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Walk Away from The Walking Dead? Shentel and the AMC Renewal Decision

Scott Gallagher, James Madison University
Chris Kyle, Shenandoah Telecommunications

Chris Kyle, a Vice President responsible for video programming at Shentel (NASDAQ: SHEN), looked at his spreadsheet:

> *…in excess of $1.25 per subscriber per month increasing to approximately $2.00 over five years, compared to $0.45 for just the AMC channel.*[1] *Ugly. At least it's an improvement over the initial offer of $2 per subscriber going to $4 over ten years.*[2] *I am not sure which is worse, the significant rate increases, or the other contract provisions forcing Shentel to add other AMC channels or reposition the channels that we are currently carrying.*" (see Exhibit 1: Current & Proposed AMC Contract)

It was December 2015 and Chris was looking at the last, best, and final renewal offer AMC Networks had made to the National Cable Television Cooperative (NCTC). NCTC was the trade organization for over 850 cable companies serving 4 million households in the United States and was conducting renewal negotiations on behalf of its members including Shentel.[3] He would have to make a recommendation on accepting the offer soon to his leadership at Shentel.

Shenandoah Telecommunications (Shentel)

Founded in 1902 as Farmer's Mutual Telephone System to provide telephone service to its shareholders, Shentel was one of many regional cable operators in the United States.[4] It provided cable programming, broadband internet, wire-line and wireless communications to about 60,000 households in the states of Virginia, West Virginia, and Maryland. As befitting its roots, it focused on serving rural markets and had grown from its start in Shenandoah County, Virginia largely through acquiring nearby, though rarely contiguous, telecommunications operators. Its mission was to *...ensure that rural communities have access to the same level of telecommunication services as those found anywhere else in the U.S.* The strategy had been hugely successful. After converting to a public company via a shelf registration it had grown dramatically, a $10 share in 1902 would be worth over $400,000 today.[5] (see Exhibit 2a & 2b: Shenandoah Telecommunications Financial Data)

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The Cable Industry

While large operators such as Time Warner and Comcast dominated large cities, the cable industry was actually quite fragmented with hundreds of smaller private operators. Due to its capital intensive nature, most operators were highly leveraged. In an effort to offset the power of the increasingly consolidated programming companies, which were controlled by about eight media conglomerates, the smaller cable companies such as Shentel negotiated though their trade organization the NCTC.

Local governments, e.g. cities or counties, granted franchises to cable companies to operate in a geographic area. This allowed the cable companies to service customers in those areas for a fee, invariably passed along as a tax on cable bills. Common provisions of this franchise were that the cable company would provide service to everyone within the municipal border, as well as a MFN[6] provision that prevented the local government from making another deal with a rival operator without extending the same terms to the incumbent operators. Thus if a second operator wanted to enter a community it had to promise to provide service, i.e. run a physical cable, to every household. While this did occur in some major metropolitan markets, it was unheard of in the rural markets served by Shentel.

The primary cost for cable operators in the U.S. was programming. Almost every channel transmitted over a cable system had to be compensated, even if the channel could be received for free over the air. Early in the history of the cable industry these carriage charges had been modest, especially for broadcast channels in the basic cable tier (NBC, CBS, Fox, & ABC). In the early 2000s this started to change. Carriage fees increased dramatically for each broadcast network, going from around $0.25 per month per subscriber to around $2. Sports programming was especially expensive, ESPN alone was over $5 per month, with additional charges for its sister channels ESPN 2, Classic and U. Large cable operators had MFNs as well for programming costs, so content providers could not give smaller operators a lower price than larger ones.

In addition to increases in prices, programmers also started to extend the length of their contracts with cable companies. For non-sports programmers this was a way for them to offset their risk. The life of a hit show generally ranged from three to five years, but by demanding ten-year contracts programmers could ensure profits regardless of how many viewers watched their shows.

AMC Networks (American Movie Classics)

With over $2 billion in revenue and profits of over $260 million in 2014, AMC Networks was one of the smaller programmers in the rapidly consolidating cable programming universe.[7] AMC Networks was comprised of five channels - AMC, IFC, SundanceTV, WeTV, and BBC America. The AMC channel was its most popular channel since it had taken over the hit series *Mad Men* and then developed *The Walking Dead* franchise.

The Walking Dead was both a critically acclaimed and highly viewed show. It grew its audience from 5.24 million households during its first season to 14.38 million for the last complete season (the fifth season). It was the number one rated show among adults 18-49 in 2014-15[8], and it was on track to be the number one rated show in the 2015-16 as well. Its related show, *Fear the Walking Dead* also appeared on AMC and was the 11th highest rated show with a 3.6 rating. Other AMC shows in the top 100 were *Talking Dead* ranked 20th with 3.0 rating, *Into the Badlands* ranked 31st with a 2.7 rating, and *Better Call Saul* ranked 54th with a 2.1 rating.[9]

THE PRICING DECISION

There were two longstanding issues for cable companies dealing with programmers, the cost of the programming and determining which "tier" of cable service the programming would appear in. Programmers wanted the highest possible fee, called a carriage fee, for their programming. In addition, programmers wanted their content in the most popular tier, usually the Expanded Basic tier, offered by the cable company.

However, with the advent of digital cable another issue arose which was additional channels that programmers controlled. It was not uncommon for programmers to insist cable companies carry all of their channels in order to receive any of them. In addition to the AMC Channel, AMC was insisting that cable operators carry IFC, WeTV and Sundance TV as well in their best-selling tier of service.

A final consideration was the length of the contract, three to ten years was the usual range, with the carriage fee paid to the programmer usually increasing each year.

Renewal negotiations usually opened in July with a final deadline of 31 December. Common tactics used by programmers were to threaten the loss of channels to viewers and encourage them to "contact their cable company" to prevent this loss. This was usually effective as the end of the calendar year usually fell in the middle of a television show season. For example, 31 December 2015 fell between episode 8 and 9 of season six of *The Walking Dead*. In response cable operators were usually fairly passive, expecting to strike a last minute deal before New Year's Day secure in the knowledge they would simply pass on the increased costs to their subscribers.

While AMC was confident given *The Walking Dead*'s position in the Nielsen ratings, Shentel had aggregate data from set top boxes on what its customers were watching. Based on this data about 10% of its customers watched *The Walking Dead*. This was consistent with the show's Nielsen share. However, Shentel also knew that customers had other ways to view *The Walking Dead*. For example, *The Walking Dead* episodes were made available the day after broadcast on Amazon Prime. Subscribers would use Shentel's broadband internet service to access this streamed content.

Against this, Chris knew that Shentel's customers could easily defect to one of the two satellite networks, DISH or Direct TV, if they wanted to keep seeing AMC and its family of channels. While these companies faced the same programming costs as cable operators, they routinely offered promotional rates of around $30 per month for the first year to encourage customers to switch. Shentel's rates were almost double the promotional rate for expanded basic, but about the same as the regular rates charged by the satellite networks. Loss of subscribers was not trivial. Based on its market capitalization, Shentel estimated the value of each subscriber at about $4,000.

Chris wondered, "*Is the risk of losing so many potential customers worth not passing along a one dollar a month price increase that they would probably not even notice?*"

A final consideration was network capacity. Shentel used the same network to deliver cable TV services as it did broadband service. As it added more and more channels its capacity for broadband dropped. Industry wide, broadband service, since it lacked programming fees and relied on more robust equipment, was about twice as profitable as cable service.

Was it time to walk away from *The Walking Dead*, Chris pondered? AMC was asking for more, both financially and conditionally, than they had ever asked before. At the same time, if there were mass subscriber defections the finger would clearly point to him. What justification could he give if that happened? Chris looked at his spreadsheet again and contemplated what decision to recommend and what other suggestions he could offer the Shentel's CEO to handle the ramifications of his recommendation.

Exhibit 1: Current & Proposed AMC Contract Terms

Terms	Current Contract	Proposed
Cost per month per subscriber	$.45	$1.25 rising to $2.00 over 5 yrs.
Channels that must be in most popular tier (e.g. Expanded Basic)	AMC	AMC, IFC, Sundance, WeTV and BBC America

Note: Amounts are disguised due to confidentiality agreements.
Source: Shenandoah Telecommunications

Exhibit 2a: Shenandoah Telecommunications Financial Data
(consolidated, amounts in thousands of US dollars)

	Op. Rev.	Op. Exp.	Op. Inc.	Int. Exp.	Inc. Taxes	Net Income	Total Assets	Total Debt
2011	245,145	218,855	32,290	8,289	10,667	12,993	479,979	180,575
2012	288,075	253,417	34,658	7,850	12,008	16,303	570,740	231,977
2013	308,942	253,535	55,407	8,468	19,878	29,586	597,006	230,000
2014	326,946	265,003	61,943	8,148	22,151	33,883	619,242	224,250
2015	342,485	268,399	74,086	7,355	27,726	40,864	628,740	201,250

Exhibit 2b: Cable Segment Financial Data

	Video Sub.	Hi Speed Internet Sub.	Revenue	COGS	SG&A	Deprec.	Operating Income
2013	53,076	45,776	75,872	45,767	19,052	21,202	(10,149)
2014	52,095	51,359	84,553	51,982	19,521	23,148	(10,098)
2015	50,215	55,690	97,622	54,611	19,412	23,097	502

Notes: Numbers in thousands except for subscriber data. CGS - Costs of goods sold, primarily programming costs; SG&A - Selling, General and Administrative expenses
Source: Shenandoah Telecommunications 2015 Annual Report

Exhibit 3: Ratings Information for *The Walking Dead*

Season	Year	Rating (18-49)	Total Viewers (in Millions)
One	2010	2.7	5.24
Two	2011-12	3.6	6.91
Three	2012-13	5.4	10.4
Four	2013-14	6.8	13.33
Five	2014-15	7.4	14.38

Note: mid-season results suggested that season 6 ratings would be comparable to season 4 and 5 ratings.
Source: Nielsen[10]

Notes

[1] These numbers are disguised due to confidentiality agreements.
[2] These numbers are disguised due to confidentiality agreements.
[3] https://www.nctconline.org/index.php/about-us
[4] https://www.shentel.com/shentel/history
[5] Split adjusted that one share would be 17,280 shares today trading at ~$25 per share. Adjusted for inflation, that $10 in 1902 would be worth $277 today.
[6] MFN stands for most favored nation, a common provision in trade treaties that if a better offer is extended to another country, it will apply to the first country as well. For example, if the US has a deal with France and then makes a better deal with Italy it has to give the better terms to France as well. Obviously, here it is being applied to cable companies and content providers.
[7] AMC Networks Inc. 10-K (2015) for the fiscal year ended December 31, 2014.
[8] http://www.indiewire.com/2016/05/most-watched-tv-show-2015-2016-season-game-of-thrones-the-walking-dead-football-1201682396/
[9] ibid.
[10] as cited in: http://tvbythenumbers.zap2it.com/more-tv-news/heres-just-how-huge-the-walking-dead-has-been-in-the-ratings/ NOTE: Chris did not have full season six information at the time of the decision, but based on set top box data would have a good sense that season six was on par with seasons four and five.