TOWARD A NEW MODEL OF BROADCAST ADVERTISING

After decades of uninhibited success, broadcast advertising is slowly choking to death. The problem is buried in its century-old supply chain. The solution lies just over the horizon with Digital TV, but it won't be technology that saves the day; it will be the market infrastructure that DTV enables.

The future of a forty billion-dollar industry now hangs on the concept of "micro-addressability"… and who makes the first move.

Don DiPietro
USC / Marshall School Of Business
don.dipietro.2004@marshall.usc.edu

INTRODUCTION
[SIDEBAR]

In many ways, today's advertising industry resembles the shipping industry of the mid-twentieth century. Trans-oceanic shipping is a hugely profitable business, especially when transporting mountains of a single commodity, such as wheat or oil, via immense cargo vessels. Moving more fragmented loads, however, reduces the economies of scale with predictable results. In this analogy, the national broadcasters are the supertankers moving tons of a single commodity – specifically, viewers – at a low per-unit cost. Local TV stations and niche cable channels are the spot-cargo shippers; they serve the lower-volume customers but at higher per-capita costs. In both shipping and broadcasting, however, there comes a point where an individual load simply becomes too small to make economic sense.

Now imagine a plan to sub-divide these giant vessels into small, standardized compartments in such a way to pack each ship more thoroughly with more varied products. The startup infrastructure will be costly to build because the loading process will be far more complicated than simply pouring tons of stuff into a cargo hold. However, under this new system, we can charge significantly higher rates for each cubic yard of space and still deliver impressive savings to thousands of new customers.

This is exactly what happened when *Sea-Land* revolutionized the shipping container industry in the mid-twentieth century. Today, the broadcast industry is ripe for a similar upheaval.

Of all the annoying clichés left over from the dot-com era, “content is king” still maintains a stubborn relevance. After 30 years of furious investment in content-based enterprises – from the seminal media mergers of the late 1970s, through the cable, video and digital consumer electronics revolution, to the feeding frenzy and subsequent bust of the Internet decade – content hasn’t been dethroned so much as given a time-out. As yet another media giant (NBC/Universal) rises *Terminator*-like from coalescing puddles of production, distribution and finance, content is now poised for its second coronation. It is, after all, the stuff upon which the entire information/entertainment industry is built.

And yet, from Gutenberg to Google, the fundamental mechanisms for selling content have remained essentially unchanged for half a millennium. Whether we’re talking about entertainment, sports, news or information, there are only three ways to make money with content:

1. Sell the content.
2. Give away the content, sell the audience it attracts.
3. Support #1 and/or #2.

While the focus of new media investments seems to be zoomed in on the first category (selling the content); there is considerable evidence that real growth opportunities exist under categories two and three (advertising supported content and related service industries). In fact, the recent reorganization of Time Warner into two massive verticals –

essentially, Free and Pay – and the pending restructuring of Viacom's media divisions, seem to bear this out.

Like the credit card business or online auctions, broadcasting is a textbook example of a *multisided market*. It provides a differentiated value proposition to two distinct customer groups – viewers and advertisers – and charges one for the participation of the other.[1] In this universe, viewers are a basic commodity sold to advertisers in bulk. The broadcaster uses his unique programming to accumulate viewers. He is, in effect, an "eyeball rancher". The advertiser is a buyer of these eyeballs, or more precisely, the impressions they transmit to the minds of potential customers. The basic measurement of media sales is the CPM, or cost-per-thousand viewers, and the revenue strategy is simple and clear for each side of the negotiation: extract the most value from any given population of viewers on a per-capita basis, for every dollar spent.

Of course, free television is not actually free. There is the initial expense for the television set and, in most cases, the ongoing cost of a cable subscription, a PVR. etc. More oblique to the viewer, but more costly over time, are the incremental advertising costs embedded in the majority of products sold at retail. The cost of advertising a can of soda is three-to-ten times the cost of carbonated water and sweetened syrup. Here is where the gross inefficiencies of the supply chain are hidden from the customer and exploited by intermediaries.

In the United States, broadcast advertising is a 40 billion dollar industry[2] from which these intermediaries – the major advertising agencies, media brokers, and their parent holding companies – siphon off 5 to 6 billion dollars each year. By all practical measurement, it is a grossly inefficient market. In fact, the advertising industry we know today will not exist in 10 years. While this claim might seem overly dramatic, we need

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[1] For more on multisided markets, read "Managing The Maze Of Multisided Markets" by David S. Evans. Strategy+Business Magazine, Fall 2003.

[2] Advertising on Broadcast and Cable represented $ 28.3 Billion in 2002 and is expected to grow to 37.4 Billion by 2007, which represents a 5.7% compound growth rate. Radio, internet and "other" electronic media represent approximately 14 Billion. Pricewaterhouse Coopers, Spring 2003.

only look at the music industry to see how abruptly a multi-billion dollar industry can be brought to its knees by an unexpected and relatively cheap technology.[3]

Throughout the 20th century, the parallel explosions of a consumer-driven economy and the media marketplace helped camouflage the inefficiencies of the retail advertising supply chain. This is no longer the case. A recent report by Market Management Analytics, Inc. states, "Campaigns that measurably increase sales are outnumbered by campaigns that don't by at least two-to-one...In the case of consumer packaged goods (CPG), advertising on television returned about 49 cents for every dollar spent". This is an ironic if painful validation of Lord Leverhulme's century old and often-quoted gripe, "*I know half my advertising is wasted. Tell me which half*!"

Another research paper, the 2001 AdWorks survey, described how "…The top 10% of CPG advertising paid back about 32 cents in the first year". At these rates of return advertising isn't a business, it's a very expensive hobby. Of course, many of these reports are created from within the prevailing agency-driven culture so most tend to temper their own grim findings with more uplifting data that suggest, for example, that advertising does increase ROI *over time*. Nevertheless, serious flaws infect this supply chain and they're beginning to fester.

The problem does not lie with the basic usefulness of advertising. If anything, quite the opposite is true. The sophistication, speed and efficacy of what David Ogilvy called the "product propaganda business" have never been more favorable to advertisers. The industry continues to evolve new techniques to craft its messages and new media mechanisms to deliver these messages to hundreds of millions of consumers. The networks continue to announce record "up front" commitments from major sponsors such as P&G and General Motors. The problem is not with the fundamental value of

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[3] File-sharing wouldn't have been as cataclysmic to the recording industry had the record labels gotten there first. The real shock of file-sharing happened because the lethal blow came from the one place the music industry wasn't looking – its customers.

advertising, the problem is with its economics -- more specifically, the market apparatus by which viewer impressions are bought and sold.

It is important to understand that advertising deals with…nothing. Unlike any other massively traded commodity, no *thing* is acquired, made, transported or consumed. The basic element of all media transactions is a small slice of broadcast time and, by implication, its promise to attract many people to an advertiser's message. It is both immaterial and ephemeral. Yet it costs advertisers billions of dollars every year. The question is not whether advertising works or doesn't work. Clearly, it does. The question is: what is it worth?

Since the days of radio, audiences have been bought and sold using essentially the same transaction model still in use today. A broadcaster creates or acquires appealing content, which in turn attracts an audience. This audience can be measured to acceptable degrees of precision using typical sampling methods. Segments of 30 or 60 seconds are carved into each broadcast and these segments are provided to advertisers to insert their commercial messages[4]. Although all broadcasters publish some form of rate card, the actual price of this time is determined by means of a zero-sum negotiation between the seller (broadcaster) and the buyer (advertiser). While these transactions can range in size from local cable insertions at forty dollars a pop to hundred-million-dollar national brand campaigns, the value of any individual ad segment continues to be negotiated in terms of how much, or how little, either side can get away with.

While this would seem to describe an efficient market, in fact it is distorted by the fundamental nature of each transaction. The primary concern on both sides of the bargaining table is not cost, but risk. For the broadcaster, risk is embedded in the perishable nature of his product: his inventory is constantly evaporating. Unsold air time cannot be stored on a shelf for later discount. The cost of producing and acquiring his content continues to increase while an ever-growing swarm of media competition snaps

[4] Because of the high cost of broadcast time, 15-second segments have become increasingly more common.

at his margins. The risk for a broadcaster, therefore, is *collecting less than the maximum* revenue for his continuously vanishing asset: his audience.

For the advertiser, the risks are no less threatening. The advertiser has no guarantee his message will actually reach the viewers promised by the broadcaster. There is no guarantee these people will actually buy the product. Frequently, he will spend money on advertising and not recover it in sales. The risk for the advertiser is paying *more than the absolute minimum* to reach this unpredictable and distracted pool of "maybe" customers.

With any bilateral transaction, there is an implicit antagonism between buyer and seller. In the case of media advertising, this antagonism is magnified by the specter of these oppressive risks. Moreover, when the thing being transacted is by its very nature *immaterial*, the element of risk is further amplified on both sides. For any investment, the decisive measures typically focus on ROI. With any media investment, the buyer isn't actually buying anything tangible so the critical measurement is less about Return On Investment than it's about Risk Of Investment. In other words, it isn't a matter of *What do I get when I spend this money?* but *How much do I risk losing*?

Entire industries have sprung to life offering to reduce the risks associated with buying and selling advertising impressions. Market research, media planning, audience measurement and the numerous ratings services are part of a vast enterprise whose sole purpose is to mitigate advertising risk. For most of the 20th century, this was a lofty and profitable pursuit. Then something unimaginable happened -- the Internet -- and overnight, all the rules were rendered obsolete. Suddenly, an audience could be measured not by the broad strokes of statistical speculation but precisely, down to the individual viewer. Even more significant, the strength of each message could be measured instantly and not weeks or months later in a report. Today, even the most scattershot brand advertiser wants direct-response accuracy from his media spending. While this level of analysis and control is clearly beyond the capability of today's broadcast or cable technology, the bar has been raised irreversibly. Now more than ever, pressure is being

put upon broadcasters to justify the huge risks advertisers assume for every dollar they spend.

Broadcasters are a cunning and opportunistic breed. They will respond to this challenge by emulating the characteristics of the Internet without compromising their individual brands, their programming leverage or their massive audience pools. Over the next few years, digital TV standards will be firmly established[5] and shortly thereafter, every television in North America will have basic addressability built in.[6] At that point, *broadcasting* will be replaced by *high-volume narrowcasting*. In other words, the media delivery system will be able to segment any massive audience into smaller subsets all the way down to individual viewers, not unlike the immense roll-up container ships of the modern transport industry. This disaggregation -- and re-aggregation -- of the broadcast audience will allow thousands of advertisers to bid on smaller chunks of this audience but at higher per-viewer (CPM) rates. This will happen. It will happen in this decade. It will happen by means of a centralized trading floor where blocks of individual broadcast segments are traded much the same way blocks of corporate shares are traded on the NASDAQ stock exchange.

A commoditized exchange brings buyers and sellers together without the pressure (and cost inflation) of salespeople. A buyer can be any advertiser meeting the membership criteria of the exchange. The prices will reflect real supply and demand as well as the degree of risk assumed by individual advertisers for individual advertising messages. The broadcasters will accept all purchase commitments from the highest bid downward, until the actual viewing audience for each commercial slot is exhausted. This will happen around the clock and in real time. When fully operational, this exchange will not only manage the trading floor and execute trades; it will monitor thousands of broadcast

[5] [FCC update goes here]

[6] ":Addressability" is the degree to which a cable operator can identify and interact with an individual television on its system. For example, in order to provide Pay Per View movies, a cable system needs to be able to selectively activate each subscriber's feed by channel and time period. This capability defines an addressable system.

transmissions for audit compliance and oversee the transfer of funds between buyers and sellers.

Clearly, this will be a hugely expensive operation to set up and maintain but its costs will be more than justified by hundreds of millions of dollars in supply-chain efficiency and increased CPM valuations across the entire market. This exchange will operate in a balanced and unbiased fashion, favoring neither the buyers nor the sellers. As with any legitimate exchange, its executives and managers will be forbidden to take any position in the trades.[7] As with the securities exchanges, this exchange will generate revenue from transaction-based fees paid by the sellers. These fees, though substantial in the aggregate, will represent a small fraction of the current “risk premium”, sales commissions, and other administrative overhead lost to the industry today.

In any bilateral transaction, the upside for one party is the downside for the other. With an exchange, the participants determine the precise value of each *content segment* as well as each *audience segment* on a continuous, market-driven basis. Price discovery is by market force, not sales force. Performance is no longer a calculation of risk, gambled upon by buyers and sellers and pushed across the table as "the other guy’s problem". Good performance is rewarded in both directions. Under-performance does not punish either side because the risks are offset by the leveling dynamics of the exchange. As a result, even the most risk-averse buyers and sellers can comfortably test-drive the marketplace with predetermined limits and no downside exposure. A small audience means a small bill. A large audience can be broken down to manageable lots of individual viewers, each with a price tag to find a motivated buyer. What’s more, because a thriving exchange does not require either a contractual obligation or purchase minimums, it allows for a painless, incremental migration from old methods to new.[8]

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[7] *Enron*, for example, was not a legitimate exchange in that its officers took massive and obviously conflictive positions on its own trading floor.

[8] A good example of this zero-risk, critical mass-building dynamic can be found in the phenomenal growth of the *Overture* search-engine exchange. *Overture*, which didn’t exist six years ago, not only survived the collapse of the dot-com economy it was acquired by *Yahoo* for $ 1.82 billion llast fall.

In this model, everyone's needs are served. The smallest advertisers can bid for any audience segment to the limits of their budget and target CPM rates. Large advertisers can likewise do the same and all will be billed for the *exact number* of impressions delivered. The broadcasters can fully maximize each and every broadcast minute (or *content unit*) while all costs associated with "ad sales" can be swept from their balance sheets. The exchange rewards better programming and larger audiences but doesn't punish smaller, more targeted content. No seat goes unsold and no advertiser gets billed for an empty seat.

With this capability in place, the entire broadcast marketplace will be upended. Instead of several hundred big-spending advertisers negotiating with a handful of powerful content aggregators, the media business will shift to an open marketplace where tens of thousands of small to mid-sized advertisers can now purchase advertising impressions in smaller lots but at higher CPM rates. Advertisers will get exactly what they pay for and broadcasters will be paid for exactly what they deliver. Inventory will be sold to the highest bidder and every single viewer will represent measurable income. The net effect will be a win-win for content providers who generate increased revenue for the same inventory as well as for advertisers who can buy chunks of media to suit their market segments and budget limitations precisely.

There are a thousand features that can be discussed here in great detail but the most pressing question now becomes: how can we build such a massive infrastructure from where we are today?

The evolution of this broadcast exchange will begin with an existing media marketplace begging for such a system: the floundering streaming-media component of the Internet. This is an ideal platform to build and refine a working media exchange and one that can unlock tens of millions of dollars of pent-up advertising demand right from the start. The technology is in place. The audience is in place. The buyers and sellers are in place. Perhaps the best way to understand the commodity this exchange will traffic in is to describe what it stimulates: *Advertiser-Sponsored Pay-Per-View*. Suddenly, there is

legitimate market component to this over-hyped, under-utilized broadband network; one that actually makes economic sense.

Ironically, as broadband penetration grew at a brisk pace over the past decade, paid and subscription-based content initiatives fell by the wayside[9]. One reason for this is lopsided economics. Unlike broadcasting and page-based Internet websites, where variable costs are virtually unaffected by traffic volume, streaming media is far less scalable. Each viewer adds an incremental cost for providing the content. The more successful a program, the more it costs to deliver. Today, on-demand content such as movies or sports is sold via cable or direct broadcast satellite at a price-point high enough to offset administrative overhead and delivery costs -- as well as to provide a reasonable profit margin. It is important to remember that the enabling technology driving on-demand (until recently, “pay-per-view) content is not the delivery mechanism; cable and direct-broadcast satellite (DBS) are still pretty low-tech, especially when compared to the internet. No, the technology driving on-demand today is basic addressability -- the capacity of the system operator to regulate individual streams of content. If the costs of this addressability were reduced to tolerable limits, advertisers would be more than willing to pick up the tab; or at least to share it with other advertisers.

The Internet is one hundred percent addressable right now. A functioning exchange will allow this “micro-addressability” to be fully exploited – at fractions-of-a-penny per transaction – by buyers and sellers of all streaming content, live or pre recorded. It is ideally suited for the kinds of sponsored mini-films already produced by web advertising pioneers such as BMW, Victoria’s Secret, The Gap and Honda along with numerous direct-response brands where CPM isn’t as critical a measurement as Cost Per Sale.[10]

History demonstrates how costs will drop as the risks assumed by early adopters are spread across an expanding market. Right now, all streaming media funnel through a narrow roster of service and bandwidth providers – each with a powerful incentive to

[9] With the exception of fee-based adult content, which is flourishing.

[10] The CPS is to DR (Direct Response) advertising what CPM is to broadcast or brand advertising. High price, high margin items such as automobiles will have higher CPS ranges. In practice, Cost-Per-Sale can be surprising. For example, at its peak, the CPS of each new *DirecTV* subscription approached two thousand dollars.

keep costs high. This has been the most serious roadblock to building critical mass. [Imagine how VCR penetration would have stalled out had the cost of a blank VHS cassette settled at five dollars. The streaming medium is at a similar juncture.] Today, only a handful of service providers have the capability to manage large audience volumes. These providers make every effort to keep the price of individual streams high. They do this simply because they can. Of course, this tends to scare off all but the most adventurous and well-funded advertisers. An exchange will break this logjam by allowing sponsors to establish risk-free limits to their bandwidth costs *prior* to any streaming commitment. It also allows multiple sponsors to underwrite single events with CPM targets and cost-caps decided in advance of signing a deal.

Going forward, the necessary solutions will be found not only in the technology but in the commercial infrastructure as well. By establishing an open, exchange-based commerce platform, buyers and sellers of linear content will participate in this emerging medium at their own rates of speed and financial exposure. When this happens, the broadband market “tips” in favor of ad-sponsored content. One immediate result will be a measurable acceleration of broadband penetration and usage. Costs will drop and aggregate revenues will climb. With the exception of a few soon-to-be-obsolete constituents (commissioned salespeople and audience ratings firms come to mind), every participant in this modern marketplace will observe a vast improvement over the encrusted supply chain that is currently dragging the industry deeper into the mud.

[*POST SCRIPT – Spring, 2005*. One year has passed since the initial incident, but the regulatory pressure still reverberates from the Janet Jackson “wardrobe mishap” and its costly legal repercussions. Over time, however, the 2004 Super Bowl will be remembered for its far more significant milestone: Pepsi’s multi-million dollar program to underwrite music purchases from Apple’s iTunes. This was simply an individualized, advertiser-sponsored content model modified for music downloads. It is also another powerful indication of the degrees to which major advertisers will go to find new mechanisms to

connect their products with appropriate entertainment. The pressure is building. If you substitute video content in place of music, the potential – and inevitability – become glaringly obvious.].