Content Strategies for Telcos

Venturing into Content Production

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Contents

1 Abstract

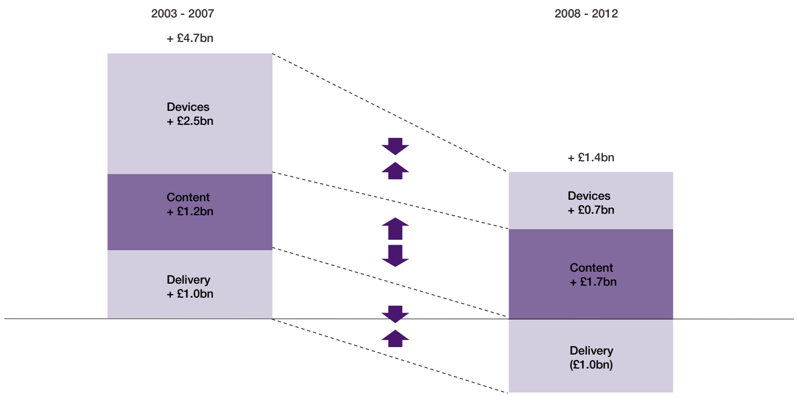
Content is expected to constitute a significant share of consumer spend on TME services in the next five years. Recognizing its importance, multiple telcos have ventured into producing content in-house either by organically building capabilities or acquiring content companies selectively. While operators have always exhibited an interest in having a strong content portfolio, many of them have been acquiring it through other means such as partnerships or rights acquisition. However, the rising costs of acquiring premium content rights, and the constraints of revenue sharing agreements will require operators to look at content production as a viable alternative. Capgemini believes that investments in content production are essential for telcos to become serious contenders in the Pay TV space over the long-term. Producing certain types of content does not entail huge investments – Capgemini analysis suggests that an IPTV operator, producing its own movies and monetizing them solely through subscriber revenues on a pay-per-view basis, can expect to break-even by the fifth year from conceptualization. However, producing content in-house is likely to present various challenges and risks that telecom operators will have to work around to succeed. Telcos will need to have sizable scales of operation, and significant subscriber bases in order to break-even on the investments in producing content solely for distribution on their own platforms. Telcos will also need to build up marketing prowess similar to leading content producers to effectively monetize their own content across multiple platforms. We recommend leading telcos gradually build a portfolio of their content over a period of time, starting with general entertainment that is cheaper to produce and attracts wide audiences. Telcos should steer clear of making large acquisitions, but should consider selective acquisitions to bolster the gaps in their content production portfolio.

2 Introduction

The advent of multiple content types and advanced digital devices is rapidly changing the consumer basket spend on TME services.

Total consumer spend on content in the UK has grown from around £ 10.4 billion in 2003 to over £ 12.7 billion in 2007, representing a growth of around £ 2.3 billion in nominal terms and about £ 1.2 billion in real terms (constant 2003 prices). This is expected to continue growing at a rate of 3.5% in real terms over 2008-2012, even as the growth in overall consumer TME expenditure slows down to around 0.6% in real terms[1]. Consequently, the next five years will see a value shift from other TME areas to content, as consumers continue to spend more on content at the cost of delivery and devices. The absolute growth in consumer spend, in real terms, on content in the UK is expected to grow from £1.2 billion during 2003-07 to about £1.7 billion during 2008-2012 (see Figure 1).

Figure 1: Absolute Growth in TME Consumer Expenditure, UK, 2003-2012E, Real 2003 £bn



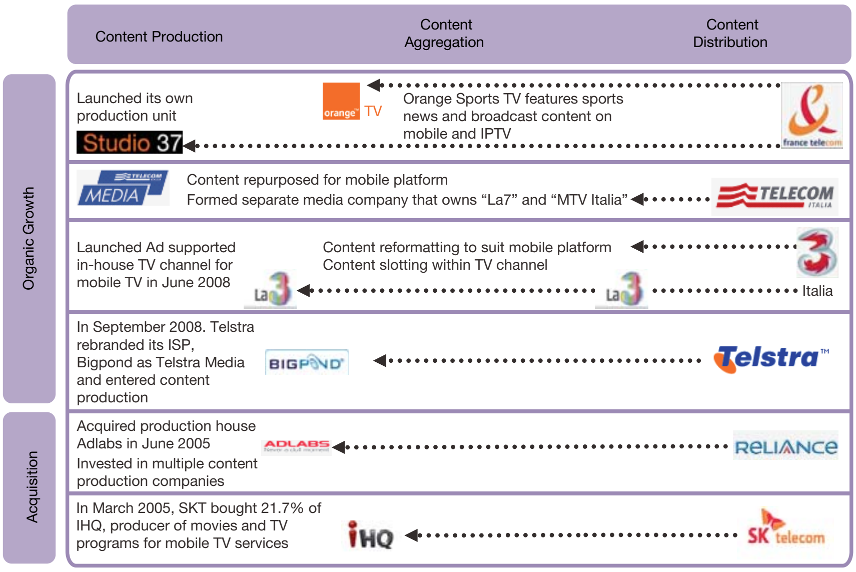
Source: Capgemini TME Strategy Lab Analysis

TME players, including many telcos, have begun to recognize this shift and the rising importance of content in their service portfolios. Consequently, a few telcos have forayed into content production, either by organically building content production capabilities in-house or by acquiring content production companies (see Figure 2).

In this paper, we analyze whether telcos should move into content production, the benefits that can accrue, and challenges whilst diversifying into this area.

1 Capgemini Analysis based on company reports, analyst forecasts and data from regulators/industry bodies.

Figure 2: Select Telcos' Moves into Content Production



Source: Capgemini TME Strategy Lab Analysis; Digital Media, "BigPond dismembered, reborn as Telstra Media", September 2008; Orange, "Orange and TV", April 2007; Variety, "India's Reliance grabbing Adlabs", June 2005; France Telecom, "Orange Content Strategy", April 2008; Company websites and news releases

Consumer spend is rapidly shifting to content

3 Rationale for Telcos to Enter Content Production

Content offerings are increasingly an important constituent of telco services. With an objective to gain a larger share of consumer spend, and make up for slow growth in their core communication and Internet access services, telcos have ventured into linear TV broadcasting, Video-on-Demand, and online as well as mobile portals. In this section, Capgemini assesses the key factors that make a case for telcos to own content production capabilities to complement their core services. This research focuses on linear TV content and on-demand video content, since these constitute over 90% of digital content revenues in Western Europe[2].

Importance of Content to Differentiate

Content has always played a key role in influencing consumer interest in Pay TV. A consumer survey conducted by Ofcom indicates that over 85% of consumers cite availability of content as the key factor for selecting Pay TV services, compared with only 53% of users choosing price as the most important reason[3]. Pay TV providers have recognized this and are integrating backwards to gain content exclusivity, including access to production capabilities (see Figure 3).

Figure 3: Position of Pay TV Players in France and Spain

	Content Production	Aggregation (TV Channels)	Distribution (Retail Service)
France	Subsidiary StudioCanal is a major studio producing movie content	Produces over 20 special interest channels	Satellite Operator
France	Some in-house production through a subsidiary e -TF1	Owns 11 thematic channels	Minority stake in satellite operator Canal
France	Has recently launched Studio 37 for producing movies	2 new movies and sports channels	IPTV Operator
Spain	Produces and distributes movies through subsidiaries, Sogecine and Sogepaq	22 Digital Only channels, including the Canal + bouquet	Satellite Operator
Spain	Investment in 'Teuve', production company	11 thematic channels	Cable Operator
Spain		Partially owns Canal+ bouquet through 16.7% stake in Sogecable	IPTV Operator

Source: Capgemini Analysis; Ofcom Pay TV consultation, September 2008; Vivendi, "Creation of Canal Plus France", January 2007; WorldScreen, "They Aim To Please", April 2008; Advanced Television, "Telefonica and Walt Disney in a VoD deal", September 2006; PaidContent, "French TV Companies Marathon and TF1 In Digital Content Creation Deal", October 2007; Company websites

2 Data from Ovum, Screen Digest, Strategy Analytics, France Telecom, April 2008.
3 Ofcom's Pay TV consultation documents.

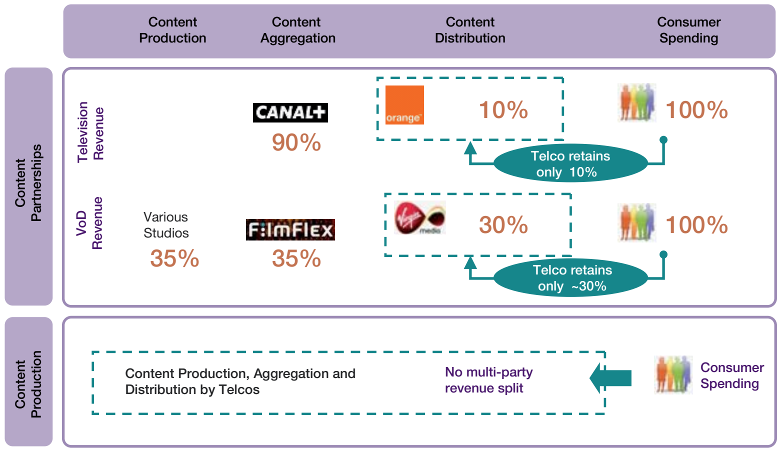
Effectively competing with Pay TV players in these markets will require telcos to firm up a content strategy that includes access to exclusive content and even content production capabilities.

The importance of exclusive content in the successful uptake of operator driven services has been vindicated by early successes in the mobile TV space. For instance, consider the case of mobile operator 3 Italia. The operator launched its mobile TV service, La3, in June 2006 with a variety of themed channels across various genres as well as exclusive rights to football content in Italy. Consumer uptake of the service reflected its strength and in just over two years from launch, by July 2008, over 10% of 3 Italia's subscriber base signed up for the service and part of the success can be attributed to a strong content strategy at launch.

Significant Revenue Shares Involved in External Partnerships

A traditional route for acquiring content has been that of partnering with third-party content owners. This has been the preferred way for both Pay TV and IPTV providers. However, these agreements have the potential to significantly reduce the revenues that can be retained by the operators as they will have to contend with complex revenue-sharing agreements with multiple parties in the content value chain (see Figure 4). These revenue-sharing agreements severely limit the upside for telecom operators in delivering content. Moreover, operators will usually be required to negotiate separate revenue-sharing agreements for each platform.

Figure 4: Distribution of Revenues across the Value Chain in Partnerships



Source: Capgemini TME Strategy Lab analysis. Ofcom, "Movie Markets in the UK", December 2007. Company websites

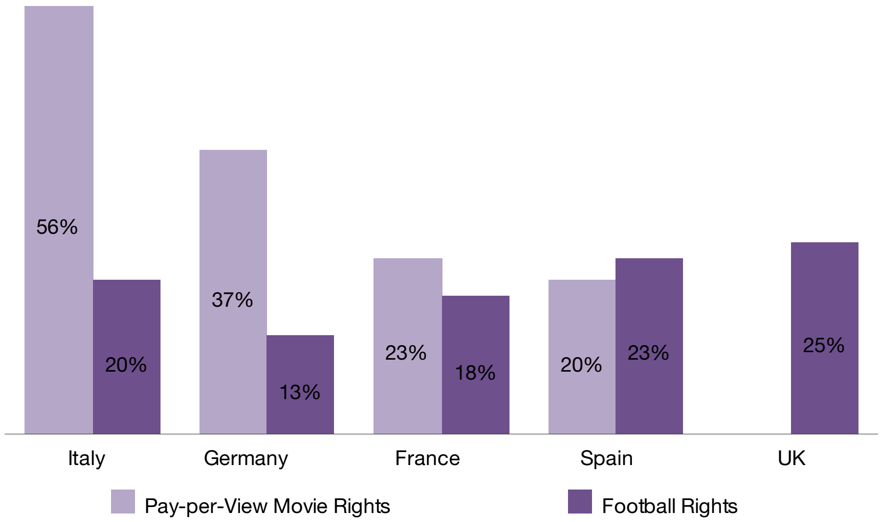
Rising Cost of Exclusive Content Rights

Another traditional route of acquiring exclusive content has been through acquisition of content rights. This route is most preferred when it comes to acquiring rights for popular sporting events. Given the high consumer interest in sports, Pay TV operators have been at the forefront of spending significant amounts of money in acquiring these rights. While offering attractive off-the-shelf exclusivity for telecom operators, however, acquiring rights for premium content poses two significant challenges for telecom operators: cost of procurement and monetization.

Over recent years, the rapid proliferation of media outlets has meant that rights to premium events are keenly contested among large global Pay TV players. This has led to a steep increase in the costs involved in acquiring such content. For instance, the cost of la Ligue football rights in France has been steadily increasing over the last five years at a Compound Annual Growth Rate (CAGR) of 18%.

Similarly, the cost of procuring movie content has been rising significantly in the last few years. In Italy, the cost of acquiring pay-per-view movie rights has risen at a CAGR of over 56% in the period 2004-2008 (see Figure 5).

Figure 5: Average Annual Increase in Costs for Procuring Exclusive Movie and Sports Rights, Select Western European Countries, CAGR FY2004-FY2008[a]



Note: (a) CAGR of PPV movie rights has been calculated from 2004 to 2006

Source: Capgemini TME Strategy Lab Analysis; Exane BNP Paribas, "Telecom Operators: In the Eye of the Telecom-Media Storm", February 2008; Ofcom, "Summary Profiles of Pay TV in France, Germany, Italy, Spain, Sweden and United States", December 2007

Telecom operators are faced with the additional burden of trying to monetize this content over a limited subscriber base. While media players are free to release content across multiple platforms and markets, telecom operators are constrained to first release it to their subscriber bases, and then target the larger market for a possible future release.

Relatively Low Investments Required for Content Production

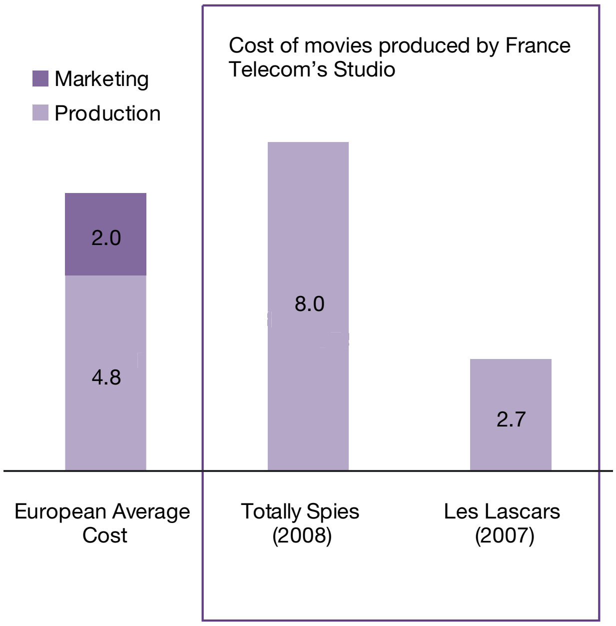
Telecom operators will have to work around these limitations that are involved in partnering with content providers or acquiring content rights. In the search for an alternative to these modes of content sourcing, content production presents itself as an alternative with strong potential for large telcos.

Content production is not an extremely expensive proposition for leading telcos with significant scales of operation. As an example, average costs for producing a movie in Europe are not very high, and usually total less than €10 million for marketing and producing a movie (see Figure 6). This implies a production cost of less than €100 million for 10-12 movies. These costs and associated risks are comparable to a mid-size telecom initiative; for instance, rolling out a countrywide DVB-H mobile TV network in Italy or the UK, would cost over €350 million[4].

For most large telcos, the expense of movie production would constitute only a small proportion of their overall costs and as such, does not require them to risk significant investments. In the next section, Capgemini evaluates whether this alternative presents a viable business case that offers tangible results.

4 World Digital Media Broadcasting, "Europe Risks Impeding Growth of Mobile TV Market", July 2007.

Figure 6: Costs of Movie Production in Europe, (€ millions)



Source: Company Websites; Arab Times, "Totally Spies: TV Hit Going Big", May 2008. Variety; "Orange, Millimages team on 'Lascars'", May 2007; Variety, "Orange outlines six co-productions", May 2007
OECD, "Remaking the Movies: Digital Content and the Evolution of Film and Video Industries", 2008

4 The Economic Case for Content Production

In this section, Capgemini research looked at the costs incurred and the potential revenue upsides from a telco's chosen venture into movie content production. This content category was chosen for analysis since a significant proportion of consumer expenditure on content is spent on movies. For instance, in the US, movies comprise almost 80% of all IPTV transactions; in France, Orange has reported that over 70% of all its VoD transactions are for movies[5].

Context and Assumptions

Capgemini assessed a mock scenario to understand what it would take for a telco to build a library of about twelve movies for distribution through its video-on-demand platform, on a pay-per-view or subscription basis. Production of an average movie typically takes around one year until it is ready for release, and the research assumed a project initiation rate of one movie every month. The analysis assumed that about 70% of the telco's IPTV subscriber base is likely to use the PPV service, with around 90% of the overall PPV subscribers viewing movie content.

The average budget for producing one movie in Europe is considered to be €5 million growing at 4% every year, and sales and marketing costs are assumed to be 15% of production costs.

The acquisition cost of premium content has been rising significantly in the last few years

Payback and Revenue Uplift

Capgemini analysis suggests that an IPTV operator with a sizable IPTV subscriber base, producing its own movies and monetizing them solely through subscriber fees on a pay-per-view basis can expect to break-even by the fifth year from the conception of the movie pipeline (see Figure 7).

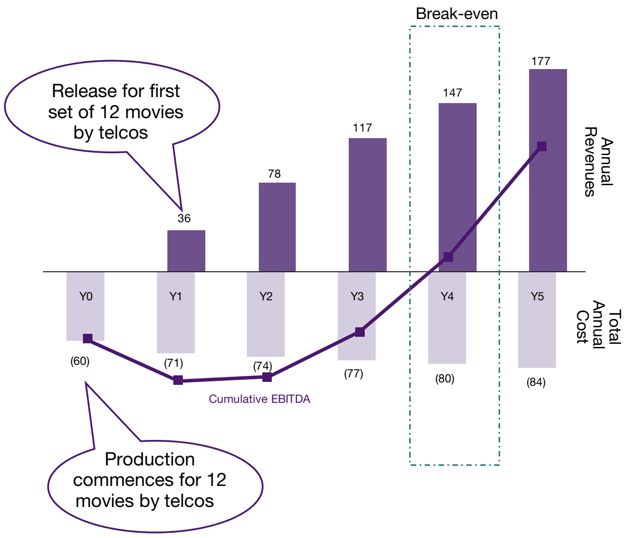
Movies offer telecom operators potential by opening up the options of differentiation, multiple revenue streams and removing the need for revenue-sharing. Moreover, telcos can expect an increase of 8% in IPTV revenues within five years of launch of an in-house produced movie library (see Figure 8). Telcos can generate up to €180 million in revenues from Pay-per-View assuming an average spend of €6 per month per subscriber on telco-produced VoD content from around 2.3 million in-house movie subscriber base, assuming that 30% telco-produced movies turn out to be popular.

Telcos with considerable scale, and a large captive subscriber base can recover their investment in production solely through distributing movies through their own platform; and revenues from multi-platform distribution will only add to the potential upside.

By producing movies in-house, telecom operators gain the advantages of exclusivity and choice to release movies on their own VoD platforms initially. However, telecom operators can subsequently monetize these movies through a wider-reaching theatrical release, DVD sales, online distribution, merchandising and sale of third-party distribution rights.

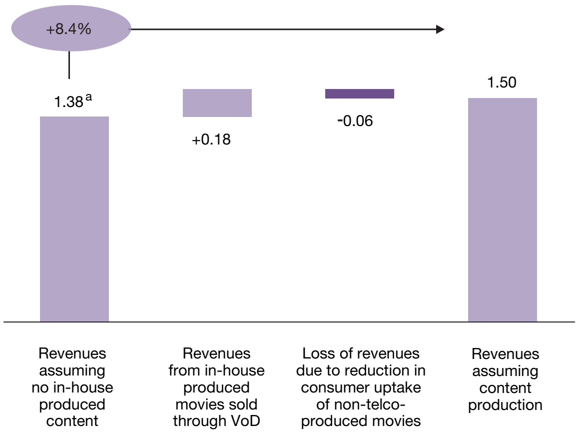
5 Capgemini TME Strategy Lab Analysis; Pyramid Research, "Can Video on Demand Save IPTV?" June 2007.

Figure 7: Break-even Analysis of Movie Production by Telcos



Source: Capgemini TME Strategy Lab Analysis

Figure 8: IPTV, VoD and PPV Revenue for Telco in the Fifth Year of Entry into Content Production, (€ billions)



Note: (a) Revenues include sales of in-house produced movies over the VoD platform. (b) Costs include movie production and marketing expenses.
Revenues include those from IPTV, Subscription VoD and Pay-per-view, but do not include those from in-house produced movies

Source: Capgemini TME Strategy Lab Analysis

5 Challenges and Risks Involved

Integrating telecom and content business will be a significant challenge

While the upside of content production in-house presents a case for telecom operators to consider such an investments, operators will also need to tackle some of the challenges and risks that are inherent in venturing into content production.

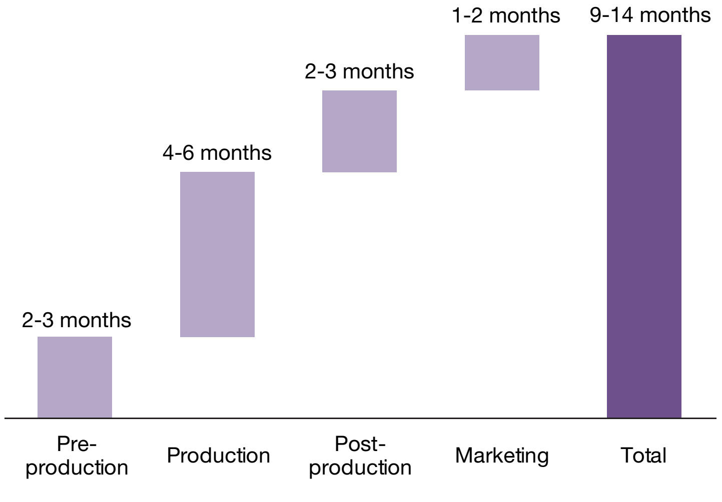
Lack of Prior Experience

Telecom operators will need to contend with what could be their biggest stumbling block in venturing into content production: lack of experience. Operators will have to rapidly scale up their understanding of the media space, and the inherent risks that are involved in producing content. While traditional media players have established partners and processes, telecom operators will need to build their media divisions from the ground up. Building up comparable marketing prowess as leading content producers will require some time, and can be a formidable task for many telcos.

Gestation Period

A key challenge for telecom operators, particularly when it comes to producing content such as movies, will be to manage the timelines involved. Starting with the pre-production stage, the typical time for a movie to hit the screens could go up to 9-14 months (see Figure 9).

Figure 9: Average Time Involved in Making and Releasing a Movie



Source: Capgemini TME Strategy Lab Analysis; Company websites; "Variety," Marathon, Studio 37 team on "Spies", May 2008; "Variety," Orange, Millimages team on "Lascars", May 2007; "Variety," Orange outlines six co-productions, May 2007

Moreover, there exists no guarantee that a movie will appeal to consumer taste and interest, thereby offering no assurance of return on investment. Movie releases need to be managed within a tight timeline that includes holiday seasons. Telecom operators will have to manage these constraints around time if they are to reap the benefits of their investments in content production. Returns on the content production venture will depend on the number of captive IPTV subscribers, consumer interest in telco produced movies, success rates and movie budgets, and telcos will need to carefully consider these aspects while firming up the case for investments.

Integration and Management Risks

The management of the content production business, and its integration with the core telecom business can be a difficult task to achieve, and can result in the failure of the telco to reap benefits. This is particularly true with acquisition of large content production houses, which can be difficult to manage and integrate.

A prominent example in the telecom space is Telefonica's acquisition of the television programming production company, Endemol. Telefonica acquired the company at a valuation of €5.5 billion in 2000. However, lack of synergies between the telco business and the content production house meant that Telefonica could accrue no clear benefits from the acquisition. The cultural differences between the two organizations prevented successful integration or cross-fertilization between the businesses, culminating in Telefonica's exit from the business in 2007 for a valuation of about €2.6 billion[6].

6 Company websites and press releases.

6 Recommendations for Telcos

Telcos may consider small acquisitions to gain select capability

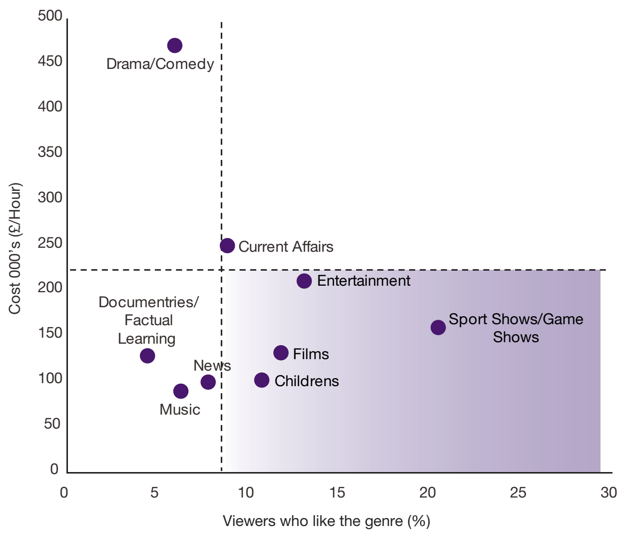
The research shows that for telcos looking at a long-term play in the media space, it makes sense to invest in content production capabilities; diversification into this space will help telcos gain long-term differentiation as well as improve returns from content services. In this section, Capgemini recommends what kind of content telcos should look at producing. The acquisition of content production companies is an important route for entry and Capgemini proposes how telcos can leverage acquisitions to jumpstart their content production businesses, and how they can manage integration issues.

Gradually Build a Portfolio of Own Content

Capgemini recommends that telcos with significant scale and large captive subscriber bases build a comprehensive bouquet of channels over a period, gradually relying on internal production expertise to supply content to these channels. Leading Pay TV players have over the years built a strong portfolio of channels, the scale of which telcos should strive to match. As an example, in France, most Pay TV operators heavily rely on the Canal+ wholesale packages to supply content to their Pay TV services, and France Telecom is positioning Orange TV as an alternative to popular channel bouquets.

Telcos should look at gradually relying on own production capabilities to supply content to their channels; they could start with popular content such as movies, reality TV and general entertainment, which have large audiences and are relatively cheap to produce (see Figure 10).

Figure 10: Cost of Production and Target Audiences for Select Content Genres



Source: Capgemini TME Strategy Lab Analysis; BBC and ITV Annual Reports

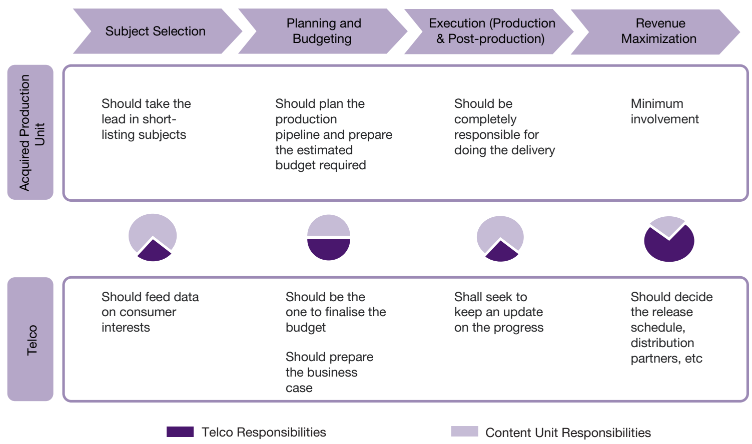
As observed earlier in the paper, movie production in Europe does not entail huge costs, and telcos should consider acquiring movie production capabilities and producing their own content for distribution through their own VoD platforms and linear channels.

Selectively Acquire Small Firms to Gain Capabilities

Acquiring existing content production houses can help telcos enter the market and scale up quickly. Telcos in Asia have made small-ticket acquisitions to slowly build content production capabilities. As an example, in March 2005, SKT bought 21.7% of IHQ[7]—producer of movies and TV programs—for €11 million while KT acquired a 51% stake in South Korea's leading movie maker, SidusFNH for € 22 million[8]. Typically, smaller production firms with valued content can be available at relatively conservative valuations and can be good acquisition targets. As an example, ITV's acquisition of 12 Yard[9] is valued at £35m, and provided the company with popular gaming content programs such as "Who Dares Wins", while its acquisition of Silverback, another content production firm, is valued at £14m[10].

The acquisition and integration of large content production businesses will entail a significant amount of challenge for telcos. Capgemini believes telcos should steer clear of large acquisitions and look at acquiring small units selectively in specific capability areas to gradually build a content production business. Telcos should maintain their content production units as separate entities and selectively acquire companies that can plug-in select capabilities. Moreover, telcos will need to clearly define the responsibilities of the content unit and the parent telco organization in each area of the content value chain (see Figure 11).

Figure 11: Management of Acquired Content Production Firms



Source: Capgemini Analysis

Telcos should provide the content unit autonomy with respect to subject selection and execution whilst providing inputs in terms of data on consumer interests; however, telcos should also continue to retain control on planning and budgeting, as well as deciding the release schedule and monetization models.

In conclusion, gaining content production capabilities will be an imperative for most large telcos looking at a long-term play in the Pay TV space. Telcos will need to consolidate their content production capabilities, preferably under a dedicated media unit whilst continuing to build new capabilities or reinforce existing ones through select acquisitions. In order to avoid risks with integration and management of content units, telcos should clearly demarcate the areas where they provide autonomy to the content unit, and retain control on key functions such as budgeting and deciding the business model.

7 IHT," Softbank warms up to buy baseball team", October 2004.
8 Company news releases.
9 Reuters, "ITV acquires 12 Yard", December 2007.
10 Guardian, "ITV buys Silverback in £14m deal", May 2008.

About the Authors

Jerome Buvat is the Global Head of the TME Strategy Lab. He has more than ten years' of experience in strategy consulting in the telecom and media sectors. He is based in London.

Kaushal Vaidya is a senior consultant in the TME Strategy Lab. His recent work includes analyzing trends in online advertising and assessing growth as well as profitability drivers of players in emerging markets. Prior to joining the Lab, Kaushal worked as a management consultant with the consulting arm of India's premier business house. He is based in Mumbai.

Varun Saxena is a senior consultant in the TME Strategy Lab. His recent work focused on advising a leading converged operator in Europe on its online advertising business. He is based in Mumbai.

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For more information contact:

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

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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