Cord Cutting: “Stupidity” Takes A Holiday
What a Difference a Year Makes

- Last year, at this time, the media world was quaking and shaking about the emergence of Netflix as a cord-cutting monster that was going to dramatically reshape the economics of the media world.
- Something funny happened along the way to this – content owners got a lot smarter about protecting the value of their most valuable content online.
- Since we last jointly tackled the subject in mid-April, we see continued emergence of positive signs that confirm that “the fear of stupidity” is waning.
  - 1st Positive: Availability of premium content for web distributors is now scarcer
  - 2nd Positive: Leading TV brands are now really extending to the web – most notably ESPN3 and HBO Go
  - 3rd Positive: Netflix has unbundled its product offering, which essentially gives customers less while paying more
  - 4th Positive: Video revenue trends do not imply secular decline
- While these are clearly positives that help debunk the initial misplaced fears in the marketplace, there continues to be some developments and headwinds that suggest that we are no longer living in the halcyon days of yesteryear.
- We see four data points that require future attention:
  - 1st Cause For Concern: Amazon emerged as a platform
  - 2nd Cause For Concern: Pay TV subs were weaker than expected in 2Q
  - 3rd Cause For Concern: Traditional TV audience pressures persist
  - 4th Cause For Concern: Netflix and Google are self producing shows
- In conclusion, we believe that the threat of consumers dropping traditional TV delivery for internet services has been reduced by the intelligent actions of the leading content producers. These actions include limiting the availability of premium content in deflationary settings while providing legitimate alternatives to emerging online models.
- While the industry lacks real Pay TV subscriber growth to rebuke cord-cutting theorists, we continue to believe tepid housing formation is the real culprit.

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What a Difference a Year Makes

Last year, at this time, the media world was quaking and shaking about the emergence of Netflix as a disintermediating, cord-cutting monster that was going to dramatically reshape the economics of the media world. Of course, Netflix was not the only threat as other vessels like Google TV, Apple and Hulu were about to attack the safe harbor known as Pay TV.

Something funny happened along the way to this nightmare – content owners got a lot smarter about protecting the value of their most valuable content online.

Even though we think the media landscape has gotten more rational, the best supporting evidence unfortunately remains Pay TV net addition figures, which are heavily influenced by household formation trends. Recent commentary from pay television distributors is positive for subscriber trends, and implies that 3Q11 trends are recovering from the seasonally soft second quarter. Additionally, by our analysis, despite all the focus on net addition numbers, the actual revenue profile of the video business is surprisingly healthy, and largely transcends the quarterly fret of subscriber trends.

Since we last jointly tackled the subject in mid-April, we see continued emergence of positive signs that confirm that “the fear of stupidity” is waning. We can break the evidence down into positive and negative buckets:

1st Positive: Availability of Premium Content for Web Distributors Is Changing

A. No Longer Seeing Starz

Perhaps the most important recent data point of a “smarter industry” was Starz’ decision to walk away from a potential renewal with Netflix. While it appeared that the price tag for the deal was within the ballpark of reason, the sticking point, according to Starz management, was the inherent conflict between premium channel economics and the Netflix model. When Starz is collecting an estimated average of $5.42 per month from its traditional partners, it runs the risk of trading this for a flat fee from Netflix streaming which is priced at $7.99 per month. As CEO Greg Maffei said at the Liberty Media Annual Shareholders Meeting, there were three costs: 1) A Netflix deal would have resulted in higher payments to Starz’ studio partners; 2) Starz’ traditional distribution partners would be dis-incentivized from selling Starz on consignment and risking part of the $1.2 billion in revenue they receive; 3) Netflix’s model (in John Malone’s words of “random over the top”) is congruous with where Starz needs to be in the long run and subrogates any ability to control pricing or build brand identity.

A simple back of the envelope calculus shows that Starz would need to be paid at least $4.58 per user per month by Netflix on their 21.8 million Expected streaming users times 12 months to offset the potential risk of losing this $1.2 billion in revenue from Starz traditional distributors. A per sub fee of $4.58 paid to Starz equates to 50% of the monthly Netflix streaming subscription.

B. The Ability to Add More Movie Product Is Closing...For Now

If Starz indeed is no longer interested in sub-licensing their movie output deals to Netflix and HBO remains focused on using its product for HBO Go, then the potential partners willing to sell first run product to over-the-top content companies is severely limited to essentially EPIX (Paramount, Lions Gate, and MGM) as well as a handful of smaller independent studios. By our count, EPIX related studios, based on the 5 year average market share of U.S. box office revenues, accounted for about 18% share of the market (see Fig 1).
The next few years won’t be any easier as the next major output deals are Warner Bros. and DreamWorks Animation, which are both up in 2014. While a DreamWorks Animation deal is the more likely of the two, the studio represents less than 3% of box office sale – nowhere near the 29% Starz content commands. Furthermore, Netflix’s exclusive relationship with EPIX is set to expire next year so there is a chance that the deal is renegotiated for an even higher amount and/or another player like Amazon could enter the bidding.

Further complicating the picture is the fact that 20% of Paramount’s recent box office revenues could be attributed to the distribution of Marvel films, which are now a Disney owned property.

C. TV Content Is Not Breaking Windows

Five television companies – 20th Century Fox, Warner Bros., CBS, NBC Universal, and ABC Studios – effectively program 89% of the scripted schedules of the five over the air, English language broadcast networks (see Fig. 2).
can license. Recent quotes from media executives confirm a disciplined approach in selling content to SVOD (Subscription Video On Demand) platforms without cannibalizing other revenue streams as Time Warner’s Bruce Rosenblum, President of Warner Bros. Television Group, noted at a recent industry conference:

In that three to five year time period, the most efficient way to monetize those shows will still remain the traditional way, which is free television and basic cable. And the reason I suggest that is what we need to do as an industry and certainly at Warner Bros. what we strive to do is always look at what’s in the long-term best interest of any kind of a program asset. So any show that we have that we’re confident in success, we’ll get to a second or third cycle, we won’t move too early to an SVOD [online] window.

News Corp’s COO, Chase Carey, at the same event described a similar approach to content licensing as hit shows become even more valuable:

Now, you’ve got to make sure in this place you don’t sort of get enticed and chase a quick buck, to your long-term detriment. And so I think is why with something like Netflix, we were, I think for us, we were very determined to have a setup disciplined with rules and how we looked at it and what we’d license, what we wouldn’t and figure out how it fits into the larger ecosystem of all these distribution patterns.

Earlier this year, CBS Les Moonves reinforced the same theme at Nomura’s Media Summit:

We’ve talked [about] this many times, we view our – what we call our content food chain, where the number one source of revenue was advertising. Number two is syndication, international then domestic. Then you throw in retrans on top of that. Then you throw in DVRs and DVDs and the iTunes of the world. And then a Netflix comes along, and you say where do they fit into the food chain? And they’re offering a lot of money, and you’re saying, okay, but you don’t want to affect your first two parts of your business.

By now, it should be clear that owners of leading scripted dramas and comedies understand that online distribution should be limited to content that has been fully amortized across traditional windows.

D. Hulu Is Putting Up Walls and Adding Inventory

Since our last update, Hulu, the joint venture between ABC, FOX and NBC and private equity firm Providence Equity Partners, put itself up for sale, with a myriad of potential buyers jockeying for position. While chatter on whom the sale will go to remains noisy at best, one thing we can note is that the SVOD player has clearly started to move towards a more restrictive business model. Not only has the company dialed back on the amount of current content available to its non-subscription users, but it has also increased its advertising inventory.

Hulu is also feeling pressure from the broadcasters on both sides of the aisle. Most recently, FOX began enforcing an 8-day delay to access new episodes of current shows on Hulu and FOX.com with authenticated pay TV subscribers (currently only DISH Network subscribers) having the ability to watch “next-day” content. With News Corp’s FOX taking an early stance, we expect similar policies to take form as echoed by Bob Iger, Disney’s President and CEO, on the company’s most recent earnings call:

You are right in your assessment that we’ll basically push the window back or make access to the programming more difficult or later except if a customer is authenticated as a subscriber. We now have to hope that not only does the technology improves that enables authentication, but that the whole user experience gets better.

However, as shown in Fig. 3, top broadcast shows remain plentiful online with 65% of last season’s top 20 broadcast shows available on either the big 4 broadcast network websites or Hulu.
Fig. 3: Top 20 2010/11 Broadcast Network Shows – Online Availability

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<td>The Big Bang Theory</td>
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<td>NCIS</td>
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<td>Two and a Half Men</td>
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<td>Glee</td>
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Source: Company websites, Hulu.com, Nomura research

For the network owned and operated sites, the ad loads for streaming have effectively at least doubled since online shows became available with anywhere from 5-6 minutes per half an hour show to as much as 10 minutes for some shows without the ability to skip. Interestingly, the placement of ads have also shifted for some sites to be included more within the show and less pre-roll advertisements, which has helped abandonment rates drop as viewers get hooked on the programming.

2nd Positive: Leading TV Brands Extending To The Web – Most Notably ESPN3 and HBO Go

As traditional media companies become smarter about the proliferation of its content online, extending its television brands through an authenticated model becomes increasingly important. Both ESPN and HBO have built strong brands over the years and each have online/mobile products that allow existing users the ability to view content outside of the living room.

ESPN also has one of the clearest digital strategies among our media coverage universe. As part of their renewals, incremental payments are made for its ESPN3 digital offering. ESPN has pushed forward with its authentication of its networks while the rest of the industry figures out how to make TV Everywhere a reality.

HBO Go is Time Warner’s product offering that allows users to watch HBO whenever and wherever they are on whatever device they choose. HBO Go officially launched May 2, 2011 on the iPad, iPhone and Droid phones. It is now available on 80% of its pay TV base (still excluding TWC and CVC) with plans to roll out on connected TVs and game platforms through the end of 2011. The content on HBO Go is all exclusive to HBO, and given the company owns all of their original series, customers have the ability to watch any past episode from all seasons of all past and current series. HBO Go can be streamed to three simultaneous devices at one time, and, importantly, the company has the ability to track usage, which is a key aspect to gathering incremental viewer metrics.

HBO Go increases the price/value proposition for consumers by driving usage and loyalty, which in theory should lead to a longer subscriber life and reduce churn. In the U.S., HBO is not focused on the small percent of customers (about 4mn households) who take internet only but no television service because their research shows they are not the target audience for pay television. Interestingly, the HBO service is bundled with
other pay service 90% of the time. Some have suggested that HBO take HBO Go over-the-top to build a standalone business apart from their distributors. Our sources from a wide variety of pay TV platforms suggest that is a very dangerous strategy as HBO's subscriber base is supported by the cross-marketing efforts of their distributors. Taking an over-the-top path could quickly turn their new subscriber marketing effort off and produce a materially dilutive result. Given the higher revenue capture of HBO vs. peers, we would assert that their model is a nice job of maximizing subscriber value vs. peers.

3rd Positive: Netflix Has Unbundled Its Product Offering Which Essentially Gives Customers Less While Paying More

Netflix, since our last report, has also begun to rethink its business. In July, the company announced that they would be separating its streaming and physical renting businesses, and increasing the pricing for their most popular plan (streaming plus 1 DVD-at-a-time) by 60%. The two businesses will soon be further split as the DVD business moves under the newly created Qwikster brand. While Netflix anticipated customer backlash, negative sentiment may have been underestimated as the company last week took down 3Q guidance for net additions by a million subscribers.

4th Positive: Video Revenue Trends Do Not Imply SecularDecline

In Figure 5, we have attempted to approximate the industry revenue growth rates using the reported subscriber counts of the large operators, and ARPU to the extent possible. Within our video framework, we incorporate the ~83mn subscribers reported by the top eight operators, and only utilize estimates for FiOS and U-verse ARPU and advertising revenue at the DBS and telco providers. By our calculation, video industry revenue, excluding advertising revenue, has consistently grown at 5%-6% for the past 12 quarters, with the exception being ~4.5% growth in 2H09. In our view, this is indicative of the overall healthy state of the video business, despite persistent concerns of subscriber loss to cord cutting. At a high level, the consistent growth should reduce concerns that the video business is in secular decline. As a side note, compared with sectors such as wireless, the presence of pricing power makes the comparative competitive dynamic of video feel relatively subdued.
Despite all the support of the traditional business model, signs of stress still exist

While these are clearly positives that help debunk the initial misplaced fears in the marketplace, there continues to be some developments and headwinds that suggest that we are no longer living in the halcyon days of yesteryear (even if those days never existed for media investors). We see four data points that require future attention:

1st Cause For Concern: Amazon
Amazon is materializing as a competitor to Netflix as the e-commerce giant continues investing in digital content rights to build on its free unlimited streaming offer for Amazon Prime members. Amazon has struck digital streaming deals with CBS and NBCU (for an estimated $50m per year each) and now offers ~9,000 titles of unlimited streaming to its Prime members. While a new bidder may initially drive up the price of content, it will be increasingly important that the content players exercise discipline and maintain proper controls and windowing over premium content, as there is a risk that Amazon, with its 144 million global active customers (and reportedly an Amazon tablet to come yet this year) may advance the threat of disintermediation to the ecosystem.

2nd Cause For Concern: Pay TV subs were weak in 2Q
Video subscribers were clearly weak in the most recent quarter, however we believe there is more going on in the undercurrent of the U.S. housing market than what total subscriber counts otherwise indicate. According to government data, there were roughly an equal number of households created in 2Q11 as 2Q10. However, of the ~300k units created in 2Q11, ~670k were rental properties. This compares with ~75k incremental rental occupancies in 2Q10, and implies that ~360k owned homes were vacated in 2Q11.

As shown in Figure 6, we direct investors to focus on the change in the subscriber contribution from DBS providers DIRECTV and DISH Network. Collectively, the pair combined to shed ~110k subscribers in the quarter, which compares to ~80k subscriber additions in 2Q10, and accounts for nearly 100% of the incremental industry subscriber losses. In general terms, DBS subscriptions are sold with a two-year commitment making the product less attractive to a renter, in our view, than the no-contract offerings of cable and telco bundles.
So what happened, and why are 265k subscriber losses not a significant problem for the pay television industry? Ultimately, what we see is an economic stress, likely housing, not a discrete election by consumers to disconnect their traditional pay television subscriptions. In our view, if subscribers were really replacing their video service with internet streaming options, we would expect to see a deviation in the penetration rates of high-speed broadband connections versus video. As shown in Figure 7, the historical relationship remains extremely strong, and 2Q11 results do not appear to be significantly different from typical second quarters. Secondarily, we note that the change in DBS subscriber additions was not a function of elevated subscriber disconnects, or churn. Rather, the DBS sub-sector gross additions declined by 170k compared to 2Q10.

Fig. 7: We observe a strong relationship between video and broadband penetration
Penetration of occupied homes

Source: Company data, Nomura estimates

3rd Cause For Concern: Traditional TV audience pressures persist
As the 2011-12 broadcast season kicks off this week, a quick look back at the past season shows overall audience levels slowed by -1% with broadcast network declines (-8%) offsetting modest growth at cable networks (+3%) (see Fig. 8). We note the growth at cable networks is inflated by roughly a couple hundred basis points as new networks are continually added to the Nielsen coverage universe. While there is no clear answer...
on whether the lack of quality/hits is driving the declines or an actual shift in consumer behavior, this is an underlying trend that we continue to monitor closely.

**Fig. 8: Full Year Broadcast and Cable Network Audience Growth**

![Graph showing full year broadcast and cable network audience growth.](image)

Source: Nielsen, Nomura research

### 4th Cause For Concern: Netflix and Google Self Producing Shows

The relationship between Netflix and the pay TV networks changed slightly on March 18, 2011 when Netflix announced that it had committed to a minimum of 26 original episodes of the soon to be produced TV series, *House of Cards*. Shortly thereafter, Showtime, which had previously allowed Netflix to have streaming rights to its currently airing first-run series, such as *Dexter* and *Californication*, decided that this content would be better off utilized in their VOD service named Showtime Anytime.

In addition, Liberty Media’s Starz changed its policy as well. Starting with its drama *Camelot*, Starz will no longer put its original series on Netflix the day after they air on TV. Instead, Starz will institute a 90-day delay before Netflix subscribers can watch the shows.

Ted Sarandos, Netflix’s Chief Content Officer, summarized the shift at a recent industry event:

> Super-serialized shows are going to end up on HBO, Showtime and Starz – three guys who don't necessarily want to sell to me. So we said, maybe we'll have to develop this content ourselves.

Unlike Netflix, Google has thus far not written the big check to acquire premium content for its digital platform YouTube. However, recent press reports cite Google’s willingness to spend as much as $500-$600mn to develop original content for YouTube. It remains to be seen if the internet giant will make a legitimate push to acquire additional content.

In conclusion, we believe that the threat of consumers dropping traditional TV delivery for internet services has been reduced by the intelligent actions of the leading content producers. These actions include limiting the availability of premium content in deflationary settings while providing legitimate alternatives to emerging online models.

While the industry lacks real Pay TV subscriber growth to rebuke cord cutting theorists, we continue to believe tepid housing formation is the real culprit.
Appendix A-1

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A rating of ‘Reduce’, indicates that the analyst expects the stock to underperform the Benchmark over the next 12 months.

A rating of ‘Suspended’, indicates that the rating, target price and estimates have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including, but not limited to, when Nomura is acting in an advisory capacity in a merger or strategic transaction involving the company.

Benchmarks are as follows: United States/Europe: Please see valuation methodologies for explanations of relevant benchmarks for stocks (accessible through the left hand side of the Nomura Disclosure web page: http://go.nomuranow.com/research/globalresearchportal). Global Emerging Markets (ex-Asia): MSCI Emerging Markets ex-Asia, unless otherwise stated in the valuation methodology.

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A ‘Bullish’ stance, indicates that the analyst expects the sector to outperform the Benchmark during the next 12 months.

A ‘Neutral’ stance, indicates that the analyst expects the sector to perform in line with the Benchmark during the next 12 months.

A ‘Bearish’ stance, indicates that the analyst expects the sector to underperform the Benchmark during the next 12 months.
Benchmarks are as follows: United States: S&P 500; Europe: Dow Jones STOXX 600; Global Emerging Markets (ex-Asia): MSCI Emerging Markets ex-Asia.

Explanation of Nomura's equity research rating system for Asian companies under coverage ex Japan published from 30 October 2008 and in Japan from 6 January 2009

STOCKS
Stock recommendations are based on absolute valuation upside (downside), which is defined as (Target Price - Current Price) / Current Price, subject to limited management discretion. In most cases, the Target Price will equal the analyst's 12-month intrinsic valuation of the stock, based on an appropriate valuation methodology such as discounted cash flow, multiple analysis, etc.

A 'Buy' recommendation indicates that potential upside is 15% or more.
A 'Neutral' recommendation indicates that potential upside is less than 15% or downside is less than 5%.
A 'Reduce' recommendation indicates that potential downside is 5% or more.
A rating of 'Suspended' indicates that the rating and target price have been suspended temporarily to comply with applicable regulations and/or firm policies in certain circumstances including when Nomura is acting in an advisory capacity in a merger or strategic transaction involving the subject company.

SECTORS
A 'Bullish' rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a positive absolute recommendation.
A 'Neutral' rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a neutral absolute recommendation.
A 'Bearish' rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a negative absolute recommendation.

Explanation of Nomura's equity research rating system in Japan published prior to 6 January 2009 (and ratings in Europe, Middle East and Africa, US and Latin America published prior to 27 October 2008)

STOCKS
A rating of '1' or 'Strong buy', indicates that the analyst expects the stock to outperform the Benchmark by 15% or more over the next six months.
A rating of '2' or 'Buy', indicates that the analyst expects the stock to outperform the Benchmark by 5% or more but less than 15% over the next six months.
A rating of '3' or 'Neutral', indicates that the analyst expects the stock to either outperform or underperform the Benchmark by less than 5% over the next six months.
A rating of '4' or 'Reduce', indicates that the analyst expects the stock to underperform the Benchmark by 5% or more but less than 15% over the next six months.
A rating of '5' or 'Sell', indicates that the analyst expects the stock to underperform the Benchmark by 15% or more over the next six months. Stocks labeled 'Not rated' or shown as 'No rating' are not in Nomura's regular research coverage. Nomura might not publish additional research reports concerning this company, and it undertakes no obligation to update the analysis, estimates, projections, conclusions or other information contained herein.

SECTORS
A 'Bullish' stance, indicates that the analyst expects the sector to outperform the Benchmark during the next six months.
A 'Neutral' stance, indicates that the analyst expects the sector to perform in line with the Benchmark during the next six months.
A 'Bearish' stance, indicates that the analyst expects the sector to underperform the Benchmark during the next six months.

Explanation of Nomura's equity research rating system for Asian companies under coverage ex Japan published prior to 30 October 2008

STOCKS
Stock recommendations are based on absolute valuation upside (downside), which is defined as (Fair Value - Current Price)/Current Price, subject to limited management discretion. In most cases, the Fair Value will equal the analyst's assessment of the current intrinsic fair value of the stock using an appropriate valuation methodology such as Discounted Cash Flow or Multiple analysis etc. However, if the analyst doesn't think the market will revalue the stock over the specified time horizon due to a lack of events or catalysts, then the fair value may differ from the intrinsic fair value. In most cases, therefore, our recommendation is an assessment of the difference between current market price and our estimate of current intrinsic fair value. Recommendations are set with a 6-12 month horizon unless specified otherwise. Accordingly, within this horizon, price volatility may cause the actual upside or downside based on the prevailing market price to differ from the upside or downside implied by the recommendation.

A 'Strong buy' recommendation indicates that upside is more than 20%.
A 'Buy' recommendation indicates that upside is between 10% and 20%.
A 'Neutral' recommendation indicates that upside or downside is less than 10%.
A 'Reduce' recommendation indicates that downside is between 10% and 20%.
A 'Sell' recommendation indicates that downside is more than 20%.

SECTORS
A 'Bullish' rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a positive absolute recommendation.
A 'Neutral' rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a neutral absolute recommendation.
A 'Bearish' rating means most stocks in the sector have (or the weighted average recommendation of the stocks under coverage is) a negative absolute recommendation.

**Target Price**
A Target Price, if discussed, reflect in part the analyst's estimates for the company's earnings. The achievement of any target price may be impeded by general market and macroeconomic trends, and by other risks related to the company or the market, and may not occur if the company's earnings differ from estimates.
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