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Snapchat is Building its Content Business for Scale

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6-7 minutes

In October Recode reported that Snapchat is changing it's payment model with publishers who create content on the platform:

> Instead of sharing ad revenue that section produces, Snapchat wants to pay content partners a flat license fee up front and keep the ad money for itself. It's the same model that TV networks use when they buy programming.
>
> That's a switch from the terms Snapchat has offered since it launched Discover in 2015. Up until now, it has let publishers sell ads against their own content, and Snapchat has also sold ads against the same content using its own sales team. Splits have varied depending on the deal and who sold the ads.

In short, Snapchat is moving away from revenue split deals with publishers to paying flat-fee licenses for content rights. This move is an important one and better aligns their business model with their product strengths.

To understand why Snapchat made this move, let's first look at the different ways content distributers pay content owners today.

How Content Distributers Pay Content Owners

There is a long history of content distributors paying content owners for rights. From Netflix to Pandora to Spotify, each has struck unique deals for content. A few structures emerge when looking at these deals:

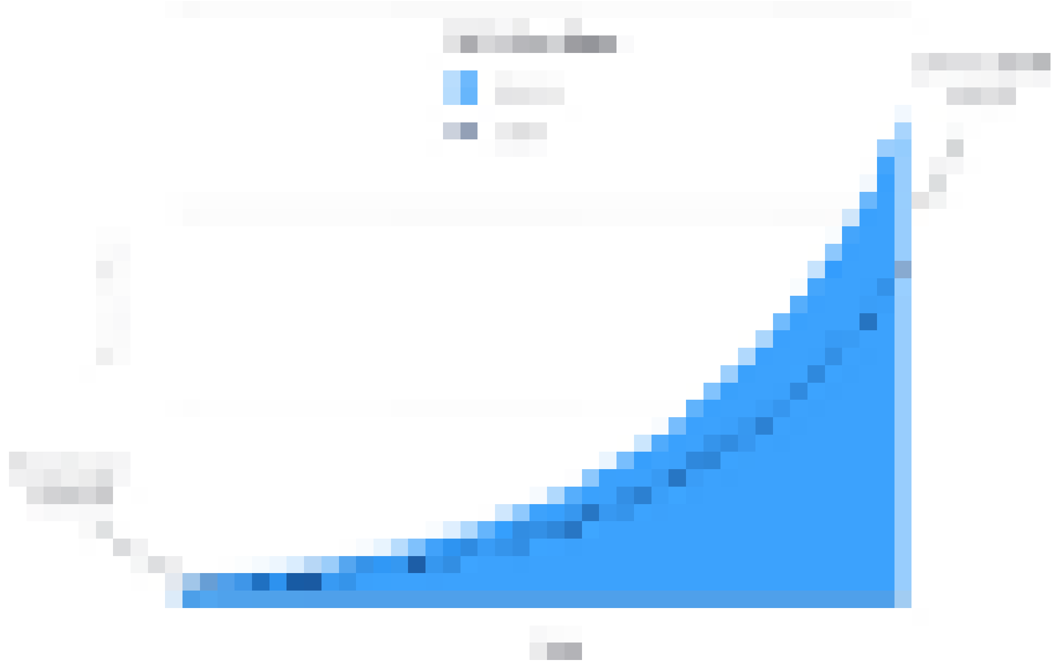
- **Revenue Splits:** An agreement to split revenue generated from all customers in a specific proportion (70/30, for example).
- **Per-Subscriber Fees:** A set dollar amount paid to the content provider for each subscriber who is active in a period.
- **Per-Use Fees:** A set dollar amount paid to the content provider each time their content is consumed.
- **Flat-Fee License:** A guaranteed dollar amount that will be paid to the content irrespective of subscribers, usage, or revenue generated by consumers. This is sometimes layered on top of a Per-Subscriber, Per-Use, or Revenue Split arrangement as a "Minimum Guarantee."

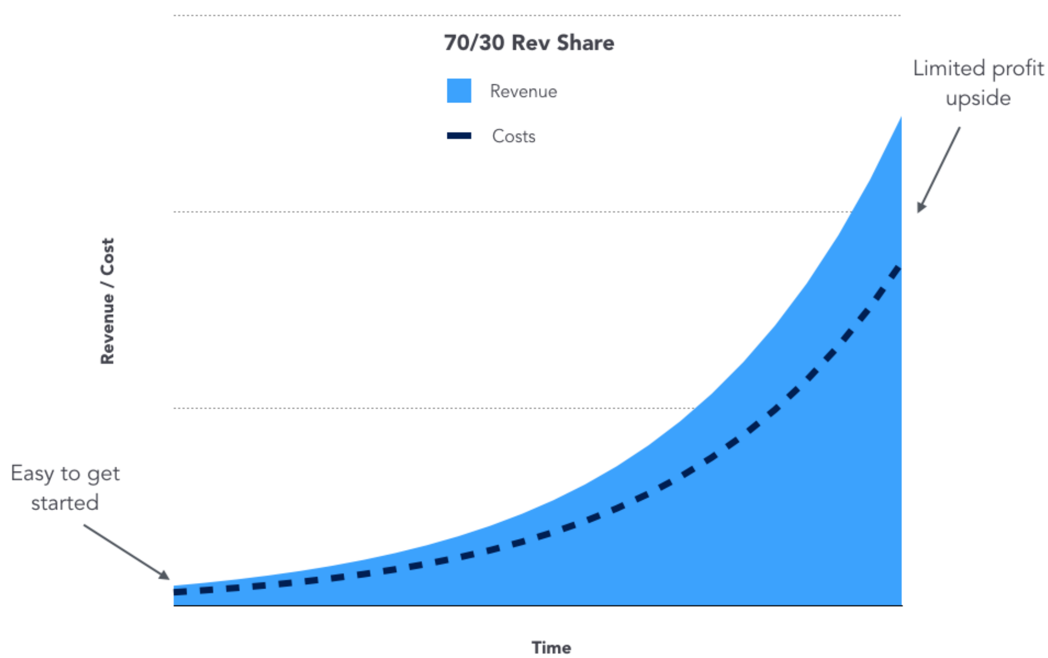
Distributors will sometimes blend different models together. For example, it's been reported that Spotify pays music labels the higher of a flat-fee dollar amount or a 70/30 revenue split.

Why Snapchat is Changing Payment Models

Snapchat started out striking revenue split deals with publishers. Revenue splits make it easy to enter the market because your costs scale in proportion with your revenue base. You can never pay out more than you take in, and the splits are desirable when revenue is low and hard to predict.

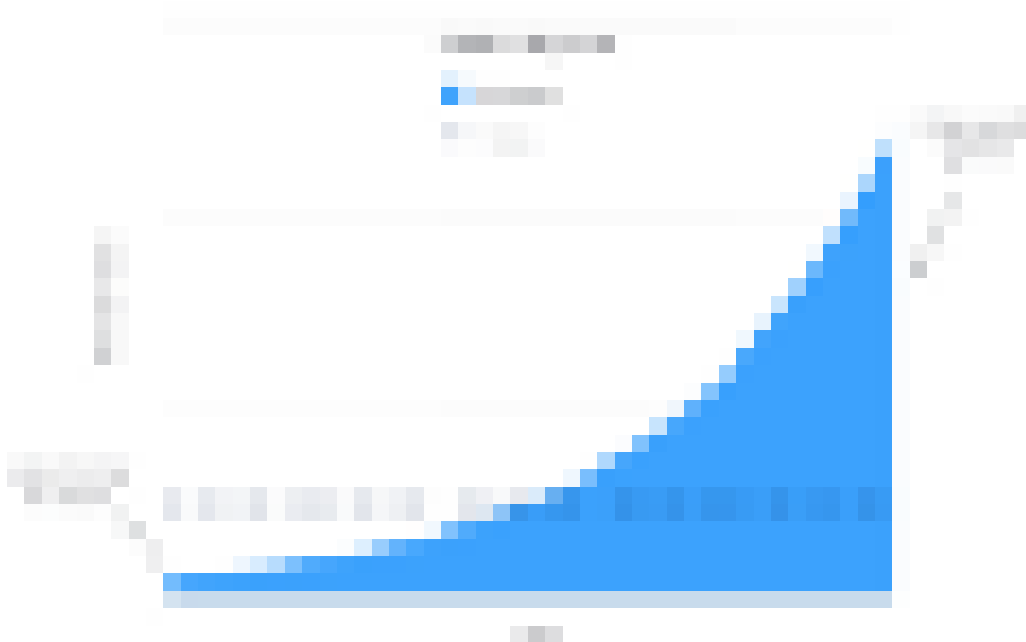
However, once you reach scale the profit upside is capped, which makes it harder to reap the benefits of scale. Below is a theoretical example of revenue and costs in a revenue split model:

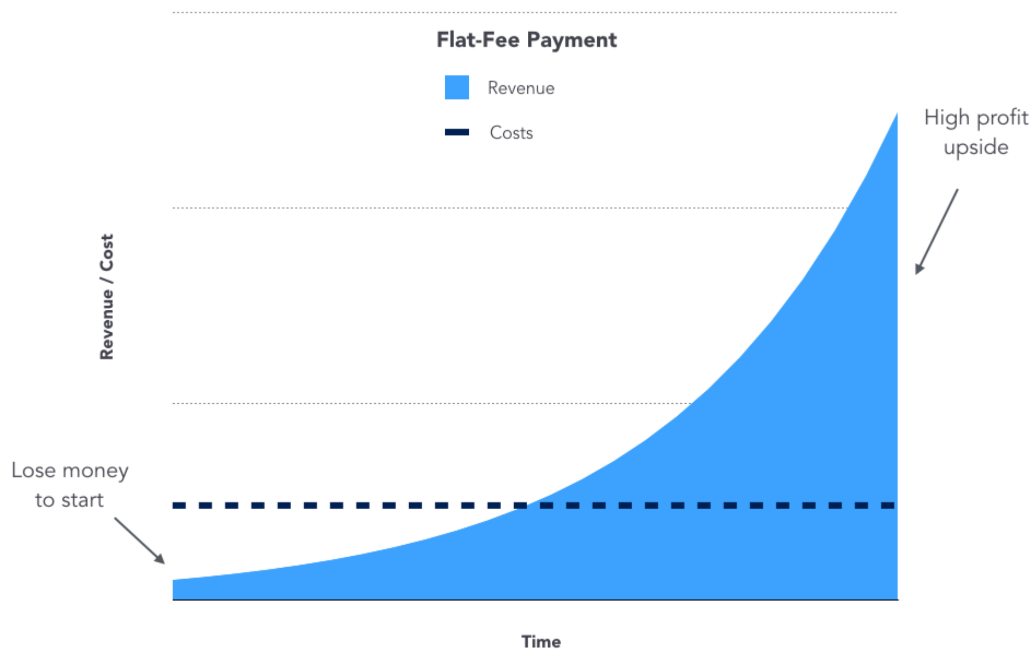




Revenue split deals make it easier to enter a market but harder to capitalize on scale

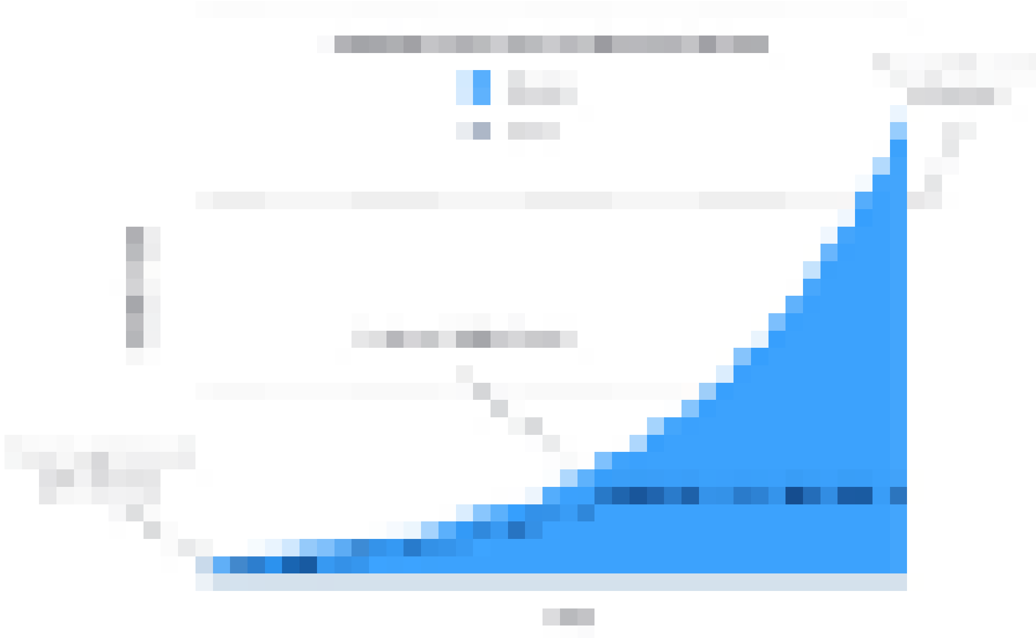
On the other hand, flat-fee license deals usually make it much harder to enter the market. You must commit to paying content owners high amounts before you have scaled revenue, regardless of performance. This is generally prohibitive for new startups and not desirable when experimentation is high and ROI uncertain. However, flat-fee licenses have the benefit of providing a high degree of upside on profit when you reach scale and bet on the right content (think Netflix's big bets on originals like House of Cards):

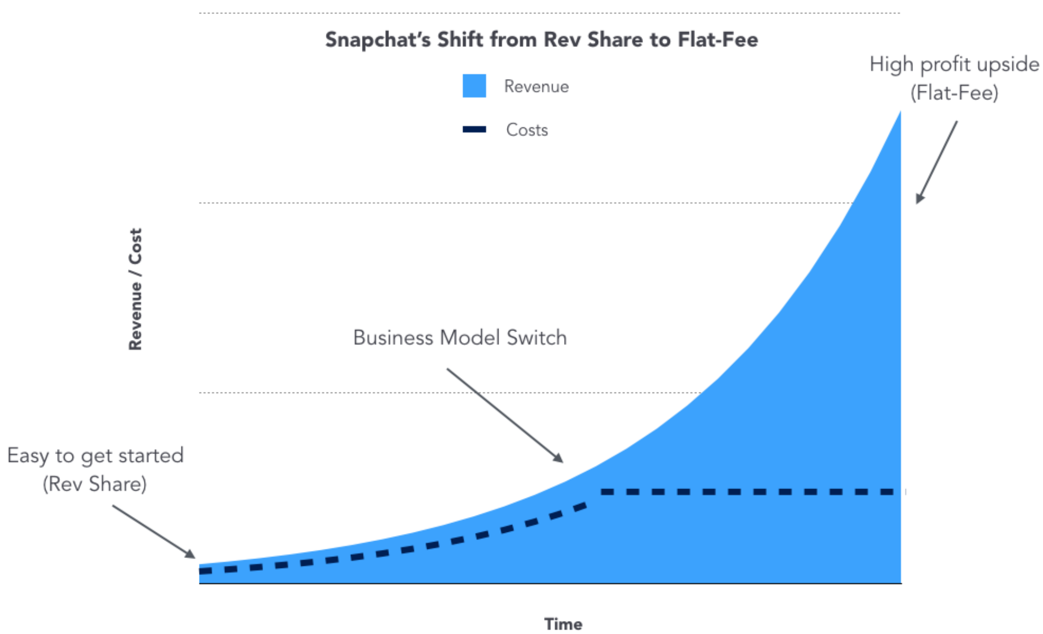




Flat-fee deals make it harder to enter a market but easier to capitalize on scale

With this backdrop, it’s clear that Snapchat navigated their entrance into the content market and transition quite well. Revenue split deals allow for easier market entry in the early stages, while flat-fee models allow for higher profit upside as the company grows. Snapchat was able to enter at a low cost but will enjoy the benefits of scale:

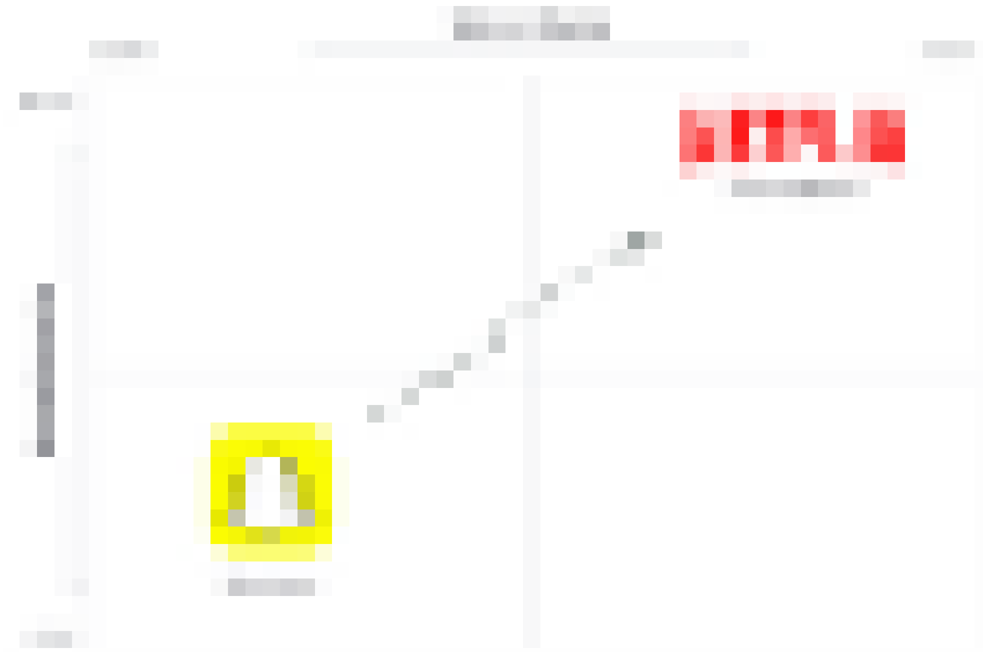


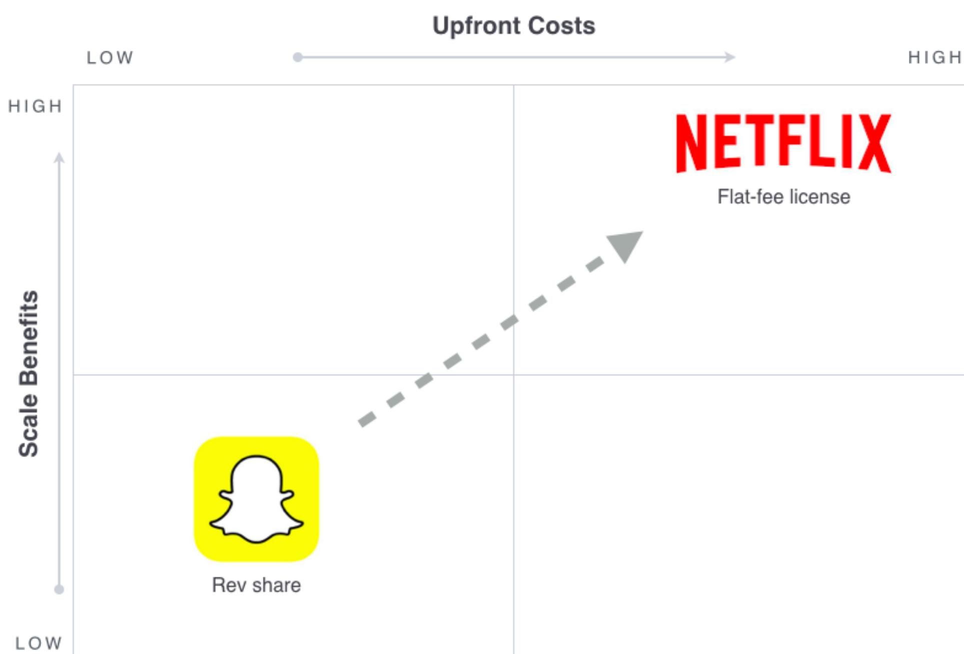


Snapchat's strategy made it easier to get started while giving it the benefit of large scale

Of course, the key assumption in all of this is that Snapchat continues to grow revenue and the content performs well. The flip side of this business model shift is that Snapchat will now be taking on more risk if they pay for content that does not perform well (i.e. the revenue graph for the content goes down, not up over time).

In the matrix below, Snapchat is looking to move from the bottom left quadrant to the top right quadrant (with Netflix). The result will be a higher profit upside on their biggest hits. Profit can then drive a virtuous cycle that allows them to make even larger investments in content.





The Move Aligns their Business Model with Product Strengths

Content platforms that drive discovery are the ones that win. This is what makes Netflix so powerful. They can take a show like *Breaking Bad* that had a modest audience at the time and make it into one of the most popular TV shows ever with their massive distribution.

A show like *Breaking Bad* also drives outsized profit for Netflix. They can pay a relatively low flat-fee compared to more popular shows, and then generate customer demand for the show by putting it in front of just the right people. The fixed-cost structure allows them to enjoy all of the upside of demand creation. Here, Netflix is a textbook example of a popular phrase in media:

> "Whoever generates the customer demand gets to capture the value."

Snapchat is one of the more powerful content discovery platforms we have seen in a long time. In other words, they are great at generating customer demand. Millions of people are spending more and more time on Snapchat and will watch whatever content Snapchat pushes to them.

Moving to a flat-fee licensing model allows Snapchat to acquire content rights for a fixed rate, and capture the value in the upside when they generate demand for content by putting it in front of their growing and engaged audience. They wouldn't be able to do this as effectively in a revenue-split model where they were committed to sharing 70% of the revenue even when they created all of the demand for it.