



Cable at the Crossroads: Pondering the Future of Pay TV

Recent data points to a small but perceptible pullback in traditional pay TV subscribership over the past several years. In this *Executive Insights*, L.E.K. Consulting looks at a number of factors that could determine whether established pay TV providers will be able to keep pace, particularly as younger viewers continue to tune out and a new wave of emerging digital platforms envelops the market.

Digital disruption

Over the past decade, new models for accessing digital media have helped reshape entire industries and buying patterns, revolutionizing consumer choice in the process. But as we've seen in other markets, this digital innovation can be highly disruptive, turning one-time stalwarts into eventual also-rans. Three examples stand out (see Figure 1).

1. The rise of file sharing and subscriber-based music-streaming services decimated the traditional recorded music industry, reducing physical sales by some 84% since 2007.
2. The increase in the number of readers opting for online news has severely affected newspaper industry revenue, which has fallen roughly 50% from its 2005 peak.

3. Home entertainment revenues have also rapidly declined as consumers transition from physical to digital formats while embracing subscription video on demand (SVOD) models offered through the likes of Netflix, Hulu and Amazon Prime Instant Video.

The pay TV market is no exception: Rather than continue to lock in extended contracts with traditional cable operators, customers are increasingly being drawn to competing service providers that offer flexible plans and budget pricing. This raises a critical question: Will pay TV suffer the same fate as other traditional media segments? Is all the talk about "cord cutting" just talk, or are there already cracks in the foundation?

A generational divide

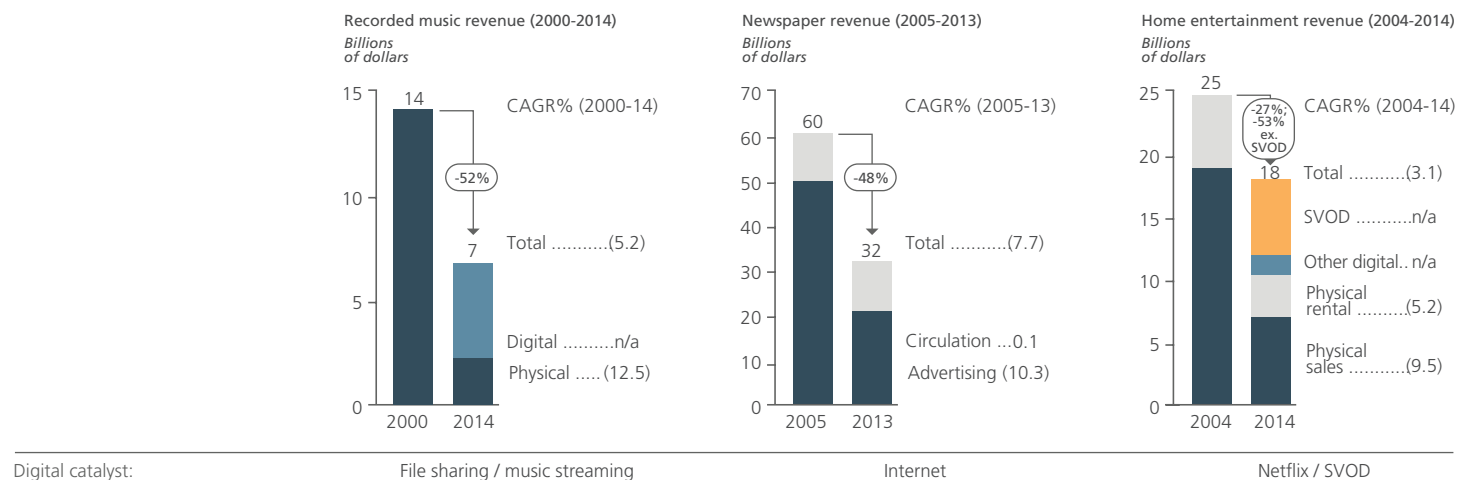
Though not quite yet cause for alarm, recent data points to the unmistakable signs of a pay TV pullback. Multichannel household subscribership has fallen an estimated 5 percentage points since 2010 (see Figure 3), while ratings for even the most popular network programming continue to tumble. And whether it's through erecting old-school antennas or switching to competing video platforms, consumer cord-cutting has escalated, resulting in some 900,000 fewer subscriptions since 2012.

Research from L.E.K. as well as from media analysts SNL Kagan and Nielsen paints a stark portrait of an industry divided by age. While those age 65 and up actually spend a bit more time in front of the tube than they did four years ago, Gen Xers and, in particular, millennials are rapidly tuning out, with declines among

Cable at the Crossroads: Pondering the Future of Pay TV was written by **Alex Evans**, Managing Director, and **Stephen Matthews**, Manager, in L.E.K.'s Media & Entertainment practice. Alex and Stephen are based in Los Angeles.

For more information, please contact mediaentertainment@lek.com.

Figure 1
Financial impact of new models for accessing digital media



Sources: The Digital Entertainment Group; Newspaper Association of America; Recording Industry Association of America; L.E.K. research and analysis

18- to 24-year-olds the steepest — down sharply by 10% through the period (see Figure 2). As has been the case in other industries, millennials have shown far less affinity for traditional brands and services than their older counterparts, and are also more likely to cut and run should a better deal appear elsewhere.

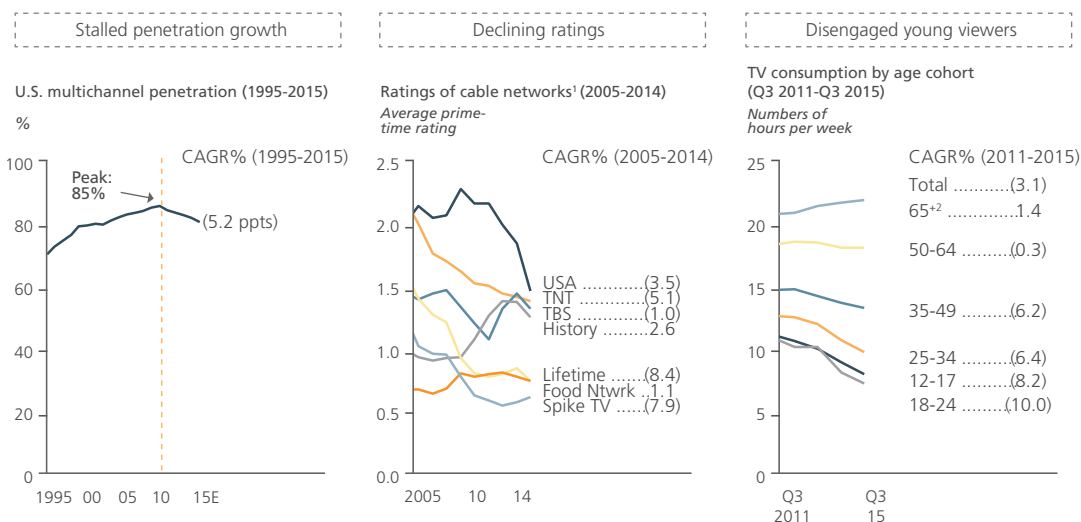
While there is little doubt that pay TV subscribership is on the wane, several factors could determine just how fast and widespread the declines may be in the years to come. For instance, predictive models that use age as the primary determinant show pay TV subscribership remaining relatively stable, dropping only incrementally

to around 97 million by 2025, or just slightly below today's estimated 100 million customers. However, a “shrink to the core” scenario — in which marginal cable customers such as those without any advanced services such as HD or DVR exit the market in favor of competing alternatives — is much less rosy: By 2025, only 57 million subscribers would remain, according to our analysis (see Figure 3).

Bundled alternatives

Meanwhile, a growing number of alternative — and in some instances, lower-priced — delivery platforms continue to cut into the pay TV market share. These include web-based “skinny bundles” offered through virtual multichannel video programming distributors (V-MVPDs) such as Dish’s Sling TV or Sony’s cloud-based PlayStation Vue. Slimmer than standard cable tiers, these bundles nonetheless provide viewers with a broad range of popular network programming from the likes of CBS, Fox, NBC and Discovery, with monthly pricing starting at around \$20 (although consumers who choose such options could wind up paying more for broadband or other stand-alone services once unbundled from their regular pay TV double-play or triple-play package).

Figure 2
Pay TV business model



¹Sample of top 20 cable networks by 2014 ratings; ²persons aged 65+.
Sources: SNL Kagan; Nielsen; L.E.K. analysis

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After years of reticence, some traditional providers are themselves offering budget packages in an effort to minimize subscriber defections, among them Comcast's Digital Economy tier and Time Warner Cable's Starter TV service. According to a recent L.E.K. survey, some 15-20% of existing pay TV subscribers would consider transitioning to one of these lower-priced options in the near future. Although it is a potentially attractive proposition for would-be cord-cutters and pay TV loyalists alike, this phenomenon could further erode the pay TV ecosystem by reducing the number of "network households" (those reached by unique networks) at a rate even faster than that of subscriber decline.

The anticipated growth in budget alternatives — and subsequent pressure on subscriber revenue streams — could have an even wider impact, affecting, for instance, the viability of smaller, less-popular cable networks excluded from skinny bundles and other basic packages; even the seemingly impervious "top 25" major networks face flat or declining subscribership as well as reduced affiliate fees, despite their continued availability in most viewing bundles. The winnowing effect is likely to weigh on television content producers as well, as surviving networks become more selective about programming and cost outlays (in sharp contrast to the increased production spend over the past several years).

Not fade away?

The increasingly competitive pay TV market compels companies to adopt innovative new approaches in order to maintain profitability and keep pace with consumers' fluctuating viewing habits. Lack of participation among fickle and perpetually mobile millennials

puts added pressure on industry stalwarts to sharpen their game in order to remain relevant, including offering programming that caters to the needs of niche viewers. Cost is also a factor: Like previous digital rebellions, the current evolution in TV subscribership is at least partially built on the premise that one need not overpay to access content on demand.

For traditional pay TV participants, there's a silver lining of sorts: Current subscriber revenues are derived mainly from households where the decision-maker is age 50 or over, a demographic typically resistant to change and therefore less likely to abandon tried-and-true providers in order to save a few bucks. As such, any hemorrhaging is likely to be gradual in the near term, giving providers time to formulate effective counterstrategies.

For today's pay TV players to remain viable, we offer the following recommendations:

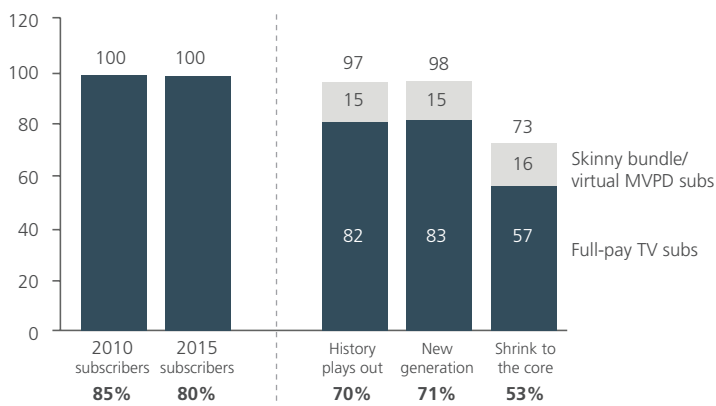
- **Become omnichannel across both pay TV and over-the-top broadband Internet television (OTT).** Networks like HBO and WWE have been particularly successful with this approach, which nonetheless requires the right investments and windowing strategies, a loyal customer base, a robust library/pipeline of content and a promotional platform.
- **Create a programming-services portfolio for serving unique viewer groups.** By our estimates, over 30 new OTT services were launched in 2015 alone, many of them targeting devoted niche audiences (e.g., fans of documentaries, Broadway shows and autos) deemed too narrow to be properly served by traditional cable providers.
- **Ensure digital readiness.** Companies should conduct an internal review to determine whether they have the capability to serve viewers wherever/whenever needed (which, admittedly, may be challenging because many requirements typically fall outside of traditional players' purview).
- **Tap next-generation distribution partners.** Through nontraditional partnerships (such as NFL's teaming with Twitter for Thursday-night games), companies can access video content consumers outside of the traditional pay TV periphery.
- **Access the OTT value chain.** NBC Sports' recent launch of Playmaker Media and Warner's recent acquisition of Drama Fever are examples of how traditional firms can use their scale to participate more aggressively in OTT infrastructure and content (in Warner's case, Korean drama).

Figure 3

Implied household penetration: All subscribers

If skinny bundles are widely adopted, 57 million-83 million full-pay TV subscriptions are expected to remain in 2025

Historical and forecast 2025 subscribers under each scenario
Millions of subscribers



Source: L.E.K. analysis



About the Author

Alex Evans, CFA, is a Managing Director in L.E.K. Consulting's Los Angeles office. He focuses on consumer-facing sectors encompassing both retail and media. Alex also focuses on a diverse set of verticals including Health & Wellness, Food & Beverage, Specialty Retail, Sports/Live Entertainment, Television and OTT / Digital Media.

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