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US video streaming: have we come full circle?

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The video entertainment industry has undergone significant change over the past decade, as improved access to high-speed internet has enabled new ways of delivering content to consumers. While the shift to streaming has created opportunities for the media industry, increased competition and uncertain economics has also brought new challenges.

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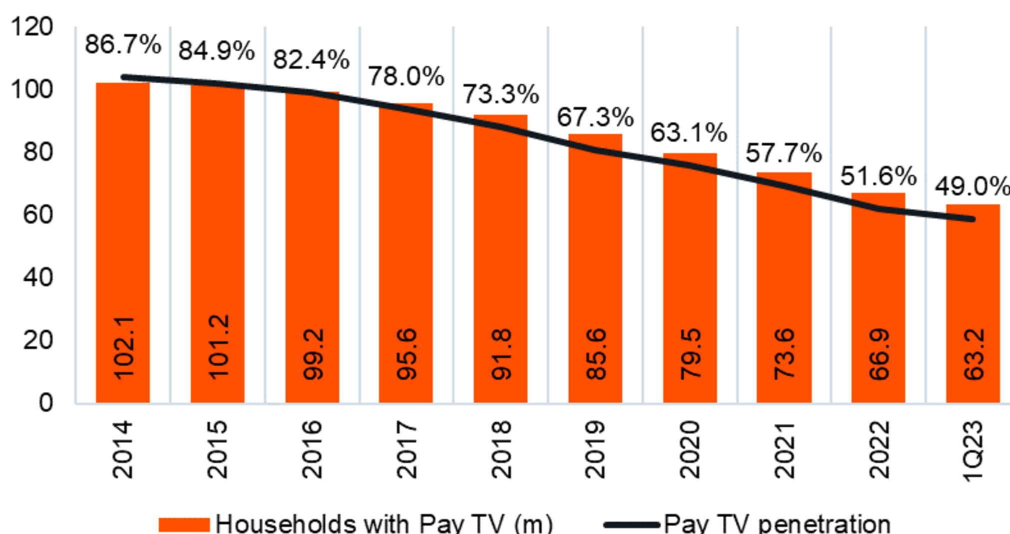
Pay TV (a form of linear TV which refers to media distribution via cable and satellite networks) has historically been a highly profitable enterprise for media providers, with companies being able to leverage distributors' scale to generate steady streams of affiliate fees and advertising revenue. However, the deteriorating economics of pay TV have prompted legacy providers to launch direct-to-consumer (DTC or streaming) offerings in an effort to better position for the future.

Streaming services were introduced to address a gap in the market.

In recent years, subscribers have begun to question the value they derive from their legacy pay TV products – with many of these products having morphed into expansive offerings of quantity over quality, and with many incumbents leveraging their scale to extract excessive profits from consumers. The industry started to change when players like Netflix began to demonstrate that there may be alternatives.

Traditional pay TV penetration peaked at around 89% of US households in 2009, according to nScreenMedia. This fell to only 49% of homes at the end of the first quarter of 2023. These numbers are anticipated to continue to drop at mid- to high-single-digit rates per annum for the foreseeable future.

Figure 1: The decline of traditional pay TV in the US



Source: nScreenMedia, Denker Capital. 31 March 2023

To be clear, we do not expect linear TV to become obsolete anytime soon. Certain types of content, like live sports and news, may continue to be better suited for a linear viewing environment for many years to come. Live sports and news offer highly predictable viewership (as opposed to the hits and misses that continue to plague scripted series) and contain natural pauses that create advertising opportunities. Although linear offerings may continue to narrow in scope, some of these businesses could continue to generate highly attractive cash flows.

Consumers are still enjoying the benefits of streaming, but providers are feeling the pressure.

Although the makings of an industry revolution have been building since the mid-2000s (Netflix launched its streaming service in 2007), it began to really gain traction from 2019. News of media providers' plans to launch streaming services were met with great enthusiasm, and companies like Disney added billions of dollars in market

value almost overnight. The bullishness was further compounded by seemingly insatiable demand for content during the COVID-19 pandemic.

The enthusiasm has since been tempered as participants massively underestimated the funding and effort required to build out these solutions. For example, in 2019 NBCUniversal owner Comcast guided that its DTC offering, Peacock, would require $2bn of investment before becoming self-sustaining. Instead, the service has lost over $5bn to date, with $2.5bn of losses generated in 2022 alone. Losses are projected to further increase to approximately $3bn in 2023. The shift in outlook further coincided with a change in investor priorities, as market participants have begun to place greater emphasis on near-term profitability in response to rising interest rates.

While going direct has its advantages for companies, increased competition and uncertain economics make us question whether media companies will be able to return to their former glory or if future returns could be permanently impaired.

The shift to streaming has come with challenges and important lessons for media providers.

The initial promise of streaming offerings was one of lower fees for consumers, while simultaneously enabling companies to leverage data and direct customer relationships to improve monetisation. However, with the benefit of hindsight, it has not been as simple. We highlight some of the learnings below:

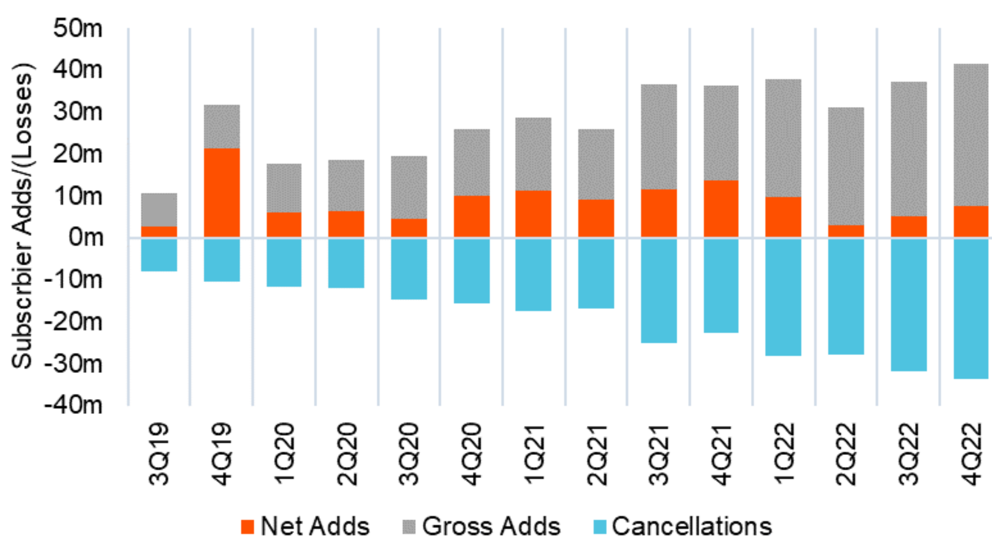
1. Lower switching costs have resulted in higher churn and greater rivalry between providers.

In the pay TV era, there was little incentive for customers to switch providers, as long as they maintained broadly similar offerings – especially considering the hassle of installing a new cable service or satellite dish. Competition tended to be relatively more rational and earnings more predictable.

While the streaming industry continues to gain subscribers, consumers are more prone to switching between product providers. Research platform Antenna estimates that industry-level churn rose to almost 6% of subscribers per month in 2022, from 3% in 2019. To put it differently, the average customer lifetime has almost halved (from 33 to 17 months).

Increased churn has significant implications for the extent to which companies can claw back production costs and marketing spend. Having to continuously lure back defectors can become an expensive exercise over the long term. Figure 2 shows how providers' efforts to attract new customers have at least partly come at the expense of increased cancellations at their competitors.

Figure 2: Subscriber churn within US streaming offerings



Source: Antenna, Denker Capital. 31 December 2022

2. With the current model, effectively monetising content is more challenging.

With pay TV, the bundling of content enabled media providers to extract stable recurring revenues via affiliate fees (the fee paid by a multichannel distributor to include a channel in its offering) and advertising. This held true even for more marginal content. Distribution agreements tend to be relatively long-term in nature and provide a predictable floor for companies to invest off. In addition, licensing and advertising enable providers to generate supplementary revenue particularly from older content.

This contrasts with the current streaming environment where consumers can be much more selective regarding what they pay for, and content that does not garner sufficient interest to support incremental subscriptions is unlikely to recuperate its cost.

3. To be successful, scale is essential.

It's costly to keep producing attention-grabbing content, so doing so without significant scale or ancillary revenue streams is tough. In addition, advances in technology have lowered the barriers for technology giants like Apple and Amazon to compete. User-generated content, from social media platforms like Instagram, TikTok and YouTube, presents a further challenge.

Scale is crucial to spread expenses across as large an audience as possible. In an ideal world, most consumers would prefer greater control over the content they subscribe to, instead of being compelled to adopt mass market or bundled offerings that include content they have little interest in. However, to make targeted offerings feasible, providers would have to make do with much smaller budgets. We think the lack of spending power will ultimately make it hard for smaller players to outbid larger general entertainment offerings for the best content.

4. General entertainment offerings likely stand the best chance of succeeding.

In the early days, WarnerMedia intended to maintain more than 10 separate DTC offerings for its various audiences. Most of this has since been folded into a single streaming service known as Max. While Disney initially maintained Disney+ and Hulu as separate offerings (with Disney+ focusing on more premium scripted content

and Hulu on general entertainment), Disney recently indicated that it will be looking at closer integration between the services going forward in order to realise greater scale.

Despite the challenges noted above, streaming models have their benefits.

These include access to wider markets, more direct customer relationships that can support cross-sell, and better-quality consumer data.

It remains to be seen whether media companies will be able to translate data into consistently higher hit rates. Data can enable companies to optimise their content portfolios. In a world where providers are no longer constrained to one show in a specific timeslot on a specific channel, they are incentivised to maximise engagement across their entire content portfolios. This means it is better to maintain a compelling offering across a variety of categories, as opposed to narrowly focusing on a specific niche, to cater for the largest possible number of subscribers. At the same time, providers need to maintain a deep enough offering to ensure subscribers keep coming back. We think that data can help to identify potential weaknesses and monitor the relationship between engagement and subscriptions to ensure that budgets are allocated optimally.

After a period of rapid expansion, the focus has turned to profitability.

To the dismay of the many consumers (including ourselves) who cheered at the prospect of entertainment undisturbed by advertising, in exchange for a modest fee – it seems advertising is making a comeback. Without it, media companies will struggle to generate adequate returns on capital. It turns out advertising is just too valuable to ignore.

- Ads are typically expected to generate at least as much revenue as premiums subscriptions do. Streaming services can offer advertisers superior insights and deliver highly targeted marketing directly to the intended consumers. This should translate into higher CPM (cost per thousand impressions) than what was previously achievable with pay TV advertising offerings.
- Advertising is also one of the best ways to monetise incremental consumption. Once a consumer has derived adequate value from their subscription, further consumption no longer affects their decision to renew. Since streaming offerings are typically charged at a flat fee, additional upside is left on the table. In fact, elevated usage could be detrimental, as providers will have to keep generating more content to retain users over time. Advertising scales well with user engagement and presents a way to extract incremental upside from higher consumption.

With the return of advertising, there will be new opportunities as well as challenges.

When it comes to advertising, we would like to see advertisers better embrace the opportunities presented by advances in technology. This includes ‘shoppable TV’ where, for example, someone would be able to buy the clothing worn by their favourite character in a scene with the click of a button; and more creative product placement, including on-screen products or billboards that can be altered to display relevant branding (almost akin to how perimeter boards at sporting stadiums can be used to display ads to viewers at home).

The ability to better track viewing behaviour should also enable advertisers to construct more cohesive advertising campaigns. In a linear TV environment, it was difficult to track who had seen which ads, meaning advertisers

largely had to resort to simple messaging that could be displayed repeatedly. However, in a DTC environment advertisers can construct much more cohesive narratives via ads that build upon one another over the course of a user's viewing.

As scale is important to be able to improve margins, we think companies with access to globally relevant intellectual property will be advantaged. Internet streaming has reduced some of the barriers to expansion and diminished the need for local distribution partners. Providers have also increasingly been securing global distribution rights for their content. Nevertheless, international expansion could present some new challenges, including a need for local advertising partners.

Finally, we expect a return to licensing to generate supplementary revenue. Over the past few years, media companies withdrew a lot of licensed content to maintain an element of exclusivity. However, this means that large portions of company back catalogues potentially generate little value at present, which could be better utilised going forward.

Looking to the future, streaming providers are not positioned equally.

As part of our investment process, we aim to identify businesses with sustainable competitive advantages that should be able to grow intrinsic value over time, and that offer an adequate margin of safety at the time of purchase. While we think that some of the businesses discussed below offer some of these characteristics, the environment remains fluid and highly uncertain. While we share our high-level thoughts on specific companies below, please note that this should not be taken as investment advice.

- As things stand, Netflix has the largest scale and the most mature offering. The group has already spent years refining its user experience and boasts one of the most profitable subscriber bases to invest off. Netflix also benefits from the lowest churn among the peer group. In an environment where most competitors are still scrambling to figure out how to scale while simultaneously making do with less, Netflix is in the enviable position where the management team can focus attention on incremental opportunities to enhance monetisation and improve customer loyalty.

- Of the traditional players, Disney stands out for its best-in-class intellectual property and track record in content production. The company has a strong brand and many of its franchises boast multi-generational and global appeal. Disney is also well-versed in leveraging its intellectual property to drive multi-platform engagement. Its film, TV, theme park, cruise line and merchandise offerings all work together to drive cross selling and create a virtuous flywheel that enhances the value of the whole. We think Disney+ can serve as a powerful customer acquisition tool for the overall business.

- We think Warner Bros. Discovery could present a compelling offering. Unfortunately, strategic missteps by its previous owners have resulted in a company saddled with debt just as conditions turned more challenging. That said, the company operates a host of leading brands (including HBO, which boasts a stellar production track record) that span a range of media segments including film, TV and gaming. Warner Bros. Discovery has been on the forefront of consolidating its content and exploring licensing deals to improve profitability, admittedly driven by immense pressure to generate near-term cash flows. It remains to be seen whether the company will be able to successfully conclude its transition without impeding its long-term prospects. However, if management succeeds the company could emerge as a strong competitor.

- In time, advertising activity is likely to gravitate to the companies that can offer the largest audiences, and content to the players with the biggest purchasing power. We therefore think that more marginal players with less essential content could struggle. While the landscape continues to evolve, second-tier offerings like NBCUniversal's Peacock and Paramount's Paramount+ could be relatively more at risk and might be better served by licensing their content or combining with a competitor.
- Finally, we would be remiss not to mention Apple and Amazon. While Apple+ appears to suffer from elevated churn and Amazon Prime Video has delivered several high-profile misfires, both are part of much larger ecosystems designed to promote overall company sales and customer loyalty. These companies will therefore likely be able to continue to participate, regardless of short-term success, as long as they desire to.

As we unpack the last few years' developments, it feels somewhat ironic to conclude that the most sustainable model might not look all that different from how it started.

To some extent, it feels like we have come full circle. If media companies want to grow profits, the future will likely require a return to advertising, more considered content production and the aggregation of content and services. That said, we should not discount the substantial benefits derived from being able to stream content on demand from almost anywhere over the internet.

Consumers would be willing to maintain two to three premium subscription offerings on average, according to UBS estimates. This suggests that we are likely to see a handful of winners, while several more marginal providers may fall by the wayside. However, premium subscriptions are likely to be complimented by free and ad-supported offerings, and hope remains for companies that are willing to adapt their business models.

The biggest development that is yet to be concluded is the future of live sports. Sport has historically served as a key differentiator for pay TV offerings, and the demand attracts strong affiliate fees and advertising revenue. While the shift to a streaming environment may accelerate the decline in legacy revenue, the change seems inevitable. Content will likely have to be priced at a significant premium while achieving high penetration to offset wholesale revenue losses. Sporting rights are also relatively fragmented across providers, meaning that fans will have to maintain multiple premium subscriptions to follow their favourite teams. Disney is investigating options to bring more of its ESPN content to a streaming environment. As one of the highest regarded sport networks in the US, ESPN could very well serve as an example of how the industry may evolve.

Ultimately, the media industry remains far from its final form.

It took cable TV more than 40 years to overtake broadcast TV in popularity after first being introduced in 1950. In many respects, streaming is still in its infancy, and many variables remain uncertain. Uncertainty and volatility may provide investors with attractive opportunities to invest in companies with valuable intellectual property and significant economies of scale as the industry continues to evolve. However, it is likely to be a bumpy ride.

Glacier Research would like to thank Ryno Truter for his contribution to this week's *Funds on Friday*

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