Telemedia's New Reality Show: Cord-Cutting, Shaving and Cord-Nevers

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KEY TAKEAWAYS

- We believe cable will continue to thrive...less clear is the outlook for media, in general.
- Frequently disruptive, creative change will always be a key factor to reckon with in the telemedia industry.
- By 2025, the population of millennial cord-nevers and cord-cutters is expected to equal cable-TV subscribers.
- Cable is entering a new era of profitability, with broadband being multiple times more profitable than video.
- While media profitability likely has peaked, fears of media falling off a cliff are grossly exaggerated.

"This Will Be The Best Year To Ditch Your Cable Subscription" – HUFFPOST TECH, January, 2015

"The Non-Techie's Guide to Cutting Cable" – GQ, January, 2016

"7 Streaming TV Packages That Will Let You Cut the Cord for Good" – MONEY, July, 2015

The reality is that change—frequently disruptive, creative change—will always be a key factor to reckon with in the telemedia industry as long as telemedia remains as vital as it is today. It's part of the combined cable, telecom and media sectors' dynamism— its DNA.

Providing information services and entertainment to consumers around the world has never faced more challenging industry conditions, as dramatic shifts in technology, competition, consumer behavior and regulation transform the landscape.

Still, difficult as the current telemedia environment may appear to some, we believe cable will continue to thrive, benefiting greatly from its dominant position in providing burgeoning broadband communication. Less clear is the outlook for media, in general.

Transformative Change: Out of the Blue or Just Around the Corner

Transformative change for telemedia can seemingly come out of the blue or linger just around the corner.

Just think what change could be wrought if Apple TV, Amazon or Google make larger, turf-changing inroads into the industry? Just think. Also remember, a decade and a half ago, only 3% of American households had broadband access, according to Pew Research. Today, it's well over 70%.

Today, however, the latest unsettling reality to confront the telemedia industry is a phenomenon that has been around the corner for some years—so-called "cord cutting" and "cord shaving." Consumers opting not to pay for cable-TV and choosing to view video directly online or through the internet (online) or shaving down a cable package is not new, but it has become more worrisome to industry participants and investors alike.

CABLE SUBSCRIBERS

The number of US pay-TV video, cable subscribers peaked at nearly 100 million at the end of 2012 and according to SNL Kagan and company reports, has been declining at the rate of about 250,000 a year—not a huge decline, but still a decline. Adding fuel to the fire, consumers have been getting more and more advice from all over the lot—from the media as cited on the previous page, corporations and individual providers—as to how to improve and/or reduce the cost of the way they receive information, entertainment and data and cut or, at least shave, the cable package. And then there are the cord-nevers to fret about.

Cord-Nevers: A Frustrating, Key Marketing Cohort

Perhaps even more frustrating to the industry are the mounting numbers of unpredictable cord-nevers, consumers who have never signed up for cable-TV. According to a recent study by Forrester Research, a healthy portion of US adults—some 76%—still subscribe to cable, but 24% don't, with 18% being cord-nevers and the remaining 6% cord-cutters.

Moreover, cord-never and cord-cutter growth in a key demographic group—18- to 30-plus year-olds, the much sought-after millennials—is expected to burgeon in the coming decade largely at the expense of traditional subscription TV.

By 2025, the population of millennial cord-nevers and cord-cutters is expected to equal cable-TV subscribers, with the combined group—35% cord-nevers and 15% cord-cutters—up 15 percentage points from today's levels. On the other hand, according to Forrester Research, cable-TV's share of the entire US adult viewing public will decline from 65% to 50% during the ten-year period.

Winners and Losers: Why Cable Could Win Out

Our view is that while each sector in the telemedia universe—cable, telecom and media—will have a combination of winners and losers, as a whole, we believe cable is best positioned to withstand current and foreseeable industry pressures and that cable's top-line growth will continue on a positive trajectory.

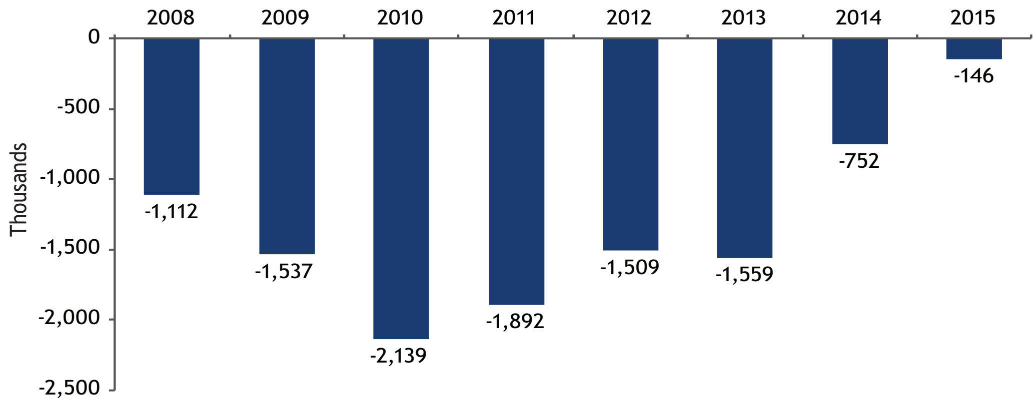
For media providers, the road ahead could be rougher than cable's for a variety of reasons, which we discuss along with highlighting potential sources of future industry disruption.

We expect industry-wide video subscriber losses to continue, but at the more gradual pace set in the past two years. A bigger source of revenue pressure will be cord shaving or reducing the size of the video bundle. However, cable should be further insulated from subscriber losses as it continues to defend its share of video more successfully and keeps on extracting market share from telecom and satellite providers.

VIDEO NET ADDS FOR U.S. CABLE OPERATORS

Source: Charts are created by Loomis Sayles using data gathered directly from company reports and various street reports, including JPMorgan, as of 3/31/2016.

Cable: Video Net Adds (thousands)



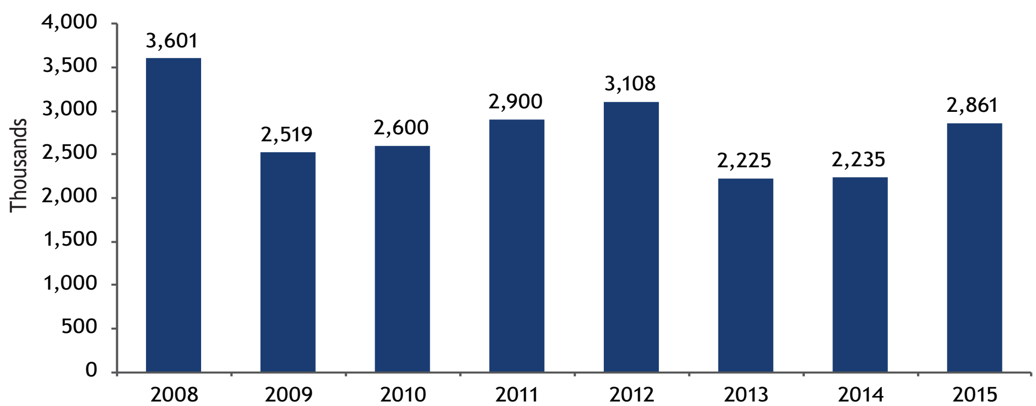
Cable-TV's Saving Grace: Broadband

But while the cable industry has been losing video subscribers, it has been gaining many more broadband customers as the demand for high-speed internet continues to rise. Cable companies are capturing the lion's share of new customer additions because they offer the fastest and most reliable internet service, which consumers increasingly value.

BROADBAND NET ADDS FOR U.S. CABLE OPERATORS

Source: Charts are created by Loomis Sayles using data gathered directly from company reports and various street reports, including JPMorgan, as of 3/31/2016.

Cable: Broadband Net Adds (thousands)



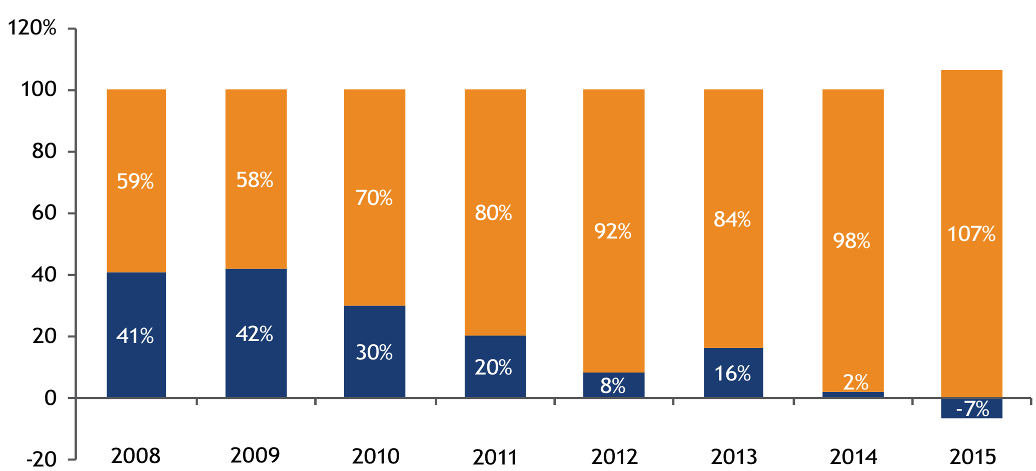
HIGH SPEED INTERNET NET ADDS SHARE IN THE U.S.*

**Unusually high 2Q15 and 3Q15 telco share loss attributable to AT&T during DirecTV merger integration before new marketing plans were launched.*

Source: Charts are created by Loomis Sayles using data gathered directly from company reports and various street reports, including JPMorgan, as of 3/31/2016.

Telco Share

Cable Share

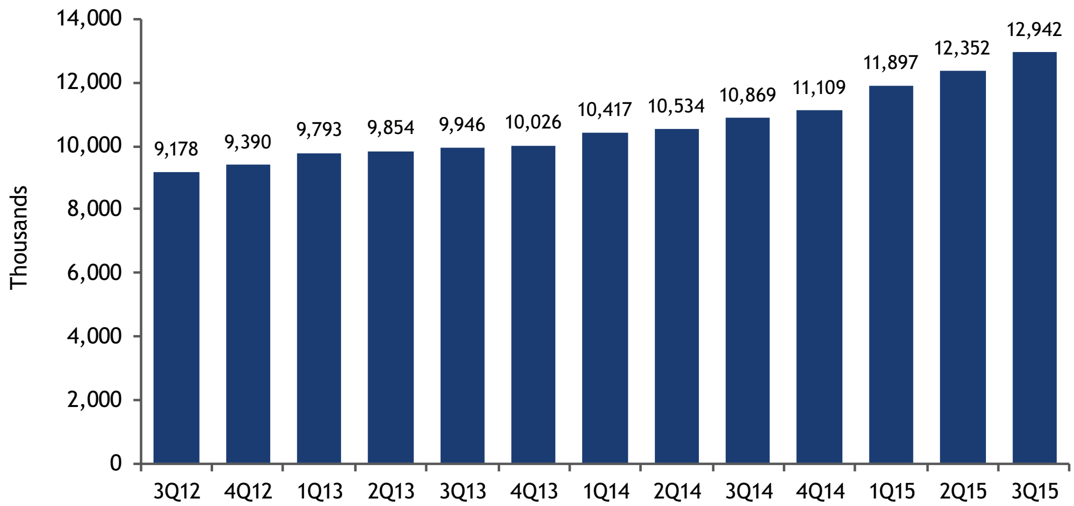


And as broadband subscribers move up to higher-speed tiers, the average revenue per user (ARPU) will also rise. There is also the likelihood of introducing usage-based pricing beyond set data caps as data volume gains exponentially on rising internet video downloading.

As the online video services continue to proliferate, the number of broadband-only households continues to grow, as seen below. Notably, the inhabitants of over half of the broadband-only US households are the millennials, according to Nielsen's recent reckoning.

BROADBAND-ONLY HOUSEHOLDS

Source: SNL Kagan, as of 12/31/2015.



While Verizon Fios and Google Fiber—or true fiber-to-the-home networks from telecom and technology companies—do rival cable, they only cover 16-18 million homes out of a total of 120 million US households and are unlikely to expand much beyond the current footprint due to poor return on investment.

Hardly a "Dumb Pipe," At Least for Now

Cable, which at times has been regarded as little more than a "dumb pipe," is entering a new era of profitability, with broadband being multiple times more profitable than video. Still, for large cable operators, video remains marginally profitable and a way to differentiate services through set-top box technology features.

PROFIT MARGINS

We expect cable companies to preserve their profit margins as they experience a positive revenue mix with a higher proportion of total sales shifting to broadband from video.

Over the past ten years, due to escalating programming costs, video margins have shrunk from roughly 60% to about 40%, according to our estimates derived from a review of historical data. For many smaller cable operators, lower gross margins, coupled with much higher customer service, marketing and equipment costs, means cash flow generated from video is already barely breakeven.

We expect cable companies to preserve their profit margins as they experience a positive revenue mix with a higher proportion of total sales shifting to broadband from video. Broadband cash flow margins we estimate to be in the 70-80% range as there are comparatively few costs once the network build is complete.

Potential risks for cable include pricing regulation on broadband being introduced under Title II of the Communications Act of 1934 at some future date, and cable subsequently being reduced to a "dumb pipe" without value-added customer interface.

Cord Cutting and Media: The Picture Blurs

In our view, greater uncertainties face the media industry when compared to cable, but while media profitability likely has peaked, fears of media falling off a cliff are grossly exaggerated. So what sort of uncertainties do media companies have to deal with?

One of the most immediate threats confronting them is that their programming content gets left out of the new bundles being offered to consumers. Recent surveys indicate that the percentage of adult broadband users moderately likely to definitely intending to cut the cord actually dropped in 2015, from 7% to 5.7% of the population per TDG Research. We believe that cord shaving, or reducing the number of channels in the video bundle, could be the more acute risk versus cord cutting.

Verizon, for example, is seeing strong demand for its Custom TV skinny bundle with one third of its new pay-TV customers choosing this option. According to Morgan Stanley's research, roughly 11% of pay-TV subscribers traded down to smaller packages over the past 12 months.

"MUST HAVE" CONTENT

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Media also has to deal with maintaining or possibly enhancing its economics in an over-the-top (OTT) world where media, video and audio content is delivered directly through the internet. While more online video options mean more outlets for content, media companies must ensure that their fee structure is commensurate with the traditional fee-based pay-TV business model or the so-called linear pay-TV ecosystem.

Preserving the Old Ecosystem: Is It Possible?

How can the currently lucrative linear pay-TV ecosystem be preserved (or the runway at least lengthened)?

Two primary ways that can help are disciplined selling of content outside of the bundle to video distributors such as Netflix, Hulu, YouTube, or direct-to-consumer like HBO Now or CBS All-Access and improved targeted advertising as measurement companies develop better technologies and more robust data sets.

Still, with telemedia—and media in particular—being in such a state of dynamic flux, expecting to maintain the status quo to any great degree seems a far-fetched hope at best.

In Such Times of Flux, the Survival of the Fittest

While it is naïve to believe the ecosystem will be preserved in its current form over the long-run, we do not profess to know precisely how the ecosystem will evolve or the shape it will ultimately take. As such, we favor companies most adaptable to a shifting ecosystem and where our conviction in maintaining solid (albeit likely lower) profitability remains.

ADAPTABILITY

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To elaborate, we believe companies with lower advertising exposure, content less amenable to time-shifted viewing (e.g., sports and news), properties that work in a direct-to-consumer platform, meaningful international growth prospects, and lower event risk potential are those best positioned to withstand an evolving and uncertain ecosystem.

In other words, picking the right company within the media sector garners considerable importance.

Potential Disruptions in the Ever-Changing Telemedia Universe

Below is a list of potential future disruptions in the telemedia universe. It's a long, fluid list that can change almost with the swiftness of clicking to a new channel. That's part of telemedia's current reality.

THREAT TO THE TRADITIONAL INDUSTRY

Apple's brand power and uncanny ability to create the best user interface presents the biggest threat to the traditional, linear pay-TV industry.

- **Apple TV.** Netflix, Hulu, YouTube, Sling by DISH, HBO Now, CBS All-Access, and Amazon Prime are just a few online video options that have already made major inroads into the linear video ecosystem. BUT the most anticipated formidable entrant, an Apple live TV service, has yet to launch. Apple's brand power and uncanny ability to create the best user interface presents the biggest threat to the linear TV industry. However, this service has been repeatedly delayed by what we believe is greater difficulty in acquiring content.
- **Google** has made splashy headlines on its entry into residential fiber, online video through YouTube, as well as wireless ON Wi-Fi. Thus far, the impact on the telecom, cable and media industries has been limited, but the tech giant's actions will keep existing industry players on their toes. For example, AT&T has accelerated fiber roll-out in cities offering Google Fiber. Thus far, Google has only rolled out fiber in selected areas in Kansas City, Austin and Provo, but according to Google, has plans to expand in bigger cities including Chicago and Los Angeles.
- **5G, the next wireless evolution,** could potentially match cable in speed. Per Verizon, the first trials will begin within the next 12 months, with some level of commercial deployment in 2017. Tests so far show speeds at 30-50 times that of 4G, or faster than Google Fiber. So, wireless can be a more credible contender to cable for video downloading in the future.
- **Wireless over Wi-Fi.** There are currently ~50 million Wi-Fi hotspots across the nation, and cable companies and municipalities plan to add many more. Thus far, Wi-Fi-first or Wi-Fi-only services have not made much of a dent on cellular provider revenues, but it is conceivable that with hand-off or base-station switching technology advancements, new spectrum allocation and network contracts with cellular carriers, wireless on Wi-Fi could pose a more serious threat to the wireless telecom industry.

- **Direct content production.** Media companies are beginning to show more discipline as it relates to selling content to OTT services. Will OTT services (e.g., Netflix, Amazon, Hulu, YouTube) make a bigger push into original content, or could big tech (Apple, Google) make their own push?
- **FCC regulation on set-top box competition.** The Federal Communications Commission (FCC) recently passed a Notice of Proposed Rulemaking (NPRM) that could eventually lead to an order requiring third-party competition in set-top boxes. Given the highly controversial nature of the proposal, it is unlikely to be implemented before the current FCC Chairman departs. However, this poses a huge risk to the cable industry, particularly those companies like Comcast that have invested billions in creating a superior consumer interface, which has paid off handsomely. It has boosted on-demand video spending, raised ancillary service revenues such as high-definition digital video recorders (DVR/HD) and reduced subscriber churn.

"The times they are a-changin',"—for better for some, for worse for others.

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Disclosure

*Source: SNL Kagan provides in-depth analysis and proprietary data on the constantly-evolving **media and communications** business.*