INFERENTIAL FOCUS

BRIEFING

IF 3405 March 8, 2013

THE GREAT RESTRUCTURING COMES TO VIDEO DISTRIBUTION

We're all just a moment away from commodity hell.

– Jeffrey Immelt, CEO, GE

CONTEXT & DYNAMICS

Providing video to customers *when they want it, where they want it and how they want it has gotten easier lately. Low barriers of entry, the ease of duplicating distribution systems online and individualized distribution capabilities are making it feasible for more and more potential providers to enter the overall market, making for a proliferation of competitors who are challenging cable's hegemony and even the industry's basic business model. Welcome to the era of Great Restructuring as it sweeps into the video-distribution industry! Hanging on to margins in a period of proliferating distributors increasingly depends on having or creating original or exclusive content – and so far, three tactics for exploiting unique content have emerged. We call them: Secure Supply, Market Store Brands and Develop Verticality. Big piles of money are facing off against new styles of delivery – this would make a good reality show.*

OPPORTUNITIES

- *Content providers*
- *Writers and other creative workers*
- *Advertisers who get in early with a new system*
- *Sports franchises and high-profile special-events producers*
- *Providers of production equipment*
- *Providers of cross-platform program guides*

RISKS

- *Too many choices disaggregate viewership*
- *Rising content costs turn off viewers and advertisers*
- *Young viewers opt out or never subscribe to cable*
- *Premium channels get bypassed*
- *Set-top box makers lose markets*
- *Content costs rise sufficiently to squeeze distributors' margins*

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More of the Same, or What?

Despite obfuscating public-relations campaigns and highly touted celebrity secrets, the entertainment industry can be very transparent. When it feels really threatened, it files lawsuits, as, for instance, the music industry did in great abundance when file sharing started to unravel the music industry's production and distribution model. So this item recently caught our eye:

◆ Cablevision filed a lawsuit in federal court charging Viacom with unfairly marketing to the cable distributors by bundling channels, forcing the carrier to pay for "14 lesser-watched ancillary networks its customers do not want." (*Reuters*, 2/26/13; *Hollywood Reporter*, 2/26/13)

"I'm not motivated by profit, Henderson—I'm motivated by excessive profit."

Surely, Cablevision realized, that should it be successful in its suit, in short order its own cable subscribers would file suits using the same argument against Cablevision itself for bundling (or "tiering," as cable companies prefer) its channels and forcing customers to pay for channels they "do not want." Something must be happening that is very challenging for video distributors.

Ignoring such a risk suggests that the cable giant is really concerned about its market. Perhaps the bundling issue is important from the point of view of cluttering the cable line-up with too many unwatched channels. But more likely, Cablevision is getting concerned about the steady proliferation of real-world competitors in the area of video distribution – a rare concern for a company that once enjoyed status as an authorized monopoly – and the proliferation is prompting the company to think about ways to trim costs.

The New Industrial Revolution Plays Out

What we have dubbed the New Industrial Revolution (NIR) is the large force driving market shifts in video distribution. The NIR outlines how owners of the means of production capabilities gained marketplace leverage (the original Industrial Revolution), but then how they lost that position to the marketers, who, in turn, lost that leverage to the consumers (the NIR). The critical part of that pathway of leverage transference started when producers, who had been concentrated in highly developed countries, began surfacing worldwide, and the proliferation of production capacity lowered the cost of production but also lowered the value of each producer. That moved marketplace leverage to distributors or marketers, who could play one producer against another for price advantage. But then, with the Internet, the number of marketers and distributors proliferated, lowering the prices they could charge and lowering their value as well. That transferred marketplace leverage to consumers, who could play one marketer against another for price advantage. Such a shift has left a trail of troubled companies and industries that have had to rethink their operations, sell themselves at a loss or, in the worst case, go broke (see "The Playing out of the 'New' Industrial Revolution, Part III: Turmoil Rules, Dude," **IF 2107**, 3/31/00).

> The video-distribution industry is going through the phase wherein the number of players is increasing rapidly and customers are learning how to play one video provider against another for price.

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The video-distribution industry is going through the phase wherein the number of players is increasing rapidly and customers are learning how to play one video provider (multiple online sources, cable, over-the-air, satellite) against another for price...and ease and convenience and variety and, most important, control. One result of that last item is "binge viewing," a change in consumer behavior made possible by the availability of whole seasons of television shows on DVDs or streamed online. Some viewers will hold marathon viewing nights and even watch an entire season in one sitting. Consumers no longer need to watch a show at a given time or even record it to watch later. They can binge on a show's entire season and not have to wait for next week's episode to learn what has happened, say, to-the-manor-born gang at *Downton Abbey*. That is viewer control. (*New York Times*, 2/1/13)

"WELL, SO MUCH FOR HIBERNATION!"

Consumer behavior is changing because of new capabilities, more distributors are surfacing because of the needs of these new consumers, and some of these distributors are creating new content because they know uniqueness will do them well in the new crowded marketplace.

Amazon – This online retailer provides video streaming through its subscription service, Amazon Prime. The company recently gave a production go-ahead for 11 original programs, for which the online channel will be the sole distributor. (*Internet Retailer*, 2/27/13)

Netflix – The well-known renter and streamer of movies and television shows has become a producer of original programming, recently streaming its first such program, a 13-part series called *House of Cards*, starring Kevin Spacey and directed by movie veteran David Fincher. Netflix saw its subscription tallies jump by 2 million in the fourth quarter, due, in part, to the extensive publicity the 13-part series received. Netflix, which now has 27 million subscribers for its streaming service, has announced production of five more series for 2013. (*Wired*, 2/1/13)

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Yahoo! – This online portal is now delivering original video productions. Its first original-content series, *Burning Love*, which satirizes ABC's *The Bachelor*, attracted 11 million unique visitors in its first season and has been renewed for 2 more seasons. (*Adweek*, 2/4/13)

YouTube – This ongoing video competitor for the consumer's attention operates 100 channels of original (and increasingly formatted) programming, which it distributes on a subscription basis. Currently, the most watched channel on YouTube, *Smosh,* features two young males acting, well, like young males and has 7.9 million subscribers. The channel produced upwards of $10 million in revenues from advertising, merchandising and iTunes downloads over the past 12 months. The *Smosh* duos' success has led to their expanding to five channels with a total of 157 million viewers. To keep these kinds of success stories coming, YouTube has opened production studios in Tokyo, Los Angeles, New York City and London to help raw talent generate quality programs to fill its channels. To ensure quality in these new productions, YouTube provides funding, as it did for LookTV, which secured $5 million of such funding to develop an all-fashion channel. Recognizing the value of online video distribution, News Corp., owner of Fox networks, recently took an unspecified stake in one YouTube channel, *Wigs*, which is aimed at female viewers. (*Bloomberg BusinessWeek*, 3/4/13; *Forbes*, 2/11/13; *Entertainment Weekly*, 3/8/13; *Women's Wear Daily*, 2/6/13; *Variety,* 2/20/13)

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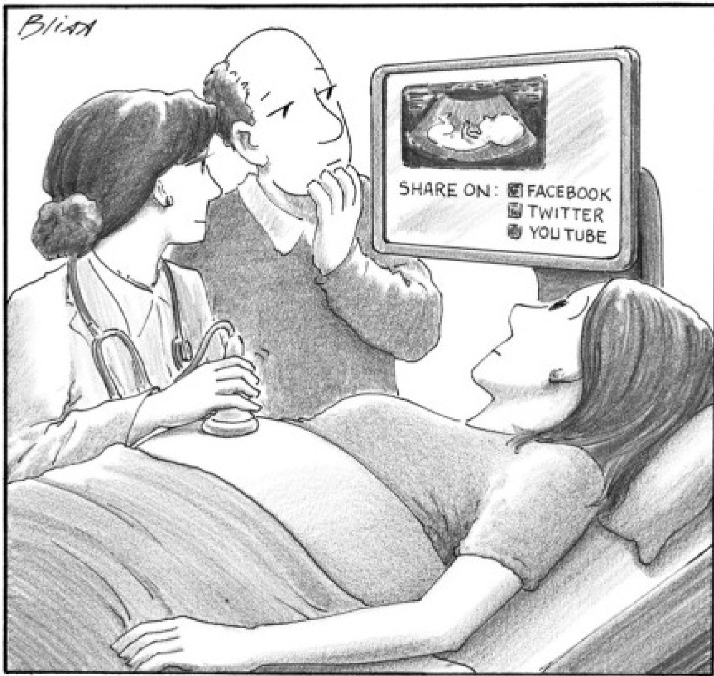


These are all online distributors who have upped their game by creating new and original programming or by greatly expanding how they secure content. Structurally, cable has other kinds of competitors.

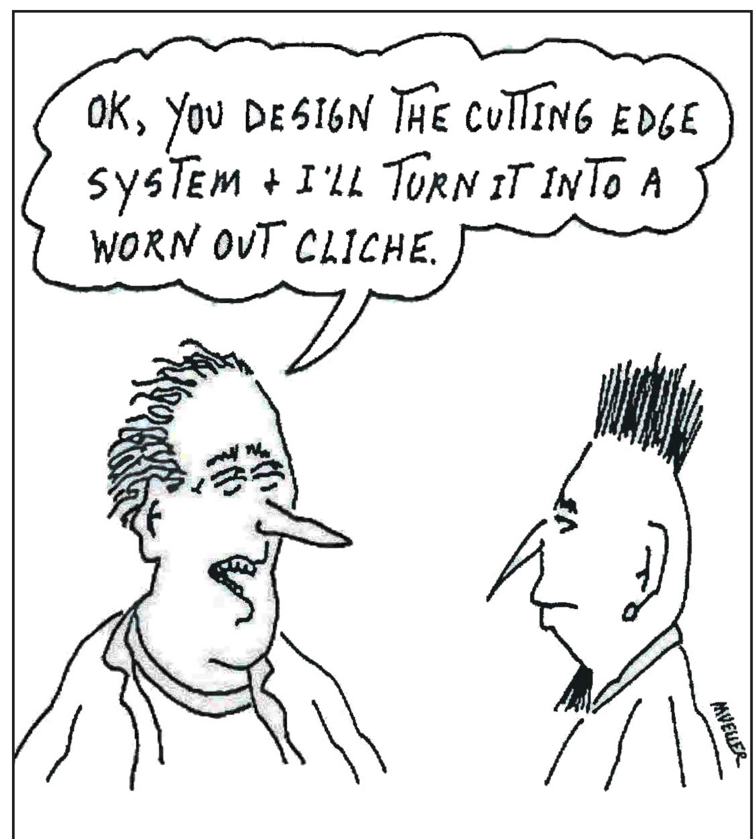
◆ Intel announced that it is working with Apple, Netflix and Google to create a new video-distribution network that will be able to deliver live television, on-demand programming and streaming video, while also supporting most apps – which is to say, the network will be platform agnostic. This broadband-based service will come over a new kind of set-top box that will "get to know" the user and suggest appropriate programs from any and all available sources, including online and television programming as well as movie and television streaming options. (*Los Angeles Times*, 2/12/13; *Multichannel News*, 2/18/13)

◆ Microsoft announced plans to exploit the Xbox platform and provide original programming that will include real-time interactivity between viewers and on-screen shows. Programming will come from Microsoft's new Xbox Entertainment Studios in Los Angeles and will be sent to the more than 76 million owners of the Xbox as well as the 24 million owners of Kinect sensors. Microsoft already has a sizable 46 million subscribers to Xbox Live, its online video service. (*CNet*, 3/4/13)

◆ Tesco, the British grocery chain, is offering its "loyal customers" (*i.e.*, holders of the company's ClubCard) a television- and film-streaming service for free. The service runs over technology provided by blinkbox, which is 80 percent owned by Tesco, and streams popular movies and television shows. It will soon have its own competitor in Sainsbury, another British grocery chain, which announced that it, too, would be offering its customers a video-on-demand service. (*Telegraph*, 2/11/13)

As the New Industrial Revolution has shown in numerous industries, a proliferation of distributors challenges the value of all distributors.

While cable companies hardly have to worry about grocery stores stealing away a vast majority of their subscribers, they should realize that Tesco's service demonstrates just how easy and efficient it is to start offering a parallel service. These services are free and are being provided by companies in an industry not known for large profit margins. The low barrier to entry in the distribution arena suggests that any number of such alternatives could surface in the future, provided content costs do not become prohibitive. As the New Industrial Revolution has shown in numerous industries, a proliferation of distributors challenges the value of all distributors (see "The End of Video Distribution As We Know It," **IF 3001**, 1/28/09, and "Stay Tuned…Please: Challenges to Television's Industrial Structure," **IF 3204**, 2/14/11).



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Content – The Near-Term Answer

The proliferation of distributors nudges everyone toward commodity status, thereby forcing the increasing number of providers to scramble for ways to make their service more attractive than others.

At present, the tool of choice in this competition has become content. We have noticed a few intriguing tactics in this new battle for content and have identified an analogy from another industry for each tactic, a way to suggest that what the video-distribution industry is going through today is an experience other industries have already faced.

Secure Supply – The analogy for this situation is the natural-gas industry. For years, the gas suppliers who had access to or ownership of the pipelines controlled the market. But as we have noted, a more efficient spot market has developed because of the availability and portability of liquid natural gas, thereby challenging the power of the pipeline powerhouses. Also, former natural-gas customers have become natural-gas producers. The defensive strategy in this industry is to own or develop supply.

And so it is here, but in the video-distribution arena, content is the valuable supply to be secured. Unlike the recent value of natural gas which is becoming plentiful, content – at present, in somewhat limited supply – is becoming more valuable...for now. Comcast just paid a reported $20 billion to secure access to Disney channels and programs for the next 10 years. Also, Comcast dropped another $16.7 billion to purchase the portion of NBCUniversal that it did not already own. Evidently, Comcast, which, under conditions in the original deal, had the right to purchase the remaining portion of NBCUniversal in 2018, must have realized that the market value of content was going nowhere but up in the next few years and decided to buy it now. Netflix also inked a deal with Disney, gaining the exclusive rights to stream Disney's new releases, including those from Pixar and Marvel Studios, starting in 2016. HBO responded to that signing with an exclusive deal with Universal Pictures for sole permission to stream Universal movies for the next 10 years. Meanwhile, Amazon announced a deal to be the sole subscription-based video-streaming provider of the very popular television program *Downton Abbey*. At the same time, Amazon Prime, which streams content to subscribers and has 140,000 movies and television shows in its archive, signed a deal with CBS that will bring shows such as *America's Next Top Model* and *Everybody Loves Raymond* to subscribers. Also, Microsoft recently premiered a new movie, *Pulp*, a first for Xbox Live, which streams thousands of formerly released movies but which has never been the premier distributor. (*Houston Chronicle*, 2/13/13; *The Week*, 1/8/13; *Wired*, 2/1/13; *CNet*, 3/4/13)

INSTEAD OF READING PROUST...

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YOU'RE LOOKING AT A CARTOON CAT

Market Store Brands – Retail provides an analogy for this situation. When the number of distributors or retailers began to increase, retailers looked for ways to secure unique products that could not be purchased at any of the other retailers, and they landed on store brands.

Video distributors are doing the same thing. In April, DirecTV, the satellite-based video distributor, will begin beaming its first original program, *Rogue*; Netflix will be streaming its next original series, *Arrested Development* (based on the former Fox series), in May; Amazon will be sending out pilots for six comedy series and five children's shows (comprising the 11 shows mentioned earlier) to its subscribers and asking them to decide which pilots the company should convert into season-long series. Also, Microsoft hired the former president of CBS to oversee new productions for distribution solely to Xbox owners and subscribers. (*New York Times*, 3/5/13)

These companies are trying to find unique programming that can be seen only on their distribution networks as a means to attract more subscribers or, in models dependent on advertising, more viewers, who will, in turn, attract advertisers. But producing one's own programming is not necessarily cheap. *House of Cards*, for instance, cost Netflix roughly $3.8 million per "chapter," nearly double what hour-long television shows typically cost. (*Wired*, 2/1/13; *Ars Technica*, 2/1/13)

That said, Netflix seems to be moving toward more production. It paid $2.6 billion to buy rights for content

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distribution in 2012 but has dropped that number to $2 billion for 2013. Meanwhile, it has increased its budget for production of original content to $100 million, after the success of *House of Cards*, which cost less than $50 million to produce. (*Bloomberg BusinessWeek*, 2/14/13)

"Not bad, fellas. Let's do one more take, with more emphasis on tone, harmony, melody, rhythm, composition, lyrics, musicianship, tempo, and originality."

Develop Verticality – The analogy for this intriguing tactic is the movie industry, whose studios started as a production industry but soon spread out to own the movie theaters that displayed the movies produced in the studios. As a result, studios had the talent under long-term contracts, owned production facilities and controlled most first-run movie theaters. They were producer and distributor...until the courts broke that apart in 1949.

While these emerging distributor-producer combinations cited earlier might never own all the talent, per se, they are, nonetheless, working their way backward from being first a distributor and then a producer. Each company seems to have its own marketing tactic to gain momentum in its verticalization. For example, Netflix and YouTube claim they grant complete artistic freedom to those making the programs, a way to lure talent away from traditional producers. YouTube (Google), Intel and others claim to have deep pockets to support artists and keep programming going. Microsoft and Amazon claim to have built-in, guaranteed audiences. And so on. What they all have in common is a need to attract attention to their new offerings, to expand their audiences and to lure talent and revenues away from traditional outlets.

"I'm on to your little game, Harrison!"

So What?

If nothing else, the proliferation of distributors is providing a hiring boost to those who make videos. This is an attractive time to be graduating from film or television school. More specifically, it is a good time to be a writer or someone who creates stories. The irony of the great online success of Netflix's *House of Cards* is that the story for the Netflix product started as a novel in traditional hardcover form and was produced and marketed by an old-school publishing house. The more things change, etc., etc. (*Wired*, 2/1/13)

For the wider video-distribution industry, the eventual consequences of this latest challenge to cable hegemony are likely to be slow in developing but substantial in effect. Tesco's streaming-video channel shows how easy and relatively inexpensive it has become to start a system to deliver video content to customers. Netflix, Amazon, YouTube and others are showing that they can easily replicate traditional sources of video production, capabilities once thought to be beyond the means of anyone but well-funded studios. Intel and Microsoft are demonstrating that the cable model with its embedded equipment can easily be duplicated, and with new

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audio and video technologies feeding their systems, online models now suffer much less from a quality deficit in image and sound. Meanwhile, services such as HBO Go and Max Go suggest that, should markets shift sufficiently, highly successful cable-based channels could start going straight to consumers, although HBO president Eric Kessler insists the "economics today don't support this." Yet interestingly enough, HBO started just such a stand-alone operation (no cable subscription necessary) in Scandinavia. For TimeWarner, which owns HBO, going abroad for the stand-alone service might make sense. What makes internationalization seem wise is the fact that HBO has 26 million subscribers in the U.S., but a considerable 60 million international subscribers. This could signal a shift in the business model, a willingness to unbundle channels to compete directly with streaming distributors on an international basis as well as domestically. (*Bloomberg*, 2/11/13; *The Week*, 1/8/13)

As a result of these kinds of pressures, Cablevision is suing Viacom for channel bundling, hinting that even if cable companies are pulling down loads of cash right now, they see real risks ahead and want to lower their costs to halt the slow erosion of their subscription base. Cable prices, on average, increased 68 percent in the past decade. Another decade of that kind of increase would not sit kindly with consumers and, consequently, would be highly beneficial to the online networks and channels now taking shape.

The significant numbers of one-off challengers to video distributors that continue to surface and offer a narrow but appealing product suggest that cable systems might feel pressure to adopt an *à la carte* system. Recently, Suddenlink, the eleventh-largest cable company in the country, got into a tussle with Fox Networks over channel bundling. Suddenlink suggested that News Corp. put an individual price on each channel it supplied and let customers pick the ones they want. Although Fox refused the offer, it was only four hours later that the two announced an agreement in principle. Networks might fear the disaggregation of their offerings, but cable companies might fear subscriber loss even more. Which fear will prevail going forward will be determined by the extent to which cable alternatives succeed in aggregating more and more followers. (*New York Times*, 1/6/13)

Comcast has claimed that the fourth quarter of last year was the company's best quarter in five years in terms of customer retention: It lost only 7,000 subscribers. That is, losing fewer customers is the best the company has done in five years. Of course, that still leaves the cable giant with a hefty 22 million subscribers, but losing customers as a positive outcome is hardly a sustainable model. (*Houston Chronicle*, 2/13/13)

Success in this industry will likely result from providing the most engaging (and exclusive) content, at the best price, to as many devices as possible. The New Industrial Revolution, as it spreads across the video-distribution industry, is putting great power in the hands of consumers – as it has done in numerous industries over the years – and is making it possible for producers to bypass traditional distributors and send their products directly to consumers. Last year, advertisers spent $2.93 billion to place ads on streaming video content, an increase of 46 percent. That kind of support will only increase the capabilities of online distributors. (*Wired*, 3/1/13)

These kinds of market shifts are eventually going to:

(1) challenge the content-bundling model and steady pattern of price increases for distributors (as market shifts have been doing to the natural-gas industry);

(2) create a wide variety of new content and expanded delivery choices (as market shifts have been doing to the retail industry); and

(3) give rise to new models that challenge existing industry monopolies (as market shifts have done to the movie industry).

"All in favor of ditching the suits and forming a rock band say aye."

Already, cable is in a position to develop an *à la carte* menu or even lower its prices because it can then increase the price of its broadband service. Such a shift is just part of the restructuring that is likely to take place in the months and years ahead. In short, the Great Restructuring, driven by the realities of the New Industial Revolution as it plays out, has come to video distribution.

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