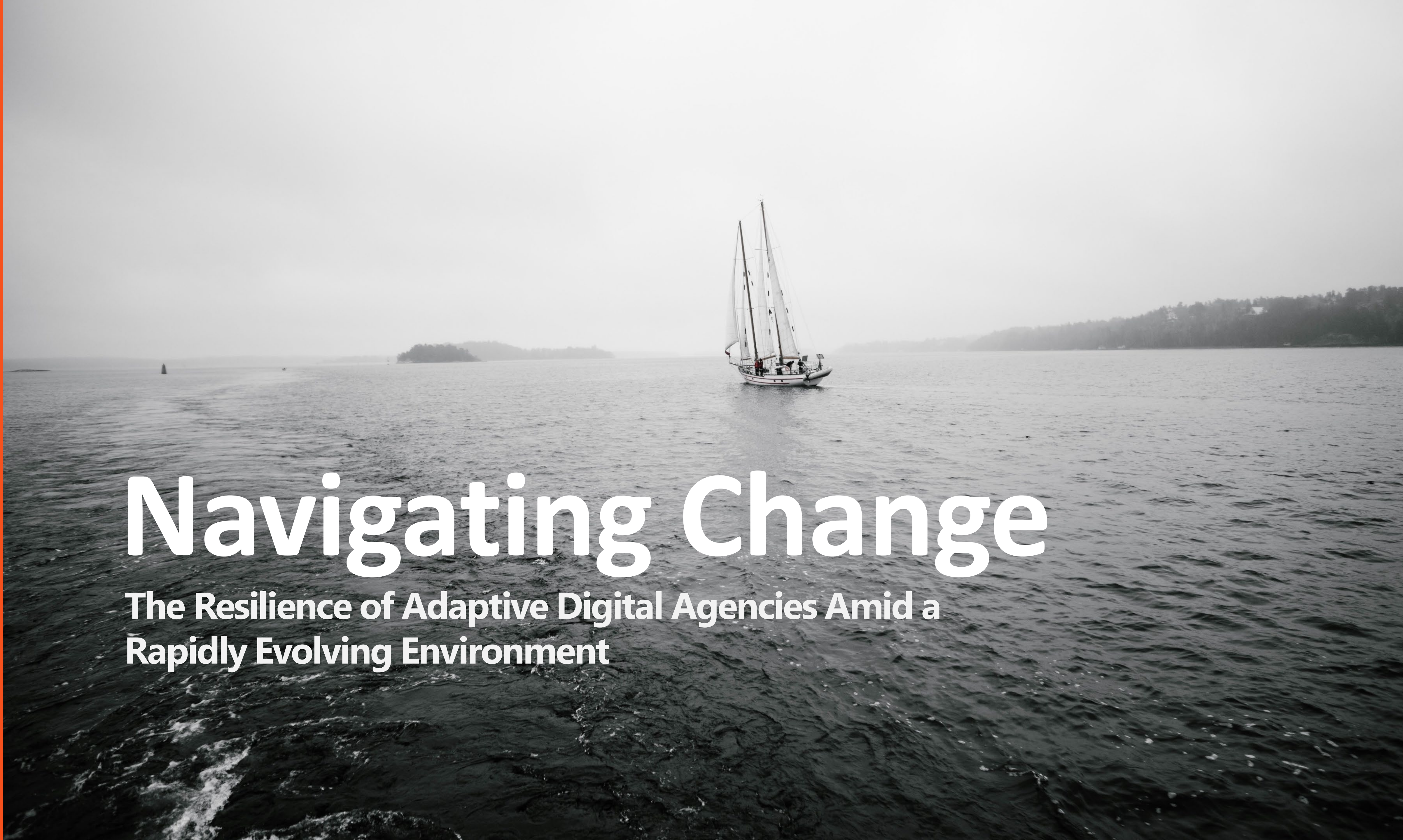

Navigating Change

The Resilience of Adaptive Digital Agencies Amid a Rapidly Evolving Environment

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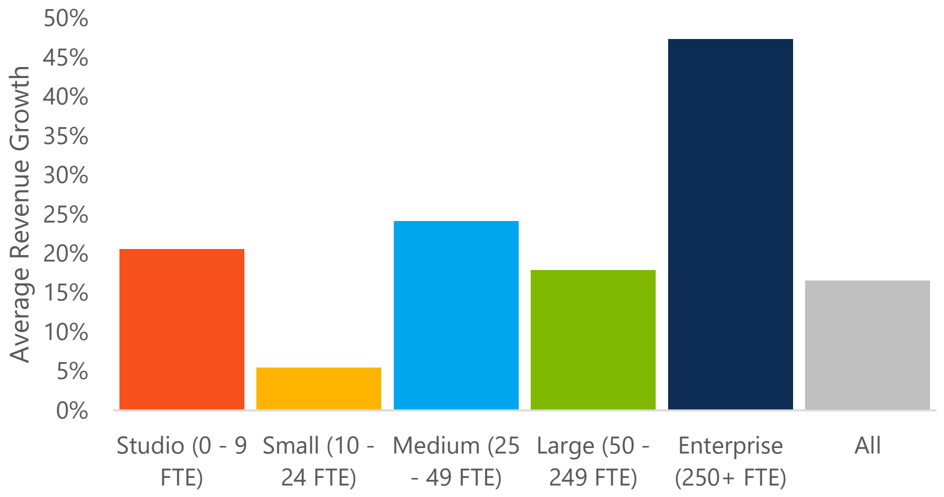
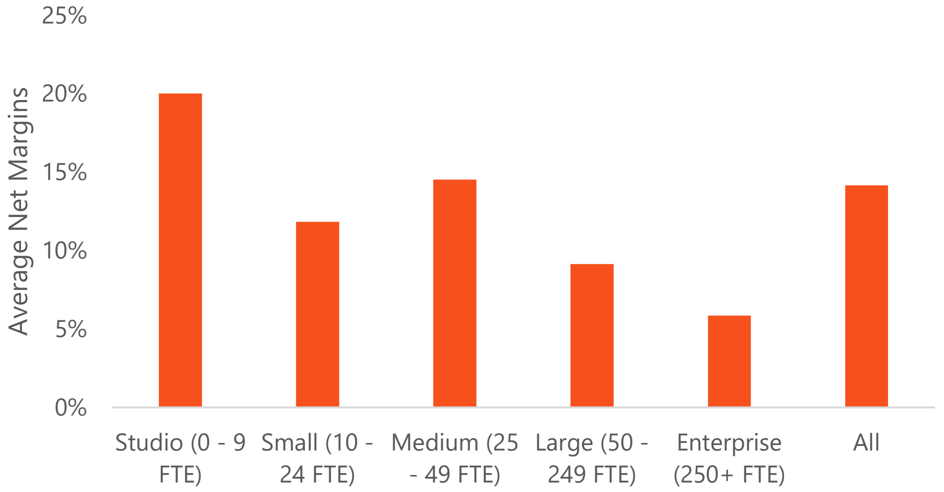
Introduction

Report Summary

Digital agencies' average revenue grew by 17% in 2022, a slower rate than the 25% seen in 2021, but still above historical trends. This was partly driven by the continued pull-forward in digital transformation spending from the pandemic. While Small agencies only saw a 5% increase, Enterprise agencies reported high growth. A careful selection of services led to better growth rates, with the most successful agencies refocusing their service mix rather than simply expanding it. There was a substantial increase in agencies identifying as specialists in their services or industries, leading to higher growth rates. Raising prices also became more common, with higher hourly rates seen in 2022. Agencies that used value-based pricing saw slightly above-average growth rates and higher profitability. In 2022, agencies reported an average net margin of 14%, a decrease from 2021. Efficiency dipped slightly, with revenue per full-time employee falling. Employee turnover remained a concern, with high turnover rates slowing growth and reducing efficiency. Anticipation of AI's impact varied but was generally slightly positive, and early adoption of AI tools correlated with higher growth rates, net margins, and utilization rates. Remote work remained stable, and firms utilizing offshore or nearshore talent saw higher growth rates and margins. The few agencies that began testing a 4-day workweek reported faster growth and higher earnings.





The Bureau of Digital

Founded in 2012, the Bureau of Digital brings together leaders from all corners of digital, to connect, share and learn together. With professionals from agencies, in-house teams, product shops and many of the world's largest brands, the Bureau of Digital is a diverse, peer-based community and support network. Providing insights, events and resources, the Bureau helps teams and organizations to evolve and grow, while collaborating within the Bureau community to help shape the future of digital.

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Bureau of Digital

Insights, Events & Resources for Digital Leaders

About The Author

Nicholas Petroski is the founder of Promethean Research.

Since 2015, he has helped over 100 digital agency owners better understand their industry and chart more effective paths to success.

Prior to cofounding Promethean, Nick worked as an equity analyst at a Wall Street firm where he covered the enterprise software and semiconductor industries.

When he's not in the office, you can find him backpacking around the Midwest or making elaborate firewood in his woodshop.

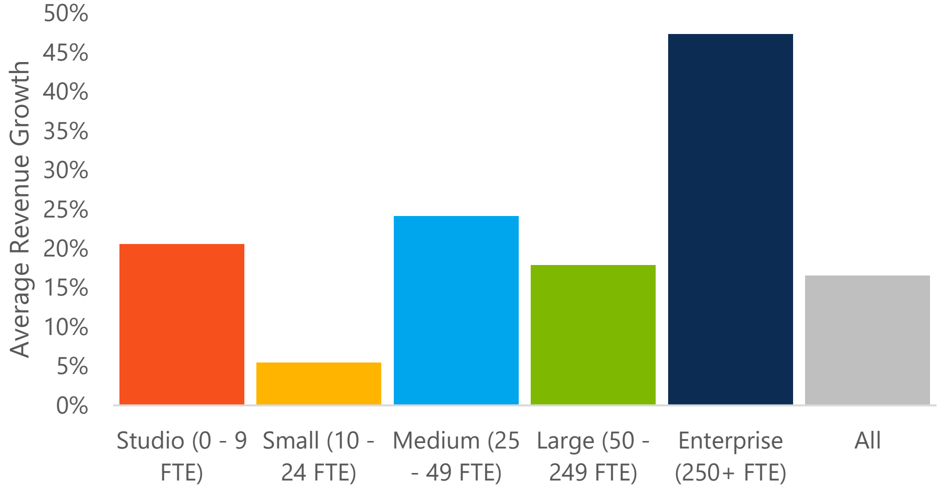
2022 In Review

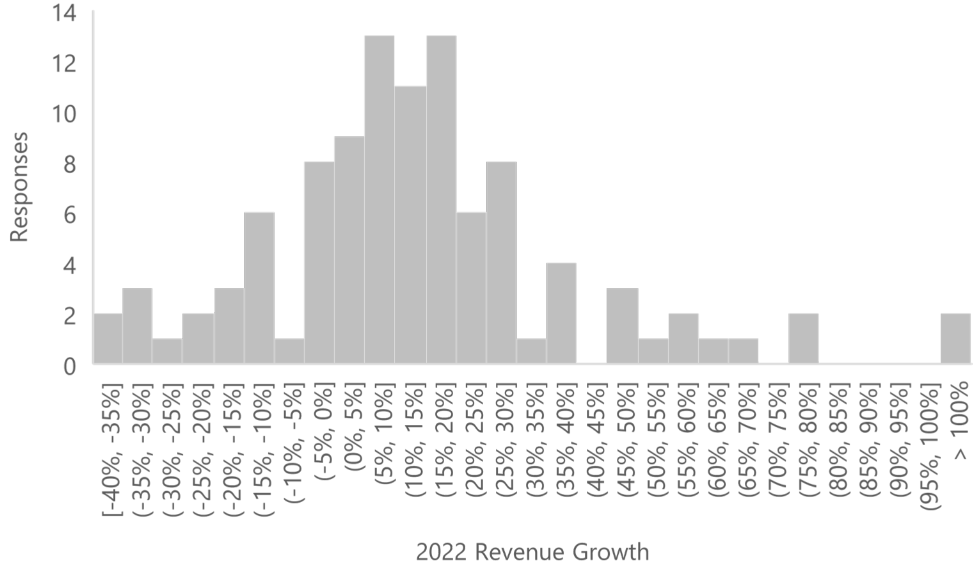
2022 In Review: Growth

In 2022, the average revenue of digital agencies increased by 17% compared to the previous year. Although this rate was slower than the 25% year-over-year growth witnessed in 2021, it still outpaced historical trends. The uptick in digital transformation spending, which propelled revenue growth to record levels in 2021, seemed to persist in 2022, although its impact varied across agencies of different sizes.

The slower growth in 2022 resulted in a flatter distribution of growth rates that shifted towards lower percentages. Notably, there were fewer rapidly growing agencies (with growth exceeding 34%) in 2022 than in 2021 (18 compared to 33), and there was an increase in the number of agencies with negative growth rates (26 in 2022 versus 17 in 2021).

Small agencies found the year challenging, recording a modest 5% growth. Conversely, the few Enterprise agencies that participated in our survey reported extraordinarily high growth rates. Studio, Medium, and Large shops all reported robust revenue growth for the year.



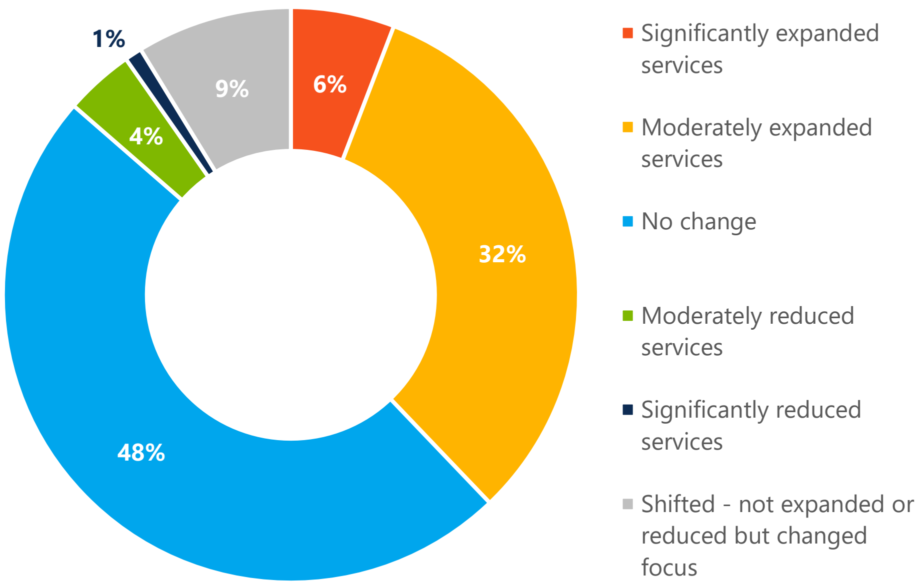


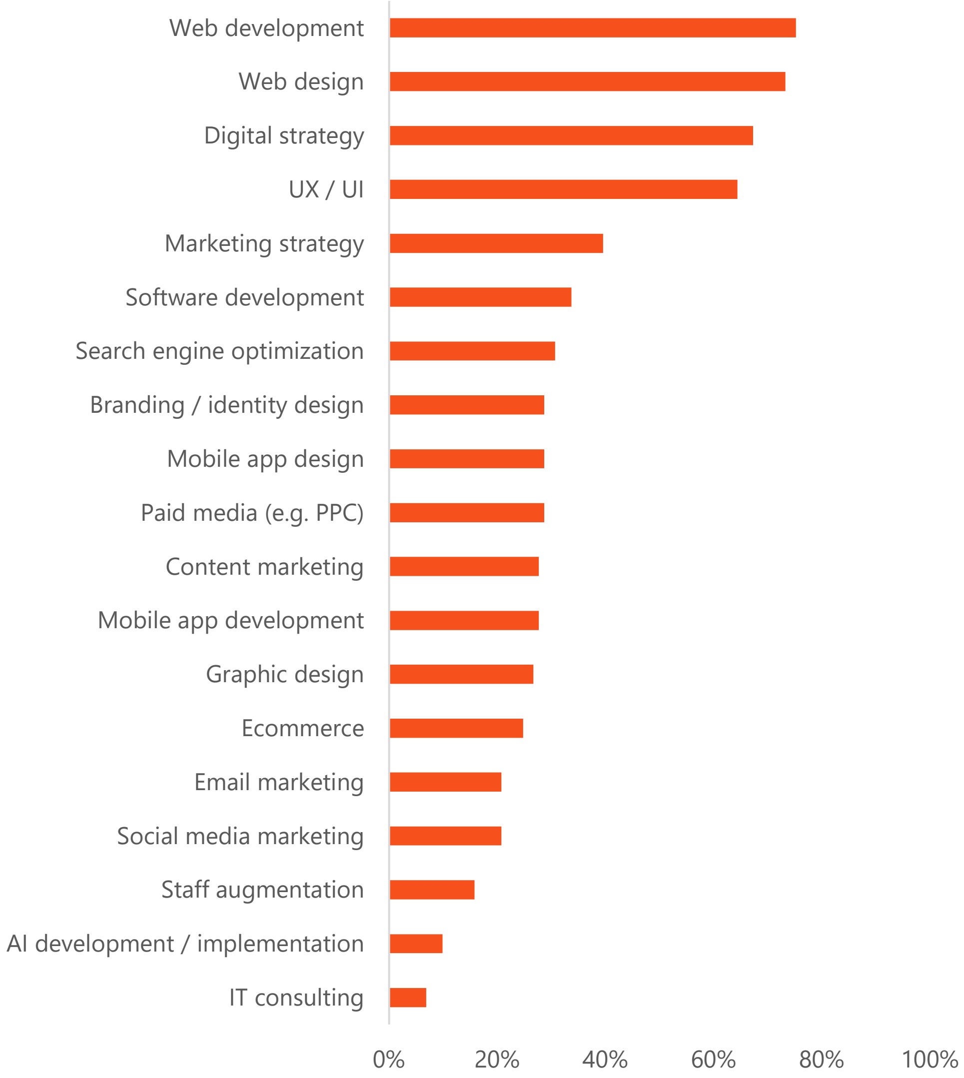
2022 In Review: Service Mix

On average, each agency offered 6.6 distinct services, a figure that has seen an incremental rise from 5.7 in 2021 and 5.3 in 2020.

Last year, 38% of digital agencies included in our survey broadened their service mix. This led to an average growth rate that was 41% higher than agencies that maintained their existing service mix and it was triple the growth rate of agencies that reduced their offerings.

However, agencies that shifted their service mix (didn't expand or contract but changed focus) experienced even more substantial growth. They grew 56% faster than those that expanded their services. In addition, these adaptive agencies were able to increase their hourly rates four times more than average.





2022 In Review: Specialization

In a remarkable jump from previous years, 86% of agencies identified as specialists based on either their service offerings or industry focus, a substantial increase from the traditional 50:50 split.

At this point, the majority of agencies (84%) identify as having a specialized service mix, whereas only 41% categorize themselves as having an industry-specific focus. A mere 2% of agencies fall into the unusual category of providing general services to specific industries.

Growth came significantly easier for those that offered specialized services to specific industries. Those that tailored both their service mix and industry focus saw average revenue growth of 20% in 2022. These agencies grew 29% faster than those without an industry focus and twice as quickly as pure generalist shops.

The industries most commonly targeted for specialization were Finance & Professional Services (16%), Technology & Software (14%), and Education (12%).

Representation

	Vertical Specialist	Vertical Generalist
Service Specialist	39%	46%
Service Generalist	2%	14%

Revenue Growth Rates

	Industry Specialist	Industry Generalist
Service Specialist	20%	16%
Service Generalist	9%	10%

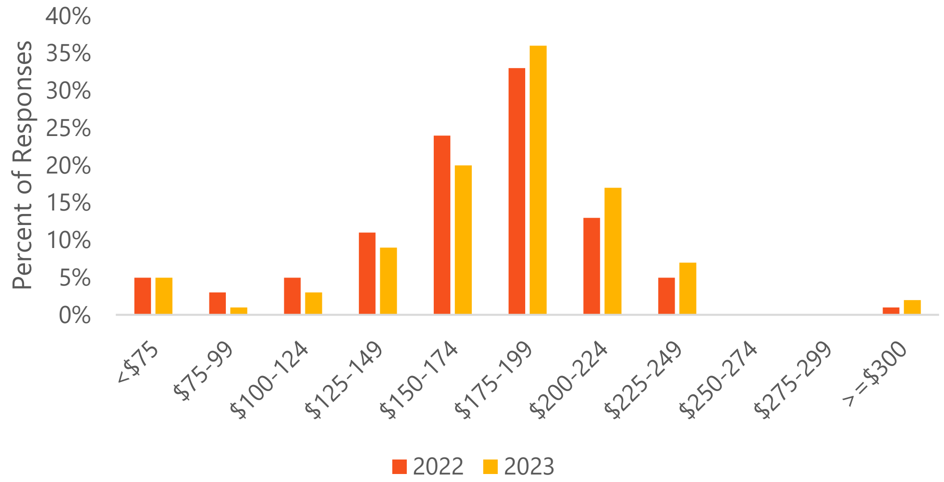
2022 In Review: Pricing & Methods

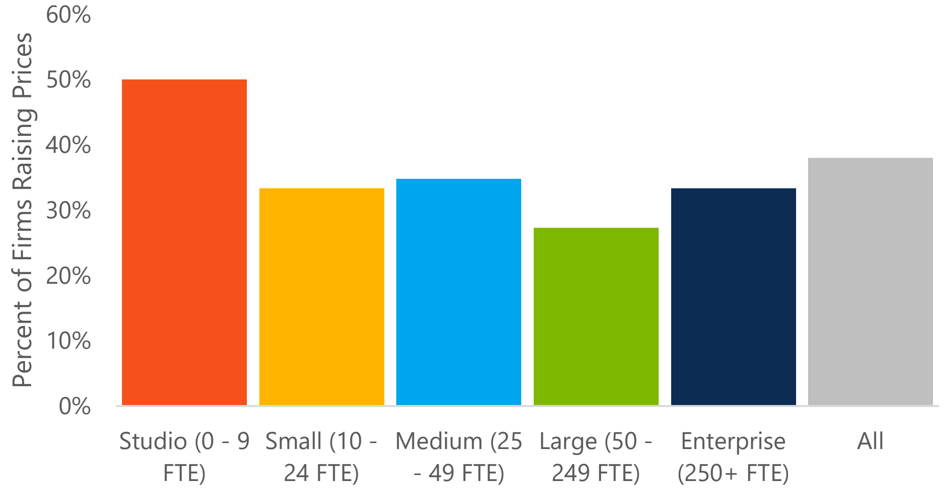
In our survey, 38% of the agencies reported raising their prices in 2022. The most frequent hourly rate in 2021 fell within the $150-174/hr range. However, by the start of 2022, the rate had shifted to the $175-199/hr range. The average rates climbed even higher by the beginning of 2023, primarily driven by Studio agencies catching up a bit, half of which raised their prices last year, compared to only 28% in 2021.

When asked to indicate all the pricing strategies their agency uses, respondents reported an average of 2.6 different methods. Seventy-five percent of firms used Time & Materials and Retainer models, while 65% used Fixed Bid pricing, and only 37% used Value-based pricing.

Agencies utilizing Time & Materials, Fixed Bid, and Retainer pricing models exhibited slightly below-average growth rates and profitability. However, those using Value-based pricing saw a slightly higher-than-average growth rate of 19% year-over-year, and they were more profitable, with an average net income of 18% in 2022. Performance-based pricing, used by only 5% of agencies, led to notably faster growth at 22% and higher profitability with average margins of 17%.

Since 2018, the average growth rate for agencies using Value-based pricing has fluctuated considerably. This pricing strategy tends to correspond with faster-than-average growth during market upswings, but it tends to underperform during turbulent times. Agencies using Time & Materials and Retainer pricing models generally exhibit more stable growth rates.

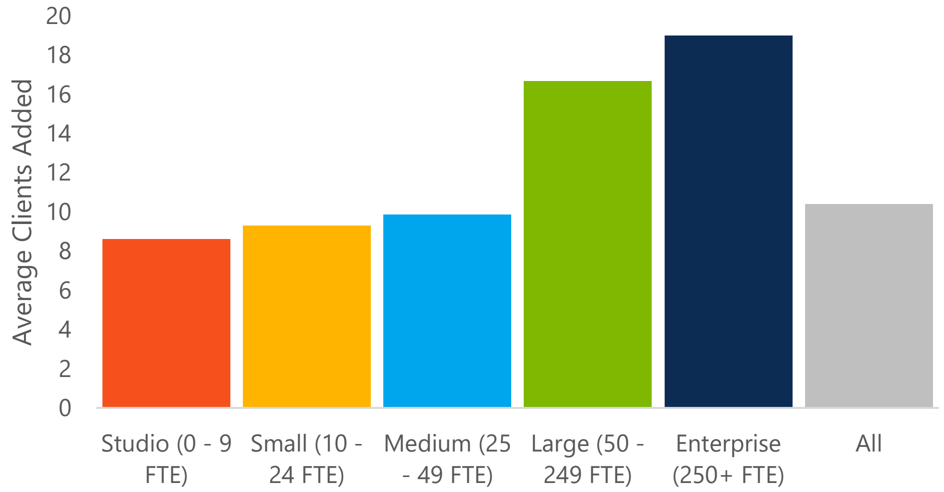


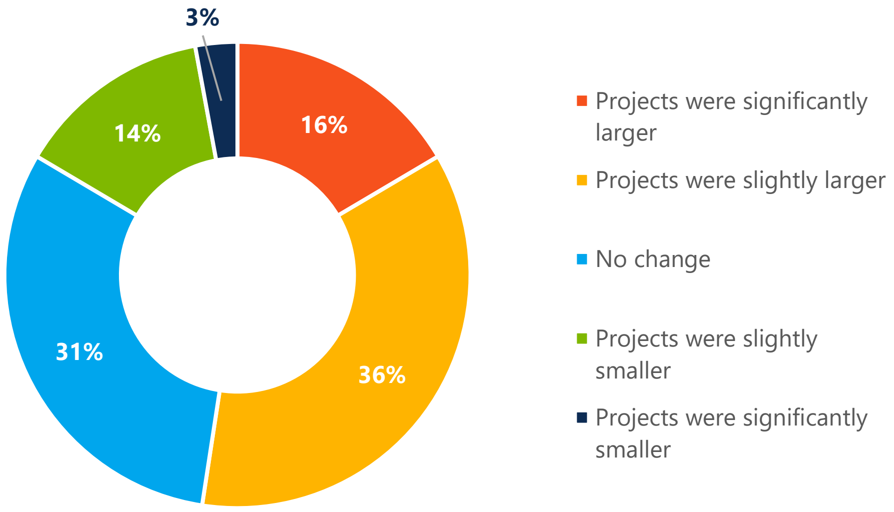


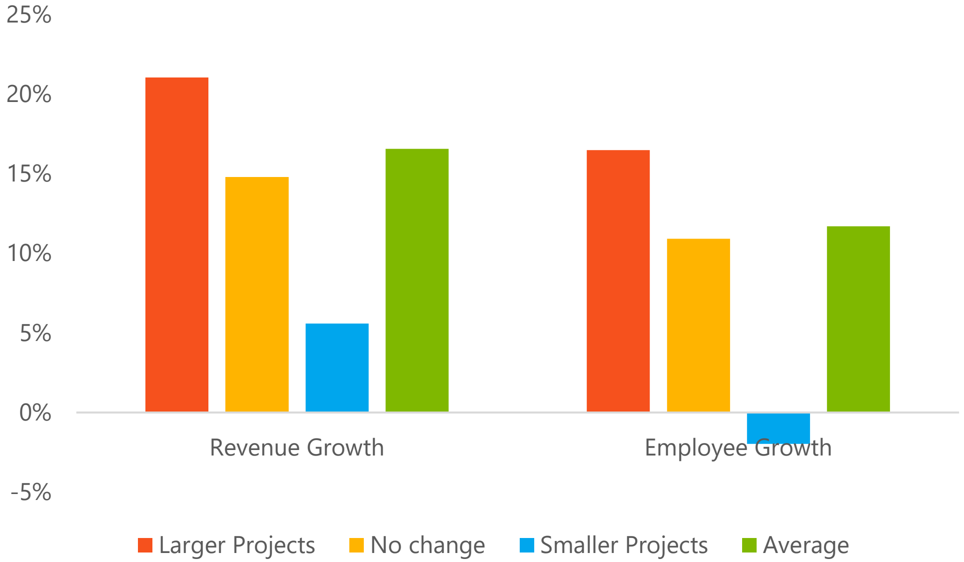
2022 In Review: Clients & Projects

On average, agencies acquired slightly less than one new client per month in 2022, marking a slight decrease compared to 2021. Agencies with a rapid growth rate, defined as over 34% revenue growth (2x the average), attracted an average of 13 new clients in 2022.

Consistent with previous years, a positive correlation was observed between changes in project scope and revenue growth. Agencies with expanding project scopes experienced a 21% growth rate in 2022, whereas those with shrinking project scopes saw a much lower growth rate of 6%.





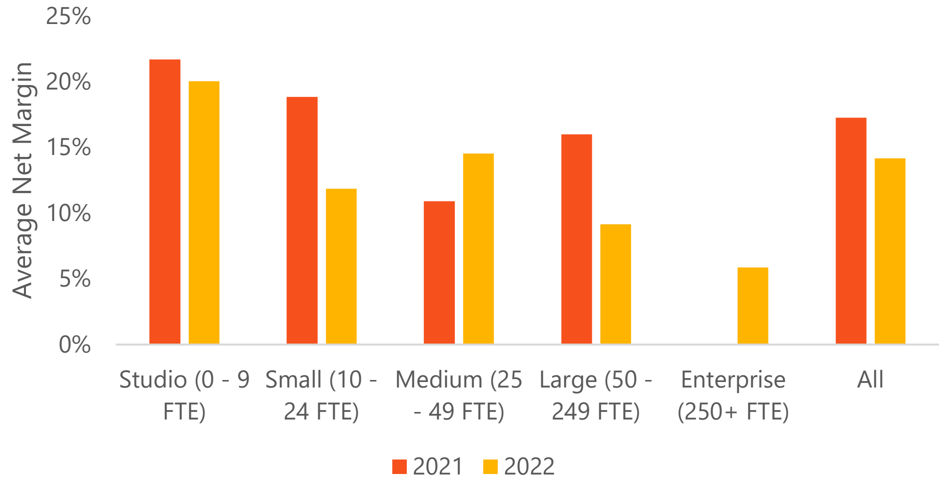


2022 In Review: Profitability

In 2022, the average digital agency in our survey reported a net profit margin of 14%, a decrease from the 17% observed in 2021.

Though industry specialization had a minimal impact on profit margins, with industry generalists slightly outperforming specialists, agencies with specialized service offerings reported considerably higher margins.

Interestingly, while an increase in project scope was associated with faster revenue growth, it tended to put pressure on profit margins. Agencies with expanding project sizes had an average net income of 11%, slightly below the average of 13%. Those with decreasing project sizes fared even worse, earning an average net margin of just 9%. However, agencies with stable project sizes outperformed others, boasting significantly higher average margins of 18%.



Net Margins

	Industry Specialist	Industry Generalist
Service Specialist	14%	15%
Service Generalist	7%	11%

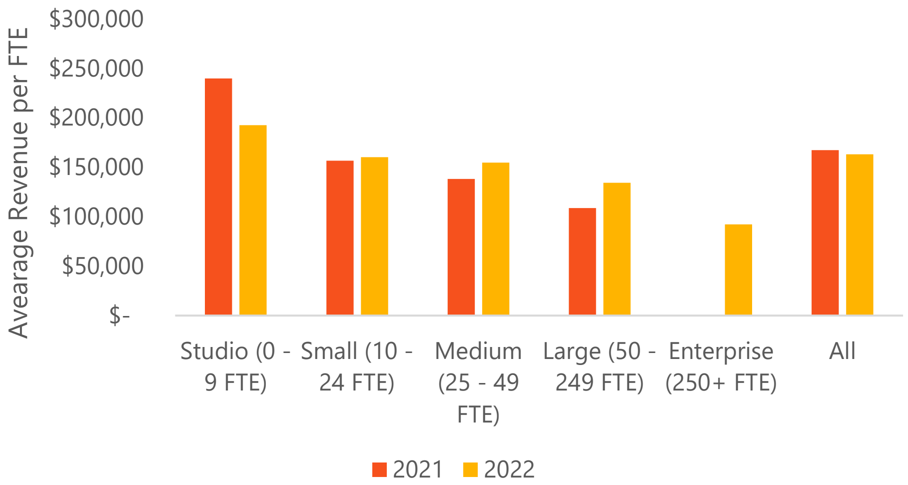
2022 In Review: Efficiency & Utilization

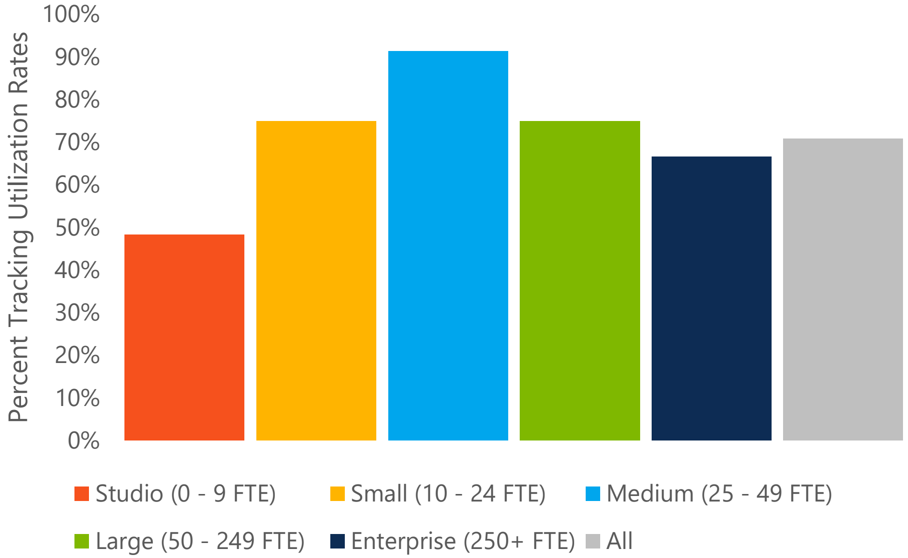
In last year's 2022 Outlook Report, we reported that agency owners were forecasting a 30% increase in revenue for the year. However, agencies actually saw revenue growth of about half that. Many agencies staffed up to meet the perceived demand, and they were unable to react quickly enough when it didn't materialize. We believe this is the major cause of the efficiency challenges the industry faced in 2022.

Digital agencies experienced a slight dip in efficiency last year. Revenue per full-time-employee (Rev/FTE) averaged $163k, a decrease from $167k per employee in 2021. The primary factor contributing to this change was the significant decline among studio-sized agencies, even as other size cohorts increased their Rev/FTE. Interestingly, while studio-sized agencies raised their prices the most last year, they also expanded their workforce by an average of 24%, thus offsetting any potential efficiency gains.

Over the years, we've seen increasing levels of sophistication within the industry. Now, 71% of agencies in our survey track their utilization rates. There's a concern that tracking utilization rates—and thus time tracking—could negatively impact morale and frustrate employees. However, our data showed that voluntary employee turnover was less than 5% higher among agencies that track utilization rates compared to those that don't, suggesting that such concerns may be overstated.

The average production utilization rate among agencies in our survey was 68%. This figure is well below the 80-90% target that most firms aim for, which resulted in significant pressure on profit margins in 2022.





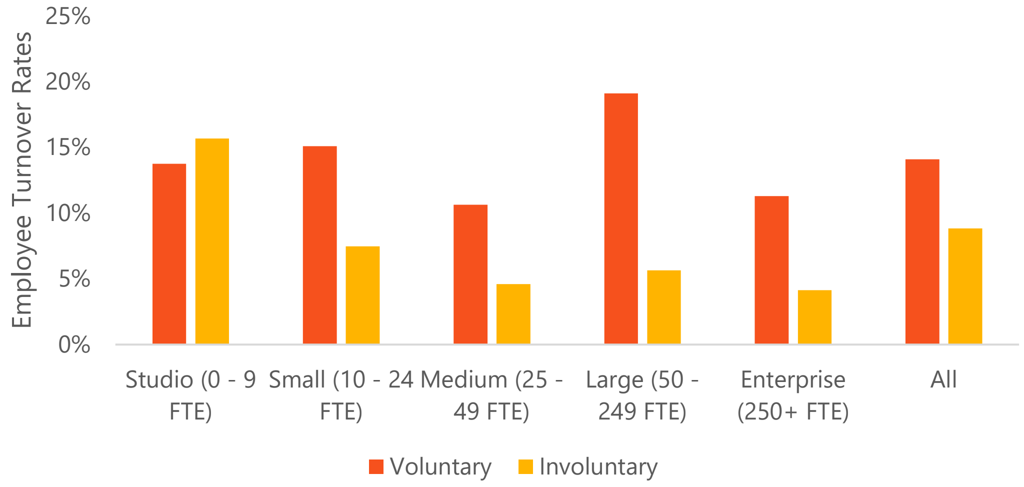
2022 In Review: Team

In 2022, the average rate of voluntary employee turnover was 14%. Meanwhile, involuntary turnover, encompassing layoffs, terminations, and other forms of dismissal, averaged 9%. This resulted in a combined average turnover rate of 23%.

Such high turnover rates cause enormous strain on digital agencies. This is illustrated by the inverse relationship between turnover rates and growth rates. Agencies with a combined turnover rate below 10% saw growth rates that were 68% faster than the average, whereas those with turnover rates above 50% grew at a pace 118% slower than the average.

Increased turnover also had a negative impact on production efficiency, as evidenced by falling utilization rates in line with rising turnover.

Despite agency owners starting 2022 with a pessimistic view of hiring and retention, this survey's results suggest that these issues have at least stabilized.



Go Beyond the Industry Average

Grow sustainably and earn higher margins with an Agency Assessment from Promethean Research.

Identify risks, ensure alignment, and evaluate implementation with a comprehensive review of your shop's strategy and structure. We designed our Agency Assessment for leaders who want to de-risk their strategy and increase the effectiveness of their entire team.

More info on our Agency Assessments

"Working with Promethean was the most impactful decision we've made in the ten years since I started RocketBike."

Max Greenhood

Founder & CEO, RocketBike

Promethean Research

Trends Shaping 2023 and Beyond

Key Trends: Artificial Intelligence Impact

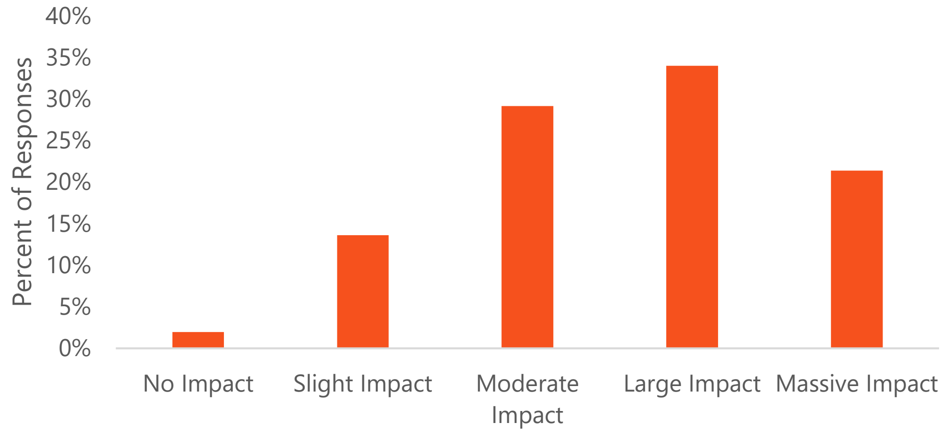
Since early 2022, Artificial Intelligence (AI) has become an incredibly hot topic. While owners generally predict AI will have a modest and somewhat positive impact, opinions differ significantly. Sixteen percent foresee slight to no impact, 29% anticipate a moderate impact, and 55% are preparing for a large to massive impact.

As detailed in our post, "Artificial Intelligence is Disrupting Digital Agencies," there is a clear potential for AI to enhance operational efficiency at digital shops. A majority of agency owners tend to agree with this perspective. Only 8% predict AI will have a negative impact, 38% foresee a neutral effect, and 54% anticipate a positive impact.

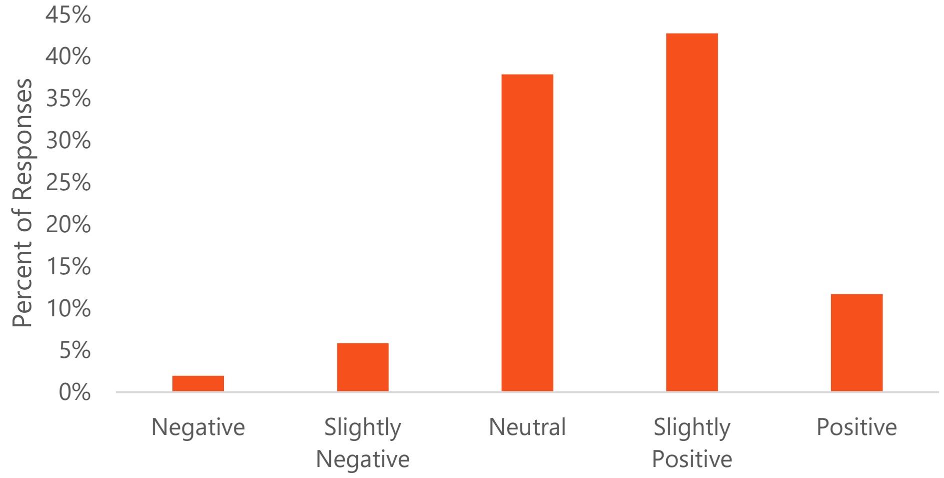
Agency owners who predict larger impacts from AI typically report lower involuntary employee turnover, higher Rev/FTE, faster revenue growth, higher profit margins, and they charge higher hourly rates.

Those anticipating positive impacts from AI generally experience lower involuntary employee turnover, faster revenue growth, higher margins, and improved utilization rates.

These insights suggest that those who are expecting significant positive transformations from AI are running agencies that are operating at more advanced levels.



“How big of an impact will AI have on your agency in 2-3 years?”



“Will the net impact of AI be more positive or negative for your agency?”

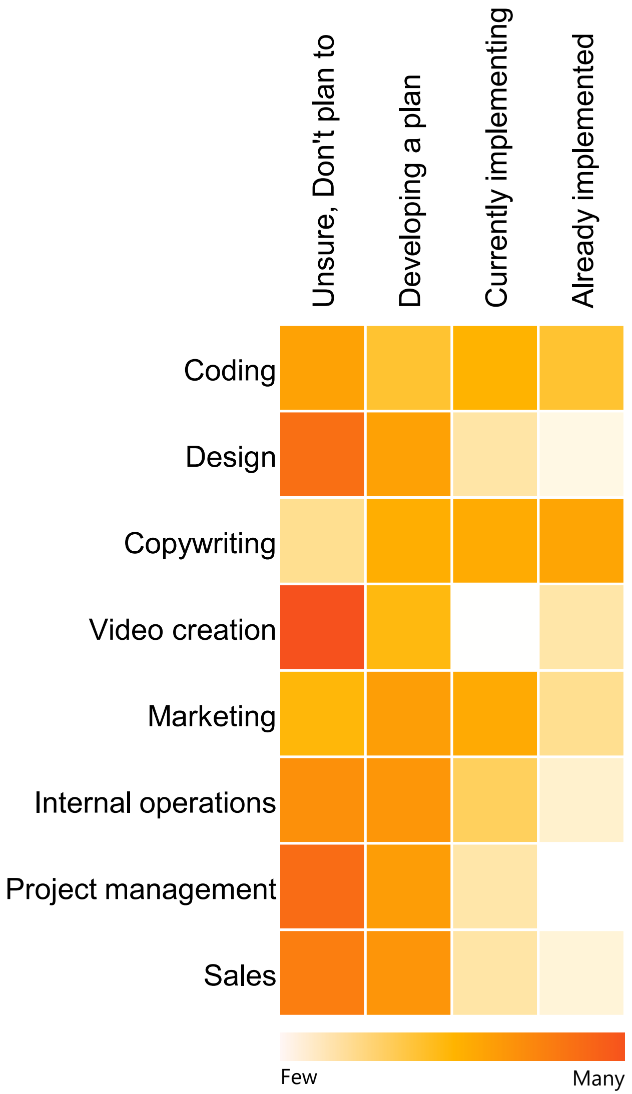
Key Trends: Artificial Intelligence Implementation

Our 2023 Tools Survey revealed that most agencies had already started using some form of AI in their operations by the start of the year. This State of Digital Services survey allowed us to delve deeper into how agencies had integrated AI tools within their various services and operations. This heatmap displays the percentage of responses we received for each stage of AI tool implementation for different agency functions. The darker the square's color, the more agencies reported being at that particular stage of implementation for a given function.

These results reflect the developmental stages of the AI tools themselves. The earliest mainstream AI tools to emerge were for copywriting, and this is the area where agencies have advanced the most in implementation. Coding is another domain where agencies have made significant progress, thanks to mainstream AI tools that have been available since late 2021.

On the other hand, AI tools for video creation, design, project management, and sales have yet to see significant implementation across agencies. While video creation and design tools aren't necessarily as capable as the copywriting tools are, sales AI tools are moderately mature, and we would have expected to see them better integrated into agencies at this point.

Agencies that have progressed further in their AI implementation grew twice as fast, earned 70% higher net margins, and reported higher utilization rates compared to those in the early stages of their AI implementation journey.



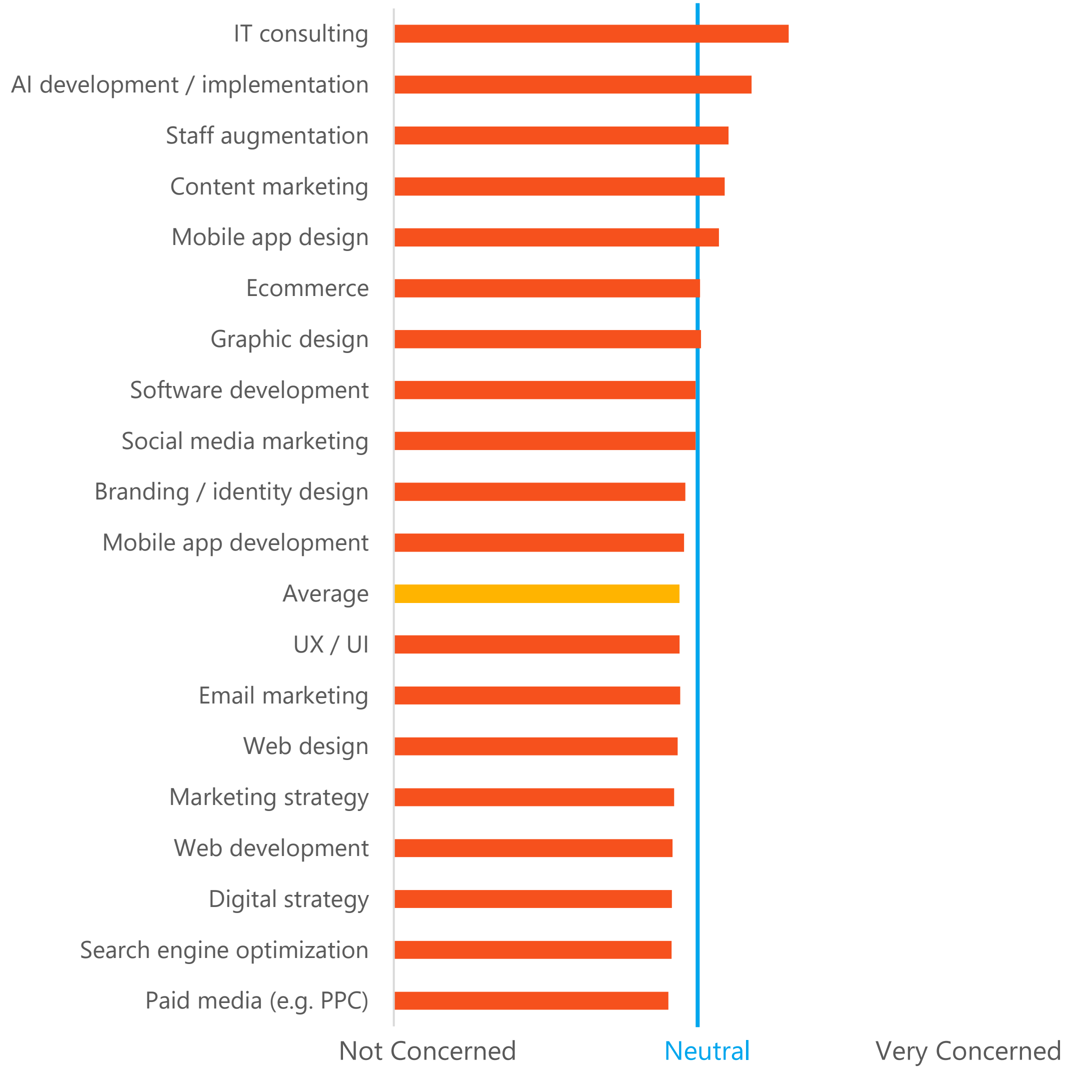
Key Trends: Biggest Challenges

Revenue generation is top of mind for owners in 2023 with Sales, Lead generation, and Account retention / growth making up 3 of the top 5 concerns. Profit margin concerns are shared by 38% of owners and employee compensation has faded but remains an issue for 16% of owners.

Key Trends: In-housing

Most owners weren't that concerned about clients potentially moving their services in-house. Even the most concerned ones offering IT consulting and AI dev. / implementation were only slightly above the neutral point.

Those that were more concerned grew much more slowly, had much higher turnover rates, lower utilization rates, gained fewer clients, and charged lower hourly rates. This leads us to believe that anxiety around in-housing is likely due to internal business conditions just as much as it is any kind of industry shift for specific service mixes.

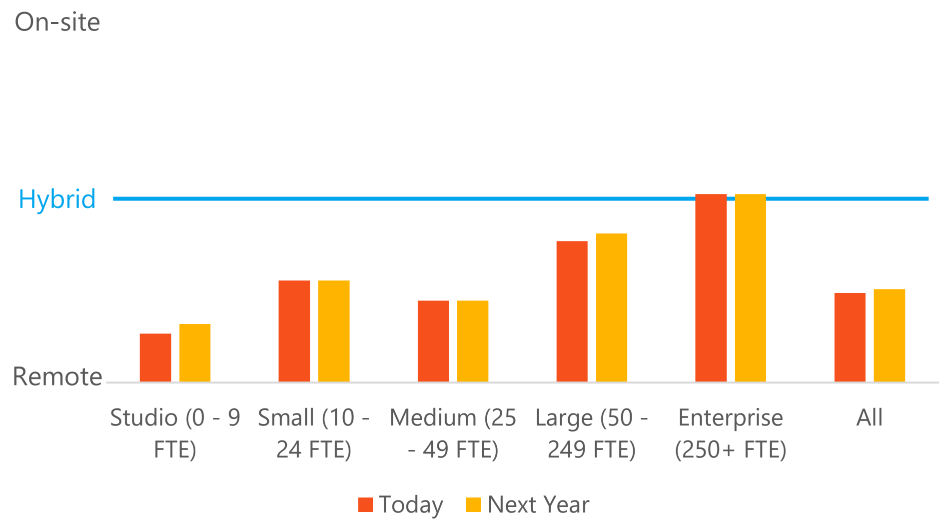


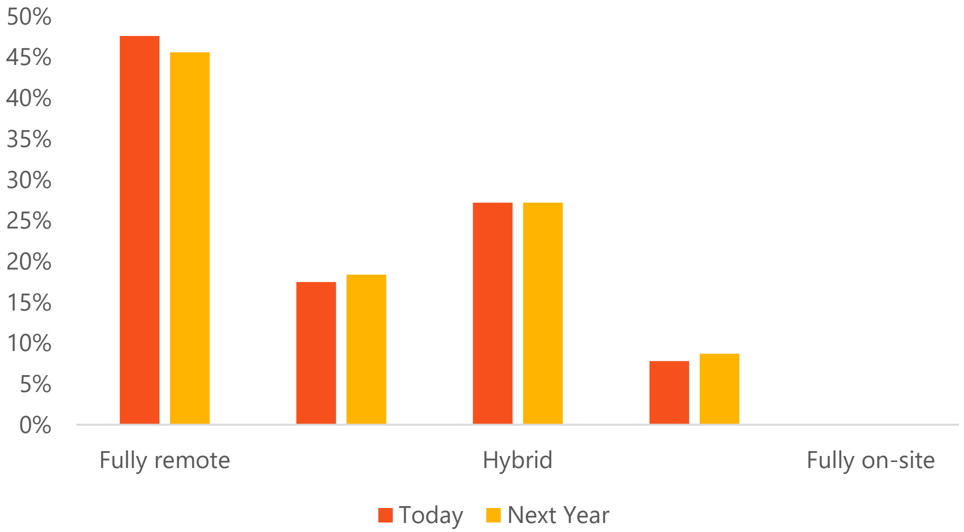
Key Trends: Remote Work

The present state of remote work appears to be stable and is likely to remain so over the next year.

Smaller agencies were more inclined to adopt a fully remote model, whereas larger firms often leaned towards a hybrid setup. Interestingly, none of the respondents to our survey operated a completely on-site model, nor did anyone plan to shift to a fully on-site arrangement in the coming year. Nearly half of the responses indicated that they operated a fully remote agency this year, and the vast majority of these planned to continue with this arrangement next year.

One notable distinction between predominantly remote agencies and largely on-site ones was their average net profit margins. Agencies that operated more remotely reported an average net margin of 16%, compared to a 9% average net margin for more on-site firms. While remote agencies had slightly lower utilization rates, they typically charged higher hourly rates. This implies that, although remote work poses certain efficiency hurdles, these can be balanced by decreased facility-related costs and the ability to impose higher rates, possibly attributed to attracting higher-caliber talent.





Key Trends: Offshore/Nearshore Talent & the 4-day Workweek

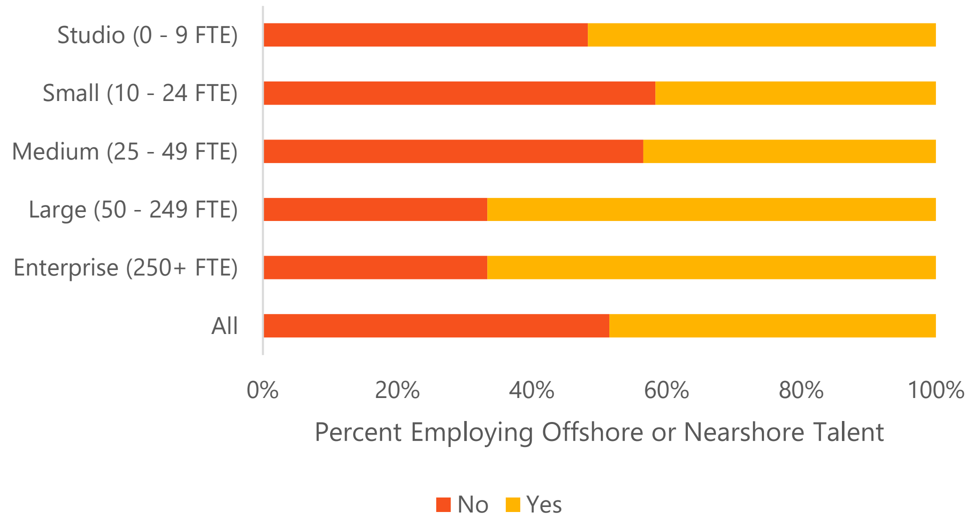
Our survey revealed an almost equal division between all onshore shops and those employing offshore and nearshore operations. We saw this trend pick up significant steam after 2020, and it appears that companies that have adopted this approach are faring better than those relying solely on onshore talent. Over time, we anticipate the terms "onshore," "offshore," and "nearshore" to lose their significance as the industry increasingly embraces a remote workforce.

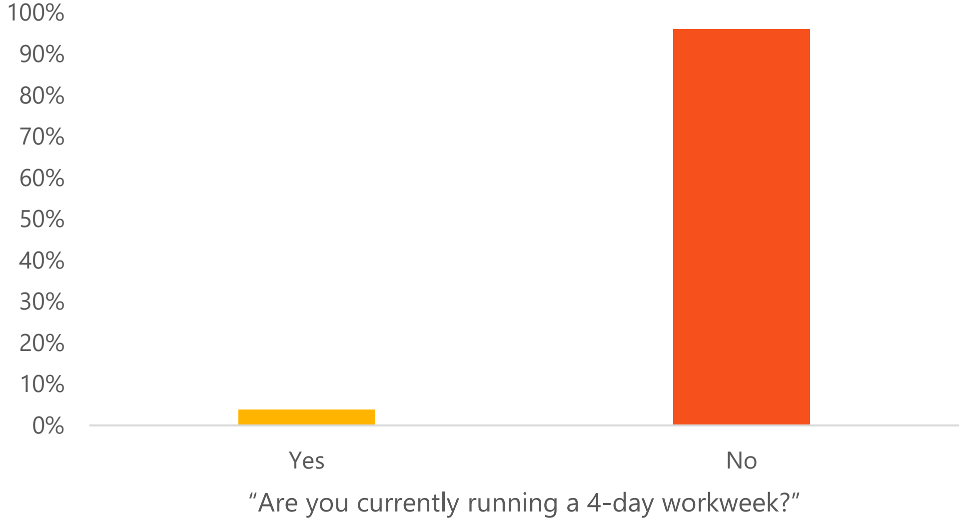
Those using offshore talent were typically larger companies, and they grew significantly faster (22% vs 11%) and earned much higher margins (17% vs 11%). However, a minor drawback of using offshore or nearshore talent was a marginally higher employee turnover rate, recorded at 25% compared to the 21% for those not using this approach.

While production efficiency rates were comparable, firms not employing offshore talent managed to generate slightly higher revenue per full-time employee (FTE) — $166k as opposed to $160k.

Currently, 4% of the agencies in our survey are testing a 4-day workweek. Among the remaining 96% not implementing this, 7% plan to give it a try this year.

Those agencies either currently operating or planning to transition to a 4-day workweek reported faster growth (20% vs. 16%) and higher earnings (20% vs. 13%) in 2022. However, they also reported above-average difficulties in employee retention. This concern for retaining talent could be a major factor driving interest in experimenting with a 4-day workweek.





Methodology & Demographics

About This Report

This report is a joint project between the Bureau of Digital and Promethean Research.

The objective of this report is to provide a high-level understanding of the digital services industry in 2023.

This report was published in May 2023.

Photos by:

Erwan Hesry

Erik Eastman

Mehmet Turgut Kirkgoz

Alexander Shatov

Lala Azizli

Cherrydeck

Erol Ahmed

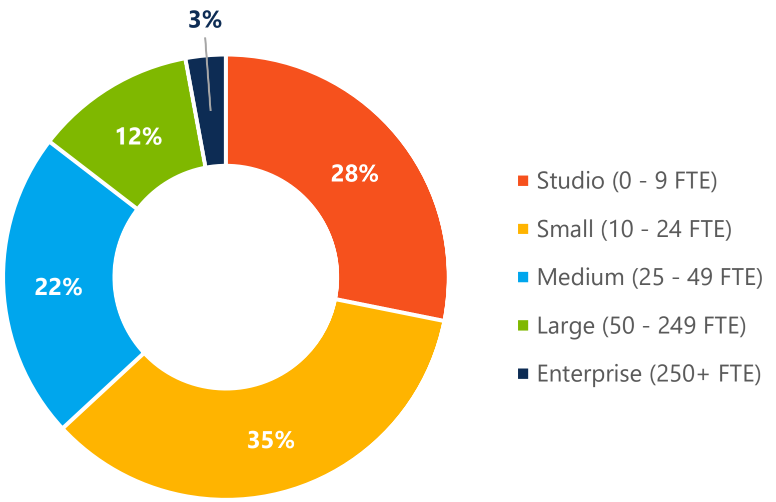
Respondent Demographics

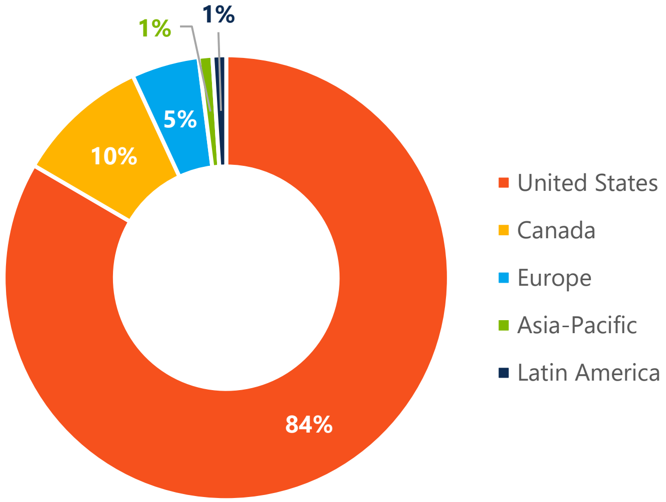
This report is a compilation of responses from digital agency owners and managers, primarily from North America. An online survey was conducted of digital service company owners during April 2023 to collect insights across many key performance indicators.

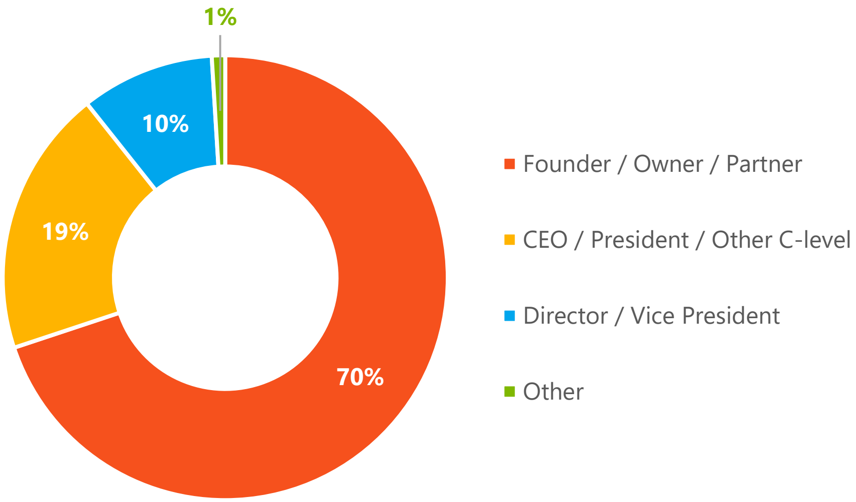
We received a total of 103 responses.

Average size: 35 employees

Median size: 16 employees







Thank you to everyone who participated in this year's survey!

For more information, including research and resources for digital shops, visit Promethean Research and the Bureau of Digital.