Quest for Growth in Turbulent Times

Revenue Stimulation Strategies for TME Players

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1 Abstract

TME players have recently been facing challenging conditions with slow down in growth below economic growth rates in consumer expenditure. In the US, growth in overall TME spending in real terms has declined to an average rate of 1.2% since 2000; and this is despite growth in the overall economy during this period. TME expenditure peaked in 2000, reaching about 7.5% of overall household expenditure, and since then has declined to about 7%. The impending recession is likely to only aggravate the situation further, and players will need to identify strategies that will help them weather the storm. Our analysis indicates that in the UK, the overall spend on TME in real terms is likely to stagnate at an average growth of around 0.6% over 2008-2012.

However, the aggregated numbers mask the potential growth in some TME sub-categories such as gaming or PVRs which are expected to continue growing over the next five years, but at a slower pace. The evolution of technology and emergence of new business models, such as advertising, has lowered entry barriers for players to exploit these segments and seek growth. Players such as Orange have already gone into new areas, such as movie production and gaming, to make up for decline in traditional revenue streams. Bundling across the value chain is a strategy that players can adopt to improve wallet share. Players such as Nokia and the BBC have been bundling devices with gaming, music and TV content. Developing customized offerings for consumer micro-segments can also help players maximize their market share and sustain growth.
TME players in developed markets have recently been facing challenging conditions as a consequence of the very low growth witnessed in consumers’ per capita TME expenditure. The pace of increase in TME expenditure has been slowing down, and has fallen below economic growth levels in recent years. Moreover, the impending recession is likely to only exacerbate the slowdown. Players will need to identify strategies that will help them ride the storm.

In this paper, we seek to understand the behavior of consumer expenditure in developed TME markets and its relationship with the wider economic cycle. We identify what could be growth areas for TME players in an otherwise slowing industry, and propose strategies that players could adopt to tap these pockets of growth.

TME Expenditure Compared with Overall Household Spend

TME expenditure in real terms has been declining in recent years as a percentage of household spend. It peaked in 2000, reaching about 7.5% of overall household expenditure, and since then has declined to about 7%. In the US, TME spending per capita in real terms has grown since 1984 by a CAGR of 2.9% in three distinct phases, however, this growth has been slowing down to fall to an average rate of 1.2% since 2000. This is despite growth in the overall economy during this period (see Figure 1).

Figure 1: Comparison of TME Consumer Expenditure with Overall Household Spend

Source: Capgemini TME Strategy Lab Analysis; US Bureau of Economic Analysis
There are a number of reasons that can explain this phenomenon. The growth in digital content consumption, especially from free online services, has become difficult to monetize. Competitive and regulatory pressures have resulted in a rapid decline in prices in the delivery segment, affecting overall consumer expenditure in this area. Services such as broadband and mobile, which up until now drove growth, have seen slowdown as markets peaked. Consequently, per capita consumer expenditure on TME services has slowed down in comparison with the expenditure on the overall basket of goods and services consumed.

**TME Expenditure Compared with GDP**

In order to understand the future growth prospects for TME consumer spend, we first assessed what the growth in the past has been after stripping out the effects of inflation and population growth. We compared this ‘real-terms’ TME expenditure per capita with overall economic cycles. The analysis indicates that per capita consumer spending on TME correlates significantly with the performance of the wider economy (see Figure 2).

Real-term growth in TME consumer spending has outperformed GDP during times of strong economic growth, for instance between 1993 and 1999, when TME grew at a rate of around 2-3 percentage points higher than the overall economy. There were a number of drivers that helped growth in TME spending to perform better than the GDP during the period. In particular, Internet services and mobile services registered a significant upside. In the US, expenditure on Internet services grew at a CAGR of over 50%, driven by the uptake of dial-up services, and mobile services grew at over 20% a CAGR.

On the other hand, when the overall economy declined in the two previous US recessions, TME spend followed suit and declined with the economy. In the last downturn, consumer spend took a hit on all TME areas – content, delivery and devices. Per capita spend on television sets, for instance, registered a sharp drop, to decline by 2.1% year-on-year in 2001. The music devices market witnessed a steep 21% reduction in per capita expenditure in 2001 compared with 2000, and the magazine/newspaper market experienced a sharp reduction in 2001, with around 4% year-on-year decline, after growing steadily since 1993b.

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a and b: Capgemini TME Strategy Lab analysis; US Bureau of Economic Analysis
The impending recession is only likely to aggravate the recent decline in TME spending, as consumers curtail their expenditure on telecom and media services. We have already started observing instances where consumers have shifted from high-value TME services to relatively lower-priced services in response to the unfavorable economic environment. For instance, survey results\(^1\) indicate that around 10% of consumers in the UK plan to end their pay-TV contracts and migrate to cheaper substitutes such as Freeview in the short term.

Ad-funded services are unlikely to be a source of growth for the industry, in the wake of declining consumer expenditure. A comparison of year-on-year advertising expenditure per capita with GDP reveals that, like consumers, advertising is sensitive to economic cycles. The TV advertising industry in the UK is set to decline by over 5% during 2008, and growth in online advertising is expected to slow down to a rate of 18%, compared with the robust 40% growth it enjoyed during 2007\(^2\).

The declining growths in direct consumer spend and advertising, present a formidable challenge to industry players. To sustain growth, players will need to identify growth pockets within an otherwise declining industry, and adopt measures to tap these areas effectively.

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1 Telegraph.co.uk, “Pay-TV customers to cancel contracts as credit crunch bites”, October 21, 2008.
With a view to identifying the likely growth areas, we analyzed consumer spend on the three major TME categories of content, delivery and devices, and how the expenditure in each of these categories is likely to evolve over 2008-2012.

Expected Evolution of Overall TME Consumer Expenditure
The overall spend on TME in real terms is likely to stagnate at an average growth of 0.6%, from the growth rates enjoyed over the past five years or so (see Figure 3). Our analysis indicates that delivery, which forms the most significant proportion of consumer spend on TME, is likely to register negative growth over the next few years, while the spend on devices is likely to slow down to a rate of 1.3%, from the average growth of over 5% enjoyed in the past.

TME Categories Likely to Drive Future Growth
We have seen that growth in consumer spend on TME services will decline in most categories, with the exception of content, which will continue to grow at an average annual rate of 3.5% from 2008 to 2012. However, the overall numbers mask the potential growth in some TME sub-categories, such as gaming and PVRs, which are expected to show moderate to robust growth over the next few years (see Figure 4).

Within content, gaming is likely to emerge as the key growth driver, with per capita expenditure expected to grow at 17% CAGR in real terms from 2008-2010, and grow from the current 17% to constitute about 25% of total spend on content by 2012. This growth will be driven by the increasing penetration of gaming consoles—the UK alone has an installed base of 21 million gaming consoles – as well as the growth in online gaming.
Overall TME spend is likely to stagnate

In delivery we have seen penetration of broadband reach 58% of households in the UK, while mobile penetration is over 100%. Broadband prices have declined from £70 per Mbps per month in 2002 to about £2 per Mbps\(^3\) per month. Mobile prices have eroded due to competition, and regulatory directives such as the cut in termination fees are likely to drive this even lower. The growth in devices is likely to come from gaming consoles and PVRs. The proportion of UK TV homes with a PVR is expected to rise to 35% in 2010 and up to 50% by 2013, up from just 13% at the end of 2007\(^4\).

In the next section, we turn our attention to how players can effectively tap these pockets of growth to tide the slowdown.

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\(^3\) Ofcom Communications Market Report 2008.
\(^4\) Informa Estimates from Media week, “PVR Homes in the UK”, October 2008.
4 Strategies for Growth

Convergence as an Enabler of Growth
During the previous periods of slowdown, individual areas in the TME value chain helped to provide the necessary impetus for a recovery in consumer spend. As an example, mobile services and broadband have largely helped the recovery from the last slowdown that ended in 2001-02. This time around, we believe convergence across the value chain is likely to drive growth by lowering entry barriers for players diversifying across the value chain. We define two types of convergence within the wider value chain (see Figure 5). Vertical convergence is the movement of services or players within the same element of the value chain, keeping the fundamental business model intact; for example, Vodafone’s acquisition of Tele2 to enter the fixed line business. Horizontal convergence encompasses player moves into adjacent areas of the value chain, for instance, device manufacturers such as Nokia launching content services.

The evolution of technology and emergence of new business models such as advertising, has lowered entry barriers for players to seek growth by moving horizontally across the value chain. For instance, the unshackling of the ‘closed’ mobile value chain, driven by open-source OS and devices, enables online players to directly distribute applications such as IM and location-based services to users. Similarly, the emergence of Internet TV has allowed content players to reach consumers directly.

In this section, we assess the strategies that TME players could adopt to effectively utilize the opportunities presented by the converging telecom and media industries in order to sustain growth.
Strategies for TME Players

Diversify into Content Services

Content is expected to grow faster than the device and delivery areas of the TME value chain over the next few years. The broader content market is expected to grow at a CAGR of 3.5% (in real terms) from 2008 to 2012 in the UK, compared with expected CAGRs of -0.9% and 1.3% (in real terms) for delivery and devices, respectively, over the same time period. Therefore, TME players that do not have a presence in content services should certainly examine entering this fast-growing area of the value chain.

Orange (France Telecom) has already started to tap extensively into the gaming market in France. Through its mobile portal Orange World, it offers a myriad of games on both subscription as well as on an à-la-carte basis. It has also established a presence in the MMG (Massively Multi-player Game) segment by distributing the popular game Dark Age of Camelot. Such MMGs can offer significant revenue upside as evidenced by the immensely popular World of Warcraft, which has more than 11 million users worldwide with an average monthly user spend of about $105.

Many industry players have also started making the shift towards offering other content services apart from gaming. For instance, France Telecom (FT) has evolved from a pure IPTV delivery-based operator to an integrated and differentiated player in the content space with presence across the value chain (production, aggregation and delivery). FT produces content in the form of movies6 as well as premium soccer games and offers own-branded channels7 that broadcast sporting content, movies and TV shows to support its delivery products – IPTV and Mobile TV. This shift into content has helped FT to differentiate and gain additional share of consumers’ wallets, especially through its presence in original content production that allows it to monetize the rights it fully owns.

Similarly, Belgacom has also acquired sports rights to drive subscriber growth for its IPTV platform. Asian telcos such as Reliance in India and SK Telecom in South Korea are also following the content route to drive growth. The Reliance ADA Group8 bought 71% stake in film production and processing company Adlabs for $83 million. SK Telecom bought 21.7% of IHQ, producer of movies and TV programs, for over $13 million. Content produced by iHQ is used by SK Telecom to bolster its mobile TV services.

Bundle across the Value Chain

Consumers have started to embrace bundled services. For instance, in Q1 2008, around 32% of consumers in the UK opted for ‘triple-play’ bundles of Internet, voice and TV compared with 18% in 2007. Similarly, TME players can stimulate growth by offering a bundled package of services across the value chain. In fact, many device players have already started bundling content and delivery services with their core offerings (see Figure 6).

Nokia’s CWM (Comes With Music) offer is an example of content bundled with device, however Nokia has taken a step forward with the development of its online content portal Ovi. Other device players, such as the PMP9 vendor SanDisk, have started mirroring this trend of offering bundled services.

PMPs and gaming consoles are increasingly becoming content hubs with multimedia support. For instance, BBC’s iPlayer can now be accessed over Nintendo’s Wii gaming console and BT Vision can be viewed over Microsoft’s Xbox.

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6 Orange has established a subsidiary Studio 37 to produce movies and TV content.
7 Orange Foot+, Orange Sports and Orange Cinema.
8 Reliance ADA Group owns and operates India’s second largest mobile operator, Reliance Communications.
9 Personal Media Player.
Sony also launched Go!View jointly with Sky during the summer, allowing subscribers to download TV shows onto the Sony PSP gaming console. By registering online, consumers can select monthly entertainment, comedy or sports packages for €7 each or simply rent on a pay-per-view basis with TV episodes and movies available from €2 and €3.20 onwards, respectively.

Effective Segmentation and Targeting
In order to drive growth even in difficult times, TME players should continue to pay heed to the old marketing adage of identifying superior consumer insights coupled with effective segmentation and targeting. It is likely that, even in declining markets, operators can identify customer segments that offer growth opportunities if they really understand consumer needs.

A corroboration of this theory is found in the music industry, where the value of sales declined almost 15% from £1,109 million in 2006 to £942 million in the UK10, and yet there are still certain segments where spend is growing as these users remain highly engaged with music.

Another example of an operator bucking the overall market trend of negative growth is Germany’s E-Plus (owned by KPN). E-Plus launched multiple brands, each aimed at specific usage segments and with market-leading pricing. For example, its Base brand offers heavy voice users large and unlimited voice bundles, while its Simyo brand offers users no-frills and SIM-only pre-paid plans. Its Al-Yildiz brand offers Turkish immigrants discounted calls to Turkey and no additional charges while roaming in Turkey. Its Vybe mobile service targets teenagers with cheap monthly fees, large SMS bundles and, free song downloads and web browsing on its music portal.

Effective targeting through customized offerings, as discussed above, helped E-Plus to grow service revenues by around 7-8% year-on-year11, whereas its competitors suffered from negative revenue growth (see Figure 7). This was driven by an overall increase in monthly usage from 79 minutes per subscriber in 2005 to 136 minutes.

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11 In Q1 and Q2 2008.
E-Plus also grew its market share from 13% to around 15% in the same time period, and in the first half of 2007 gained the second most net additions, 1.4 million, behind only the market leader T-Mobile. Moreover, its EBITDA margin also expanded from 22% in 2005 to around 40% in 2007. A media company that has employed segmentation and targeting very effectively is CNBC, which delivers business news through its TV channel and website. CNBC has defined its target audience as up-market men in the top 20% income bracket. Moreover, over the last few quarters, it has started to focus on shows that deal with issues that its target segment is worried about, for example, debt makeover or investment management. This has attracted eyeballs, especially during a recession when consumers need to make even more decisions about their businesses and wealth.

Advertisers have been attracted by the quality of the audience offered, because, for selling and tracking the performance of advertisements, CNBC measures only the viewers belonging to the target segment. Advertisers see this highly targeted audience with CNBC as a way to beat fragmentation in today’s TV market.

CNBC has benefited significantly from its segmentation and targeting approach as its revenues from Europe, the Middle East and Africa increased by around 39% year-on-year in H1 2008. In comparison, the European TV advertising market grew by only around 2% year-on-year in Q1-2008 and declined by around 3% year-on-year in Q2 2008. Moreover, channels such as ITV1 and Channel 4 witnessed around 10-13% decline in ad revenues over the corresponding timeframe, further driving home the success of CNBC’s segmentation strategy.

13 KPN Annual Report 2007
14 Independent on Sunday, “Amid the TV turmoil, it’s always good news at CNBC”, September 14, 2008.
In conclusion, the economic recession is likely to exacerbate the slowdown in the TME industry, adversely affecting growth prospects for players. However, all hope is not lost as convergence presents some new and exciting growth opportunities. Innovative players with agile business models and comprehensive consumer insights are likely to emerge as successful in tapping growth. The acquisition and integration of new capabilities and the adoption of new business models will remain key challenges as players seek to make difficult and expensive moves across the value chain. Players will also need to develop an exhaustive understanding of consumer requirements and behavior in order to create customized offerings and innovative bundles that can help to benefit from latent growth.
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