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Pay-TV Operators: To Cut or Not to Cut?

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Key Points:

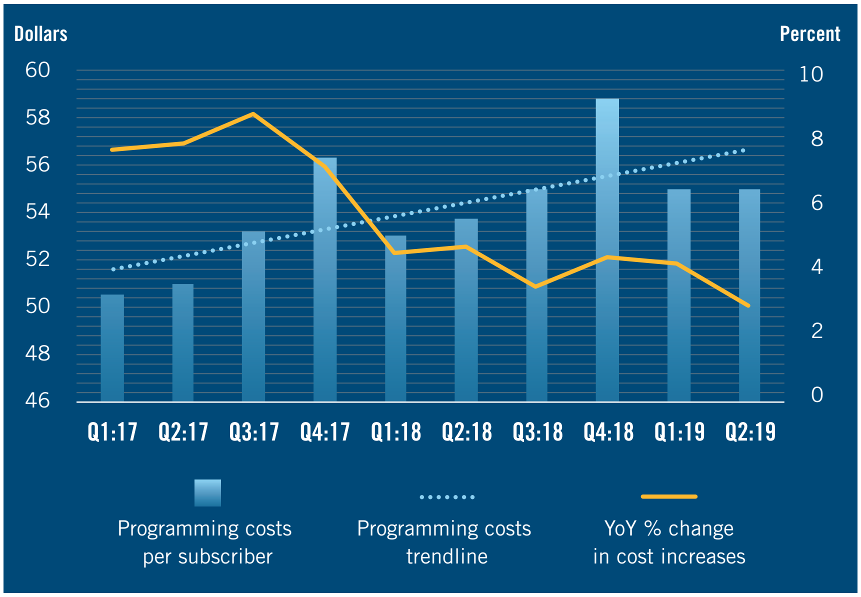
- Consumer adoption of over-the-top video streaming services, coupled with rising programming costs, have created significant headwinds for traditional pay-TV operators.
- Major technology companies are entering the streaming market with disruptive pricing strategies, putting more pressure on the traditional pay-TV industry.
- Despite the business challenges streaming services create for traditional pay-TV providers, they are a boon for the lucrative broadband industry.
- Deciding to deemphasize or exit the pay-TV business is scary given the potential rise in customer churn. However, our analysis suggests that this risk is fairly low.
- Some rural operators have demonstrated that by offering a white label streaming service, corporate operating margins can expand.

Introduction

The cable and satellite pay-TV industry is currently going through a major structural change as consumers "cut the cord" in favor of over-the-top streaming video services such as Netflix, Hulu, and Amazon Prime Video. Streaming companies are spending billions of dollars on original content, and deep-pocketed media companies are entering the market. To put this into perspective, Comcast, the largest cable company in the U.S., has been in business for 56 years and has 21 million video subscribers.[1] Netflix, founded 20 years ago, already has 61 million U.S. subscribers and 157 million worldwide.[2] As programming costs continue to rise, these foundational changes have put enormous pressure on pay-TV margins. Many small operators are struggling with the decision to be in the traditional cable/satellite pay-TV business.

In this report we look at the underlying trends and economics for streaming video services and how some operators are navigating these changes. We also address the churn risks of deemphasizing or exiting the video business, and how a broadband-first mentality can be a good thing for operating margins.

EXHIBIT 1: Quarterly multichannel programming costs per subscriber



Source: S&P Market Intelligence
Companies include: Altice USA, Charter, Comcast, DIRECTV and DISH

Over-the-top video

Instead of accessing video via a cable/satellite TV package, Netflix took its content directly to consumers over their broadband internet connection – known as over-the-top video. By charging a modest monthly fee, subscribers received access to Netflix's large catalog of commercial-free video content. Initially, the content wasn't considered first rate, but as Netflix scaled its subscriber base and saw its stock soar, it started investing in quality, original content. The service took off and ushered in a host of on-demand and virtual multichannel video programming distribution (vMVPD) services.

Background

Consumers have traditionally accessed video through linear programming channels distributed by cable and satellite operators. Pay-TV operators negotiated content distribution rights with networks and repackaged the channels for sale to their pay-TV subscribers. This model worked for a very long time, with pay-TV operators accruing healthy margins, but it also forced consumers to subscribe to networks they had no interest in. For example, if you wanted ESPN (the most popular and most expensive channel[3]) your only choice was to buy a package that bundled cheaper cable channels with ESPN. This strategy was designed to give consumers perceived value through choice, but in reality, consumers ended up paying for lots of channels they never watched. Throw in a bunch of commercials and the cable industry's low customer satisfaction ratings, and consumers were open to a new way to access video content. Sensing this frustration, Netflix saw a market that was ripe for disruption.

The added sweetener for customers is that some of these new market entrants are less concerned about making money with their video service, and instead see it as a tool to drive other business objectives. This resulted in lots of high-quality, low-cost original content. For example, Amazon doesn't view Amazon Prime Video as a direct revenue driver. Instead, it views video as a way to increase Prime subscriptions. And in the case of Apple TV, its aggressive pricing is designed to increase hardware sales and gain scale. Perhaps as Apple adds more content, it may increase the price. For now, this kind of disruptive pricing strategy makes it very difficult for traditional pay-TV providers to turn a profit.

In addition to the aforementioned competitive headwinds, programming costs for pay-TV operators are rising *(Exhibit 1)*. These two factors are squeezing margins and forcing operators to make tough decisions. Industry margins are under so much pressure that Cable ONE has reportedly told financial analysts that it loses money on every pay-TV customer it signs up.[4]

EXHIBIT 2: Pay-TV Margins

($ millions)	2018	2017	2016
Comcast			
Pay TV revenues	$22,455	$22,874	$22,204
Programming costs	$13,249	$12,907	$11,576
Margin ($)	$9,206	$9,967	$10,628
Margin %	**41%**	**44%**	**48%**
Charter Communications			
Pay TV revenues	$17,348	$16,621	$11,955
Programming costs	$11,100	$10,600	$7,000
Margin ($)	$6,248	$6,021	$4,955
Margin %	**36%**	**36%**	**41%**
Altice USA			
Pay TV revenues	$4,156	$4,274	$2,788
Programming costs	$3,173	$3,035	$1,911
Margin ($)	$983	$1,239	$877
Margin %	**24%**	**29%**	**31%**
DISH Network			
Pay TV revenues	$13,456	$14,260	$15,033
Programming costs*	$8,545	$8,920	$8,913
Margin ($)	$4,911	$5,340	$6,120
Margin %	**36%**	**37%**	**41%**

*includes other subscriber related expenses

Source: SEC filings

Pay-TV gross margins for publicly-traded cable operators are 24% to 41% *(Exhibit 2)*. Despite the fact that the National Cable Television Cooperative (NCTC) negotiates content licensing agreements on behalf of its 750 members,[5] programming costs are even higher for small, rural pay-TV operators. As a result, their pay-TV gross margins are likely below 20%, and operating margins are negative.

Despite these headwinds, over-the-top streaming services are a bright spot for the broadband market given the need for a fast and reliable broadband connection. Thus, consumers are opting for high-speed broadband plans, pushing broadband operating margins for smaller fixed operators into the 35% to 45% range.

Life without video

The theory behind bundling is that the more services a customer subscribes to, the stickier that customer becomes. This creates a conundrum for pay-TV operators who are considering exiting or deemphasizing the business. The question for these operators is how do you exit or deemphasize the video business without negatively impacting your broadband subscriber base? After all, despite the growth in over-the-top streaming video, the lion's share of consumers still subscribe to traditional pay-TV services. Taking these services away could drive consumers to another provider that does offer the services they want.

On the surface, messing with one's pay-TV service seems risky. However our analysis shows that operators would need to shed 10% of their broadband subscribers before their exit from pay-TV would negatively impact their operating margins *(Exhibit 3)*. This suggests that with the right strategy, operators can successfully transition their pay-TV subscribers to alternative video platforms without negatively impacting their business.

Navigating risks

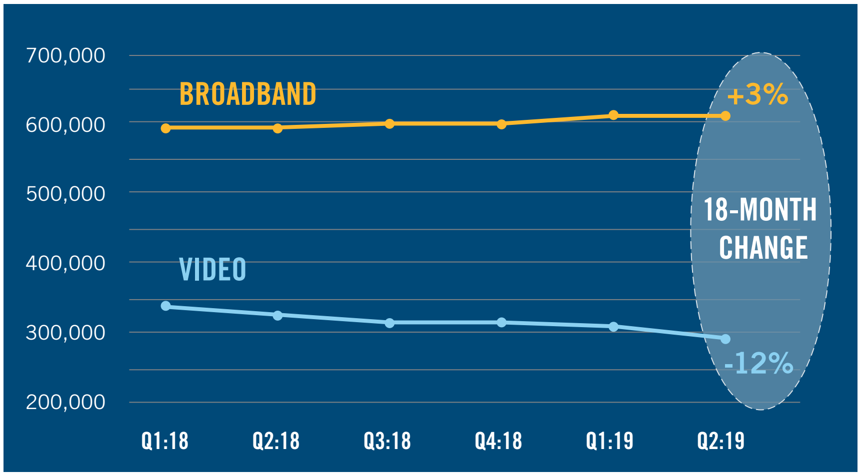
To mitigate churn stemming from a new video strategy, operators can educate consumers about their streaming options and teach them how to set up over-the-top streaming video hardware. The process of buying the hardware, learning how to use it, and figuring out what applications to subscribe to can be overwhelming. But once users get past the initial learning curve, many realize that they can access more content at less cost than their pay-TV subscription.

EXHIBIT 3: Margin Contribution Analysis - TV versus no TV

	Beginning Subscribers	Churn	Ending Subscribers	ARPU	Margin %	Margin $
Business as Usual						
Pay-TV Customers	325	0%	325	$85.00	-3.8%	$(1,047.31)
Internet Customers	500	0%	500	$54.00	39.5%	$10,672.68
Margin Contribution						**$9,625.38**
No TV						
Pay-TV Customers	325	100%	0	$85.00	-3.8%	$-
Internet Customers	500	10%	450	$54.00	39.5%	$9,605.41
Margin Contribution						$9,605.41

Source: CoBank Estimates
Ratio of Pay TV subscribers to internet subscribers is based on industry averages. ARPU and margin estimates are rural operator-based

EXHIBIT 4: Cable ONE Video and Broadband Subscriber Trends



Source: SEC filings

Operators typically implement a cost-plus model for content streaming services. While the margins are extremely thin, the service isn't a financial drain. Also, according to the operators who have transitioned away from a traditional cable TV service to an operator-branded streaming service, the increase in broadband subscriptions exceeded their expectations.[6]

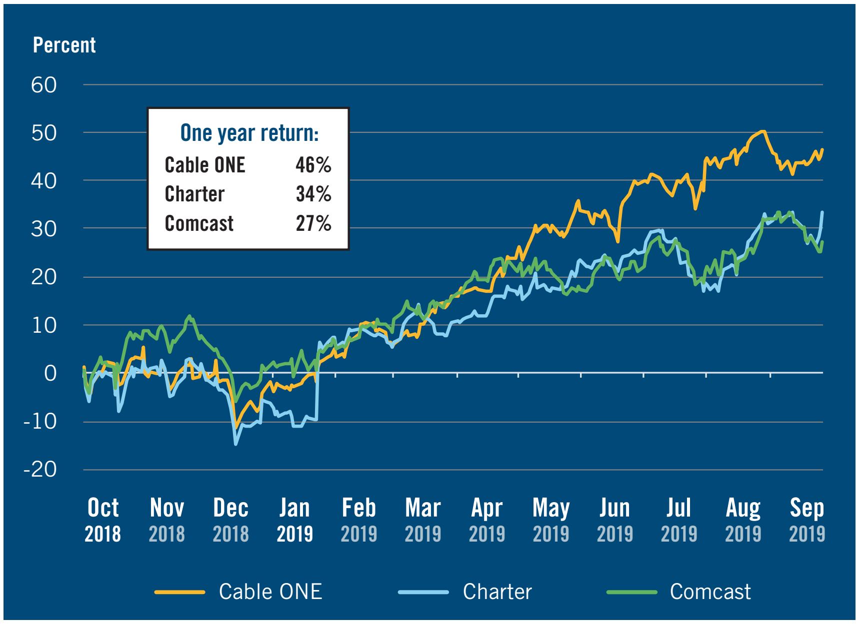
Some in the industry believe that once consumers get used to streaming with a private label application, they will eventually disconnect and move on to subscribing directly with the programmers. Consumers will likely save money with this approach, but it does take time to get comfortable with a "sushi menu" approach to video streaming. For the operators, it doesn't really matter when or if this happens as long as they keep the broadband connection.

We've also seen some operators adopt a white label streaming strategy with a third-party platform provider such as MobiTV. By taking this approach, the operator still owns the customer relationship and eliminates the lion's share of its (video) network capital and operating expenses, but also gives up most control. The third party platform provider develops the streaming application and consumers access content through a streaming device (Roku, Amazon fire stick, Apple TV). The service has the operator's brand and the operator negotiates all the programming deals.

Cable ONE

Cable ONE has been deemphasizing its video business and adopted a broadband-first strategy. The company is rebranding itself "Sparklight" as it moves away from its cable TV heritage. Cable ONE isn't abandoning its pay-

EXHIBIT 5: Twelve Month Stock Chart (percent gain)



Source: Yahoo Finance

TV service, instead it's taking a conservative approach to pricing. For example, instead of changing its price based on factors such as competitive promotions, it simply passes along any rate increases it receives from networks onto its customers. For those customers looking to cut the cord, Cable ONE is proactively educating them about their streaming options. Predictably, this strategy has contributed to its video subscriber losses, but at the same time, the company has been able to grow its lucrative broadband business *(Exhibit 4)*. The key here is that Cable ONE representatives are quick to remind cord cutters that they need a fast and reliable broadband connection to watch streaming video. This tip has helped the company grow its lucrative broadband business and as a result, investors have rewarded the company with an outperforming stock price *(Exhibit 5)*.

Conclusion

Pay-TV is just the latest example of how technology has disrupted business models and industries. For example, Apple's iPhone was the death knell for cell phone heavyweights Nokia and Motorola. Amazon has fundamentally changed the retail industry and forced some retailers into bankruptcy in the process. The foundational changes in the video market may not be as drastic, but a change in thinking on the part of pay-TV operators is clearly needed. Cable ONE has showed that deemphasizing video and educating consumers on their streaming options doesn't need to hurt business performance and can in fact help it. Given its lack of negotiating leverage with networks and margin pressures on pay-TV, rural cable/telco operators would be well served to take a page out of Cable ONE's playbook.

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