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PUBLIC OWNERSHIP, COMPETITIVE STRATEGY, AND FIRM PERFORMANCE IN PROFESSIONAL SERVICES: EVIDENCE FROM U.S. ADVERTISING AGENCIES

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ABSTRACT
The rise of publicly traded professional service firms seems puzzling. Where skilled human capital is of critical value and physical assets are of little value, theory would suggest that insiders, not investors, should own firms, as is the case with the traditional professional partnership. In the extreme, investor ownership should reduce insiders’ incentives without offering offsetting benefits, leading to a less competitive firm. At a minimum, outside owners should make the firm more “commercially” oriented, leading to a strategic position based less on an elite reputation and high human capital and more on standardization, scale, and/or capital-substitution. The advertising industry offers a useful setting to test these expectations, as there have been both public and private agencies since the 1960s. Agencies have to strike a difficult balance between employees’ private benefits from producing “creative” output and clients’ desires for output that balances creativity with effectiveness. Outside owners should favor client satisfaction over insiders’ benefits, leading publicly owned agencies to be less creative than privately owned agencies. Agency creativity can be measured through the industry’s annual awards shows. Analysis of a panel of 50 U.S. advertising agencies from 1961 through 2000 shows some evidence that going public does reduce an agency’s creativity. However, there is even more evidence that public agencies are still at least as creative as, if not more creative than, private agencies. A number of possible explanations for these results are discussed, but overall they suggest that ownership is not the only incentive mechanism available to PSFs. Publicly owned agencies are able to maintain creative output through alternative incentive mechanisms, including perhaps higher compensation. These results also belie the notion that professional service firms are best operated as employee-owned partnerships. The current dominance of publicly traded ad agencies suggests that public ownership will increasingly pervade other professional services as well, including strategy consulting and even law.

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1. INTRODUCTION

“About a week later, I was sorry we did it [went public]. I immediately sensed in board rooms, hallways, creative meetings, a different attitude about the work. We now owed our allegiance to the stockholders. What had made us great – our unrelenting creativity, trying to create stuff that was surprising and perhaps outrageous – that attitude was smashed within a couple of days. I literally left my first agency because it went public.”- George Lois, co-founder Papert, Koenig, Lois

The professional services have long been populated by private partnerships, rather than public corporations. This pattern of pervasive employee ownership is one of the important and distinguishing characteristics of professional service firms (PSFs). This ownership form is assumed to be appropriate for businesses which rely critically on the inputs of highly-skilled employees and require little in the way of major capital investments (Dow and Putterman 2000; Hansmann 1996; Hart 1995; Jensen and Meckling 1979; Roberts and Van den Steen 2000; Williamson 1983). Investor ownership would dilute the incentives for human capital investment in a human-capital-intensive business. In fact, some scholars look to PSFs as potential harbingers of the organizational implications of the rising value of human capital in the general economy and suggest that employee ownership will become increasingly prevalent (Greenwood, Empson, and Hinings 2002; Roberts and Van den Steen 2000).

This makes the trend toward publicly traded PSFs rather puzzling. In the last few decades, a number of professional service industries, including advertising, investment banking, and management consulting, have seen many of their leading firms convert to public ownership. On its face, public ownership seems like a waste of valuable incentives for insiders, while the increased ability to raise capital from investors seems relatively useless.

This phenomenon gets only more puzzling if we listen to the surfeit of lamentations from those who have experienced the change. Mr. Lois’ quote, which opens this paper, is a prime example, but by no means exceptional. A principal in an economics consulting firm lamented the fact that once the firm went public, “the work was no longer any fun” (personal interview). The head of an executive recruiting firm that went public lamented years later that “we should not have gone public. It was a big mistake, because it hasn’t ever added any

1 Rothenberg, 1989.
value” (Martinson 1997). Even in the more capital-intensive, money-driven world of investment banking, going public seemed to threaten the firm’s culture: “[Morgan Stanley] was the ultimate white-shoe firm. But after it went public, they lost something in the translation ... it lost some of its aura.” (Groysberg, Matthews, Nanda, and Salter 1999)

A element common to many of these quotes is the perceived effect that public ownership has on PSF culture. Professionals often have allegiances to standards of conduct and sources of status that are not perfectly correlated with financial success. The “professionalism” of the firm may be an important element of PSF culture. And a strong culture is typically considered to be an important source of competitive advantage for for PSFs (Gilson and Mnookin 1985; Greenwood, Li, and Deephouse 2002; Levin and Tadelis 2002; Lorsch and Tierney 2002; Maister 1993; Maister 2001). Having outside shareholders is said to make the firm more financially driven, focused on growth and quarterly results, to the detriment of the firm’s professional ethos as well as its work process and product. This commercialization is said to hurt the firm’s work processes and product, demotivating current staff, and also harms the firm’s “cachet”, weakening its recruiting ability.

In the extreme case, public ownership might be expected to erode a PSF’s overall incentive system, without offering offsetting benefits, leading to poorer competitive performance relative to private PSFs. Of course, there may be offsetting advantages (which, for example, lead the firms to go public in the first place) that keep the public PSF competitive. However, we might at least expect that public ownership would lead to a shift in the firm’s basis of competitiveness, and hence a change in its strategic position. We would expect this this strategic shift for two reasons: first, public ownership would make the firm disadvantaged in inducing human capital investments but advantaged in raising financial capital, leading to a more capital-intensive production process; and second, public ownership would lead the firm to value only financial returns, rather than a blend or mix of both financial returns as well as professional status. So we might expect that public PSFs would compete less on the basis of high human capital and and high-quality “elite professionals” reputation, and more on the basis of scale, standardization, and capital-substitution.

To test these expectations, this paper looks at the U.S. advertising agency industry. Advertising agencies were some of the first professional service firms to go public, with a wave of IPOs starting in 1962. From the mid-1960’s to the mid-1980’s, a number of public
advertising agencies competed against private agencies that were competitively similar in many respects. In addition, the advertising industry’s numerous annual awards shows offer an observable measure of agency creativity. Creativity is an important dimension of agency output that is particularly dependent on human capital inputs and is also a core element of advertising professionals’ expertise and status. Thus, this industry affords an opportunity to assess whether public PSFs compete less effectively or at least differently than private ones.

Creativity is an important dimension of agency output, but is a major source of tension between an agency’s clients and its creative personnel. While clients value creativity, they do not value it as much as those who produce it within the agencies. Agency creative personnel are often driven not only by the goal of helping the client increase sales but also by the goal of establishing their reputation among other creative professionals. Agencies must constantly balance client satisfaction against personnel motivation. Different agencies may strike different balances, leading to different strategic positions. Some agencies may emphasize client satisfaction and develop reputations for good service but mediocre creativity, while other agencies emphasize creative “integrity” even to the point of foregoing potentially lucrative client accounts in favor of preserving their creative “edge.”

Publicly owned agencies, with their lower levels of insider incentives and exclusive focus on financial returns, might then be expected to be associated with the not-so-creative, client service strategy. In its simplest terms, the hypothesis is that public agencies are expected to be less creative than private agencies, which can be measured by their rate of winning creative awards.

However, contrary to these expectations, cross-sectional and longitudinal analyses of a panel of 50 agencies from 1960 through 1986 reveal that public agencies were not less creative than private agencies on average; in fact they were generally more creative. There is some evidence that agencies that went public suffered a decline in creativity, but they still outperformed private agencies on their average level of creativity.

This unexpected finding could be the result of a number of factors which are discussed more systematically in Section 7. The most likely explanation is that the proposed model of agency incentives and incentives for inducing creative output is incomplete. While it may be that ownership matters, and that outside ownership may negatively effect insider incentives as well as the agency’s culture, there are other incentive mechanisms aside from
ownership. For one, public agencies may be able to offer higher compensation to attract talented creative personnel. In particular, publicly traded stock is typically more valuable than private stock, so offers of stock and stock options would be more valuable at the public agencies. Secondly, if talented creatives typically seek to work at agencies with strong creative reputations, then creative reputations may be self-reinforcing over extended periods of time. Creative agencies that go public may be able to continue to attract creative personnel because of that reputation, leading to a continuation of the creative reputation. This conforms to a notion within the industry that creativity is “in the genes” of an agency: that creative reputations—good and bad—are long-lived and hard to change. Future research in this industry and with this dataset will focus on testing the various explanations proposed in Section 7.

Finally, for those PSFs that are still private, the advertising agency experience suggests that there is no overriding reason that such firms have to be private. Public ownership certainly does not seem to weaken PSFs in general nor even along the dimensions of professional expertise and status. In fact, the financing advantages that public agencies enjoyed accelerated a consolidation movement in the industry that has led to a dominance of public ownership among the large and medium sized agencies. Thus, it is not unreasonable to expect that other PSFs will go public and that it will only take the aggressive acquisition activity of a few such firms to transform the industry to public ownership. This may very well happen to management consultancies, several of which have gone public already. It may even happen to law firms, despite the current institutional prohibitions against outside investors. The conclusion discusses why the advertising example suggests that this might occur nonetheless.

The paper proceeds as follows: Section 2 reviews organizational economics based theories regarding the effects of outside ownership on insider incentives. Section 3 applies this theory to the expected effect of outside ownership on professional service firms. Section 4 introduces the advertising industry, the role of creativity within the industry, and the expected relationship between public ownership and agency creativity. Section 5 describes the data and variables; Section 6 presents the results; and Section 7 discusses possible explanations for the unexpected results. Section 8 concludes.
2. THEORY: OUTSIDE OWNERSHIP, INSIDER INCENTIVES, AND FIRM OBJECTIVES

There is an extensive literature in corporate governance on the allocation of ownership among insiders (entrepreneurs, managers, employees: those who provide “work” for the firm) and outsiders (usually, investors). Fundamentally, the optimal allocation of ownership involves a trade-off between the providers of labor and capital--i.e. between insiders’ incentives to exert effort and invest in human capital versus outsiders’ incentives to invest financial capital in the firm. Ownership should be allocated to those parties whose investments are both valuable to the firm and hard to contract for (see Hansmann 1996 for a useful summary).

Theoretically, there are three main mechanisms by which outside ownership may dampen insiders’ incentives, based on different properties of ownership. The first is based on the residual cash flow rights that come with ownership and that act as incentive-based or performance-based compensation. Jensen & Meckling (1976) argue that if ownership is allocated to an entrepreneur whose effort level has an effect on the firm’s residual returns, then all of the returns accrue to the entrepreneur, who will then exert optimal effort. However, allocating some portion of ownership to outside investors diverts some of the returns to the entrepreneur’s effort to the investors, hence inducing less effort.

The second mechanism stems from the property rights / incomplete contracts approach, which focuses on the residual control aspects of ownership, rather than the residual returns. In the property rights view of the firm (Grossman and Hart 1986; Hart 1995; Hart and Moore 1990) ownership of an asset provides “residual control rights”-- the authority to make decisions about the use of the asset in all situations not already contracted for. Residual control rights offer increased bargaining leverage in negotiations over the surplus generated by the asset. Hence ownership should increase a party's incentive to make non-contractible specific investments because that party can expect a larger share of non-contractible surplus. If insiders own the firm, they can ensure that they get a return on any firm-specific investments that they make. But if outsiders own the firm, the risk of them expropriating the returns to insiders’ investments reduces the insiders’ ex-ante incentives to make such valuable investments.

The third mechanism revolves around the idea of insiders’ private benefits. Inside owners’ utility may be a function of more than just their share of the firm’s residual cash
flows. It may also depend on a range of things that can be enjoyed only by insiders, such as a plush office environment, or the insiders’ status among industry peers, or even the aesthetic value of the firm’s output. Inside owners may balance their effort and investment across both the financial returns and the private benefits. However, outsiders derive no direct benefit from the insiders’ private benefits. Outsiders are interested only in the firm’s profits. If outsiders own the firm, they will seek (as far as possible) to minimize insiders’ pursuit of private benefits that come at the expense of profits.

If profits can be substituted for private benefits, then outside ownership will not necessarily reduce insiders’ level of effort or investment. Still, these outside owned firms might be expected to compete on different bases than inside owned firms, as more effort will be shifted into generating financial returns than private benefits. For example, Fee (Fee 2002) investigates the relationship between the characteristics of motion pictures and whether they are financed independently (where the producer retains residual control) or by a studio (where the studio retains residual control). Films that are more artistic and win more critical acclaim are more likely to be independently financed (i.e. insider ownership), while films with low artistic content and larger marketing budgets are more likely to be studio financed (outsider ownership).

But there are several models in which insiders’ efforts towards private benefits may be correlated with increases in profits too. In other words, there may be situations in which allowing insiders to pursue private benefits produces effort that also increases profits. Aghion & Tirole (Aghion and Tirole 1997) develop a model in which a subordinate engages in a costly search for investment projects which the superior can then accept or reject. Projects provide both returns (to the superior) and private benefits to the subordinate. As the correlation between returns and private benefits increases, it becomes more worthwhile to let the subordinate choose which projects to pursue, despite the expectation the she will choose high private benefits.

For example, in the human-capital-intensive environment of pharmaceutical R&D, allowing research scientists to spend time and energy publishing papers in academic journals seems like an activity that offers private benefits to the scientists but does not generate profits for shareholders. However, there is evidence that allowing such publication activity results in higher research productivity for the firm, perhaps through increased effort by scientists or
by the ability to recruit top scientists who highly value the opportunity to “do real science” (Cockburn and Henderson 1998; Cockburn, Henderson, and Stern 1999). Thus, if outside owners disallow the pursuit of private benefits, it may not only shift the nature of the firm’s production process and/or output but also the overall level of insider initiative.

Of course, despite all these potentially negative effects, firms are often owned by outside investors. The primary reason for this is that in many environments investors’ incentives are also important. Allocating ownership entirely to insiders can pose problems for generating and making investments in physical capital. First, insiders may have trouble generating capital themselves because of wealth constraints and they may have difficulty securing external financing because both debt and equity investments would be subject to significant agency costs (Dow and Putterman 1999; Jensen and Meckling 1976). Second, insiders, even if they have access to ample capital, may be investment-averse. This is because insiders already have their human capital tied to the firm and so will be reluctant to increase their undiversified risk by also committing their financial capital to the firm (Jensen and Meckling 1976).

Thus, outside ownership may reduce insider incentives for effort because (a) it reduces the insiders’ returns to effort; (b) it threatens, hence reduces, insiders’ firm-specific investments; and (c) it reduces insiders’ enjoyment of private benefits. On the other hand, outside ownership may be important and necessary to raise finances for firm-specific capital investments. Thus, the allocation of ownership between insiders and outside investors depends on the importance and contractibility of physical investments relative to labor effort and human capital investments.

3. THEORY: APPLICATION TO PROFESSIONAL SERVICES

The nature of production in professional service firms (PSFs) would seem to suggest that ownership would predominantly be allocated to insiders. And for those PSFs where ownership is allocated instead to outside investors, there should be a marked effect on the insider’s incentives and the strategic position of the firm. This is because the PSF, or the classic archetype thereof, relies critically on skilled human capital and very little on physical capital.
PSFs produce and sell customized advice based on the application of expertise to a client’s specific situation. This means that PSF competitiveness depends almost entirely on the skill level and motivation of its employees (e.g. Lorsch and Tierney 2002).\footnote{\textit{The central difference – and distinguishing characteristic—of the PSF business model is its reliance, its absolute dependence, on skilled and motivated professionals.”} (Lorsch and Tierney 2002, p.24)} Not only are insider effort and human capital not only incredibly valuable, but they are also non-contractible (or at least costly to contract for). The firm’s assets—employee skills and client relationships—are inalienable to a large degree. The high skill and expertise of professionals makes their performance levels hard to monitor, or at least hard to verify.

On the other hand, PSFs typically employ very low levels of physical capital. The physical assets that they do employ are often generic: office leases, office equipment, computer systems.\footnote{Even investment banks’ high capital-intensity is based on \textit{generic} assets – money – rather than firm- or industry-specific assets, and hence was long financed by insiders and/or debt (Hansmann 1996).} Thus, outside finance is typically considered of low importance for PSFs. Allocating ownership to outsiders would seem to be a waste of incentives, leading to reduced employee effort or investment without a countervailing benefit from capital investment.

Correspondingly, professional service firms have traditionally been private partnerships, owned exclusively by partners who provide both labor and capital inputs. A number of economic analyses ascribe the partnership model among PSFs to the high levels of non-contractible, hard-to-monitor human capital involved (Gilson and Mnookin 1985; Jensen and Meckling 1979; Levin and Tadelis 2002; Williamson 1983). Roberts & Van den Steen (2000), for example, conclude:

“in the limit, if all that matters is human capital, then, from a wealth-maximization perspective, the human capitalists should control the firm and receive all the returns. ... This conclusion is consistent with one of the striking stylized facts of corporate governance. In professional service firms, where arguably only human capital matters, ownership and control is typically vested solely in the human capitalists.”

Furthermore, most studies of PSF management assert that a good “culture” is of particular importance to PSF success. Given the inalienability of its assets and the non-contractibility of its inputs, the PSF has few formal, contractual means by which to attract talent and induce effort. Culture, as an informal source of employee motivation, is thus a key source of competitive advantage (Gilson and Mnookin 1985; Greenwood, Li and Deephouse 2002; Levin and Tadelis 2002; Lorsch and Tierney 2002; Maister 1993; Maister 2001).
common aspect of PSF culture involves the very “professionalism” that defines a PSF. For example, professionals may value adherence to a set of standards regarding their conduct and their production process that is not totally driven by commercial concerns – i.e. they may also incorporate ethical or aesthetic or cooperative norms. These standards may not be anti-commercial – i.e. adherence to them may foster a high-quality reputation in the long run that is good for business – but they may conflict with profits in the short-term or simply involve “grey” areas, where a more financially-driven party would interpret adherence in one way and a more professionally-driven party would interpret it in another way. Another common aspect of professionals is their concern for their status among other professionals. And professional status may be only imperfectly correlated with financial success. Professionals that are “too” financially oriented may be accorded lower status by other professionals.

In addition to the potential benefits to the firm’s reputation for integrity from the development of a highly professional culture, such a culture may also be important to the firm’s reputation for quality, as talented professionals may seek out firms that have professional cultures. “Star” employees may seek such “elite” firms for a number of reasons, including the “brand” or signal it provides to the external labor market, the actual development of skill and human capital the firm provides, and even the private utility that the employee derives from doing “good work.” Thus, these “professional” PSFs may have an advantage in recruiting the top talent, leading to higher quality output.

Outside owners may not value much of this professionalism or other of the firm’s pursuits that develop and maintain its culture. Of course, if the culture contributes to the firm’s financial returns, then rational investors would allow and encourage such a culture. However, one can easily imagine that privately owned PSFs may “over-invest” in culture, relative to the choices that an investor owed PSF would make, since the insiders would derive benefits not only from the financial returns but also from the private benefits that come from intra-profession status and adherence to internalized norms. Thus, the publicly owned PSFs would be unlikely to be the “most professional” firms with the strongest cultures. In other words, public PSFs, even if they are not uncompetitive, may shift the bases on which they compete, opting for a somewhat more commercially-oriented firm rather than developing a “high-quality” or “high-brow” professional reputation.
4. THE ADVERTISING INDUSTRY: CREATIVITY AND (OR?) FIRM PERFORMANCE

4.1 Industry Overview

Advertising agencies have long dealt with these factors – skilled human capital, little physical capital, tension between professional aspirations and client satisfaction. Furthermore, there have been both public and private agencies competing at the same time for an extended period (in many other professions, public and private firms have not co-existed for a long period for robust empirical comparison). Thus, the industry seems to provide a useful setting for exploring the hypothesized effects of public ownership on PSF incentives and strategy.

The advertising agency in the United States was born in the middle of the 18th century and functioned primarily as a broker of advertising space in newspapers and magazines. The first U.S. agency was founded in 1838 in Philadelphia. Expenditures on advertising began to grow rapidly in the latter half of the 1800s, in combination with the rise of mass circulation periodicals and the mass production of consumer goods (Bojanek 1980). J. Walter Thompson, the oldest agency that continues to exist, was founded in 1878 and began the service of designing advertisements for clients (Micklethwait 1990). By the 1920s, agencies had evolved to provide the set of functions that define the typical “full-service” agency today that designs and implements advertising campaigns for clients (Pope 1983). These functions include three distinct activities: (a) Market research and advertising strategy development: The agency suggests which customers to target with what message and positioning and how best to allocate the client’s advertising budget across various media (TV, print, direct mail, etc.) (b) Creative: The agency creates the advertisements. (c) Media Buying: On behalf of the client, the agency negotiates rates for and buys media space and time for the dissemination of the advertisements.

Agency output – customized advertising campaigns – is almost entirely produced by labor inputs. For the typical agency, salaries and benefits comprise about 65% of total costs, with an additional 15% going to office rent (Nohria and Cook 1991). There is very little capital investment aside from computer systems. The work that does involve expensive, specialized equipment – TV production, commercial printing – is typically outsourced and hired on an as needed basis and the costs are passed directly to the client.
Given the low barriers to entry and low economies of scale, it is unsurprising that the advertising industry overall is highly fragmented. The Census Bureau reported that there were 5,348 advertising firms in the U.S. in 1967 and that number grew to 12,607 in 1997. The Herfindahl index was .00231 in 1948, .00258 in 1967, and has since fallen to .00094 in 1997 (King, Silk, and Ketelhohn 2001). In 1997, the average U.S. agency had revenues of $1.3 million and had 11 employees.

4.2 Creativity

At the core of the advertising industry is an age-old tension between “art and commerce.” In this industry, “art” takes the form of “creativity”, an ill-defined, subjective property of advertising messages that involves its novelty or originality (other ill-defined terms, to be sure). Regardless of how well defined it is (or isn’t), creativity is an obsession with the advertising industry. The trouble is, advertising personnel are more obsessed with it than their clients.

Creativity is an important characteristic of an agency’s reputation, and clients do seem to value creativity in an agency’s output. The creative function has traditionally been the core function of an agency, the industry’s raison d’etre. The capability to produce creative advertising messages seems to be the key reason that clients use agencies at all, rather than producing advertising campaigns in-house (Bojanek 1980; Forman 2002; Rosenshine 1991). Client surveys, both commercial and academic, routinely rank creativity as an important, if not the most important, criteria in clients’ evaluation and selection of agencies (Helgesen 1994; Winski 1985).

But creativity is neither the only dimension on which agency output is judged by clients nor the only determinant of agency success. In addition to designing the actual advertisements, the agency’s basic service to its clients also includes advising on overall marketing strategy as well as buying the media time and space in which to place the advertisements. Clients also value these other aspects of an agency’s performance and many very successful, long-lived advertising agencies have mediocre creative reputations but strong reputations for client service or marketing savvy, for example.

However, many agency personnel are concerned almost exclusively with creativity. The industry evaluates and labels its own members primarily according to their creative
reputation: creativity is “the most frequently used and admired characteristic in the industry and probably the single most important criterion of agency achievement and success” (Helgesen 1994). Industry trade publications are rife with discussions of “hot shops” and their innovative, cutting-edge work. Many “creatives” – the copywriters and art directors who create advertisements for their clients – are interested in more than just producing ads that sell their clients’ products. They also seek to establish their creative reputations among their community of peers, independent of – and not infrequently in conflict with – the needs of their clients.

This contrast leads to endless conflict between creatives and clients. This tension is exacerbated by the difficulty in measuring both the “objective” level of creativity of an agency’s output in the first place, as well as the actual value of creativity in the overall effectiveness of an advertisement (i.e. its effect on client sales). Clients and creatives can argue both over whether a specific advertisement is creative as well as over whether it is appropriate for the sales task at hand (see Rothenberg 1994 for lively illustrations of the tensions between clients and creatives).

For the agency, this tension presents the need to strike a balance of some kind between creatives and client. The agency needs to produce work of a certain creativity level yet also keep the client satisfied that she is getting not just creativity but also effectiveness. Yet always catering to the client’s desires and demands can have a negative effect on the agency’s creative capability as existing talent can get demoralized and/or leave and new talent may be harder to recruit (Kover 1970; Nohria and Cook 1991). This balancing need gives rise to a key functional department in the agency—account management. Account managers are essentially a bridge or liaison between clients and creatives.

Different positions on this “creatives vs. clients” balance are one important source of alternative competitive positions among advertising agencies. While some amount of creative “competence” is necessary for most agencies, not all agencies compete on the basis of strong creative reputations, as alluded to above. Client service, marketing savvy, and breadth of service (geographic and functional scope) are other dimensions on which agencies compete and build reputations (Bacon 1987; Winski 1985).

One of the common characteristics of agencies with strong creative reputations – the “hot shops” – is the “protection” of the agency’s creative output from the input, demands,
and desires of its clients. Kover (1970) shows that more creative account teams are structurally insulated from client input, with little client or account management input into the design of advertisements and fewer internal approval points, while less creative teams operate in an organizational environment set up to cater to client desires, with lots of account management input during production and more internal approval steps. Furthermore, creative teams are associated with what he calls a “professional” culture: “an internalized set of attitudes and norms ... that says ‘the members of this account team are experts, advertising professionals ... therefore we will not accept [the clients] tampering with our work.’” Less creative agencies, on the other hand, are marked by what he terms an “accepting” culture, that “says ‘We are hired by a client to do a job. If the client doesn’t like our work he will go elsewhere. Therefore, what the client wants, he gets.’” (Kover 1970, p.19) In other words, creative agencies choose to maximize the private “professional” benefits of artistic expression and peer recognition with the hope that the creative advantage will generate a sufficient amount of client satisfaction and competitive success to sustain the business, but with the recognition that the agency cannot satisfy all clients and runs the risk of foregoing some accounts that may be highly lucrative from a purely financial standpoint.

4.3 Awards

An important carrier of creative reputation within the industry are the annual awards shows. Numerous regional, national, and international shows bestow awards to the most creative advertisements in various product categories and media. The judging panels are typically composed of prominent creative personnel from multiple agencies. Most shows are organized by non-profit professional associations (e.g. The Art Director’s Club of New York), with a few organized as for-profit enterprises (revenues are generated both from entry fees as well as tickets to the awards presentation galas). Almost all awards shows are explicitly intended to recognize creativity (Helgesen 1994), rather than client service of media buying effectiveness.  

The imperfect correlations between creativity, advertising effectiveness, and agency performance can be seen in the contradictory evidence on the effects of awards. In some ways, awards are seen as a critical component of agency success. An HBS case on Hill

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4 The most prominent exception are the Effies, organized by the American Marketing Association of NY, which are awarded on the basis of overall campaign effectiveness as well as creativity.
Holliday Connors Cosmopulos argues: “In the absence of more quantifiable measures, a firm’s reputation was absolutely crucial. There were many highly competitive advertising awards shows every year, and recognition for an agency’s creative work was vital in the securing of new clients” (Nohria and Cook 1991). The founder of a small Boston agency described how awards were critical to establishing the firm’s early reputation as a creative shop, which helped get the agency invited to pitch to new clients (personal interview). Helgesen’s (1994) review of the academic literature on advertising claims that winning many awards leads to agency financial success. In the same study, however, he finds that awards have not been demonstrated to have any correlation (negative or positive) with advertising effectiveness.

From this, it seems fair to conclude that awards are a reasonable proxy for an agency’s creative reputation and/or actual creative talent, but that awards do not have a necessary or monotonic relationship with overall agency commercial success. This corresponds to the idea that creativity is a key element in agency output, but not the only one, and that there can certainly be “too much” creativity, at least from the client’s perspective.

4.4 Outside Ownership

Given the importance of talented personnel to agency success and the imperfect relationship between creativity and agency financial performance, advertising agencies seem particularly susceptible to the hypothesized incentive effects of insider vs. outsider ownership. Both incentives per se as well as private benefits should be important determinants of not only of an agency’s strategic position but even perhaps its overall performance.

The most commonly cited concern regarding public ownership involves its effects on the firm’s culture. As discussed more generally in Section 3, outside shareholders will likely value only the agency’s financial returns, hence will minimize the pursuit of private benefits. Where this conflict of values would show up most is in the agency’s attitude towards clients. Not only do creative agencies develop a structure and culture to protect their work from client “meddling”, they also can be very picky about choosing their clients in the first place. Some industries, such as consumer packaged goods, are known for being particularly unreceptive to “leading edge” creative work and for instead requiring “boring” advertising
that may demoralize the agency’s creative staff. And certain firms, regardless of industry, are known as “good” or “bad” clients for the opportunity and freedom (or lack thereof) that agency creatives are allowed. Creative shops may well forego the pursuit of large, lucrative accounts because of the desire to avoid such work. Outside ownership might make such decisions much harder, as outsiders could care less about the nature of the client’s demands, seeing only the size of the client’s business. Thus, insider owned firms may choose to avoid certain types of clients because of the utility they get from the creative process, while outsiders, who don’t care where the profits come from, might push the firm to expand to the “boring” clients.

Anecdotes about this shift in attitude toward clients and commercialism are not hard to come by in the advertising trade press and histories. This paper’s opening quote is one example. Similarly, Millman’s (1988) industry history retells the insiders’ take on Doyle Dane Bernbach:

“Almost everyone who was a star at [DDB] when it was the greatest advertising agency in New York says its death began when the company went public in 1964. (65) ...the agency that had been dedicated to the creative product above all else ... became as financially motivated as its counterparts on Madison Avenue, a factor that caused disillusionment among the most talented and committed of the creative staff ... ‘the agency took an expansion route through supermarket products’ that resulted in the ‘invasion of the MBAs’. (Millman 1988 p.71)

Finally, the International Directory’s historical capsule on Ogilvy & Mather argues:

“with larger and larger amounts of an agency’s shares under public ownership, firms have a propensity to become conservative. They feel an obligation to their shareholders to secure consistent dividends and minimize risks, and therefore shy away from the innovative in favor of going with ‘what has worked in the past.’ Ogilvy & Mather, long thought of as an ‘idea shop,’ became a victim of this kind of corporate syndrome.”
(International_Directory 1988)

4.5 Empirical Predictions

4.5.1 Cross-Sectional Predictions

The primary expectation from the previous sections is that public agencies will forego the private benefits of creativity for creativity’s sake in favor of clients and output that maximize financial gains. This will lead to lower creativity, both through the shifting of insider effort away from creativity and through reduced ability to attract talented creatives. This lower emphasis on creativity will be manifested in winning fewer awards.
Publicly owned advertising agencies will be less creative – hence, will win fewer awards – than privately owned agencies

4.5.2 Panel Predictions

In addition to cross-sectional differences between different public and private agencies, we can look at the effects of ownership on firms that switched from private to public (or vice versa, which did happen occasionally). From the discussion above, we would predict that agencies that went public would experience reduced creativity, relative to when they were private:

- *Agencies that go public will experience a decline in their rate of winning awards.*
  
  *Conversely, public agencies that go private will experience an increase in their awards rate.*

Not all agencies compete on the basis of strong creative reputations. Those that do not would seem best suited for public ownership (as predicted above, in the cross-section). On the other hand, particularly creative agencies would seem least suited for public ownership, as they would experience stronger conflicts between employee and stockholder expectations and attitudes towards clients and revenues. Thus, the outside ownership arguments would suggest that it is the lower-creativity agencies that go public in the first place:

- *Award rates will have a negative effect on the likelihood of going public.*

5. DATA & VARIABLES

5.2 Sample

Much of the analysis in Section 6 is based on a panel of 48 U.S. advertising agencies from 1960 through 2000. The sample was selected using *Advertising Age*’s annual “Agency Report.” *Advertising Age* is the industry’s leading trade magazine. Each year since 1945, the magazine publishes its “Agency Report”, which lists around 500 U.S. advertising agencies, ranked by revenue. The total number of agencies varies from year to year, depending on Advertising Age’s minimum size criteria as well as on agency responses to the magazine’s
survey request, but typically includes at least 400 agencies. This annual report lists the agency’s name, global and domestic revenue, and, for some years, total number of employees.

The 48 agency panel includes the 25 largest agencies in 1961, as reported in Advertising Age. The remaining 23 agencies include those agencies listed in the 1961 report for whom complete data has been located on founding dates and exit dates. Determination of an agency’s founding date and exit date (acquisition, failure, or name change) involved searches of the Standard Directory of Advertising Agencies (aka “the Advertising Red Books”) in various years, Ward’s Business Directory, and Lexis-Nexis-based searches of articles in major newspapers as well as in the industry’s two main trade publications, Advertising Age and Adweek.

Of the 48 agencies, 14 survive through 2000. The resulting panel includes 1,529 agency-year observations. Table 1 shows the number of private and public agencies at various points in the panel. All agencies begin as privates and nine go public during the sample period. One public agency subsequently re-privatized. All the exits are by way of acquisition—none of these 48 agencies failed before they got acquired.

<table>
<thead>
<tr>
<th>Year</th>
<th>Pvt</th>
<th>Pub</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>1961</td>
<td>48</td>
<td>0</td>
<td>48</td>
</tr>
<tr>
<td>1971</td>
<td>41</td>
<td>6</td>
<td>47</td>
</tr>
<tr>
<td>1981</td>
<td>31</td>
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<td>1991</td>
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</tr>
<tr>
<td>2000</td>
<td>11</td>
<td>3</td>
<td>14</td>
</tr>
</tbody>
</table>

While the panel extends through 2000, the panel analyses in Section 6 are run on more limited time frames. The advertising industry underwent a period of significant merger and consolidation activity from the mid 1980s through the 1990s. Industry observers sometimes refer to 1986 as the “Big Bang”, when Saatchi & Saatchi, the largest U.K. agency, acquired the second largest U.S. agency, Ted Bates, and then three large U.S. agencies—Doyle Dane Bernbach, Needham Harper Steers, and BBDO—merged into Omnicom only two weeks later. In 1987, the oldest and largest U.S. agency, J. Walter Thompson, was hostilely acquired by a U.K. holding company, WPP, which also made a successful hostile...
bid for Ogilvy & Mather in 1989. The reasons for this consolidation are several and are beyond the scope of this paper. One of the main effects, however, was that many independent advertising agencies, including many of the largest, became subsidiaries of larger holding companies over a fairly short period of time. In addition to removing many of the firms from my panel, this reorganization of the industry also led to a redefinition of the way in which Advertising Age reported its rankings and revenue figures. Thus, comparing revenue figures before 1990 and after 1990 become more problematic. For these reasons, the panel analyses only extend through 1985.

5.3 Variables

Ownership Form

Public/Private (Pub). Ownership is a dichotomous variable indicating whether an agency is public or private (public = 1). An agency is considered to be public if its stock is traded independently. The value of pub is changed in the year after the firm’s ownership status changes (i.e. in the year after the IPO or re-privatization).

Determination of which agencies were public during what years is not as straightforward as one might expect. The identification involved three sources and there may still be several agency IPOs unidentified as yet. First, a listing of all firms in the Compustat and CRSP databases under the SIC codes of 7311 and 7310 yielded 20 U.S. agencies traded on a stock exchange at some point between 1950 and 2001. However, these two databases only include securities that were traded on a stock exchange. Several agencies issued stock that traded over the counter but was never listed on an exchange. Second, the Securities Data Corporation (SDC) Platinum database yielded one additional public agency. Third, a review of the Business Periodicals Index (BPI) for the years 1962 through 1972 identified three more.

This produced a list of 24 publicly traded agencies. Of these twenty-four, only nine are included in the 48 firm panel. The remaining 15 were either not founded before 1961 or too small in 1961 to make Ad. Age’s annual listing. However, the “switchers” analysis in Section 6.2 (and Table 6.3) uses as many of the 24 as data could be collected for.

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5 This search actually revealed thirty-six total firms, but I excluded sixteen. Two represented ADRs of non-U.S. agencies. The remaining fourteen were not classic “full service” advertising agencies. They were a mix of
IPO (ipo). This is a dichotomous variable indicating whether an agency had an IPO in a
given year (yes = 1). This variable is used in the event history analysis (assessing the
likelihood of going public) in Section 6.3.

Creativity (Dependent Variables)

Award Rate -- The awards data is based on annual results from four major awards shows:
Clios, Oneshow, Cannes, and Kelly. There are innumerable awards shows in the advertising
industry, particularly if regional shows (e.g. for Los Angeles-based agencies only or New
England-based agencies only) are included. However, some awards are more prestigious
than others. Some shows have specific reputations or genres. For example, the Clio awards,
one of the industry’s oldest shows, were originally awarded only for television and cinema-
based advertising. The Kelly awards, on the other hand, are exclusively for print
adsvertisements. Many shows give out awards across various advertising media and even
across different product categories. Input from several industry participants identified a list
of six major shows that represented the most prestigious, best known shows that U.S.
agencies would enter. The four shows whose results are included were those whose data was
easiest to transform into electronic form. Future revisions of this analysis will hopefully
include the remaining two shows.

An agency’s award rate in a given year is measured as its share of the total awards
bestowed in that year. Using share helps control for the fact that the total number of awards
bestowed varies from year to year. Additionally, a share measure gives greater weight to
winning an award from a show that gives out fewer awards. For example, it is presumably
harder to win one of the 25 annual Kelly awards then it is to win one Clio award, of which
there are between 100 and 200 in a given year. Hence, an agency’s total share is the average
of its share of each award show (rather than all its awards divided by the total number of
awards across all four shows). This share is used in five alternative measures:

• Awards Share_{it} (awdsh). An agency’s share of awards in year t.
• 3-year Average Awards Share (awd3). An agency’s average awards share over the last
  three years. In other words, the average of awdsh across (t-2), (t-1), and (t). Because
there are not that many awards in any year and many agencies win no awards in any given year, the three year average attempts to reduce the idiosyncratic elements of the awards measure for any given year.

- Awards Share per $million Revenue (awdshperr). Award share divided by the log of the agency’s domestic revenue (in millions). Agency size has a positive first order effect on awards share. This is because larger agencies typically work on many more campaigns and hence can submit many more entries into the competitions. Furthermore, awards are given out across different media and some smaller agencies do far less television work than larger agencies, hence do not qualify for a significant portion of the total awards. This measure controls, to some extent, for the first-order effect of size on awards rates.

- 3-year Average Share per $million Revenue (awd3perr). This measure is the average awdshperr from (t-2) to (t).

- Awards Share per Employee (awdshpere). Award share divided by the agency’s number of domestic employees. This may be a better control for size as the number of employees may be a better indication of the number of chances or entries an agency has. Employment data, however, is less available than revenue data. The employment data also comes from Advertising Age’s Annual Agency Report but was not reported for all agencies and not reported at all after 1989.

**Independent Variables**

**Size (lnrev).** Agency size is measured by the log of annual revenue. The advertising industry term for revenue is “gross income.” This measure is based on agencies’ domestic revenue, which is reported separately from their total worldwide revenue. Revenue data comes from Advertising Age’s annual Agency Report.

**Firm Age (age).** The age of the firm is measured as the current year minus the year the firm was founded.
Available Awards. The total number of awards given out by all four shows in year \( t \); i.e. the total number of awards ‘available’ to win. This is used to control for the variance in total awards across years.

**Growth Rate**

- Residual Growth Rate (\( \text{rgrw1} \)). Growth rate is measured as an agency’s revenue growth rate net of the industry’s overall growth rate, or the “residual” growth rate. An agency’s basic growth rate is calculated as the percentage change in revenue from year (\( t-1 \)) to year \( t \). Note that this measure does not exclude acquisitions, so agencies making large acquisitions exhibit large growth rates. The industry’s growth rate is measured as the percentage change in total U.S. advertising expenditures, as reported by Coen (Coen 2002). The residual growth rate is the agency’s basic growth rate minus the industry growth rate.

- 3-year Average Residual Growth Rate (\( \text{rgrw3} \)). Additionally, compound annual residual growth rates (CAGR) over the three previous years (i.e. from year (\( t-3 \)) to year \( t \)) are calculated to smooth out some of the idiosyncratic elements of annual growth.

**6. Evidence**

**6.1 Cross-Section: Are public agencies less creative than private agencies?**

In a word, no, public agencies are not less creative than private agencies. In fact, across a number of analyses and specifications, public agencies win more awards than, or at worst as many as, private agencies.

Table 6.1 shows a cross-sectional comparison of means, with the mean agency size and award share (measured in several ways) for the public and private agencies in the 48 agency sample in 1975, 1980, 1984, and 1995. Public agencies’ award shares are always at least equal to those of privates and in most instances are significantly higher. This holds even when award share is divided by logged revenue to control for agency size.

These results also hold in a multivariate regression on the 48 firm panel from 1960 through 1985. The award share measure cannot be negative and the modal value is zero, because both a very uncreative agency and an “almost creative enough to win an award” agency both realize a zero value. For this reason, I use a Tobit specification, assuming a left-truncation at zero on award share, to model the relationship between agency ownership and
award share. Column 1 in Table 6.2 shows the results from the Tobit regression of awards share using the 48 agency panel from 1960 through 1985. This model includes robust standard errors clustered on agencies, but does not include firm fixed effects. Column 1 shows that being public has a significant positive effect on awards share, even controlling for agency size – as shown in the means comparisons – and also for year effects. Column 1 adds two more controls, the square of revenue and the agency’s 3-year average residual growth rate, and the significant positive coefficient on public remains.

**6.2 Switchers: Does going public have a negative effect on agency award share?**

While the cross-sectional results contradict the predictions, with public agencies winning more awards than private agencies, the within-firm results do show some evidence of a negative effect of public ownership on creativity. Table 6.3 shows the before-and-after award share averages for agencies that went public between 1962 and 1973. (As mentioned in Section 5.1, this analysis consists of 16 agencies, which is more than the 9 included in the panel described above, but less than the total of 24 public agencies. This analysis includes those agencies that did not exist in 1961 (which the panel does not) and for which five years of pre-IPO data was located.) Column 1 of Table 6.3 shows the average difference between an agency’s average award share in the five years before going public and its average award share in the five years after going public (the year of the IPO is excluded from both averages). On average, agencies that went public had a higher average awards share (by 0.29) in the five years after they went public then in the five years before the IPO, but the difference in not statistically significant.

Columns 2 through 4 look at whether there was a trend before or after the IPO. Column 2 shows the average difference between the average award share in the three-year period before the IPO and the average in the period three years before that (i.e. years -6 to -4, relative to the IPO). Column 3 shows the difference between the three years before and the three years after the IPO. And Column 4 shows the difference between the three years immediately following the IPO and the three years after that (i.e. years +4 to +6, relative to the IPO). While there was no significant trend leading up to the IPO or just before and after the IPO, there was an average decline of 1.18%, significant at the 5% level, between the first three years and the second three years after the IPO. Thus, while agencies that went public
continued to win awards at a high level for a few years after the IPO, they then suffered significant declines in creativity (on average) several years out.

This result is also borne out in the multivariate regression. Column 2 in Table 6.2 adds firm dummies to the Tobit regression to control for firm fixed effects, in effect focusing only on those agencies that switched from private to public (or public to private, as in one case). This table shows that public agencies were less creative than when they were private. Going public in fact had a negative effect on their creativity; but not so great an effect as to make them less creative than their private rivals. This suggests that the agencies that went public were, on average, more creative agencies to begin with – opposite the prediction in section 3. This implication – that awards positively predict going public – is analyzed more systematically in the next section.

6.3 Adoption: Are awards negatively related to going public?

The 48 agency panel is also the basis of an analysis of the adoption of public ownership. In this panel, the failure event is going public. Firms are at risk while they are private and independent (they leave the at risk sample when they get acquired). Here too the time frame is 1960 to 1985. To estimate the effects of various agency characteristics, including award share and 3-year award share (in separate specifications), on the likelihood of an agency going public, I use a Cox Proportional Hazard Rate model.

Table 6.4 shows the results of the proportional hazard rate model, with IPO as the dependent variable, and firm size, age, 3-yr average residual growth rate, and award share as independent variables. The award rate, in both specifications (one year and three year), has no significant effect on the likelihood of an IPO. This is odd in two ways. It is contrary to the prediction from Section 4 which expected a negative relationship. But it also does not corroborate the expectation from the award share regressions, namely that agencies that went public were, on average, higher award winners.

In this sample at least, public agencies defy the predictions of Section 3. Public agencies do not win fewer awards, but in fact, seem to win more awards. Public agencies do not grow more slowly than private agencies. And awards are not a negative predictor of going public in the first place. There is some weak evidence that going public has a negative
effect on agency creativity, but not enough to offset the higher award rate relative to private agencies.

7. DISCUSSION & IMPLICATIONS

Given our theories about the incentive effects of ownership and the nature of production and competition in advertising agencies, it is surprising that publicly owned agencies seem to be, on average, more creative than private agencies, even controlling for their larger average size. To suggest possible explanations and implications of these results, it is helpful to review the proposed mechanisms linking ownership to creativity:

1. Public ownership leads to investor control
2. Investor control leads to:
   2A. Threat of expropriation of firm-specific human capital investments
   2B. Commercialization of firm’s objectives, favoring profits over private benefits
3A. Expropriation threat leads to reduced firm-specific human capital investments
3B. Commercialization of firm’s objectives leads to:
   3Bi. Shift of effort from creativity into other service dimensions
   3Bii. Reduced insider effort
   3Biii. Reduced ability to retain and recruit top creative talent
4A. Firm-specific human capital investment levels affect creativity of output
4B. Shifts of effort, reduced effort, reduced talent lead to reduced creativity
5. Agency creativity is reflected in agency award share

The unexpected results could come from a “breakdown” at several points in this logic chain. The first issue concerns #1, the equation of public ownership with investor control. Going public does not necessarily shift control to outside investors. Insiders could still own a majority of the shares or at least a majority of the voting shares. Table 7.1 shows the percentage of shares owned by insiders for several public ad agencies at several different points in time (based on data collected to date). None of the firms floated a majority of their shares at their IPO. By 1980, however, a majority of the stock had passed into outsiders’ hands. And by 1994, the remaining public agencies had very low insider ownership shares, with the exception of Grey. Of course, there is evidence that insiders do not need to control a
majority of shares to wield effective control, particularly if outside shareholdings are diffuse (Morck, Shleifer, and Vishny 1988). So it may be reasonable to assume that most of these agencies were still effectively controlled by insiders at least through 1980. Still, even if only a minority of shares are held by investors, it is this minority that effectively determines the value of the firm through their trading. A number of interviewees suggested that outsiders can certainly influence management decisions through their valuation of the stock. Furthermore, the public agency advantage in awards persists in the 1990s, albeit the sample of publics is quite small. Nonetheless, the question of the actual influence of outside interests on agency objectives is an open one, and without further analysis, it could be argued that control did not pass to outsiders; hence insiders’ objectives and incentives were never altered.

Second, there could be a problem at #5, using awards to measure creativity. Creativity is, to a large degree, in the eye of the beholder. Reports in the trade press sometimes mention “riots” at the awards ceremonies, as members of the audience express their disagreement with the judges’ selections, indicating that the definition of creativity is often disputed. Winning an award may indicate creativity to one ad person but not to another. There also may be different types of awards that are more respected – i.e. indicative of more creativity – than others. For example, Clios are awarded in different product categories. Winning an award in the automotive category may simply indicate that an agency is the best of the worst. It may be that public agencies win many of the awards in the categories that “real” creatives disdain in the first place (a proposition that will be tested in the next version of this paper). Awards are also given out by medium (print, radio, television, etc.). It may be that smaller agencies cannot compete effectively in certain higher-cost media, such as television. In this case, the public agencies, which are larger on average, would win a disproportionate share of the awards in the higher-cost media categories.

A look at the distribution of award rates by agency size rank (I use rank rather than absolute size to control for inflation) for the Clio awards and the Kelly awards lends some credence to this idea. The Kelly awards are for print ads only, a medium in which agencies of all sizes compete. The Clio awards began solely for television advertising, branching into print in the early 1970s. Figures 7.1 and 7.2 show that larger agencies tended to have higher
average Clio award shares, but that for the Kellys, the biggest award winners were mid-sized “boutiques.” Large agencies did win awards, some at a high level, but with not the same dominance as in the Clios. However, large agencies were not equivalent to public agencies – and there is no apparent pattern between large publics vs. large privates. So while it may be true that in the award categories most available to agencies of all sizes the large agencies do not win the largest shares, it is not true that public agencies win different kinds of awards than large private agencies. In other words, we cannot explain the large privates’ lack of awards advantage by discounting of the quality of the public agencies’ awards.

The most likely explanation for the awards results, though, is that there is a flaw in the proposed model of incentives for creativity represented in #2 through #4. Regarding #3A and #4A, which link firm-specific human capital investments to creativity, there is a good case to be made that employee efforts toward increased creativity are not firm-specific in the first place. Awards are awarded not only to agencies but also to individuals within the agency, and so awards are often an important individual-level labor market signal to other firms looking to hire talented creatives. Turnover within the advertising industry is legendary (King, Silk and Ketelhohn 2001), suggesting that much of the industry’s human capital is not firm-specific. Thus the expropriation threat might matter little to insider incentives to be creative.

Second, the links in #3B(i-iii) may not hold. Privates may not get a creativity benefit because there may be other private benefits that insiders pursue besides “excessive” creativity. More interestingly, the equation of “creative purity” with status and value is not a necessary or inevitable basis for agency culture. Some agencies may be successful in setting or adjusting insiders’ values to define success and respect along the dimensions of “campaign effectiveness” or “superior client service”, leading to less dichotomy between the private benefits of peer status and client satisfaction and financial returns. For example, Leo Burnett, a large agency that remained private the longest (finally getting acquired in 2002), seemed to have a culture that balanced creativity with the other aspects of creating an effective campaign. The founder long elected not to have the agency’s work entered into awards competitions, believing that “advertising should be judged on its ability to increase sales for clients rather than for a statuette recognizing creative flair” (Bacon 1987), p.
Third, and probably most plausibly, the links in #3B may hold but they may be an incomplete description of all the incentive mechanisms available, and ownership may not affect some of these alternative mechanisms. For one, public agencies may not suffer a creativity deficit because the external labor market incentives for being creative, hence for winning awards, may still induce creative effort. Two, an agency’s reputation may be very long-lived and also be somewhat self-reinforcing. Creative talent may seek to go to an agency known for good creative work and thus perpetuate the firm’s output of good creative work. To the extent that creativity is a function of raw talent, rather than effort, this reputational source of creative output may be longer lived. One agency owner suggested that agency reputations for creativity--both good and bad--get established rather early in the agency’s life and do indeed persist for long period, or as he put it, “Creativity is in an agency’s genes” (personal interview). Thus, despite the ownership changes at, say, Doyle Dane Bernbach, it still retains a reputation, built at its founding in the 1950s, as one of the most creative agencies in the business (lamentations of former employees, as quoted in Section 4.4, notwithstanding).

Lastly, public agencies are sometimes argued to be able to offer higher compensation and greater responsibility than private agencies. However, some of these arguments may confuse size and publichood. It is true that larger agencies typically pay higher salaries (AdvertisingAge 2001) and that they can offer positions that are responsible for bigger clients and more visible campaigns, but then we come back to the same question: why would large public agencies be able to offer higher salaries or greater responsibilities than the large private agencies? The one compensation advantage for publics, even relative to large privates, is stock. While private agencies can certainly offer stock to their employees, publicly-traded stock is typically valued higher than private stock, largely because of its general liquidity (Ritter 1998). Public stock may be even more valuable to agency employees, relative to the traditional stock redemption practices at private agencies. The tradition at private agencies was to redeem employee shares only upon the employee’s departure from the firm and only at a fixed value, typically book value. Book value of an agency, given the intangibility of most of its assets, is generally significantly less than the discounted future cash flow potential of the firm (BusinessWeek 1964; Fortune 1966; Loehwing 1965)
So there are at least two incentive mechanisms that are available to public agencies as well as private agencies in inducing high creativity. First, the non-firm-specific nature of creative effort allows individuals to leverage their efforts into job offers at other agencies, so they have a “natural” incentive to be creative, regardless of the firm’s ownership or objective function. Second, a prior reputation for creativity may attract new creative talent that then maintains the agency’s reputation. In addition, public agencies may have advantages in the level and form of compensation, which might help explain their higher average awards share relative to private agencies.

There is some evidence that agencies become less creative after going public. And industry observers allow that a change to public ownership is often followed by the loss of important clients and important personnel. However, this is likely to be the effect of any major organizational change. A drop in creativity may be particularly unsurprising if going public is ultimately associated with the retirement of the firm’s founders or senior members. Any major leadership transition might lead to similar performance effects. The fact of public ownership per se may not be the particular cause of the decline.

It is also important to note that not all public agencies are particularly creative and not all private agencies are particularly uncreative. Very creative and rather uncreative agencies can be found in both camps. So, in the end, it is most likely that creativity is simply not much of a function of public vs. private ownership, per se, but rather be a function of the specific personalities, structures, and processes inside the agency.

8. CONCLUSION

The decision of whether to go public will likely present itself to increasing numbers of professional service firms. Tradition, theory, and anecdotal “lamentations” all suggest that public ownership may be hazardous to the health of a PSF—or at least that public ownership leads to major strategic change, which may be wrenching to current members of the organization. At the very least, the public PSF may simply be “less fun” than the private one (personal interview).

However, evidence from the advertising industry, where public agencies have competed against private agencies for four decades, shows that public ownership does not have any readily apparent negative effects on an agency’s competitive position. In fact,
publicly owned agencies have come to dominate the industry, at least at the top end. Even more suprisingly, while agencies that went public may have suffered creativity declines, they nonetheless remained more creative, on average, than the average private agency. Creativity does not seem to break along ownership lines.

Theoretically, this implies that ownership is not the only or even the most important incentive mechanism for inducing creative work, and by extension, highly “professional” work in general. The non-firm-specific nature of professional expertise may be one reason. The persistence and self-reinforcing nature of PSF reputations may be another. And the ability to offer higher compensation may be a third reason that public PSFs can continue to compete, despite the expected loss of ownership incentives.

Finally, for still-private PSFs, the advertising agency experience suggests that there is no overriding reason that such firms have to be private. Public ownership certainly does not seem to weaken or kill PSFs in general. Nor does it even force PSFs into a low-reputation, high-standardization type of strategy. Given that, we may well see more PSFs go public, as an IPO can sometimes offer a very attractive way for the firm’s partners to retire and cash out. More ominously, at least for those PSFs that might want to remain private, the financing advantages that public PSFs realize may catalyze or accelerate a consolidation process, with public PSFs making ever more and ever larger acquisitions with their public stock currency. As has happened in the advertising industry, the flotation of just a few leading firms may, in the end, lead to the transformation of the bulk of the industry to public ownership.

It would then be not at all surprising to see, for example, more consulting firms go public in the next bull market, including a paragon of “elite professionalism” such as McKinsey. In fact, it may be that a law firm will soon go public. Currently, state bar associations prohibit law firms from having non-lawyer owners – i.e. outside investors. However, the advertising agency trade association placed the same restrictions on its members through the early 1960s. Once the temptation got too great, the agencies voted to repeal such restrictions. Certainly bar associations wield far greater power over law firms than the agency association did over agencies. But with large law firms engaging in ever larger mergers to create global partnerships, and with partners facing ever greater discrepancies between what they can redeem their shares for internally and what they might realize in an IPO, it seems just a matter of time.
TABLE 6.1 Comparison of Means in Selected Years

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<td>95.7</td>
<td>+***</td>
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<td>Share / ln(Rev)</td>
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<td>+***</td>
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<td>+****</td>
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<td>0.91</td>
<td>+*</td>
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<td>1.63</td>
<td>+**</td>
<td>0.54</td>
<td>0.48</td>
<td>--</td>
<td>0.22</td>
<td>0.77</td>
</tr>
<tr>
<td>n for employ.</td>
<td>33</td>
<td>8</td>
<td>25</td>
<td>7</td>
<td>20</td>
<td>6</td>
<td>0</td>
<td>0</td>
</tr>
</tbody>
</table>

“+” indicates that the public agency mean is greater than the private agency mean; “--” indicates public mean is smaller.

* P<10%; ** P<5%; *** P<1%; **** P<0.1%
### TABLE 6.2 Tobit Regressions of Award Share

<table>
<thead>
<tr>
<th></th>
<th>Tobit 1</th>
<th>Tobit 2</th>
<th>Tobit+FE 4</th>
<th>Tobit+FE 5</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>public</strong></td>
<td>0.953**</td>
<td>1.013***</td>
<td>-1.07**</td>
<td>-0.248</td>
</tr>
<tr>
<td></td>
<td>(0.381)</td>
<td>(0.377)</td>
<td>(0.487)</td>
<td>(0.561)</td>
</tr>
<tr>
<td>total # of awards</td>
<td>-0.009**</td>
<td>-0.011***</td>
<td>-0.009**</td>
<td>-0.006</td>
</tr>
<tr>
<td></td>
<td>(0.004)</td>
<td>(0.004)</td>
<td>(0.004)</td>
<td>(0.004)</td>
</tr>
<tr>
<td>ln(revenue)</td>
<td>2.81****</td>
<td>7.83**</td>
<td>1.98****</td>
<td>17.1****</td>
</tr>
<tr>
<td></td>
<td>(0.167)</td>
<td>(3.45)</td>
<td>(0.404)</td>
<td>(3.25)</td>
</tr>
<tr>
<td>ln(revenue)^2</td>
<td></td>
<td>-0.154</td>
<td></td>
<td>-0.468****</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(0.103)</td>
<td></td>
<td>(0.094)</td>
</tr>
<tr>
<td>3yr grwth(t-1)</td>
<td>2.44</td>
<td>X</td>
<td>2.38</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(1.63)</td>
<td></td>
<td>(1.48)</td>
<td></td>
</tr>
<tr>
<td>year effects</td>
<td>X</td>
<td>X</td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>firm effects</td>
<td></td>
<td></td>
<td>X</td>
<td>X</td>
</tr>
<tr>
<td>robust errors</td>
<td>X</td>
<td>X</td>
<td></td>
<td></td>
</tr>
<tr>
<td>n</td>
<td>1,074</td>
<td>902</td>
<td>1,074</td>
<td>902</td>
</tr>
<tr>
<td>pseudo R^2</td>
<td>0.203</td>
<td>0.207</td>
<td>0.317</td>
<td>0.329</td>
</tr>
</tbody>
</table>

* P<10%; ** P<5%; *** P<1%; **** P<.01%
### TABLE 6.3 Average Change in Performance Before & After IPO

**Average Change in Performance**
*(Later Period Average) - (Previous Period Average)*

<table>
<thead>
<tr>
<th>Column</th>
<th>1</th>
<th>2</th>
<th>3</th>
<th>4</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Periods</strong></td>
<td><strong>5yrs before &amp; after IPO</strong></td>
<td><strong>Pre-IPO 3yr Trend</strong></td>
<td><strong>3yrs before/after</strong></td>
<td><strong>Post-IPO 3yr Trend</strong></td>
</tr>
<tr>
<td><strong>Years Compared</strong></td>
<td><strong>-5 to -1 -&gt; 1 to 5</strong></td>
<td><strong>-6 to -4 -&gt; -3 to -1</strong></td>
<td><strong>-3 to -1 -&gt; 1 to 3</strong></td>
<td><strong>1 to 3 -&gt; 4 to 6</strong></td>
</tr>
<tr>
<td><strong>Awards Share</strong></td>
<td><strong>Mean</strong></td>
<td><strong>0.289</strong></td>
<td><strong>0.738</strong></td>
<td><strong>0.453</strong></td>
</tr>
<tr>
<td></td>
<td><strong>Std. Dev.</strong></td>
<td>1.798</td>
<td>2.783</td>
<td>2.114</td>
</tr>
<tr>
<td></td>
<td><strong>n</strong></td>
<td>18</td>
<td>16</td>
<td>18</td>
</tr>
<tr>
<td><strong>Profit Margin</strong></td>
<td><strong>Mean</strong></td>
<td><strong>0.006</strong></td>
<td><strong>0.007</strong></td>
<td><strong>0.009</strong></td>
</tr>
<tr>
<td></td>
<td><strong>Std. Dev.</strong></td>
<td>0.041</td>
<td>0.043</td>
<td>0.052</td>
</tr>
<tr>
<td></td>
<td><strong>n</strong></td>
<td>6</td>
<td>4</td>
<td>6</td>
</tr>
<tr>
<td><strong>Residual Growth Rate</strong></td>
<td><strong>Mean</strong></td>
<td><strong>-0.079</strong>**</td>
<td><strong>0.017</strong></td>
<td><strong>-0.057</strong></td>
</tr>
<tr>
<td></td>
<td><strong>Std. Dev.</strong></td>
<td>0.105</td>
<td>0.187</td>
<td>0.150</td>
</tr>
<tr>
<td></td>
<td><strong>n</strong></td>
<td>13</td>
<td>13</td>
<td>16</td>
</tr>
</tbody>
</table>

Significance levels: * <10% / ** <5% / *** <1%

---

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### TABLE 6.4 Proportional Hazard Rate Model of Likelihood of IPO

<table>
<thead>
<tr>
<th>DV: IPO?</th>
<th>Cox 1</th>
<th>Cox 2</th>
<th>Cox 3</th>
<th>Cox 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>ln(revenue)</td>
<td>0.890**</td>
<td>1.07**</td>
<td>0.710*</td>
<td>0.762*</td>
</tr>
<tr>
<td></td>
<td>(0.347)</td>
<td>(0.410)</td>
<td>(0.375)</td>
<td>(0.386)</td>
</tr>
<tr>
<td>firm age</td>
<td>0.016</td>
<td>0.014</td>
<td>0.019</td>
<td>0.016</td>
</tr>
<tr>
<td></td>
<td>(0.015)</td>
<td>(0.015)</td>
<td>(0.013)</td>
<td>(0.014)</td>
</tr>
<tr>
<td>3yr Avg Growth</td>
<td>3.79**</td>
<td>3.54***</td>
<td>3.60**</td>
<td></td>
</tr>
<tr>
<td></td>
<td>(1.21)</td>
<td>(1.08)</td>
<td>(1.08)</td>
<td></td>
</tr>
<tr>
<td>AwardsShare</td>
<td>0.132</td>
<td></td>
<td></td>
<td>0.118</td>
</tr>
<tr>
<td></td>
<td>(0.086)</td>
<td></td>
<td></td>
<td>(0.119)</td>
</tr>
<tr>
<td>3yr Avg AwardsShare</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>n</td>
<td>639</td>
<td>629</td>
<td>629</td>
<td>629</td>
</tr>
<tr>
<td>lnL</td>
<td>-28.3</td>
<td>-26.7</td>
<td>-25.8</td>
<td>-25.8</td>
</tr>
</tbody>
</table>

* P<10%; ** P<5%; *** P<1%; **** P<0.1%
### TABLE 7.1 Insider Ownership of Selected Agencies

<table>
<thead>
<tr>
<th>Agency</th>
<th>IPO Year</th>
<th>Post-IPO</th>
<th>1975</th>
<th>1979</th>
<th>1994</th>
</tr>
</thead>
<tbody>
<tr>
<td>BBDO</td>
<td>1973</td>
<td>72%</td>
<td></td>
<td>&gt;40%</td>
<td></td>
</tr>
<tr>
<td>DDB</td>
<td>1964</td>
<td>73%</td>
<td>42%</td>
<td>50%</td>
<td></td>
</tr>
<tr>
<td>Omnicom (Holding Company for BBDO &amp; DDB)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>4%</td>
</tr>
<tr>
<td>FCB</td>
<td>1963</td>
<td>71%</td>
<td>15%</td>
<td>26%</td>
<td></td>
</tr>
<tr>
<td>Grey</td>
<td>1966</td>
<td></td>
<td></td>
<td></td>
<td>&gt;70%</td>
</tr>
<tr>
<td>Interpublic</td>
<td>1971</td>
<td>60%</td>
<td>35%</td>
<td>40%</td>
<td></td>
</tr>
<tr>
<td>Ogilvy</td>
<td>1965</td>
<td></td>
<td></td>
<td>90%</td>
<td>sub</td>
</tr>
<tr>
<td>PKL</td>
<td>1962</td>
<td>80%</td>
<td>dne</td>
<td>dne</td>
<td>dne</td>
</tr>
<tr>
<td>JWT</td>
<td>1969</td>
<td>19%</td>
<td>14%</td>
<td></td>
<td>sub</td>
</tr>
</tbody>
</table>

*dne* = did not exist  
*sub* = subsidiary
FIGURE 7.1 CLIOS: Average Agency Revenue Rank (log) by Average Awards per Year

Clio Share by Average Rank (1100 agencies)
FIGURE 7.2 KELLYS: Average Agency Revenue Rank (log) by Average Awards per Year

Kelly Awards by Average Agency Rank (1100 Agencies)
References


