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The End of Pay-TV — Matthew Ball

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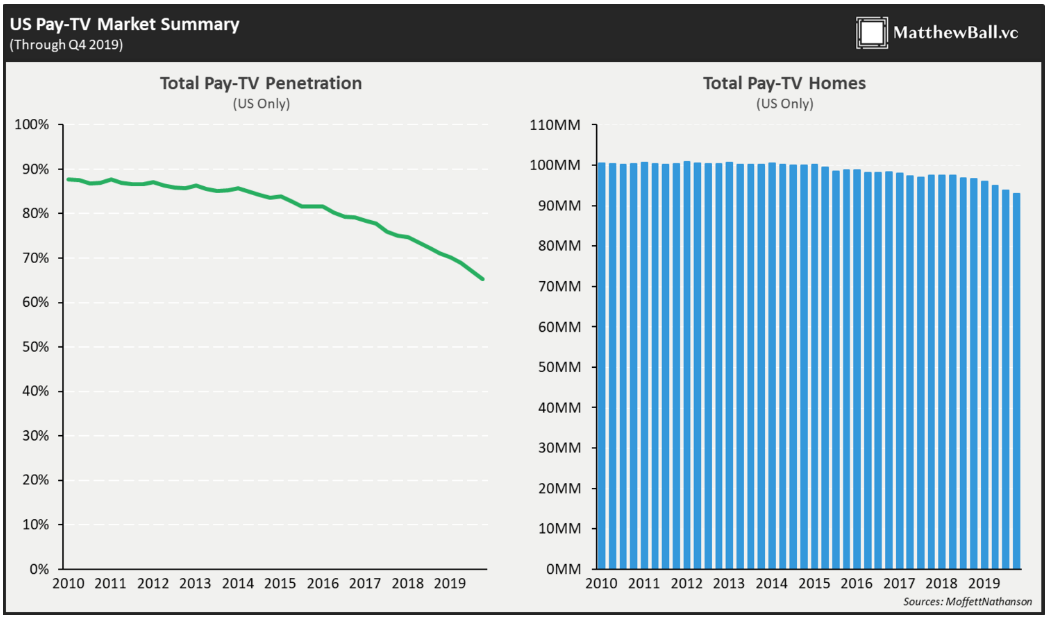
21-27 minutes

For years, the question of Pay-TV has not been "If" it will decline but "how fast?" and "to what low?" And one of the interesting things about this exercise is how hard it was to shrink the 100MM+ households that had a Pay-TV service in 2009/2010 (the peak, with roughly 90% penetration) down to something like 50MM or 60MM or even 70MM. Even *quintupling* the rate of cord cutting wouldn't get you there over any reasonable forecast period (i.e. < 5 years).

Part of the challenge is that the US has spent the past ten years adding more than 1MM households per year. Their adoption of Pay-TV was well below the penetration rate (which fell from 88% to 75%) among existing homes (showing a generational difference), but these additions still offset much of the overall decline. But even if none of these households had subscribed to Pay-TV, we still wouldn't be on pace to fall below 75MM homes until the mid-2020s.

And crucially, this durability conflicts with countless surveys that all reported that some 10-30% of all Pay-TV households "expected" or "wanted" or "planned" to cut the cord each year. Yet year-after-year-after-year-after-year-after-year-after-year-after-year, only a fraction of these respondents ultimately did. Why? The value of the Pay-TV was still enormously high. For an average of $75 per month, a household had all-you-could-eat access to thousands of hours of original and exclusive programming. And they watched more than 400 hours of it (~150 hours per person)! That was and still is a great deal.

Thus, at the start of the poorly-named "Streaming Wars" in Q4 2019, there were still 93MM homes with a Pay-TV service, per MoffettNathanson. This reflected a 23 percentage point drop from peak *penetration*, but total homes had fallen by only 8% (or 8MM). We all know these figures will continue to shrink — and their rates of decline will only accelerate. Still, most expect we're on a relatively stable path to a relatively stable low.

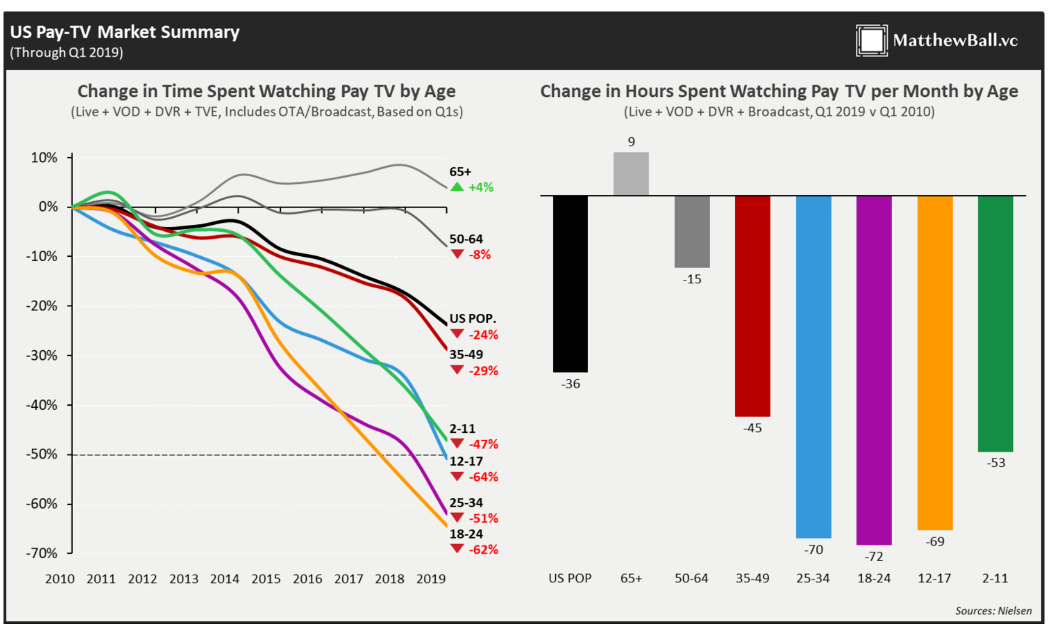


The point of this essay is to demonstrate that a unique change to this logic has now occurred. We are in a new phase state for Pay-TV, which is correlated with, but distinct from, the growth in SVOD services and investment in them.

The New Old Thing

Core to this thesis is the understanding that while Pay-TV "peaked" in 2009 in terms of penetration and total usage, value was still high due to its abundance of exclusive first-window content, live sports, and live news. What's more, the amount *and* quality of content available grew rapidly as new RSNs emerged, with "peak TV" leading to more original series, and the major sports leagues expanding their regular seasons. At the same time, the technologies and user interfaces that delivered Pay-TV were making rapid improvements (e.g. Xfinity X1). TV everywhere was never a great solution, but it *was better* than the era of linear-only television.

Of course, that doesn't mean pricing wasn't growing so fast that the price/value ratio for the consumer didn't decline. It's also clear that Pay-TV, however high its value, was overserving the millions of homes that just wanted *something* to watch and didn't care much for sports. However, the real challenge was the emergence of services like Netflix, which offered even more content, better experiences (no ads, better UI, better device), and extraordinarily low prices. Which is to say, *much* better value was available outside Pay-TV.



Then by 2015, and through 2018, we saw the rapid emergence of virtual MVPDs like Sling TV and DirecTV Now. These offered many improvements to the Pay-TV experience, including substantially better UI/X and device support; significantly lower prices (enabled by structurally lower costs thanks to the removal of set-top boxes and need for in-person installs); and the ability to cancel/sign-up on a monthly basis (Hulu even encouraged customers to do so, especially those who only subscribed for sports like the NFL, which runs September through January).

With increased value came rapid customer adoption. By mid-2018, vMVPDs had amassed nearly 8MM subscribers and altogether halted the decline of Pay-TV penetration. At this point, I wrote that faith in vMVPDs represented a "virtual fantasy". For all of their improvements, the model solved none of the five existential challenges to the Pay-TV ecosystem:

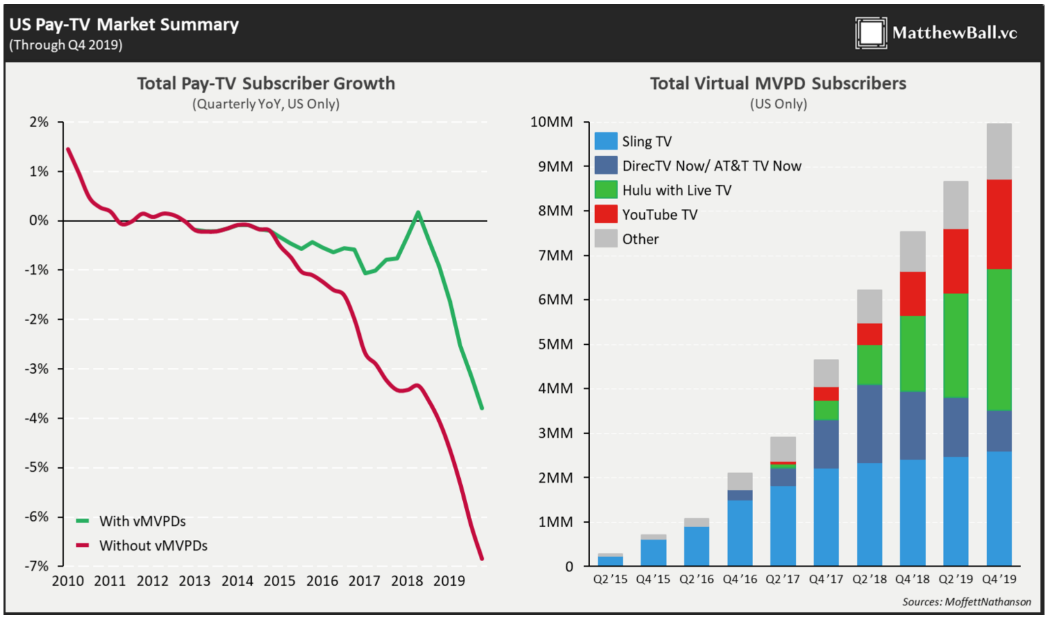
1. **The Pay-TV Product** – Despite all the experiential improvements, vMVPD-based content was still burdened by high ad loads (in excess of one of every four minutes aired) and fragmented rights (each network and/or show had different policies for in-season catch-ups). Furthermore, minimum service prices remained above $600 per year (a big ask for tens of millions of Netflix households) and forced consumers to buy dozens of unwanted channels. And while vMVPDs can be 50% cheaper than traditional services, most vMVPD consumers watched 50-75% less than those with cable or satellite-based access. As a result, vMVPDs did not solve the price/value problem of classic Pay-TV. There was clear data here. 66-75% of vMVPD subscribers came from MVPD service – meaning that as few as one in four cord cutters were being convinced to return to the Pay-TV ecosystem.

2. **The Growth in the Number and Quality of Pay-TV Substitutes** – The primary reason consumers began to reject the price/value equation of Pay-TV was because of the emergence of (much) lower cost and (much) higher value substitutes such as Netflix, Amazon Prime Video, Hulu, etc. vMVPDs didn't fundamentally alter this dynamic. In fact, we knew that these substitutes would keep getting better and grow in numbers. What's more, their success would mean more time would be taken from the Pay-TV ecosystem, thereby worsening their price/value ratio for consumers.

3. **Supplier Incentives** – Although vMVPDs stabilized the number of Pay-TV subscriptions, they did nothing to address the fact that the number of non-Pay-TV homes was growing rapidly, as was the total amount of ex-Pay-TV video viewing and ex-Pay-TV video services (e.g. Netflix). As a result, it was hard to imagine that the Disneys, Turners, and NBCUniversals of the world wouldn't see the need to establish clear OTT, ex-Pay-TV, and D2C offerings in the years to come. And if/when they did launch, they would be exacerbating substitutes problem (#3)

4. **Unsustainable Economics** – Each of the leading vMVPD services was losing $7-$15 per customer per month, and on a gross margin basis. Not only was this loss not sustainable, most of those operating said businesses admitted there was no clear plan to solve this problem. Instead, the hope was that either CPMs would eventually grow, the services would ultimately gain more negotiable leverage over content suppliers, or that vMVPDs would serve as a platform for something in the future. That logic wasn't without precedent (see Facebook). However, as I stated in my original vMVPD essay, it was better to invest in losses on something that could plausibly be the "new thing" (e.g. YouTube, Netflix, Spotify) rather than a marginally different version of the old one (Pay-TV). To point, negative gross margins meant vMVPDs were effectively paying customers to buy their service – and even then, vMVPDs only reclaimed 25-33% of former customers! That's the definition of having no product/market fit.

Six quarters later, Pay-TV declines have not only returned to their pre-vMVPD rates, they've more than tripled. More damage is likely. In response to unsustainable economics, most vMVPDs have hiked prices at least twice in 2019 (by as much as 30%) — including those that once argued that high CPMs would allow them to keep prices low (i.e. YouTube TV and Hulu). Sony Vue, an early leader in the category, has shut down, and it's hard to believe that Philo or FuboTV, both of which are venture-backed and have no clear ecosystem or content advantages, will last much longer. AT&T Now, meanwhile, is expected to be fundamentally retooled in 2020, potentially to the point of requiring annual contracts or removing many high-cost networks. Either decision makes sense — a service can't have both too-low prices and high churn, or indefinitely sell negative gross margin products – but they would further diminish the appeal of virtual MVPDs and mean unwinding what believed the services solved in the first place. Notably, the rate of subscriber growth for vMVPDs as a whole has fallen by two thirds since Q2 2018, with even gross adds down 20%.



Ultimately though, the challenge isn't problem #4, but the mix of problems #1, #2 and #3. In 2020 alone, audiences will see even more substitutes launching (Peacock, HBO Max, Quibi) with the existing players (Netflix, Amazon, Hulu, Disney+, Apple TV+) further expanding their slates of original/exclusive programming and libraries. And while there is still durability in the traditional Pay-TV ecosystem, every major content company now recognizes that there is no future in it — nor even a seamless transition from it. Instead, they are now strip mining the existing ecosystem to build a potential life raft.

This is the most important and newest point. For a decade, Pay-TV was getting better while its *value per dollar* was getting worse, and substitutes with far more value were emerging. Soon, Pay-TV will be getting worse on absolute terms. Much worse.

Heigh-Ho, Heigh-Ho

Consider the following examples from the three largest Pay-TV network groups:

NBCUniversal's Peacock: In launching its OTT service, NBCUniversal is pooling not just the best of its available in-season content rights from each of its networks, but it's also crafting a deep library of the best shows NBCUniversal has ever created (e.g. *The Office, Parks & Recreation, Everybody Loves Raymond, Cheers*). Furthermore NBCUniversal is producing a large number of marquee Peacock exclusives/originals (e.g. a *Battlestar Galactica* reboot from *Mr. Robot* and *Homecoming* writer/showrunner Sam Esmail and a *Saved by the Bell* Reboot), many of which were once intended for its traditional cable networks, such as USA.

Much of this content will be available for free and with five minutes of ads per hour (one third of traditional TV), with the full catalogue and ad-free experiences costing $5-10. For $5-10, consumers can watch ad-free. And while Peacock will lack sports, it clearly will offer a better value proposition than the entirety of NBCUniversal's linear network portfolio (which costs MVPDs $15 per month in fees and is marked up further for consumers). It has more content, better rights, exclusive content, and much lower prices. True, those with Comcast or Cox's Pay-TV service get the full, ad-free Peacock service for free, but it's hard to imagine anyone staying a full-on Pay-TV subscriber to save $5 on the service. It's like asking you to buy a $200 Sears membership so that you can save $20 on the $120 Amazon Prime.

WarnerMedia's HBO Max: AT&T, meanwhile, is essentially raiding all of TBS, TNT, and TruTV's most promising original series as HBO Max exclusives, plus it's taking exclusive digital rights these networks' most valuable reruns (e.g. *Impractical Jokers*). Some shows are still premiering on these linear networks — at least for now — such as the upcoming *Snowpiercer* TV series (which will be TNT's most expensive show ever). However, these are expected to "re-premiere" shortly thereafter on HBO Max, potentially as early as the next day (which essentially makes them HBO Max Originals).

Networks such as TBS and TNT will probably continue to have some first-window programming due to contractual requirements with distributors (i.e. they've likely committed [x] hours per year). However, there's no real quality requirement here, nor a term that says the most promising shows planned for a given network can't be shifted (or sold) elsewhere. As a result, this feels more like WarnerMedia is "working-to-the-rule". And by the time HBO Max launches a low-cost AVOD service in 2021, it'll be unclear why anyone would pay to access any of WarnerMedia's content via linear and ad-heavy Pay-TV channels.

Overall, Disney may be the most dramatic. It's clear that, going forward, all of Disney's best teen, pre-teen, kindergarten, and pre-k content will be going to Disney+ rather than Disney-ABC Television Group's cable broadcast and networks. And while Disney hasn't (to my knowledge) confirmed whether all of The Disney Channel, Disney XD, Disney Jr. back catalogue will be exclusive to Disney+, it seems likely that anything of high value will at least be on both. And why would a parent put a kid in front of a live Disney network when the same content is available on demand on Disney+?

In November, Disney also announced a strategic deployment of FX Networks, the most creatively distinct and award winning of the conglomerate's two dozen plus Disney/Fox networks. Starting this week, FX will operate its own self-branded channel on Hulu (which will come at no added cost to current or new Hulu subscribers). In addition, "FX on Hulu" will receive all of FX's catalogue rights (which were previously available only via the Pay-TV add-on through FX+) *and* all of FX's original shows the day after their initial airing on linear FX. What's more, FX will also be shifting many of its forthcoming originals to "FX on Hulu" exclusives (i.e. they won't even air on linear FX). Again, this feels like work-to-the-rule. Disney isn't closing shop on FX, but it is harvesting the absolute maximum amount of value in the "linear FX" for the "OTT Hulu". The best programming? Hulu. Catalogue? Hulu. Incremental cost? Zero. Ad-load? Low or zero. FX on Pay-TV has only one advantage: it airs a few shows a few hours earlier than FX on Hulu (and, of course, these airings are live, hard to pause, and include 16+ minutes of commercials per hour).

The Ramifications

The macro-point here is that the traditional TV players haven't just embraced D2C, they've decided they're done trying to stem the decline of Pay-TV. They are reducing their investments in the channel, pulling out many of the investments they've already started, and begun deliberately speeding the collapse in the hopes that if they burn their boats relatively faster or harder than their peers, they'll be best positioned in the future. This doesn't mean they don't still want to pull cash out of the old system — they do — but they're not optimizing for it, even when the ROIC is clear. And they're right to do so.

The knock on-effects here are profound. On a B2B basis, one has to wonder why MVPDs would continue to pay contractual rates. Of course, they don't have a particularly clear legal argument to refuse them – hence work-to-the-rule. But if I were John Malone or Charlie Ergen, I'd look at these decisions and just refuse. Disney, WarnerMedia, and NBCUniversal are making the right decisions for themselves, but these decisions aren't exactly in good faith of the contracts (and plans) they set over the past few years. The good news here is that (entirely reasonable) renegotiations would, in theory, allow MVPDs to materially reduce their programming costs. The bad news is that reductions in in Pay-TV revenues would only encourage Hollywood to move on from it.

But most important is the consumer side. From 2010-2019, the perceived value of Pay-TV eroded because (1) better, lower cost substitutes emerged, and (2) Pay-TV pricing continued to increase. even though the quality and volume of content available in the Pay-TV bundle grew. What's set to happen from 2020 onward is quite different. Pay-TV will, for the first time, get rapidly worse on an absolute basis as it is undermined, underfunded, and eventually defunded.

What's more, most of what's available in the Pay-TV ecosystem will be available elsewhere via better experiences and at lower prices (and often earlier, too). Again, this is different than 2010-2019. Netflix and Amazon, for example, had *later* content rights to Pay-TV titles. Hulu, meanwhile, only had next-day rights to a small number of currently airing shows and the last five episodes that aired. Hulu, HBO Max, and Peacock will have full rights to most in-season shows, plus the full stack of prior seasons. These services will also have many shows, such as *The Big Bang Theory*, that have never before been available in SVOD and could only be watched in a random airing order on various linear channels at various times of the day. In addition, this OTT trio will boast exclusive new originals that, for the most part, are better and higher budget than anything available through the traditional system.

This means that Pay-TV decline estimates are wrong. It's not about escalation or curve modelling. The floor will suddenly start falling out. This is almost impossible to model correctly; there's probably no equivalent example in media where all partners not only rapidly change distribution channel and halt investments, but also try to pivot from B2B to B2C monetization.

What about Sports?

The strongest counterpoint to this thesis is that the bundle will remain in place to access live sports, and that it's already the only thing households are really thinking about when buying a subscription. If true, it wouldn't matter that much of the rest is being harvested. However, I think there's more frailty and tunnel vision here than many assume.

For one, the very companies (Disney, NBCUniversal, and WarnerMedia) accelerating the decline of Pay-TV also tend to be the biggest sports rights holders (they own ESPN, NBC Sports, Turner Sports). This means those that own the most powerful sports networks have both an awareness of the impending challenges in Pay-TV *and* a willingness to lean into them. You can't logically cut off one gangrenous arm and pay no attention to another arm suffering from the same malady because it has less rot.

To point, 22 months ago, Disney's Head of Direct-to-Consumer, Kevin Mayer, told Recode that the company isn't contractually prohibited from making ESPN available direct-to-consumer, but it just didn't make business sense. There was an obvious unsaid modifier in this claim: "yet". With ESPN distribution now south of 80MM households, down from nearly 100MM, it's obvious this time is fast approaching. And you can bet Disney would rather pull the trigger early than try to perfect the timing.

Indeed, it's impossible to imagine there's a better time to make this transition. Disney will almost assuredly never have more D2C buy-in from the street than it does today. The next three years will see a substantial number of key sports rights come up for licensing, and the company is rapidly accumulating experience in D2C. It's fair to say the technical experience may not be there yet, but the adoption curve of a true D2C ESPN wouldn't be as rapid as Disney+. Disney+ is a new product with new content; ESPN is just the old thing sold in an incremental fashion. Almost all subscribers (and an even greater share of consumption) will still be via traditional TV. My bet would be that by the end of 2020, Disney will announce plans to launch D2C ESPN in 2021. To this end, Disney CEO Bob Iger recently told Bill Simmons that in the future "ESPN will be far more of a direct-to-consumer product," having previously said, "If you're running a business in a dynamic world…and you try to maintain any kind of status quo, you will become irrelevant."

In positioning HBO Max as a rebundling platform, AT&T has already begun suggesting that it will soon offer an OTT/D2C Turner Sports subscription add-on. It's hard to imagine "New Fox" isn't planning something similar with FS Go, and NBCUniversal with Peacock/NBC Sports (perhaps launching February 2022 around the Olympics).

It also seems likely that the next round of sports deals will be mostly non-exclusive – if a linear-predominant platform, such as TNT or Fox, buys the rights, it'll have to share with an online-only platform, such as YouTube TV or Amazon Prime, or otherwise demonstrate clear scale in its digital products. As a result, we're looking at a world in which the "last stand" of Pay-TV will soon be available outside Pay-TV.

(Related: It's often argued that Fox or TNT or NBC Sports, etc., doesn't have the rights for a direct-to-consumer sports offering. This was true at the time most major sports deals were struck, but these deals are frequently reopened to allow for things like sports betting, social integrations, new camera angles and devices, etc. Many have already been expanded to allow for, at additional or different fees, true D2C. And for the skeptics, consider the reverse logic. You'd have to believe, for example, that the NCAA or NBA, having sold 5–15 year rights to their leagues before the collapse of Pay-TV, would just throw up their hands and say, "Shucks, well, TNT didn't buy D2C rights, so I guess we'll have to wait". Or that having purchased these same rights, TNT would say, "Yeah, well, I guess go ahead and sell these rights elsewhere even though we bought the long-term — and highest priced — rights to the old system".)

All of which is to say that we talk a lot about the progressive, predictable, or even accelerated decline of Pay-TV and what its asymptote might look like. Does it level at 50MM households? At 55MM? At 45MM? Late 2021/early 2022, to me, looks like the point in which consumers will wake up and see that Pay-TV isn't just a zombie business and delivery model, it's a zombie product — and one that is increasingly deprived of fresh meat. There's no model for this decline, but it certainly won't look like a simple acceleration of the past decade's trendlines.

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