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Signal in the Noise: Vol. 117

Theme This Week: Why exclusive theatrical movie releases may not be accretive for Netflix

Weekly Riff: Why exclusive theatrical movie releases may not be accretive for Netflix
Weekly Monitor: Wireless price increases; federal broadband spending guidelines released; Netflix interest in live streaming; another new football league

New Event Alert: We are pleased to launch a monthly ***Signal in the Noise+ speaker series*** which will bring together thought leaders across telecom and media to share their views on industry trends. We will launch on June 1st with a virtual keynote event, *Signal in the Noise+: Future of Media*. Speakers will include **Kevin Mayer**, who architected and launched Disney+ and is presently Co-CEO and founder of Candle Media, **Patrick Whitesell**, Executive Chairman of Endeavor, **Ravi Ahuja**, Chairman, Global Television Studios and Sony Pictures Entertainment Corporate Development and **Christopher Benyarko**, EVP of Direct to Consumer, NBA. **Please reach out to your sales representative to register for the event.**

Weekly Riff: Why theatrical movie releases may not be accretive for Netflix

The Noise: Netflix apparently considering exclusive theatrical windows for some movies

The Signal: With subscriber growth seemingly in a more mature phase, Netflix has to start looking at revenue maximization approaches that go beyond just unit growth. In that context, exclusive theatrical releases can provide an obvious way to add a substantial new revenue stream given the size of the global box office at $42bn (2019 – pre Covid; ~$21bn last year)[1], which Netflix does not tap into much at present. Also, this path could allow the company tap into revenue streams in China where it does not have an operation and monetized low priced markets like India better, since box office pricing is actually higher than pay TV pricing.

Exclusive time windows in effect carve up the demand curve for content based on marginal utility ascribed to a piece of content by different audiences, something that Netflix does not do at all today. In case of sports content, this audience tiering can be done by sport or by nature of event (play off vs regular season vs in/out of market etc). In the case of scripted content however, tiering is more difficult to do by content dimension itself which is why studios learned over their 100+ year history to optimize the demand curve based on time. There will always be audiences that are willing to pay a premium for a theatrical experience and/or immediacy of access, while other audiences may be willing to wait a bit longer to watch the same content in return for a lower price. As demonstrated by the legacy studio model, this time based tiering can increase lifetime value of films by 30%+[2] over and above box office revenues because of home video and TV licensing revenues, while some titles can see even more LTV upside due to merchandizing/licensing. This is something that Netflix's flat price model doesn't solve for as of today and in theory, a wide release with an exclusive theatrical window can add a new revenue stream without (arguably) cannibalizing its existing revenue base.

While we can see how top-line growth could benefit from this approach, the impact on profitability may not be as clear in our opinion. Studios tend pay 40-50% of box office collections to distributors while Netflix effectively pays nothing for distribution of movies under its present model. Also, in theory, subscriber acquisition cost (SAC) for theatrical releases is significantly higher than Netflix releases as marketing budgets for theatrical movies can be almost as big or even bigger in some instances than production budgets. In fact, we note that in the case of Netflix, marketing as a proportion of revenues has fallen continuously over the last 5 years despite content volumes increasing significantly over this period. While Disney does not break down marketing spend for studios, we note that growth in operating income at studios pre-Covid was slower than growth in theatrical revenues, implying not much operating leverage. Pre-Covid, Disney's studio SG&A to revenue ratio at 28% was much higher than Netflix overall at 18% partly because of the high marketing spend on a small pool of theatrical content at Disney.

In order to understand this trade-off between revenues and margins, we try to calculate the break-even threshold between the economics of a movie release in theaters vs a streaming service like Netflix. This can be done by dividing the lifetime profit generated by a given theatrical title by the LTV of each streaming sub. This would effectively give us the break-even number of subs that a movie needs to bring into streaming to equate with theatrical economics.

In order to demonstrate the methodology, we use Spider-Man: No Way Home as a case study to understand how a successful release on this scale would impact streaming vs its theatrical performance (Figure 1). Spider-Man: No Way Home did $805mm at the domestic box office and $1.9bn globally. This equates to ~$1.2bn in lifetime studio revenues (across theatrical, home entertainment, and TV licensing)[3].

As seen in the table below, in order to break even with the theatrical economics of Spider-Man: No Way Home based on just lifetime value (defined as ARPU x customer lifetime – COGS – marketing)[4], a streaming service like Netflix would need to add just 5-12% of the households that watched the movie in a theater, assuming Netflix churn of 2-4%. This analysis would seem to imply that even highly successful franchise titles can generate better returns on streaming than on theatrical.

Figure 1:

Spider Man: No Way Home P&L ($mm)	
Tickets Sold (mm)	227
Average Ticket Price	*$8.36*
Global Box Office Receipts	1,898
Splits	*44%*
Theatrical Rentals	825
Home Entertainment	215
TV Licensing	190
Total Studio Revenue	**1,230**
Production Costs	200
Video Costs	56
Participations and Residuals	84
Studio Gross Profit	**890**
Marketing Expense	248
Studio Gross Profit Less Marketing	**642**

Box Office Breakeven Analysis ($mm except for per unit economics)			
Netflix Monthly ARPU	$11.70	$11.70	$11.70
Assumed Monthly Churn Rate	4.00%	3.00%	2.00%
Assumed Netflix Gross Margin (2024)	35%	35%	35%
Lifetime Subscriber Value (per Household)	**$102.38**	**$136.50**	**$204.75**
(-) SAC	$27.00	$27.00	$27.00
Lifetime Subscriber Value (per Household) Less SAC	**$75.38**	**$109.50**	**$177.75**

Breakeven Analysis At Gross Profit Less Marketing Level			
Breakeven OTT Profit (Gross Profit - Marketing Expense)	642	642	642
Lifetime Subscriber Value (per Household) less SAC	$75.38	$109.50	$177.75
Breakeven Netflix Subscribers (households)	**8.5**	**5.9**	**3.6**
Box Office Households	73.1	73.1	73.1
OTT as % of Box Office Households	*11.7%*	*8.0%*	*4.9%*
OTT as % of Global TV Households	*0.5%*	*0.3%*	*0.2%*

Source: Deadline, Company Report, Barclays Research

Based on this framework, streaming would seem to be the obvious distribution choice for revenue and profit maximization compared to theatrical. However, looking at this break-even from the filter of a single release can be highly misleading. One way to contextualize this is to look at Marvel releases in theatres vs on Disney+. The last 28 Marvel movies under Disney have generated ~$25bn[5] in revenues whereas Disney+, which includes most of these movies and a number of Marvel and Lucas originals may do ~$5bn in revenues this year based on our estimates. This is because of the fact that Marvel and Lucas fans, once they become subscribers of Disney+, pay a flat price for all content and content volumes have to keep increasing to keep this audience engaged. However, the theatrical model is monetized per view, across multiple windows which enables Disney to monetize the same fan multiple times. Subscriptions can also do generate comparable value of course across the lifetime of a subscriber. If we assume churn of somewhere between 2-3% for Disney+, its ARPU as of the last quarter would suggest life time revenues of roughly $200-300 for each Disney+ household. Compared to this, a Marvel fan who may have watched every one of the last 28 movies would have generated on average ~170-225 (assuming global box office ticket price of $6-8). At a household level, although the global number of people per home is ~4.9, this is skewed towards Africa and the Middle East excluding which, the average could be slightly north of 3x[6]. Therefore, lifetime value per family (to make it comparable to streaming) for theatrical releases could be $500-675, much higher than streaming.

Also, this framework implicitly assumes that the consumption context for a given movie is the same across both streaming and theatrical. One way to think through this is to compare Red Notice, the most successful film release on Netflix as per the company with ~364mm hours viewed by more than 50% of subscribers in the first 28 days[7] with Black Panther which was watched roughly the same amount of time during its theatrical release based on total tickets sold and duration of the movie, assuming high completion rate. However, it is not improbable to assume that completion rates for Red Notice were likely much lower than theatrical viewing of Black Panther. This is partly because Red Notice also has to stand out against 5000+ other titles on the service at release, whereas a theatrical release has to compete with a much smaller subset to titles for attention. In addition, 'switching' cost to move to another piece of content in a theatrical environment is much higher than on a streaming service. This is partly why theatres tend to be more effective channels for building franchise and brands compared to say content releases on television. What is missing and almost impossible to determine in this framework is what proportion of Red Notice viewers on Netflix would have actually spent the time and money to watch the same movie in a theater. Also, would Disney have been able to build Marvel into the same kind of franchise that it is today by purely releasing these movies on streaming and in that context, is a Netflix franchise really comparable to Disney's? Viewed from this perspective, the monetization of Marvel is still an on going process as a result of which the lifetime revenue and profitability per Marvel fan will keep growing overtime in a theatrical window. In contrast however, the value of a Marvel fan on Disney+ may arguably shrink overtime if Disney has to feed the service with much higher volumes and churn and ARPU don't grow at the same pace as content costs.

Given the above considerations, theatrical releases may drive more value than streaming over time and argues for theatrical windows remaining relevant at least over the medium term. While we recognize this opportunity, we believe the transition towards a theatrical model may not be accretive to overall earnings at least for a few years. We note that legacy studios like Warner Bros and Universal tend to margins in the 10-15% on a portfolio basis while Disney pre-Fox used to do margins double of this due to its success rate, lower volume and financing mix of movies. In the case of Netflix, if the company pivots towards exclusive theatrical releases, its marketing budget for movies alone may have exceeded its entire marketing budget for the whole service last year, specially given the volume of films released by Netflix. We also note that margins of ~10-15%, consistent with large studios may be difficult for Netflix given that legacy Hollywood studios generate significant sums from licensing of TV shows and libraries. Also, most legacy studios tend to have co financing deals for movies (with the notable exception of Disney) which tends to help reduce risk, something that Netflix may be less inclined towards given its exclusivity needs. Content costs in a theatrical model are also likely to have a higher variable component due to talent compensation being linked to box office performance rather than the fixed cost model presently used by Netflix.

This is why it is not clear if theatrical exclusivity can actually be accretive for Netflix. We note that last year, Netflix released more movies than the top 5 studios combined. One alternative could be to have a balanced model of a small sub set of titles being released exclusively into a theatrical window but most titles being released directly on the streaming service. However, even this approach would require the theatrical releases to be extremely successful in order to be accretive for overall economics. This is why Netflix may have to be a lot more selective with respect to the movies it does release into an exclusive theatrical window if the company does go down this path. In this scenario, the actual impact of the strategy pivot on revenues and earnings may not be material.

In our opinion, if Netflix does decide to go down this path, it will have to be part of a bigger strategic shift to scale other revenue lines like merchandizing, games or even live events/pop up theme parks in a bigger way. That approach would support higher spend on each title to drive multiple revenue lines over time, similar to Disney's approach today. This is also why flipping to theatrical exclusivity is not a trivial decision and needs to be a more comprehensive strategic decision which will need a very difficult approach to content overall.

Weekly Monitor

Telecom companies raise price: Verizon became the latest telecom company to raise price this week, pointing to inflationary cost pressures. TMUS did not explicitly raise price but had modified its plans to add taxes and fees separately to certain plans (which were previously part of plan price) in Q1. AT&T announced price increases of $6 a month for single lines and up to $12 per month for families on May 3rd. Verizon's price increase applies to almost its entire base of retail and wireless subs and could add $700-800mm in EBITDA annually. What is not clear is how these prices increases will impact overall industry growth which has been at record levels for the last couple of years, especially given the broader macro backdrop and competitive wireless offerings from cable companies.

Guidelines on federal broadband spending program released: The NTIA released guidelines for the $42.5bn Broadband Equity, Access and Deployment (BEAD) program in a Notice of Funding Opportunity (NOFO) last week (Please see What is the impact of Infrastructure Act on Cable/Telco 13 Dec 2021). The deadline for states to submit letters of intent is July 18th and funding allotted to each state will not be determined until the FCC publishes updated Broadband DATA Maps to determine unserved /underserved locations.

Notably, the guidelines prioritize fiber broadband deployment. In selecting between competing proposals for the same location, the notice states proposals under consideration should be "Priority Broadband Projects," which are defined as those using only end-to-end fiber-optics. The notice further emphasizes fiber capability to scale speeds over time, stating that fiber projects will "ensure that the network built by the project can easily scale speeds over time to meet the evolving connectivity needs of households and businesses and support the deployment of 5G, successor wireless technologies, and other advanced services". Only if the state does not receive a proposal for fiber deployment (within guidance) can it consider other proposals that can deliver "Reliable Broadband Service," which is defined to include fiber, cable, DSL, and fixed wireless. While ultimately the selection of proposals and allocation of funding to operators is up to each state, the states must submit proposals that adhere to guidance to the NTIA in order to determine allotment of funding received.

Figure 2: Telco/Cable broadband overlap by zip code

	As of Q3'21							
	ZIP codes with listed telco HSD subs	Shared ZIP codes - Altice USA	Shared ZIP codes - Cable One	Shared ZIP codes - Charter	Shared ZIP codes - Comcast	Shared ZIP codes - Cox	Shared ZIP codes - Mediacom	Shared ZIP codes - WOW
AT&T								
No. of ZIP codes	11,433	1,018	563	4,865	3,645	718	903	335
% in common		8.9%	4.9%	42.6%	31.9%	6.3%	7.9%	2.9%
Lumen Technologies								
No. of ZIP codes	9,095	557	302	2,756	2,196	524	1,309	56
% in common		6.1%	3.3%	30.3%	24.1%	5.8%	14.4%	0.6%
Frontier Communications								
No. of ZIP codes	6,750	682	318	2,992	1,698	82	1,081	127
% in common		10.1%	4.7%	44.3%	25.2%	1.2%	16.0%	1.9%
Verizon								
No. of ZIP codes	5,077	758	0	1,339	2,616	250	28	0
% in common		14.9%	0.0%	26.4%	51.5%	4.9%	0.6%	0.0%
Windstream								
No. of ZIP codes	4,460	382	92	1,282	806	123	812	12
% in common		8.6%	2.1%	28.7%	18.1%	2.8%	18.2%	0.3%
Averages								
No. of ZIP codes	7,363	679	255	2,647	2,192	339	827	133
% in common		9.2%	3.5%	35.9%	29.8%	4.6%	11.2%	1.8%
Total unique ZIP codes[4]								
No. of ZIP codes	27,457	2,586	956	9,188	8,542	1,406	2,702	410
% in common		9.4%	3.5%	33.5%	31.1%	5.1%	9.8%	1.5%

Source: SNL Kagan

Streamers and the livestreamed content opportunity, including sports. While the NFLX livestreamed content effort seems to be focused on reality contests and stand-up comedy, this capability would provide the option to enter bigger opportunities such as live sports in the future. In addition, it could allow for new content formats where viewers interact live with content thereby allowing for a gamified viewing experience in some instances. This would also allow for new ways to monetize advertising and make its ad offering a lot more directly comparable to legacy broadcast in some instances. Amazon has already proven out a model for livestreaming sports globally in various pockets, and could continue broadening its scope. In that regard, Endeavor Holdings' CEO, Ari Emanuel, replied at an investor conference, when asked about the potential Amazon interest in UFC rights when the Disney/ESPN+ deal expires after 2025, "I'm smiling." Part of the rationale for our recent upgrade of Endeavor shares in this note (please see Upgrading EDR to OW: A Defensive Growth Media Play, 13 May 2022) is based on the position of strength they are in as a supplier of content, both as an agent for the inputs (actors, athletes, etc.) as well as an owner of leagues (UFC, PBR) and events. Along these lines, we note that the increasingly popular Formula 1 US media rights expire this year, and while that company has operating and sponsorship relationships with Amazon/AWS, as well as having its *Drive to Survive* docuseries relationship with Netflix, there is logic that the livestreaming capability, broad subscriber reach, and desire for high-advertising-CPM-opportunity sports programming could lead to streaming competition vs. DIS for those F1 rights.

Are you ready for some (more) football? Within weeks after next season's SuperBowl, the XFL will finally launch (again), with carriage on Disney's ABC, ESPN and FX networks, and exclusive content across Disney properties including ESPN+. The XFL had been revived in 2018 by WWE Chairman/CEO Vince McMahon (who initially founded it in 2001), but after just five weeks of play in 2020, COVID shut it down. It was acquired out of bankruptcy for $15mm by Dwayne "The Rock" Johnson, his business partner/ex-wife Dany Garcia, and sports merchant banker/investor RedBird Capital Partners. The XFL season will consist of 40 regular season games, 2 playoffs, and a championship. It will be followed by the second season of Fox's new USFL (who also has a broadcast partner in NBC), which wraps up mid-summer, roughly a month+ before the NFL pre-season. Therefore, these additions of more professional football are attempts to fill out the calendar possibly without diluting the NFL franchise. The driver behind the launch of these two new leagues is the fact that 75% of the top 100 most-watched events on TV in 2021 were NFL games – which drives subscription and advertising revenue, and therefore creates the media rights business model for the IP owners. However, for the media companies, football can still end up being a loss leader, as evidenced by Fox's early exit from Thursday Night Football (Amazon bought those NFL rights), which should be a $350mm-$400mm EBITDA tailwind for Fox next season. This means that the core viewership-driven allocation of advertising and subscription/affiliate fee revenue alone may not be enough to make sports rights viable – other monetizable adjacencies may be needed (Amazon Prime or Netflix subscriptions, Apple iPhones, etc.) to attract and retain customers to whatever platform acquires these rights. This, in addition to multiple new distribution avenues due to streaming proliferation, has resulted in demand for niche events which despite past struggles, continue to spring up from time to time.

[1] Source: https://www.motionpictures.org/wp-content/uploads/2022/03/MPA-2021-THEME-Report-FINAL.pdf

[2] Based on average home video and TV licensing revenue as a % of total box office for the last 24 Marvel movies

[3] Source – Deadline -link

[4] please see: A new valuation framework for growth companies, September 23, 2019 for more details on this method

[5] https://www.businessinsider.com/marvel-movies-ranked-how-much-money-at-global-box-office-2021-11

[6] https://www.pewresearch.org/fact-tank/2020/03/31/with-billions-confined-to-their-homes-worldwide-which-living-arrangements-are-

most-common/#:~:text=Around%20the%20world%2C%20the%20average,)%20and%20Europe%20(3.1).

[7] https://www.businessinsider.com/most-popular-netflix-movies-based-on-watch-time-2021-12

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Mentioned Stocks (Ticker, Date, Price)

AT&T (T, 19-May-2022, USD 20.21), Overweight/Neutral, A/CD/CE/D/E/J/K/L/M/N

Endeavor Holdings (EDR, 19-May-2022, USD 19.76), Overweight/Neutral, CE/FA/J

Netflix, Inc. (NFLX, 19-May-2022, USD 183.48), Equal Weight/Neutral, CD/CE/J/K/N

T-Mobile US Inc. (TMUS, 19-May-2022, USD 125.88), Overweight/Neutral, A/CD/CE/D/J/K/L/M/N

Verizon Communications Inc. (VZ, 19-May-2022, USD 49.10), Equal Weight/Neutral, A/CD/CE/D/E/J/K/L/M/N

Walt Disney Co. (DIS, 19-May-2022, USD 103.14), Equal Weight/Neutral, CD/CE/J/K/N

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