

White Paper

An analysis of the \$11bn revenue shortfall in the US search marketing industry

April 2007

Key findings:

1. The search engines pay commission in the UK and this has had a firestarter effect on search penetration
2. The US market has a much higher proportion of in house search marketers, who tend to be less innovative and do not operate search as effectively as search agencies, slowing the flow of funds from other media
3. Many US search agencies reacted slowly to the paid search opportunity due to organic inertia
4. The UK market is more mature and more competitive than the US market and hence more intensely innovative
5. Cost per click prices are marginally higher in the UK, but there is no evidence to show that the engines are abusing their market dominance

An analysis of the \$11bn shortfall in search revenue in the US search Marketing Industry

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How the US search industry could have earned an extra \$11bn in 2006.

In 2006 American companies spent \$6.7 billion on search marketing, according to the IAB/PwC Internet Advertising Revenue Report. This white paper will contend that if the US paid search market was as evolved as the UK market it would have spent \$17.6bn.

We will explore the issue and explain how the US search industry may have missed out on \$10.9bn last year.

The basic facts:

IAB/ PwC report quarterly on the state of Internet marketing in the US and UK. The figures show that search marketing spend in the US is 2.5% of all advertising spend (40% of online which in turn is 6.3% of total advertising spend).

The IAB/PwC figures released on 28 March 2007 for the UK show that 11.4% of all marketing spend is online, with search marketing at 57.8% of all online. Therefore search marketing accounts for 6.6% of all advertising spend. If the US market had achieved the penetration of the UK market, advertising budgets would almost triple.

Review of the possible explanations: 1. Can the figures be trusted?

The data used in this white paper is from the same source on both sides of the Atlantic – the IAB/PwC quarterly internet marketing report. It is the most highly regarded set of data in the sector and has had a continuous run since 1997. There is no reason to suspect any mishandling of the data.

The US final figures for 2006 are yet to be released, so this report errs on the side of caution, using the 2005 figure for total advertising spend, but half year figures for online and search spend – therefore, if total US advertising spend increased in 2006 the gap

between the UK and US on search penetration will be even wider than indicated in this report.

There is supporting evidence in abundance. For example, Zenith Optimedia data shows that the UK has nearly doubled the average global share of online advertising spend 11.4% vs 5.8%.

Latitude holds nine terabytes of data on the search market state, collected over the last three years. And our internal analysis supports the argument that the UK search market is the most advanced in the world. We took a sample of the most highly competitive bid phrases and analysed the top 20 bid prices on pre Panama Yahoo data. We then compared the data for average bid price, average bid gap and Latitude Maturity Index (LMI).

a) Average bid prices for the group are higher in the UK than the US, \$5.33 vs \$4.51 (An exchange rate of \$1.80 =£1 has been used consistently throughout this white paper). Bid price economics of highly competitive words is defined by a set of complex algorithms; however one key algorithm is counter intuitive to normal economics, in that supply positively drives demand. If a phrase has a lot of searches (supply) it will have an even higher demand and cause price inflation. The US market has roughly four times the volume of searches as the UK market and in bid economics should command higher prices for highly competitive phrases. It does not and this indicates a less competitive and less developed market state

b) Average bid gap is 17 cents in the UK and 27 cents in the US. The bid gap is the mean average difference between adjacent bids over the top twenty positions. We have more sophisticated modelling that deals with the profile of bidding, but for this example the

simpler explanation is sufficient. A bid gap is an indication of both competitiveness and market efficiency; in a perfectly competitive market this will tend towards one cent or in the UK one pence. It follows that the further a market deviates from perfection, the less competitive and efficient it becomes. On this basis the UK market is more competitive and more efficient.

c) Latitude Maturity Index – this is a simple mechanism for quickly testing a market's maturity – i.e. how close it is to perfection. In a perfect market all bid prices are exactly calculated so that a client bids precisely the value it can afford, and furthermore it will sink the price into the market to a level that will give it the same position but at the cheapest price. In a less mature market many more bid prices are not calculated, but instead based on intuition. Therefore in a perfect market the last number in a bid price would be a random distribution across all numbers 0-9. However, we find that when humans take a guess and bid intuitively there is a marked tendency to round up or down and bid in increments of 5p or 5c. If a market is perfect the tendency will be for 20% of bids to end in 5 or 0 (i.e. two outcomes of ten possibilities). The extent by which the 20% mark is exceeded indicates immaturity. In our sample of highly competitive search phrases, the UK scored 25% [LMI 125], whereas the US scored 42% [LMI 210], further indicating that the US market is less sophisticated and less mature than the UK market.

These figures are so stark that they cannot be explained by random factors, there must be a factual reason for the differences in penetration in the US and UK. The facts are correct; the UK is ahead of the US in search marketing penetration.

2. Broadband penetration levels

The argument is that the UK must have a higher online or broadband penetration, This explanation is plainly wrong, the latest broadband figures show that in the UK 10 million people have broadband, whereas in the US the figure is 48 million, with 65% of the UK population online versus more than 70% of the US population.

There is a subtle argument that contends that rich media is so strong in the US (possibly because of the higher broadband penetration?), that it causes search to be proportionately smaller. However, we can show that UK non search spend is 4.9% of total advertising, whereas US non search spend is 3.8%. This indicates that in non search online marketing the UK is also ahead of the US, though not to the same dramatic degree as in the search field (6.6% vs 2.5%).

Clearly, there is no relative success of rich media in the US, it is not the cause of a relative failure in search.

3. The US advertising industry is more conservative than the UK

In the broadest sense this is a reasonable explanation, de facto, a whole new sector has failed to thrive as effectively as it should have done, and it has failed because the advertising industry in the US has adapted more slowly than in the UK. However the statement merely states the obvious and brushes the surface. There are several significant factors underlying this statement that more directly pinpoint the search gap:

a) The UK market has a greater proportion of spend with agency and search specialist

Analysis of the composition of the people controlling search engine spend in the UK and US is illuminating. In the UK most large companies employ a media buying agency or search marketing specialist to manage their search, in the US many US agencies report 75% drop in-house.

It is clear that faster adoption by big business means access to bigger budgets and greater market penetration. We believe that this is a key reason for the failure of search penetration in the US.

An agency will be better able to compare and contrast search performance with other media and there is now an ample body of evidence that search compares well against other media. The agency is influential in moving spend from poor performing media to the best performing media. It makes the allocation of budget more efficient and hence more rapidly grows search spend to its natural sustainable level (whatever that may be).

The agency is influential in moving spend from poor performing media to best performing media

The shift is even more significant with a specialist search agency, its skills will dramatically increase the performance of a search campaign, again leading to a growth in search spend at the expense of other media.

However in the US many campaigns remain in house, and simply cannot compete. The scope for learning is tiny. A company running 200 campaigns will learn significantly faster than a company running one. A business with the sole objective of improving search marketing will be more focused on innovation and, have better access to capital and resources than a standalone department within marketing or IT. Similarly with software, the in house company will at best use one of the commodotised software products, so will at best have no competitive advantage over competitors, whereas most specialist search agencies have their own bespoke software. And probably most significantly, the very best brains in Search Engine Marketing will gravitate to start their own search specialist; become affiliate marketers (dilute search with excellent short term income) or work with one of the best specialists surrounded by fellow professionals – this incidentally is why the big agencies have been so unsuccessful in developing their own in-house teams.

b) Search engine commissions

The evolution of the agency and specialist market is insightful. Yahoo followed by Google and now Microsoft paid commissions to agencies and specialists in the UK. They did not do this in the US. The lack of commissions in the US clearly did not incentivise any great degree of third party involvement and has in fact proved costly to the search engines. This is illustrated by Google declaring that about one fifth of its revenue is now from the UK.

In 2006 Google and Yahoo effectively halved commissions. This does not seem to have slowed growth, which suggests that commissions are an essential fire starter, but are less necessary to sustain the flames. It is clear that if the engines want to pump prime the US market they should introduce commissions to the specialists and agencies.

The fire starter effect of commissions is clearly a significant factor in the market penetration in the UK.

c) Innovation and creativity

However, if this was just about commissions then why do Germany and France trail so far behind UK? France and Germany have bigger populations than the UK and should have bigger search markets. The reality is that France and Germany combined is a smaller market than the UK. Indeed the UK accounts for about half of all European search spend.

It is rare that the UK is a global market leader, but when this occurs, it almost without fail has an edge on service, creativity or innovation. Examples would be in the Arts, with the UK producing an extraordinary proportion of the world's top actors and musicians. Similarly in the financial sector the City of London excels at creating innovative new markets, most recently Carbon Offset.

We witness specific evidence of greater levels of creativity and innovation in search implementation by the UK search specialists. This is quite dramatic, since virtually all search tool innovation is tested first in the home US markets by the search engines. There is no doubt that the engines would get a much more positive and synergistic response if the testing was UK based.

An exception to this US testing was when Microsoft trialled its paid search product. Due to its contractual arrangement with Yahoo it could not test in a big market like the USA, so it tested in Singapore and France. In France it had witnessed low click prices that over a period of several months grew and eventually exceeded the price Microsoft was getting from Yahoo for its traffic. When it came to the test launch in the UK, it expected a similar pattern. It did not happen; the UK is a more sophisticated market. Within a week the market was (correctly) paying more for the Microsoft traffic than it had paid Yahoo for its hybrid part Microsoft traffic.

The UK has achieved greater search penetration because its specialist search marketers are highly innovative and creative.

d) Regional players in the US

In the US there is a tendency for

In 2006 Google and Yahoo effectively halved commissions

a block of mid-sized (often regional) companies to take the higher positions. This is a result of the in-house phenomena. We surmise that in a battle of "in-housers", (and we accept that there will always be significant exceptions to these stereotypes) there will be a tendency for smaller players to be more dedicated and innovative, but they lack budget to have impact; whereas the biggest players have the budget but are less committed. This would appear to leave the US mid-sized players with a bit of innovation and a bit of budget to dominate.

We believe that this is another significant cause of poor search penetration in the US. This mid-sized group acts as a plug, blocking the bigger players from showing greater return on investment. The big players cannot justify the high click price because they are less skilled and innovative at search, so they never get to spend their big budgets at the top of the search engines. Bigger players then withdraw from the market as they cannot cross the chasm to justify higher prices.

e) Organic inertia

When paid search was developed in 2000 by Goto – later to become Overture and subsequently bought by Yahoo - there was no fanfare. It seems crazy to believe now six years later, but most people thought it was just another great dotcom idea, up there alongside boo.com and the other millions of great dotcom ideas.

However, there was one set of people who detested the concept; ironically this group was the one that should have made a fortune from paid search. The organic search optimisers had spent up to five years unpicking the search algorithms of Alta Vista, Lycos, Hotbot and others. Had wasted days and weeks in secret enclaves on the internet swapping tips and ideas on how to get pages ranked highly. They loved the purity of the new boy Google. Through dedication and long hours of toil, they had the keys to the kingdom; they had become masters and only they knew how to place a client's website at the top of a search engine.

THEN APOCALYPSE. Overnight they were knocked off top position by some techno-illiterate paying one cent

to place his website above the organic master.

It got worse. By 2002 virtually all the search engines except Google were doing it. Paid listings were everywhere. In business, there is a concept of sunk cost. Once the money is spent, it is spent – decisions should not be influenced by the money that has already been spent. In the context of search, all the organic master's efforts in learning SEO shouldn't have had an effect on the decision to reject paid search, but in most cases it did. Instead of grabbing this amazing new tool and adding it to the armoury, most organic optimisers turned their back on the devil. We term this organic inertia.

In 2000 organic search was much more advanced in the US than the UK. The UK had less baggage and an eager entrepreneurial spirit, the result is that most of the biggest search specialists in the US are predominantly natural search specialists, whereas in the UK the biggest players are paid search specialists.

And since paid search is by far the better marketing tool (Why?- The message can be controlled absolutely, varied for different searchers, turned up and down, on and off and is easily measured), it is where the marketing bucks are spent.

The SEO drag is a significant cause of the conservatism in the sector and a reason for the poor search penetration.

4. UK has less competition amongst search engines leading to higher click prices

This argument says that because there are fewer search engine players in the UK market and as a result of the relative market dominance of Google the search engines charge more for the same service. There are various ways of collating market share figures e.g. spend, clicks, commercial clicks etc. for the benefit of this White Paper we have assumed Google has 60% of the US paid search market and 75% in the UK. Clearly, if the UK is paying more for the same service, then the proportion of total marketing spend will be higher.

Our analysis of Latitude's database does show that the click prices on the highest valued terms and most competitive phrases is higher in the

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UK (in our basket some 18% higher). However, in mid-competitive phrases the price differential is negligible, while in the lowest level of competitive terms the greater keyword depth found in the UK market means that these phrases are more expensive in the US. We estimate that the overall price differential is likely to be around 10%.

In a visible bid landscape e.g. Pre-Panama Yahoo there could be no criticism of the search engines in regard to variable regional pricing. The market was open and there was clear and freely available evidence that there was no anti-competitive activity. However, an invisible bid landscape predatory pricing will only be spotted by the biggest and most sophisticated players, and there may be a need for regulatory scrutiny.

This explanation does account for about 5% of the difference, but is more an effect than a cause. In a post Panama world predatory pricing by engines could become more important and could attract regulatory enforcement.

Conclusions:

The advanced level of search penetration in the UK market is real and exceptional. There are five primary factors that explain the differing performance. In order of importance

1. The search engines pay commission in the UK and this has had a firestarter effect on search penetration
2. The US market has a much higher proportion of in house search marketers, who to be less innovative and do not operate search as effectively as search agencies, slowing the flow of funds from other media
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More questions to consider

Over the coming weeks, please join search experts such as the author, Jon Myers, Marco Brambilla and Richard Gregory at www.latitudegroup.com, when they debate critical questions such as:

- Would UK search specialists have a competitive edge in the US?
- Will US search specialists struggle in the UK?
- Should US search engines such as Ask move quickly into a UK market that looks higher priced, profitable and under supplied
- Should US search engines move their innovations teams from the US to the UK?
- Why aren't US clients using agencies and specialists to the same degree as the UK?
- Why is anybody still doing in-house search marketing?
- What are the dangers of an invisible bid landscape? Do we need regulation? Will the measurement of effectiveness become less visible and the pace of change slow down?
- Should the US search engines raise their click prices and offer commissions?
- How much more growth is there in the UK? (26% of media usage is now online, yet spend is still only 11%).



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Future Latitude White Papers

As Latitude is at the forefront of Search Engine Marketing in the UK, we continually monitor developments of interest to the industry and publish our findings on a regular basis.

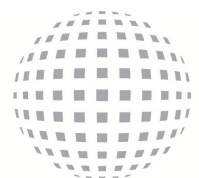
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