

# THE FUTURE OF TELEVISION

## WHERE THE US INDUSTRY IS HEADING

By Frank Arthofer and John Rose

**T**HE DIGITAL DISRUPTION OF the US television industry is at hand. Streaming video is changing every existing relationship in the TV value chain. The very neat and structured relationships of the past—with studios and rights holders relying on broadcast and cable networks to air their content, and networks relying on pay TV distributors to deliver their content into people's homes—are no longer intact. Powerful digital attackers (among them Amazon, Apple, and Google) are emerging from outside the traditional TV ecosystem, and they are armed with fundamentally different business models and motivations to engage with consumers via video services.

Many in the industry continue to believe that the TV industry will evolve with no major disruptions to existing relationships and with little shift in share.

Our view of the future of television is quite different. (See *The Digital Revolution Is Disrupting the TV Industry*, BCG Focus, March 2016.) The disruption of the TV industry is coming, and—as we've seen in other media

industries—it will be deeply rooted in the changing role of distribution as a critical driver of value. As the industry shifts from a model based on incentives that are aligned across the value chain to one in which disintermediation is not only possible but probable, the stakes are higher than ever. Already, some companies formerly bound to a specific industry function—content creation, aggregation, or distribution—are now filling all three roles at once.

Media companies need to strategically reinvent their portfolios to get ahead of the massive shifts happening across the industry. To stay competitive in the digital era, it is important to understand how the online ecosystem has changed three fundamental components of the television industry: consumer services, advertising, and content development and distribution.

### Changes in Consumer Services

For many years, streaming video didn't threaten traditional TV: the files involved were extremely large, and they required

significant bandwidth and network capacity. But the network has caught up, and the infrastructure needed to deliver long-form and live linear television content online to mass audiences is in place. Now that the streaming-video infrastructure (both landline and mobile) has matured, traditional TV distribution is at risk.

**Digital OTT companies are gaining ground.** Netflix, Hulu, Amazon Prime Video, and other Internet-based digital over-the-top (OTT) players have matured rapidly—and they’re stealing a meaningful share of business from traditional cable and satellite TV companies. We expect OTT to grow from approximately 10% of total US video industry value capture in 2014 to 20% by 2018, a percentage that represents more than \$30 billion in revenues. With more than a hundred ad-free, subscription-based OTT services operating in the US, the race is on to win those dollars.

Ad-supported OTT business models are making big bets, too. The National Football League has agreed to a \$10 million (approximately) deal with Twitter that enables the social media site to live-stream ten *Thursday Night Football* games. Although not large by TV industry standards, the deal illustrates the changing landscape with regard to how content reaches consumers. By experimenting with new media, technologies, and distribution models, companies are looking to expand digital engagement while circumventing traditional distribution partners.

**Cord cutters and cord nevers are increasingly prevalent.** US viewers spend more than four hours per day watching TV—with average monthly bills of \$75. These prices, which have grown steadily since the early days of pay TV, have fed various contributors: content creators, networks, cable companies, satellite operators, and telcos. But US consumers are dropping pay TV (or not subscribing in the first place) in larger numbers than ever before. In the fourth quarter of 2015, 13.7 million US households had broadband but no pay TV service, up from 9.8 million in the first quarter of 2013. In addition, consumers are actively thinning the services they buy from multichannel-

video-programming distributors (MVPDs). These changes are not solely a result of sensitivity to rising prices; rather, the price-to-value ratio has depreciated. The price of pay TV continues to climb, while inexpensive (or free) alternatives to pay TV have proliferated, tempting viewers to find better value elsewhere.

**Broadcast-tier (extra-cost) and skinny-bundle offerings are creating tension between cable networks and MVPDs.** In the latest round of distribution deals, many cable networks negotiated for higher rates in exchange for, among other things, lower penetration floors. As a result, where networks may previously have required MVPDs to distribute their content to 90% of all subscribers, the newer deals have lowered the floor to 75% or 80% in some cases. Consequently, MVPDs have gained the freedom to market a series of lower-priced, pared-down services to attract price-conscious consumers who can’t stomach payments of \$75 plus per month for 200 channels. (See Exhibit 1.)

Skinny bundles (scaled-down selections of pay TV channels) are margin neutral for MVPDs, compared with the traditional expanded basic package, and already more than 15% of subscribers at one major US distributor have signed up for skinny bundles. This trend is creating friction between MVPDs and cable networks. Skinny bundles often exclude the priciest networks, and consumers have adopted them faster than the networks anticipated. For cable networks locked out of bundles, subscriber losses are neutralizing the higher rates they negotiated.

**MVPDs have begun dropping top-tier cable networks.** MVPDs are taking a calculated risk in dropping certain cable networks when those networks’ value as a source of subscriber acquisition and retention ceases to outweigh the cost of carrying them. This tactic affects not only low-performing, independent networks, but also marquee network groups. When two MVPDs recently dropped Viacom, for example, they suffered limited video subscriber losses, maintained broadband subscriber levels, and increased near-term earnings before interest,

## EXHIBIT 1 | MVPDs Are Offering Cheaper Packages to Attract Price-Sensitive Consumers

	TRADITIONAL PACKAGE		CHEAPER OPTIONS	
	Expanded basic	Skinny bundles	Broadcast + OTT	OTT only
Video offering	Typically, 100+ channels with multiple tiers	45+ channels (only the most popular cable channels)	10–20 channels (no cable)	20–45+ channels (the most popular cable channels with add-on)
Other offering	N/A	N/A	Often bundled with Internet	N/A
Subscription rate (per month) <sup>1</sup>	\$49.99–\$100+	\$39.95	\$20–\$49.99	\$20–\$50
Provider example	Time Warner Cable AT&T Comcast Dish	Comcast	Time Warner Cable Verizon Fios	Sling Television
Subscription base (2015 Q3)	Majority of 90 million MVPDs, but declining	Comcast Digital Economy: ~2 million	Time Warner Cable Starter: ~1 million Verizon Fios Local: ~0.5 million	Nascent adoption (<0.5 million)

**Sources:** Company websites; BCG analysis.

**Note:** OTT = over-the-top digital.

<sup>1</sup>Certain packages quote only the first 12 months of pricing.

tax, depreciation and amortization. This is a new dynamic in the industry, and one that creates significant tension between cable networks and MVPDs. Within the fixed cable bundle, economics and incentives aligned fully. If the cable company thrived, the entire spectrum of networks thrived along with it. But now MVPDs have an economic incentive to drop costly networks—and because of their concentration within the industry, they have the power to do so. In the US, four MVPDs control 80% of distribution, with a regional monopoly in broadband, whereas six cable networks share 70% of the market and five studios share approximately 65%.

**“Digital MVPDs” are emerging.** Cable, satellite, and telecom operators have long had an iron grip on the major networks and live programming, and they relegated streaming video to serving people who wanted to do catch-up viewing. This is changing, too. With the launch of Sling TV and PlayStation Vue, viewers have access to an array of online channels that can compete with traditional cable bundles by offering live, linear programming. The cable networks are eager to promote their

programming on these new streaming services, which may pay higher rates (a typical new entrant premium) and fuel competition among distributors.

### The Evolution of Video Advertising

Spending on digital media has been booming in social and video formats, but the technology to deliver advertising in the on-line TV ecosystem lags behind usage. Nevertheless, advertising will eventually catch up. Online players are developing innovative ways to lure advertisers hungry to reach large and different digital audiences.

**Viewers watch half of all hit prime-time entertainment after using some form of time-shifting technology.** A growing number of studios, cable networks, and MVPDs have made their content available on demand. Time-shifted viewing on DVRs has skyrocketed as viewers have migrated to standalone streaming services (such as HBO Now, Showtime, and CBS All Access). This fragmentation presents a challenge to advertisers because the technology to

serve, deliver, and measure advertising in nonlinear platforms lags significantly behind the usage of those platforms.

**Approximately 50% of online viewing occurs in ad-free or ad-light formats.** In recent years, subscription-based, ad-free, video-on-demand services have become wildly popular. Netflix, the largest ad-free subscription service, reported that monthly viewing hours of its content increased from 1.2 billion in 2013 to 2.4 billion in 2015. If Netflix were a television network, it would rank as one of the top five most viewed networks today. With such extensive access to uninterrupted, ad-free viewing, it's reasonable to ask whether consumers are gradually becoming less tolerant of the ad-interrupted model.

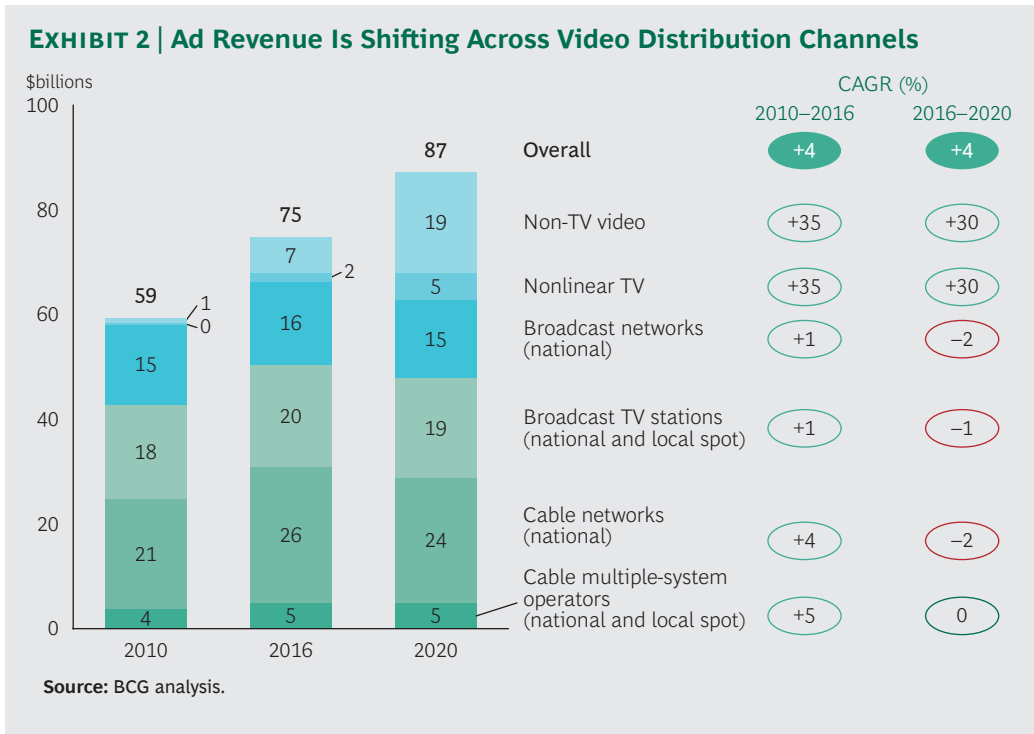
**Broadcast and cable TV premiums are beginning to erode.** Broadcast and cable networks have long been the go-to destination for advertisers because of their ability to deliver a massive number of viewers at one sitting in real time. Water-cooler events, such as the Super Bowl and the Oscars, provide singular opportunities for companies to advertise their message to millions of viewers at once—and the power of these live formats is increasing. But advertisers can now aggregate audiences of similar size

in real time via OTT entertainment programming. And these platforms benefit from real-time bidding, with better demographic targeting, at more efficient cost.

These incremental differentiators (vis-à-vis traditional TV) offer advertisers new opportunities. Much of the growth in online advertising has come from nonlinear, digital-native content—content that never airs on TV and subsists primarily on preroll advertising. We expect this digital-native content to capture nearly \$20 billion in ad spending by 2020. Nonlinear TV content, on the other hand, is likely to represent just \$5 billion in ad spending by 2020. (See Exhibit 2.) To become more attractive to advertisers, the nonlinear TV ecosystem needs to improve its measurement and delivery of ads across DVRs, set-top-box video on demand, and OTT platforms.

### Changes in Content Development and Distribution

As consumers become more conscious of the price-to-value ratio in television viewing, the days of passing network license fee increases along to consumers are over. This has led to increased tension between cable networks and MVPDs.



**Networks continue to negotiate aggressive rate increases.** Even as OTT content cuts into cable subscriptions and profits, and as MVPDs act on their threat to drop network groups, the marquee networks continue to push MVPDs for significant rate increases. But in such a cost-competitive environment, MVPDs find it difficult to pass those increases on to consumers. The favored lever for MVPDs is to market lower-priced packages with fewer channels, a trend that cable networks may not be able to reverse in future distribution deal cycles.

**Top content is thriving, but middle-tier content will eventually decline.** From 2004 through 2014, the ten highest-rated cable networks achieved a compound annual growth rate (CAGR) of 7.3% on affiliate fees per subscriber, per month; the overall networks grew by just 3.6% during the same period. Live sporting events, hit content, and original, niche programming continue to generate strong viewership and rates, while middling entertainment networks are falling behind.

**Networks are spending more to develop must-see programming.** Hit content has become a major differentiator and an increasing source of leverage for cable networks, so networks have begun to trim selling, general, and administrative (SG&A) expenses to free up funds for content development. Average industry SG&A costs declined from 35% of operating expenses in 2004 to just 22% in 2015. Meanwhile, spending on original programming has spiked. In 2014, networks spent \$45 billion on content development, resulting in the production of approximately 350 original titles.

**Linear TV rights are expanding to OTT.**

Although people often associate OTT with on-demand viewing, this is changing. A wide array of players now deliver linear programming online: studios working directly with networks, networks working directly with MVPDs, and so on. By attempting to keep pace with the trend toward multiplatform and time-shifted viewing, traditional players are looking to hold onto viewers who might otherwise pursue “sexier” OTT services.

**T**HE US TV industry is quickly transitioning from a relatively harmonious ecosystem based on mutual dependency to one in constant change. To capitalize on the new online and mobile pathways and to thrive in an increasingly combative environment, industry participants need a fresh approach. Pushing bloated cable bundles and exorbitant prices is a losing tactic in a world where streaming video is the growth engine for the industry. MVPDs and cable networks, in particular, must make the right moves to thrive amid the disruption.

*This article is the first in a three-part series. The second article will explore the risks and strategic imperatives for MVPDs in a world where streaming video is a serious threat—and opportunity. The third article will map out the most promising paths to success for cable networks.*

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