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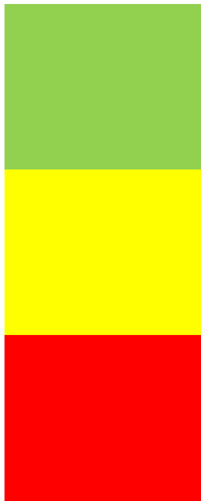

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ROKU, FB
DIS
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FOX,
TWX, VIA, TTD
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VERTICAL
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Advertisers See Digital Growth Runway Extending Many Years Ahead

AMZN, FB, GOOG, GOOGL, TWTR
CBS, DIS, FOX, CRTO, RUBI, ROKU, SNAP, TTD, TWTR, VIA

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- **Concerns about digital advertising reaching a saturation point and headed for a major growth slowdown in the next two or three years are not consistent with perspectives VMI has gotten on the internal dynamics of industry growth.**
- **The secular growth curve of digital advertising is being driven not only by penetration of traditional media and marketing budgets, but by a major structural reallocation of enterprise spending in which marketing absorbs larger portions of traditional COGS budgets.**
- **Most industry sources see a runway of double-digit growth extending several years ahead as this process plays out.**

A constant concern for digital media firms and investors is the source of digital advertising budgets' growth, how deep those pools are, and how long new digital platforms can penetrate them before the S-curve of secular growth flattens.

Following the 2008-2011 slowdown in advertising, these questions became more prevalent even if growth at Google and Facebook remained exceptionally robust. However, as the pools of dollars both firms attract has grown to eclipse television advertising the notion of "peak digital," a minority but increasingly influential point of view, has been in ascendance, arguing that the S-curve is likely to flatten out far sooner than most analysts of the space appreciate.

In this view a dramatic slowdown of digital advertising is fast approaching. The digital duopoly of Google and Facebook specifically, after a decade of disrupting traditional advertising, may be on the verge of a dramatic slowdown. Though proponents acknowledge "peak digital" will not occur in 2018 or even, perhaps, in 2019, by 2020 or

soon thereafter, a steady-state single-digit growth equilibrium is inevitable, undercutting expectations for far stronger growth for a far longer period of time.

This view is not at all supported by the perspectives VMI has gotten of the internal dynamics of growth from our explorations of the industry.

A key takeaway is that because of counter-intuitive and structurally new dynamics, the digital secular growth story is not yet in the seventh inning, even in the US, where digital advertising is most developed and sophisticated. In reality, we are perhaps in the fourth or fifth inning of the game, with the better part of a decade still ahead of us for the transition to digital media to run at a high-growth pace far from a single-digit equilibrium.

Specifically, our industry feedback strongly suggests that the concerns of “peak digital” radically understate how deeply digital performance advertising is getting in position to integrate e-commerce with the far bigger and broader multi-trillion dollar brick-and-mortar services economy. unlocking new sources of marketing spending that were not traditionally associated with marketing at all.

The Peak Digital Myth and New Advertising

A common misconception of broad macroeconomic analyses of advertising growth as it relates to other metrics (i.e. traditional brand revenues, GDP, or past advertising budgets), is that advertising operates within the enterprise the same way that it did 20, 30, or 50 years ago. Most big-picture frameworks begin from this basic assumption, whether expressed overtly or not, yet that does not jibe with the reality on the ground.

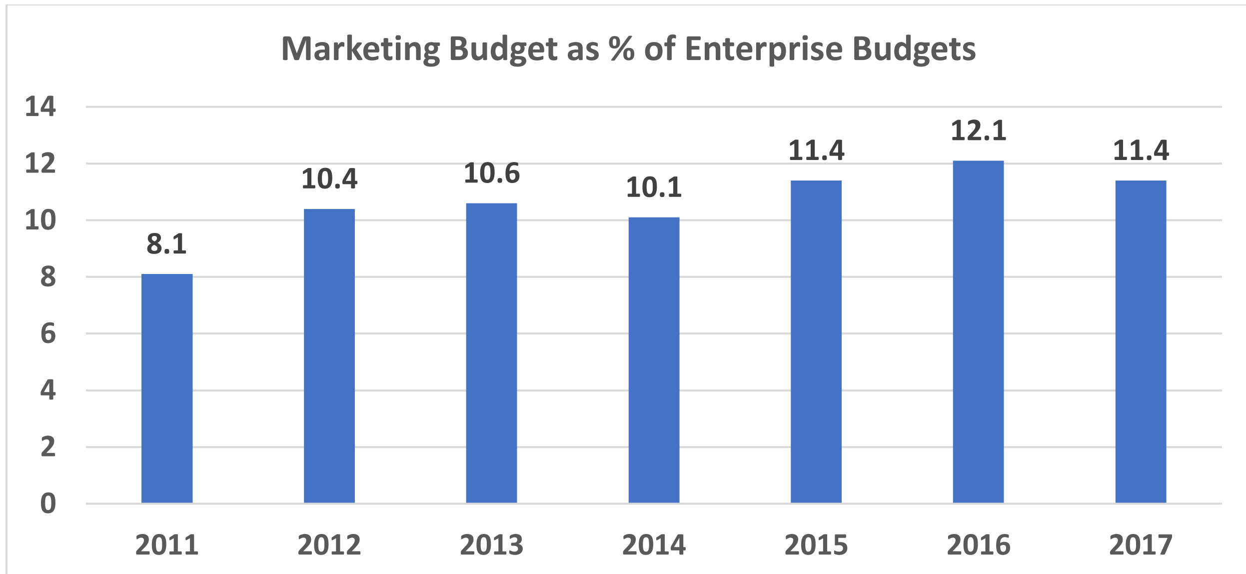
In practice, there are many demonstrable instances of digital advertising becoming much more than a replacement of traditional media advertising and marketing, and instead being integrated into other historically unrelated areas of enterprise spending. This reflects the profound and still in-process transformation of marketing’s role within enterprises both large and small now compared to a generation ago, when traditional marketing was a single discrete and highly siloed component in the product sales cycle.

Specifically, industry sources have noted that:

- Brands are increasingly trying to move from a model where products developed for fixed predefined top-down mass demographic segments to one where they are constantly discovering consumer needs and segments via bottom-up data.
- Brands are moving from a model where advertising’s purpose is primarily to spread awareness via mass media to one focused on constantly monitoring and acting upon consumer feedback gained via search, social, Amazon reviews, etc.
- Brands are moving from a model where sales are driven through indirect channels in which products are shipped to fixed points of sale to one where the goal is to make the brand experience accessible across any channel, provisioning interaction and transaction on demand wherever, whenever—and increasingly to sell direct to consumer.

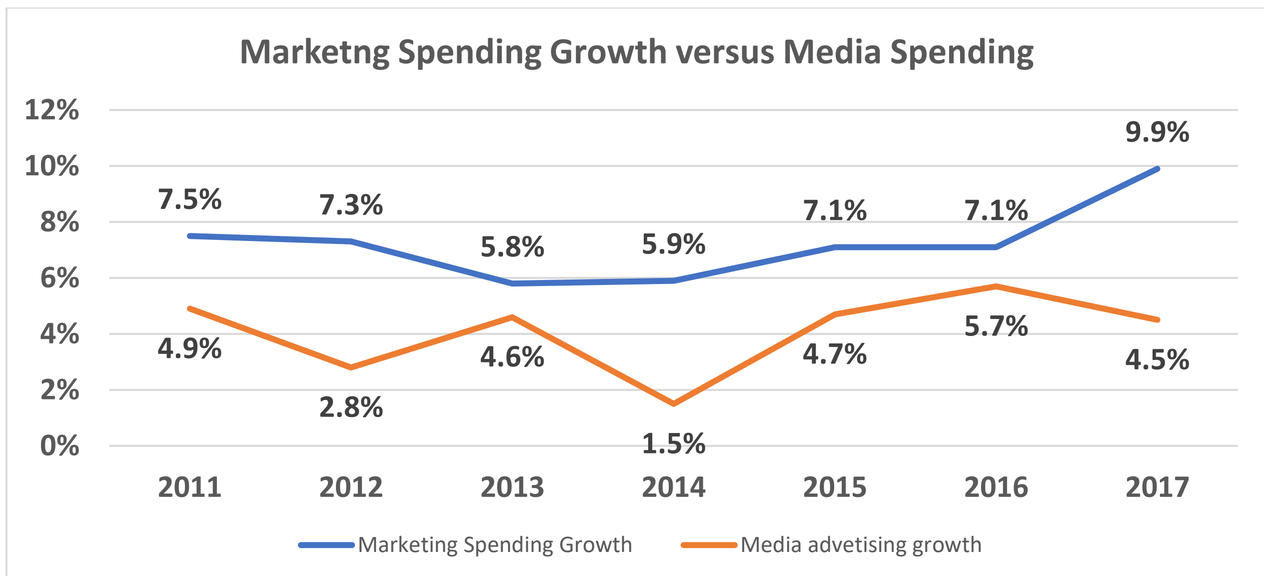
As this change has played out, the role of marketing in corporate strategy has expanded accordingly. This trend is illustrated by an annual CMO survey conducted by Deloitte

and Duke University's Fugua School of Business that showed marketing expanding as a component of overall enterprise budgets through this decade.



Source: Deloitte, Duke University, 2018

Fueled in part by savings in fixed overhead expenses including retail shop rents, payroll expenses for sales personnel, and even infrastructure and distribution costs, marketing spending is also now growing at a consistently faster clip than media advertising.



Source: The CMO Survey, Magna Global

Additionally, whole areas of traditional marketing spending, in aggregate quite a bit larger than traditional media spending, are in the process of themselves being repurposed around digital marketing and advertising as the nature of commerce moves away from a dependency on brick and mortar and as marketing becomes more about creating and managing a direct online “always-on” presence.

When Macy's closed its downtown Minneapolis department store, for instance, it had not abandoned the Minneapolis market. Instead, it searched for those shoppers online. As a result, dollars spent on staff, retail space rents, last-mile transport, and general administration are now freed to become part of Macys.com's online marketing assault on the Minneapolis market. As a result, the marketing component of Macy's SG&A expenses went from a small fraction to nearly the entirety of the budget line for this particular market.

This illustrates several transformations under way.

The $100 billion plus category known as shopper marketing or in-store marketing, formerly focused on in-store displays, kiosks, packaging etc., now is as much about optimizing and integrating the full shopping experience, including brick and mortar, with the mobile smartphone as it is decorating the storefront window. Indeed, as a VMI digital advertising source describes it, "the smartphone screen is essentially now as essential to the storefront as the actual storefront window."

Trade promotional marketing, another multi-tens-of-billions of dollars spending category, used to be focused on getting coupons and circulars distributed to drive traffic to particular retail venues or for payouts to retailers to corner the most desirable shelf real estate. For both OEMs and brands, front-of-marquee location in Amazon marketplace and Google Shopping is now as if not more important.

Lifestyle catalogs for generations have been the linchpins of direct-to-consumer efforts at outreach, lead-generation and retargeting of consumers, costing tens of billions of dollars. Now targeting the Facebook interest and influence graph, Pinterest's taste graph, Amazon's purchase graph, and Google's intent and knowledge graph is increasingly the centerpiece of go-to-market tactics.

Additionally, there is the hitherto largely overlooked component of online marketing penetrating enterprise budgets that had not existed in traditional marketing or SG&A spending at the scale currently seen. An obvious example would be the emergence of Uber, Lyft, and other ride-sharing apps as emergent marketers displacing old enterprises who had had little-to-no marketing budgets. In the 20th century, taxi companies may have had some limited late-night local TV advertising and radio ads in the most marginal cases. More frequently and regularly, yellow-page ads would have been the only always on marketing strategy.

Today, however, ride-sharing apps regularly spend a significant part of their marketing budgets on search ads, app-install ads, and other online marketing strategies to acquire and retain customers. This is an incremental budget pool that, in addition to other entirely new sectors that had either not existed in the past or spent little to nothing on marketing (subscription services, video games, etc.), provides new sources of advertising dollars that top-down estimates based on prior epochs of commerce fail to capture.

These processes, arguably more than the penetration of existing major media budgets, have been the key drivers of digital advertising growth. There continue to be compelling

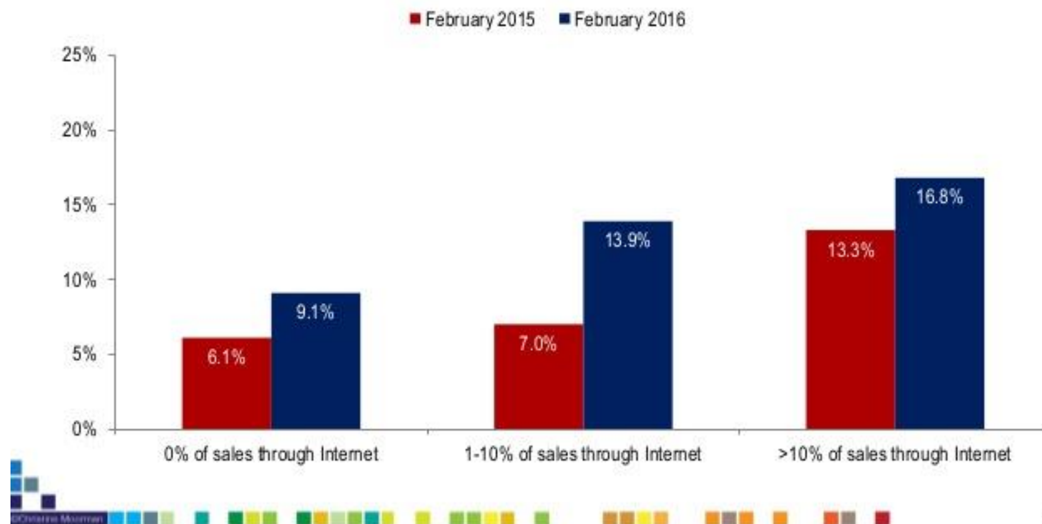
reasons to believe they are only now beginning to reach a critical mass as more and more companies become truly Internet-centric in their approach.

Unilever, for instance, has said it expects “experience platforms and e-commerce” to account for nearly one-third of sales by 2022, while Nike has said its DTC sales will grow by almost 2.5 times over 2015 levels by 2020 to nearly a third of its total sales.

Global business consulting firm A.T. Kearney projected last year that manufacturer direct-to-consumer sales fulfilled by manufacturers, which historically have accounted for between 5% and 8% of total revenue, will likely rise to between 15% and 25% over the next 3-5 years.

Though precise data remains sparse, data that is available points to a strong correlation between percentage of sales coming from the Internet (directly or indirectly) and the percentage of total revenues devoted to marketing spending. Not because internet-centric businesses are less efficient in their marketing spend, but rather because marketing is more directly and measurably attributable as a revenue driver instead of a cost.

Marketing budgets correspond with Internet sales and differences widening



Implications for Today’s Internet Titans

Exponential secular growth will not last forever for Google, Facebook, Amazon, or others in the digital advertising space. They, like every secular growth sector before them, are subject to inherent limits as well as cyclical downticks. At some point, limits to growth for digital and the oncoming of steady-state equilibrium must occur.

Right now, though, it seems that pessimists may be weighing too heavily the risks of this equilibrium coming sooner than expected and not weighing heavily enough the rewards of that equilibrium happening much, much later in the future due to a misunderstanding of the broadening range of digital marketing's penetration of the enterprise in addition to traditional marketing and advertising budgets.

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