

FUNDAMENTALS

The future of TV: It's blurred



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Predictions about the demise of the TV industry have persisted for over a decade, even as UK TV advertising and subscription revenues have continued to grow. However, we believe the industry has reached a tipping point, driven by rapid developments in technology and changing demographics.

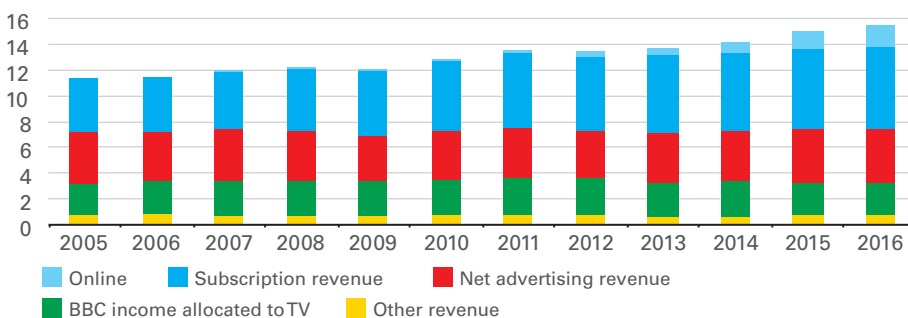
The industry hopes that today's 25 year-olds will watch more TV as they age, in line with the viewing habits of previous generations. But emerging trends already suggest this will not be the case. We believe the traditional media players are overestimating the

longevity of their current business models, with significant implications for investors. Established broadcasters still have time to adapt, but investors will need to be patient as these companies explore and exploit new technologies.

TV AT A TIPPING POINT

The UK TV landscape has already undergone significant change in the last 15 years. The number of TV channels has multiplied and we have the freedom to watch whatever we want, at our own convenience. Online platforms facilitate viewing on a plethora of devices beyond the TV set, wherever and however we like.

Figure 1: UK TV revenues (£ bn)



Source: Company data, Ofcom, LGIM.

Despite this, most TV is still viewed the old-fashioned way: via live TV channels.

As a result, business models have not changed much. Broadcast TV traditionally makes money by either charging consumers for access to TV channels or charging for adverts. Newer revenue streams are emerging but for now account for less than 10% of UK TV revenues.

In the longer term the broadcasting industry is unlikely to remain unscathed by our rapidly changing attitudes to TV. In fact, we believe it is now at a tipping point, driven by changes in technology and demographics.

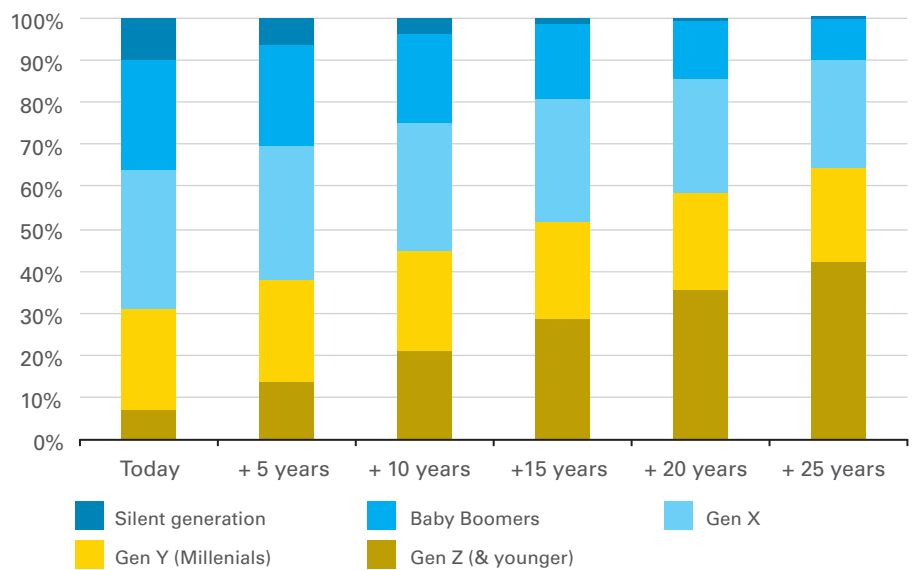
TECHNOLOGY

Because broadcasting requires that content be aired to a large audience at one time, viewing options have historically been limited by the number of TV channels. With over 1,000 channels now available in the UK, however, these obstacles have largely been overcome.

The internet has taken this a step further. Video on demand (VOD) can be accessed at any time, making viewing options almost unlimited. Importantly for investors, it has also broken down barriers to entry and allowed new TV services to emerge: one third of UK households now subscribe to at least one subscription video-on-demand (SVOD) service, a figure we expect to rise to over 50% in the next two years.

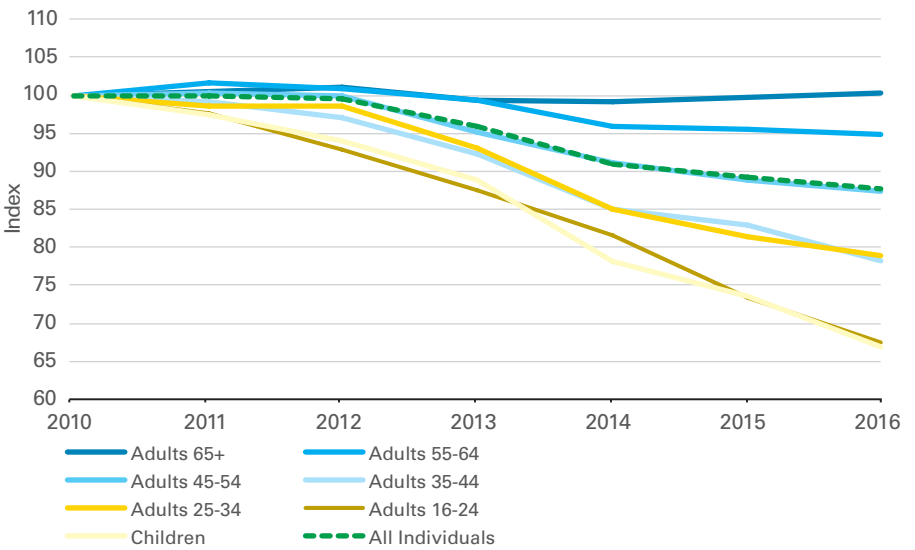
The tougher competitive backdrop does not end there. As video content has become available on a growing array of platforms, the distinction between 'TV' and 'online' has broken

Figure 2: The majority of adults in 15 years will be Gen Y or younger



Source: Company data, ONS, BARB, Ofcom, LGIM.

Figure 3: Gen Y and Z watch less TV then their parents (and falling)



Source: Company data, ONS, BARB, Ofcom, LGIM.

down. Traditional TV is therefore competing in the wider context of the overall video market – not just with Netflix, but also with Facebook and Google.

Competition for our leisure time is not a new challenge. But for the first time, TV is not winning the battle for our attention: UK TV viewing time peaked in 2010 and has been declining since. Although it is still the

number one leisure activity overall, TV is not leading in all age categories. The average UK consumer now consumes 25% of video away from traditional TV platforms; this figure increases to 44% for 16-24 year olds.

DEMOGRAPHICS

People born before 1980 (Generation X and Baby Boomers, or 'digital immigrants') currently represent the majority of UK adults. They have

access to more content choices than did previous generations, but they still typically watch TV the traditional way via live TV channels.

However, the viewing habits of younger generations are very different. Generations Y and Z watch less live TV than their parents, more video on demand and are more difficult to advertise to.

We think that demographic trends explain why the TV business model has held up so well to date. 60% of viewing is live and 75% originates from traditional channels, because that's how Generation X and the Baby Boomers watch TV.

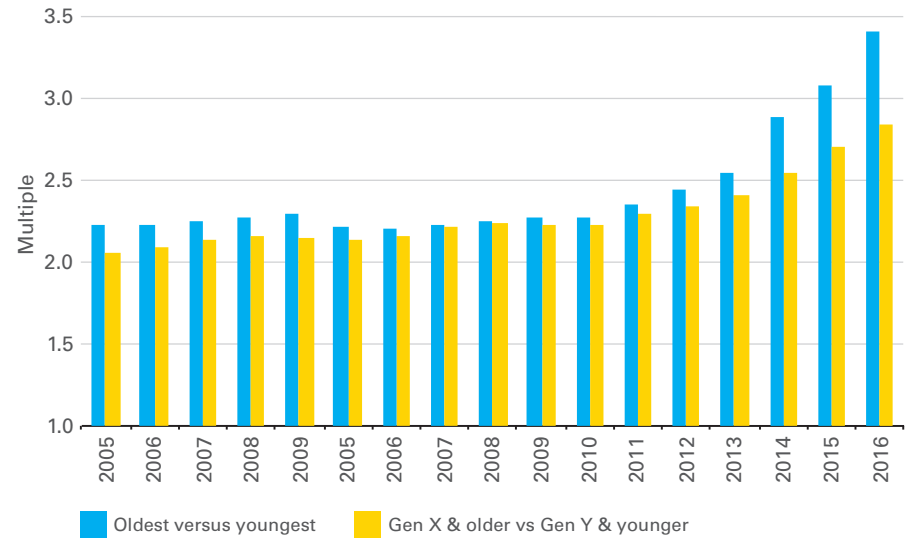
As the UK population ages, live TV viewing should therefore naturally fall. This poses an enormous challenge to the broadcasting industry. In 15 years, generations Y and Z will represent the majority of UK adults. The TV business model needs to adapt before then if it is to survive.

WHAT COMES NEXT?

Examining the viewing habits of the UK's ageing population allows us to predict the potential long-term outcomes for the TV industry. We focus on one key metric: how much time people spend watching TV (where 'TV' constitutes anything aired by a traditional broadcaster, regardless of the platform, but excluding SVOD services like Netflix).

People have historically tended to watch more TV as they age. In a best-case scenario for broadcast TV, the behaviour currently exhibited by younger generations could moderate over time, and over the next 20 years we estimate the number of TV

Figure 4: Old versus young viewing habits



Source: Company data, ONS, BARB, Ofcom, LGIM.

minutes viewed should only fall by around 4%.

However, in just the past 10 years – a period in which the population has been ageing – TV viewing minutes have already fallen by 10%, suggesting that the best case scenario is far too optimistic.

To assess whether historical norms have shifted, we initially considered the viewing ratio between older and younger generations. In the past, older generations have consistently watched around twice as much TV as younger generations. However, this relationship started to diverge from around 2011 (Figure 4).

Next, rather than comparing today's 25 year-olds to previous 25 year-olds, we analysed the behaviour of each age group over time. On average, every cohort under the age of 45 is watching less TV today than they were 10 years ago. Crucially, 16-24 year-olds are watching significantly less than they were as children.

If we extrapolate these trends, TV viewing falls by almost 25% over the next 20 years. Even this scenario may be optimistic, as it assumes tomorrow's children will watch the same number of minutes as today's. The outcome is worse if the trend of declining viewership among children persists to the next generation: TV viewing could then fall by a third.

ADVERTISING AND PAY TV

There is a direct correlation between TV viewing and advertising revenues: as viewing falls, revenues decline. But this is not the only pressure point. Broadcast TV has historically commanded a price premium due to its wide reach and mass market appeal. However, lower viewing figures could erode this core advantage, meaning that prices as well as advertising volumes will decline.

The relationship between viewing and revenues is less straightforward for pay TV, as a monthly subscription

costs the same regardless of viewing time. However, there is likely to be a point at which consumers no longer watch enough TV to justify the cost, particularly if they already subscribe to a cheaper SVOD service.

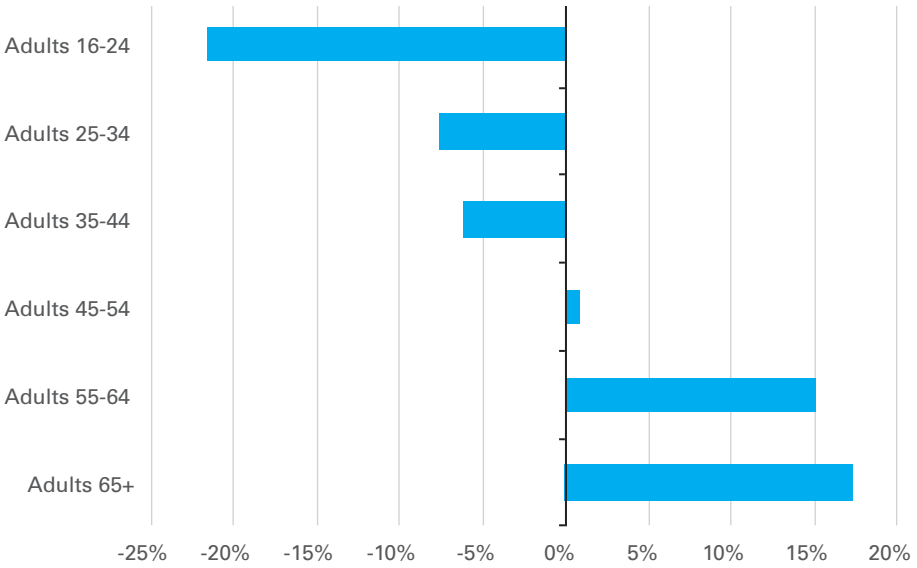
It is difficult to predict the tipping point, but the US – a more mature TV market – provides some clues. Netflix’s SVOD service has been available in the US since 2007. Initially its rapid growth did not affect pay TV, but once penetration reached around 35-40%, the US pay TV market started declining.

The UK reached 35% SVOD penetration in June 2017, which coincided with the first ever drop in UK pay TV subscribers in the first half of 2017. It is possible that this is a one-off decline, but we think it is more likely that the UK pay TV market has now peaked.

PEAK COUCH POTATO...

There are some beneficiaries of the changing TV landscape. There has never been a better time to be a producer – or a couch potato. Investment in original programming has grown rapidly, with the volume of first-run programmes aired by traditional UK broadcasters up 41% over five years¹. Content spend has simultaneously ballooned: Netflix and Amazon are expected to have spent a combined \$10bn globally on content this year, including \$3bn on original programmes.

Figure 5: 10 year change in viewing*



Source: Company data, ONS, BARB, Ofcom, LGIM. *% change in average hours viewed per day.

This means production companies are performing fantastically well in terms of profits and valuations, particularly in the premium content sector. The production arms of traditional broadcasters have also benefited: UKTV exports grew by 10% in 2016, driven by an almost 80% growth in the sale of digital rights².

...OR PEAK TV?

It is not all good news for producers. Markets have been brutal in differentiating between premium providers and those with stale content catalogues: Disney’s share price has more than doubled over the last five years, for example, while Viacom’s has halved.

We also see a danger of the premium content market overheating and reaching ‘peak TV’, a point at which

there is more content than the market can sustain. The rising cost of production, much of which is deficit-funded on the assumption of future international sales, recently prompted a Sky executive to warn this corner of the market “could be heading for a subprime mortgage moment³”.

Even for Netflix, first to the SVOD market, we think success is not a foregone conclusion. Netflix’s rapid growth has not been cheap, and deep-pocketed Amazon is already catching up. Disney, Apple, Hulu and HBO Now are also all vying for dominance of the TV market in the long term.

MUST-EXPERIENCE TV

The long-term survivors will be those who can deliver a better experience for consumers and monetise it more effectively.

We still see a place for Live TV. Mass market, time-sensitive broadcasts – such as sport – will continue to suit this medium. However, broadcasters need to drive content that promotes social and event-driven viewing, with ‘must-see TV’ evolving into ‘must-experience TV’. Technology will play a key role in this evolution. Broadcasters have tried to engage viewers by rolling out interactive apps and social media live chats in tandem with live shows, but there is still a long way to go.

VOD has allowed content producers greater creative freedom, but here, too, experimentation needs to expand to technology. While content is viewable on any screen, there has broadly been a lack of innovative content designed specifically for new mediums. Producers have been slow to exploit virtual reality and ‘choose your own adventure’ content, which could mark the most significant TV

technology revolution since silent movies became ‘talkies’ in the late 1920s.

Technological improvements in TV platforms are also important. On average consumers spend 51 minutes every day searching for something to watch⁴. The use of Big Data and artificial intelligence should enable better measurement and personalisation, leading to better tailored content suggestions. Search functionality also needs to improve. In an environment where consumers watch a growing variety of content across a range of platforms and from a plethora of providers, broadcasters who get this wrong risk being entirely overlooked by their potential audience.

BANG FOR BUCK

Waste has always been a key problem with TV advertising. A TV marketing campaign targeting a specific group of consumers will

be seen by irrelevant viewers. We think that this is another area where Technology provides a solution. Targeted advertising can utilise detailed household data, allowing set-top boxes to determine which adverts to show, tailored to that household’s attributes and meeting the marketer’s target criteria. Even in a world where traditional viewing is declining, we therefore see a path for broadcasters to protect revenues by giving advertisers more ‘bang for their buck’.

THE BOTTOM LINE

The traditional TV industry is undergoing a revolution. The good news is that the trends driving change are moving slowly, and companies still have time to adapt their business models by exploiting new technologies. The bad news for investors is this necessitates significant investment, plenty of trial and error and therefore also a lot of risk. For now, the only clear winners are consumers.

1 Ofcom, The Communications Market Report 2017

2 PACT, UKTV Exports Report 2015-16

3 Jane Millichip, Royal Television Society Conference September 2017

4 Ericsson, ConsumerLab Media Report 2017

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