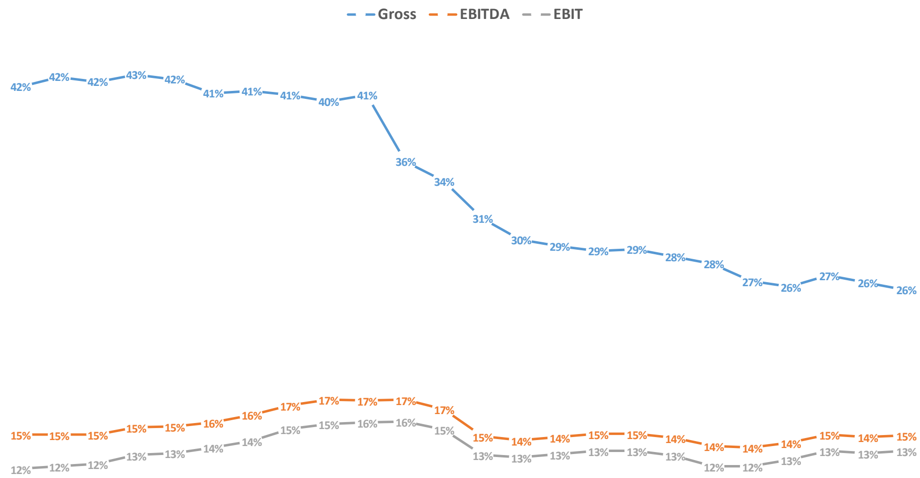
SINGULAR DILIGENCE

Omnicom

NYSE: OMC

Omnicom (NYSE: OMC)

Stock Price: $84.74



	EV/Sales	EV/Gross Profit	EV/EBITDA	EV/EBITA	EV/Owner Earnings
Interpublic	1.19	3.31	9.44	10.99	11.38
WPP	1.76	NA	10.62	12.59	13.46
Havas	1.82	4.68	10.44	12.94	12.94
Publicis	2.23	5.89	12.40	13.71	12.85
Dentsu	2.78	13.95	42.20	16.25	16.25
Minimum	1.19	3.31	9.44	10.99	11.38
Maximum	2.78	13.95	42.20	16.25	16.25
Median	1.82	5.29	10.62	12.94	12.94
Mean	1.96	6.96	17.02	13.30	13.38
STDEV	0.59	4.78	14.12	1.93	1.78
CV	0.30	0.69	0.83	0.15	0.13
Omnicom	1.54	5.96	10.57	11.52	11.66

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014
Sales	1,178	1,236	1,385	1,516	1,756	2,258	2,642	3,125	4,092	5,131	6,154	6,889	7,536	8,621	9,747	10,481	11,377	12,694	13,360	11,721	12,543	13,873	14,219	14,585	15,318
Gross Profit		514	587	637	747	952	1,086	1,290	1,676	2,077	2,521	2,469	2,583	2,710	2,900	3,068	3,289	3,686	3,800	3,270	3,328	3,622	3,839	3,860	3,968
EBITDA		181	203	223	267	345	412	506	693	892	1,065	1,196	1,254	1,253	1,388	1,515	1,674	1,868	1,925	1,618	1,713	1,945	2,087	2,110	2,239
EBIT		148	169	188	230	299	361	443	618	795	961	1,081	1,134	1,128	1,257	1,377	1,523	1,704	1,743	1,431	1,531	1,763	1,905	1,926	2,051
Receivables				864	1,021	1,322	1,529	1,732	2,242	2,967	3,608	3,789	3,844	4,248	4,723	5,141	5,680	6,412	6,303	5,675	5,776	6,305	6,795	6,795	6,579
Inventories				170	183	236	307	391	557	715	843	965	985	1,091	1,323	1,415	1,558	1,778	1,755	1,648	1,768	1,951	1,994	2,148	2,283
PP&E				157	166	186	211	231	283	386	464	511	548	577	617	623	624	673	713	698	665	668	703	731	723
Working Liabilities				1,308	1,626	2,104	2,530	3,033	3,929	5,053	5,890	6,116	6,263	6,973	7,893	8,394	9,278	10,515	10,248	9,711	10,342	11,110	11,514	11,791	11,865
Net Tangible Assets				-117	-256	-360	-483	-680	-847	-985	-975	-852	-887	- 1,056	- 1,230	-1,215	-1,416	-1,651	-1,477	-1,690	-2,133	-2,186	-2,021	-2,118	-2,281
MARGINS																									
Gross		42%	42%	42%	43%	42%	41%	41%	41%	40%	41%	36%	34%	31%	30%	29%	29%	29%	28%	28%	27%	26%	27%	26%	26%
EBITDA		15%	15%	15%	15%	15%	16%	16%	17%	17%	17%	17%	17%	15%	14%	14%	15%	15%	14%	14%	14%	14%	15%	14%	15%
EBIT		12%	12%	12%	13%	13%	14%	14%	15%	15%	16%	16%	15%	13%	13%	13%	13%	13%	13%	12%	12%	13%	13%	13%	13%
TURNS																									
Sales/Receivables				1.76	1.72	1.71	1.73	1.80	1.83	1.73	1.71	1.82	1.96	2.03	2.06	2.04	2.00	1.98	2.12	2.07	2.17	2.20	2.09	2.15	2.33
Sales/Inventories				8.94	9.61	9.55	8.61	7.99	7.35	7.17	7.30	7.14	7.65	7.90	7.37	7.41	7.30	7.14	7.61	7.11	7.09	7.11	7.13	6.79	6.71
Sales/PPE				9.67	10.56	12.12	12.52	13.55	14.45	13.30	13.27	13.49	13.76	14.93	15.81	16.84	18.22	18.85	18.73	16.78	18.85	20.76	20.22	19.96	21.20
Sales/NTA				-12.97	-6.87	-6.27	-5.47	-4.60	-4.83	-5.21	-6.31	-8.09	-8.50	-8.16	-7.92	-8.63	-8.03	-7.69	-9.04	-6.94	-5.88	-6.35	-7.03	-6.89	-6.72
RETURNS																									
Gross Profit/NTA				-544%	-292%	-265%	-225%	-190%	-198%	-211%	-259%	-290%	-291%	-257%	-236%	-253%	-232%	-223%	-257%	-194%	-156%	-166%	-190%	-182%	-174%
EBITDA/NTA				-190%	-105%	-96%	-85%	-75%	-82%	-91%	-109%	-140%	-141%	-119%	-113%	-125%	-118%	-113%	-130%	-96%	-80%	-89%	-103%	-100%	-98%
EBIT/NTA				-161%	-90%	-83%	-75%	-65%	-73%	-81%	-99%	-127%	-128%	-107%	-102%	-113%	-108%	-103%	-118%	-85%	-72%	-81%	-94%	-91%	-90%
GROWTH																									
Sales		5%	12%	9%	16%	29%	17%	18%	31%	25%	20%	12%	9%	14%	13%	8%	9%	12%	5%	-12%	7%	11%	3%	3%	5%
Gross Profit			14%	8%	17%	27%	14%	19%	30%	24%	21%	-2%	5%	5%	7%	6%	7%	12%	3%	-14%	2%	9%	6%	1%	3%
EBITDA			12%	10%	20%	29%	20%	23%	37%	29%	19%	12%	5%	0%	11%	9%	10%	12%	3%	-16%	6%	14%	7%	1%	6%
EBIT			14%	11%	22%	30%	21%	22%	40%	29%	21%	13%	5%	-1%	11%	10%	11%	12%	2%	-18%	7%	15%	8%	1%	6%
Receivables				9%	26%	32%	3%	23%	35%	30%	15%	-4%	7%	14%	9%	9%	12%	14%	-15%	-3%	7%	11%	5%	-5%	-2%
Inventories				-11%	28%	30%	30%	26%	55%	11%	24%	7%	-2%	24%	19%	-3%	24%	6%	-9%	-3%	18%	4%	1%	14%	-1%
PP&E				5%	7%	16%	11%	8%	36%	36%	9%	11%	4%	7%	7%	-4%	5%	10%	2%	-6%	-4%	5%	6%	2%	-4%
Working Liabilities				16%	32%	28%	14%	25%	33%	25%	10%	-2%	6%	16%	11%	2%	19%	9%	-13%	4%	9%	6%	2%	3%	-2%
Net Tangible Assets				240%	83%	18%	48%	36%	16%	16%	-16%	-9%	18%	20%	14%	-14%	53%	-7%	-14%	48%	11%	-5%	-10%	21%	-3%

	Minimum	Maximum	Median	Mean	Standard Deviation	Variation
Sales	1,178	15,318	7,536	7,737	5,023	65%
Gross Profit	514	3,968	2,647	2,437	1,204	49%
EBITDA	181	2,239	1,254	1,190	694	58%
EBIT	148	2,051	1,131	1,074	637	59%
Receivables	864	6,795	4,486	4,243	2,066	49%
Inventories	170	2,283	1,207	1,185	689	58%
PP&E	157	731	597	507	208	41%
Working Liabilities	1,308	11,865	7,433	7,158	3,582	50%
Net Tangible Assets	-2,281	-117	-1,136	-1,223	658	-54%
MARGINS						
Gross	26%	43%	33%	34%	7%	0.20
EBITDA	14%	17%	15%	15%	1%	0.08
EBIT	12%	16%	13%	13%	1%	0.08
TURNS						
Sales/Receivables	1.71	2.33	1.99	1.95	0.19	10%
Sales/Inventories	6.71	9.61	7.33	7.64	0.82	11%
Sales/PPE	9.67	21.20	15.37	15.81	3.42	22%
Sales/NTA	-12.97	-4.60	-6.91	-7.20	1.79	-25%
RETURNS						
Gross Profit/NTA	-544%	-156%	-229%	-240%	80%	-0.33
EBITDA/NTA	-190%	-75%	-104%	-109%	26%	-0.24
EBIT/NTA	-161%	-65%	-93%	-97%	23%	-0.23
GROWTH						
Sales	-12%	31%	11%	12%	9%	0.79
Gross Profit	-14%	30%	7%	10%	10%	1.04
EBITDA	-16%	37%	11%	12%	11%	0.93
EBIT	-18%	40%	11%	13%	12%	0.94
Receivables	-15%	35%	9%	11%	13%	1.22
Inventories	-11%	55%	13%	13%	16%	1.21
PP&E	-6%	36%	6%	8%	11%	1.40
Working Liabilities	-13%	33%	9%	11%	12%	1.03
Net Tangible Assets	-16%	240%	16%	26%	54%	2.12

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SINGULAR DILIGENCE

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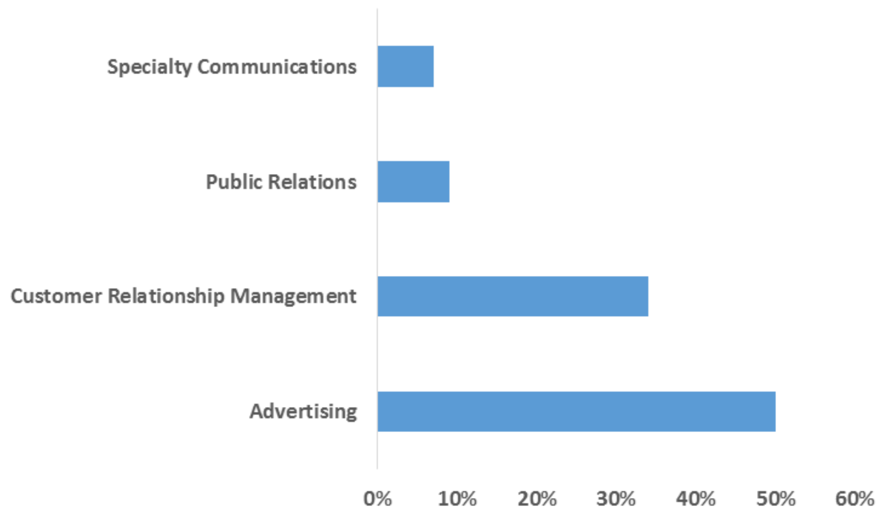
The Core of a "Marketing Services Provider" Like Omnicom (NYSE: OMC) is its Advertising Business

OVERVIEW

Omnicom is one of the world's largest "marketing services" companies. It breaks its revenue down into 4 categories: advertising (50% of revenue), customer relationship management (34%), public relations (9%), and specialty communications (7%). Omnicom is a publicly traded holding company that owns many different agencies. What most people think of as an ad agency is referred to in the industry – and by Omnicom – as a "creative agency". A small number of publicly traded corporations own many of the biggest creative agencies in the ad world. The biggest of these advertising holding companies are Omnicom, WPP, Interpublic, Publicis, Havas, and Dentsu. However, these corporate names wouldn't be the names clients would recognize. For example, Omnicom is actually a combination of 3 of the world's top 10 global ad agencies: BBDO, DDB, and TBWA. A creative agency has the primary relationship with the client. It creates and produces ads. It crafts the client's message. If you have seen the TV show Mad Men – what you are watching there is life at a creative agency. Omnicom's creative agencies are separate from one another. In fact, they actually compete with each other at times. Different clients would be served by BBDO, DDB, or TBWA. And a client could see competing pitches from say BBDO and DDB. Clients can fire one of Omnicom's agencies and hire another. So, it's important to keep in mind there is no one Omnicom ad agency. There are multiple global and national agencies under the Omnicom umbrella that are actually run separately and can even compete against each other.



Omnicom still gets half of its revenue from what management classifies as "advertising".

In addition to creating advertising a marketing services company buys the ad space for its clients. There are huge economies of scale in ad buying. Omnicom has two groups used to buy ads for clients. One is OMD and the other is PHD. OMD buys $42 billion a year in ads for its clients. PHD Is smaller. It buys $13 billion a year in ads. PHD helps Omnicom avoid conflicts of interest. OMD can't buy ads for two competing clients. Conflicts of interest are a major concern throughout the advertising industry. For example, a creative agency with Coke as a client would not also have Pepsi as a client. This does not necessarily mean that Omnicom or WPP wouldn't be simultaneously serving two carmakers or airlines at the same time. By owning multiple agencies and keeping them separate from each other – the overall corporation can have some agency without a conflict of interest in most situations. Larger media agencies – the ad buyers – get better prices on ad space than small agencies can. In fact, many independent creative agencies have eventually exited this function because they can't buy ads as cheaply as companies like Omnicom and

Interpublic can. This is an important point to keep in mind. Although the client pays an ad agency a commission, the client simultaneously gets a lower price on the advertising they buy than would be the case if they didn't use an ad agency. OMD buys $42 billion of ads each year. It's not impossible for a media agency to buy 50 times more advertising for all its clients combined than it would for its single largest client alone. So, the buying power of even the biggest multinational consumer goods client is tiny compared to the buying power of the agency as a whole.

Omnicom's marketing services (34% of sales) are handled by over 200 companies in specialist disciplines. Some of these disciplines include brand consultancy, direct marketing, social media, event marketing, graphic arts, in-store marketing, mystery shoppers, market research, etc. These are all specialties that a client of one of Omnicom's creative agencies might need. In fact, Omnicom's largest clients can be served by up to 50 different companies within Omnicom.

Omnicom was formed in 1986 as part of a wave of consolidation in the ad industry. BBDO and DDB merged to form Omnicom. Seven years later, Omnicom acquired TBWA. These three worldwide agencies – Omnicom owns smaller national agencies as well – are completely independent of each other. For example, when using specialists that handle things like brand consultancy, market research, printing services, event sponsorships, etc. – BBDO, DDB, and TBA each rely on different individual companies under the same Omnicom corporate umbrella. So, while Omnicom is huge and does benefit from economies of scale in things like media buying – it is very decentralized. Omnicom maintains triple duplication of various functions instead of merging its three agencies into one at all levels. The benefits to one giant agency would be cost synergies. But, the costs would be conflicts of interest that would force Omnicom to resign important accounts and possibly a loss of creativity. So, an ad agency holding company like Omnicom is never going to move to complete centralization. The numbers we give about Omnicom as a group are misleading in this respect. They are just aggregations of the figures from BBDO, DDB, and TBA. Each of those agencies are truly separate companies.

But, what does Omnicom look like as a group? It has about 2,500 clients. The 2,400 smallest clients are 50% of revenue and the 100 biggest clients are the other 50% of revenue. No client accounts for more than 3% of Omnicom's revenue. Each of the top 100 clients are served on average by 50 agencies (marketing services, etc.) within Omnicom. The biggest client is served by 200 agencies within Omnicom. So, again, very decentralized.

For clients with big advertising needs, the ad industry is an oligopoly. The world's biggest advertisers generally work with one of 6 advertising groups (Omnicom, WPP, Interpublic, Publicis, Havas, or Denstu). There are no exact figures on client retention. Quan and I estimate it is 95% or higher. It is extraordinarily rare for an established, currently successful brand to switch ad agencies. That almost never happens. What does happen is a troubled brand in decline tries to change direction – its image, position, message, etc. – and seeks a new agency. As we'll talk about in the durability section, many of the world's best and biggest brands have stayed with the world's best and biggest ad agencies for many, many decades.

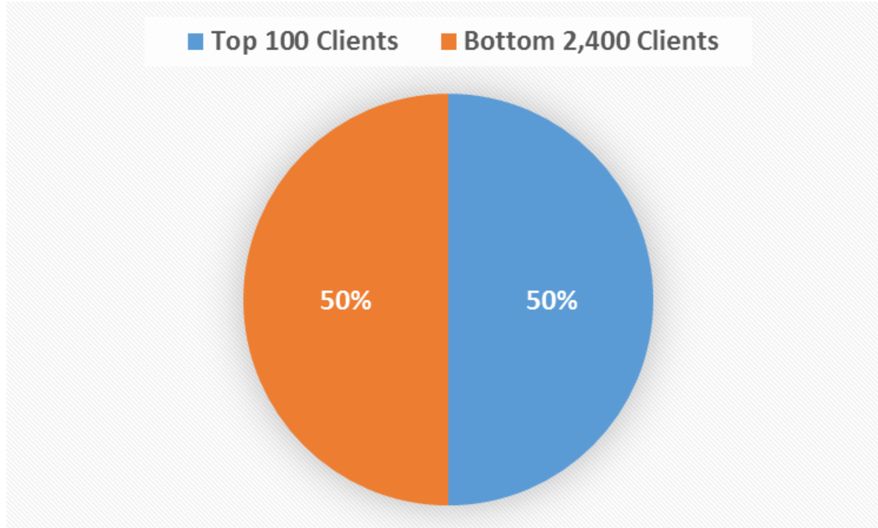
All of the global creative agencies are great businesses. Omnicom is a great business. But, honestly so are WPP, Interpublic, and Publicis. When run right in terms of costs, capital allocation, etc. all these companies can make for great long-term investments. All of them will be great businesses in 5, 10, and 15 years from now. They'll have many of the same clients. If we had to pick one best stock in the ad industry though it'd be Omnicom. It's the company with the best financial results. It has the best history of capital allocation. I'm not sure awards matter – but, Omnicom's agencies win more awards than anyone else. What does matter is price. Omnicom is probably the best stock in the group of 6 we'll keep talking about – that's Omnicom plus 5 peers: WPP, Interpublic, Publicis, Havas, and Dentsu – and yet it's the cheapest stock in the group. At $80 a share, Omnicom is priced around 11 times pre-tax profits. The rest of the group is about 20% more expensive. They go for 13 times pre-tax profits. That's a fair price for an ad agency. But, Omnicom's 10 times pre-tax owner earnings is a cheap price. So, Omnicom is definitely the best ad agency stock to buy.

DURABILITY

Omnicom Gets Just 3% of Sales from its Single Biggest Client and Just 50% of Sales from its 100 Biggest Clients Combined

The durability of an ad agency is nearly perfect. Advertising as an industry has been around for 100 years or more in much the same form it has today. Client needs are mostly the same. They need to outsource the creation and buying of advertising to experts who are not employees of their own company. This is because the biggest client of an ad agency is small relative to the creative and media buying needs of the agency's entire client roster. It has long made more sense for DDB to buy ad time on NBC than for a specific company like Ford to buy time or a specific brand like Lincoln to buy time. The aggregation of scale and talent at agencies serving many clients rather than in house at large corporations has been the way business is done for decades. The type of media clients have advertised in has changed from print to radio to television to online. Yet, many of the same clients have stayed with many of the same agencies throughout these changes. Changes in the media outlets companies advertise in haven't done much to change the way clients use agencies for their creative functions and their media buying functions.

The creative function of ad agencies is perfectly durable. Someone has to think up advertising. Coming up with the right message, the right copy, etc. can either be done in house by a brand or it can be outsourced to an advertising agency. There might seem to be a risk that big corporations would in house work that small companies don't. In other words, the marketing departments of insurers, car makers, and wireless carriers that spend hundreds of millions of dollars each year in advertising would be able to perform all the creative functions they need within their own company. However, there are some problems with this thinking. One, ad agencies would always have an advantage in attracting talent. Why would the best people in any professional services industry – the best copywriters, the best accountants, the best lawyers, etc. – want to work for one firm in one industry rather than work for a company dedicated to doing only advertising, accounting, law, etc. for many different clients in many different industries? It's possible that large corporations would never need to use outside accountants except for an audit. It's possible large corporation would never need to use outside lawyers at all. And it's possible that large corporations would never need to use outside creative talent for advertising. Yet, historically, almost all big companies have relied on outside help in these areas for many years. One possible explanation for why in housing isn't attractive in advertising is that the key metric is the return on the advertising dollars spent rather than the total costs billed for the creative aspect of advertising. Another possible explanation is just that corporation's marketing needs are too diverse to achieve scale in house in most areas. For example, a big corporation might need to create TV ads for its brands each year and buy air time. The corporation would be at a disadvantage in buying the air time versus a media agency at Omnicom, WPP, etc. So, in housing the media buying doesn't make sense. In housing the TV ad



Omnicom's 2,400 smallest clients provide half of the company's total revenue.

production – everything from the first creative steps to the actual filming of the spot – might make sense if that's all the corporation's marketing needs ever were. But, Omnicom's biggest clients use up to 50 different specialist agencies within Omnicom to serve their needs. A big corporation doesn't just make TV ads. It also needs brand consultancy, direct marketing, event marketing, public relations, etc. In many cases, it needs these different specialties to work together. If Volkswagen has an emissions scandal, it needs to do PR work to minimize the harm to its corporate image. It needs to research what consumers know about the scandal and what it would take to win back their trust. And then it needs to come up with a message that can be used to promote the brand in the future to a group of consumers who don't trust the company. Eventually, the end product may be the creation of a TV spot. But, the actual marketing needs of a client like Volkswagen are large, elaborate, and complex. Just as a law firm may have past experience in an area that a specific client is facing a problem in for the first time – an ad agency can have a breadth of knowledge in the marketing discipline that a client lacks.

The durability of media buying networks is even clearer than the durability of creative agencies. Clients of ad agencies can aggregate their buying power and get better deals for ad space by going through a single media buying network. If clients bought their own ad space – they'd have to pay higher prices for their ads. For example, each season – one of Omnicom's two media buying networks buys far, far more time from one of the big four U.S. broadcast TV networks than any single Omnicom client would ever want to buy from that same network. In some cases, we are talking about an order of magnitude type difference. The biggest client might want to buy 4% of a channel's ad time (for a single brand) versus Omnicom wanting to buy 40% of that same channel's ad time (for all clients of its biggest media buying network).

If Honda had to negotiate directly with CBS for air time, it would not get a better deal by cutting out the middle man of its ad agency – it would get a worse deal. CBS's size is huge relative to Honda. CBS's size is not huge relative to the ad agency that actually buys TV time on behalf of Honda. If Honda tried to "cut out the middleman" by buying its own air time, it wouldn't capture the savings from not paying a commission – those savings would go to the media outlet it would now have to negotiate with. Media buying networks at ad agencies shift market power away from media outlets to justify their commission. Clients can't cut out the commission without worsening their bargaining position when buying ad space. This is something a lot of people get wrong. They assume cutting out the middleman saves money for the client. It doesn't. A media buying network may charge a commission of as little as 3% of the price of the ad space a client buys. If CBS could charge each of Omnicom's clients even just a 4% higher price for its ad time when "dividing and conquering" Omnicom's client roster into a series of a hundred different one-on-one negotiations – CBS would be better off and all of Omnicom's clients would be worse off if they cut out the agency middleman.

Changes in media rarely cause changes in ad agency business. A shift from advertising on TV to advertising online by a client doesn't usually change who the client uses as their ad agency. Nor does it change how the agency makes its money. Also, digital advertising is often one part of a larger campaign. So, for example, BBDO created a Bud Light campaign to encourage more millennials to drink this brand of beer. Content created for the campaign ended up on YouTube, Facebook, Twitter, and Vine as well as a traditional Super Bowl ad. So, the campaign included both a 3 minute and 30 second short film on YouTube in the run-up to the Super Bowl and a 30 second spot during the Super Bowl. Bud Light is a huge brand. Brands like Bud Light will always choose ad agencies that can provide integrated campaigns like the one discussed above. They want event marketing, social media, online ads, and broadcast TV ads all together as part of one campaign with one consistent message about the brand. The big agencies have big clients. And so they have experience across a lot of different disciplines. When companies like Omnicom need new specialties in digital or other areas – they know this because they know their clients' needs. They then either create or acquire – usually on a small scale – the specialty a client needs. And then they scale up that specialty as more and more of their clients need more and more from that specialty. It's much easier for an agency with strengths across a dozen specialties to add a thirteenth specialty than a firm focused on one area to win a big client. Over time, clients of Omnicom have preferred to bring more and more of their business to Omnicom by consolidating accounts and they've wanted to do less and less with smaller agencies. This is the general trend in advertising. For example, in 2007, WPP bought 40% to 45% of its clients' paid search – clients used paid search specialists for the rest. By 2010, WPP bought 70% of clients' paid search needs. While a specialist in paid search may sound more attractive and more durable as a growing specialty than an old fashioned ad agency – really, it's the ad agency that eventually wins its existing client's specialty business rather than the specialist that wins more business from the client.

From 2005 through 2014, Omnicom – which acquired far less than its competitors – maintained the same relative share of total media billings. It was buying the same amount of ad time as it had 8 years before. Shifts in market share were incredibly minimal. If you look at WPP, Publicis, and Omnicom from 2005 through 2014 – there was essentially no change in their media billings. To put this in perspective, in 2003, TV was 32% of total ad spending and internet was 4%. In 2013, TV was 45% of total ad spending and internet was 26%. That means everything that wasn't TV or internet went from 64% of total ad spending in the U.S. to just 29% of total ad spending. A huge decline in areas like newspaper, magazine, and radio. And yet this huge shift in share of ad spending by media had no impact on the market share of each of the biggest advertising companies in the world. Omnicom, WPP, and Publicis basically kept the same share of ad buying they had in 2003 and 2013. There can be no better proof of the durability of ad agencies than the fact that a huge shift in the type of media space they buy for clients caused no shift in the size of their own business. What makes ad agencies most durable is their client relationships. Just like an individual bank's durability is based on its existing relationships with households and businesses who keep deposits at the bank and rarely ever switch banks – an ad agency's durability is its existing client roster. As we'll explain in the moat section, clients rarely switch ad agencies. We said in the Frost issue that Frost had an industry leading customer retention rate of 92%. While ad agencies don't provide customer retention as a percentage – you can tell by looking at their history, that 90% or higher retention rates are actually quite common. Astronomically high customer retention rates combined with the desire of clients to increase ad spending each and every years is the number one reason why ad agencies are among the most durable and predictable businesses in the world.

MOAT

Most Ad Agencies Probably Keep More Than 9 Out of 10 Clients Every Year

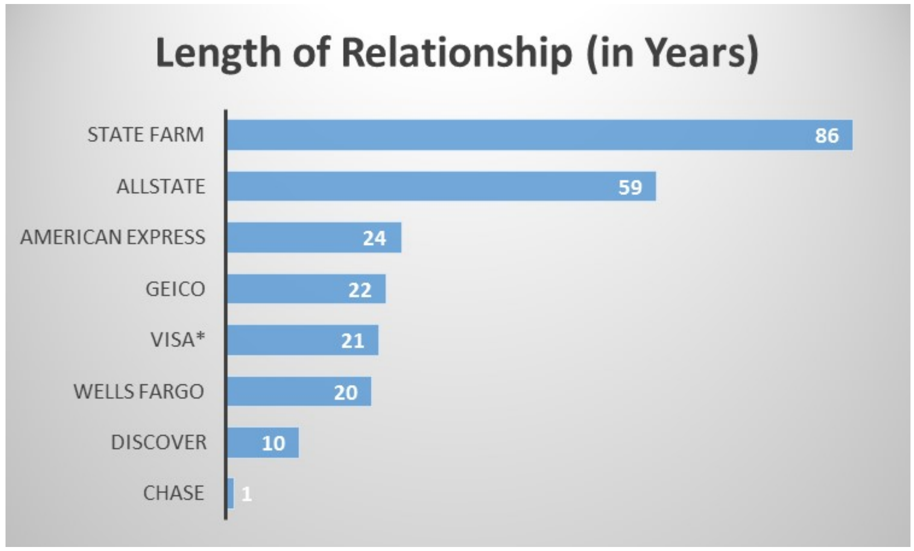
Moat is sometimes considered synonymous with "barrier to entry". Economists like to talk about barriers to entry. Warren Buffett likes to talk about moat. When it comes to investing, "moat" is what matters. Barriers to entry may not matter. Thinking in terms of barriers to entry can frame the question the wrong way.

If you're thinking about buying shares of Omnicom and holding those shares of stock forever – what matters? Do barriers to entry matter? Does it matter if it's easy to create one new ad agency or a hundred new ad agencies? No. What matters is the damage any advertising company – whether it's WPP, Publicis, or a firm that hasn't been founded yet – can do to Omnicom's business. How much damage can a new entrant do to Omnicom's intrinsic value? How much damage can Publicis or WPP do to Omnicom? The answer is almost none. In that sense, the barriers to entry in the advertising industry are low but the moat around each agency is wide. How can that be?

First of all, the historical record is clear that among the global advertising giants we are talking about a stable oligopoly. The best measure of competitive position in the industry is to use relative market share. We simply take media billings – this is not the same as reported revenue – from each of the biggest ad companies and compare them to each other. If one company grows billings faster or slower than the other two – its competitive position has changed in relative terms. Between 2004 and 2014, Omnicom's position relative to WPP and Publicis didn't change. Nor did WPP's relative to Publicis and Omnicom. Nor did Publicis's position relative to WPP and Omnicom. Not only did they keep the same market share order 1) WPP, 2) Publicis, 3) Omnicom – which is rarer than you'd think over a 10-year span in many industries – they also had remarkably stable size relationships. In 2005, WPP had 45% of the trio's total billings. In 2010, WPP had 45% of the trio's combined billings. And in 2014, WPP had 44% of the trio's combined billings. Likewise, Omnicom had 23% of the trio's billings in 2005, 22% in 2010, and 23% in 2014. No other industries show as stable relative market shares among the 3 industry leaders as does advertising. Why is this?

Clients almost never leave their ad agency. Customer retention is remarkably close to 100%. New business wins are unimportant to success in any one year at a giant advertising company. The primary relationship for an advertising company is the relationship between a client and its creative agency. The world's largest advertisers stay with the same advertising holding companies for decades. As part of our research into Omnicom, Quan looked at 97 relationships between marketers and their creative agencies.

I promise you the length of time each marketer has stayed with the same creative agency will surprise you. Let's look at some of the examples. Wrigley – now a part of Wrigley Mars – used Saatchi & Saatchi as its creative agency



Many of the biggest financial services brands have been "married" to the same ad agency for more than 20 years.

from 1954 till 1995. Wrigley left Saatchi because of squabbling within the Saatchi family itself. After leaving Saatchi, Wrigley has been with Omnicom from 1995 through 2015. So, 40 years with Saatchi and then 20 with Omnicom.

Procter & Gamble has historically used Saatchi and Grey. P&G's relationship with Saatchi dates back to 1921. Its relationship with Grey started in 1956. P&G's relationship with Grey was costly to Omnicom, because P&G acquired Gillette in 2005. Gillette had been a client of one of Omnicom's agencies for about 70 years. But, since P&G prefers working with Saatchi and Grey – it moved the Gillette account to Grey in 2013. This is how many big clients are lost. The client merges with a company that is served by a competing agency. Unilever has been an even more loyal client than P&G. Unilever prefers working with J. Walter Thompson and Lowe. It has been with J. Walter Thompson since 1902. So, that relationship is now 114 years old. It's not the oldest relationship for Unilever. The company started working with Lowe in 1899. So, that relationship is 117 years old. Another example in household products brands is Clorox. Clorox has been with Omnicom's DDB since 1996. Its prior relationship lasted 75 years. So, Clorox chose an agency in 1921. Then, it switched creative agencies in 1996. So, two moves in close to a hundred years.

Some industries have very high client retention. It seems financial services firms mostly leave agencies due to consolidation. So, one bank buys another and they switch to the bigger bank's creative agency. Otherwise, the relationships are almost all long ones. State Farm has been with Omnicom's DDB from 1930 till today. Between 2010 and 2011, State Farm shifted some of its business – especially the car insurance brand – to a different creative agency, but it moved all of that work back to DDB the following year. Allstate has been with Leo Burnett since 1957. Geico has been with the Martin Agency since 1994. All of GEICO's campaigns you remember were created by The Martin Agency. American Express has been with Ogilvy since 1962. Visa is an interesting example of "moat". Visa has been an Omnicom client from 1985 through today. However, Visa dropped BBDO in 2005. Omnicom asked Visa to limit its search for a new agency to among Omnicom owned agencies only. Visa agreed. And so the firm selected from pitches made by DDB, TBWA, etc. It didn't consider moving to an agency owned by WPP or Interpublic or anyone else. In 2005, Visa switched from Omnicom owned BBDO to Omnicom owned TBWA. However, it moved back to BBDO in 2012. So, Omnicom retained Visa as a client despite one of Omnicom's agencies being fired two different times in that period. Wells Fargo has been an Omnicom client since 1996. Discover Card was an Omnicom client from 1987 to 2006. Then, Discover moved from Omnicom to The Martin Agency. By 2006, The Martin Agency would've already been well known for the amazing work it had been doing for GEICO throughout the 1990s and early 2000s.

I don't want to bore you with almost a hundred different examples of how long one client stays with one creative agency. But, I do think this is the most important fact in this entire issue. So, I encourage you to flip to the "Notes" section of the issue and read the list of relationships and their start dates that Quan prepared for industries ranging from carmakers to transportation companies to electronics brands.

Consolidation is the leading cause of losing a once loyal client. The other reason clients leave is because they are fickle. The same brand keeps switching creative agencies. This is common among troubled brands. A good example is Heineken in the U.S. Heineken is an imported beer that basically has the same positioning as "better beer" brands like Samuel Adams. Heineken originally competed with the big, boring domestic brands like Bud. Over the last 20 years, it's had to compete with U.S. based craft beers and other imports. In the last 10 years, the brand has been in constant turmoil. From 2005 through 2011, Heineken had 4 different CEOs and 4 different chief marketing officers. Its creative agency from 2003 to 2007 was Publicis, then Wieden & Kennedy for 2008-2009, then Euro RSCG from 2009-2010, then back to Wieden & Kennedy for 2010-2015, and then in 2015 Heineken left Wieden and returned to Publicis. You can see this is not a problem with a particular creative agency. It's a problem with the Heineken brand.

The other reason clients switch is because they belong to an industry with a lot of cyclicality to brand perception. Restaurants and retailers are the most fickle client group. Still, "fickle" is a relative term. Client retention is still very high compared to other industries. Wal-Mart has used 3 agencies over the last 30 years. Darden (Olive Garden) has been with Grey since 1984. McDonalds has used Leo Burnett and DDB since the 1970s.

There is no customer retention figure generally available for Omnicom or for the industry. But, you can easily estimate the retention rate is above 90% based on the nearly 100 relationships we looked at. You can peruse many of these relationships in the notes. From time to time, articles give client retention figures for a single agency. For example, in 2001 and 2002 and 2003 it was reported that DDB retained 98% or 99% of clients. In 2014, it was reported Grey had a 95% retention rate. An industry wide customer retention rate of 90% would be conservative for key accounts. A figure like 95% may be more realistic.

The most important fact to consider is that agencies don't try to take business from each other. They try to take business once it is "in review". In 2006, Omnicom's CEO said: "We're invited to new business pitches…we can't create them…Fortune 100 companies, typically take their time and go through a lot of deliberations before they actually…put an account or an assignment into review."

In 2007, Omnicom's CEO (John Wren) again said: "…what goes into review is driven by clients…we can't cause somebody to put their account in review."

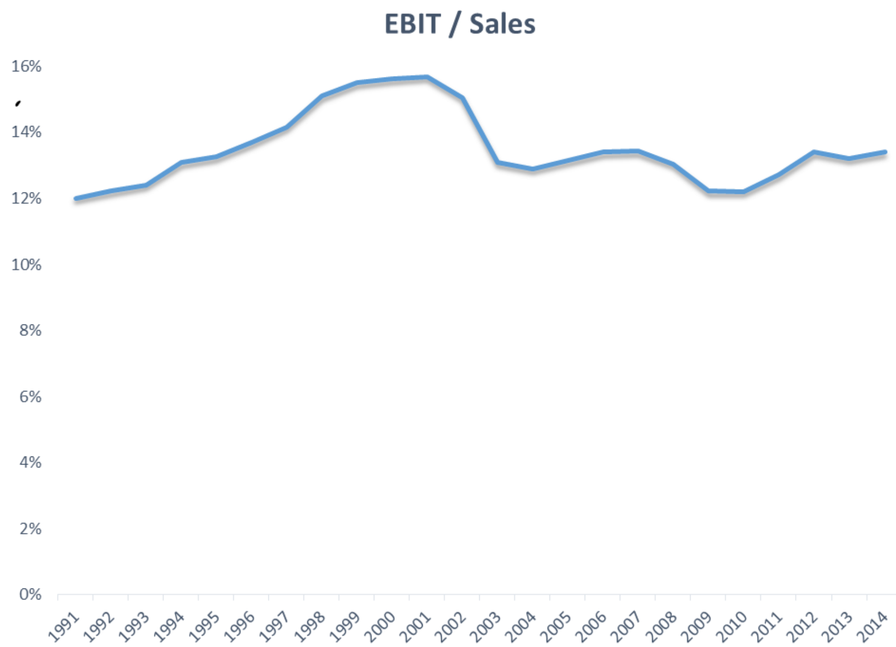
In other words, the only time one agency takes a Fortune 100 type client from another agency is when the client decides first to put the account in review. First, the client says they may fire the agency and then other agencies pitch for the business. When agencies do pitch for an account in review, they don't usually compete on price. Traditionally, creative agencies took a 12% commission on billings. Media agencies took a 3% commission on billings. Now, the work tends to be fee based. But, it doesn't matter. It's clearly been structured the same way to keep price competition from happening. Omnicom has a very consistent EBIT margin from the 1990s through today. It has a quarter century record of extreme consistency in pricing versus its expenses. It's basically a cost plus business. We can see with WPP – who reports billings while Omnicom doesn't – that sales were between 20% and 22% of billings over the last 20 years. Again, it's a consistent number and it's not lower than the traditional commission structure the industry used. So, there is no evidence of agencies competing for business by trying to offer lower fees and commissions. The moat around each ad agency is wide because: 1) Customer retention is nearly perfect 2) Pricing is very consistent and 3) The relative market share of the oligopolists in this industry is also very consistent. Without changes in prices or relative market share – a business is basically the same from year-to-year. So, ad agencies mostly report earnings growth and declines based purely on the increases and decreases in ad spending by their existing clients. In fact, what you see in the year-to-year results of an advertising company is basically just that. It's mostly just a record of what the existing client roster did in terms of their ad spending compared to last year. So, the industry is incredibly stable over full cycles. It is cyclical to the extent that ad spending is cyclical and follows the macro economy.

QUALITY

Omnicom is One of the Most Predictable Public Companies You Will Ever Find

Omnicom can turn every dollar of sales into 11 cents of after-tax free cash flow. Omnicom's margins are incredibly stable over the long-run. However, clients cut advertising budgets deeply in a recession. So, advertising agencies are less profitable at the lowest point in the macroeconomic cycle. They are cyclical businesses. And – for this reason – they can be very cyclical stocks. However, unlike many cyclical stocks, advertising agencies still generate excellent returns on capital over a full cycle. In fact, advertising agencies generate great returns on capital even at the worst point in the cycle. This is because companies like Omnicom often have low or no net tangible assets. The companies have negative working capital. They are paid by clients before they have to pay their own bills. Many cyclical industries are asset heavy. They generate poor returns on assets or even lose money at the worst point in the cycle. Ad agencies have flexible cost structures. If they lose accounts, they can fire people. If clients cut their spending – they can pay out less in bonuses to their top people. Margins do decline in bad times. But, even a bad year for an ad agency is more profitable than a good year for many asset heavy companies. So, advertising is a cyclical industry. But, it is a cyclical industry with excellent returns on capital over the long-term.

Omnicom has the most stable operating margins of any company you will ever find. From 1991 to 2014, Omnicom's lowest EBIT margin was 12%. Its highest was 15.7%. The median EBIT margin was 13.2%. The mean was 13.5%. Standard deviation was a very low 1.1%. This means the coefficient of variation – standard deviation scaled to the mean – was 0.08. I think this last number is the most important. Many companies may have a standard deviation of 1% in their EBIT margin if their average margin is say 3%. For example, they may be a supermarket or a gas station or a distributor of some kind. A margin that varies between 1.5% and 3.5% does not make for an especially stable business. It's fine. But, it's really no different than say a railroad that has an EBIT margin range of 15% to 35%. The wobbliness of the year-to-year EBIT figure relative to its own central tendency over time is what matters. So, it is the variation of just 0.08 that tells you how stable Omnicom's margin really is. What matters is not that a 3.3% change in Omnicom's EBIT margin is a 3 standard deviation move. What matters for Omnicom is that a 3 standard deviation



Over the last 25 years, Omnicom's pre-tax profit margin has ranged from just 12% to 16% of sales.

move is only a 24% change relative to the mean. In other words, a swing from a 13.5% EBIT margin to either a 16.8% margin or a 10.2% margin would be incredibly unusual. In fact, as you saw from the 24 year range we gave – 12% to 15.7% – those swings have actually not happened in the last quarter century. That's how stable Omnicom's EBIT margin is. As long as you can predict the company's sales in 3 or 5 or 10 years – you can predict the company's earnings. The best example of Omnicom's margin stability is the big decline in sales during the crisis. Omnicom's revenue dropped 12% from 2008 to 2009. But, Omnicom's EBITA (Earnings Before Interest Taxes and Amortization) margin only dropped from 13% to 12.2%. In other words, a 12% sales decline caused a roughly 17% earnings decline. A drop of 17% in earnings is a big drop. But, it's really not big for a cyclical company. And a 17% drop in earnings is not a big drop at all for a company that had a 12% sales decline.

Omnicom's expenses are pretty flexible. Incentive compensation is really big. Omnicom's incentive compensation can run as high as 6% of total revenue. This means good times are shared between employees and shareholders. Senior executives at ad agencies make a lot of money. But, they also have serious pay cuts in bad times. Some senior management can take a 50% pay cut because revenue dropped just 5%. Remember, though, that revenue at an ad agency only drops 5% in years that are essentially a recession. In 2008, Omnicom cut the pay of its top 500 to 1,000 people in the company by about 75%. However, the company issued a lot of stock options that eventually went on to be very valuable in the recovery. Omnicom has a more flexible cost structure than either WPP or Publicis. It's possible this reflects differences in how the companies are run. A more plausible explanation is that Omnicom does more business in the U.S. and it's super easy to hire and fire people in the U.S. compared to Europe. Omnicom's U.S. business is 60% of the company. WPP only gets 35% of sales from the U.S. Publicis gets 48%. I'm not sure geographic mix alone explains the differences between Omnicom and those two peers. In the crisis year of 2008-2009, Omnicom's EBIT margin dropped from 13% to 12.2%. Not a big drop. Publicis saw its margin drop from 16.7% to 15%. That's a bigger variation. And WPP had a drop from 16% to 12.7%. That's a very big drop. Omnicom's margins aren't always the highest in the industry. But, Omnicom's management has always said that the margin mix between different businesses is small with the exception of field marketing. Field marketing is labor intensive – and requires basic work done by a lot of people – and has lower margins than other marketing services. Omnicom does more field marketing than its competitors. Another factor in margin can be whether a company spends to develop its own skills in house or makes acquisitions. Omnicom spends much less on acquisitions and gets better returns on its capital allocation overall than either WPP or Publicis. WPP is a smart acquirer. Omnicom is a cautious acquirer. Publicis doesn't add value through its capital allocation. Maybe it destroys some value. So, Omnicom's margins are lower than its two closest peers. But, Omnicom is generally run in a way that suggests it's very financially disciplined. The long-term variation in results in the lowest of any ad company. And Omnicom's capital allocation results are the best of any company.

Returns on capital in advertising are high to infinite due to negative working capital. Omnicom generally has negative 20% working capital. It has varied from negative 16% to negative 23%. The negative 16% figure happened in 2008 when clients were hoarding cash. There was a financial crisis. And that is the time when a company sees the most pressure on timing of payments. Omnicom's clients had their worst liquidity position at that time – as did everyone in the world. So, the 2008 panic can be seen as a minimum. Omnicom's working capital deficit should always be at least 16% of sales. We know that at WPP, reported revenue is 20% of billings. Applying this assumption to Omnicom, working capital would tend to be negative 4% of billings. That means Omnicom – on average – probably pays its bills two weeks after it receives payment. That sounds like a small thing when put in time terms that way. But, we are talking about billions of dollars that clients are providing in financing instead of shareholders. If Omnicom paid bills and received payments at the same time, it would need to retain earnings for some time to eliminate the deficit. Quan and I don't see any reason why this will ever happen. For example, in 2015, Coty attempted to slow payments. It asked agencies to agree to 150 days between work being billed and paid. To put this in perspective, P&G pays its agencies within 30 to 75 days of work being billed. Omnicom, WPP, and Dentsu all said they would not participate in pitching to Coty under those terms. Clients don't have a lot of bargaining power relative to agencies. Agencies can choose to band together by announcing their intentions. They don't need to explicitly coordinate actions to make it clear they won't accept worse financing terms. It would be hard for many marketers – Coty, P&G, etc. – to all band together and insist on better terms. Quan and I think the big agencies would rather resign an account than give in on the principle of negative working capital. As Martin Sorrel of WPP said: "We have basically taken the position, as you know, that we are not a bank. We said that a long time ago and that we are not in a position to act as a bank and fund clients. The bank should do that, even if there's a discounted receivable scheme, because ultimately although interest rates might be low now and it be an acceptable cost now, when interest rates rise, which is likely, it wouldn't be there." It's true that ad agencies are such stable businesses that they can access commercial paper markets. So, in a period of very low interest rates, agencies could borrow very short -term and fund clients by giving them more time to pay. That's a very bad and very dangerous idea. For one thing, commercial paper was not accessible during the crisis. If conservatively financed, ad agencies can survive all financial crises, depressions, etc. with little risk of bankruptcy. They are very financially sound institutions as long as they get paid by clients before they pay their own bills. If you ever changed that recipe, the quality of ad agencies would decline somewhat because return on capital would go from infinite to finite. More importantly, the safety of the agency model would decrease a lot in times of recession and crisis. Ad agencies often have their worst credit ratings, worst earnings, etc. at the exact moment that liquidity in the financial system is at its lowest point. It's important that clients continue to fund agencies. This provides effectively infinite returns on tangible equity for shareholders. And it provides financial strength for the firm. Having a working capital deficit is the critical part of the ad agency model. Quan and I see no reason it will ever change. Advertising would be a very different business if it did.

CAPITAL ALLOCATION

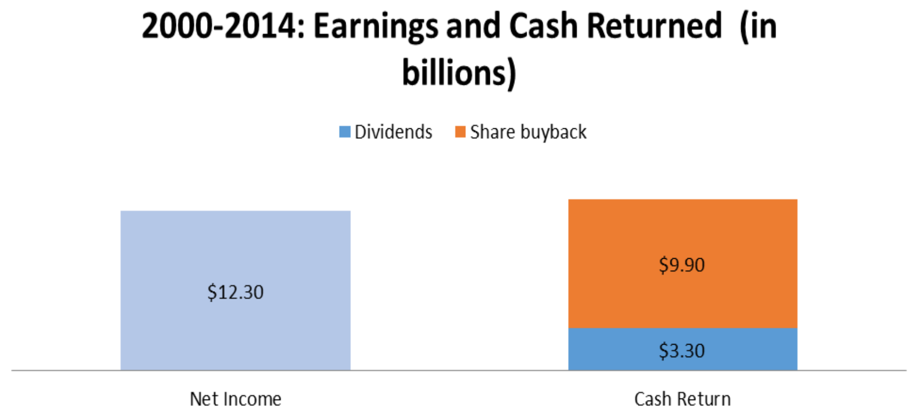
Omnicom Uses Most of its Free Cash Flow to Reduce the Number of Shares Outstanding Every Year

From 2000 through 2014, Omnicom paid out 107% of its reported earnings through a combination of stock buybacks (80% of reported earnings) and dividends (27% of reported earnings).

The results of Omnicom's capital allocation have been excellent. From 2000 through 2014, the company returned a total of 107% of its reported earnings in dividends and share buybacks combined. This leads to an excellent total return for shareholders, as long as they are careful enough to only buy Omnicom stock when it is not expensive and then keep the stock for the long haul.

Omnicom's capital allocation has two big negatives that might bother some potential shareholders. One, it dilutes shares outstanding by about 1.5% a year. This is before buybacks. It is for employee compensation. Employees are well compensated. And top employees – like the CEO, John Wren – get some very big paydays based in a lot of stock. Omnicom's actual share count declines over time. At the end of almost every year, Omnicom will have less shares outstanding than it did at the start of that year. This is because free cash flow is very high relative to net income and Omnicom uses much of its free cash flow to buy back its own shares. Omnicom spends less money on acquisitions than its peers. So, it is able to buy back more stock. The second big negative is creative – or aggressive – financing. It's possible some of the unusual financing ideas – like some bonds we'll be discussing in a moment – were Randall Weisberger's ideas. Weisberger was Omnicom's CFO for a long time. And Wren was – and is – Omnicom's CEO at the same time. So, it can be hard to disentangle one man's philosophy from the other. It's possible that the experience of going through the financial crisis and the fact that Weisberger is no longer with Omnicom means the company may use different or less financial engineering in the future than it did in the past. On a net basis, Quan and I really aren't bothered by these issues. We like Omnicom's capital allocation more than almost any other company out there. Sequoia – a great value investing fund – was very bothered by Omnicom's decision to issue a lot of stock options to its top employees in the crisis. And Omnicom is a constant share diluter. But, what matters is growth in intrinsic value per share. And Omnicom has managed to give a lot of shares to top employees while still growing intrinsic value per share faster than other companies – including other ad companies. That's what matters most.

There is one extra concern about the options. As Sequoia alluded to at one of its investor days, Omnicom was mentioned – years ago – in an article about stock option backdating. Some big, public U.S. companies did backdate stock options to make sure they were issued at the lowest or close to the lowest price of a given quarter. This makes the options more valuable to the recipient and more costly to the company giving the options. It's also dishonest. I don't know whether Omnicom's board did this. However, I do know that the company times option issuance long-term. This is in



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many ways much more important than short-term timing of options. And it's really unusual for a company to think this way. Basically, Omnicom is more likely to issue a lot of options to top employees when the stock is cheap. This is not at all true of other companies. Many companies issue a lot of options when the stock is in favor rather than out of favor. Employees receive stock options either like they are just averaging into the stock by buying the same amount constantly. So, like an indexer. Or, they receive stock more like they are a momentum investor. It's rare for employees to receive stock the way we would buy shares – as value investors. But, historically, Omnicom has actually issued a lot of options when the stock was very cheap relative to intrinsic value. It has then not issued options when the stock was more fairly priced.

Let me take you through the episode that bothered Sequoia so much. In 2009 – at the worst point of the financial crisis – Omnicom issued options to purchase 22.6 million shares. All options were issued to Omnicom employees. This was equivalent to granting them 7.3% of total outstanding shares. Put another way, it's like shifting a little under 7% (maybe 6.8%) of the entire company from the hands of existing shareholders to the hands of employees. Now, the options weren't granted at a zero dollar strike price. So, it's not just a wealth transfer that way. There is uncertainty as to the future price of the stock versus the price the option can be exercised at. But, not much here. The options were issued on March 31st, 2009. The exercise price was $23.73 a share. To put that in perspective, we are saying Omnicom stock is worth buying now and it is $80 a share or higher. It's also seven years later. Omnicom stock had been a lot more expensive till early 2009. The company didn't issue any options to top executives from 2003 through 2008. In a sense, Omnicom issued options during bear markets and didn't issue options during bull markets. That's an oversimplification. But, it gets to the heart of this issue. At the same time a value investor like Sequoia would want to perhaps buy more Omnicom stock – the company was actually shifting ownership away from outside shareholders and to employees. Omnicom's CEO John Wren got 500,000 options at $23.73 a share. If OMC stock was then trading at about 50% of its intrinsic value – as I believe it was (this was a $50 stock trading for a little under $25 in the crisis) – then what Omnicom did was basically pay Wren a $12 million bonus.

Was that fair? Omnicom had good reasons for doing this. As we mentioned, Omnicom's margin declined way less than the margins at either Publicis or WPP. The company obviously reduced pay-out to top employees. The top 500 or 1,000 people at Omnicom would make a lot less money without these options. Normally, Omnicom grants restricted stock units instead of options. At lower prices, Omnicom needs to issue more restricted stock units to provide the same compensation. So, it didn't want to do that. Eventually, John Wren made something like $20 million off options. Like we've said, he's very well paid. But, he still makes far less than the CEO (and founder) of WPP, Martin Sorrell. Over the last decade or two, Wren has done better running Omnicom's capital allocation than Sorrell has done running WPP's capital allocation. Sorrell is good. The second best in the industry. But, honestly, Omnicom's long-term results for shareholders are better even than what Sorrell has managed to deliver. So, is it worth it to shareholders? Is the option issuance in 2008? Is the high stock compensation to employees in restricted stock and/or options? Is the generally high compensation to Wren? I don't know. Maybe some of it could be less. But peers do it too. And anyone could leave Omnicom's agencies for the agencies at Publicis or WPP. This is what Omnicom wanted to avoid. With pay cuts and without options, they feared that top people would defect in the crisis and the Great Recession that followed. I think that's a valid fear. What matters most to investors is the total effect on share dilution. Long-term, the combination of restricted stock and options has grown Omnicom's shares outstanding by 1.5% a year before buybacks. But, those buybacks have been big. So, Omnicom's actual shares outstanding figure always declines.

Omnicom had 374 million shares in 2004 and 247 million shares in 2014. This is a 4% annual decline in share count over 10 years. So, Omnicom adds 4% annual growth to EPS through buybacks. It also pays out a dividend. So, your return in Omnicom is dividend yield plus organic sales growth plus 4% share buyback sales growth. Remember, Omnicom would dilute by about 1.5% a year without buybacks. So, it's actually spending enough to buyback 5% to 6% of the company each year. Buybacks are the main use of cash flow.

Over the last 10 years, Omnicom has spent less on acquisitions than either Publicis or WPP. WPP spent 44% of cash flow on acquisitions. Publicis spent 43%. Omnicom spent just 16%. Omnicom generally makes small acquisitions. For example, in 2005, Omnicom didn't consider buying Grey. WPP bought Grey for $1.75 billion. It had sales of about $1.5 billion. This was a good deal for WPP and could've been a good deal for Omnicom. But, it was a big deal. Big deals tend to be more expensive and harder to integrate. The two biggest deals Omnicom has done in the last two decades were both done in 1998. Omnicom bought Abbott Mead Vickers and Gold Greenlees Trott in that same year. AMV was then the world's 20th largest agency. Omnicom had owned a stake in AMV for 7 years. It did a stock swap for the whole company. Omnicom was trading at 2.7 times sales at the time – this was the dot com bubble – and AMV for just 2.2 times sales. So, it was a good deal. GGT was a $235 million dollar deal. At this time, peers like Interpublic were on acquisition binges. So, even in 1998, Omnicom's activity in terms of buying stuff was relatively tame. Recently, Omnicom hasn't spent more than about $100 million on one acquisition at one time. Since 2001, Omnicom has made a total of 193 acquisitions. The average acquisition had a $15 million up front payment combined with a $9 million earn out agreement. So, we are talking about an average deal size of $24 million. Omnicom says most acquisitions are a "make or buy" decision. The company buys a marketing services agency instead of developing the competency in house. Either way, it would cost Omnicom something to gather the right talent in the right place and compensate them accordingly.

It's possible Omnicom has been too conservative in passing on some deals. The company didn't buy Grey, FCB, or Razorfish. All those deals were eventually done by somebody else at a decent price. Finally, and most famously, we need to discuss the Omnicom and Publicis proposed merger. It fell through. It's not going to happen. This would've been a great deal for Omnicom and a horrible one for Publicis. It was structured as a merger of equals. Omnicom had $998 million in net income and Publicis had $947 million at the time. It's been speculated – for example, you can read Sequoia's understanding of the situation in one of their investor day Q&As – that this was really going to be a takeover of Publicis by Omnicom and it was being done because Omnicom has better management than Publicis. Wren and Levy (the rather old head of Publicis) would be Co-CEOS for a while. Then, Wren would run the company. Then, when Wren retired, the directors from Omnicom would pick the next couple CEOs. If that speculation is true, it certainly means that the Omnicom half would've controlled the top spot at the combined company for 30 years or more. And perhaps many, many more. Wren and Levy have certainly run their respective companies for decades. The deal was a potentially strange one. On the one hand, it would've been very synergistic. On the other hand, capital allocation at Publicis and Omnicom has been completely different. Publicis is attracted to seeking fast growth and digital acquisitions. Omnicom is attracted to buying back its own stock, making small acquisitions, and spending more money developing digital internally rather than buying it than any other big ad company. If the deal happened and Omnicom's people eventually filled the CEO and CFO roles – I think it would've been a terrific success long-term. But, it's hard to do a deal like this especially when it comes to fighting about who is really buying whom. A deal this big may never happen in the advertising world.

Finally, I mentioned creative financing. Omnicom has done some strange things in the past when it comes to how it raises capital. In 2001, the company issued $850 million in senior unsecured zero-coupon bonds. The bonds were due in 2013. They were convertible into 15.5 million shares. That's equivalent to $55 a share. At the time, that was 40 times earnings. So, it's like issuing a security that is a zero coupon bond – a bond that sells at a deep discount to its value at maturity, but pays no interest between now and maturity – that you could turn into stock at a 40 P/E. You can see why Omnicom would issue such a security. The company's stock was overpriced. The security was more complicated than these headline figures though. You can go to the "Notes" section and look on page 8 of the "Capital Allocation" section for all the details. There were certain things – most worryingly, a two notch credit downgrade – that could trigger an event where holders could "put" the bonds to Omnicom. Basically, if Omnicom's credit rating was downgraded far enough, bondholders could force Omnicom to cash them out at a good price. Omnicom did a series of such transactions.

These were smart, speculative decisions. Interest payments were low. The convertible price was high. And there were probably tax advantages to doing it as a zero. The two risks are that Omnicom stock would have too good a long-term return due to stock buybacks. This is a risk. But, it's a manageable one. It means upside is capped for long-term shareholders because some bondholders could convert if OMC stock did really well for a decade or so. That doesn't worry us. What worries us about doing something like this is the put part. In February 2009, $841 million worth of these bonds were put to Omnicom. Omnicom was fine through the crisis because cash flow as good and it had access to credit. But, Omnicom's working capital deficit shrank from negative 21% in 2006 at the economy's boom to negative 16% in December 2008 at the economy's bust. Then, in February 2009, the bonds were put. So, you have a 5% of sales decline in the working capital deficit. This is a 5% of sales cash outflow over a couple years. In addition, you have earnings down 15% to 20% in a crisis year. Not a bad performance at all. But, still coinciding with the bonds being put.

Right now, Omnicom uses short-term credit instead of these sorts of bonds. It may never issue these kinds of bonds again. The unique appeal of these bonds to Omnicom was its own high stock price combined with low interest rates. That happened from 2000-2003. Today, interest rates are low. But, Omnicom is probably 50% cheaper than it was when it did these convertibles. The company wasn't risking a lot by issuing a bond convertible at 40 times earnings. They knew that interest rates in 2000-2003 were abnormally low. And they knew a 40 P/E was abnormally high. So, Omnicom tried to take advantage of this. In fact, they did take advantage of this. But, its's essentially just a financial speculation any investor can make. It made sense because shorting a stock with a P/E of 40 and shorting a zero coupon long-term bond both made sense in the early 2000s.

Today, Omnicom's debt costs between 3.6% and 6.3% and is due from 2016 through 2024. It is mainly medium term and floating. One odd feature of Omnicom's current situation is that it entered into an interest rate swap to switch some fixed debt to floating. This is a bit weird, because companies often prefer low fixed rates. And the rates Omnicom had (3.6% to 3.7% due in 6 to 8 years from now) were perfectly good rates. This could be a speculation on short-term interest rate changes. Maybe the company expected lower LIBOR rates for longer. If so, it's speculative. And it wasn't really necessary to do this.

Historically, Omnicom's choice of how to finance its operations has been unconventional and speculative. It's also been smart. That's not important though. The company's discipline in rarely buying other companies and constantly buying back its own stock is what matters. Quan estimates that Omnicom's return on retained earnings has been higher than 13% a year during the 2000s. This is much better than Publicis and WPP. In fact, very few companies are able to sustain a 13% return on retained earnings. Here, we mean earnings not paid out in dividends. For Omnicom, a lot of its return has come from buying back its own stock. When priced like an average stock, Omnicom is an excellent buy and hold investment. So, it's a great idea for the company to focus most of its free cash flow on buying back stock each year. Omnicom is what Charlie Munger calls a "cannibal". You can be sure there will be fewer shares of Omnicom outstanding when you sell the stock than when you buy it. If you become an Omnicom shareholder, you know your own personal slice of the Omnicom pie will grow each year.

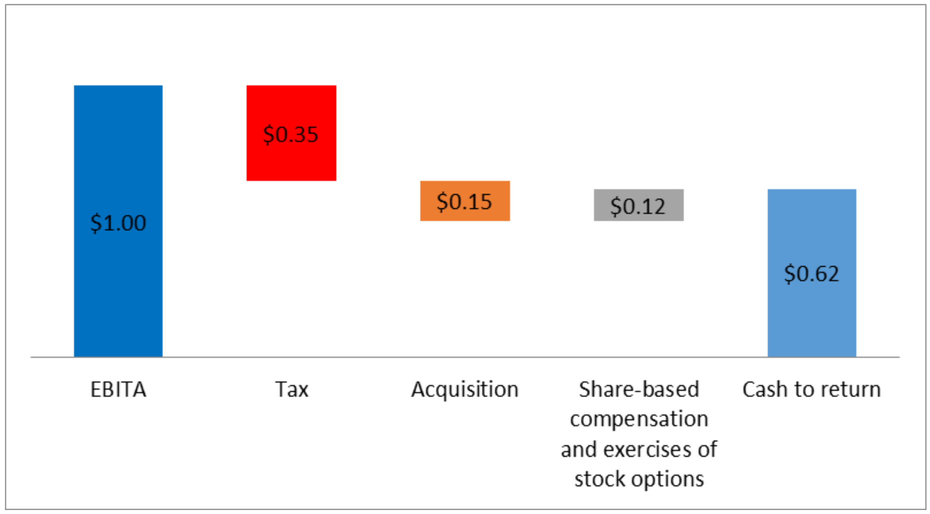
VALUE

Omnicom is Such a High Quality Business That It Can Only Be Considered Fairly Priced When it Trades at a P/E of 20 to 25

Omnicom trades at 11 times EBIT. This is a normal price for a normal stock. Today, stocks are expensive. So, Omnicom is not an expensive stock compared to other choices available today. It is also not an expensive stock compared to its own past. Most importantly, Omnicom is actually cheap relative to its intrinsic value. Advertising agencies are about the best businesses in the world. Omnicom is probably the best run ad agency holding company in the world. It is capable of turning every dollar of pre-tax profits into 62 cents of free cash flow that owners actually get to keep. In other words, when Omnicom trades at 10 times EBIT it is trading at a price that yields 6.2% after-tax purely in terms of stock buybacks and dividends. In addition to this 6% returned to shareholders you get both organic growth and acquired growth. The combination can easily provide a high return for shareholders even when those shareholders buy Omnicom stock at a "normal" price of around 10 times EBIT.

Omnicom is best valued against its peers. The company has 5 publicly traded peers around the world: WPP, Publicis, Interpublic, Havas, and Dentsu. WPP trades for about 12.6 times EBIT and 13.5 times our estimate of normal earnings. We use a long-term median operating margin and apply it to current sales. Omnicom's 25-year average operating margin is the same as its current operating margin. WPP's margin is a little higher than its average. Even if you ignore this fact, WPP is still trading at about 12.5 times EBIT versus about 10 times EBIT for Omnicom. WPP is the closest and best peer for Omnicom. It has the best acquisition record. It has the best capital allocation next to Omnicom. If all ad companies were available at the exact same multiple, investors should buy Omnicom first and WPP second. But, WPP would be a close second. Today, investors should prefer Omnicom stock over WPP because WPP is about 25% more expensive than Omnicom.

Publicis is an inferior peer to Omnicom and WPP as a stock. The business is very similar in quality to Omnicom and WPP. However, capital allocation at Publicis has been much worse. The company's return on retained earnings has been worse. So, long-term, the stock is bound to perform worse than WPP and Omnicom when priced the same. Publicis is not priced the same as Omnicom. It trades at 13.7 times last year's EBIT. We put the price at 12.9 times "normal" EBIT. Publicis is about 30% more expensive than Omnicom. Publicis is not superior to Omnicom in any way. It is the equal to Omnicom in many respects. And then it is perhaps inferior to Omnicom in geographic mix. Omnicom gets more of its sales from the U.S. and less from Europe. And Publicis is definitely inferior to Omnicom in terms of capital allocation. This is a huge deal for an ad company. As we mentioned, Omnicom is able to return 62 cents after-tax for every one dollar earned pre-tax. This is after acquisitions. Ad companies can actually translate something like 105% of earnings into free cash flow. The long-term average for Omnicom has been around 107%. So, an ad company has a huge amount of capital to allocate. The business doesn't require reinvestment at the agency level. So, all that free cash flow is available to be directed by the board. They can pay down debt, acquire creative agencies, acquire marketing services agencies, pay a dividend, or buy back stock. Which of these actions they choose to take is very important. Omnicom has focused more on buying back stock than its peers. Therefore, its return on retained earnings has been higher. Publicis



For each dollar of pre-tax profits, Omnicom can return 62 cents in after-tax cash to its shareholders.

should not be valued any higher than Omnicom. Yet the stock costs 30% more.

Interpublic is a little tricky to value. The stock goes for 11 times EBIT. We would say this is also 11 times "normal" EBIT using the sales times median margin approach Quan and I prefer. However, there is a case to be made that this undervalues Interpublic's "potential" EBIT. Of all the companies we'll be discussing, Interpublic has the worst history. It owns a good creative agency in the U.S. and elsewhere. Interpublic is McCann. It has strong positions in creative and media buying. And it has a strong geographic position in the U.S. Interpublic is weak in marketing services agencies. It is not as diversified as Publicis, WPP, and Omnicom. And it may not be in as good a position to capture a larger share of wallet from its customers. But, the U.S. is a good market. Creative is a good business. And Interpublic should be capable of having better margins. If the company has the same EBIT margin as Omnicom has had in the past – it wouldn't be expensive at all. But, Interpublic hasn't achieved that in recent years. Nor has Interpublic achieved that on average. However, the average includes some troubled years. Interpublic serves many of the same sorts of clients in many of the same ways in many of the same geographies as Omnicom. Marketing services agencies shouldn't necessarily have much higher margins than the combination of creative and media buying. So, it's possible Interpublic is – of all 6 companies we'll discuss here – the one ad company that is under earning its potential. Interpublic is 10% more expensive than Omnicom. And it's unproven. Interpublic may have as much – or even more – upside than Omnicom. But, it is not a safer bet than Omnicom. And it is more expensive relative to its actual long-term past record.

Havas goes for 13 times EBIT. That is 30% more expensive than Omnicom. Havas is smaller than the other companies we are discussing. It is comparable to inferior in most other respects.

Dentsu is not a good investment option at all. The stock goes for 16 times EBIT. So, it is 60% more expensive than Omnicom. And where Omnicom gets an especially good chunk of its earnings form the U.S. – Dentsu gets an especially large chunk from Japan. It's much better to be concentrated in the U.S. rather than in Japan. Dentsu is probably the worst choice among the stocks we're comparing here.

A fair price for Omnicom would be about 13 times EBIT. Quan estimates that 13 times EBIT is equivalent to 21 times truly free cash owner earnings. So, this is a 4.8% yield. Basically, Omnicom can return 5% of a shareholder's purchase price if that shareholder buys the stock when it trades at 13 times earnings. The money is returned through a combination of buybacks and dividends. Omnicom can grow its sales by between 5% and 6% a year. Its market share does not decrease over time. And advertising spending as a percent of GDP has been fairly constant in developed economies – like the U.S. – for the last century or so. It's cyclical. But, it has no trend up or down. It's very reasonable to assume that Omnicom can grow at the same rate as nominal GDP of the economies it is in – mainly, U.S., E.U., and U.K. – while paying out the vast majority of its earnings. The stock has 1.5% annual share dilution. So, at a price of 13 times EBIT, we'd have about 5% worth of dividends and buybacks plus 5% to 6% of growth – we'll use 5% to be conservative – minus 1.5% in employee compensation drag on the share reduction rate. So, that's an 8.5% return if the stock trades at about 13 times earnings or about a P/E of 21. That's a fair price. An 8% return is a fair return for a "normal" stock priced normally. In reality, we expect Omnicom to return 10% a year or better from here on out. The stock is priced at around 15 times free cash flow right now. That's a 6.5% free cash flow yield. Employee comp drag on total return is 1.5% a year. So, that's a 5% free cash flow after assuming Omnicom has to buy back the options and restricted stock it dishes out. If sales grow just 4.5% a year, the stock would return 9.5% a year. Unless nominal GDP of the economies Omnicom is in grows less than 4% a year – I think it's very likely Omnicom will grow sales by more than 4.5% a year. That means the stock will return 9.5% a year or better if you buy today and hold the stock indefinitely. Although Omnicom is not cheap based on its price to reported earnings, the stock has a better chance of returning about 10% a year if bought and held forever than most stocks with much lower P/E ratios.

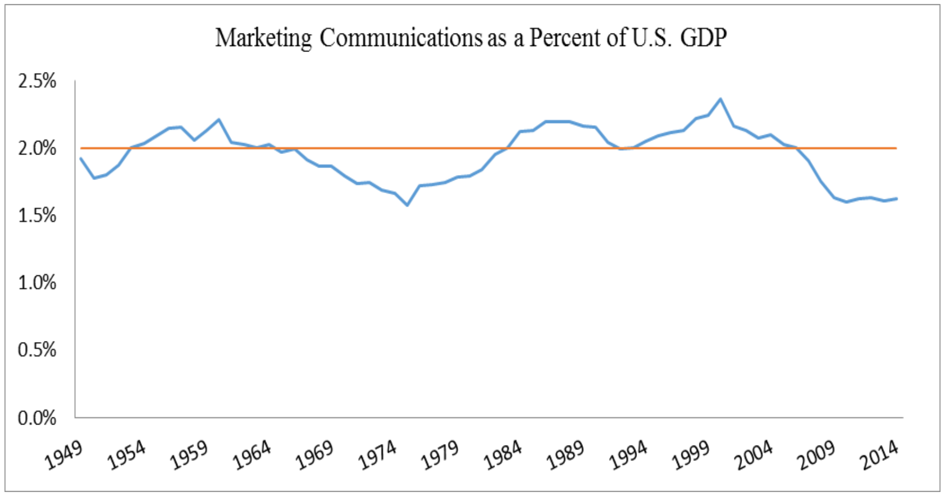
GROWTH

Omnicom Can Grow Companywide Sales as Fast as U.S. Nominal GDP and It Can Grow Sales Per Share Much Faster

Historically, marketing communication expenditure – what we'll call "advertising" – has been about 2% of total GDP in the U.S. We have data from 1949 through today shown in the graph above. There are some data sources from earlier times that suggest the pre-1949 period was not different in this respect. It's likely that for the last 100 years in the U.S. at least, the advertising market has tended to average 2% of GDP and then follow GDP growth. Today, advertising spending is at a lower than normal level. It is probably around 1.5% of GDP. Advertising peaked relative to GDP around 2000. It did not grow as fast as GDP till the crisis. And then in around 2009, advertising fell off a cliff. It has recovered since. But, it hasn't really recovered faster than GDP. So, as a percent of GDP, advertising is at roughly the same low levels it hit around 1980. We can't say for sure that advertising will grow faster than GDP in the future. But, we can say that advertising is at about a 30-year low relative to GDP. Today's advertising levels relative to GDP are similar to the levels seen in the U.S. around 1950 and 1980. So, it's a once every 30 years or so type low. I'm confident that over the next 5-15 years, advertising will not grow slower than GDP. It may grow faster. It's safe to assume advertising will grow as fast as nominal GDP.

Some ad companies like Omnicom have grown at a decent rate even while the market did not. It's possible that part of this is due to capturing more of the market. For example, agencies capture the lowest percent of client expenditure in traditional media – like television – and capture the most in new media (like social media). This is because there is more work done by people at the agency to target specific ads to specific audiences for even small buys. In TV, an ad can be expensive to make. But, then there's not much work in buying time and showing it to millions of people at once. Right now, this is especially true in media buying. Media buying for TV generates relatively low amounts of revenue for an agency relative to the client's total spend. Historically, a media agency might charge a 3% commission. TV networks are a lot more concentrated than online media outlets. Things like key word search and banner ads generate more billable hours of work and more revenue for an agency than buying time on traditional media. The more fragmented media becomes, the more profitable advertising becomes for ad agencies and the less profitable it becomes for the owners of media outlets. For example, since the early days of television – media outlets have become more and more fragmented in terms of the audience size they can deliver while media buyers (like Omnicom) have become more and more consolidated. Long-term, it's possible that buyers of ad space online can grow faster than if they were buying ad space on a TV network. Quan think agencies can grow 1% to 2% higher than GDP over the next 5 to 10 years as advertising as a percent of GDP rises cyclically and as online advertising – like advertising on social media – provides a better sales mix for agencies than buying a lot of TV time.

Omnicom's revenue mix is 60% North America, 26% Europe (16% Continental, 10% U.K.), and 14% Other (mainly Asia). This is one of the best revenue mixes for an ad company. North America has better nominal GDP growth prospects over the next decade or two due to better demographics than Europe. Over the last 10 years, Omnicom grew sales 1% faster than GDP. This is a good record because ad spending overall grew slower than GDP. So, Omnicom grew more than 1% a year faster than the industry. Growth in the U.S. could be 6% a year for Omnicom – it depends on U.S. nominal GDP growth. Growth in the rest of the world is more complicated. It could be as low as maybe just 4% in Europe. Maybe 5%. But, there is the potential for quite slow growth in European advertising. And Omnicom is not especially strong in Europe. But, Omnicom is strong in Asia relative to every other global ad company except WPP. WPP is probably a lot bigger than Omnicom in Asia. I say probably because WPP doesn't separate Asia from other regions. But, it's safe to assume WPP is the leader in Asia. Meanwhile, Omnicom is about 50% bigger than Publicis, Interpublic, and Dentsu in Asia. Those three are about similar sized in Asia. There is the potential for a lot of growth in Asia for all these companies. Asia is 33% of the world's advertising spending. But, Asia is just 12% of Publicis's total revenue, 12% of Interpublic's revenue, and 10% of Omnicom's revenue. The most likely explanation for this is that these companies generate much of their Asian revenue doing work for multi-national companies headquartered in Europe and the U.S. rather than for companies headquartered in Asia. These companies could gain more clients in the region based on their work for multinationals. They can also focus their acquisitions on Asia. For example, Omnicom doesn't buy much in the U.S. Overall, Omnicom should be able to grow – including acquisitions – at least 6% a year in Asia, and maybe a lot faster. But, combining this with European growth that could be as bad as 4% really brings down Omnicom's overall growth prospects. Using a worldwide average, Quan and I have come up with a compromise estimate between us of between 5% and 6% a year in sales growth for Omnicom. However, this is complicated by currency. Omnicom reports in U.S. dollars. We are talking here about constant currency in all countries. I don't think it's a good idea to look at revenue booked in Asia – for example – but converted into U.S. dollars. That's not meaningful because it will mostly just reflect the rise and fall of the dollar. The dollar has risen a lot recently. But, there are other currencies that we could see falling against the dollar over the next 5 or 10 years. So, I'm not sure it's worth saying anything about currencies except that you should always focus on constant currency results and never pay attention to sales results once they've been converted into dollars. We expect Omnicom to grow 6% in U.S. dollar terms in the U.S., we expect Omnicom to grow 6% in local currency terms in Asia, at least 4% in Pounds Sterling in the U.K., and at least 3% in Euros in Europe. We have no predictions about what 3% growth in Euros would be when translated into dollars. And we don't think you should pay any attention to this. In the very long-run, currencies won't do much but cause volatility in Omnicom's results. The company's revenue and costs both match up in local regions for the work done in those regions. Omnicom is not an exporter or an importer. It just operates in a bunch of different countries with different currencies and then translates that back to the U.S. Overall, we think it's best to assume 5% constant currency growth for Omnicom from now till basically forever into the future.



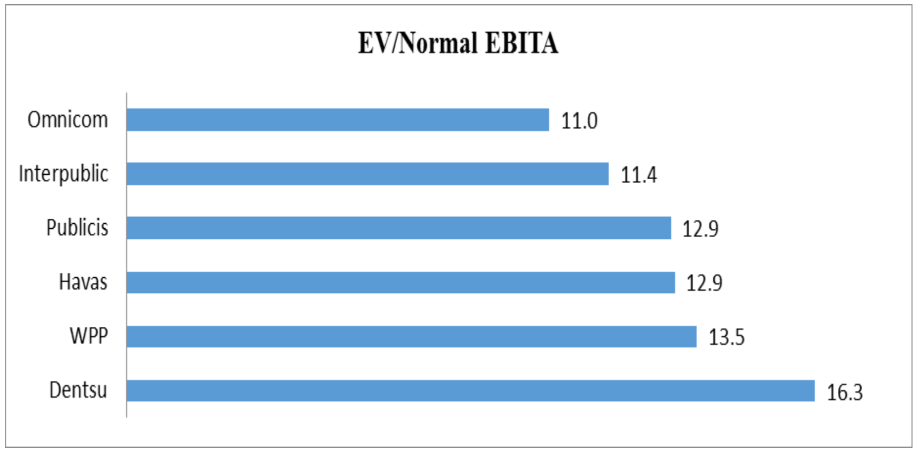
Over the last 65 years, advertising spending in the U.S. has ranged from 1.5% to 2.5% of GDP

MISJUDGMENT

Why is Omnicom Cheaper Than the Other Big Global Ad Agency Holding Companies?

There are two risks of misjudgment at Omnicom. The first risk is a risk because we simply don't know anything about it. It's digital. Is Omnicom strong enough in digital? Omnicom has only grown sales by 4.6% a year – as a company – over the last 10 years. Now, what matters is the return to shareholders. And since Omnicom both buys back stock and pays a dividend – the return to shareholders can be quite a lot higher than the company's overall revenue growth. But, some investors could be concerned that Omnicom doesn't grow much. I'm not sure if this fear makes much sense. Over the last 10 years, advertising spending as a percent of GDP clearly declined. Also, over the last 10 years, nominal GDP growth was weak. In the long-run, the advertising industry tends to track nominal GDP growth. So, what matters in any point in time is how high or low advertising is relative to nominal GDP. For example, Quan and I think advertising in the U.S. has been so weak relative to GDP over the last 5-10 years, that it could grow 1% a year faster than nominal GDP over the next 5-10 years, and there'd be no problem of ad spending being too high. It would be just right relative to GDP. Advertising cycles are long. So, as much as 1% of growth could be due to a cyclical lull in advertising versus GDP. Over the next 10 years, in the same nominal GDP environment, a company that grew 4.6% a year could grow 5.6% a year. That's our thinking. But, other investors might think sales growth of just 4% to 5% a year at Omnicom over the last decade means the company lacks the digital skills needed to keep up with the competition.

WPP and Publicis talk about how much revenue they get from digital. WPP once said it got 36% of total revenue from digital. Publicis said 42%. Publicis spent over $6 billion buying 4 digital agencies: Sapient ($3.7 billion), Digitas ($1.3 billion), Rosetta ($575 million), and Razorfish ($530 million). Omnicom doesn't spend that kind of money on acquisitions. And investors might actually like that Publicis does. So far, the numbers support Omnicom over Publicis in this regard. Omnicom's return on retained earnings has been higher than 13% a year. Publicis's return on retained earnings has been worse than 9% a year. These are important numbers. Returns in the business of advertising itself are effectively infinite (due to a working capital deficit that grows over time). Agencies are funded by clients rather than shareholders. So, what matters to your long-term return in an advertising stock is: 1) The price-to-sales you pay when you buy it 2) The rate of organic sales growth at the company 3) The amount of earnings the company retains 4) The return on the retained earnings. Earnings in advertising are retained – that is, not paid out in a dividend – to either make an acquisition or buy back stock. Publicis has favored acquisitions. Omnicom has favored stock buybacks. Omnicom is probably right about this for a reason Omnicom CEO John Wren explained in 2012: "Increasingly clients are looking to go to a smaller group of agencies to reduce the roster number of vendors that they have to interface with so a lot, in my view, of the valuations for one-off small digital companies have been good on owners since they've gotten decent prices through selling it, but they aren't really justified when you compare it to the growth in the general market and some of the trends which are going on." In other words, the desire by clients to have their digital needs served by their primary advertising agency relationship means the sellers at places like Sapient, Digitas, Rosetta, and Razorfish get good prices. It doesn't mean Publicis gets a good return on its investment.



Omnicom has the best capital allocation of any ad agency holding company – yet it trades for the lowest price to "owner earnings"

Omnicom doesn't provide information on digital revenue. It's possible Omnicom lacks certain skills that Publicis and WPP have in digital. The evidence for this is that Publicis and WPP spent billions on acquisitions – Omnicom didn't. And Publicis and WPP disclose digital revenue. Omnicom doesn't. But, neither do several other publicly traded ad agencies. To be fair to Omnicom, it really doesn't seem to make any sense to break down sales by digital versus non-digital work. The logical ways to break down revenue are by geography (especially the currency a client is billed in), by client (and the client's industry), and by discipline (so, PR versus creative). WPP and Publicis talk about the amount of revenue they get from digital. But, it's unclear if those numbers are really that high. For example, we know that Dentsu bought Aegis in 2013. Aegis was an independent media network. It wasn't owned by any of the big companies we're talking about. Yet digital revenue now accounts for 43% of Aegis's revenue under Dentsu's ownership. This wasn't a specifically digital acquisition. And yet there was no problem getting revenue at Aegis up to the levels of digital revenue at big ad companies that do acquire digital agencies. Likewise, in 2010, the then CFO of Omnicom mentioned that PR revenue was probably 30% digital by then. This was more than 5 years ago. And revenue was already 30% digital. Omnicom's a leader in PR. But, its agencies are traditional PR agencies. They weren't bought as specifically digital acquisitions. And yet, 5 years ago, they had already transitioned to getting almost a third of their revenue from digital. So, it may not make sense to go out and acquire specific digital agencies to gain those skills the way Publicis and WPP have. It may make more sense – and generate better returns for shareholders – to develop organically into digital along with client needs.

Omnicom's CEO, John Wren, has talked about digital twice in ways I think it's important to repeat. The first was in 2012: "…we've always believed that anything can be digital, will be (digital), and that means pretty much everything we do. We have long encouraged and helped our agencies to invest in digital skills sets and talent, and they all have. Whether in brand advertising, shopper marketing, PR or any of our disciplines, all of our agencies have developed and hired talent to embed digital capabilities in our core offerings." The other point Wren made is simply that Omnicom's agencies around the world are always hiring people and these people will have more digital skills in the future than they did in the past. In 2012, Omnicom's CEO said: "…we're in the service business. The average age of our employees is early 30s. The digital capability of those people becomes more ingrained every day and the distinction between what was called traditional and digital diminishes every day." Remember, in just a couple years, the median aged employee at all global ad agencies will be a millennial.

So, the risk of misjudging Omnicom in digital can be that the strategies of acquiring digital capabilities at Publicis and WPP will work better than the strategy of growing digital purely organically at Omnicom. Omnicom does make acquisitions. But, each acquisition is really, really small. So, it could never transform itself digitally through acquisitions. Quan and I think the risks to making acquisitions like Publicis and WPP do in digital – and elsewhere – are much higher than the risk of not keeping pace with the leaders in digital because you failed to make those acquisitions. We'd prefer a company that didn't buy big, digital businesses over one that did. Other investors may feel differently. It's possible this can contribute to why Omnicom is actually a bit cheaper stock than WPP, Publicis, etc. It's also possible that because Omnicom doesn't seem to put as much effort into investor relations this could hurt the company. I'm not sure of any of these explanations. I think it can just be mostly other rather random reasons that explain Omnicom's lower price. It's a big, U.S. stock. I think those are cheaper now than stocks in the markets where WPP (U.K.) and Publicis (France) now trade. Omnicom is also cheaper than Interpublic. But, there's a legitimate question of whether Interpublic could improve its operations over time and thereby grow earnings faster than peers. Interpublic has usually had a worse margin. So, if priced on its future potential, investors could be pricing it on EV/Sales rather than EV/EBIT. Omnicom is a very, very boring U.S. based company. It's the most predictable business in one of the world's most predictable industries. This probably explains the lower stock price best.

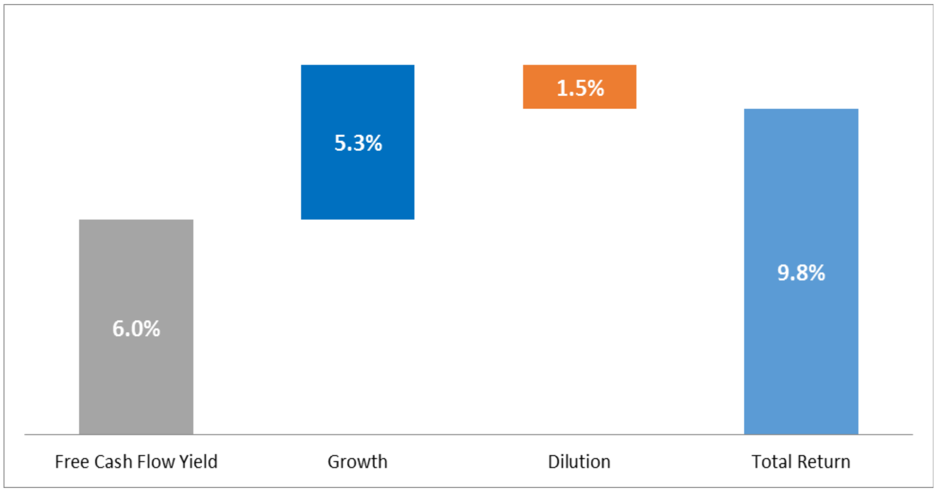
So, Quan and I don't see Omnicom's lack of big, digital acquisitions as a risk. We do wonder about succession. Omnicom's capital allocation has been excellent under CEO John Wren. The company's long-term CFO, Randall Weisenburger, left. So, he won't replace Wren when Wren retires. The longest track record we had was for the CEO Wren and CFO Weisenburger. Wren is 62. Wren was asked about retirement in a 2007 interview: "I think it's more of a problem for my competitors than it is for me. Michael Roth is 60. Martin is 61, and I know he'll be 62 on Valentine's Day. Maurice is 64. I won't be CEO when I'm Martin's age." A few interesting points here. One, Wren is now the age Martin Sorrell was when Wren made that comment. He's 62. And yet he is still the CEO. And there's been no announcement about if and when he'll leave and what succession will be like. The second thing is that Michael Roth, Martin Sorrell, and Maurice Levy are still running Interpublic, WPP, and Publicis respectively. So, nine years ago, Wren mentioned the names and ages of people at the big, global ad companies. They sounded near retirement age (60 to 64 years old). Yet, they're still there. And Wren's still at Omnicom despite saying nine years ago, he didn't think he'd still be there.

Capital allocation is key to Omnicom's success Wren has done a better job running Omnicom than many others might do. Omnicom has succession planning throughout the company. And there should be as many qualified people at Omnicom to take over as anywhere else in the advertising industry. In fact, Sequoia seemed to feel that one of the reasons for the proposed Publicis and Omnicom merger was that Omnicom had better potential successors at the top executive levels than Publicis did. The heads of advertising companies stay basically forever. As a group, they have the longest tenures of any heads of any public companies I can think of. Sorrell has been at WPP (he founded it) for a very time. Levy has been at Publicis (he took over from the founder) for a very long time. For most of the period we've shown you in this report – see the datasheet at the start of the issue for a quarter century of financial results – Omnicom has been run by John Wren. So, it's possible that the good capital allocation at the company was more the result of one person than the corporate culture at Omnicom. This is an important issue, because over the long-term, Omnicom has been able to create better returns for shareholders than say Publicis or Interpublic because those companies made overpriced acquisitions or other errors at the very top of the company. The differences in stock market results between the different big, global ad companies has been at the corporate level. It's been capital allocation. It's been top management. It hasn't really been at the agency level. The quality of all the agencies these groups own is uniformly high quality and oligopolistic. They all have 90% plus client retention rates, working capital deficits, and the ability to grow along with nominal GDP without retaining any shareholder money to do so. The real danger to an ad company's stock is its own top management. Rivals can't really do much damage to each other. If WPP or Publicis make successful digital investments, that doesn't have much of a direct impact on Omnicom's business at all. The moat around each client relationship is very wide. But, the free cash flow generated by agencies is so high that capital allocation is critical. John Wren could retire this year or in 10 years. Both are reasonable enough guesses. We have no reason to believe the person who replaces him won't be adequate. But, it's hard to imagine someone having a better record of capital allocation over two decades. So, when John Wren will replace and who will retire him and how that person will allocate capital different than Wren did are the most important unknowns at Omnicom.

CONCLUSION

Buying Omnicom at $85 a Share is Like Buying a Perpetual Corporate Bond with a 6% Yield and a Growing Coupon

Buying Omnicom at $85 a share, can result in a 9% long-term return. Omnicom is the best business we've ever analyzed. It is most comparable to Wiley's journal business in terms of quality (both have negative working capital), competitive position (both are in oligopolies), and customer retention (both win very few new customers but rarely lose existing customers). Omnicom and Wiley also both tend to get more of their client's overall spending over time. However, there are differences between John Wiley and Omnicom. The first is that Wiley has two other much worse businesses. These are education and books. They aren't nearly as good as the academic journal business. So, they weigh down the overall business quality. Second, in Wiley's favor, it has economies of scale that Omnicom does not. Omnicom's operating margin never expands. The operating margins of most of Omnicom's peers show no signs of expansion. This is because the business is essentially cost plus. Ad agencies may collect fees or commissions or make money in slightly different ways in different disciplines. But, it's clear that over the entire group, the more work they do in terms of man hours the more money they make in revenue. A large part of Omnicom's expenses are salary and bonuses. These won't stay flat while revenue rises. The pay of people working at agencies will keep pace with client spending. This is different from Wiley. Academic journal publishers can have expanding margins over time. They have economies of scale. Because they are providing much the same amount of work regardless of whether a journal has 100 subscribers or 1,000 subscribers or 10,000 subscribers. And they are providing much the same amount of work per customer whether that customer subscribes to 4 titles or 40 titles. Technology is an important part of Wiley's business but not of Omnicom's. Omnicom's work is more custom tailored to each client. There will be no margin expansion at Omnicom.



Buying Omnicom at $85 a share, can result in a 9.8% annual return if the stock is held forever

On the other hand, Omnicom's market grows faster than Wiley's. The budget of university libraries does not grow fast at all. In recent years, some of these budgets have been flat to negative. That is not true of ad budgets at big companies. Ad spending by big brands will always keep pace with nominal GDP. So, Omnicom can maintain the same margin while growing as fast as GDP. Over the next 5-10 years, it is possible Omnicom's growth could even be a bit faster than nominal GDP, because ad spending since 2008 has been unusually weak relative to GDP.

Omnicom's capital allocation is very good. And it's likely to stay that way. The company competes in an industry that has good economics overall. They key to the excellent economics of ad agencies generally is that they receive payments from clients before paying their own bills and their clients don't leave them. As long as a business's customer retention is nearly perfect and it has negative working capital – it will be a terrific business. There is little price competition in an industry with near perfect client retention. There certainly isn't price competition in advertising. And shareholders don't have to worry about low returns on their capital – because shareholders don't provide capital to ad agencies. Ad agencies are funded with client money. If there is overcapacity in the ad industry, it does not hang around in the form of half empty factories financed by shareholder money as it does in a manufacturing business. Instead, it simply takes the form of a reduction in the working capital deficit for a year or two until the industry turns around and – of course – the firing of employees at the agency who don't have enough work to do anymore. Also, at places like Omnicom, the top few hundred people at the company get a lot of their money through incentive compensation. They faced deep pay cuts in the 2008 crisis. But, they also got lots of stock options that made them a lot of money in the recovery. This leads to a flexible cost structure and stable margins. Consider how weak advertising is versus GDP right now. As we mentioned earlier, ad spending in the U.S. had often been 2% of GDP. Today, it is closer to 1.6% of GDP. So, the level of activity in the industry is about 20% below trend. When you are 20% below the mid cycle point in the homebuilding industry or the steelmaking industry or the oil industry or the airline industry the results can be severe. Margins look different from when you are well above trend. That's not really the case for Omnicom. A lot of the cost structure moves together along with revenue. So, clients may spend a little less and shareholders may make a little less than normal. But, that means executives are making less than normal. And fewer people are working in the industry than is the case during a boom period.

Omnicom is the perfect buy and hold forever stock. The price is good but not great right now. However, the stock will perform better than the S&P 500 – and most alternatives – if held forever. In fact, it is easier to beat Omnicom investing in another stock for 5 years than it is to beat Omnicom investing in another stock for 15 years. The business quality of most companies in most industries just isn't good enough to match Omnicom. It comes down to return on retained earnings. Although you can do well buying a stock that is cheap today and holding it for 5 years, the return on the earnings that company retains will tend to be 10% or lower. Meanwhile, the return on the earnings that Omnicom doesn't pay out to you in a dividend – the money it uses to make acquisitions and buy back its own stock – will tend to return 10% or more. In the past, Omnicom managed a 13% annual return on its retained earnings. So, if you buy a stock priced to return say 10% or 11% a year long-term and then the company never reinvests any of the money it keeps at worse than a 10% or 11% a year long-term return, you can actually keep making that 10% or 11% a year forever. This isn't true at most companies. With most stocks, the more the company reinvests, the worse your long-term return potential gets versus the return you expected when you first bought the stock.

Let's look at the math for Omnicom's return. The stock's 3-year average free cash flow – working capital fluctuations make it better to always use a 3-year average than a one-year figure – is $1.26 billion. It's about $5.18 per share. We expect the stock to dilute 1.5% a year. Basically, Omnicom gives 1.5% of the company to its executives and employees each year. It buys much more than this amount back each year, so the share count declines. But, it's best to do the calculation by looking at free cash flow before this compensation expense and then taking the stock option and restricted stock expense as a dilution figure rather than a dollar based expense. We said Omnicom should grow at least 5% a year long-term. This is because of its tendency to track nominal GDP. So, we have 5% growth minus 1.5% dilution equals 3.5% nominal earnings growth per share before Omnicom uses any of its cash for dividends or buybacks. At Omnicom, buybacks don't destroy value. In fact, as we said, in the very long-term Omnicom stock should outperform other stocks you might buy and hold. And you pay taxes on dividends but not buybacks till you sell your stock – and you shouldn't sell your Omnicom stock, you should just hold it – so, realistically, buybacks should tend to be more valuable to you than dividends. Therefore, we can lump dividends and buybacks together as if they were all valued equally. Like the growth figure, this is a little conservative. I think the buybacks add value. And I think you'll end up better off the more Omnicom buys back stock instead of paying dividends. But, we'll just pretend it's all a dividend. That would mean $5.18 a share in a combination of dividends and buybacks plus 3.5% annual growth. You can think of this as a bond with a coupon that keeps growing. So, for example, if you buy the stock at about $85 a share, your coupon starts at about a 6% annual yield and then grows by 3.5% forever. It is a perpetual coupon, because Omnicom's durability as an advertising agency is perfect. So, you can buy a perpetual bond yielding 6% a year at the time of purchase and growing 3.5% a year forever after. It's a good deal. In fact, as a buy and hold investment, it's one of the best deals you can find. For the next 5 years, I can't recommend Omnicom as highly as Frost or perhaps even Hunter Douglas. Certainly not Frost. Because Frost could return a lot more than 10% to 11% a year over the next 5 years as interest rates rise to more normal levels. So, if you are looking for one stock to own for the next 5 years, buy Frost. If you are looking for one stock to own for the next 25 years, buy Omnicom. We suggest most investors simply buy both. However, Omnicom is one stock that if you do buy, you should simply keep forever. For an ad agency with good capital allocation, we have no suggested holding time period. Omnicom will continue to outperform the S&P 500 for decades to come. So, you should simply keep holding the stock once you own it. I think it's one of the very rare stock out there that can return close to 10% a year even if you hold it literally forever.

Omnicom (NYSE: OMC)

Appraisal: $95.20

Price to Appraisal Value: 90%

Omnicom Owner Earnings	(in millions)
Pre-tax Owner Earnings	
2014 Revenue	$15,318
* Normal EBIT Margin	13.2%
= Pre-tax Owner-Earnings	$2,026

Business Value

Omnicom's business value is $26,338 million.

- Pre-tax owner earnings are $2,026 million
- Fair multiple = 13x pre-tax owner earnings
- $2,026 million * 13 = $26,338 million

Fair Multiple

Omnicom's business is worth 13x pre-tax owner earnings.

- At this price, 8-9% long-term return is a certainty

Share Value

Omnicom's stock is worth $95.20 a share.

- Business value is $26,338 million
- Cash: $1,362 million
- Debt: $4,567 million
- Equity value is $23,133 million
- $26,338 million + $1,362 million - $4,567 million = $23,133 million
- Equity Value = $95.20/share
    - 243 million outstanding shares
    - $23,133 million / 243 million = $95.20

Price to Appraisal Value

Omnicom is trading at 90% of its value.

- Business Value = $26,338 million
- Enterprise Value = $23,797 million
- $23,797 million / $26,338 million = 90%

	EV/Sales	EV/Gross Profit	EV/EBITDA	EV/EBITA	EV/Owner Earnings
Interpublic	1.19	3.31	9.44	10.99	11.38
WPP	1.76	NA	10.62	12.59	13.46
Havas	1.82	4.68	10.44	12.94	12.94
Publicis	2.23	5.89	12.40	13.71	12.85
Dentsu	2.78	13.95	42.20	16.25	16.25
Minimum	1.19	3.31	9.44	10.99	11.38
Maximum	2.78	13.95	42.20	16.25	16.25
Median	1.82	5.29	10.62	12.94	12.94
Mean	1.96	6.96	17.02	13.30	13.38
STDEV	0.59	4.78	14.12	1.93	1.78
CV	0.30	0.69	0.83	0.15	0.13
Omnicom (Market Price)	1.54	5.96	10.57	11.52	11.66
Omnicom (Appraisal Value)	1.72	6.65	11.79	12.84	13.00

ABOUT THE TEAM

Geoff Gannon, Writer

Geoff is a writer, blogger, podcaster, and interviewer. He has written hundreds of articles for Seeking Alpha and GuruFocus. He hosted the Gannon On Investing Podcast, The Investor Questions Podcast, and The Investor Questions Podcast Interview Series. He wrote the Gannon On Investing newsletter in 2006 and two GuruFocus newsletters from 2010-2012. In 2013, he co-founded The Avid Hog (the predecessor to Singular Diligence) with Quan Hoang. Geoff has been blogging at Gannon On Investing since 2005.

Quan Hoang, Analyst

Quan is a stock analyst. Quan won first prize in Vietnam's National Olympiad in Informatics in 2006. He graduated from Manhattanville College in 2012 with a B.A. in finance and a minor in math. In 2013, Quan co-founded The Avid Hog (the predecessor to Singular Diligence) with Geoff Gannon.

Tobias Carlisle, Publisher

Tobias Carlisle is the founder and managing director of Eyquem Investment Management LLC, and serves as portfolio manager of the Eyquem Fund LP and the separately managed accounts.

He is best known as the author of the well regarded website Greenbackd, the book Deep Value: Why Activists Investors and Other Contrarians Battle for Control of Losing Corporations (2014, Wiley Finance), and Quantitative Value: a Practitioner's Guide to Automating Intelligent Investment and Eliminating Behavioral Errors (2012, Wiley Finance). He has extensive experience in investment management, business valuation, public company corporate governance, and corporate law.

Prior to founding Eyquem in 2010, Tobias was an analyst at an activist hedge fund, general counsel of a company listed on the Australian Stock Exchange, and a corporate advisory lawyer. As a lawyer specializing in mergers and acquisitions he has advised on transactions across a variety of industries in the United States, the United Kingdom, China, Australia, Singapore, Bermuda, Papua New Guinea, New Zealand, and Guam. He is a graduate of the University of Queensland in Australia with degrees in Law (2001) and Business Management (1999).

SINGULAR DILIGENCE

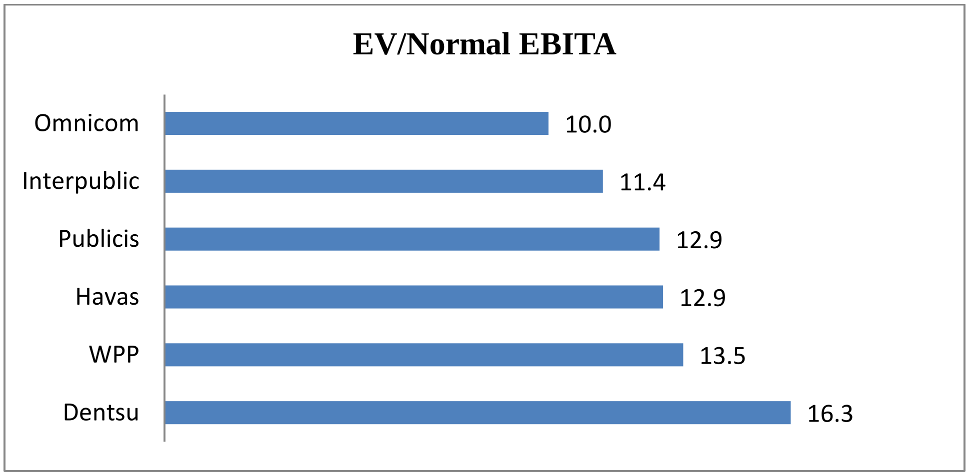
NOTES

Omnicom

NYSE: OMC

Overview

Omnicom Is the Best yet the Cheapest Marketing Services Provider



Omnicom is trading at the lower multiple of operating profits

Business Introduction

- OMC's revenue mix
  - Advertising: 50%
  - Customer Relationship Management: 34%
  - Public Relations: 9%
  - Specialty communications: 7%
- OMC is the second largest marketing services provider
  - But is the biggest in advertising and marketing services
  - Advertising services revenue
    - OMC: $7,594 million
    - WPP: $7,417 million
      - £4,502 million
    - Interpublic: $6,097 million
    - Publicis: $3,870 million
      - €3,120 million
    - Havas: $2,313 million
      - €1865 million
  - Marketing services revenue
    - OMC: $7,724 million
    - WPP: $6,283 million
    - Interpublic: $1,440 million

        - Publicis: $1,350 million
            - €1,088 million
        - Havas: none
- OMC's advertising business include
    - Creative agency (also called advertising agency)
        - Worldwide networks:
            - BBDO
            - DDB
            - TBWA
            - These are 3 of the world's top 5 agencies
        - National networks:
            - Goodby Silverstein & Partners
            - GSD&M
        - Creative agency creates ads and produces ads
            - Has the primary relationship with client
    - Media agency: Omnicom Media Group (OMG)
        - OMG has two networks
            - OMD and PHD
        - OMD
            - OMD is the world's second biggest media network
                - Handles about **$42 billion** total billings
            - Acknowledged as Most Creative Media Agency by The Gunn report for unprecedented 8 consecutive times
                - From 2006 to 2013
                - (The report was launched in 2004)
        - PHD
            - Handles about **$13 billion** billings
            - PhD was initially a specialty network
                - Focused on creativity
            - But PhD became a worldwide network
            - Help deal with conflict issue for OMD
                - OMD sometimes can't serve two competing clients
        - OMC may plan to create a third media network
        - Media agency handle media planning and buying
            - Delivers ads created by creative agency to target audience
                - In the most effective and efficient way
        - Creative agencies used to handle media buying and planning

                - Then they created joint venture to aggregate buying power
            - In late 1990s, big groups created their own media agencies
                - To consolidate the media buying function
            - Media agencies started pitching for media-only business
                - => They started handling media planning
                    - To be more competitive
            - OMG also has
                - Global data and analytics company Annalect
                - Media specialist companies
                    - Search specialist: Resolution
                    - Digital trading platform: Accuen
                    - Direct response agency: Pathway
- OMC's marketing services include
    - CRM
    - PR
    - Specialty communications
        - Healthcare
        - Recruitment
- Marketing services are provided by OMC's DAS companies
    - DAS = Diversified Agency Services
    - DAS include over 200 companies in various disciplines
- **Some main disciplines are:**
- Branding consultancy (Interbrand)
    - Customer insights
        - Using research, analytics to understand unmet needs, etc.
    - Strategy
        - Defines brand's purpose, identity, and role
    - Experience
        - Build unique, holistic experiences that connect people and brands
            - Retail & environment
            - Consumer branding & packaging
            - Messaging
            - Content (real-time written and visual content that engages audiences)
    - Activation
        - Go-to market strategy
        - Brand management platforms

            - Build systems, processes or technologies to manage and access brand assets
                - Brand guide lines
                - Identity
                - Content
            - Deploy cohesive brand touchpoints
                - Enhance productivity
        - Implementation
        - Internal engagement
- Direct/database marketing (Rapp Collins Worldwide, Russ Reid)
    - Agency: **Rapp Collins**, http://www.rapp.com/
    - Customer-managed relationships
        - Example:
        - Toyota's customer data were collected from
            - Music festivals
            - Auto shows
            - Action sport events
            - Sponsorships
        - => provides cues for more relevant content and purchase intent
    - Curated social engagement
        - Example:
        - Content was curated from diverse Toyota sources
            - And deployed through
                - Behavioral CRM
                - Social media
                - Online channels
                - Direct mail initiatives
- Content Marketing
    - Agencies:
        - **Freshwire**, http://www.freshwire.com/
        - **Specialist**, https://www.specialistuk.com/
    - Creates and distributes content to acquire a clearly defined audience
        - Content of different forms
            - News, video, white papers, mobile apps, infographics, how-to guides, etc.
        - Distributes via different channels
            - Social, YouTube, etc.

- Entertainment, Event & Sports Marketing
    - Agency: **GMR Marketing**, http://gmrmarketing.com/en-uk
    - Identifies and implements sponsorship opportunities
    - Creates innovative experiences to strengthen emotional relationship between brands and their target audiences
- Graphic Arts
    - Agency: **Signature**, https://signaturegraphicsinc.com/
    - Provides graphic solutions
        - Graphic arts/digital imaging
        - Print services
        - Example:
            - Vehicle wrap to promote a business
            - Floor graphics, event graphics, etc.
- Retail/Promotional/shopper marketing
    - Agency: Alcone, https://alcone.com/
    - **Promotional marketing**: any message that include an incentive to persuade the target audience to take immediate action
    - **Shopper marketing**:
        - Understand how target consumers behave in different channels
        - Using shopper insights to
            - Improve shopping experience
            - Affect purchase behavior in order to increase sales
    - Case study: https://alcone.com/lg-iron-man.html
    - Verizon launched the first LG smartphone: Verizon LG Ally
    - Alcone helped drive traffic and sales at Verizon stores
        - With a unique promotion
            - Target young, male, tech enthusiast consumers
        - Alcone aligned LG with the blockbuster Iron Man 2
        - In-store: life-size standees of Iron Man promoting LG Ally
        - Alcone partnered with Marvel Comics
            - Created an exclusive Gift with Purchase
                - An Iron Man comic book with built-in Augmented Reality content
                - Users can place the front and back covers in front of their LG Ally's web-enabled camera
                    - Immense themselves in the world of Iron Man
        - Result: over 1 million page views on the microsite

                - More than 100,000 unique visitors
                - A flurry of in-store activity
- Field marketing
    - Agency: **CPM International**, http://www.cpm-int.com/en/home
    - Mystery shopping
    - Sales service
        - Syndicated sales team (telesales)
            - Example: CPM cost $13 per call
                - 15 minutes per call
        - B-2-B sales force
            - Example:
            - CPM's sales teams work on behalf of HP's Mobile Printing Solutions
                - Work with multi-media retailers
                - Negotiate in-store event space
                - Set appointments to execute demonstrations
    - Merchandising: maximize in-store presence
        - Example: (same example with HP)
        - CPM's merchandising teams implement POS and print system displays in store
            - Attract consumers
        - 170 demonstrators undertook live product demonstrations
            - Show consumers
                - Benefits of HP Mobile Printing
                - Ease of use
                - Foster usage and sales of mobile printing products
- Market research
    - Agency:
        - M/A/R/C Research: http://www.marcresearch.com/
        - Communispace: http://www.communispace.com/
    - Conducts surveys
    - Runs market research panels
    - Gains customer insights

History and Organization

- OMC was formed in 1986
    - In a merger of

            - BBDO
            - DDB (Doyle Dane Bernbach)
            - Needham Harper
    - DDB merged with Needham Harper
        - Later called DDB Worldwide
- The merger was a defensive move amid a frenzy of consolidation
    - Saatchi & Saatchi and WPP were building its empire
        - Fueled by debts
- OMC was a holding company for ad executives who didn't want to be owned by a holding[1]
- The name Omnicom was to convey the idea that they would not just handle advertising
    - But also all marketing communications
- The joke around Madison Avenue was
    - "**O**perations **m**ay **n**ot **i**mprove **c**onsidering **o**ur **m**erger"
- OMC later acquired TBWA
    - In 1993
    - Some smaller acquisitions helped created TBWA as a third worldwide network
- OMC's 3 advertising networks are totally independent
    - Each can provide full services and compete with each other[2]
        - Each is aligned with other marketing services agencies of OMC
            - BBDO is aligned with
                - Organic: interactive agency
                - Proximity: direct response
                - Atmosphere: retail marketing
            - DDB is aligned with
                - Tribal DDB: interactive agency
                - Rapp Collins: direct marketing
                - TLP: brand activation
            - TBWA is aligned with
                - Agency.com
                - Integer Group: retail activation
                - Tequila: direct response
    - Independence allows OMC's networks to fully commit to creativity
        - OMC's networks receive the most awards
            - Example: The Gunn report's Network of the Year

        - Started in 1998
        - BBDO won 12 in of 16 years
            - 9 consecutive years from 2006 to 2014
        - BBDO and DDB usually get the 1st and 2nd places
- The roles of the corporate are[3]
    - Providing resources that various agencies need
    - Making sure clients get what they have been promised
        - "guarantor and provider of resources"
- OMC made acquisitions and grew other marketing services
    - Public relations (PR)
    - Customer relationship management (CRM)
    - Today advertising account for just 50% of OMC's revenue
        - This number is overstated
        - Many marketing services are integrated into OMC's networks

OMC's Attractions

- OMC's strength is its breadth to serve big clients
    - OMC has 2,500 clients
    - But the top 100 clients represents 50% of revenue
        - The biggest clients represents 2.5% of revenue
    - Each of the top 100 clients are served on average by more than **50** of OMC's agencies
        - The biggest client is served by more than **200** of OMC's agencies
- This strength helps protect the oligopoly
    - The big 6 groups control most of business with big clients
    - The close and complex relationship with clients results in 95-99% retention rate
        - Gives big groups stable market share
        - => able to grow and evolve with clients
- Total marketing spending can follow GDP growth in the long run
- Marketing services companies can capture more % of client spending
    - New mediums lead to more work
    - Fragmented media reduce power of traditional media owner
        - Shift marketing spending from media buying to agencies
- => the marketing services industry can grow faster than GDP
- OMC is the best in the industry
    - Has least exposure to Europe

    - Its agencies are best creatively
    - Has the best capital allocation
- But OMC's stock is the cheapest in the industry
    - At $70 per share, its value is 10x EBITA
    - Peers trade at 13x EBITA

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[1] "The dream that became Omnicom was originally called Project Stanhope after the New York hotel where Allen Rosenshine of the then public company BBDO, and Keith Reinhard, of the privately held Needham, met early one morning in late 1985.

Both had identified a need to huddle together for mutual protection amid a frenzy of consolidation. Philip Morris and General Foods was just one of the massive client-side mergers. **Saatchi & Saatchi, laden down with bags of other people's money, was intent on storming the Madison Avenue citadel**.

The Big Bang, as Omnicom's birth was dubbed, came in 1986 when the publicly held Doyle Dane Bernbach and the idea of a three-way merger came into the mix. The deal aligned BBDO, the sixth-largest agency in the US, with the 12th-ranked DDB and the 16th-ranked Needham Harper.

From its inception, then, this was a marriage brokered by advertising executives who wanted to be housed together in a holding company but did not want to be owned by any of the existing players. None of them stood to make vast personal fortunes from the deal itself because it was a merger in which no agency actually acquired any of the others. A shared commitment to becoming a branded creative superpower held the negotiations together." – Omnicom at Twenty, Caroline Marshall, Campaign, 24 February 2006

[2] "**Omnicom's subsidiaries compete head to head and the plan is that each will offer full service before long**. In fact, Omnicom has been there for a while in Europe - witness AMVs mini-conglomerate of companies. It is in the US that a separation exists.

"**Clients are looking for greater coordination of some key resources that represent 70 per cent to 80 per cent of their marketing spend: general media advertising, the internet, CRM, retail activation of the ideas and so on**. Because we have three great agencies that have never lost their way in terms of creative prowess, and because the three leaders buy into this view of what clients require, **we have been working to align some of our DAS companies more closely with the agency groups. We will not merge them, but we want to create an environment where they think alike, talk alike and pitch alike**."

The alignments, for instance, will see BBDO align with Organic (interactive), Proximity (direct response, although it is already part of BBDO) and Atmosphere (also an existing part of BBDO, for retail marketing). DDB will team up with Tribal DDB (interactive, aligned since it was founded by DDB, although it will lose the DDB part of its name if Wren has his way), Rapp Collins (direct marketing in most markets) and TLP (brand activation). TBWA will team up with Agency.com (interactive), the Integer Group (retail activation) and Tequila (direct response)." – Omnicom at Twenty, Caroline Marshall, Campaign, 24 February 2006

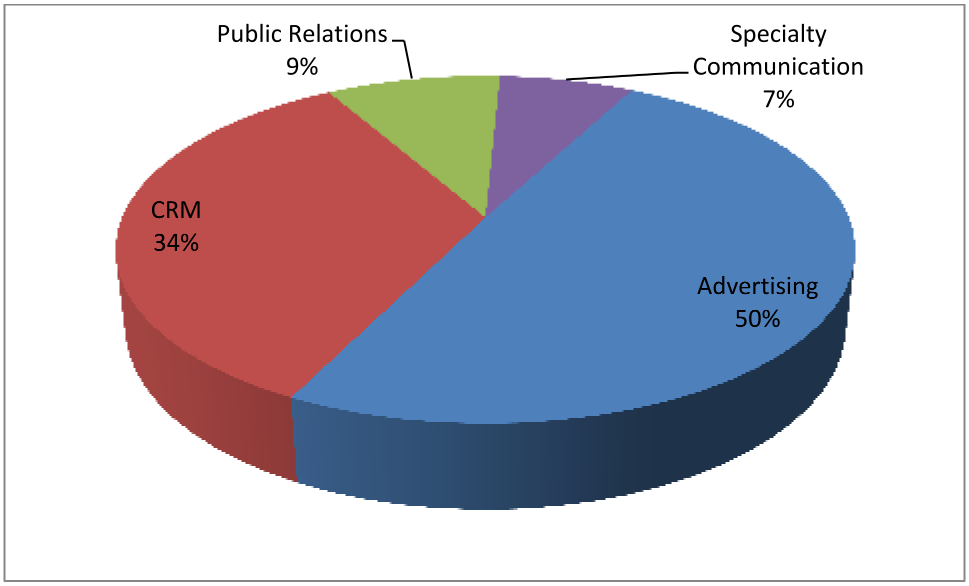
[3] "Mr Wren sees Omnicom as having a two-fold role: providing the resources that its various agencies need to be successful and making sure the clients get what they have been promised.

"**Internally, I see Omnicom as a service organisation for my major groups**," he says. "**The role of the holding company becomes that of guarantor and provider of resources**."

Mr Wren has become particularly interested in promoting standards through an in-house education strategy. Omnicom University, headed by Tom Watson, first president of the company's Diversified Agency Services division, has trained 700 executives - and counting." – Omnicom Let Its Agency Do the Talking, Gary Silverman, Financial Times, 15 March 2005

Durability

Omnicom Evolves Along Clients' Needs



Marketing services account for 50% of Omnicom's revenue

Biggest Negative:

- The need for media buying agency may disappear
    - Clients will be able to more advertising in an automated way

Digital media create more opportunities than threats

- PR and CRM agencies enjoy favorable trends
    - Clients always need PR
    - Clients always need CRM
        - Brand consultancy
        - Direct/database marketing
        - Content marketing
        - Entertainment, event & sports marketing
        - Retail/promotional/shopper marketing
        - Field marketing
    - New mediums lead to new ways for brands to interact with customers
        - => more demand for PR and CRM
    - CRM campaigns are measurable
        - The trend is to use more measurable marketing methods

- Creative agencies face minimal risks
  - Opportunities: more work for new mediums
    - Example: apps, banners, long video, etc. for digital campaigns
  - Risk: competition from pure players in new mediums
    - Some clients pick digital creative agency of record
      - (separately from traditional creative agency of record)
      - Some don't
  - This risk is minimal
  - Clients tend to consolidated creative accounts overtime
    - More cost efficient[1]
    - More integrated campaigns
      - Easier to coordinate campaigns across different mediums
  - Traditional agencies have great advantage
    - They have close relationship with clients[2]
      - Agencies work for a client's brand like for their own brand
      - Usually call the client's business as
        - "Our brand"
        - "Our business"
        - "Our strategy"
    - They already have expertise in old mediums
      - TV
      - Newspaper
      - Radio
      - Outdoor
      - Etc.
    - They just have to add digital skills[3]
      - Self-build, or
      - Acquisitions[4]
        - OMC makes a lot of tiny acquisitions to get new skills
          - Cross-sell to a large number of clients
            - And a large number of situations
  - OMC's creative agencies have good digital skills
    - Example of an integrated campaign: BBDO's work for Bud Light[5]
      - Tried to attract millennial consumers
      - Centered a multi-agency, multi-partner team
        - Deliver the integrated plan
        - 18 pieces of unique content distributed through

            - YouTube
            - Facebook
            - Twitter
            - Vine
        - A consumer call to action was created
            - Fueled mass engagement on social media
                - And at events through New York
        - 112 million viewers of Super Bowl
        - The 3.5-minute film was the most watched video on YouTube
            - For 24 hours leading into Super Bowl Sunday
            - Generated 25 million views
            - 33 million total minutes of time spent with the brand
- New mediums create more opportunities than risks for media agencies
    - More opportunities
        - Search engine optimization (SEO)
        - Search engine marketing (SEM)
        - Mobile
        - Social
        - Analytics
        - Etc.
    - Risks
        - Pure digital competitors
        - Automatic buying can eliminate the media buying job
    - OMG is well positioned against the first risk
        - Similar to OMC's creative agencies' advantages
        - Traditional media agencies have
            - Close relationship with clients
                - Example: WPP's SEM[6]
                - WPP bought 40-45% of clients' paid search in 2007
                    - There were a lot of search specialists
                - WPP's penetration increased to 70% in 2010
                    - Thanks to cross-selling
            - Scale to acquire or invest in new capabilities
                - Example: OMC invested a lot data and analytics
                    - Help markets reach people better
                        - Right time

                - Right place
                - Right mood
            - Annalect has 1,250 professionals[7] [8]
                - PhD's
                - Behavioral analysts
                - Data scientists
                - Programmers
                - In 45 markets
- OMC's media agencies performed very well
    - OMD was often named Media Agency of the Year
        - By Advertising Age
            - 2002, 2005, 2009, 2011
        - By Adweek
            - 2008, 2009, 2011, 2013
    - OMD is the most creative media agency
        - Acknowledged as Most Creative Media Agency by The Gunn report for unprecedented 8 consecutive times
            - From 2006 to 2013
            - (The report was launched in 2004)
    - Example of OMD's work
    - Addition Alle: a "plus-size" women's clothing retailer[9]
        - (in 2014)
        - Its best ambassadors are confident women
            - Not ashamed of their size
        - OMD developed a new type of targeting
            - Support the launch of the brand's first line of model Ashley Graham-branded lingerie
            - Formed national partnerships with online dating sites
                - Target women self-described as "plus-size"
            - Used Facebook as a retargeting platform
                - Encouraged these women share the new collection
            - Organized a "live chat" with Ashley Graham
                - Enable plus-size women to converse with others
        - => reached more than 2.8 million consumers
            - 76% of the target

        - Cost-per-click: $0.69
            - Industry benchmark: $1.85
        - Visitors spent 154% more time on the brand's site
        - Exceeded online sales objectives by 118%
    - Hasbro's campaign for its Monopoly game[10] [11]
        - In 2005
        - In London
        - OMD worked with Tribal DDB
            - A OMC's digital creative agency
        - Real taxis was equipped with GPS devices
            - Moving about London as game pieces
        - 190,000 players across the U.K. played the game
            - Over 28 days
            - Nearly 100,000 players agreed to receive further contact from Hasbro
        - Generated $3.5 million in publicity and other PR
            - 5 times the cost of the entire campaign
        - Bumped Monopoly sales in the U.K. by 450%
        - The campaign was replicated in other countries
    - OMC managed to maintain relative market share
        - Although WPP or Publicis spent billions of $ in acquiring digital skills
        - Relative media billings market share of top 3 groups[12]
            - 2005:
                - WPP: 45%
                - Publicis: 32%
                - OMC: 23%
            - 2010:
                - WPP: 45%
                - Publicis: 33%
                - OMC: 22%
            - 2014:
                - WPP: 44%
                - Publicis: 33%
                - OMC: 23%
        - OMC's gained media billings market share
            - 2004: 7%

            - 2008: 8%
            - 2011: 9%
            - 2014: 10%
    - The second risk is minimal
        - It takes a long time for marketers to shift budget to digital ads
            - 2003:
                - TV: 32% of total ad spending in the U.S.
                - Internet: 4%
            - 2013:
                - TV: 45% of total ad spending in the U.S.
                - Internet + Mobile: 26%
        - Media buying + planning = just 12-13% of OMC's revenue
        - Media planning will become much more complex
            - Offset the less important role of media buying
        - OMC is investing in programmatic buying
            - To leverage the investment in analytics
- Agencies capture more % of ad budgets as clients shift spending to new media
    - Traditional media: agencies captures 15% of client expenditure
    - Search/Display: 15-20%
    - Mobile/Social Media: 40-45%
    - Example[13]
    - $10 million spending on traditional media
        - Most go to the media and production
        - OMC gets paid for the design, architecture, creative work
    - $10 million spending on the web
        - OMC gets paid for
            - Design, architecture, creative work
            - Execution work
                - Very little money goes to third parties
        - Commission for online media buying is higher than TV
            - Buying and planning
            - Key word search
            - Banner ads
            - Rich media
        - Higher commissions due to more work to spend $20m on online
            - Online content owners are fragmented

            - TV networks are much more concentrated

Insourcing poses little risk

- Some experts talked about the death of Agency of Record model (AOR)
    - Some marketers switched to selecting agencies on a project basis
        - Instead of using a lead agency
    - They pointed to the ANA's survey among its memberships
        - (the Association of National Advertisers)
        - In 2013
    - **Finding**: the penetration of in-house agencies increased to **58%**
        - In 2013
            - 203 members responded
            - 118 members stated that they have in-house agencies
            - 40% cited moving creative strategy to their in-house agency
        - Penetration was only **42%** in 2008
    - **Reasons**:
        - Cost cutting
        - Quicker turnaround
            - The growth of digital channels requires quicker turnaround
        - Technology
            - Marketers can reach out directly to Facebook or Google
                - For insights
- That doesn't make sense
    - Marketers usually save money by consolidating accounts
        - Example:[14]
        - DaimlerChrysler consolidated its $1.8 billion account in 2000
            - Brands include
                - Chrysler
                - Jeep
                - Dodge
            - The work had been handled by
                - True North's FCB
                - OMC's BBDO
        - DaimlerChrysler was spending about $260 million in fees
            - FCB got $140 million
                - Provided 622 employees

            - BBDO got $120 million
                - Provided 500 employees
        - DaimlerChrysler gave the whole account to BBDO
            - BBDO got about $170-180 million revenue
                - Hired some of FCB's employees
            - DaimlerChrysler saved about $80 million
        - Biggest marketers consolidated accounts overtime
            - P&G consolidated its brands at
                - Grey
                - Saatchi & Saatchi
            - Unilever consolidated its brands at
                - J. Walter Thompson
                - Lowe
            - Pepsi works with OMC's agencies
        - P&G said recently that it's reducing the number of agencies[15]
            - To cut costs
    - Why AOR dies when marketing becomes much more complex?
        - Many new mediums[16]
            - Need a team for each medium
                - Social media
                - Mobile apps
                - Etc.
        - Doing more work in-house requires investment in
            - Talents
            - Training
            - Staffing manager
            - IT support
            - Other administrative personnel
        - Or the ability to
            - Select the right agencies for each medium
            - Coordinate many agencies
- There are good reasons to use external agencies
    - It's easier for external agencies to attract talents
        - And acquire new skills
    - It's more cost flexible to use external agencies
        - Can easily cut budgets

        - Or switch agencies
      - Marketers don't have to fire people
  - External agencies are more motivated to retain business
      - Internal agencies have job safety
- An ad veteran said the trend away from AOR is just cyclical[17]
  - Clients will get sick of micromanaging every agency
      - And every campaign

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[1] "Well I think **the account consolidation is a trend** that is in place and quite a number of our clients are going through the process and quite a number of our clients and other people's clients are discussing the process and I think **that's driven by desire in a low-growth environment to gain efficiencies**. **I also think the shift in media mix and how you reach consumers also has an impact on wanting to depend and deal on fewer people and not have an unlimited number of vendors serving you up specialties which you may respond to and haven't fully thought through in terms of what is the most effective way to get to a consumer**. I think this trend is in place for now and I think it will only continue because companies, our clients, most of the major companies around the world are under some degree of pressure to become more efficient and so that's where we are today and I think as we go into 2013" – John Wren, Omnicom's CEO, 2012 Q3 Earnings Call Transcript

[2] Someone at a research agency commented: "*I actually made an observation about this in a client meeting a few weeks ago:*

The meeting was between us, our client and our client's ad agency. ***The lexicon the ad agency employed spoke volumes about the relationship they had with our client and their role within the business.***

They used inclusive pronouns when referring to the client's business - ***"Our Brand" "Our Business" "Our Strategy". (Rather than "Your brand" etc)***

This simple linguistic nuance accents the ad agency's affinity with the client, and reflects the indivisibility of their role with the client's business. (I've never seen this with a research agency)" – <u>*Research Agencies Should 'Be More Advertising Agency'*</u> – Jon Puleston, Research-live.com, 13 October 2014

[3] "As you know, largely through the absence of acquisitions over the last several years, we are extraordinarily disciplined, in terms of what our needs are, and the prices we are ultimately willing to pay, and increasingly, especially when you get

into areas of digital and some of the new emerging technologies, **in 85% of the cases of the opportunities that present themselves, you are faced with a build versus a buy strategy on many of those things, and oftentimes we have opted to go to the build side of it.**

The pipeline still remains very robust. If market trends continue in terms of private equity and other things, I think we should see prices come more in-line with what our disciplines say we should pay. There is no way to predict it, other than say we that we will in fact be disciplined, and do whatever is appropriate for our businesses." – John Wren, Omnicom's CEO 2007 Q3, Earnings call Transcript

[4] "So the acquisition front, to get back to your point, not to get too far off track -- **certainly anything in that analytics, behavioral marketing, targeting area are great potential acquisitions. The advantage of an Omnicom buying them is we can maybe buy a small business, introduce them to a large number of clients, a large number of situations and leverage that acquisition quite rapidly**." – Randall Weisenburger, OMC's former CFO, BMO Advertising & Marketing Services Conference, 10 June 2010

[5] "This next generation of storytelling is being amplified by informed insights and new technologies that allow us to deliver personalized and relevant brand messages in real time. **We develop these capabilities by ensuring that each of our agencies, at a very early stage, invested in digital skill sets and talent**. As a result, we are extremely well positioned and equipped to assist clients in building their brands and communicating the brand message across multiple channels.

An example of our capabilities is our work for AB InBev, which hired us last year to handle Bud Light, and attract millennial consumers. The Bud Light BBDO team elected to give one person a truly epic experience that would become the center of a completely integrated Super Bowl program. **BBDO centered a multi-agency, multi-partnered team to deliver the integrated plan. The campaign generated 18 pieces of unique content that was distributed through YouTube, Facebook, Twitter, and Vine.**

A consumer call to action was created to fuel mass engagement on social media and at events through New York during Super Bowl weekend. The results are surpassing all expectations.

In addition to the 112 million viewers of the Super Bowl, the 3.5-minute film was the most-watched video worldwide on YouTube for over 24 hours leading into Super Bowl Sunday. The online content has already generated 25 million views, and 33 million total minutes of time spent with the brand. And it is still growing." – John Wren, OMC's CEO, 2013 Q4 Earnings Call Transcript

[6] "Rob Norman, CEO – North American Operations, WPP's Group M: **Going back I think that in terms of the percentage of the business if I go back three years I'm guessing it would have been in there of about 40 to 45%.** There were a lot more search specialists in the marketplace than there were then. We haven't acquired very many of them. We've acquired one or two. But **it's actually been organic very much organic in terms of the shift from specialist agencies to us in that area**.

Richard Jones, Analyst: And just so I understand that is the percentage of your traditional clients that you're doing the search buying for, is that right?

Rob Norman, CEO – North American Operations, WPP's Group M: What I'm only says and this is the example number to keep them round, **if there's a million dollars of paid search in the entire client base of GroupM we're handling $700,000. That's what the 70% is.**" – WPP Digital Day, 23 April 2010

[7] "At Annalect, Omnicom's primary data and analytical business, **our team is aggressively working with partners and clients to collect this vast array of global and local data, centralize it, secure it, analyze it, and translate it, empowering users to make better marketing decisions. Our agencies are hiring talent with new skill sets such as PhD's, behavioral analysts and data scientists to provide actionable insights using this trove of data**. These efforts are driving a tangible shift in how our agencies work together, and are delivering benefits to our clients in the form of stronger, more consistent, and ultimately more effective communications, and they are allowing us to deliver integrated campaigns across disciplines and platforms." – John Wren, OMC's CEO, 2012 Q4 Earnings Call Transcript

[8] "Second is an area of data and analytics, new platforms that enable marketers to identify and reach the right people at the right time in the right place, and even when they are in the right frame of mind**. For us, that's Annalect, with more than 1,200 professionals in 45 markets. Annalect is a resource for all Omnicom companies.**" – John Wren, OMC's CEO, 2014 Q2 Earnings Call Transcript

[9] "Studies show the best Addition Elle "ambassadors" are confident women who are not ashamed of their size. So OMD developed a new type of targeting to ensure these brand advocates would share the launch of the "plus-size" brand's first line of model Ashley Graham-branded lingerie.

The strategy was to reach plus-size women while they were in a state of seduction (and therefore, the perfect mindset to buy lingerie). **It developed national partnerships with online dating sites, and for the first time, only women self-described as "plus-size" were targeted.**

The agency used Facebook as a retargeting platform to encourage these women to share the new collection. A "live chat" with Ashley Graham was organized on Twitter to enable plus-size women to converse with others.

The campaign reached more than 2.8 million consumers (76% of the target) at a cost-per-click rate of $0.69 (versus the industry benchmark of $1.85). Visitors spent 154% more time on the brand's site, and the online sales objectives were exceeded by 118%." – *OMD Turns Up the Heat Tech*, Val Maloney, Strategy, 30 October 2014

[10] "The OMD "Global Ace" award last year went to OMD U.K. for a campaign it created for the U.K. version of Hasbro's Monopoly board game. The centerpiece of the campaign was the creation of a live online version of the game that featured **real taxis equipped with GPS devices moving about London as game pieces. The upshot: 190,000 players across the U.K. played the game over the course of 28 days, with nearly 100,000 players agreeing to receive further contact from Hasbro. The agency calculated that the campaign generated $3.5 million in publicity and other PR, or about five times the cost of the entire campaign.**" – *OMD Worldwide*, Steve McClellan, Adweek, 2006 February 27

[11] "In February, Hasbro came to DDB London for help introducing its revamped 70-year-old Monopoly board game. While a modest digital initiative was originally planned, Tribal proposed a more ambitious venture: **Turn London into a virtual game board, and allow users to experience the game. In June, Tribal used GPS and hotspots scattered throughout London to create Monopoly Live online, which drew 1 million visitors who spent up to 20 minutes online with the game. The effort helped bump Monopoly sales in the U.K. 450 percent, according to Tribal**. Hasbro has even created a business unit to bring the concept to other markets in Europe and the U.S. 'There's the potential to

think of it as a new product in itself," notes Matt Dyke, planning director at Tribal DDB London." – Tribal DDB, Brian Morrissey, Adweek, 16 January 2006

[12] Source: **RECMA** for estimate of each group's total media billings; **WPP's annual reports** for worldwide advertising expenditure.

[13] "**If a client were to spend $10 million in traditional media much of that money is going to the media. Another chunk of money is going to third parties that are actually, I'll say, producing the commercial** and then we're getting paid for the design, architecture, creative work. **When you throw that on the web we're getting paid for the design, architecture, creative work, plus the execution work and very little money is really going to third parties. If we're doing online, say, media buying and planning, key word search, banner ads, rich media, whatever, again the commission percentage or the fee percentage to our agencies is generally much higher than TV**. It's obviously a lot more work to spend $20 million on online than it is to spend $20 million in a TV campaign, so the commissions are generally multiples of each other. Behind it with the [ND] margin, the margins are about the same." – Randall Weisenburger, Omnicom's former CFO, 2008 Q2 Earnings Call Transcript

[14] "In one of the largest consolidations ever of advertising assignments by a giant marketer, the Chrysler Group said late yesterday that it had decided to use units of the Omnicom Group in New York to handle its worldwide creative and media accounts, with **billings estimated at $1.8 billion**.

The loss of the work is a devastating blow to True North because those assignments accounted for about $140 million, or 9 percent of total revenue, and as much as 15 percent of total earnings.

…

The consolidation is the most recent in a skein of such decisions **as multinational marketers seek increased efficiency and economy in their advertising. Chrysler Group rivals like General Motors have also been consolidating creative and media tasks**.

When the review began, Mr. Liebler emphasized that it stemmed solely from company-wide efforts to save money, not dissatisfaction with the work of either Omnicom or True North.

…

For Omnicom, its Chrysler Group assignments accounted for $120 million, or 2 percent, of total revenue. The consolidated account is estimated to total about $170 million to $180 million in revenue, reflecting the cost-cutting proposals Omnicom made to land the business." – *In Blow to True*

North, Chrysler Shifts Ad Accounts to Omnicom, Stuard Elliott, the New York Times, 04 November 2000

[15] "**Procter & Gamble Co. is preparing to make deep cuts in the number of advertising agencies it works with, hoping to save up to half-a-billion dollars in fees that it now pays to outside firms** to help pitch its myriad everyday items, from Gillette razors, to Tide detergent, to Pantene hair care, to Bounty paper towels.

What worries Madison Avenue isn't only the pressure agencies will feel as P&G tries to wring better prices from them—or risk losing the business altogether—but that **the consumer-products giant is joining other big companies, including Unilever, L'Oréal SA, Coca-Cola Co., S.C. Johnson and Visa, that are evaluating some part of their ad accounts**.

…

P&G Chief Financial Officer Jon Moeller said Thursday that the household-products giant **plans to "significantly simplify and reduce" the number of agencies it works with on ads, media buying, public relations, package design and in-store marketing**.

Unilever, which spent roughly $7 billion on advertising and marketing last year, is currently reviewing its global media-buying business. The process is being driven in part by the need to find "cost savings and efficiencies," a person familiar with the matter said." – *Big Companies Put the Squeeze on Ad Agencies*, Nathalie Tadena, Wall Street Journal, 27 April 2015

[16] Someone said on Quora: "Large companies require large creative teams. For example, I was freelancing as a senior digital producer for a large automotive brand last year -- **just our digital team included one creative director, two associate creative directors, two art directors, two senior writers, four designers, two junior writers, one information architect, two junior producers, four account executives, three senior developers, four junior developers, a product expert, and countless part time** (.2, .4, .6, etc.) talent for everything from rights management to CGI development, and so much more. **All said and done, you were looking at 30+ full-time people for just the digital work, and we were all overworked and in dire need of even more full-time hands... for one brand!**

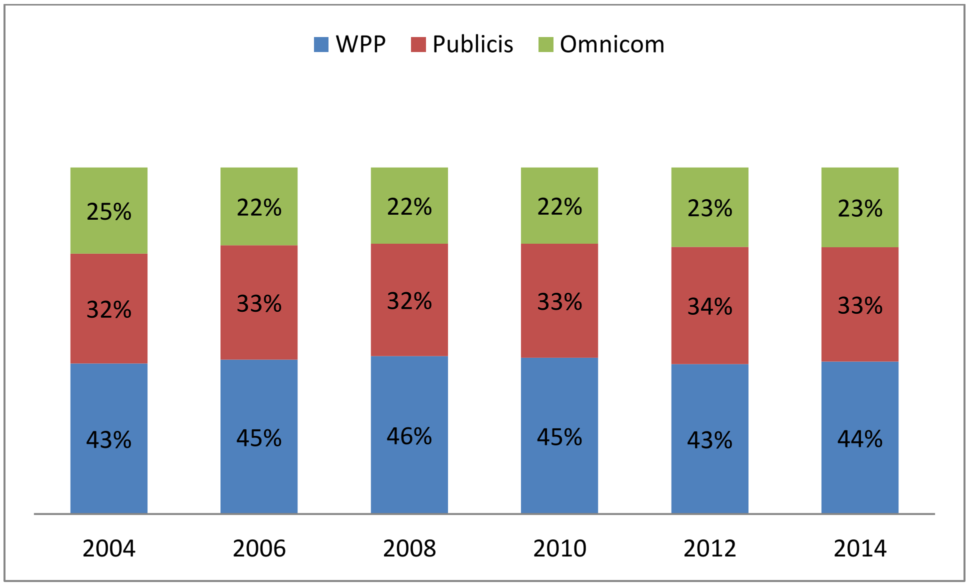
Now, what if your company wanted to try something different? With all these people in-house, **if you wanted to really delve into social media or mobile phone applications, you'd have to hire even more people, because it's entirely possible your 30+ person in-house team wouldn't have professional experience in either**. Outsourcing to an agency would be much faster, and provide higher levels of talent, whereas trying to bring more people in-house, or making personnel changes (ie, firing a banner ad writer to hire a social media writer) would be bad for morale, and potentially leave you even less talent. Big agencies have these people on-hand, and can easily invite them onto a project with a few days, or less, notice.

My example above was just for digital -- now factor in how much bigger the team would get when you added on broadcast and print teams! A full in-house creative team for all your advertising for a large company can easily hit 100 people, especially when you factor in that you'll need staffing managers, HR people, more IT support, and other administrative personnel to keep the creatives working (and getting paid, and having paper and pens, and disk space, and and and). A full in-house creative team for a large company is often the size of its own mid-size company."

[17] "**It's a cyclical thing as well as a side effect of the increased specialization with digital. The pendulum is swinging away from AOR but it will swing back when clients get sick of micromanaging every agency and every campaign**. Digital AOR is where the new center is." – *The Advertising 'Agency of Record' Model Isn't Dead, It's Just Being Reinvented*, Will Burns, Forbes, 14 May 2015

Moat

Omnicom Operates in a Stable Oligopoly



Relative market share of media billings among WPP, Publicis and Omnicom was stable

Biggest Negative:

- Barrier to entry is low

Michael Porter Questions

- (-) means low
- (=) means medium
- (+) means high
- **For the industry**
    - Is the threat of new entrants high or low?
        - (-) Barrier to entry is low
            - But entrants pose little threat to big networks
    - Is the bargaining power of buyers high or low?
        - (-) Clients don't select agencies on fees
            - They focus on quality to maximize ROI
    - Is the threat of substitutes high or low?
        - (-) Technology won't replace creativity
    - Is the bargaining power of suppliers high or low?

        - (=)
            - Media networks have pricing power
            - Talents may move if they aren't offered promotions
    - Is the rivalry within the industry high or low?
        - (-) Competitors don't persuade marketers to switch agencies
            - They pitch hard when an account is up for review
            - They don't compete on price
- **For the company**
    - Is the threat of new entrant different for this company specifically?
        - Same
    - Is the bargaining power of buyers different for this company specifically?
        - Same
    - Is the threat of substitutes different for this company specifically?
        - Same
    - Is the bargaining power of suppliers different for this company specifically?
        - Same
    - Is the rivalry within the industry different for this company specifically?
        - Same

Relative market share

- OMC has the biggest market share in the advertising business
    - (creative and media agencies)
    - Revenue
        - OMC: $7,594 million
        - WPP: $7,417 million
            - £4,502 million
        - Interpublic: $6,097 million
        - Publicis: $3,870 million
            - €3,120 million
        - Havas: $2,313 million
            - €1865 million
    - OMC has a great market share of the creative side
        - Its media business is smaller than WPP's and Publicis's
            - Total billings (source: RECMA)
                - WPP: $106 billion

                - Publicis: $79.4 billion
                - OMC: $55.5 billion
                - Dentsu: $55.3 billion
                - Interpublic: $37.1 billion
                - Havas: $19.6 billion
        - OMC’s media revenue is about $1.8 billion
        - => WPP’s media revenue would be $3.6 billion
            - => $3.8 billion creative revenue
                - Compared to OMC’s $5.8 billion creative revenue
- OMC has bigger relative size in marketing services
    - (including CRM, PR and specialty communications)
    - Revenue
        - OMC: $7,724 million
        - WPP: $6,283 million
        - Interpublic: $1,440 million
        - Publicis: $1,350 million
            - €1,088 million
        - Havas: none
- Marketing services follow creative agencies
    - => We’ll focus only on creative and media agencies in this section

It’s impossible kill an existing national or worldwide creative network

- New entrants pose little threat
    - Barrier to entry is low
        - Little capital requirement
        - Talents can easily open a new office
    - Some genius can succeed
        - Example: 72andSunny
            - Founded in 2004
    - But it’s hard to expand
        - It’s hard to attract new talents
        - Must have excess servicing capacity to pitch new business
    - The market is very big
        - Damage to existing networks is negligible
    - Example:
        - It took 72andSunny 9 years to make $85 million revenue in 2013
            - 0.55% of OMC’s revenue

- Small entrants don't have the breadth to deal with big clients
  - Big clients prefer big networks[1]
    - Able to provide services across
      - Disciplines
      - Mediums
      - Geographies
    - Able to provide other marketing services[2]
      - CRM
      - Public relations
      - Etc.
  - OMC's top 100 clients represents 50% of revenue
    - Each is served on average by more than 50 of OMC's agencies
  - Big clients consolidated agencies overtime
    - More cost efficient[3 4]
    - More integrated campaigns
      - Easier to coordinate campaigns across mediums
- => successful entrants usually get acquired by large groups

- Creative agencies have long-lasting relationships with clients
  - (We looked at current and past creative agencies of 97 marketers)
  - Consumers product companies are the most loyal clients
    - Relationships tend to last forever
    - Big groups prefer some holding companies or big networks
    - Pepsi, Mars, and Wrigley use OMC
      - They may shift accounts among OMC's agencies
      - The relationship with Mars was since 1993
        - With Pepsi since 1960
        - With Wrigley since 1995
      - Wrigley used Saatchi & Saatchi from 1954 to 1995
        - Dumped Saatchi in 1995
        - Because of the bickering between Saatchi brothers
    - P&G prefers working with
      - Saatchi & Saatchi: Since 1921
      - Grey: Since 1956
      - OMC worked with Gillette since 1930s
        - PG acquired Gillette in 2005
        - OMC tried hard to get other PG brands

            - But failed
                - PG moved Gillette brands to Grey
                    - In 2013
        - Unilever prefers working with
            - Lowe: since 1899 (no error, 1899)
            - J. Walter Thompson: 1902 (no error, 1902)
        - Clorox worked with FCB from 1921 to 1996
            - Has been working with DDB since 1996
        - Some brands in trouble may become fickle
            - **Heineken** US had **6 agencies** in **9 years**
                - From 2002 to 2011
                - Reasons:
                    - Had 4 CEOs from 2005 to 2011
                        - And 4 CMOs
                    - Sales volume slid 20%
                        - 2007: 5.2 million barrels
                        - 2010: 4.1 million barrels
                - Finally it turned to old agencies
                    - 2003-2007: Publicis
                    - 2008-2009: Wieden & Kennedy
                    - 2009-2010: Euro RSCG
                    - 2010-2015: Wieden & Kennedy
                    - 2015-now: Publicis
    - Without consolidation, financial services firms may stay forever
        - State Farm: with DDB since **1930**
            - State Farm gave its automotive brand and digital work to DraftFCB in 2010
            - But returned to DDB in 2011
        - Allstate: with Leo Burnett since **1957**
        - Geiko: with The Martin Agency since **1994**
        - American Express: with Ogilvy since **1962**
        - Visa: with OMC since **1985**
            - Shifted from BBDO to TBWA in 2005
                - Returned to BBDO in 2012
            - OMC persuaded Visa to limit its search to OMC's agencies
        - Wells Fargo: with OMC since **1996**
        - Discovery Card: with OMC from **1987 to 2006**

        - With The Martin Agency since 2006
    - Fickle clients are
        - Chase: with McGarryBowen from 2004 to 2015
            - Switched to Droga5 in 2015
        - Bank of America
- Some carmakers maintain relationship for decades
    - Ford: with J. Walter Thompson since **1943**
    - Chrysler: with BBDO from **1960** to **2009**
    - Volkswagen US: with DDB from **1949** to **1995**
        - With Arnold since 1995
    - Volkswagen global: with DDB since **1959**
    - Nissan: with TBWA since 1991
    - Some troubled carmakers are very fickle
        - **Cadillac** had **4 agencies** since 2010
- Transportation companies tend to stay for 20-30 years
    - FedEx: with BBDO since **before 1989**
    - Delta Airlines:
        - With BBDO from **1946** to **1999**
        - With Leo Burnett from 1999 to 2010
        - With Wieden & Kennedy since 2010
    - American Airlines: with McCann-Ericson sine **1981**
    - Southwest Airlines: with GSD&M since **1980**
    - Carnival Cruise Lines: with Arnold since **2008**
        - CCL lost VP of sales and marketing in 2008
        - No information about previous agency
            - Perhaps a long relationship
- Household products, sport brands, tech/electronics stay for 10-20 years
    - GE: with BBDO since **1920**
    - Electrolux: with DDB since **2006**
    - Sherwin Williams:
        - With Wyse Advertising from **1998** to **2008**
        - With McKinney since 2008
    - Select Comfort:
        - With Euro RSCG from **1996** to **2006**
        - With McKinney since 2006
    - Nike: with Wieden & Kennedy since **1981**
    - Adidas:

        - With 180LA from **2001** to **2015**
        - With 72andSunny since 2015
    - Microsoft: with McCann-Ericson since **1999**
    - Cannon: with Grey since **1976**
    - Symantec: with Grey since **2003**
    - Dell's consumer brands: with Young & Rubicam since **2001**
    - HP: with OMC's agencies since **1995**
    - Unsuccessful clients may stay for less than 10 years
        - Reebok:
            - 2004-2009: McGarryBowen
            - 2009-2014: DDB
            - Since 2014: Venables & Bell
- Without consolidation, telecom companies may stay for decades
    - AT&T: with OMC's agencies since **1997**
    - But consolidation, changes in control made some clients fickle
        - Sprint:
            - 2007-2011: Goodby
            - 2011-2014: Publicis
            - Since 2014: Deutsch
- The most fickle group is **restaurant & retailers**
    - Clients tend stay for decades
        - Wal-Mart:
            - Before **1987**-**2006**: OMC's Bernstein Rein
                - Since Sam Walton started using agency
            - 2006-2007: DraftFCB
            - Since 2007: The Martin Agency
        - Macy: with J. Walter Thompson since **2006**
            - Used in-house agencies before
        - Darden: with Grey since **1984**
        - Dunkin Donut
            - **1977**-**1995**: Ally & Gargano
            - 1995-1998: Euro RSCG
            - Since **1998**: Hill Holiday
        - McDonald: with DDB and Leo Burnett since **1970s**
        - Gap: with Leo Burnett since **2002**
    - Desperate clients change agencies every 1-2 years
        - **Taco Bell**

                - Early 1980s to 1994: FCB
                - 1994-1997: Bozell
                - 1997-2000: TBWA
                - 2000-2013: FCB
                - Since 2013: Deutsch
            - **JC Penny**
                - 2006-2011: Saatchi & Saatchi
                - 2011-2013: PMK-BNC
                - Since 2013: Young & Rubicam
    - Consumer products or financial services firms are loyal because the business is stable
        - Clients in less stable business are more fickle
- Retention rate is in the high 90s
    - The number isn't available
    - But from some articles
        - DDB
            - 2001: 98%
            - 2002: 99%
            - 2003: 99%
        - Grey in 2014: 95%
    - Reviews happen because of
        - Consolidation
        - Changes
            - New CMO
            - Very poor business performance
                - (lead to new CMO)
- Agencies don't try to steal business from each other
    - They pitch hard when there's a review
        - They can't create reviews[5] [6]
    - When they pitch, they don't pitch on price
        - Traditionally
            - Creative agencies get 12% of billings
            - Media agencies get 3% of billings
        - Today compensation is fee-based
            - But revenue/billings remains consistent
                - WPP's net sales/billings was between 20-22%
                    - Since 1997

                - The trend was upward from 20% to 22%
        - Quality usually declines when clients pay less than a fair price[7]
            - Agencies put weaker people on the job
        - It's better to focus on non-fee costs
            - 80-85% of total costs
                - Control production costs
                - Negotiate harder for ad space
                - Buy and use media smarter
                - Cut out middlemen
                - Etc.
    - Agency's challenge is to have free people to work on new pitches[8] [9]
        - They have finite resources
    - => Agencies focus on existing clients
        - Grow with existing clients
        - Lean towards pitching for companies they already work for
        - Adding new clients doesn't really move the needle
            - OMC's biggest client represent just 2.5% of revenue
- After losing a business, agencies can get assignments in the same sector[10]
    - Perhaps the number of people working for a sector doesn't change much
- => we can expect stable market share
    - Although OMC's networks are the most creative[11]
        - BBDO, DDB, and TBWA are among top 5 biggest networks
        - Goodby Silverstein & Partners are famous for creativity
            - A national network
        - OMC's networks received the most awards
            - Example: The Gunn report's Network of the Year
                - Started in 1998
                - BBDO won 12 in of 16 years
                    - 9 consecutive years from 2006 to 2014
                - BBDO and DDB usually get the 1st and 2nd places

Media agencies require scale

- Media agencies can leverage
    - Relationship with and knowledge about media owners
    - Knowledge of audience in different mediums
    - Buy media for many brands

- Buying clout
- Creative agencies used to handle media buying
    - Then they created joint venture to aggregate buying power
- In late 1990s, big groups started their in-house media agencies
    - To consolidate the media buying function
- Media agencies started pitching for media-only business
    - Started handling media planning
        - To be more competitive
- Buying power is important
- But it's unclear at what size most of buying power is realized
    - OMC's total media billings is ½ of WPP's
        - But able maintain relative market share
            - Relative media billings market share of top 3 groups[12]
                - 2005:
                    - WPP: 45%
                    - Publicis: 32%
                    - OMC: 23%
                - 2010:
                    - WPP: 45%
                    - Publicis: 33%
                    - OMC: 22%
                - 2014:
                    - WPP: 44%
                    - Publicis: 33%
                    - OMC: 23%
    - Tiny player like Havas can also maintain relative share
        - Havas's total billings/WPP's total billings stays about 18%
        - Havas's total billings
            - 2004: $8.7 billion
            - 2014: $19.6 billion
    - According to John Wren: "<u>You have to be big enough to be efficient for your clients - you don't have to be number one. On the other key measurement, quality, I'd argue Omnicom is number one</u>"
    - Clout can come in different forms
        - Not just total billings
        - Example: OMC can buy the **whole ad space** of a TV shows for a line-up of **8 brands**

- Creativity is important
    - Helps improve effectiveness of each $ spent on media
    - Omnicom is number one in this aspect
        - OMD was often named Media Agency of the Year
            - By Advertising Age
                - 2002, 2005, 2009, 2011
            - By Adweek
                - 2008, 2009, 2011, 2013
        - OMD is the most creative media agency
            - Acknowledged as the most Media Agency by The Gunn Report for Media for unprecedented 8 consecutive times
                - From 2006 to 2013
                - (The report was launched in 2004)
- Big networks as a group gained market share
    - Including WPP, Publicis, Omnicom, Interpublic, Havas
        - Aegis/Dentsu was excluded
        - Its combined data wasn't available before 2013
    - Total networks billings
        - 2004: $145 billion
        - 2014: $298 billion
        - => **7.5%** annual growth
            - Exceeded total advertising expenditure growth
                - Just **2.9%** annual growth over period
                    - (data from Zenith Optimedia)
                    - 2004: $405 billion
                    - 2014: $539 billion
    - Total market share of big networks
        - 2004: 41%
        - 2014: 65%
        - Be careful with this number
            - The denominator might not be accurate
            - Some sources said OMC has 10% market share
            - => 65% combined market share can be a good estimate
                - Based on relative share
- New media will strengthen big networks' scale advantage
    - Huge investment in
        - Analytics

        - WPP and OMC hire thousands of
            - Data scientists
            - Behavioral analysts
            - Programmers
      - Programmatic buying
        - WPP spent $1 billion in acquisitions for this business
        - OMC builds organically
- Customer retention seems high
  - Client relationship is similar to creative agency's
  - We didn't analyze media agency roster of the 97 brands we looked at
    - Media agencies are relatively young
      - Just formed in late 1990s
    - Clients may review media agencies more often
      - Due to the rise of new mediums
  - It seems retention rate is very high
    - According to OMC: there are only 15-20 big pitches in a big year
      - (Big pitches are for over-$500-million account)
    - 2015 is a big year
    - OMC said that an "unprecedented" number of media accounts are up for review
    - It's defending $1.2 billion
      - (in the first 2 quarters)
      - => OMC may have to defend $2.4 billion in a big year
      - OMC's total billings: $55 billion
        - => less than 5% of the business is up for review
        - Retaining 20% of the reviews => 96% retention rate

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[1] "Increasingly, **our large multi-national clients are asking us to manage their entire marketing process, bringing big creative ideas, and delivering them seamlessly across disciplines, media, and geographies**. This is changing the manner in which we offer our services, and enhancing the growth of our largest clients." – John Wren, Omnicom's CEO, 2013 Q4 Earnings Call Transcript

[2] "We have for a very long time assembled our services as our current clients as well as prospective clients, have required them, and we have a great deal of experience within the company in responding to whatever the clients' needs are.

So this current trend of where **people are no longer simply just asking for advertising services but they're asking for how do you respond to my entire marketing budget, it comes right to our sweet spot**. We're very capable and very practiced at responding to clients who make these requests.

And for the first time, and that's always, it's been true certainly recently in the last few years. What's **absolutely interesting is the fact more and more clients, instead of simply putting their advertise business up for review are stepping back, taking a deep breath and saying how many CRM providers do I have, what are we doing in public relations, what are we doing in other areas, and are there companies such as Omnicom that can come in and speak to my entire budget as opposed to just speaking to me about aspects of the budget**. That's what we're seeing increasingly in the new business activity." – John Wren, Omnicom's CEO, 2004 Q1 Earnings Call Transcript

[3] "Well I think **the account consolidation is a trend** that is in place and quite a number of our clients are going through the process and quite a number of our clients and other people's clients are discussing the process and I think **that's driven by desire in a low-growth environment to gain efficiencies**. **I also think the shift in media mix and how you reach consumers also has an impact on wanting to depend and deal on fewer people and not have an unlimited number of vendors serving you up specialties which you may respond to and haven't fully thought through in terms of what is the most effective way to get to a consumer**. I think this trend is in place for now and I think it will only continue because companies, our clients, most of the major companies around the world are under some degree of pressure to become more efficient and so that's where we are today and I think as we go into 2013" – John Wren, Omnicom's CEO, 2012 Q3 Earnings Call Transcript

[4] "If you remember, I put up a slide of what our clients want from a global business like ours and if you read through all the things, the one continuity item is consolidation. So what they want to be able is to consolidate. **Because many of our clients, many of these global clients you see and many more, are literally working with tens of thousands of vendors around the world. So if they can consolidate that into one or two partners, that's a huge savings to them**, but net it's a huge opportunity for the agency. We're seeing a lot of that business coming our way and it's clearly very powerful.

Then for the client, the upshot is that the money that they have to spend on actual marketing programs is net greater.

So we're seeing less money being spent on lots of irrelevant things. More money being spent on consolidation and then that frees up, on their side, more money to go into actual programs." – David Sable, CEO of WPP's Young & Rubicam, WPP Digital Day, 23 April 2010

[5] "**We're invited to new business pitches** and we can always -- we're not-- **we can't create them**. So it's a belief that when we get up to the plate we bat very well. But we can't predict quarter-by-quarter what the opportunities are going to be. **I can tell you that I spend a good part of my time with existing clients and what their growth is**, and with potential clients that haven't necessarily made any shifts yet, or formal announcements about making any shifts. **And blue chip, real blue chip Fortune 50, Fortune 100 companies, typically take their time and go through a lot of deliberations before they actually-- and do a lot of due diligence before they put an account or an assignment into review**, especially when you look at how the marketplace is consolidated and the number of possible competitors there are today versus years back." – John Wren, Omnicom's CEO, 2006 Q3 Earnings Call Transcript

[6] "So it's a combination of a lot of factors, and **what goes into review is driven by clients, and then we are responding to it. It's not -- we can't cause somebody to put their account in review**, so we tend to be -- it's a reflection of what's going on in the marketplace in any given quarter." – John Wren, Omnicom's CEO, 2007 Q1 Earnings Call Transcript

[7] "In his view, do they push prices down? "I don't know," he [John Wren] says. **"But if you accept a piece of business for less than a fair price, logic says put your weaker people on it and do a worse job."**" – Omnicom at Twenty, Caroline Marshall, Campaign, 24 February 2006

[8] "For agency CEOs, the pace of reviews is unprecedented and has their staffs scrambling between pitches and existing accounts. The spate of contests also forces bosses to make hard choices about what to pitch.

"**There are finite resources available, and you've got to look at where you've got the best opportunity to convert**," said Doug Ray, U.S. CEO and global president at Carat. "**The other thing is that our clients that we currently have—we cannot lose track of them.**"

Chasing new business "puts existing business at risk," Ray added. "**And I'd rather grow my business organically with the current clients than have a revolving door of new business [that with] every new business pitch you bring in, you lose a client.**"

Agencies generally are leaning toward pitching companies they already work for rather than unknown entities, particularly when a marketer is only considering roster shops, as with Coke, J&J and Citi. As a result, **CEOs are turning down chances to expand their client base because they don't have the bandwidth to do both.**" - Epic Wave of Media Reviews Comes at a Crucial Time for Media Buying, Andrew McMains, Ad Week, 29 May 2015

[9] "We've never been known as a pitch agency," said Mr. Sann [BBDO's New York Chief Creative Director]. "Lately, we've changed our point of view and we started pitching more business. **The toughest thing about pitching is you have to have people free to work on it. The last thing you want to do is shortchange your existing clients.**" – Recreating BBDO, Richard Linnett, Advertising Age, 06 November 2000

[10] "I would say that once you get past the immediate short term of these unknown situations occurring, **I can't think over the years of too many situations where we lost a client in a sector, and then over a reasonable period of time following that we weren't able to replace it**, and that just gets down to the quality of our brands, and the fact that we are focused especially, we are always focused, but especially focused on the fundamentals right now." – John Wren, Omnicom's CEO, 2008 Q3 Earnings Call Transcript

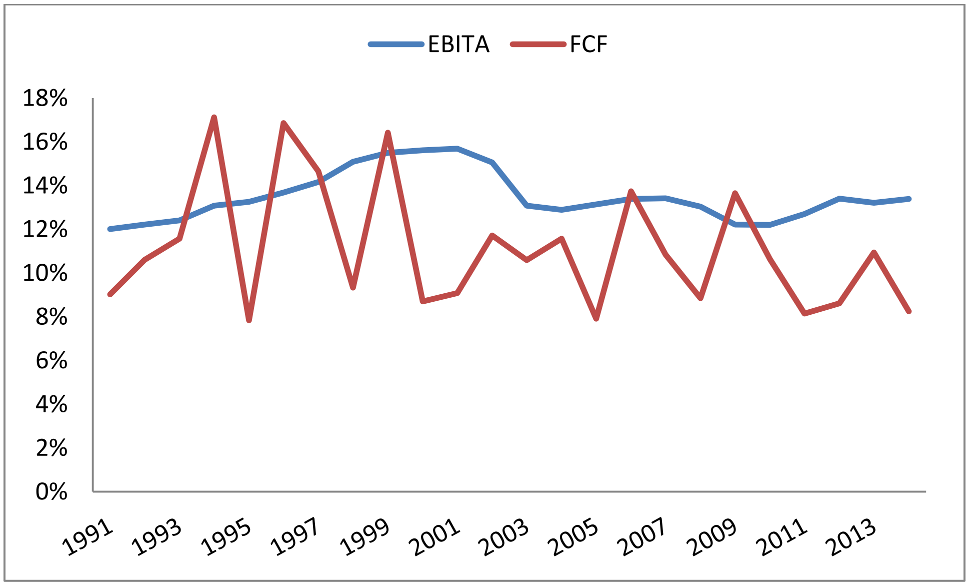
[11] "One senior executive who has been a benefactor of business from his Omnicom siblings observed: "**John has three strong networks to put in front of the client and say, 'Why would you need to look beyond these agencies?**' And he'd have a legitimate story to tell there." **The executive added that the other multinationals—WPP, IPG, Publicis Groupe and Havas—"don't have the strength across the board and the variety of agencies to do this with.**"

A U.S.-based advertising search consultant concurred. "**If these are client companies that cherish ideas, Omnicom has multiple resources for idea generation," he said. "They also hold a lot of the more creative agencies than other holding companies."**" – The Omnicom Handoff: Keeping Clients Inside, Kathleen Sampey, Adweek, 13 February 2006

[12] Source: **RECMA** for estimate of each group's total media billings; **WPP's annual reports** for worldwide advertising expenditure.

Quality

Each $ of Sales Can Turn into 13 Cents of Pre-tax Profit and 11 Cents of Free Cash Flow



EBIT and FCF margin are about 13% and 11%, respectively

Biggest Negative:

- Clients take deep cuts in their advertising budgets in recessions

Michael Porter Questions

- (-) means low
- (=) means medium
- (+) means high
- **For the industry**
    - Can the industry charge a high price?
        - (=) The industry has a cost-plus model or a commission model
    - Does the industry have low costs?
        - (=) Cost is fair
    - Does the industry have low need for assets?
        - (-) The industry has negative working capital
- **For the company**
    - Can the company charge a higher or lower price than the industry?
        - (=) same

- Does the company have higher or lower cost than the industry?
  - (-) big networks can have lower media buying costs
- Does the company have more or less need for NTA than the industry?
  - (=) same

OMC's margin is extremely stable

- EBITA/Sales was about 13.2%
  - From 1991 to 2014
    - Min: 12.0%
    - Max: 15.7%
    - Median: 13.2%
    - Mean: 13.5%
    - Standard deviation: 1.1%
    - Variation: 0.08 (very stable)
  - Revenue declined by 12% in 2009
  - But EBITA margin declined only 0.8%
    - 2008: 13.0%
    - 2009: 12.2%
- OMC has the most stable margin we've ever seen
- Stable margin result from
  - Variable cost structure
  - Little price competition
- OMC's cost is highly variable
  - Office-level cost is variable
    - The business has a cost-plus model[1]
      - The marketing business has always been fee-based
      - The advertising business used to be commissions-based
        - 12% of billings went to creative agencies
        - 3% of billings went to media agencies
      - But the advertising business has moved towards fees[2]
      - OMC adjust staff level at each office to client activity[3]
        - When clients want to reduced cost in 2008-2009[4]
          - They didn't press for reduced fees
          - Instead worked with OMC to reduce the scope
            - Adjust staff
            - Adjust expectation of services
      - If clients pay less than a fair price[5]

        - Agencies put weaker people on the job
- Incentive compensation for management is highly variable[6]
    - **4-5%** decline in revenue => a **40-50% cut** in pay for some senior people
        - Reduced senior compensation by 75% in 2008[7]
            - 500 to 1000 senior people
    - Incentive comp is 5-6% of revenue
- Office and general expenses are less variable
    - Include
        - Rent and occupancy costs
            - Rent expenses are just **3%** of revenue
        - Technology costs
        - D&A
        - Other overhead expenses
    - Represent less than **16%** of revenue[8]
        - 16.2% of revenue in 2009
        - 15.8% of revenue in 2008
        - Was only 13.2% in 2014
- OMC has a more flexible cost structure than WPP or Publicis
    - It's easier to fire people in the U.S. than in Europe
    - OMC does much less business in Europe
        - OMC
            - North America: 60%
            - U.K.: 10%
            - Europe: 16%
            - Asia Pacific: 10%
            - Others: 4%
        - WPP
            - North America: 34%
            - U.K.: 14%
            - Western Continental Europe: 21%
            - Other countries: 30%
        - Publicis
            - North America: 48%
            - Europe: 31%
            - Asia Pacific: 12%
            - Others: 1%

        - In 2009
            - OMC's EBITA margin declined from 13.0% to 12.2%
            - Publicis's EBITA margin declined from 16.7% to 15%
            - WPP's EBITA margin declined from 16.0% to 12.7%
- Margin seems consistent across segments
    - OMC's margin was very stable over 24 years
        - Revenue mix must be stable, or
        - Segments have similar margins
    - Marketing services actually grew much more than advertising
        - Advertising revenue is still 50% of total revenue
            - But OMC integrated marketing services into its network overtime
    - => segments may not have a big difference in margins
        - OMC said so for many times[9] [10]
        - At WPP
            - Advertising: 16% margin
            - Public Relation & Public Affair: 16% margin
            - CRM: 14% margin
        - One exception is field marketing
            - Example of field marketing services
                - B2B sales force
                - Merchandising teams to maximize in-store presence
            - Field market has low margins[11]
- It's difficult to interpret the difference in margins of groups
    - They may have different reporting
        - Gross sales vs. net sales
    - Omnicom has bigger field marketing operations than Publicis
    - Omnicom grow digital skills more organically
        - WPP or Publicis makes more acquisitions
            - It's another type of development expenses

Omnicom has negative working capital

- Working capital/Revenue is stable about -20%
    - From 2000 to 2014
        - Min: -23%
        - Max: -16% (2008)
        - Median: -20%

        - Mean: - 20%
        - Standard deviation: 2%
        - Variation: 0.11 (very stable)
- If revenue is 20% of billings like WPP
    - => working capital = -4% of billings
    - => OMC pays billings about 15 days later than it receives payments
- Agencies seem disciplined in maintaining this gap
    - Example:
    - Coty initiated a review in 2015[12]
        - Consolidating its $1.07 billion account
        - Asked agencies to agree to 150-day lags in payments
        - Most marketers pay faster than 120 days
            - P&G pays within 30-75 days
        - ODM declined to participate in the review
            - Handling Coty's media in the U.S., U.K., Ireland, and Canada
        - Other agencies chose not to participate
            - WPP's Group M
            - Dentsu Aegis
    - WPP is resolute on this issue[13]
        - WPP isn't a bank to fund clients
- It'll be hard for clients to press for longer payment terms
    - If they succeed, agencies may just pay suppliers even slower
        - They are the biggest buyers

OMC's cash flow can be similar to annuity

- Very stable cash flow
    - Margin is stable
    - Working capital is stable as a % of sales
    - Negative working capital => cash flow exceeds earnings
- Growth can be very stable
    - Retention rate is high
        - 95-96%
        - Despite short contracts
            - 60-days to 6-month notice provisions
    - Revenue is well diversified
        - By clients

        - The largest clients are 2.6% of revenue
        - Top 100 clients represents 50% of revenue
        - => minimal shock from losing a client
    - By industries
        - Food and Beverage: 13%
        - Consumer products: 10%
        - Pharmaceuticals and Healthcare: 10%
        - Technology: 9%
        - Auto: 8%
        - Financial Services: 7%
        - Travel and Entertainment: 6%
        - Telecommunications: 5%
        - Retail: 6%
        - Other: 26%
  - Clients maintain a constant % of revenue for marketing budget
  - => Total marketing spend follow GDP growth
    - Similarly to bank deposits
  - Agencies capture more and more of marketing budget overtime
    - Traditional media: agencies captures 15%
    - Search/Display: 15-20%
    - Mobile/Social Media: 40-45%
  - => stable long-term growth
- The industry is highly cyclical
  - Clients are quick to reduce advertising budgets in recessions
  - OMC's revenue declined by 12% in 2009
  - But OMC has flexible costs
    - => margin and cash flow stayed strong

8 dimensions of quality

- Relative size
  - Low customer concentration
  - Media networks are concentrated
  - Non-TV media are fragmented
- Focus
  - OMC's business is built around clients
    - Build and acquire new capabilities based on clients' needs

- Customer engagement
    - Agencies work closely with clients
        - See clients' brands as their own brands
- Cross-selling
    - Cross-sell all marketing services
        - Example: over 200 of OMC's agencies serve its biggest client
- Retention
    - 95-99%
- Words of mouth
    - No information
- Reinvestment rate
    - Spent $7.6 billion in acquisitions since 1991
    - If OMC spends 20% of FCF
        - => has $250 million each year to acquire new skills
- Stock's popularity
    - Short-interest: 7.9%
    - Share turnover: 129%
    - 3-month average daily volume: 1.64 million shares
    - Float: 242 million shares
    - Big investors owning the stock
        - Robert Zagunis – Jensen: 3.45% of the portfolio
        - Jean-Marie Evillard – First Eagle U.S. Value: 3.44%
        - John Rogers – Ariel Appreciation: 3.21%
        - Richard Pzena – Hancock Classic Value: 2.66%
        - Wallace Weitz – Weitz Value: 2.04%

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[1] "We're in a lot of countries and a lot of different businesses that are service businesses, **and we're largely getting paid our cost of labor plus overhead and a margin**. That labor varies by skill level quite dramatically, and by country quite dramatically." - Randall Weisenburger, Omnicom's CFO, 2012 Q4 Earnings Call Transcript

[2] "Randall Weisenburger, Omnicom's CFO: **If you look at our business, I mean, which is predominantly marketing in services, not advertising, that has always been a fee-based business. If you look at our general media advertising, since 1988, it's been moving towards fees** and been moving that way even prior to the recession occurring, so we're not a Viacom or another media entity.

John Wren, Omnicom's CEO: **We have been living with fees as part of the way we get compensated for a very long period of time. So, we stopped thinking about, you know, the days of when media raised its prices, we got an automatic bump. Really ended in the beginning of the '90s**, it hasn't been a part of our economics for a great deal of time." – Omnicom's 2003 Q3 Earnings Call Transcript

[3] "Severance cost was higher, the year-over-year increase in severance cost was higher than I expected it to be in this quarter. That's a difficult number to necessarily predict, you know, we're dealing with a lot of locations, and as John mentioned, you know**, we always try to manage our cost structures on a location-by-location basis. Those managers adjust their business or adjust their staffing levels to their client activity**, so it's, you know in, most quarters we have severance cost and we have recruitment costs. I'm sure this quarter we have the same." – Randall Weisenburger, Omnicom's former CFO, 2003 Q3 Earnings Call Transcript

[4] "Peter Stabler, Analyst, Credit Suisse: Good morning. Thanks for taking the question. We've been hearing anecdotally that clients are pressing hard for reduced fees, beyond those associated with reductions in scope. Could you comment on the nature of your ongoing fee negotiations with your existing clients? And on the new business win side, just from a judgment side, how much new business activity do you think is being motivated by companies who are seeking to reduce run rate fees?

John Wren, Omnicom's CEO: We haven't seen -- **we haven't experienced any client actions other than to respond to a reduction in the scope of work that we're providing. There have been a lot of conversations, but in each case where we've gone and we've had to sit with clients and adjust our staff, the expectation of service has been adjusted accordingly**. And your second question?

Peter Stabler, Analyst, Credit Suisse: Just on the new business side, do you have a sense that some large clients are initiating fee reviews, perhaps in this climate, more due to a goal of cost cutting than in normalized terms?

John Wren, Omnicom's CEO: No. No. Most major advertisers are still following whatever procedures they've established for the selection of their partners and **we haven't seen -- we haven't seen any of that -- any pitches that have been purely put up from a fee point of view. Simply to reduce fees. It's too vital, too vital an area for clients to -- for major advertisers to make decisions**

based upon -- purely on fees. It's the quality of the service that you're seeing." – Omnicom's 2009 Q1 Earnings Call Transcript
[5] "In his view, do they push prices down? "I don't know," he [John Wren] says. **"But if you accept a piece of business for less than a fair price, logic says put your weaker people on it and do a worse job."**" – Omnicom at Twenty, Caroline Marshall, Campaign, 24 February 2006

[6] "Michael Nathanson, Analyst, Sanford Bernstein: Thanks, let me follow-up the last question, then I have one for Randy. John, can you give us a sense of how much flexibility is? How much of your salary and service let's say cost are -- of flexible nature?

Randall Weisenburger, Omnicom's CFO: Well, two things happen it with. First of all at a -- I describe it as product level, so the people that are actively engaged in clients, they are somewhat of a direct cost. The client is looking for people to execute on work if the work isn't there those costs are as painful as it is, somewhat flexible. With depreciational people and senior management, the incentive comp pools are highly flexible. If business is down, those numbers can be adjusted. **For senior people, the incentive compensation can be a much greater percentage change in their compensation than the change in revenues. A 4% or 5% decline in revenue could mean a 40% or 50% cut in pay for some of those senior people** that their overall positions aren't necessarily flexible, but their pay certainly is.

Michael Nathanson, Analyst, Sanford Bernstein: Randy, on that point is incentive comp -- what is **incentive comp as a percentage of revenue**? Is it in the 5% to 10% range?

Randall Weisenburger, Omnicom's CFO: I think it's in the **5% to 6%** range." – Omnicom's 2008 Q4 Earnings Call Transcript

[7] "Executive compensation in particular gets lots of headlines. Compensation in a services company, probably in every company, but certainly in a services company, is pretty critical. Omnicom has a -- probably somewhat of a unique focus. We don't have formulaic compensation at senior levels. Almost anywhere in the Company there is -- certainly we've hired some people, or bought some companies in the past, **we have contracts in place, but for the most part it is a trusting relationship where the employee needs to feel like he is being treated fairly throughout a period**.

In 2008 we took some steps, we took some pretty significant reductions of executive compensation. I will say senior compensation, **really not just executives. So probably 500 to 1,000-person layer across Omnicom**.

Generally it took probably a 75% reduction in compensation versus what mathematically, based upon our 2008 performance, they would've expected. And we accelerated a lot of severance and other things, getting ready for 2009." - Randall Weisenburger, Omnicom's former CFO, BMO Advertising & Marketing Services, 10 June 2010

[8] "I think our people have done an extremely good job of managing [costs]. Some areas are difficult to manage on a short term basis. We had a very rapid change in the economy and our revenues. **So while people can adjust head counts in some places very quickly and they can try to manage these managed costs, we can't exit real estate, we can't exit computer licenses and office furniture and those sorts of things that quickly. Over time they will adjust. Leases will roll off, and computer licenses and things that we don't need them, they will expire and we won't renew them, but it takes a couple of years to get those in line. As an percentage, office and general expense last year was about 15.8% of revenue and this year is about 16.2% of revenue**. I would think we will get them back more in line with last year. It would probably take us another year or two, I would suspect." – Randall Weisenburger, Omnicom's former CFO, 2009 Q4 Earnings Call Transcript

[9] "Paul Ginocchio, Analyst, Deutsche Bank: Thanks. Quick question about **margins for those pure play digital operations**, because of higher digital salaries for people in the interactive, are those margins better or worse than your more traditional agencies? Thanks.

Randall Weisenburger, Omnicom's CFO: **They are pretty much in-line with our traditional agencies**. Right now the demand for those services is pretty high, so the utilization rate in those units are pretty high. The services and the growth of those agencies is actually probably coming faster than we can recruit the qualified people." – Omnicom's 2007 Q3 Earnings Call Transcript

[10] "Catrina Fallon, Analyst: Great, and then one other question. You've said that you do receive a larger share of the pie for digital campaign. Can you give us some color on the contribution in a campaign like that for creative, **whether it's website development, display buying, ad word buying, and then within that then what are the areas of strength and how do the margins compare to this type of work versus traditional advertising**?

Randall Weisenburger, Omnicom's CFO: **Margins are pretty comparable**. As far as the work goes there's significantly more work that we do. If we're doing -- say, we're building websites or web presence, web marketing ideas, all of that wave is really ours, so if a client were to spend $10 million in traditional media much of that money is going to the media. Another chunk of money is going to third parties that are actually, I'll say, producing the commercial and then we're getting paid for the design, architecture, creative work. When you throw that on the web we're getting paid for the design, architecture, creative work, plus the execution work and very little money is really going to third parties. If we're doing online, say, media buying and planning, key word search, banner ads, rich media, whatever, again the commission percentage or the fee percentage to our agencies is generally much higher than TV. It's obviously a lot more work to spend $20 million on online than it is to spend $20 million in a TV campaign, so the commissions are generally multiples of each other. Behind it with the [ND] margin, the margins are about the same." – Omnicom's 2008 Q2 Earning Call Transcript

[11] "We've pointed out for a while, **the media business in general has higher margins, and some of our field marketing, shopper marketing businesses have lower margins, of field marketing especially, but they have very good returns on equity. They have very little capital committed to those businesses**. So they are frankly, excellent businesses from a return perspective, but their overall EBIT margins are a bit lower." – Randall Weisenburger, Omnicom's CFO, 2011 Q1 Earnings Call Transcript

[12] "Coty is the latest in a string of big marketers to ask for extended payment terms, but **its 150-day ask is aggressive compared to those marketers who have capped the terms at 120 days**. Global candy giant Mars last year sought to extend the period before suppliers get paid to as long as 120 days, and **a couple of years ago Mondelez International confirmed it was instituting 120-day terms. Around that time, Procter & Gamble Co said it would seek to extend payment terms from 30 to 75 days in new contracts with agencies**.

According to its 2014 10-K filing, **Coty's consolidated expenses for advertising and promotional costs were $1.07 billion and on par with spending in 2013**.

…

OMD, which supports Coty in the U.S., U.K., Ireland and Canada, has declined to participate in the review due to the terms of the brief, according to people familiar with the matter.

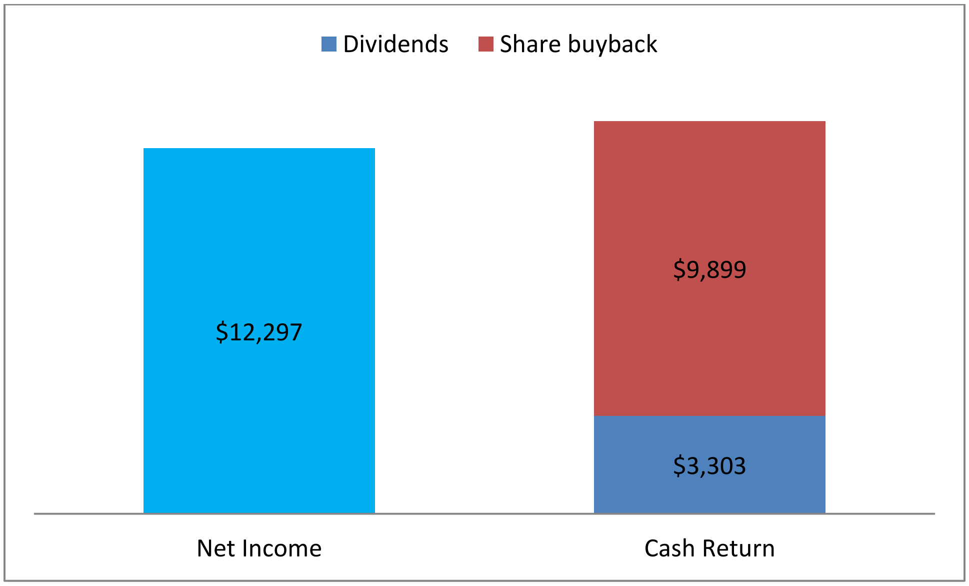
They're not the only ones. Agencies within WPP's GroupM and Dentsu Aegis are also choosing not to participate, according to industry executives." – Coty Asking for 150-Day Payment Terms in Global Media Review, Alexandra Bruell, the Advertising Age, 14 April 2015

[13] "**We have basically taken the position, as you know, that we are not a bank. We said that a long time ago and that we are not in a position to act as a bank and fund clients**. The bank should do that, even if there's a discounted receivables scheme, because, ultimately, although interest rates might be low now and it might be an acceptable cost now, when interest rates rise, which is likely, it wouldn't be there.

So I would say the pressure continues to be there. You said is it a regional thing? **I think it's not a regional thing in one sense, but where you get faster growth there is less pressure**. I think there's also, which came out this morning in response to another question, on the digital side of the business there is currently less pressure because it's 20% of total spending." – Martin Sorrell, WPP's CEO, WPP 2013 Q4 Earnings Call Transcript

Capital Allocation

After Making Bolt-on Acquisitions, Omnicom Return All Cash to Shareholders



Omnicom returned 107% of total income since 2000

Biggest Negative:

- OMC is aggressive in using "creative" financing

Share dilution is about 1.5% annually

- Compensation includes
  - Base salary
  - Annual performance-based award
    - Cash or equity
    - 40% is based on financial performance against annual targets
      - Diluted EPS growth: 1/3 weight
      - EBITA margin: 1/3 weight
      - Organic growth: 1/3 weight
    - 40% is based on financial performance against peers
      - ROE: 40% weight
      - Organic growth: 20% weight
      - EBIT margin: 20% weight
      - Organic growth + EBIT margin: 20% weight

        - 20% is based on individual performance
    - Long-term equity award
        - Use restricted stock units
        - Vest over a 5-year period
        - Rarely use stock options
        - Award is based on ROE as compared to ROE of 4 principal competitors
- OMC got a lot of criticism when it issued options in 2009
    - OMC issued 22.6 million options to employees
        - (7.3% of total outstanding shares)
        - On March 31, 2009
        - Exercise price: $23.73
        - John Wren got 500,000 options
    - OMC had not issued options to its top executive since 2003
    - Some people questioned whether OMC timed the issuance
    - But there are reasons for OMC to do so[1]
        - The awards were based on 2008 performance
            - 2008 was a good year
            - OMC usually grants restricted stock units (RSUs)
            - At low price, OMC would also have to issue a lot of RSUs
        - Margin declined only 0.8% in 2009
            - Employees shouldn't take any pay cut
        - There were concerns about OMC's liquidity at the time
            - Issuing stocks or options was the most feasible
    - The cost would be expensive whether OMC used RSUs or options
        - Ideally OMC should never have share-based compensation
            - It's such a good business to dilute
        - But service companies use share-based compensation heavily
    - John Wren profited $20 million from the options
        - But that's far lower than Martin Sorrell's annual compensation
            - 2014: £43 million
            - 2013: £30 million
            - 2012: £18 million
            - 2011: £12 million
- The total effect of RSUs and options is **1.5%** annual share dilution

OMC return all excess cash to shareholders

- Share repurchase = Cash flow – CapEx – Acquisitions – Dividends[2]
- Since 2000
    - Total earnings: $12,297 million
    - Total dividends: $3,303 million
    - Total share repurchase: $9,899 million
        - Net of share-based compensation
    - => OMC returned 107% of earnings since 2000
- Total share declined 4% annually over the last 10 years
    - 2004: 374 million
    - 2014: 247 million
- Dividend payout rate is currently 45%
    - Payout rate may decline when OMC grew very fast
        - Declined from 55% in 1990 to 19% in 2008
        - Annual growth was 14% over this period
    - Payout rate increased to 45% in 2014
        - Annual growth was just 2.3% over this period

OMC's acquisitions don't destroy value

- OMC spends much less on acquisitions than peers
    - Over the last 10 years
        - OMC spent **16%** of cash flow in acquisitions
        - Publicis spent **43%** of cash flow in acquisitions
        - WPP spent **44%** of cash flow in acquisitions
- OMC doesn't like making big acquisitions[3]
    - Big acquisitions are expensive[4]
    - OMC didn't look at Grey
        - WPP paid $1.75 billion
            - In 2005
        - Grey's revenue was about $1.47 billion
            - 1.2x P/S
    - Studied FCB for 11 months but didn't buy
        - Interpublic bought in 11 weeks
            - Paid $100 million
                - In 1996
            - FCB's revenue was $79 million
                - 1.27x P/S
    - John Wren doesn't want to overpay

        - He said he'd never seen anyone make a large acquisition without going backward
    - OMC's largest acquisitions in the last 20 years were
        - Abbott Mead Vickers (AMV)
            - In 1998
            - AMV was the world's 20th largest agency
            - OMC had owned a stake in AMV in 1991
            - OMC paid $545 million
                - In a stock deal
                - OMC was trading at **2.7x** revenue
                - The deal valued AMV at **2.2x** revenue
        - Gold Greenlees Trott (GGT)
            - In 1998
            - Paid $235 million
            - Helped from TBWA as a worldwide network
                - From the 18th biggest to the 10th biggest agency
    - The biggest acquisition recently was Communispace
        - An online market research company
        - OMC paid $100 million
- OMC doesn't want to acquire creative or media agency[5]
    - AMV was the last big creative agency it acquired
    - Most acquisitions are in
        - Marketing services
            - Focus on top 250 clients
            - Acquire companies that are serving these clients
                - That can add new skills to OMC
        - Developing markets
- OMC does scuttlebutt for its acquisitions[6]
- Since 2001, OMC made 193 small acquisitions
    - Paid $2,887 million upfront
        - Average **$15 million** per acquisition
    - Paid $1,694 million in earn-outs
        - Average **$9 million** per acquisition
    - => the average deal was **$24 million**
- OMC find small acquisitions more affordable[7]
    - A way of sharing the development of a business
    - Based on performance over the next 3 to 5 years

- => can get a lower multiple
- Sellers get the chance to reach more clients
  - At a lower client acquisition cost
- If the business triple or quadruple in 3 years
  - => Price is **15-20x** the trailing earnings when OMC bought it
  - But it's still **5-6x** the average over the 3-5 year period

- Most acquisitions are a make-or-buy decision[8] [9]
  - Acquisitions are fantastic at a good price
    - Accelerate change
    - Get to where OMC wants to be faster
  - But building internally has worked pretty well in most cases
- There's no quantitative way to judge OMC's acquisitions
  - It doesn't disclose sales of acquired business
  - But there are good evidences
    - Margin was very stable despite many acquisitions
    - OMC passed on some deals at 1.2x P/S
      - Grey
      - FCB
      - Razorfish
        - OMC invested in Razorfish in 1996
          - One of the leading digital agency
        - OMC owned 32.4% of Razorfish
          - Owned 20% after the IPO in 1999
        - OMC sold for $110 million gain
          - Implied $550 million more than cost
        - Razorfish was later acquired by other companies
        - Publicis eventually acquired Razorfish from Microsoft
          - In 2009
          - Paid $530 million
            - 13.7x EBITDA
            - 1.4x P/S
              - $380 million revenue
    - Total earn-outs were about 37% of total acquisitions
      - Performance must have been good
      - Otherwise OMC wouldn't have to pay earn-outs
    - Growth far exceeded GDP
      - (comparing U.S. revenue growth with U.S. GDP)

        - Before 2004
            - 5-year CAGR exceeded GDP growth by 10-15%
            - OMC made the most acquisition during this period
        - OMC made much fewer acquisitions after 2004
            - In the 2003-2008 period: exceeded by 3.6%
            - In the 2009-2014 period: exceeded by 1.5%
- OMC almost merged with Publicis
    - The deal was structured as a merger of equals
    - OMC and Publicis had comparable market cap
        - OMC: $17.4 billion
        - Publicis: $17.7 billion
    - Comparable net income
        - OMC: $998 million
        - Publicis: $947 million
    - According to Sequoia Fund[10]
        - Publicis's CEO Maurice Levy couldn't find a successor
            - He had been with Publicis for 40 years
        - Wanted to look for the best home for his business
            - He thought OMC would be the best home
        - OMC would control the management overtime
            - John Wren and Maurice Levy would be Co-CEOs
            - After 30 months
                - Levy would become non-executive Chairman
                - Wren would remain as CEO
            - Each company has the same # of directors on the board
            - But directors from OMC have the right to pick the next 2 CEOs after Wren retired
                - => OMC would control at least 25 years
    - The deal didn't go through
        - Management of the two companies have different opinions
            - Example:
                - OMC doesn't like making big acquisitions
                    - Prefer organic growth
                - Publicis paid hefty price for digital companies
        - They might not agree on who would stay and who would leave
            - Who would be the CFO?

Omnicom created more value than peers

- Since 2000
    - OMC
        - Total dividends were **27%** of total earnings
        - Sales per share compounded by **9.8%** annually
            - 2000: $16.7 per share
            - 2014: $62.1 per share
        - => implies **13.4%** return on retained earnings
            - = 9.8%/0.72
    - WPP
        - Total dividends were **32%** of total earnings
        - Sales per share compounded **8.4%** annually
            - 2000: £2.5
            - 2014: £7.6
        - => implies **12.4%** return on retained earnings
            - = 8.4%/0.68
    - Publicis
        - Total dividends were **19%** of total earnings
        - Sales per share compounded **7.1%** annually
            - 2000: £3.3
            - 2014: £7.6
        - => implies **8.8%** return on retained earnings
            - = 7.1%/0.81
    - That makes sense
    - Both WPP and OMC pay a lot of dividends
        - OMC uses the excess cash to buy itself
            - On average at a fair price
        - WPP uses the excess cash to make acquisitions
            - Usually pay a premium price for mid-size acquisitions
            - Mid-sized companies with $20 million EBIT are expensive[11]
                - A lot of competition from private equity

Omnicom is aggressive in financing the business

- Used puttable, convertible bonds in the past
    - Issued in 2001 $850 million senior unsecured zero-coupon securities
        - Due February 07, 2013

        - Called "2031 Notes"
    - Convertible to 15.5 million shares
        - Equivalent to $55.01 per share
        - Implied $20.2 billion market cap
            - 40x P/E
    - Convertible if
        - Shares trade above certain levels, or
        - OMC effect extraordinary transactions, or
        - OMC's Long-term debt credit ratings are downgraded by at least 2 notches
    - Holders have the right to **put** the notes back to OMC for cash
        - In February each year
    - OMC has the right to **redeem** the notes
        - After February 07 ,2009
    - Beginning in February 2006 and every 6 months thereafter
        - If market price of OMC shares exceed certain thresholds
        - => OMC has to pay contingent cash interest for that period
            - Didn't have to pay in 2006, 2007
- Issued in 2002 $900 million senior unsecured zero-coupon securities
    - Due July 31, 2032
        - Called "2032 Notes"
    - Convertible to 16.4 million shares
        - Equivalent to $55.01 per share
        - Implied $21 billion market cap
            - 41x P/E
    - Convertible if
        - Shares trade above certain levels, or
        - OMC effect extraordinary transactions, or
        - OMC's Long-term debt credit ratings are downgraded by at least 2 notches
    - Holders have the right to **put** the notes back to OMC for cash
        - In August each year
    - OMC has the right to **redeem** the notes
        - After July 31 ,2009
    - Beginning in August 2007 and every 6 months thereafter
        - If market price of OMC shares exceed certain thresholds

- => OMC has to pay contingent cash interest for that period
  - Didn't have to pay in 2007
- Issued in 2003 $600 million senior unsecured zero-coupon securities
  - Due June 15, 2033
    - Called "2033 Notes"
    - Later extended to July 1, 2038
      - Called "2038 Notes"
  - Convertible to 11.7 million shares
    - Equivalent to $51.50 per share
    - Implied $19.4 billion market cap
      - 30x P/E
  - Convertible if
    - Shares trade above certain levels, or
    - OMC effect extraordinary transactions, or
    - OMC's Long-term debt credit ratings are downgraded by at least 2 notches
  - Holders have the right to **put** the notes back to OMC for cash
    - On June 15, 2010, 2013, 2018, and
      - On June 15 each year from 2023 to 2032
  - OMC has the right to **redeem** the notes
    - Beginning on June 15 ,2010
  - Beginning in August 2010
    - If market price of OMC shares exceed certain thresholds
    - => OMC has to pay contingent cash interest for that period
      - Didn't have to pay in 2007

- With hindsight, it was smart to using puttable, convertible bonds
  - Interest payment were low
  - OMC sometimes paid "interest payment" for holders not to put the notes
    - Example:
    - In July 2006
      - Offered to pay $32.50 per $1,000 principle of notes to holder of 2032 Notes that did put their note
        - Implied 3.25% interest rate
    - On August 4, 2006
      - $165.2 million was put
      - OMC paid $23.6 million to the remaining $727 million of
        - Or 3.25% interest rate

        - In July 2007, OMC didn't pay any interest payment
            - No notes were put
        - In Feb 2008, OMC offered to pay just $9 per $1,000 to holders of 2013 Notes
            - Implied 0.9% interest rate
            - No notes were put
    - The convertible price was high
        - Share price exceeded convertible bonds only after 2012
            - OMC already called most of the bonds by that time
            - As of December 31, 2012
                - All 2031 Notes were called
                - $647.3 million of 2032 Notes were called
                    - $252.7 million outstanding
                - $193.3 million of 2038 Notes were called
                    - $406.6 million outstanding
            - OMC had to issued 2.7 million shares as premium for the remaining notes
                - Just 1% dilution
- Using long-term convertible, puttable notes is risky
    - OMC issued when share price was very high
        - Didn't issue when share price was fair
    - But OMC's share price can increase a lot in the long run
        - OMC repurchases a lot of shares
    - The right to put caused big concern in 2009
        - Clients reduced budget
            - => OMC need cash because of negative working capital
                - Working capital/sales increased to -16% in Dec 2008
                    - 2006: -21%
                    - 2007: -18%
        - Holders put the notes at the same time
            - $841.2 million of 2031 Notes were put in Feb 2009
                - OMC was able to borrowed under its credit facility
                - OMC survived thanks to
                    - Strong cash flow
                        - 2007: $1.4 billion
                        - 2008: $1.2 billion
                        - 2009: $1.6 billion

                - Available credit facility
    - OMC may not use these notes in the future
        - OMC's price today isn't as high as in 2000-2003
- OMC uses short-term debt
    - OMC's working capital fluctuate throughout the year[12]
        - Fluctuations can be more than $1.5 billion
    - OMC funds short-term need by short-term debt[13]
        - Credit facility, or
            - $3.4 billion available credit lines
                - $2.5 billion committed credit line
                - $0.9 billion uncommitted credit line
        - Commercial paper
            - Can issue up to $2 billion
            - During 2014
                - Average amount outstanding: $909 million
                - Maximum amount outstanding: $1,795.8 million
                - Total issuances: $18,539.9 million
                - Average days outstanding: 20.3 days
                - Weighted average interest rate: 0.29%
        - OMC used little commercial paper during 2009
            - Average amount outstanding: $180.3 million
            - Maximum amount outstanding: $618 million
            - Total issuances: $12,703.3 million
            - Average days outstanding: 5.2 days
            - Weighted average interest rate: 0.72%
        - OMC relied more on credit facility in 2009
            - Average amount outstanding: $753.3 million
            - Maximum amount outstanding: $1,500 million
            - Total issuances: $21,562.0 million
            - Average days outstanding: 12.4 days
            - Weighted average interest rate: 0.61%
    - Using short-term debt make sense
        - OMC can add $2 billion capital
            - Equity or long-term debt
        - But it'll have excess at times during the year
        - Funding short-term needs by short-term debt is more efficient
        - But OMC will be dependent on availability of short-term credit

- OMC uses float-to-floating interest swap
    - OMC's long-term debts include
        - $1 billion @5.9% due 2016
        - $0.5 billion @6.25% due 2019
        - $1 billion @4.45% due 2020
        - $1.25 billion @3.625% due 2022
        - $0.75 billion @3.65% due 2024
    - OMC borrowed some long-term debt because of attractive interest rates
    - But it entered fix-to-floating interest swap
        - Turned the 2020 notes into LIBOR + 2.16% debt
        - Turned the 2022 notes into LIBOR + 1.05% debt
    - Why??

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[1] "In 2008 we took some steps, we took some pretty significant reductions of executive compensation. I will say senior compensation, really not just executives. So probably 500 to 1,000-person layer across Omnicom.

Generally it took probably a 75% reduction in compensation versus what mathematically, based upon our 2008 performance, they would've expected. And we accelerated a lot of severance and other things, getting ready for 2009.

The general view of that is those incentive compensations would have been paid out at the beginning of 2009. At the same time those executives were going to be ask to go make a large number of layoffs to get the cost structures right in the units. We didn't think that is -- we didn't think that was a good thing to do, so we asked them -- they took those pay cuts, I will say, voluntarily.

At the beginning of 2009 we did a large option grant. We don't do options annually, we do them very periodically. I think the last one we did in a large scale was like 2003 or 2004.

We knew 2010 was actually going to be the challenging year from a management standpoint. We managed through 2009 with about a 70 basis point reduction in our operating margins, and an EBITDA level, which given the state of the revenue drop in a services business, we thought was fairly exceptional.

2010 is the challenge. In 2009, everyone knew that the economy was bad and having pay freezes and cutting back on all of your expenditures, everyone is sort of expecting and it is fine. 2010 is the challenge, because revenues are starting to improve, the headlines are starting to get better, yet you can't just put all of those costs back.

And people are getting tired. You know, 18 months or 24 months of no pay increases and things, **that's when it starts to become a real challenge from a management perspective. When other companies are starting to see a recovery, they want your best talent.**

So that option grant did a few things for us. It helped lock in those people, because the options vest over a three-year period. **So what we assumed is if the stock market recovered, that we would have a lot of retentive power on say the top 1,000 people in the Company. If it didn't return, it didn't really matter, we weren't giving out a lot. They took their pay cuts and got whatever**.

And we kept a -- you know, I think we kept a good relationship and a good balance with those executives overall. So we thought -- we think overall it has worked out pretty well. We were able to manage through, again, '09 with about a 70 basis point drop in margins." – Randall Weisenburger, BMO Advertising & Marketing Services Conference, 10 June 2010

[2] "**Our share repurchase activity is really kind of the net of our cash flow after CapEx, acquisitions and dividends**." – Randall Weisenburger, Omnicom's CFO, 2007 Q3 Earnings Call Transcript

[3] "Alan Gottesman, a former Wall Street analyst of the New York-based West End Consulting, says: "**John is as distinguished for what he has not done as what he has. He's not a fashionista**." **Another observer points out that WPP spent £844 million to buy Grey to get Procter & Gamble, while P&G spent £30.2 billion to get Omnicom when it bought Omnicom's Gillette client**.

"**My biggest acquisitions are normal work for my competitors**," Wren says. "**We did not look at Grey. I was not interested. We studied FCB for 11 months and walked away; IPG bought it in 11 weeks. I will not overpay; I do not believe in large acquisitions. I've never seen anyone do a large acquisition where they didn't go backwards.**"

Omnicom's biggest purchase was Gold Greenlees Trott for $235 million in 1998. Its scale and geography let the group launch TBWA as a third network, until then a pale imitation of BBDO and DDB. The most expensive was Abbott Mead Vickers, part sold to Omnicom in 1990, fully sold in 1998." – Omnicom at Twenty, Caroline Marshall, Campaign, 24 February 2006

[4] "**We never had a problem against larger to medium sized acquisitions. We have a problem against expensive dilutive acquisitions. So, it is not a size issue, it is really we are out for our shareholders, not the seller's shareholders**. And so if we can find acquisitions that are fairly priced that fit well with our existing businesses and client base, we are more than interested." – John Wren, Omnicom's CEO, 2009 Q2 Earnings Call Transcript

[5] "Well, there has been a lot of discussion in the industry about acquisitions. It is important to just take a second to explain how we look at them. They are acquisitions which can be put into two broad categories. Acquisitions which change the nature and the makeup of the holding company and the major brands within it. And then there are acquisitions which support the brands and the extension of those brands, which make up the holding company. **We've always--we've been very happy with the profile of the holding company for a long time now, nearly a decade. So we haven't looked to large acquisitions at any point, which would change that composition. We have focused completely on extending the value of our brands through geographic extension and through private extension. And through being able to better service our top 250 clients**.

So with that in mind, that's what we focus on in the business plans of each one of those individual units, and what their requirements are. Rather than looking at a discipline, or making a comment on a discipline, it's easier to make a comment towards a broader geographic area, which says that **our focus increasingly is in Asia, in terms of increasing the size and the depth of our operations in that region. Whilst we look at other acquisitions as they come up which support our key CRM businesses, our PR businesses and our specialty advertising businesses**." – John Wren, Omnicom's CEO, 2004 Q2 Earnings Call Transcript

[6] "ADWEEK: How did you select the agencies you ultimately invested in?

WREN: We evaluated the market two ways. First, we independently went out and evaluated who is in this space, what are their principals, and what kind of environment are they interested in. **Then we went to our top clients and**

asked, "Have you guys toyed with this and if so, who have you spoken to?" Essentially, we married the two lists and cut the population down to 15. Then I personally went out and spoke to all 15. You can review the client list, but the rest of it is gut; it's intangible. These companies were so small and brand new they could have either succeeded or failed. So **I had to determine which type of people I wanted to work closely with and assist in becoming successful.**" – Q&A: Omnicom's John Wren, Adweek, 18 October 1999

[7] "The seller's expectations are probably based upon good market knowledge. **If you've got a larger size digital asset, scarcity value has driven some of the prices of those, at least in our view, to very high levels**. I just scarcity value always drives prices to a relatively high level.

For smaller assets the scarcity value isn't quite there, and the value proposition of joining an Omnicom Group hasn't really changed very much.

Our pricing and the way we have historically done deals, is a little bit of a different model. We have historically used earn-out structures that in effect is a way of sharing the development of a business.

So we will make an acquisition, and **we will price the deal actually over the performance of the company over, say, the next three to five years. And in doing that, we are getting -- it is a lower multiple**, but it is based upon what the company can become as part of the Omnicom Group.

They are going to join the Omnicom Group because they're going to get the ability of a faster introduction to a large number of clients, hopefully at a lower client acquisition cost; be able to expand their business at a much more rapid rate. They benefit from that, we benefit from that.

They have to do the execution. We are buying them because they are an intelligent, cohesive group that can provide a valuable service to clients, that we think the quality of their services is high that we're willing to introduce them to a lot of other clients.

That's a pretty good joint relationship. And the pricing on that, if it works well, on an historical basis could actually be extremely high**. If they triple or quadruple their business over that three-year period, the trailing multiple on the**

earnings that we bought when we bought it, it could be 15, 20 times. But it is still 5 or 6 times the average over that three to five-year period.

You know, it's a good overall -- we think it's a good overall relationship for us. It puts the risk as joint risk between us and them. **It makes a commitment on their part to integrate within the Omnicom Group and to take advantage of the group. And it places an incentive at the right levels with us on integrating and making those introductions**.

It has worked out very well for us with those types of acquisitions. Obviously, **some acquisitions, they've already gone out and had private equity or other investors in it. Those investors aren't with the business. Later they don't want to share in that type of relationship, so we structure other things. Certainly larger acquisitions tend to be that way, and pricing is varied**." – Randall Weisenburger, OMC's CFO, BMO Advertising & Marketing Service Conference, 10 June 2010

[8] "**I think with personally all of our acquisitions, and especially true with some of the smaller ones, it's really a make or buy decision. At a good price for our shareholders, acquisitions are fantastic. They can accelerate change**. They can get you to where you want to be faster versus starting from scratch and trying to build it. **But we found for the better returns for our shareholders a constant focus on building our business internally has proven to work pretty well in most cases**. Doesn't mean we're not going to do acquisitions. They just have to be right-priced for our shareholders as well." – Randall Weisenburger, Omnicom's former CEO, 2012 Q3 Earnings Call Transcript

[9] "As you know, largely through the absence of acquisitions over the last several years, we are extraordinarily disciplined, in terms of what our needs are, and the prices we are ultimately willing to pay, and increasingly, especially when you get into areas of digital and some of the new emerging technologies, **in 85% of the cases of the opportunities that present themselves, you are faced with a build versus a buy strategy on many of those things, and oftentimes we have opted to go to the build side of it.**

The pipeline still remains very robust. If market trends continue in terms of private equity and other things, I think we should see prices come more in-line with what our disciplines say we should pay. There is no way to predict it, other than say we that we will in fact be disciplined, and do whatever is appropriate for our businesses.” – John Wren, Omnicom’s CEO 2007 Q3, Earnings call Transcript

[10] “My personal feeling — which nobody has confirmed, so take it how you want — is that **Mr. Lévy at Publicis did not have a successor lined up and was looking for the best home for his business and thought Omnicom would be that best home**. They struck a deal that looked like a merger of equals but Omnicom treated it as if it were a soft acquisition. Omnicom would control the management over time. **The deal that they struck made John Wren, the Omnicom CEO, the CEO of the combined company after two and a half years**. **And while the number of directors on the board from each company would be the same, the directors from the Omnicom side had the right to pick the next two CEOs after Wren retired**— which means, practically, you could have 25 years during which Omnicom would control the business.

My understanding is that **there was an agreement up front that Omnicom would control the financial portion of the business as well**, which makes sense because if John Wren were going to be the CEO, the financial function was not going to be in Paris; it was going to be in New York. When the deal came apart, that was one of the things that were cited. But I am not sure that was ever really an issue. **I think Publicis struck a deal and then was not crazy about the deal that it struck. It was not really a merger of equals; it was a soft takeover… It was struck as a merger but I am not sure Omnicom ever treated it as a merger**.” – David Poppe, Sequoia Investor Day, 16 May 2014

[11] “Alexia Quadrani, Analyst: Has the environment gotten more competitive from a pricing standpoint or has it pretty much been the same all year?

John Wren, Omnicom’s CEO: Well, our behavior hasn't changed all year.

Randall Weisenburger, Omnicom’s CFO: I think the competitive environment's been about the same all year which for larger acquisitions, and larger, I'll say **mid-size acquisitions, things with $20 million of EBIT, it's pretty competitive**.

The financial buyers are private equity, you know, seem to be very aggressive. Smaller acquisitions, I think, have very pretty consistent for quite a while.

John Wren, Omnicom’s CEO: Nobody's sent the private equity guys the note saying that there're probably only three or four guys that could actually buy these things after they restructured them and our discipline is not going to change.

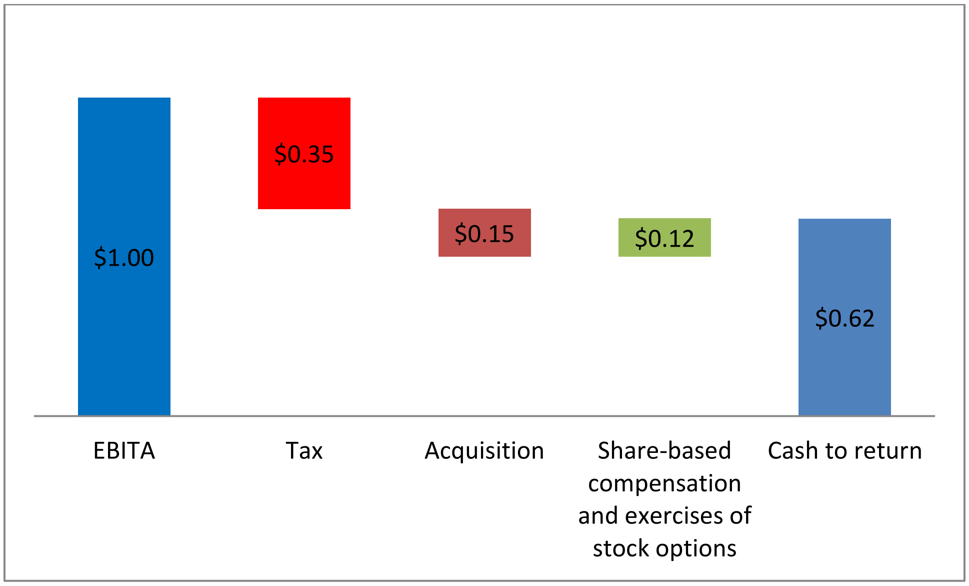
So some of this is just sloshing money around but, again, **we have always been very, very disciplined and we always seem to manage to grow I think faster than anybody in our space**. So we haven't had to over pay or pay what we would believe are unjustified prices under the guise of its strategic." – 2006 Q4 Earnings Call Transcript

[12] "We have a seasonal working capital cycle. Working capital requirements are lowest at year-end. **The fluctuation in working capital requirements between the lowest and highest points during the course of the year can be more than $1.5 billion**. This cycle occurs because our businesses incur costs on behalf of our clients, including when we place media and incur production costs. **We generally require collection from our clients prior to our payment for the media and production cost obligations**." – Omnicom's 2008 Annual Report

[13] "We manage our cash and liquidity centrally through our regional treasury centers in North America, Europe and Asia. The treasury centers are managed by our wholly-owned finance subsidiaries. Each day, operations with excess funds invest these funds with their regional treasury center. Likewise, operations that require funds borrow from their regional treasury center. The treasury centers aggregate the net position which is either invested with or borrowed from third parties. To the extent that our treasury centers require liquidity, they have the ability to access local currency uncommitted credit lines, the Credit Agreement or issue up to a total of $2 billion of U.S. Dollar-denominated commercial paper. This process enables us to manage our debt balances more efficiently and utilize our cash more effectively, as well as better manage our risk to foreign exchange rate changes. In countries where we either do not conduct treasury operations or it is not feasible for one of our treasury centers to fund net borrowing requirements on an intercompany basis, we arrange for local currency uncommitted credit lines." – Omnicom's 2014 Annual Report

Value

Omnicom Can Return Almost All Earnings While spending $300 million in Acquisitions



For each dollar of pre-tax profits, Omnicom can return 62 cents to shareholders

- **Biggest Negative**:
  - OMC has 1.5% annual share dilution
- Key inputs
  - Number of outstanding shares: 243 million
  - Share price: $70
  - Market cap: $17,006 million
  - Cash: $1,362 million
  - Debt: $4,567 million
  - EV: **$20,211 million**
  - Tax rate: 35%
    - Actual tax rate is about 33%
    - Cash tax is even lower
  - Current EBITA: $2,051 million
  - Normal EBITA: **$2,026 million**
    - = Sales * 24-year median EBITA margin
  - EV/Current EBITA: 9.9x
  - EV/Normal EBITA: 10x
- OMC is cheaper than peer

- WPP
  - WPP is smaller than OMC in ad and marketing services
    - Advertising revenue
      - OMC: $7,594 million
      - WPP: $7,417 million
        - £4,502 million
      - WPP has a much bigger media business
        - Total billings double OMC's
        - OMC's media revenue is $1.9 billion
        - WPP's is probably $3.5-4 billion
      - => OMC has a much bigger creative business
    - CRM, specialty communications, and PR revenue
      - OMC: $7,724 million
      - WPP: $6,283 million
  - WPP is very big in research
    - Net sales: $2,881 million
      - £1,749 million
    - Acquired TNS in 2008
      - Paid £1.1 billion
      - TNS's 2007 revenue: £1,068 million
        - EBIT was £103 million
    - => paid 1x P/S
    - 10x EBIT
  - The research business stayed flat in the last 5 years
    - A cost-plus business model
    - Online research has reduce cost
    - => headwind on revenue
      - Margin is stable about 10%
  - WPP is a smarter acquirer than Publicis
    - Tends to make smaller acquisitions
    - Some big acquisitions were at fair price
      - Acquired TNS at 10x EBIT
      - Acquired Grey at 1.2x P/S
    - The acquisition of 24/7 Real Media was stupid
      - Paid $650 million
      - In 2007
      - 24/7 Real Media competed with DoubleClick

                - WPP call itself “frenemy” of Google
                - WPP made some more acquisitions to build Xaxis
                    - A programmatic buying business
                    - Total acquisitions were over $1 billion
                    - Gross billings last year was $770 million
                        - $40 million gross margin
                - OMC built a similar business organically
                    - Gross billings is about $300 million
        - WPP has much less exposure to the U.S. market
            - WPP’s revenue mix
                - North America: 34%
                - U.K.: 14%
                - Western Continental Europe: 21%
                - Other countries: 30%
                    - Asia Pacific
                    - Latin America
                    - Middle East
                    - Central & Eastern Europe
            - Why didn’t WPP separate out Asia Pacific?
                - To overstate how big it is in developing markets?
            - WPP may grow fast in Asia Pacific
            - But it may have a big business in Europe
        - It’s unclear whether WPP has better growth potential than OMC
        - WPP’s value creation is good
            - Since 2000
                - Total dividends were **32%** of total earnings
                - Sales per share compounded **8.4%** annually
                    - 2000: £2.5
                    - 2014: £7.6
                - => implies **12.4%** return on retained earnings
                    - = 8.4%/0.68
    - Publicis
        - Publicis makes too many acquisitions
            - To grow the digital business
        - Paid hefty price
            - Sapient
                - In 2014

        - Paid $3.7 billion
        - Revenue: $1.3 billion
        - EBITA: $135 million
        - => 27.4x EBITA
    - Rosetta
        - A digital agency
        - Acquired in 2011
        - Paid $575 million
        - Revenue: $207 million
        - 2.8x P/S
        - 12.5x EBITDA
    - Razorfish
        - In 2009
        - Paid $530 million
        - 13.7x EBITDA
        - 1.4x P/S
    - Digitas
        - In 2007
        - Paid $1.3 billion
        - 17x EBITDA
  - Publicis's value creation is mediocre
    - Since 2000
    - Total dividends were **19%** of total earnings
    - Sales per share compounded **7.1%** annually
        - 2000: £3.3
        - 2014: £7.6
    - => implies **8.8%** return on retained earnings
        - = 7.1%/0.81
  - Publicis does more business in Europe than OMC
    - Revenue breakdown
        - North America: 48%
        - Europe: 31%
        - Asia Pacific: 12%
        - Latin America: 6%
        - Africa and Middle East: 3%
  - => Publicis shouldn't be more expensive than OMC
- **Interpublic**

- Interpublic was of similar size to WPP and Omnicom in 1990s
- Interpublic got into an accounting scandal in early 2000s
  - Revenue declined
    - 2000: $6.9 billion
    - 2006: $6.2 billion
  - Revenue recovered shortly to $6.9 billion in 2008
  - Then declined to $6 billion in 2009
  - Revenue has grown about 4.6% annually since 2009
- Interpublic has a big advertising business
  - Revenue
    - OMC: $7,594 million
    - WPP: $7,417 million
      - £4,502 million
    - Interpublic: **$6,097 million**
    - Publicis: $3,870 million
      - €3,120 million
    - Havas: $2,313 million
      - €1865 million
- Interpublic is much smaller than OMC and WPP in marketing services
  - Revenue
    - OMC: $7,724 million
    - WPP: $6,283 million
    - Interpublic: **$1,440 million**
    - Publicis: $1,350 million
      - €1,088 million
- Interpublic has similar geographic mix to OMC
  - North America: 56%
  - U.K.: 9%
  - Europe: 11%
  - Asia Pacific: 12%
  - Latin America: 6%
  - Other: 6%

- **Dentsu**
  - Dentsu has 25% market share in Japan
  - Dentsu also owns Aegis
    - A media agency with about $40 billion billings

- Revenue breakdown
  - Japan: 49%
  - EMEA: 20%
  - Americas: 17%
  - APAC: 14%`
- **62%** of profits come from its Japan business
- Growth potential should be lower than OMC
- But it's more expensive

- **Havas**
  - Havas is a pure advertising agency with
    - Creative agencies
      - Havas worldwide
      - Arnold worldwide
    - Media agency
      - Havas media
        - About $20 billion billings
  - Revenue is well diversified
    - The biggest client account for 4% of total revenue
    - Top 10 clients account for 18.1% of total revenue
  - A lack of marketing services might be a disadvantage
  - Havas has big exposure to Europe
    - Revenue mix
      - North America: 32%
      - France: 19%
      - Europe, excluding France and UK: 19%
      - UK: 13%
      - Asia-Pacific and Africa: 8%
      - Latin America: 9%
    - => 38% of revenue is in low-growth market
    - 51% of revenue is in Europe
  - Havas is the weakest peer
- OMC is the best in the industry
  - Its agencies are the best creatively
  - Little exposure to continental Europe
  - 60% of the business is in the U.S.
  - Second only to WPP in developing market
  - Has the most stable margins

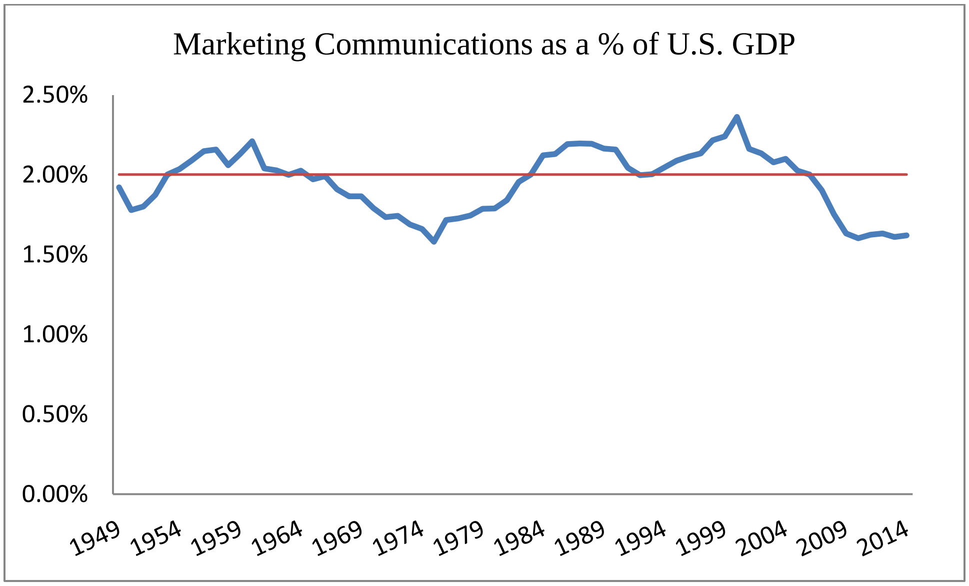
        - Best capital allocation
    - Peer valuation
        - WPP
            - Share price: £13.75 ($21)
            - EV: £20,280 million ($30.8 billion)
            - EV/EBIT: **12.59**
            - EV/Pre-tax Owner Earnings: **13.46**
                - = Sales * Median EBIT margin
        - Publicis
            - Share price: €61 ($68)
            - EV: €16,205 million (€18 billion)
            - EV/EBIT: **13.71**
            - EV/Pre-tax Owner Earnings: **12.85**
            - = Sales * Median EBIT margin + Sapient's EBIT
        - Interpublic
            - Share price: $19.64
            - EV: $8,987 million
            - EV/EBIT: **10.99**
            - EV/Pre-tax Owner Earnings: **11.38**
            - = sales * Median EBIT margin
        - Dentsu
            - Share price: ¥ 729 ($6.1)
            - Market cap: ¥ 1,814 billion ($15 billion)
            - EV: ¥ 2,026 billion ($17.9 billion)
            - EV/EBIT: **16.25**
        - Havas
            - Share price: €7.55 ($8.5)
            - EV: €3,404 million (€3.8 billion)
            - EV/EBIT: **12.94**
- Each $ of EBITA can turn into between 62 cents of cash return
    - Total acquisitions over the last 10 years were < **15%** of total EBITA
        - Total acquisitions: $2,451 million
        - Total EBITA: $16,954 million
    - At this rate, OMC can have **$300 million** annual budget for acquisitions
        - That's a lot for bold-on acquisitions

- Share-based compensation and proceeds from exercises of stock options were about 12% of EBITA
- To calculate FCF, we should
  - Add back share-based compensation
    - It's non-cash expense
  - Add back proceeds from exercises of stock options
    - Because we'll consider dilution separately
- Non-controlling interests income is about 10% of total income
  - About 0.85% of sales
  - Distribution to non-controlling interests is more than offset by decrease in working capital
    - About 1% of sales each year
  - => we can just ignore non-controlling interests
- True FCF = EBITA – Tax – Acquisition + Share-based Comp + Options
  - = (100% - 35% - 15% + 12%) * EBITA = 62% * EBITA

- This result is consistent with OMC's past capital allocation
  - OMC returned 107% of after-tax earnings since 2000
    - After-tax earnings is a bit understated because of amortization expense
- OMC deserves 13x EBITA
  - 13x EBIT is equivalent to 21x True FCF
  - => 4.8% yield
  - OMC can grow at least 5.3%
  - Dilution is 1.5%
  - => 8.6% net yield
- OMC is cheap based on cash flow
  - FCF = CFFO – Capex – Dividends paid to non-controlling interests shareholders
  - 3-year average FCF is $1,258 million
  - Current price is 13.5x FCF
  - => **7.4%** yield
    - or 5.9% real yield after 1.5% dilution
    - adding 5.3% growth => **11.2%** potential return

Growth

Omnicom Can Grow 1-2% Faster than GDP



Marketing communication expenditure fluctuates about 2% of U.S. GDP

Biggest Negative:

- The business is cyclical

The industry can outperform GDP in the future

- Communication expenditure/U.S. GDP fluctuated around 2.00%
    - Communication expenditure include all spending all media
        - Direct mail
        - Billboard
        - Outdoor
        - TV
        - Internet
    - The data from 1949 to 2007 comes from Robert J. Coen
        - At Magna in the McCann Erickson ad agency
    - The data from 2008 to 2014 was extrapolated from
        - 2007 data
        - WPP's estimated growth over the period
    - Total expenditure can outperform or underperform GDP for 5-10 years
        - 1951-1960: Outperformed GDP

- 10 years
- 1961-1975: Underperformed
  - 15 years
- 1976-1987: Outperformed
  - 12 years
- 1988-1992: Underperformed
  - 5 years
- 1993-2000: Outperformed
  - 8 years
- 2001-2010: Underperformed
  - 10 years
- 2010-2014: Outperformed

- From 1949 to 2014
  - Annual growth was positive in 91% of the years
    - In 59 of 65 years
  - Annual growth was over 3% in 80% of the years
    - In 52 of 65 years
  - 10-year CAGR was over 3% in 88% of the years
    - In 49 of 56 years
  - Long-term average growth was 5.9%
- Current Communication Expenditure/U.S. GDP is **1.62%**
  - Below the average level of **2%**

- Advertising expenditure/GDP (AE/GDP) shows similar pattern
  - Advertising expenditure doesn't include
    - PR
    - Direct and specialist communications (CRM)
  - The data comes from Zenith Optimedia
  - We have only data from 1998 to 2014 for the U.S.
    - This isn't a good period
      - 1998-2000 was a bubble period
        - AE/GDP increased from 1.29% to 1.50%
      - 2008-2014 was a long recession
      - AE/GDP was about 1.25% in 2003-2007
      - AE/GDP was about 1.00% in 2003-2007
    - Media AE/GDP was **1.23%** over the period
  - Japan's AE/GDP was more stable
    - From 1996 to 2014

        - Min: 1.11%
        - Max: 1.37%
        - Median: **1.21%**
        - Mean: 1.23%
        - Standard deviation: 0.08%
        - Variation: 0.07 (very stable)
- Global AE/GDP is about **0.7%**
    - (according to WPP)
    - China's AE/GDP is now **0.79%**
- It's possible that Global AE/GDP will increase
    - As advertising increase penetration in developing market
- => total marketing expenditure won't underperform GDP in the future
- Agencies can capture more % of total marketing expenditure
    - Fees equal to costs plus margin
    - New mediums results in much more work
        - Ad agencies will create ads for TV, online, mobile, etc.
        - Media agencies will handle
            - TV
            - Search
            - Social marketing
            - Etc.
    - More work => more costs => more fees
    - Agencies capture more % of spending in new mediums
    - Traditional media: agencies captures 15% of client expenditure
    - Search/Display: 15-20%
    - Mobile/Social Media: 40-45%
    - Example[1]
    - $10 million spending on traditional media
        - Most go to the media and production
        - OMC gets paid for the design, architecture, creative work
    - $10 million spending on the web
        - OMC gets paid for
            - Design, architecture, creative work
            - Execution work
                - Very little money goes to third parties
        - Commission for online media buying is higher than TV
            - Buying and planning

                - Key word search
                - Banner ads
                - Rich media
            - Higher commissions due to more work to spend $20m on online
                - Online content owners are fragmented
                - TV networks are much more concentrated
- => agencies can grow 1-2% higher than GDP

OMC can grow at least 5.5%

- OMC's revenue by region
    - North America: 60%
    - U.K.: 10%
    - Europe: 16%
    - Asia Pacific and others: 14%
- OMC's growth far exceeded US GDP growth in the past
    - (comparing U.S. revenue growth with U.S. GDP)
    - Before 2004
        - 5-year CAGR exceeded GDP growth by 10-15%
        - OMC made the most acquisitions during this period
    - OMC made much fewer acquisitions after 2004
        - In the 2003-2008 period: exceeded by 3.6%
        - In the 2009-2014 period: exceeded by 1.5%
            - Understated by OMC's disposal of some business
    - Over the last 10 years, OMC outpaced GDP growth by 1.0%
        - This was a very bad period
            - Industry headwind
                - Total Ad spending underperformed GDP
            - OMC made much fewer acquisitions than previous periods
                - Total acquisitions were just 19% of total FCF
            - OMC might not make many acquisitions in the U.S.
                - The priority was in developing markets
- OMC can easily growth 1-2% faster than GDP in the future
    - Total ad spending would revert to the mean
    - OMC may grow more if it spends more than 19% of FCF in acquisitions
- => OMC can grow **6%** in the U.S.
- OMC can grow **6%** outside the U.S. and Europe
    - Annual growth was 10.7% over the last 10 years

- OMC has a good competitive position in Asia-Pacific
  - Revenue in Asia-Pacific (10% of OMC's revenue)
    - OMC: $1,603 million
    - Publicis: $1,068 million
      - €861 million
    - Interpublic: $922 million
    - Dentsu: $840 million
  - Revenue in Latin America (3% of OMC's revenue)
    - OMC: $433 million
    - Publicis: $557 million
      - €449 million
    - Interpublic: $470 million
  - WPP is the biggest player in these markets
    - It doesn't disclose revenue in specific regions
    - It disclose revenue in Asia Pacific, Latin America, Africa & Middle East and Central & Eastern Europe: **$5,634 billion**
      - £3,420 million
  - OMC's networks are the most creative in these markets
    - Received the most number of awards
- Asia-Pacific is **33%** of worldwide advertising expenditure
  - North America: $182 billion
  - Europe: $116 billion
  - Asia-Pacific: $168 billion
  - Latin America: $30 billion
  - Africa & Middle East: $18 billion
- Asia-Pacific is **27%** of worldwide communication services expenditure
  - North America: $321 billion
  - Europe: $256 billion
  - Asia-Pacific: $245 billion
  - Latin America: $72 billion
  - Africa & Middle East: $23 billion
- But Asia-Pacific represents a small % of revenue of most groups
  - OMC: 10%
  - Interpublic: 12%
  - Publicis: 12%
  - Dentsu: 14%
- It's possible that big groups mainly serve multi-national clients

        - They may gain more business with regional clients overtime
        - The market may consolidate
        - => big groups gain market share
    - => it's not aggressive to assume **6%** growth in these markets
- Europe has low growth
    - OMC may grow **4%** in the U.K. and **3%** in Europe
- Weighted average growth is **5.3%**
    - = 0.60*6% + 0.14*6% + 0.10*4% + 0.16*3%

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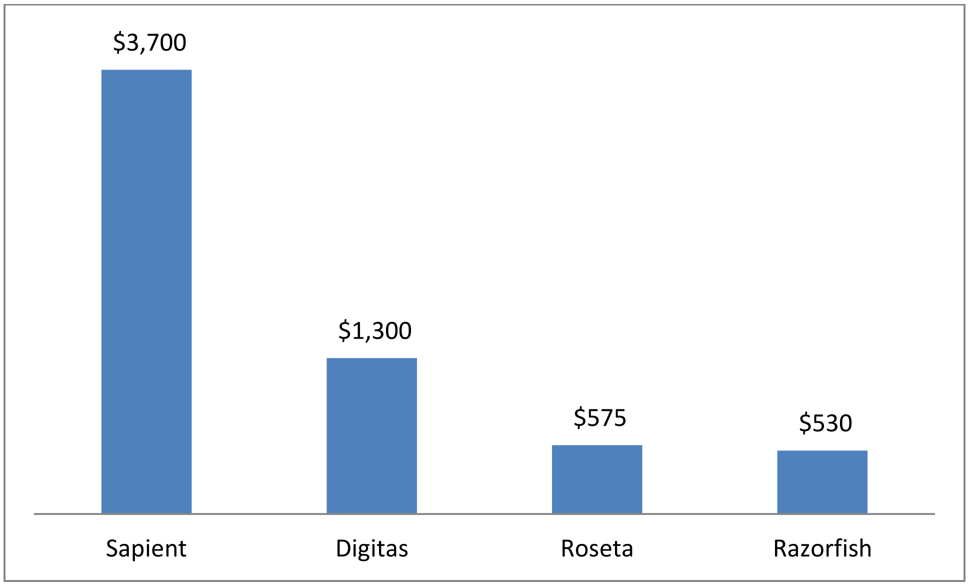
[1] "**If a client were to spend $10 million in traditional media much of that money is going to the media. Another chunk of money is going to third parties that are actually, I'll say, producing the commercial** and then we're getting paid for the design, architecture, creative work. **When you throw that on the web we're getting paid for the design, architecture, creative work, plus the execution work and very little money is really going to third parties. If we're doing online, say, media buying and planning, key word search, banner ads, rich media, whatever, again the commission percentage or the fee percentage to our agencies is generally much higher than TV**. It's obviously a lot more work to spend $20 million on online than it is to spend $20 million in a TV campaign, so the commissions are generally multiples of each other. Behind it with the [ND] margin, the margins are about the same." – Randall Weisenburger, Omnicom's former CFO, 2008 Q2 Earnings Call Transcript

Misjudgment

Why is OMC cheaper than peers?



Publicis spent $6.1 billion in 4 big acquisitions of digital agencies

- **Biggest Negative**:
  - Value creation depends on OMC's capital allocation
- OMC doesn't look sexy
  - WPP and Publicis present at dozens of analyst conferences each year
  - OMC rarely presents at analyst conferences
    - Just does quarterly conferences
  - OMC's annual reports are boring
    - Reveal little information
      - Few charts
      - Few industry data
      - Don't disclose billings like WPP
      - Don't discuss in detail the acquisitions it make
        - Perhaps too many tiny acquisitions
      - Don't even describe its business segments
      - Don't break out one-time expenses in income statements
        - WPP shows its calculation of "headline PBIT"
  - John Wren is known as a quiet man of advertising[1]
    - A laconic accountant
    - Competitors derive him as "an accountant"

        - He's in contrast to WPP's Martin Sorrell
            - A visionary CEO
    - WPP and Publicis talk a lot about digital
        - WPP boasted 36% of its revenue coming from digital
        - Publicis boasted 42%
    - WPP and Publicis spent billions in acquisitions
    - OMC doesn't separate out the digital business
        - It sees digital as just a medium
        - => integrate digital skills into agencies[2] [3]
        - OMC once mentioned that 30% of PR revenue was digital[4]
    - It's difficult to judge how strong OMC's digital capabilities are
        - OMC doesn't disclose digital revenue
            - Interpublic and Havas don't
    - It's possible that all these companies can have strong digital skills
        - Ageist was an independent media network
            - (before being acquired by Dentsu in 2013)
            - Revenue was just about $1.5 billion
        - Digital domains accounted for **43%** of Aegis's revenue
            - (according to Dentsu)
    - OMC may have adequate digital capabilities
        - OMC just doesn't talk about them
    - OMC was able to gain market share
        - Digital should have brought the most changes to media agencies
        - Yet OMC's total billings grew **7.4%** annually since 2004
            - 2004: $27 billion
            - 2014: $56 billion
        - That's faster than the global advertising market growth of **2.9%**
            - 2004: $405 billion
            - 2014: $539 billion
- People may think that OMC is obsolete
    - OMC is known as an advertising agency
    - Facts:
        - Advertising revenue is just 50% of total revenue
            - And many CRM services are integrated into ad agencies
        - Agencies adapted from newspaper to radio and TV
- OMC had poor growth in recent history
    - 5-year sales CAGR: 5.5%

    - 10-year sales CAGR: 4.6%
    - In the U.S.
        - 5-year sales CAGR: 5.5%
        - 10-year sales CAGR: 4.4%
    - Investors may neglect how bad the ad market was over the period
- The biggest concern is whether John Wren's successor will be as good
    - The business is so good
    - Value creation will depend on capital allocation
        - IPG missed 10 years of growth due to corporate problems
            - Not agency problem
        - Publicis makes less than 9% return on retained earnings
    - It's not easy given the rise of new mediums
        - Competitors like Publicis reacted by making splashy acquisitions
        - OMC is much more focused on organic growth
            - Runs Omnicom University since 1995
                - Trained thousands of executives
                - Help develop new skills
            - Has detailed succession management at every office[5]
        - OMC complements organic growth with bold-on acquisitions
- John Wren once said "I won't be CEO when I'm Martin's age"[6]
    - Martin Sorrell was 62 years old at that time
- John Wren is now 62 years old
    - But there's no talk about his retirement
    - He's not old
        - He may stay for another 10 years

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[1] "Throughout its existence, Omnicom has taken a unique approach to one of the biggest issues in business: parts and whole. In other words, which powers and responsibilities lie with the corporate centre and which with individual operating companies.

Here, Omnicom and WPP (the two leading groups in the industry) are polar opposites. WPP is the classic command-and-control centrist: positioned as a parent company (albeit with offspring more than 100 years older than the parent), **WPP is positioned as an operating entity in its own right. Reflecting this approach, its glossy annual report acts as a marketing document for**

WPP's chief executive, Sir Martin Sorrell, for WPP and the group companies.

Omnicom, by contrast, publishes an annual report so self-consciously basic that Wren cheerfully admits it is "boring". "I don't even get to pick the colour for the front page," he says. "Showy reports are just ego for the boss - I would rather send people home with bigger bonuses."

Its hands-off stance has convinced many entrepreneurs, including the iconoclastic founders of Abbott Mead Vickers, TBWA, Goodby Silverstein & Partners, OMD and PHD, to sell their precious companies to Omnicom. "**He's convinced a lot of people that, top price or not, Omnicom is the place to sell your company. He's made a cult of operating company autonomy**," Gottesman says." – Omnicom at Twenty, Caroline Marshall, Campaign, 24 February 2006

[2] "On the topic of digital strategies, I will remind you of what I said in our last call about the way Omnicom breaks down the broad category of digital. **First, we've always believed that anything that can be digital, will be, and that means pretty much everything we do. We have long encouraged and helped our agencies to invest in digital skill sets and talent, and they all have. Whether in brand advertising, shopper marketing, PR or any of our disciplines, all of our agencies have developed and hired talent to embed digital capabilities in our core offerings**.

Second is an area of data and analytics, new platforms that enable marketers to identify and reach the right people at the right time in the right place, and even when they are in the right frame of mind. **For us, that's Annalect, with more than 1,200 professionals in 45 markets. Annalect is a resource for all Omnicom companies.**

Third, there's an area of technology-driven marketing, such as e-commerce and m-commerce, where firms like Deloitte, IBM, Wipro, and agencies like Sapient compete. We have some capabilities in this area, and we see it as a potential opportunity for further growth." – John Wren, 2014 Q2 Earnings Call Transcript

[3] "**Increasingly clients are looking to go to a smaller group of agencies to reduce the roster number of vendors that they have to interface with so a lot of, in my view, a lot of the valuations for one-off small digital companies have been good on the owners since they've gotten decent prices through**

selling it, but they aren't really justified when you compare it to the growth in the general market and some of the trends which are going on. And again, we're in the service business. **The average age of our employees is early 30s. The digital capability of those people becomes more ingrained every day and the distinction between what was called traditional and digital diminishes every day**. I think what does improve is the information and our ability to analyze the information and direct the messaging to individuals and to measure those results. And that's a trend that's well in place and going to only continue." – John Wren, 2012 Q3 Earnings Call Transcript

[4] "Sure, we've got a very substantial PR practice. I think of the major holding companies, I would think our PR business is the largest. We have Fleishman, Ketchum, Porter Novelli, and a few other smaller specialty brands as well.

You had shown up here organic search. You mentioned a few data companies. **Frankly the PR strategies are pretty important in organic search as well. There is a lot of strategy to do with press releases and things to improve that**.

Social network monitoring is critical, because things move on a viral basis at effectively the speed of light. Companies make changes, do things, launch a new product, change a pricing plan, whatever. And they can get instantaneous response through Twitter or social media blogs, etc.

So the PR business -- the expertise necessary in the PR business is expanding quite a bit. The fundamentals are still the same. It is proper messaging, understanding the dynamics in the marketplace, but the way you get there is dramatically different.

So I think at this point probably about 30% of our revenue in our PR firms is digital. Most of the new hires seem to be trying to supplement our capabilities in that digital area, both on the monitoring side from corporate reputation, brand reputation, as well as the -- say the PR or marketing side is a lot more electronic press to deal with, a lot more important bloggers or influencers." – Randall Weisenburger, OMC's CFO, BMO Advertising & Marketing Services Conference, 10 June 2010

[5] "Drawing on 18 years, we established the real need for training and development of our people**. So we started with Omnicom University, and then we've invested quite a bit in that area in terms of how do you bring**

somebody new into the business? What do you train them on? How do you develop them? And we have that.

In terms of succession management, **we have detailed plans for every office, every significant client around the world. Not only who is leading something in a small office in India**; to food that individual's successor would be if some actions occurred; **if we have 3 years to train and develop somebody, who that individual would be; and 5 years out, who that individual would be.**

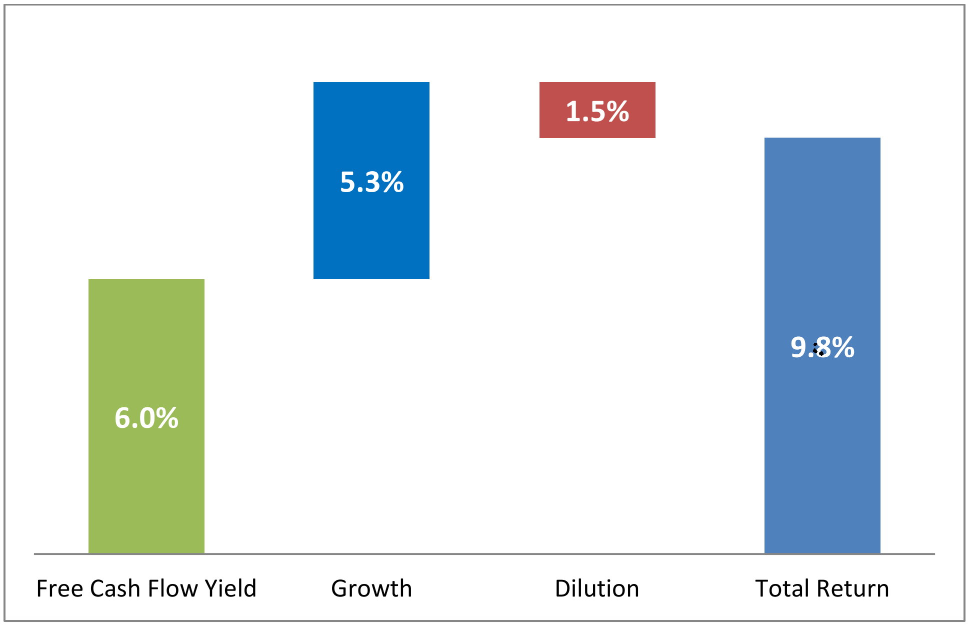
Now, there's a lot of white space, as you can imagine, in the system, but it's constantly updated by our folks. And it helps guide us when we are developing and training people, the type and level of training we want to put them through and the speed with which we want to do it. Because of the core, what Maurice outlined -- what I outlined -- the only obstacles to them, truthfully, because our clients are dying to get somebody who can handle all this complexity and make intelligent strategic choices with them and advice, our only limitations are time, getting people educated as to what services are where and why these will benefit people, and talented people.

So we will be able to deploy those systems, get even greater information, find subject matter experts that maybe we were lacking that they have, and vice versa. So there's real upside, and having the information, having it organized, knowing what you're doing, knowing what expectations you have of your management -- that will aid this success and reduce the amount of time that will be needed to achieve our objective." – John Wren, Omnicom's CEO, Publicis and Omnicom Conference on Merger, 31 July 2013

[6] "On succession: "I [John Wren] think it's more of a problem for my competitors than it is for me. **Michael Roth is 60. Martin is 61, and I know he'll be 62 on Valentine's Day. Maurice is 64. I won't be CEO when I'm Martin's age**. This is no reflection on Martin, but next year will be my 11th year as CEO, and you always have to guard against a couple of things. **You have to bring things to the party besides being the boss. You have to create ideas, revenue in order to do this job well. There'll be a moment, and I don't know when that will be, when I-or someone else on the board-will say the same old juice ain't flowing.""** – Wren Gives Omnicom Tools to Reinvent the Ad World, Matthew Creamer, Advertising Age, 08 January 2007

Conclusions

Omnicom Stock Is Like a Bond with Growing Coupons



Buying Omnicom at $70 per share can results in 9.% long-term return

- The business faces more changes than banks
    - OMC can spend $300 million a year in acquisitions to fortify its moat
        - While returning 62% of EBITA to shareholders
- OMC has the highest business quality among companies we looked at
    - Negative working capital
        - Much more profitable than Frost or Hunter Douglas
    - Long-term growth can be better than GDP
        - Because agencies can capture more % of ad spending
    - **Weakness**
        - Total ad spending has long cycle
            - Can have 10 years of underperforming GDP
        - OMC doesn't have margin expansion like
            - Frost
            - Wiley
- Capital allocation is good
    - Doesn't overpay for acquisitions
    - OMC does a good job at growing organically
    - **Weakness**

            - OMC just buy back stock if it has excess cash
                - Doesn't buy opportunistically
                - That's okay
                    - It pays a fair price for itself overtime
                    - That's better than paying a premium for acquisitions
                    - If shareholders think OMC is expensive, they can sell
            - OMC is aggressive in financing the business
- The stock price is boring
    - It's not cheap
    - Investors may have to hold the stock for many years to realize the value
        - That's boring
        - But worthy
            - Investors will certainly beat the market
            - 3-year average FCF is $1,258 million
                - $5.18 FCF per share
            - => **7.4%** yield at $70 per share
                - or 5.9% real yield after 1.5% dilution
                - just need 2% return to match market's return
                - Adding 5.3% growth => **11.2%** potential return
- The biggest risk to an investment in OMC is a loss of John Wren
    - It would be difficult to judge his successor
    - It'll be difficult to decide whether to hold the stock