Changing Channels: Media's New Direction

The Long View

Investment Insights

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Changing Channels: Media's New Direction

"Change is a constant in media. But the pace of change has definitely accelerated. The technology that's now available and the infrastructure that's in place has allowed new companies to grow incredibly rapidly."

Brad Barrett, Investment Analyst

The landscape of media is undergoing a tectonic shift as the way people consume information, entertainment and even communicate with each other has been transformed by innovation and technology.

Investment analysts say it's a fascinating time for the media industry – social, mobile, digital and broadcast platforms are converging to create new opportunities to connect with global audiences. They say the future of news, entertainment and communications is under construction.

"Change is a constant in media," says investment analyst Brad Barrett. "But the pace of change has definitely accelerated. The technology that's now available and the infrastructure that's in place has allowed new companies to grow incredibly rapidly."

In essence, the race is on to provide content to consumers any way they want. "People no longer watch TV by appointment in the living room – they watch on laptops, tablets and smartphones. The mantra of the industry is, 'We want people to be able to consume media anywhere, anytime, on any device,' and we're moving in that direction," investment analyst Andrei Muresianu says.

This move to an on-demand world is being paced by a mix of changing technology, demographics and consumer tastes, investment analyst Jim Kang says.

"For two decades, content creators and pay-TV providers had a mutual interest in preserving the conventional distribution model, in which households pay $100 or more monthly for cable or satellite service," says Jim. "However, the proliferation of internet options, combined with dissatisfaction over rising pay-TV fees, has prompted consumers to look for alternatives."

The media industry may sometimes be fast changing, but that doesn't necessarily put long-term investors at a disadvantage. Sometimes, it's a case of believing in what will happen, not when.

"The pace of change has accelerated and it's hard to predict when something's going to happen," Brad says. "But because we take a long-term approach and have a high conviction in our investment thesis, short-term volatility can actually play to our strength, especially when fear is overdone, because we can watch things play out."

Take the recent concern over cord-cutting. While the headlines may sometimes indicate that millions are cutting the cord on their cable TV, that isn't quite the case.

"First, the saving grace of the business is that consumers are reluctant to cancel their traditional subscriptions for the time being because of the sheer mass of content available, their desire for that specific content, like sports, the high reliability, and how deeply television is ingrained in their lives," Brad says.

But, Brad and other analysts caution, this is no time for complacency. "Technology is disrupting many industries, perhaps none more so than media," he says.

Key Takeaways

We live in a transformational time:

- Technology and innovation have led to new business models that are disrupting the old ways.
- The race is on to provide consumers with information and entertainment any way they want, on any device, at any time.
- Companies that are poised to take advantage of these changes have the potential to reap new profits, and provide investors with opportunities that few could have imagined a decade ago.

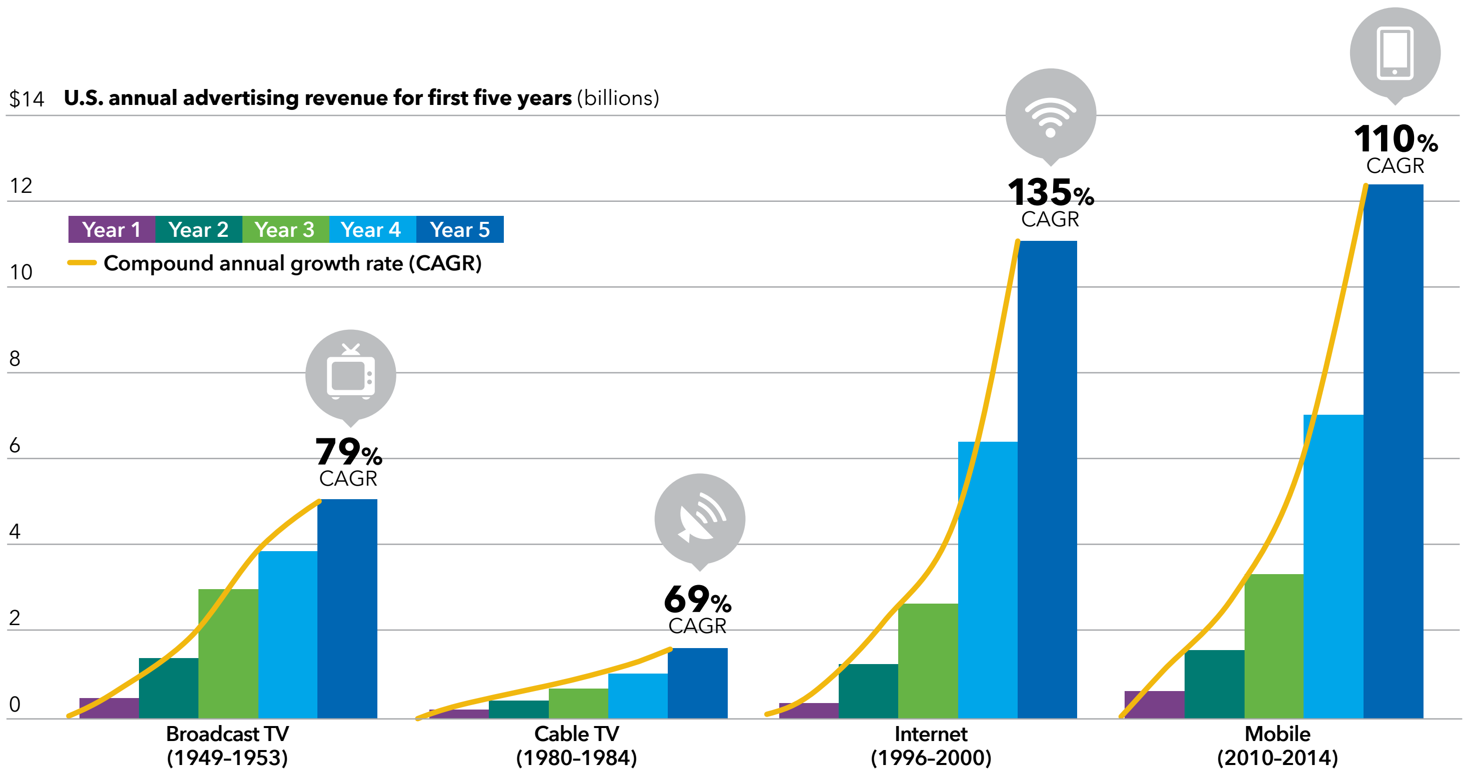
Cover: Society of Motion Picture and Television Engineers (SMPTE) Engineering Guideline EG 1-1990, used to calibrate monitors

Digital Dollars: Ad Money Didn't Waste Any Time Moving Online

Advertisers Have Flocked to the Internet and Mobile as Consumers Change Behavior

"My expectation is that newer technologies and consumption habits are going to continue to disrupt many established players."

Tim Armour, Portfolio Manager



Source: *IAB/PwC Internet Advertising Revenue Report, 2014 Full Year Results*, April 2015, © PricewaterhouseCoopers LLP (PwC). Not for further use or distribution without the permission of PwC. The data for broadcast TV, cable TV and the Internet were adjusted for inflation.

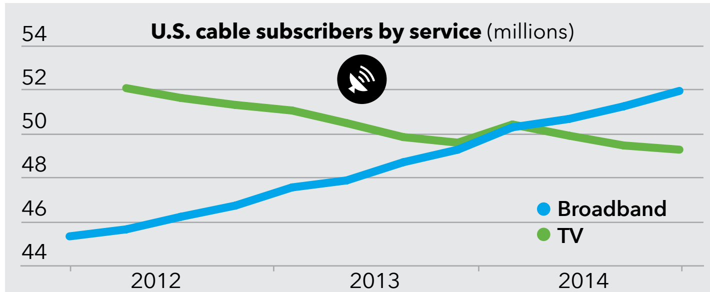
- The face of the world's media market is changing. Advertising dollars are increasingly flowing from traditional ads to digital. Increased spending on mobile, social media and digital video propelled U.S. digital advertising revenue to $49.5 billion for the full year of 2014, a 16% increase over 2013.
- Total U.S. digital ad revenue is expected to grow to about $82 billion in 2018, according to Business Insider Intelligence and the Interactive Advertising Bureau.
- Digital advertising is becoming a dominant force in the global media advertising market. Newspaper advertising revenues are declining, while radio and magazine advertising are expected to increase slightly through 2018. Worldwide, digital advertising will reach about $250 billion by 2018, rivaling TV ad revenue, according to McKinsey & Company's *Global Media Report 2014*. The report calls that possibility "a development perhaps unforeseen even 10 years ago."
- The chart shows how quickly advertisers moved to the Internet in the late 1990s and mobile this decade. Going forward, mobile is projected to be the fastest-growing advertising channel. Indeed, mobile advertising in the U.S. totaled $12.5 billion during 2014, a 76% increase from the prior year total of $7.1 billion. The huge growth of mobile ad spending is a result of advertisers "chasing eyeballs" as audiences migrate their media consumption to mobile devices.

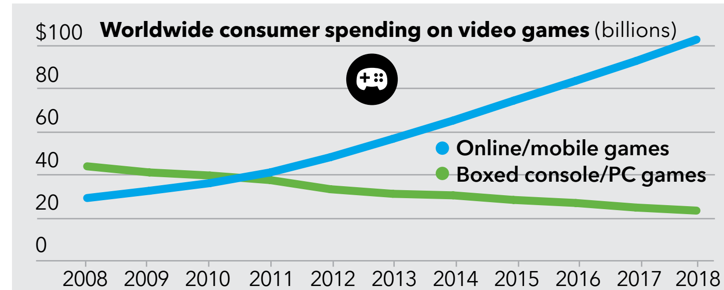
Inflection Points Abound as Consumers Embrace New Technology

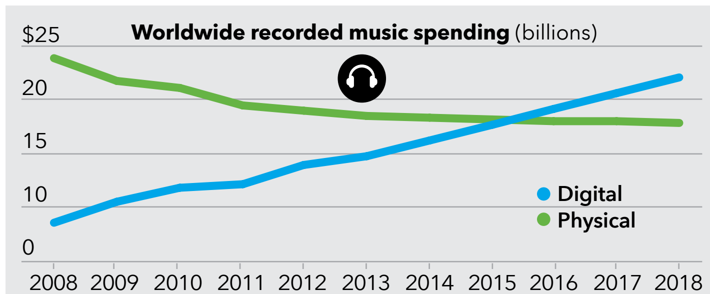
Streamers, Gamers and Cord-Cutters Are Part of the Landscape, but Not Point-and-Shoot Cameras

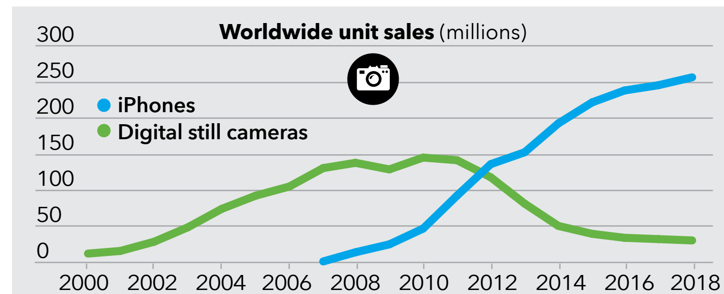
"For companies to succeed, they must prove that they are both willing and able to navigate uncharted territory. But companies with a clear vision and the ability to adjust to this new reality should produce superior results for investors over time."

Jim Kang, Investment Analyst









Sources: BI Intelligence and Leichtman Research Group (cable subscribers by service); *Global Media Report 2014*, Global Media and Entertainment Practice, © McKinsey & Company, all rights reserved, reprinted by permission (video games and recorded music spending); and International Data Corporation (digital still camera and iPhone sales). Cable subscribers by service reflect quarterly data based on select major cable providers. TV data are not available and, therefore, not shown for the first quarter of 2012. Data beyond 2014 are estimates.

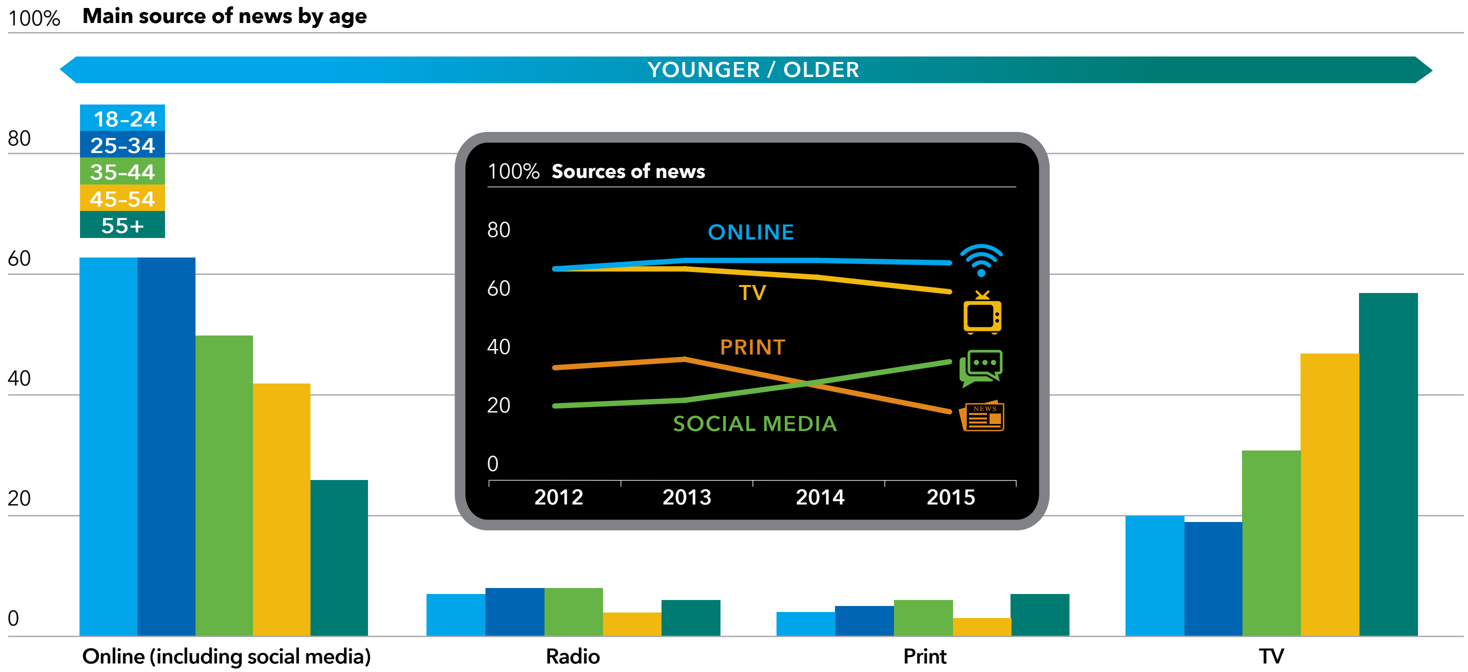
- One need not look too far these days to find an example of how innovation can transform an industry. The charts above show a remarkable array of change, some of which are still evolving. Many gamers now play on mobile devices, not consoles. Most pictures are taken on phones, and most point-and-shoot cameras have been put on the shelf. Apple's iTunes rocked the music industry, but many listeners are moving away from downloads to streaming services, another digital transformation for music.
- Cable TV may be where the signal is the shakiest. Many consumers, particularly millennials, are opting for online platforms such as Netflix, Hulu, Amazon and Apple TV over a traditional cable or satellite subscription. That, in turn, has the potential to hurt incumbent distributors and programmers. The growing unease about the pay-television ecosystem was on display earlier this year when major media companies spooked investors by raising concerns about consumers dropping their pay-TV services.
- Even so, evidence of cord-cutting – whereby households cancel their pay-TV subscriptions – is limited. A July survey by research group TDG found that 84% of Netflix subscribers used pay-TV, compared with 87% three years ago. In Europe, where most households do not pay for a cable or satellite subscription, cord-cutting is an even more distant prospect. Still, while viewers may be enjoying a golden age of television, the industry, like many others, may be in for technical difficulties.

Not Exactly a News Flash — TV's Prime Time May Have Passed

Online and Social Media Rival Television as the Main Source of News in the U.S.

"The dramatic decline in newspaper ad revenues since 2000 has to be one of the most significant and profound Schumpeterian gales of creative destruction in the last decade, maybe in a generation. And it's not even close to being over."

Mark J. Perry, Economist, University of Michigan



Source: University of Oxford, Reuters Institute for the Study of Journalism, *Reuters Institute Digital News Report 2015*. Data from YouGov are based on an online survey conducted in 12 countries, including the U.S., at the end of January/ beginning of February 2015. The total sample size was 23,557 adults, approximately 2,000 per country, with access to the Internet. Respondents were screened out if they had not accessed news in a month. Data for sources of news for 2014 were estimated.

- How people consume news has undergone a sea change. More people now get their news from digital sources than they do from either print newspapers or the radio, and digital is starting to make a move on TV as the dominant place people go for news.

- Indeed, while TV news still has millions of viewers, the medium may be losing its hold on the next generation of news consumers. In the U.S., about two-thirds of those 18 to 34 years old say they get most of their news online.

- The rise in digital news consumption is largely attributable to technology that made new businesses possible, which changed people's behavior. Technology enabled social media sites, such as Facebook and Twitter, where many people now get their news. The proliferation of connected devices has also enhanced consumers' ability to choose how, when and where they access news, films, music and books. The shift has far-reaching consequences for media groups as they struggle to adapt to changing habits.

- What happened to reading the paper? The chart shows that every age group has largely abandoned the paper, even the oldest surveyed. Digitalization has been catastrophic for papers. It took a half century for annual newspaper print ad revenue to gradually increase from $20 billion in 1950 (adjusted for inflation in 2014 dollars) to $67 billion in 2000, and then it took only 12 years to go from $65.8 billion in ad revenues back to less than $20 billion in 2012, before falling even further in 2013 and 2014.

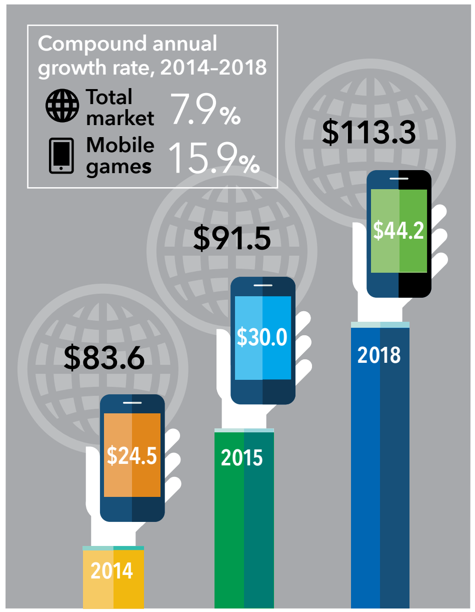
Going Mobile: The Serious Business of Playing Games

With Sales About to Exceed $100 Billion a Year, Video Games Are Hardly Kid Stuff

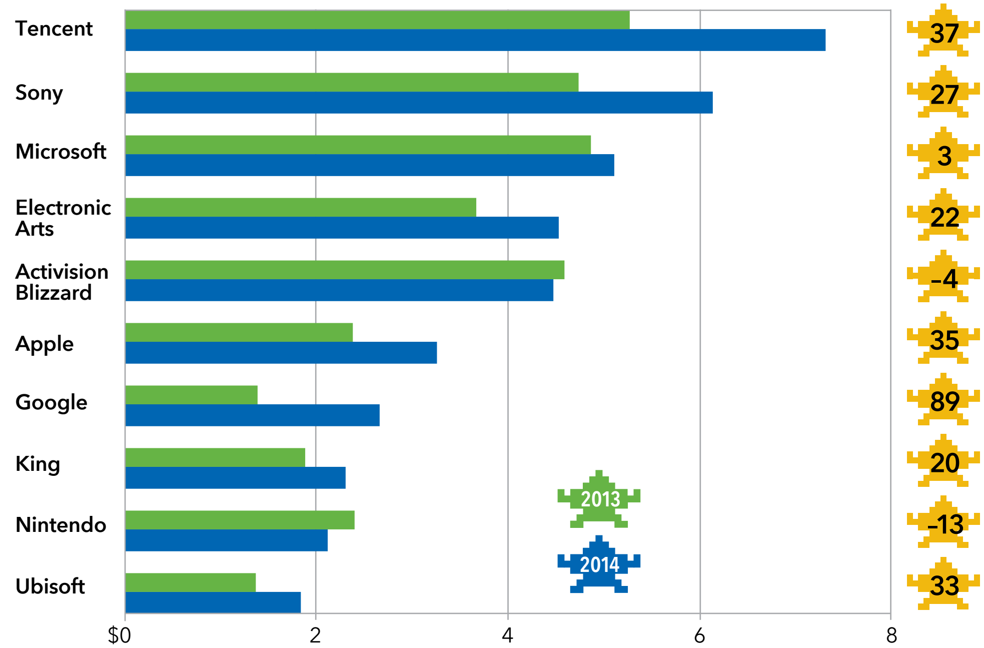
“The unique capabilities of smartphones are allowing for new user experiences and new value creation.”

Brad Barrett, Investment Analyst

Global games market revenues (billions)



Top 10 public companies by game revenues (billions) **Year-over-year growth** (%)



Source: Newzoo, *Newzoo Global Games Market Report Premium*, April 2015 quarterly update. The global games market represents revenues for entertainment (television), floating (tablet or handheld console), computer and personal (mobile) screens. Mobile represents personal and floating screens, not including handheld consoles. Data for 2015 and 2018 are estimates. The top 10 companies are based on US GAAP (Generally Accepted Accounting Principles) revenues and IFRS (International Financial Reporting Standards) for Tencent. Data for 2013 and 2014 are based on December 31 exchange rates for each year. Revenues for Sony, Microsoft, Apple and Google are estimates using quarterly earnings reports in which game revenues are not specifically segmented out.

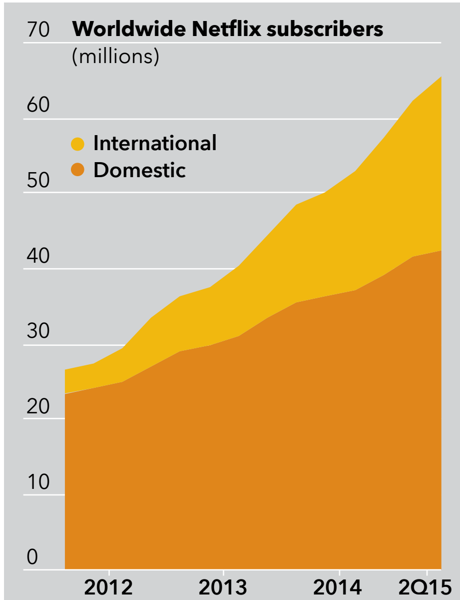
- In 2013, Grand Theft Auto V became the fastest-selling entertainment product of all time, with sales of $1 billion in just three days. That probably disabused most people of the notion that video games were kid stuff. If more evidence is needed, in 2014, global sales of video games topped $83 billion, or more than double the $36 billion global box office for movies. Worldwide, video game sales are expected to reach $113 billion in 2018. The video game industry has become a global phenomenon.
- Once played largely on consoles, video games have escaped the living room. Today, mobile devices, largely smartphones, are fueling the industry’s growth. Smartphones may be used for everything from Facebook to boarding passes, but from Candy Crush Saga to Clash of Clans, what they mostly do is let people play games. Sales of video games for mobile devices are expected to rise from $30 billion this year to $44 billion in 2018, accounting for 39% of the global game market.
- The top market for gaming is China, where an estimated $22 billion will be spent on video games this year. In the U.S., about $20 billion will be spent on games. According to researchers at the Entertainment Software Association, 155 million Americans play video games. The average game player is 35 years old. Only 26% of game players are under 18. Women 18 or older account for 33% of the game-playing population, while boys 18 or younger account for only 15% of game players.

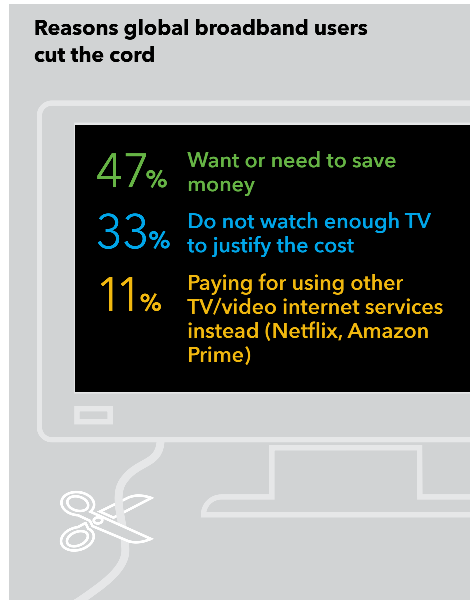
Has Streaming Turned Cable TV Into a House of Cards?

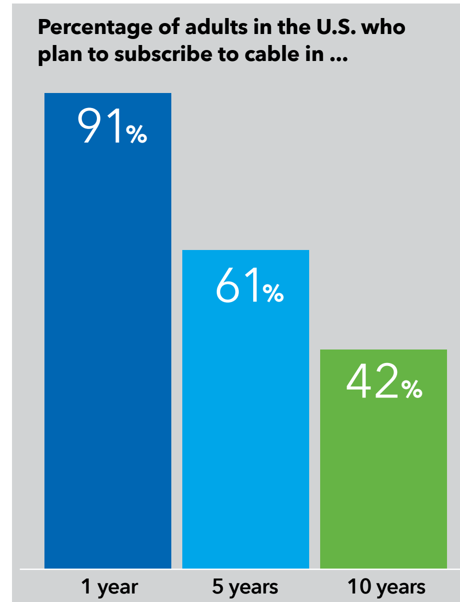
Netflix and Others Have Redefined TV, but Consumers Are Reluctant to Cut the Cord

"Netflix is a proxy for the disruption of the status quo."

Andrei Muresianu, Investment Analyst







Sources: Netflix (Netflix subscribers), Ericsson *ConsumerLab TV & Media 2015* report (reasons users cut the cord), PricewaterhouseCoopers LLP and BAV Consulting 2014 (adults planning to subscribe to cable), and BI Intelligence (all charts). The percentage of broadband household users who have cut traditional TV service is based on weekly viewers, between the ages of 16 and 59, of video/TV in 20 markets. The percentage of consumers who plan to subscribe to cable is based on a survey of 1,024 adults between the ages of 18 and 59.

- Netflix can seem like a juggernaut. The company recently reported that it had 65.6 million subscribers at the end of the second quarter of 2015. Of those, 42 million are in the U.S. and another 23 million are international. The company expanded to New Zealand and Australia in March, and will offer its streaming service in Japan, Spain, Italy and Portugal later this year. Netflix predicted it would have 69 million subscribers by the end of the third quarter. The company hopes to introduce service in China next year.

- The popularity of Netflix, Hulu, YouTube and other services that stream content over the Internet has raised a number of questions about the viability of traditional cable TV. Indeed, cable, satellite and telecom pay-TV companies lost more than 600,000 subscribers during the second quarter of 2015, their worst three-month period ever. Despite the losses, the number of pay-TV subscribing homes and businesses remains at 100.4 million, with 83% of homes still connected.

- Some consumers have not cut the cord and fully substituted cable TV with streamed TV because certain popular content, such as local news, sports or reality TV, have limited availability online. Still, ratings are down by double digits at many of the top cable channels due largely to increased competition from the broadcast networks and the growing adoption of streaming services. Innovation and technology have disrupted TV, and viewers may be on the verge of changing channels.

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