

THE Ramsey Report

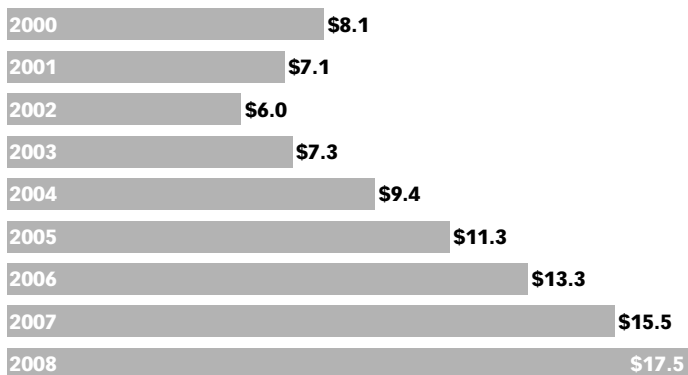


November 8, 2004

eMarketer™ GEOFFREY RAMSEY, CEO

The State of the Online Advertising Industry

US Online Ad Spending, 2000-2008 (in billions)



Note: eMarketer benchmarks its US online ad spending projections against the Interactive Advertising Bureau (Interactive Advertising Bureau (IAB)) - PricewaterhouseCoopers (PwC) data, for which the last quarter measured was Q2 2004. Source: eMarketer, October 2004

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You had to be living in a cave for the past six months to not realize that the Internet is back. The headlines in the media are pretty compelling:

"At Google, Earnings Soar, and Share Price Follows"

New York Times Online, October 22, 2004

"Yahoo's 3Q Profit Quadruples" *Forbes.com, October 13, 2004*

"eBay Says Hooray after 77% Bounce in Quarterly Profit" *USA Today, October 20, 2004*

The mood is "frothy." If you recall the wild and woolly days of the pre-bust Internet frenzy, which was quickly followed by the implosion of all things Internet, you might feel like we're headed down the same dark path. But that's not the case. Unlike before, the fundamentals are there. Internet companies, big and small, have real revenue. Traditional firms that are selling on the Net are making money, too.

A recent Shop.org and Forrester Research study that showed that 79% of online retailers are profitable now, with the average margin at a respectable 21%. I was struck by a quip from LandsEnd.com CFO, Don Hughes, who said, "Customers are driving us to online channel. It's already more profitable than our catalogs."

Online Ad Market Numbers Tell a Good Story

Researchers, investment banks and media gurus are predicting heady growth for the online ad space. Looking to the end of this year,

eMarketer forecasts a 28.8% growth rate over 2003. Estimates from American Technology Research (35%) and Deutsche Bank (33%) are even higher. The majority of estimates fall into the 10% - 20%+ range.

Amazingly, we could all be wrong – on the low side.

The IAB/PwC, which eMarketer uses a benchmark for projections, reports that overall online ad spending shot up 39.7% in the first half of this year. I remember the moment, when at the Interactive Advertising World conference in New York City last September, Greg Stuart of the IAB made the announcement about the nearly 40% growth figure. It was a great way to kick-off the IAW event, which took place during Advertising Week in New York. [CHART 2]

Based on eMarketer's growth rate of 28.8%, we're looking at an annual spending figure of \$9.4 billion. That's over a billion more than was spent in the Internet hey day of 2000 (\$8.1 billion). It's also more than consumers spend every year going to the movie theaters. It's even more than the combined revenues of WPP and Grey Advertising.

The growth train is not stopping anytime soon. In fact, I expect 2005 online ad spending growth to come in at 20.2%, with double-digit rates of 17.7% and 16.5%, respectively for 2006 and 2007.

[CHART 3] [CHART 4]

"I don't think anything has peaked." *Terry Semel, Chief Executive Officer, Yahoo!*

A 2004 research survey conducted by CPRI, among 2,500 marketing professionals in Fortune 500 companies, found that 77% cited the need to hire additional marketing staff over the next year, while 52% said they had specific plans to do so. Millward Brown, in a separate study among marketers, found that fully 60% of them expect to increase their budgets in 2005.

Importantly, in 2004 at least, search will no longer exclusively account for the growth in overall online ad spending. In 2003, search was the sole driver of online ad spending. In other words, if search were removed, online advertising in 2003 would have actually declined by 7%, instead of growing by 21%. But in 2004, while search will grow a respectable 55%, non-search spending, including rich media and display ads, will grow 15%. That's a much healthier situation for the overall industry. [CHART 5]

What's Driving Growth?

Researchers and analysts love to speculate about the future, throwing out predictions about every aspect of the industry, but what's important is to look at the market fundamentals that drive advertisers to spend their dollars online. Seven factors drive interactive advertising today:

- 1) The consumer is in control
- 2) The Internet delivers on the corporate mandate for marketers to be more accountable
- 3) The economy continues to plug along with reasonable growth
- 4) Broadband is changing the consumer Internet landscape
- 5) The crack in the foundation of the \$60 billion television industry is widening
- 6) Search continues to evolve and draw more dollars
- 7) With increasing numbers of Americans shopping and buying online, marketers have greater opportunities to reach consumers who are interested in a given category

The Consumer is in Control

This is a hot concept at conferences and meetings, and yet the shift in power, from the marketer to the consumer, has been occurring for years. It started with the TV remote control. Viewers have been switching channels and avoiding commercials for over three decades.

But the phenomenon was ignored. Now marketers are frantically trying to deal with it. You can almost see them sweat. When you've spent your career pushing messages out to target groups, it is hard to relinquish the reins.

Nearly five million Americans are walking around with Apple iPods, able to control music and related content. Another 64 million signed up for the Do-Not-Call Registry. Then there's the TiVo-factor. For the first time consumers have the media under their thumbs.

Converging Data Points Spell Trouble Ahead

59% of US consumers feel that most advertising has little relevance to them. *Yankelovich, 2004*

60% of online consumers feel banner ads are "always annoying" *Poneman Institute, 2004*

57% of consumers find TV commercials "annoying" *Havas MPG study, 2004*

Internet users are also taking advantage of technologies that cut out ads. Between 30% and 50% of Internet users have spam blockers, and at least 20% have pop-up blockers. Those numbers will grow over the next 12 months. And 24 million US Internet users participate in some form of product reviews, such as on Amazon or eBay. Consumers are making their voices heard.

"Mass marketing today is a mass mistake." *Larry Light, Global Chief Marketing Officer, McDonalds*

"The traditional marketing model we all grew up with is obsolete." *James R. Stengel, Global Marketing Officer, Procter & Gamble*

Message to CMOs: Show Me Some ROI, or You're Fired!

Today, it's all about ARM – Accountability, Measurement & ROI. And the Internet is inherently more measurable as a medium than television, radio, print, outdoor or even direct mail. Marketers can measure, with granular detail, all aspects of their online campaigns.

Meanwhile, never before has there been so much weight placed on advertising accountability. The 94th annual meeting of the ANA held in Naples, Florida, in October was a major wake-up call to marketers. "Change or Die" was the unofficial theme of the show.

"We marketers need to get our collective butts kicked around a bit!" *Robert D. Liodice, President and CEO, Association of National Advertisers (ANA)*

Here's a scary stat: while the average tenure for a CEO is 54 months, it's only 23 months for a chief marketing officer.

Booz Allen Hamilton conducted a study among 370 firms and found that 66% of executives say true ROI analytics is marketing's greatest need. However, most firms are still using surrogate measures, such as advertising and brand awareness. From what we see, corporate CEOs no longer get excited about those soft-measure proxies. They're looking for harder numbers. In a study by the CMO Council, conducted among 1,000 marketing executives, 80% of respondents said they were "dissatisfied" with their ability to measure ROI. Finally, in a joint ANA/Forrester survey, 70% of marketers said that even gaining agreement within their company for the definition of ROI is "somewhat" or "very difficult."

"It's not about measurement for the sake of measurement...Many marketers measure a lot – too much, in fact." *Bill Glazier, Partner, Redwood Ventures*

There's a cost to this lack of measurement, too. According to the ARE, which recently conducted the largest post-buy analysis of all time, \$50 billion of US ad spending is "wasted" every year. That figure equates to nearly 19% of total media spending of \$266 billion. They attributed the \$30 billion in waste going to the wrong message, and the remaining \$20 billion to wrong timing.

"These are the biggest ways of pissing money away." *Taddy Hall, Chief Strategy Officer, ARF*

Online advertising can solve some measurement problems. Online advertisers are sitting on a boatload of data that puts all other media to shame. Need to measure the results of a branding campaign? Hire Dynamic Logic. Need to figure out how much online is contributing to sales in your media mix? Do an XMOS study with Rex of Marketing Evolution. Want to know how well your e-mail campaign fared? Use your e-mail provider to look at open rates and conversions. eMarketer writes entire reports on measuring online advertising effectiveness. Frankly, we couldn't do the same for television, radio or print (unless they were very short reports).

The Economy: A Rising Tide Lifts All Boats

The economy will continue to grow next year, and that's going to have buoyant effect on overall media spending, including online.

Certainly there are mixed signals in the economic data, but 2005 should be a decent, but not great, year for economic growth. Economy.com expects GDP in America will grow a respectable 4.4% in 2004, followed by a 3.3% growth rate in 2005. At least it's better than the 0.3% growth we had in recessionary 2001.

[CHART 6]

"If all goes according to script, then growth will come in near the economy's potential of 3.5%" *Mark Zandi, Chief Executive Officer, Economy.com*

In the IT world, IDC is predicting 5% growth in worldwide technology spending next year, up from -1.0% in 2004. That's not up to the level of double-digit rates we enjoyed in 1999 and 2000, but it's heading in the right direction.

Other metrics deserve attention, too. Economy.com estimates that total employment will accelerate in 2005 to 1.8%. That's sluggish, but still better than the 1.1% growth rate pegged for 2004.

Three separate but converging studies among SMEs indicate that spending will be up next year. That's important because small businesses create the majority of jobs in America. **[CHART 7]**

On a recent visit with the Conference Board, I learned that consumer confidence remains mixed, though it dropped 3.9 percentage points to a seven-month low in October.

Broadband is Changing the Landscape

Next year is a seminal moment in US broadband history. By year-end 2005, broadband will be in over one-third (35.3%) of all US households. In addition, within the universe of online households, broadband will beat dial-up by a 53% to 47% share. With a total of 40 million households on broadband next year, marketers can finally exploit the interactive advantages of the Internet while employing the sight, sound and motion elements associated with television.

With broadband entering 40 million households this year, you can bet that spending by marketers on rich media campaigns will finally take off. **[CHART 8]**

Building from a small base of only \$301 million in 2002, rich media ad spending expanded by a record 94.3% in 2003. We won't see another increase like that in 2004, but spending on rich media will grow by more than 25% annually through 2008. **[CHART 9]**

Broadband changes everything – for Internet users at least. Broadband users spend more time online, go online more frequently, spend more money and shop online more than their dial-up counterparts.

According to Arbitron, broadband users spend 57% more hours online per week than dial-up users. comScore puts that premium usage factor at 40%, Forrester at 52%, UCLA at 57% and In-Stat/MDR at 67%. Broadband users represent an extremely attractive target to advertisers given their usage habits and propensity to spend money online. **[CHART 10]**

Of course, the US still has a long way to go before it catches up with leading broadband countries like South Korea, or even Canada, where household broadband penetration as of 2003 was 70.5% and 36.2%, respectively.

The \$60 Billion TV Industry: On the Brink of Shrinkage

Although there wasn't much press fanfare about it, during the 2004/2005 television upfront season, broadcast TV decreased by 1.4%. American Express spent 80% of its total media budget in television in 1994, but the company spent only 35% of its dollars in that medium in 2003. TiVo launched a \$15 million media campaign this year, and not one dime was placed in television. Presumably, TiVo figures no one would see their ads if they ran them on television.

"A 30-second television spot isn't always the answer." *Barbara Ford, VP Global Advertising, Kraft Foods*

"Every indication is that corporate advertising budgets are increasingly allocated to the Internet." *David Garrity, Financial Analyst, Caris & Company*

Building awareness has been television's strength as an ad medium for decades. And yet its hegemony is dissolving. While the networks continue to jack up CPM prices, and advertisers have traditionally forked over the dollars, the ratings for television continue to decline. The "mass" in the most massive of all media is becoming more fragmented. Consumers have hundreds of channels to choose from, and they're increasingly picking cable over networks (targeting works). What's more, 27% of viewers say they regularly go online while watching television, so viewing is diffused.

Consumers with TiVos, or other DVRs, use them to skip ads. Every survey I've seen puts the ad-skipping factor at well over 70%, and many claim that 90% of DVR users skip all or most ads.

DVRs are in only 5.3% of all US households today. But the will be in over one-fifth of them (22%) in three years. **[CHART 11]**

In absolute numbers, there will be 25.3 million US households with ad-zappers by 2007. If you think that forecast is too rosy, Forrester's number for the same year is 25.7 million, and Yankee Group's is 24.7 million. Deutsche Bank predicts 24 million by 2006.

That has to be a game-changer for heavy-TV marketers. According to SG Cowen, by 2007, DVRs will have wiped out \$6.6 billion worth of television ad sales. By my calculations, the figure will be \$8.0 billion. Ouch.

Search Will Continue to Expand in Every Way

No matter how you slice it, search is taking off. It's growing because it works – it's measurable and efficient. Paid search capitalizes on many of the trends I cover in this newsletter; the consumer in control, the advertiser's need to justify ad spending with ROI and the growing use of the Internet as a shopping and buying channel.

The consumer perspective is equally compelling. Search answers their needs because it delivers relevant information exactly when they need it.

There are 121 million searchers in America, and they conduct an average of 35 searches per month.

Online advertising today is dominated by paid search. Spending on paid search will surpass \$3.9 billion in 2004—and leap to more than \$6.7 billion by 2008. [CHART 12]

As the paid search market matures, however, three-figure growth rates will evaporate to 54.6% growth in 2004, and by 2008, 11.5% growth. [CHART 13]

Search will continue to evolve. For example, behavioral targeting, or BT, expands the 1:1 model of search by capturing interested prospects that may or may not choose to use a search engine. As cited in the eMarketer white paper, “What Comes Before Search,” spending on behavioral targeting will rise nearly 50%, from \$627 million in 2004 to \$934 million in 2005. By that point, BT will comprise 8.3% of the total US online ad market.

Dozens of new products and solutions exploit searchers’ needs for local search information. Kelsey Group estimates local online advertising will increase from \$1.0 billion in 2003 to \$2.5 billion by 2008.

The only problem I see with the search market – beyond the continually rising cost-per-click – is that it’s getting too complicated. With every new bell-and-whistle technology, with every new “must do” technique and fresh iteration of search algorithms, marketers must upgrade their skill sets, or fall behind the pack. JupiterResearch found that 50% of large marketers and 34% of smaller ones claimed to have difficulties managing their keyword buys. In response, 48% of large marketers and 23% of small firms had to resort to hiring search engine marketing “experts” to manage their campaigns. Search has created its own cozy consultant community.

Americans Lead the World in Online Shopping and Buying

If you’re an online marketer, but not currently selling anything online, you might think that you shouldn’t care about e-commerce activity in its many forms and fashions. But you’re wrong, and here’s why:

- A person buying online signals a greater involvement with the Internet, and that person is a good candidate for online marketing pitches
- People who buy online, by definition, have money to spend, and therefore represent good marketing targets
- If you reach an online buyer with a relevant message at the appropriate time, you stand a good chance of selling to that person – whether they purchase online or offline
- Online buyers usually shop before they buy, and online shoppers are also great candidates for relevant marketing messages

The e-commerce gravy train is chugging along. Even eMarketer, and we’re usually conservative, is predicting a 28% increase in online holiday shopping this year. In the fourth quarter, consumers will spend \$22 billion over the Internet. Throw in travel and \$121 billion

will be spent online in 2004. That’s a little less than half of Wal-Mart’s global revenues of \$256 billion, but not chump change.

Between 2001 and 2004, online retail sales grew at a steep 27% annual rate. Growth from 2004 to 2007 won’t be as brisk, but will still be a strong 19%. Growth rates for total retail sales were up by only 5.2% from 2002.

Today, 95 million Americans buy online, [CHART 14] and 115 million use the Internet to “shop and browse” products. A study by Dieringer Research Group, found that online shopping is a significant driver of offline spending. Consumers who researched and compared products online drove \$180.7 billion in offline spending, compared to \$106.5 billion in direct online spending. In other words, for every retail dollar spent online, \$1.70 was spent offline. [CHART 15] ☺

Upcoming Appearances

Interactive to the Max: The 2004 Canadian Tour

November 2-3, 2004 (Toronto Nov 2, Montreal Nov 3)

Keynote: The State of Online Advertising in Canada

AD:TECH November 8, 2004, New York, NY

The State of Online Advertising

About Geoff Ramsey

CEO and co-founder Geoff Ramsey has appeared as a commentator on radio and television programs across the country and is a regular keynote speaker at events including AD:TECH, IAB’s Interactive Advertising World, The Conference Board, The Advertising Research Foundation, American Marketing Association, Association of National Advertisers and the Direct Marketing Association, as well as corporate events sponsored by IBM, American Express, the US State Department and The Economist. Recent press mentions include The Wall Street Journal, Forbes, Fortune, Business Week, CNN, Business 2.0 and Advertising Age.

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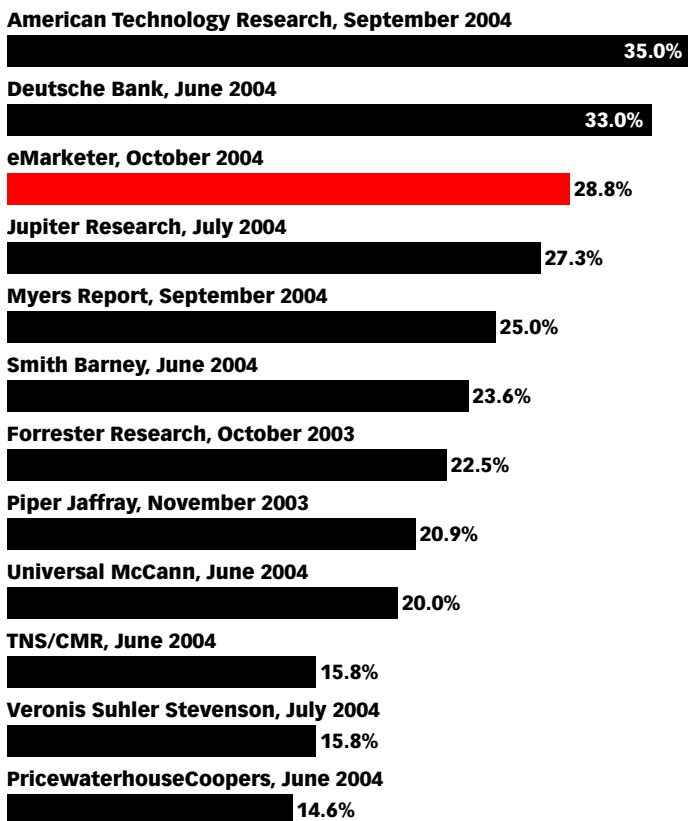
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CHART 2

Comparative Estimates: US Online Ad Spending Growth, 2004 (as a % increase vs. prior year)



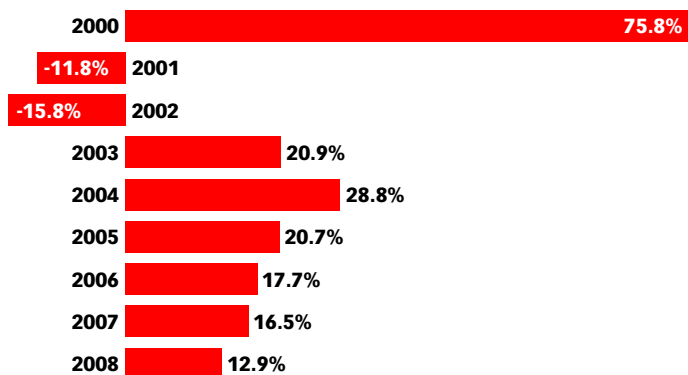
Note: eMarketer benchmarks its US online ad spending projections against the Interactive Advertising Bureau (IAB)/PricewaterhouseCoopers (PwC) data, for which the last full year measured was 2003
Source: eMarketer, October 2004; various, as noted, 2003 & 2004

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CHART 3

US Online Ad Spending Growth, 2000-2008 (as a % increase/decrease vs. prior year)



Note: eMarketer benchmarks its US online ad spending projections against the Interactive Advertising Bureau (Interactive Advertising Bureau (IAB)) - PricewaterhouseCoopers (PwC) data, for which the last quarter measured was Q2 2004. Source: eMarketer, October 2004

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CHART 4

Comparative Estimates: US Online Ad Spending Growth, 2005 (as a % increase vs. prior year)



Note: eMarketer benchmarks its US online ad spending projections against the Interactive Advertising Bureau (IAB)/PricewaterhouseCoopers (PwC) data, for which the last full year measured was 2003
Source: eMarketer, October 2004; various, as noted, 2003 & 2004

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CHART 5

Growth in Paid Search vs. Non-Search Online Advertising Spending, 2004 (in billions and as a % increase vs. prior year)

	Online ad spending	% growth
Search spending	\$3.93	55%
Non-search spending	\$5.43	15%
Total	\$9.36	29%

Source: various, as noted; eMarketer, October 2004

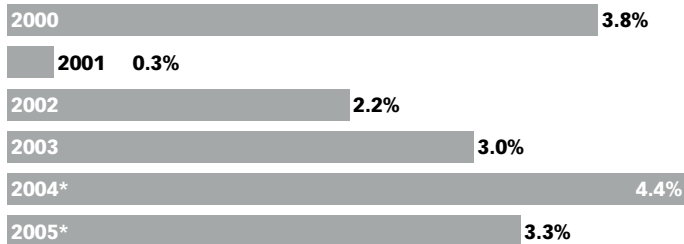
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THE Ramsey Report *By the Numbers*

CHART 6

Growth in Gross Domestic Product (GDP) in the US, 2000-2005



Note: *forecast

Source: US Department of Commerce Bureau of Economic Analysis (BEA), October 2004

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CHART 7

Economic Optimism Ratings for the Year 2005 among SMEs in the US

MasterCard (survey among 1,145 small business owners and financial decision-makers)	33% expect a "substantially" better year
American Express (survey among 773 small business owners and managers)	30% expect the economy to grow and that their business would expand along with it
CIT Group (survey among 448 small businesses)	28% "strongly agreed" with the statement that they were confident about the economy

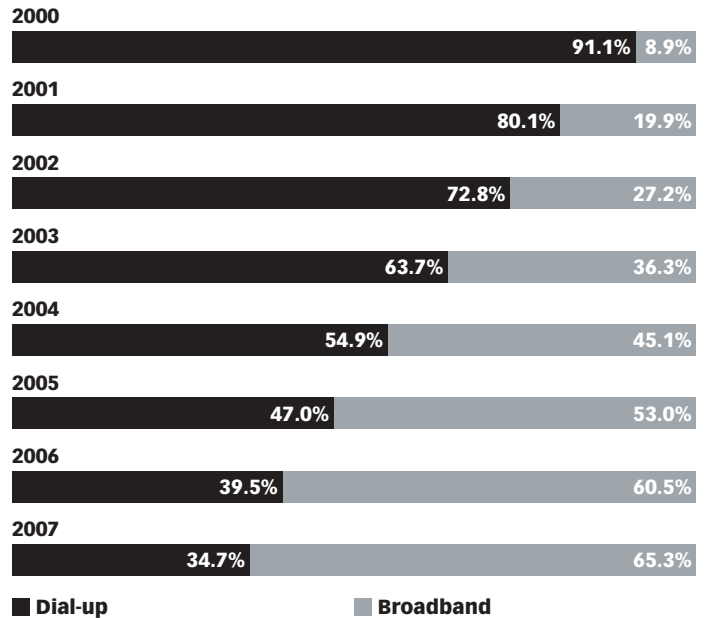
Source: New York Times, October 2004; various, as noted, October 2004

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CHART 8

Broadband and Dial-Up Households in the US, 2000-2007 (as a % of online households)



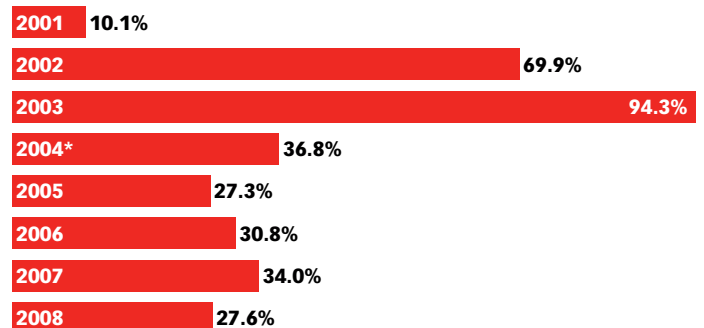
Source: eMarketer, March 2004

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CHART 9

US Rich Media Ad Spending Growth, 2001-2008 (as a % increase vs. prior year)



Note: eMarketer benchmarks its US online ad spending projections against the Interactive Advertising Bureau (Interactive Advertising Bureau (IAB)) - PricewaterhouseCoopers (PwC) data, for which the last quarter measured was Q2 2004; *as of 2004, interstitial ads included in rich media

Source: eMarketer, October 2004

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CHART 10

Percent of US Online Households Shopping on the Internet in the Past 60 Days, by Access Technology, Summer 2003



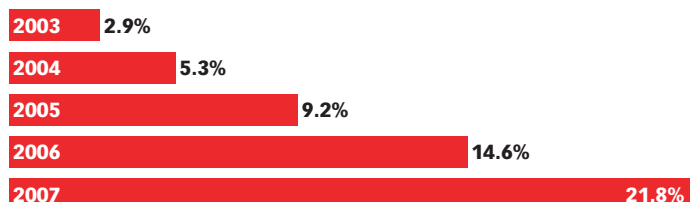
Source: Knowledge Networks/Statistical Research, January 2004

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CHART 11

DVR Households in the US, 2003-2007 (as a % of total households)



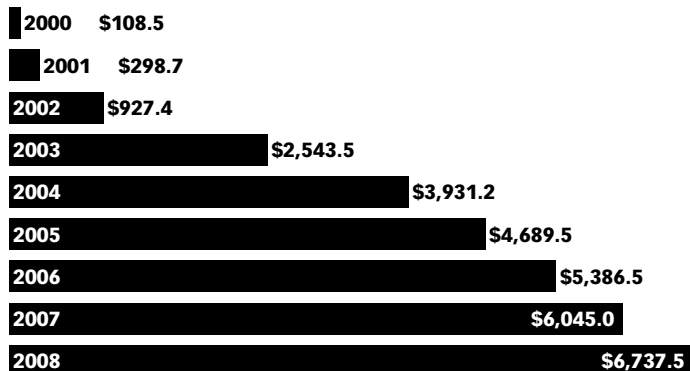
Source: eMarketer, August 2004

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CHART 12

US Paid Search Ad Spending, 2000-2008 (in millions)



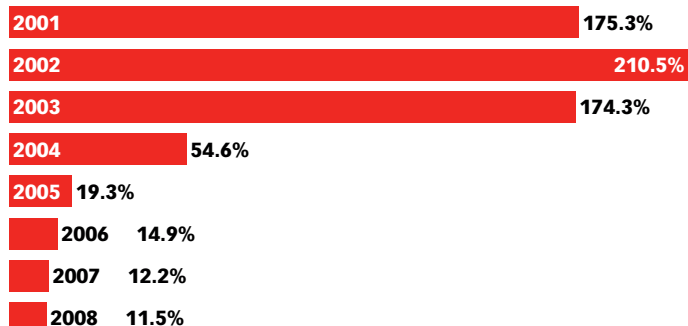
Note: eMarketer benchmarks its US online ad spending projections against the Interactive Advertising Bureau (IAB)/PricewaterhouseCoopers (PwC) data, for which the last full year measured was 2003
Source: eMarketer, October 2004

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CHART 13

US Paid Search Ad Spending Growth, 2001-2008 (as a % increase vs. prior year)



Note: eMarketer benchmarks its US online ad spending projections against the Interactive Advertising Bureau (IAB)/PricewaterhouseCoopers (PwC) data, for which the last full year measured was 2003
Source: eMarketer, October 2004

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CHART 14

US Consumer Online Buying Breakdown, 2001-2007

	Buyers ages 14+ (in millions)	Average annual retail purchase per online buyer*	Online retail sales* (in millions)
2001	65.3	\$524.43	\$34,263
2002	77.2	\$573.75	\$44,287
2003	85.7	\$653.17	\$55,996
2004	94.9	\$748.23	\$71,006
2005	102.2	\$860.03	\$87,934
2006	108.9	\$954.74	\$103,977
2007	115.0	\$1,053.21	\$121,077

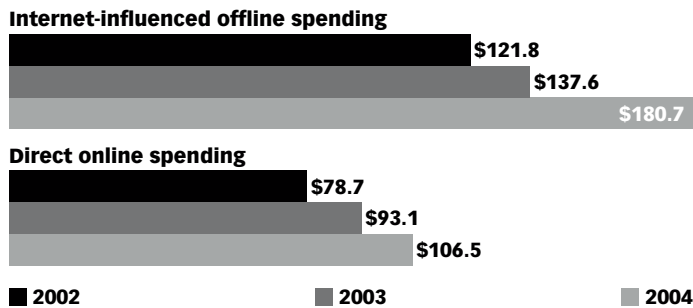
Note: *excludes online travel
Source: eMarketer, October 2004

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CHART 15

Internet-Influenced Offline Spending and Direct Online Spending among US Consumers, 2002-2004 (in billions)



Note: based on consumer self-reports of their spending in the 12 months prior to the survey

Source: The Dieringer Research Group, October 2004

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