks, with industries marked by higher ticket items being most lucrative. In the words of one lead generation respondent, vertical-specific sites are considered “an opportunity to print cash;” the most attractive prospects offer the ability to aggregate thousands of small-to-medium-sized businesses in highly fragmented and thus vastly underserved verticals, such as home services, cosmetic surgery and automotive dealerships. Respondents are also enamored with both the healthcare vertical (where growth rates are exceptionally high) and the education segment (which commands higher premiums).

As buyers continue to acquire properties to help monetize traffic, the online lead generation industry will eventually consolidate into a handful of industry leaders per vertical served, driven by the need to enable scale, as well as their customers’ disdain for managing multiple partner relationships. This change has already started to take hold in the education vertical, where fewer than ten providers still maintain direct relationships with institutions.

“Lead gen has to evolve to allow for feedback loops where lead providers enable marketers to send profitability data back so that it can be applied to the acquisition process. In this way, the lead provider and marketer can jointly focus on high-level leads, not average quality leads.”

— Kevin Lee
Executive Chairman
Didit.com

Whether vertically-focused or yield-driven, providers almost universally seek to develop analytics and CRM platforms in an effort to deliver higher quality leads and help manage the entire “customer lifecycle”—from lead generation through conversion and follow-through. Transparency is a major priority in this respect, say marketers, given that the old mantra that “all leads are created equal” no longer holds water. Respondents noted that aggressive re-selling has led to rampant “lead degradation.” The ultimate lesson is that the quality of today’s leads is directly dependent upon how they are generated and what other marketer interactions have come into play.

Going forward, integrated marketing service providers and database marketers alike will seek to broaden their customer acquisition platforms by acquiring lead generation providers populating 100 percent opt-in databases

with rich targeting attributes (e.g. demographic, geographic, psychographic and transactional data capture) off of proprietary content. In terms of major players' influence, respondents speculated that DoubleClick, Right Media and BlueLithium may have a transformative impact on the overall performance-based marketing services industry, though it remains too early to determine their ultimate role. Google introduced a cost-per-lead offering, while Yahoo! has enhanced its targeting capabilities and may make forays into online lead generation. The last two examples may prove to be the most significant of all as size clearly matters in this niche offering, motivating the defensive strategies of smaller players. Middle market players, in particular, would be well-served by remaining aggressive and focusing on their operating efficiencies to maintain market positioning. Furthermore, providers that are *managing* leads without *generating* leads will suffer as clients realize the lack of value proposition.

Database management companies have aggressively acquired e-mail service providers in a move to enhance their retention-oriented execution capabilities. This consolidation has precipitated resurgence among surviving independents, spurring them to develop stronger technological foundations in support of their own growth initiatives.

Long associated with acquisition-oriented marketing—which relies on the continuous flow of new names to drive customer acquisition—the database management sector initiated a fundamental shift in direction over the past few years. Through the consolidation of what was then a highly fragmented e-mail service provider marketplace, several large database players (including Acxiom, Epsilon, Experian, Harte-Hanks and infoUSA) sought to simultaneously broaden their campaign execution footprint, add retention-oriented services to their offering mix, gain a general online marketing presence and empower a more robust multichannel service platform.

“The success of the many acquisitions that database management providers have made isn’t predicated on the *strength of their vision* of integrated marketing, but on *tenacious execution* that brings product and service groups together.”

— Ragy Thomas
President and CTO
Epsilon’s Interactive
Services Group

The jury is still out on whether those efforts were successful. Initially, integration was slowed by a set of common challenges: technological hiccups related to platform migration, cultural assimilation issues, mismanaged succession planning and general day-to-day management distraction being foremost among them. According to one e-mail service provider (ESP) expert, entrepreneurs are lost in larger organizations, and founders leave within a year’s time in eighty percent of the cases, leading to profound cultural confusion for the remaining workforce.

Those obstacles, according to some, were accepted as the price to be paid for the kind of full-service execution platform that a smaller provider could not, in all likelihood, deliver. As one respondent reflected, “Anyone can send

the first million e-mails cheap and easy. However, getting to the second level—doing the reporting, incorporating the behavioral data and analytics—is extremely difficult.”

Ironically, though, ESP consolidation by large database firms may have served to benefit the surviving *independents* just as much as the consolidators. Free from the encumbrances of large strategic ownership (and the challenges that come along with integration), a handful of providers are now achieving significant year-over-year growth by taking advantage of the benefits that accrue to nimble players in what is still a fundamentally fragmented marketplace.

Led by a small cadre of “enterprise” providers, the prevailing strategic growth approach in the e-mail segment reflects this renewed focus: Rather than aligning execution with underlying data sources—as the database providers first set out to do—many providers are now looking to build out a range of addressable channels through the acquisition of software developers and adjacent digital service providers. Witness Silverpop’s acquisition of marketing automation software provider Vtrenz—offering an MRM backbone to supplement Silverpop’s e-mail execution capabilities—as just one recent example.

“Most clients are lagging indicators—they primarily look at Forrester and Jupiter rankings when picking a provider. They’re not experienced enough to be pushing their ESP for support across other channels and are looking to us for guidance as thought leaders.”

— Dan Springer
CEO
Responsys

Today’s ESPs are essentially evolving from single channel e-mail service providers into multichannel solution providers, with value-added campaign management capabilities extending into areas like mobile and print-on-demand. As ESPs branch out into these tangential offerings, they will usurp agency share with the introduction of an automated agency service model alternative that leverages a core technological platform. Going forward, respondents expect ESPs to continue to seek additional technology complements, as well as acquisitions intended to fill out geographic footprints (enabling, for example, comprehensive support across time zones). In doing so, some ESPs are effectively positioning themselves to become public companies—Constant Contact listed on the Nasdaq in October 2007, while ExactTarget has filed the paperwork and E-Dialog is pending acquisition by public e-commerce platform company GSI Commerce.

Looking Ahead: Consolidation on the Horizon

Several market segments—including mobile marketing, online video and social networking tools—have yet to undergo consolidation but are expected to do so beginning in late 2008 and early 2009, enabled by a demonstrated ability to monetize their offerings, an increase in consumer receptivity and the achievement of “critical mass.” During the near-term period, these segments are benefitting from early-stage funding provided by both financial and strategic investors.

On a scale of 1 to 5 (with 5 being “very important” and 1 being “not important”), please rate the extent to which you expect the following factors will drive *future* consolidation activity in the digital marketing services segment:

Future Digital Marketing Services Consolidation Drivers	Extent of Impact
Demonstrated ability to monetize offerings and improve economics within their particular service segment	4.0
Increase in consumer receptivity, driving marketer adoption	3.8
Achievement of “critical mass,” whereby providers have reached an annual revenue threshold of approximately \$10 million	3.7
Improvements in the technological capabilities of underlying platforms, allowing for enhanced usability	3.5
A generally more permissive marketing environment	2.6

Despite the impressive potential of the mobile medium as a *messaging* tool, mobile service providers will not present scalable acquisition opportunities until the medium demonstrates its usefulness as a practical, replicable *marketing* application.

Mobile devices are growing more sophisticated, and American consumers are beginning to mimic their counterparts in Europe and Asia in their adoption of Short Message Service (aka “text messaging” or “SMS”), search and other non-voice applications. Though the domestic platform has yet to shake out fully (mobile marketing services in the U.S. only generate about \$1.1 billion, or 0.2 percent of total advertising and marketing spending), marketers appear poised to take advantage of this compelling media platform, driving strong compound annual spending growth of 26 percent through 2011.

Much has been made of the fact that, for all its future potential, few successful mobile campaigns have taken hold in the U.S. But that sluggishness in adoption may be attributed as much to dismal campaign economics—marketers must pay telecom providers to have texts delivered,

while recipients must also pay to receive the messaging—as any inherent weaknesses in the channel. As a result, most of today’s mobile marketing initiatives center around consumer-initiated “pull” activity.

New technologies are enabling more sophisticated pull marketing that aligns naturally with the convenience of the mobile platform. Certain out-of-home ads, for example—those on billboards, bus stops and other public places—are applying image recognition and bar coding technology to mobile pull marketing efforts. And several early-stage, best-of-breed technologies stand to change the rules of the game altogether; applications like Kameleon (in Paris) and HyperTag (in London) are incorporating Bluetooth activity in mobile environments, enabling phones to receive audio/video files and recognize the most detailed images.

Mobile search represents yet another significant opportunity, driven by growth in areas like locally- and vertically-focused search. Research firm eMarketer, for example, projects a 170 percent compound annual growth rate for such spending from 2007 through 2011 (though analysts warn of likely growing pains over the next two to three years as operators, portal players, media and mobile search start-ups continue to struggle over influence). Growth is likely to be propelled by such factors as ad-sponsored directory assistance and mobile Internet ads on sites, such as Google Maps.

“Until we see a percentage in the low-single-digits of clients’ ad budgets moving into mobile, you won’t see very much consolidation activity there.”

— **Walter Schild**
CEO
Genex, Inc.

From the text-messaging standpoint, a number of respondents noted that a potentially enormous opportunity lies in the development of an opt-in consumer file. Though its precise execution requirements have yet to be determined, one oft-mentioned nascent offering is event-triggered text messaging, whereby users are alerted to particular sales or promotions as they enter the proximity of a particular retail store. This activity is, however, predicated upon the wide-scale adoption of GPS-enabled devices so as to allow for both speed and appropriate location-based targeting. But this raises yet more challenges—users will no doubt resist any marketing dialogue that requires multiple screen pass-throughs, while platforms and formatting must be standardized to accept and deliver content uniformly.

Consolidation activity will likely be spurred by marketer allocation of spending to those providers that can handle entire projects, encompassing myriad functions. Respondents echoed the theme that mobile is now “where e-mail marketing was five or six years ago,” meaning that less experienced marketers are still willing to enlist large, generalist agencies to “do it all” in the near term, but will likely look for greater specialization as they enhance their mobile awareness. Mobile-centric service providers are already beginning to attract the attention of investors. Players, such as HipCricket—which provides services for mobile campaign development, execution, tracking and analysis—and Amobee Media Systems and AdMob—which

connect mobile advertisers and content publishers through contextually-targeted networks— have received support from financial sponsors.

Despite a promising outlook, mobile growth continues to be inhibited by the structural constraints of the U.S. telecom industry. Defiant telecom carriers—who feel that their network investments entitle them to the lion’s share of mobile marketing profits and remain protected by infrastructural agreements with the U.S. government—are unlikely to promote the development of a common communications platform. And the fragmented nature of the installed mobile base (with its vast array of handsets, content and usage contracts that span both geographies and providers) presents yet another adoption obstacle.

Online video content *enablers*—including video search providers and video ad networks—will become prime acquisition targets, while online video *aggregators* (i.e. “destination sites”) will assume a secondary role.

The audience for those seeking to watch and upload or share videos online is rapidly growing. According to eMarketer estimates, there will be 200 million broadband Internet users across the U.S. by 2011, 92 percent of whom will regularly watch online video. But even as the medium grows toward universal adoption, marketers are already finding it extremely difficult to cut through the “video clutter” that has grown to characterize both the commercial and user-generated media environments.

At this stage, it remains very difficult for marketers and service providers to effectively monetize user-generated video. Major advertisers simply cannot trust aggregators (such as YouTube) to choose the most appropriate online material and cannot afford to gamble on misleading or even off-color content. What’s more, marketers who would otherwise flock to attractive online video options remain stymied by the sheer lack of quality content; large brand marketers are looking to buy space across AOL Video, Google Video and NBC Direct, but have been frustrated by the lack of quality impressions to justify their time and effort. This demand for online inventory has driven strategic investment and development of new portals around editorialized content, such as News Corp’s investment in video content solution provider Roo and NBC Universal’s formation of premium video content sharing provider Hulu.

“This category will support at least one or two market leaders in the near term.”

— Adam Berrey
VP Product Marketing
Brightcove

Some video content aggregators are now being forced to shift their operating platforms—specialty providers are moving away from the traditional “destination site” model and are looking to instead serve ads across networks targeting differentiated audiences. One example is The Heavy Corporation, whose Husky video ad network serves as a complement to its video site Heavy.com, providing brand advertisers with hand-selected premium publishers that appeal specifically to the 18-34 male demographic.

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A plethora of new video content appears on the Web every day. But only a limited set of vendors is capable of performing the sought-after search-related services—including content archiving, indexing, encoding, transcoding and rating functions—that help break up video and successfully mine it for marketers. Tagging has proven particularly difficult to perform as it requires significant labor and expertise. Likewise, the pairing of advanced targeting and video-enabling solutions for relevant and timely content delivery will become lucrative. YuMe Networks, ScanScout and Tremor Media have benefitted from financial and strategic investment to fund the creation of video advertising networks based on proprietary, contextual targeting technology. As early-stage providers of video search, analytics and rating mechanism capabilities scale their networks through funding, their enterprise values may limit the strategic buyer universe to aggressive acquirers like AOL, Google, Microsoft, News Corp and Yahoo!.

Point solution providers may also look to stretch out further across the value chain to become “one-stop-shops” for digital video, offering strategy, creative, media buying, execution and fulfillment, propelled by their core capabilities in Web analytics, search and ad networking capabilities. Video ad solution provider VideoEgg—known for facilitating psychographically-relevant ads across social media networks and portals—aspires to create an agency-style layer, increasing its involvement in the media buying and creative process and playing a more active role in brand marketers’ overall strategy. As publishers and vendors boost their offerings via acquisition, campaign management will become a compelling addition for other noteworthy players.

“A new generation of ‘digital creatives’ is emerging—online video is an integral part of their lives, and we will see them hired separately or as part of a small acquisition to ensure speed to market.”

— **Shailesh J. Patel**
Partner
xperience Media

Respondents contend that digital video remains a “free-for-all,” with providers approaching online video at different angles—those straddling both the interactive ad serving and traditional TV media buying models that exist within online video are considered the most likely to succeed. A small group of best-of-breed providers has emerged amidst this confusion. But once the first of this group is acquired by a large interactive player—expected to take place in the next 12 months, according to multiple respondents—“We’ll see a feeding frenzy afterwards for the remaining guys,” in the words of one. Google’s ongoing involvement with video—propelled by its pending acquisition of DoubleClick—is expected to cast a long shadow over this segment, prompting agency holding companies, media conglomerates, specialized interactive agencies and private equity firms to defensively bid for the remaining digital assets.

Strategic consolidators will see brand monitoring and measurement providers as attractive means to protect and promote their clients amidst the explosion of potentially disruptive user-generated content.

Although no reliable spending estimates exist to quantify the opportunity presented by social networking, few question the significant interest and impact that has already been driven by user-generated online content. According to eMarketer, 95 million Web users will be generating custom content by 2011, up from 64 million last year.

Amidst this explosion in “unstructured” activity, perhaps no service will be of greater use to marketers than brand monitoring—providing the constant observation of blogs, podcasts, RSS feeds and general online content that may impact a brand and how it’s perceived by consumers. “Brands need to *listen* to all this noise as opposed to *enabling* it, tapping into what users are saying about them at all times” commented industry analyst Elana Anderson, formerly of Forrester Research. A small faction of service providers has already emerged to provide this type of support and is poised to receive investment from large research companies, agencies and interactive marketing service providers alike. During 2007, brand monitoring service providers Cymfony and BuzzMetrics became acquisition targets of large market research and information companies TNS Media Intelligence and The Nielsen Company, respectively, while brand management platforms BazaarVoice and Visible Technologies completed venture funding rounds.

For some providers, product reviews represent the most actionable opportunity to incorporate social networking elements into their own Web content or into their commercial e-mail; respondents noted that the integration of such content has emerged as a major priority of both agencies and publishers. Specifically, PowerReviews has gained popularity as a product review tool, completing its second round of funding in 2007. RSS and text-messaging, by contrast, have generated less interest—with several contributors calling them “check box” campaign options.

“You don’t need to own the [social networking] media—brand monitoring capabilities are going to become more important. Big players like Yahoo! are going to make the inventory available through exchanges and sell premium social networking spots themselves.”

— Richard Howe
Chief Marketing Officer and
Business Strategy Leader
Axiom Corporation

Perhaps the haziest current question impacting the social networking discussion, though, concerns the usage of specialty interest applications through broader platforms such as Facebook. Sponsored by marketers and fueled by self-reported data provided through individual user profiles, these applications depend upon both continued user interest and support from the hosting social networking platform. While some marketers have achieved success at driving small-scale applications thus far, respondents expressed doubts about the long-term viability of the medium, given the fickle nature of social networking audiences and requirement that a marketer would be forever “at the mercy” of Facebook and its application support.

In Summary

Marketing service providers will increasingly explore digital marketing services M&A opportunities, in light of the speed-to-market requirements dictated by this industry and the murky economic outlook tempering historical avenues for growth. Though large opportunities will almost certainly emerge over the next 12-18 months, it is likely that most providers will pursue small- and medium-sized deals that can be executed with greater confidence. The forthcoming digital marketing services M&A environment may be so active, in fact, that marketing service providers will likely *build* instead of *buy* only in instances where new services are deemed to be fundamentally core to their offering and guided by explicit client needs.

Although the digital marketing services M&A outlook is decidedly favorable, a number of marketplace challenges must be resolved to allow for funding and growth in certain niches:

- Government regulation, negative publicity and the emergence of anti-viral programs are factors provoking certain marketing service providers to rethink their service models
- Business rules and fragmentation of user interfaces are retarding adoption in segments, such as mobile marketing and online video
- The institution of marketing standards, the achievement of “critical mass” and greater potential for monetization are needed to allow for consolidation in various emerging areas (some may, in fact, never consolidate).

Similarly, acquirers must overcome several common impediments in order to promote the successful execution of digital marketing services transactions by:

- Executing transactions as a thoughtful complement to a well-articulated strategic growth plan (instead of pursuing acquisitions for the sole purpose of accessing greater addressable spend)
- Overcoming their own inability to package integrated marketing solutions and the post-M&A branding issues that often arise
- Making purchases of requisite size, in terms of revenue and client base, to sufficiently “move the needle”
- Accessing the necessary industry expertise to understand the business models of their proposed acquisitions and determine the appropriate ways to leverage those transactions internally
- Anticipating the cultural issues that may arise and proactively implementing behavioral, as well as structural, change.

Despite the presence of these marketplace and integration-related obstacles, digital marketing services transaction activity is creating a variety of benefits for marketing service providers and marketers alike. Forward-thinking acquirers are poised to capitalize on a growing number of near-term actionable plays, as well as several opportunities that are visible on the digital marketing services horizon.



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