LEAFLET

Markup Recommendation

Our format for offers (SCoPE) is designed in a way that the markup, i.e. the margin that is applied by the advertising film producer, is no longer shown individually. Nevertheless, the markup is of course still of absolute relevance for the calculation of productions for advertising film producers. This fact sheet is intended to provide basic information as well as a recommendation from the Association on the amount of the markup. Furthermore, despite the new offer format that does not show the markup individually, many customers and agencies are currently (and unfortunately) still asking for the disclosure of the markup, although the association of course hopes that such requests will soon be a thing of the past as soon as the new order format has established itself as an industry standard.

The Association assumes that a production company must achieve an average markup of 20% in the calculation of production commissions to operate within a reasonably viable commercial framework.

<u>As a rule:</u>

A constant markup that is added to the production costs as a lump sum has become established practice for commissioned TV productions since the 1950s. In a similar way, a standard lump-sum markup of 20% on the production costs has now become common practice in the production of advertising films as well. This calculation method is considered usual and reasonable in the meaning of Section 632(2) German Civil Code [BGB].

The offer prices quoted by the producers include calculated third-party expenditure on crew, actors' fees, location rental, technical costs, directors' fees, and such like. The market participants are competing to procure these production resources. We advise our members not to deviate from international practice in regard to the markup of 20%, unless there are exceptional circumstances (see below).

The background for this is as follows:

<u>Purpose of the markup:</u>

The bidding competition for the tendering of commissioned productions is organized in such a way that the advertising film producer prepares a **<u>lump-sum offer</u>** for all complex production processes. In this process, the producer will request and calculate third-party services as close as possible to market conditions in order to receive the order. Third-party services – which for the producer are transitory items – account for the bulk of the budget. It is common for additional lump-sum reductions and corrections to be implemented during the process of contracting as a result of negotiations with the clients, agencies or the purchasing departments.

The 20% markup on the transitory items covers the following services provided by the producer:

- Participation in the tender procedure/calculation/preparation of the offer; included also is the retention of qualified staff in order to be able to participate in the tender in the first place;
- Ordinary business operations unrelated to the project (office management, general permanent staff, finances);
- Contribution margin to mitigate the risk of budget overrun; and
- Management and return on the equity investment.

While technical progress over recent years has led to a drop in third-party expenditures for the average advertising film project, the office costs and tender costs have risen, as savings potential cannot be leveraged within operations or human resources, for instance through automation. Cost optimization cannot be implemented in the calculation or completion of individual projects for advertising films. Studies conducted by the Association (producer study) indicate that merely 4% of revenue now remains from the markup as entrepreneurial profit (so 10% of the markup). Companies that for structural reasons tend to have lower revenues (so not comparable with the economies of scale run by large retail chains) are unable to absorb a further erosion of these figures, and they must therefore be taken as a threshold that cannot be undercut.

Given the purpose of a markup as outlined above, calling the usual markup rates into question would be inconsistent, as – in an environment of price competition – the producers' contribution margins are linked to the third-party expenditures for the production. Were they to be adjusted in favor of the clients in response to the price competition, the markup's capacity to cover the costs would be lowered commensurately. A client that then calls into question the calculation of cost contribution margins is acting unreasonably from a business perspective, if one assumes that an average company profit of 2% cannot be negotiated downward in any meaningful way.

Exceptions:

It is naturally at the discretion of the producer to apply unusually low rates that defy the principles of sound business judgement. Nobody is forbidden from jumping off a cliff, although clients would be wise to consider whether they want to entrust their projects to companies that are willing to do so.

But it is conceivable nonetheless that a company may consciously embark on a loss-making project in order to notch up a favorable reference. Undercutting the competition in this way can make sense to a certain extent, although no business will ever survive adopting the principle as a long-term strategy. Dumping policies to secure market shares will always be ruinous in the creative industries, where there is neither a standardized product (e.g. crude steel) nor financially endowed market players who are able to invest their own equity to occupy the market over a longer period (and then naturally recoup their equity due to the market position they acquire in the process).

Nevertheless, departing from these principles is justified in exceptional cases, for instance to secure an unusually large budget for a production that would only require the expenses associated with projects of a more standard size. Where this applies, it makes sound business sense to agree a rebate on the items mentioned above. In many cases the promise or continuation of long-term business relationships will also lead to concessions, as the cost of acquisition (and other things) is less in these cases.

We therefore advise all members to base their assertion of a necessary 20% margin on these arguments in case of requests to disclose the markup.

Dr. Martin Feyock
Legal Counsel

Stand 2021