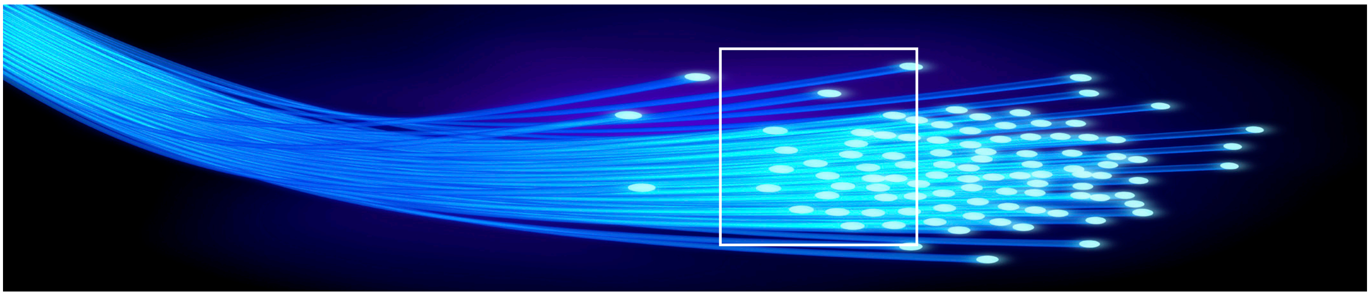
Online media and content winning

Arthur D. Little's Media Flow of Funds Analysis – Germany



Over the last several years, the German media ecosystem has shifted online. While the physical home video market and traditional (offline) pay TV are holding up against online video, physical music distribution has been hit the hardest. Content producers, online aggregators and search engines are capturing more and more value. Broadcasters and Publisher were most resilient, effectively protecting their value capture against new entrants and business models.

Arthur D. Little has conducted a structured analysis of the German media industry value chain resulting in a comprehensive view of the state of this industry (see figure 1 overleaf). Capital inflows into the media industry come from advertisers, consumers and public funding. For consumer spendings, distributors are typically the first recipients of inflows (e.g. CD/DVD retail & rental, pay TV revenues, circulation revenues of print media, box office …). The distributors pass on part of their revenues to aggregators as is true for most of advertising revenues (e.g. TV/radio broadcasting, advertising revenues of print media, online portals, online services …). Aggregators in turn pass on revenues to rights owners and content producers. Our analysis focuses on two main KPIs: (i) the *share of total media industry revenues* an individual value chain step can attract, and (ii) its *retained value,* i.e. the amount an individual value chain step does not pass on to other players in the industry. Analyzing this data for offline and online players separately provides unique insights into the transformation of the German media industry.

Online drives moderate revenue growth in German media industry

In 2013, the German media industry generated in excess of EUR 52 billion in revenues, up 7 percent since 2007, representing roughly 2 percent of GDP.

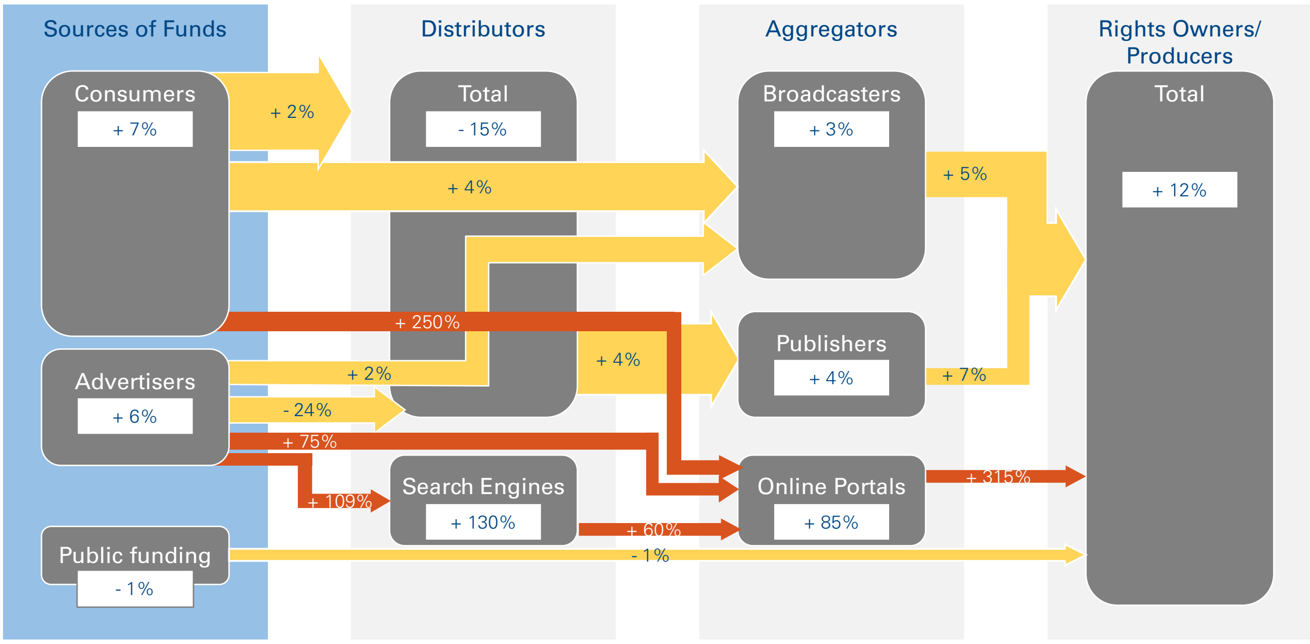
As part of a global trend, the sector is undergoing a continuous shift in revenues from offline media, such as newspapers, CDs, DVDs or TV broadcasting, to digital media and online distribution like eBooks, music streaming or Video-on-Demand.

Overall, consumer spending on media in 2013 was EUR 36 billion, up 7 percent compared to 2007. Consumer spending represents the largest source of capital inflows in the media value chain (70 percent of total). However, revenue growth in offline and online media is split unevenly. Revenue of offline media increased by only 5 percent, whereas revenue of online media increased by a remarkable 315 percent, albeit from a much smaller base. Approximately 90 percent of consumer spendings still remain with offline distribution channels; however, migration to digital content and distribution is increasing at a fast pace.

With the introduction of online services, consumers can choose from a wide variety of possibilities to access movies, music, games or written content. The high penetration of internet-enabled devices further encourages consumption of online content. In 2013, 77.2 percent of all adults (over 14 years of age) in Germany have been online; only the age group of 60 years and over showed an online penetration of less than 50 percent. Hence, future growth in digital revenues cannot come from an increase in internet penetration, but rather requires increased usage. The increase in average internet usage of 169 min per day, up by 36 minutes from 2012, is clear evidence of this trend. In the segment of 14 to 29 year-olds, the daily usage reached 218 min per day in 2013.[1]

1 http://www.ard-zdf-onlinestudie.de/

Figure 1: Flow of Funds German Media Industry, 2007 vs. 2013



Source: Arthur D. Little analysis

Online video quadrupled since 2007, but cannibalization is limited

The home video market (retail & rental) is a prominent example of how online content distribution could act as a substitute for offline distribution. New services offered over the internet are often cheaper and more convenient to access for consumers. Since 2007, several new distributors in online video have launched in Germany, ranging from online players like LOVEFiLM, WATCHEVER, maxdome, Videoload, and Apple's iTunes, to Video-on-Demand offers of Deutsche Telekom's IPTV and cable operators' digital TV services. In 2013, this online market accounted for more than EUR 200 million, up from approximately EUR 30 million in 2007.

Physical video distribution (rental and retail), however, declined only slightly by 1 percent 2007-2013. Traditional (offline) pay TV providers also managed well through the crises and were able to increase consumer revenues in recent years. Subscriber and pay TV ARPU growth indicate that consumers still value premium content, advanced features and a strong offer combining offline and online channels. At least in the medium term, these new services in online video distribution appear to generate incremental revenue rather than replace existing services.

Advertising has shifted online the fastest; search engines and online platforms are biggest winners

The shift from offline to online media has been most evident in the change in advertising expenditures, which account for approximately 30 percent of total media industry revenues. Whereas the offline advertising market decreased by 13 percent, online advertising increased by 89 percent from 2007 to 2013.

Most of the advertising funds were spent on search engines and related areas, which are the primary winners from the shift online. In 2013, search engines received more than twice (+109 percent) the advertising spend than in 2007.

The retained value of search engines grew by more than 130 percent between 2007 and 2013. Search engines now account for about 4 percent of the overall Germany media industry revenues in 2013.

Online media aggregators like social networks and online gaming platforms increased their retained value by a remarkable 85 percent versus 2007. This is largely a result of economies of scale in online distribution and highlights the attractiveness of investments in the digital media space. As their share of industry revenues increases, these players are becoming important business partners, dispersing EUR 1,044 million into the ecosystem, up from EUR 252 million in 2007.

Physical distribution under pressure, but broadcasters are resilient

Even though media spend from both consumers and advertisers increased, physical content distribution decreased significantly. The overall retained value of distributors in the media industry declined by 6 percentage points between 2007 and 2013, from 27 percent to 21 percent. Hardest hit was the physical music distribution segment, which reported revenues of nearly a third less compared to 2007. Newspapers and books achieved moderate growth, which was mainly driven by increased online sales. While currently representing a small proportion of the book market, eBooks already show the potential to transform consumers' reading habits in the future. Increasingly affordable tablets and eBook readers will play a major role in this development.

Traditional aggregators, such as public & private TV, pay TV and radio broadcasters, were not struck as hard by the shift in the media environment. Also publishers fared comparatively well, remaining the largest players in the media ecosystem, with an estimated share of retained value of 29 percent.

Distributors and aggregators will need to fundamentally re-invent the consumer experience from physical to digital as they risk being increasingly side-lined by new players (e.g. search engines, social media actors…). The retailer's attempt to stay relevant in home video through UltraViolet is one such example. On the other side, online players are also not sitting still, highlighted by recent co-operations between Netflix and selected cable operators in Europe to become more relevant on the TV set in the living room.

The need for distributors and aggregators to control the User Interface will become ever more important. The challenge is not just about providing the right content, it is also about offering the best consumer experience. (Further details and related viewpoints on customer experience can be found on our website).

So far, Google, Facebook, or Netflix have not yet come up with an integrated user experience across multiple platforms and services, which is what enables offline pay TV players to secure and strengthen their position so far. However, in the US the room for "content value-for-money arbitration" is sometimes so large, that consumers favor a non-integrated experience to get a better deal.

Content owners and producers monetize new emerging opportunities

Our analysis reveals that the increasing trend of online media consumption did not impact revenues for content owners and producers negatively. In 2007, content owners and producers represented 23 percent of retained value in the industry; in 2013, they increased this share to 24 percent. Consequently, they are rather winners than losers from the transformation of the industry, illustrating that "content is king" even more so in the new age of online media.

Despite the abundance of low-quality, consumer-generated content, consumers are again turning towards professional, higher production value content. This trend is also evident in the online environment. YouTube, for example, invested more than USD 200 million in original content from 2011 to 2013. Video streaming provider Netflix annually invests more than USD 100 million in original content, producing much acclaimed series like "House of Cards". The company has announced plans to double these investments in 2014.

Besides providing more attractive, original content via online channels, distributors and content owners have begun to find strategies for the monetization of content online. This can be seen by the successful OTT (Over-The-Top) offers, like Spotify or Deezer, often made available in cooperation with telecom providers. Traditional (offline) publishing houses are also starting to monetize their online content more effectively. However, successful monetization of online content is resulting in a limited number of portals playing a leading role in future content distribution. This distribution clearly benefits from economies of scale.

Radical moves can pay off for offline players, but online relevance is not a given

Axel Springer AG has successfully reinvented itself from an offline publishing to a leading digital and online media business. Specifically, Axel Springer forcefully changed its offline business model to cross-media. The positive business figures show that the company is beginning to benefit from these brave steps. Today, it generates more than one-third of its revenues from digital media.

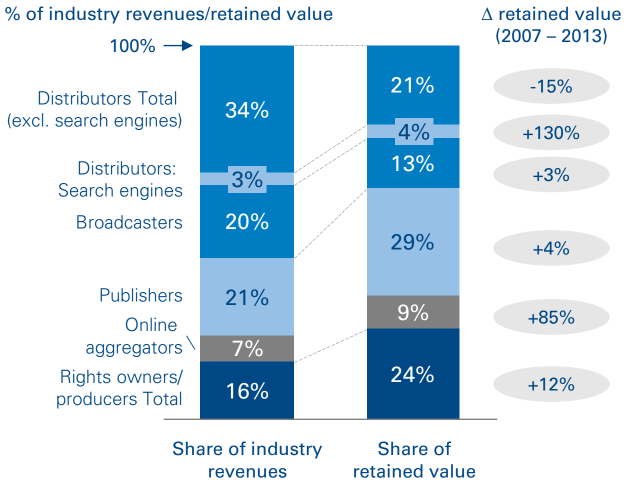
Another example of a very successful traditional player grasping the opportunities in the digital space is ProSiebenSat1. Through radical moves into non-core areas, the company transformed its business and proves the viability of these activities as a financial investment. It also engages in media-for-equity and revenue-share deals with smaller start-ups and built up a diversified portfolio, also via its incubator "epic companies".

While customer churn was comparatively low in offline media, today's digital natives can turn quickly to other, more attractive offers on the web – and they do. The online environment has comparably low entry barriers, evidenced by new online offers appearing almost by the second; globally, a new domain goes live every two seconds. Hence, every online service that is attractive today can quickly become out-dated. Prominent examples are social networks like StudiVZ or MySpace. Both companies were initially praised as the rising stars in social networks with millions of active users on their platforms. Today, those early stars are rather a shadow of their initial success; even Facebook appears to struggle to continually innovate itself.

Conclusion

The German media industry, despite the economic crises, witnessed moderate overall growth over the past six years, and has seen a strong shift online. Future growth, however, will mainly come from generating value from increasing usage rather than new internet users.

Figure 2: Industry revenues vs. retained value, 2013



Source: Arthur D. Little analysis

Figure 2 shows that some players were able to retain higher value than their share of industry revenues. In particular, rights owners/producers, search engines and online aggregators were able to strengthen their position in this fast changing market environment. At the same time, physical distribution has not found a recipe against further value erosion yet and risks losing further share in the coming years. Hence, in particular physical distributors need to re-think their business models and define their role and value add in a future multi-channel product distribution.

We also expect that financial investors will continue to find attractive investment opportunities in the German digital media market as illustrated by the recent acquisition of the Scout24 group by a private equity fund.

To capture value from the transformation in the German media landscape, offline players need to

- Optimize and secure relevance on the User Interface and offer integrated experiences
- Extend and rethink existing business models to extract more value from the online opportunity
- Acquire start-ups, identified by continuous market monitoring for targets and trends

Key actions for online players include:

- Extend reach through partnerships and secure local relevance
- Focus on product/service life-cycle management to keep the innovative edge over new comers
- Leverage knowledge of customer behavior and demands to react to changing trends early and avoid customer churn

However, all players have one action point in common: be alert, be brave and even radical at times, but primarily take action early to embrace the online opportunity!

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Arthur D. Little

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