Future of Broadcasting

A new model for profitability

Telecom & Media Insights
Issue 37, April 2009

Contents

1 Abstract

The TV industry in Europe and the US is facing unprecedented structural and cyclical changes that have profound implications for all players in the value chain. The emergence of devices such as personal video recorders, the increasing penetration of fixed and mobile broadband and proliferation of multiple media platforms are giving TV viewers unlimited flexibility. Consumer behaviors are undergoing a dramatic move towards time-shifted and on-demand content. A key consequence of these behavioral changes has been the impact on TV advertising revenues. With consumers increasingly shifting to online video aggregators and preferring short-form content, advertising dollars are also making a beeline to the new medium. From the other end, the current economic slowdown is having a significant impact on both advertising and TV subscription revenues. The result is a very challenging financial outlook with total TV revenues likely to fall by 12% between 2008 and 2010, and not likely to reach 2008 levels in real terms in the UK before 2014. These developments have far reaching implications for the fundamentals of the TV industry. Traditional models of content commissioning, and exploitation will need to be overhauled in order to maintain profitability and develop new revenue streams. TV players will need to sharpen their focus on the commissioning process and explore ways and means of exploiting content in non-traditional windows.

2 Introduction

The television sector has seen better times. Uninterrupted growth, where all players in the TV value chain have experienced strong revenue and profit increases, could be a thing of the past. Over the past 18 months, some TV players had to contend with a rising tide of bad news. Revenue growth began to dry up for most free to air (FTA) broadcasters, resulting in a sharp decline in their share prices and the need to make redundancy plans. For instance, Channel 4 in the UK is looking to reduce its workforce by 15%, translating to almost 150 jobs, in an attempt to cut costs by £200 million[1] to counter the effects of declining advertising revenues. Similarly, the share price of Britain's largest commercial broadcaster, ITV plc has fallen from highs of over 100p to a low of 39.75p[2] at the end of December 2008, a fall of over 63% from the peak of January 2007.

In this paper, we will look at how the TV industry can sustain profits in such turbulent times. We start by pinpointing the two main trends affecting the TV landscape: the rise of digital TV and a change in consumer viewing behaviors. We continue the analysis by giving a five year forecast of how revenues across the TV value chain are likely to evolve in light of the worsening economic conditions. We then end the paper with a set of actionable recommendations aimed towards sustaining profitability in this uncertain TV landscape.

Our analysis and diagnosis covers the TV industry as a whole but our recommendations are targeted specifically at commercial broadcasters in developed countries.

1 Telegraph, "Channel 4 to axe 150 jobs as advertising revenues slide", September 2008.
2 ITV plc investor website.

3 Consumers are Adopting More Flexible Viewing Patterns

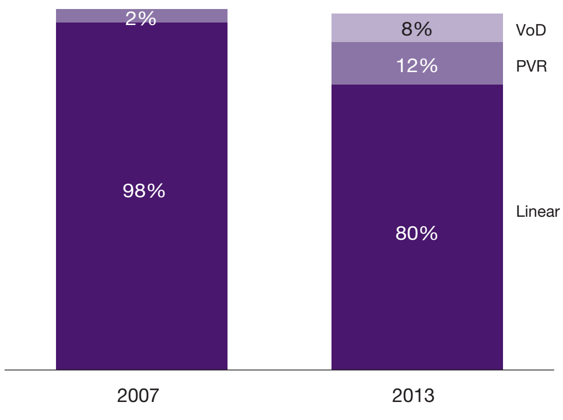
Digital distribution drives greater channel choice and – increasingly – greater flexibility about how and when to view content. As a result, consumers are watching more TV programming in catch-up and on-demand windows, and consuming more content on their PC and via mobile devices.

Digital TV has increased choice and flexibility
The first phase of digital TV take-up from the mid nineties onwards removed the bottleneck in analog spectrum capacity and resulted in a substantial increase in the number of TV channels available. In the UK, for example, the number of channels doubled between 2002 and 2007[3].

We are now entering the second phase of digital TV penetration, which is characterised by the successful launch of new services that enable flexible viewing such as Personal Video Recorders (PVRs), catch-up TV and Video On Demand (VoD). By the middle of 2008, over 20% of UK TV homes owned a PVR[4]; we forecast that this figure could exceed 70% by 2012. Another indicator of the increase in flexibility is the emergence of catch-up services such as the iPlayer from the BBC, which attracts forty million views per month, 85% of which are via a PC[5].

People will watch more time-shifted and on-demand TV
As more people have access to time-shifted services, the amount of viewing allocated to non-linear viewing is increasing. For instance, year-on-year online video viewing in the UK increased 50% to 85 minutes per person per week between 2007 and 2008[6]. Going forward, Capgemini estimates that the total time spent on TV viewing could increase slightly in the UK over the next five years as

Figure 1: Breakdown of TV Viewing Time (%), 2007-2013(e), UK



Source: Capgemini Analysis

3 OFCOM, Communications Market Report.
4 Enders Analysis, PVR+, 2008.
5 Screen Digest, the future of online video, 2008.
6 OFCOM, Communications Market Report, 2008.

time-shifted viewing increases faster than cannibalization of linear viewing. Linear viewing is likely to decline over the same period, dropping to 80% of overall viewing by 2013, down from 98% in 2007 (see Figure 1). By that time, PVR and VoD viewing could account for 12% and 8% of all viewing, respectively.

As a result of these changes, competition in the TV industry will be harder to predict. TV players have traditionally competed with other channels in the Electronic Program Guide. However, new players offering non-linear services and online aggregation pose new competition to TV players. Such content will be discovered by viewers using web search tools and shared across broadband networks. This is posing new threats and opportunities to established TV players.

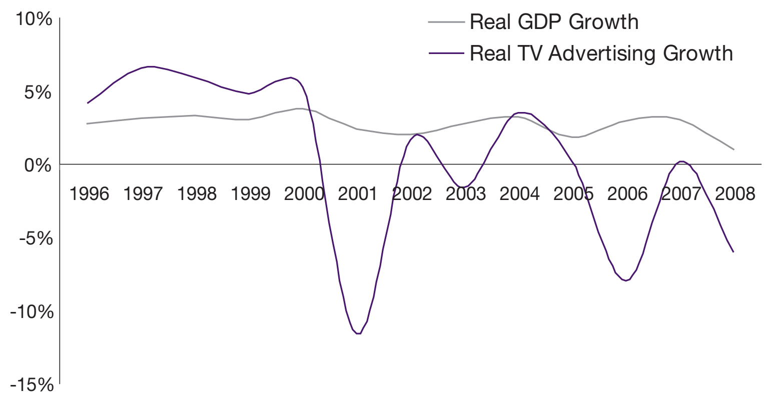
4 Revenues are Falling in Real Terms

It is a paradox in broadcasting today that, while consumers enjoy increasing choice and flexibility in their viewing, the money entering the TV value chain is decreasing. Spot advertising revenue is falling sharply and evidence from the last downturn suggests that there will be no bounce-back when gross domestic product (GDP) starts to recover. This section provides an analysis of the revenue drivers of the TV value chain and proposes a five-year revenue forecast for the TV industry as a whole.

TV advertising revenues are growing slower than GDP

The relationship between TV net advertising revenues (NAR)[7] and GDP shows that, prior to 2000, advertising tended to grow faster than GDP in periods of economic expansion and decline more rapidly than GDP in times of recession. Post 2000 however, the relationship between TV advertising revenue and GDP no longer appears to hold. In the UK, for example, advertising did not recover even after GDP growth resumed in 2003 and it actually dipped again in 2006 at a time when GDP was still growing. In other words, TV advertising has been a slow growth sector since 2000 (see Figure 2). The trend is similar in other geographies as well. In the US, TV NAR has been consistently growing slower than the GDP since 2004.

Figure 2: Real TV Net Advertising Revenues, Real GDP, Year-on-Year Growth, UK, 1996-2008(e)



Source: Capgemini Analysis; Enders Analysis, "UK TV and Display Advertising Outlook", November 2008; Measuringworth.com

Pay TV revenue growth is slowing down

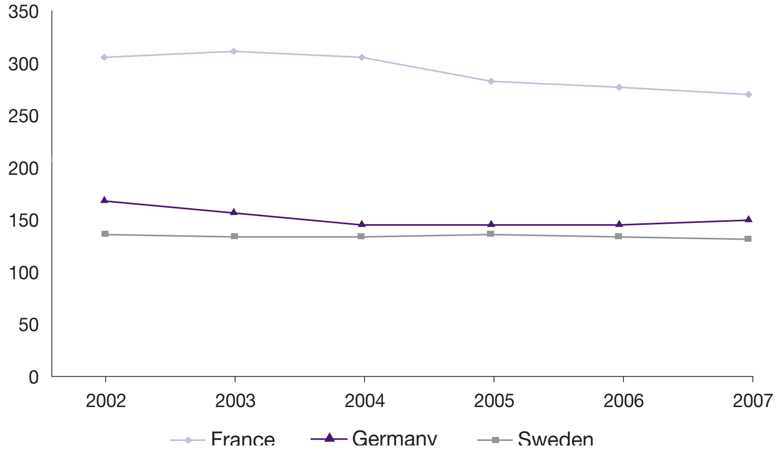
In the last decade, Pay TV revenues have been steadily increasing across markets; however, they now appear to be reaching saturation levels. In countries like France, for instance, penetration of pay TV households has been decreasing slowly from around 35% in 2003 to an estimated 31% in 2008[8]. The reasons for this gradual decline are largely attributable to the rising popularity of free digital terrestrial services. Similarly, in the UK, net additions for digital pay TV

7 Net Advertising Revenues (NAR) include both commercial analog and multi-channel revenues.
8 Enders Analysis, "French Pay-TV: Back to Growth", November 2008.

subscriptions have been showing clear signs of a saturated market. Net additions in the first three quarters of 2008 are estimated at around 0.3mn, almost replicating the growth that was seen in the first three quarters of 2007[9]. The pressure on subscription revenues has already been visible in select geographies, which are seeing declining average revenues per user (ARPU) (see Figure 3). Increasing popularity of free digital terrestrial services, such as Freeview in the UK, and the pressure on pay TV operators to offer a compelling value proposition to consumers are leading to a softening in ARPU.

TV revenues are likely to fall by 10% between 2008 and 2010 in the UK and not likely to reach 2008 levels in real terms until 2014

Figure 3: Average TV Subscription Revenue per Subscriber per Annum (€), Select Countries, 2002-2007



Source: Capgemini Analysis, Ofcom, "The International Communications Market 2008", Nov 2008

We are entering a new era of slow revenue growth

Revenue growth is beginning to slow on both the advertising front as well as consumer subscriptions.

Going forward, structural factors will continue to negatively affect TV NAR. The increase in multi-channel penetration up to the impending digital switchover will likely continue to reduce commercial networks' audiences. The audience share of the thematic channels taken as a whole will also increase as more households migrate to multichannel. Since advertising minutes per hour are higher on those channels, the supply of commercial impact will increase substantially in the next few years. Lower CPMs on thematics will contribute to deflationary pressures on the price of TV advertising.

Additionally, competition from online players is likely to prove a significant challenge to TV operators. Television share of overall advertising is falling in most countries. In Spain for example, the TV share of overall advertising fell 3 percentage points to 43% between 2006 and 2007[10]. In the UK, online advertising is estimated to have overtaken TV advertising in 2008[11].

Furthermore, contrary to past recessions, the current slowdown appears to be having a direct impact on overall consumer spending: total personal expenditure growth reached a 30-year low in the US in Q3 2008 compared to the previous quarter. This could have a significant impact on Pay TV subscriber numbers. In the UK, some independent surveys are predicting that over 25% of pay TV customers are considering either switching to a cheaper package or dropping their subscription altogether[12].

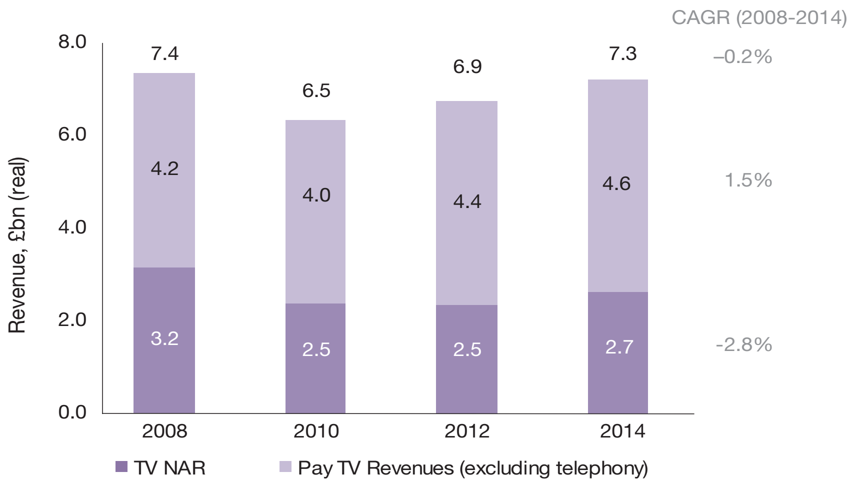
9 Ofcom, "Digital TV Market Update", Q3 2008.
10 Ofcom, "The International Communications Market 2008", November 2008.
11 Enders Analysis, "UK TV and Display Advertising Outlook", November 2008.
12 Telegraph, "Pay-TV customers to cancel contracts as credit crunch bites", October 2008.

Given these challenging circumstances, whilst forecasting is difficult in the current environment, Capgemini expects that:

- TV net advertising revenues are likely to fall by at least 20% in real terms between 2007 and 2011, with an anaemic recovery thereafter.
- Subscription income earned by pay TV services is likely to fall in real terms between 2008 and 2010, with some recovery afterwards.

The result is a very challenging financial outlook, with total real terms revenue likely to fall by 12% between 2008 and 2010, and revenues not likely to recover to 2008 levels in real terms before 2014 (see Figure 4)[13].

Figure 4: Forecast Real TV NAR and Real Pay TV Revenues (£bn), UK, 2008-2014(e)



Source: Capgemini Analysis

Expansion in the TV industry, driven by growth in both advertising and pay TV income, has been replaced by a much tougher climate. Companies are entering a new era in which traditional business models may no longer work; they need to adopt radical new approaches as top line growth becomes increasingly difficult. Those businesses with the sharpest focus on maintaining profit margins in their core business while developing new revenue streams beyond core activities will be the winners.

13 Secondary revenues (not shown) such as international format sales are growing rapidly according to UK Trade and Investment (by 23% in 2007 to £663m) but the growth is insufficient to offset falling domestic revenues.

Lessons from the Music Industry

Recorded music was the first sector in the media industry to experience the radical impacts of digital technology, accompanied by shifts in consumer behaviors. Recorded music industry revenues declined by 25% between 2004 and 2007[a] across the US, the UK, France and Germany. At the same time, consumption of music grew by 10%[b] a year with piracy often cited as the main driver. However, the root causes of revenue decline go beyond piracy and reflect major structural shifts that have their parallels in today's TV landscape.

Drivers of Change	Music Industry	TV Industry
Consumer Behaviors	Rapid adoption of digital formats	Rise of time-shifted viewing and short-form content
New Players in the Value Chain	Digital music leadership taken by Apple, followed by a wide variety of new digital distributors, e.g. Nokia	New online content aggregators from outside and inside the TV industry, e.g. YouTube and Hulu
Business Models	From one dominant revenue source (CD) to several smaller revenue flows with higher degrees of uncertainty	Introduction of new platforms and windows for content consumption

A fresh look at profitability, growth and innovation

There may be useful lessons in the way that the music industry at first struggled to address these fundamental issues, and how business models are now being re-invented to drive growth and profitability.

The past: Initial Music Industry Responses
Failure to understand fully the implications of digital: Focus on fighting piracy, which may have shifted attention away from building new business models to monetize the nascent digital opportunities
Limited investment in understanding consumers at a time when music behaviors started to change significantly
Lack of innovation and collaboration: • Reliance on the CD-led, mass-marketing-based model while consumer spend was shifting to more interactive media • Enabling players to whom music was a loss leader to set pricing and experience (Apple in digital, mass retailers in physical)

The future: Actions to Re-invent the Music Business
Widening scope of agreements with content creators: The old model of signing artists with large up-front fees is being balanced with an increasing focus on profitability across different monetization windows. 360 degree deals and risk sharing with artists are manifestations of this new approach
Investing in growing segments of the wider music market: While the recorded music market is in decline, other sectors of the wider music market such as live performances and merchandising or music gaming are growing. Labels are building capabilities in these areas through organic growth as well as acquisitions
Embracing business model innovation: While innovations such as music games are often driven by players from outside the industry, the potential appears promising, as evidenced by over 18 million copies of the Guitar Hero game being sold since launch

a & b Capgemini analysis

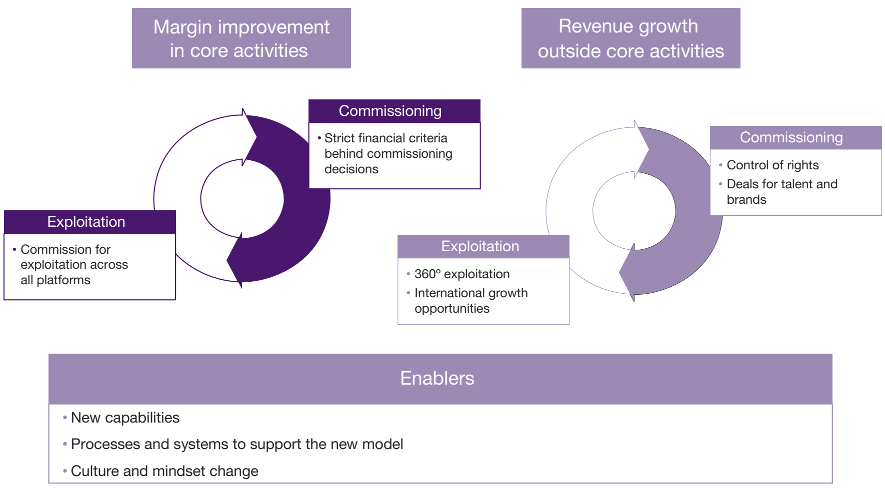
5 Creating a New Model Tuned Towards Profitability

There are useful lessons to be drawn for TV broadcasters in the way the music industry at first struggled to address structural changes in the market, and how business models are now being re-invented

For most commercial TV networks, programming costs typically represent between 60% and 70% of the overall cost base[14]. In an analog world with few channels, the cost of content could be recouped from advertising sold in the live broadcast window. This traditional commissioning model may no longer work; but while broadcasters are earning lower revenues from the first broadcast, the range of revenue streams has diversified – with new revenue sources from on-demand distribution and download-to-own, strong growth in international sales of built programs and formats, and increasing value realized by producers and talent outside of the broadcast window.

Broadcasters will need to recognize that the key to survival in light of the changed dynamics is to adapt. In this section, Capgemini recommends an integrated approach that responds in a two-pronged manner. This new model responds to falling revenues in the broadcasters' core business by improving margins, whilst achieving revenue uplift by focusing on growth opportunities outside the core business. Successful implementation of such an approach will require some key enablers including full alignment of the organization around the new business model and a set of new relationships with other players in the TV value chain (see Figure 5).

Figure 5: Structural changes in the broadcasting industry: A new model for profitability



Source: Capgemini Analysis

14 Company websites.

There is a need to increase focus on profitability in the commissioning process

Broadcasters should look across the whole life cycle of each piece of content to maximize revenue potential in all windows

Margin improvement in core activities

Commissioning will need to be driven by metrics

Currently, the bulk of commissioning is carried out by networks, who may produce internally or commission from external producers. Creative considerations are often the main driver of commissioning decisions. In these tough economic conditions, however, there is a need to increase focus on profitability in the commissioning process. Networks will need to put in place a rigorous financial analysis on a program-by-program basis and in all distribution windows to ensure that they derive the maximum margin uplift.

By having a clear metric-driven approach on the value of each program, broadcasters will be in a significantly better position to balance the creative considerations with the financial contribution of a program, and accordingly decide on the commissions. Furthermore, the metrics need to go beyond volume indicators – an example from the music industry would be to track the profitability of a song or album alongside its chart position.

Margin focus will need to be extended to all mediums

Profitability analysis of the broadcasters' programs is still driven too often by performance in the linear window. Increasingly, a significant proportion of revenues will be earned in non-linear distribution. Consequently, broadcasters should look across the whole life cycle of each piece of content that is commissioned to maximize revenue potential in all windows. A similar case in point from the music industry has been the renewed focus of major music labels to recognize revenues through non-traditional mediums such as gaming and music embedded in devices.

Revenue growth outside core activities

Commissioning models will need to be redrawn

Monetization of content across multiple windows will become a necessity in the near future. New commissioning models will be needed as it becomes more difficult to recoup the full cost of production in the primary window. The challenge for commissioners and producers is to identify the business principles on which new forms of engagement should be based, and then to work together to define the new approach. The elements of a new business model are likely to include tighter control of the inputs and outputs in the production process, a greater sharing of the initial investment risk, and a partnership approach to maximize exploitation in secondary windows and internationally. There is unlikely to be a 'one size fits all' solution; instead, new business models will need to be flexible to ensure that the returns to each player are consistent with the amount of risk that each is able to take on. In this way, broadcasters and producers can manage their profit margin and share growth opportunities.

Likely areas of revenue growth in domestic markets will be targeted advertising revenues from on-demand content and consumer payments from download-to-own. Capgemini expects strong growth in international sales of built programs and formats to continue.

360 degree deals might offer a potential new revenue stream

Another important way in which commissioning broadcasters can improve margins is by recognizing that a proportion of the value that they create is earned outside of the broadcast value chain. For example, the careers of actors and presenters can be 'made' by appearing in a successful TV series; they may then go on to earn substantial sums through their career. There may be partnership opportunities where broadcasters, with their reach to domestic audiences and their international distribution, can work with new talent to develop and exploit commercial opportunities in a way that is beneficial to both. In the music industry,

TV broadcasters need to morph into agile companies that partner with upcoming and established players to ensure they maximize the monetization potential

companies such as Live Nation are pioneering this approach by securing access to live concert and merchandising revenues.

Key enablers will make the difference between success and failure
The transition to new business models will have to be supported by the clear presence of key enablers within the organization. TV players will need to ensure that their operating model, processes and capabilities are aligned and a sound structure put in place to support the transition to the new business model. They will need to recognize and appreciate the importance of collaboration and partnerships in driving future growth. From organizations that have been used to organic growth, they will need to morph into agile players that partner with upcoming and established players to ensure they maximize the monetization potential. However, the most important enabler that will determine the success or failure of TV players in these changing times is that of the mindset. TV players will need to effect a change of mindset to shift thinking focused on the primary linear window to a more balanced view of the revenue opportunities across the content life cycle. They will need to clearly understand the trade-offs in terms of content and spend that may be required to maintain margins during this period of declining revenues.

In conclusion, Capgemini believes that a radical refocus on the content commissioning and exploitation cycle is needed to drive margin improvements. Our roadmap for commissioning for profit consists of three steps – a sharp focus on profit margin, a holistic approach to commissioning, and a 360 degree approach to capture more of the value that is created outside the traditional linear window. This is a challenge that broadcasters, with key skills in understanding their audiences, are well placed to meet, but they could find themselves usurped by other players if they do not aggressively restructure their current business models to make them fit for purpose.

About the Authors

Ari Iso-Rautio is a vice president in Capgemini's TME consulting practice and head of media consulting in the UK. He works on strategic issues with leading media and telecom companies and has 14 years of consulting experience in Europe and the US. He is based in London.

David Candlin is a principal in Capgemini's UK TME consulting practice with a specialization in broadcasting and media. Before joining Capgemini he worked in a boutique media strategy consultancy and started his career in political consulting. He is based in London.

Benjamin Braunschvig is a senior consultant in Capgemini's media practice. He has more than 4 years of experience working on consulting projects with broadcasters and media groups. His recent work focuses on the impact of convergence on the media sector and on the monetization of digital content. He is based in London.

About Capgemini and the Collaborative Business Experience®

Capgemini, one of the world's foremost providers of consulting, technology and outsourcing services, enables its clients to transform and perform through technologies. Capgemini provides its clients with insights and capabilities that boost their freedom to achieve superior results through a unique way of working, the Collaborative Business ExperienceTM. The Group relies on its global delivery model called Rightshore®, which aims to get the right balance of the best talent from multiple locations, working as one team to create and deliver the optimum solution for clients. Present in more than 30 countries, Capgemini reported 2008 global revenues of EUR 8.7 billion and employs over 90,000 people worldwide. More information is available at **www.capgemini.com/tme**

For more information contact:

Jerome Buvat
Head of Strategic Research
Telecom, Media & Entertainment
jerome.buvat@capgemini.com
+44 (0) 870 905 3186

www.capgemini.com/tme

Australia
Level 7
77 King Street
Sydney NSW 2000
Tel: +61 2 9293 4000

Belgium
Bessenveldstraat 19
B-1831 Diegem
Tel: +32 2 708 1111

China
Unit 1101-04, Azia Center
1233 Lu Jia Zui Ring Road
Shanghai 200120
Tel: +862 161 053 888

Denmark
Ørnegårdsvej 16
DK-2820 Gentofte
Tel: +45 70 11 22 00

Finland
Niittymäentie 9
02200 Espoo
Tel: +358 (9) 452 651

France
Tour Europlaza
20 ave. André Prothin
92927 La Défense Cedex
Tel: +33 (0)1 49 00 40 00

Germany
Hamborner Strasse 55
D-40472 Düsseldorf
Tel: +49 (0) 211 470 680

India
Piroshanagar, Vikhroli
SEP2 B3 Godrej Industries Complex
400 079 Mumbai
Tel: +91(22) 5555 7000

Italy
Via M. Nizzoli, 6
20147 Milano
Tel: +39 02 41493 1

Middle East
P.O. Box 502 420
Dubai
UAE
Tel: +971 50 884 77 64

Netherlands
Papendorpseweg 100
3528 BJ Utrecht
Postbus 2575
3500 GN Utrecht
Tel: +31 30 689 0000

Norway
Hoffsveien 1D,
0275 Oslo
Tel: +47 24 12 80 00

Poland
Al Jana Pawla II 12
00-124 Warsaw
Tel: +48 (22) 850 9200

Portugal
Edifício Torre de Monsanto
Lugar de Romeiras
Miraflores
1495-046 Algés
Tel: +351 21 412 22 00

Spain
Edificio Cedro
Calle Anabel Segura, 14
28100 Madrid
Tel: +34 91 675 7000

Sweden
Gustavlundsvägen 131
PO Box 825
161 24 Bromma
Tel: +46 8 5368 5000

United Kingdom
76 Wardour Street
W1F 0UU London
Tel: +44 20 7734 5700

United States
623 Fifth Avenue
33rd Floor
10022 New York
Tel: +1 212 314 8000