

The Entertainment Earthquake: Evolve or Succumb

Walt Disney Co (NYSE:DIS) – market cap as of 27/04/18: \$151.2bn

Twenty-First Century Fox Inc (NASDAQ:FOXA) – market cap as of 27/04/18: \$67.7bn

AT&T Inc (NYSE:T) – market cap as of 27/04/18: \$215.8bn

Time Warner Inc (NYSE:TWX) – market cap as of 27/04/18: \$75.8bn

Introduction

M&A activity is not a steady phenomenon. Rather, it tends to cluster in time and usually occurs in large waves. Such waves can be brought about by differing events, such as technological advancements, changes in regulation, pressure on prices, or - this article's main inspiration - disruption. Disruption is a main driver of M&A activity, both for incumbents striving to stay relevant and newcomers seeking to grow. If we were to hand-pick 2017 and 2018's most spectacular candidate for disruption, the choice would obviously be the Entertainment Industry. No other sector has experienced such geographical expansion, fierce competition and ignited such an enormous outbreak in M&A megadeals. Netflix's uprising has already revolutionized what consumers come to expect from entertainment and subscription services in general, and the Entertainment Industry will change as a sub-product.

Industry Overview

The entertainment industry provides a broad range of media contents, including: movies, TV shows, radio shows, news, music, newspapers, magazines, books and gaming. Entertainment companies operate in a fast-paced, evolving environment and need to constantly adapt and reshape their business models. The main activities of content production and distribution, as well as their revenue-generating model are indeed evolving and morphing as new technologies and distribution channels come into play, disrupting traditional business plans. Recently the entertainment business has been under the press' spotlight and has grasped regulators' attention. Furthermore, as recent events have already shown us, the entertainment industry will probably continue to be an ideal candidate for future M&A activity, although it has already undergone a strong wave of consolidation.

The ups and downs of the entertainment industry are closely tied to consumers' spending, making economic expansion fundamental for profitability and revenue growth. The dynamics of the entertainment industry are continuing to shift from traditional publishing in print media and TV broadcasts to new business models involving online content and subscription base.

The industry is characterized by a high level of competition among incumbents. The entertainment sector is extremely concentrated with few players making up a big share of global market. The list of market leaders is dominated by American firms, representing a third of the global industry, and includes Time Warner, Disney, Paramount Pictures and 21st Century Fox, Netflix, Spotify, Sony Music Entertainment, Direct Group Holdings (DIRECTV). Moreover, the entertainment industry features a high degree of vertical integration: many players, following the strategy that emerged at first in the film industry in the United States, are both producers and distributors of content. We resort to Porter's Five Forces framework to disentangle the complexities of our Industry analysis.

Rivalry among Competitors

In any industry with few players, competition is fierce. The entertainment industry, and all of its subsectors, faces tight rivalry from alternative content producers and delivery methods, which has increased the competition among

entertainment players. Entertainment services are mutually exclusive: consumers have only two eyes and can focus them either on one or on another entertainment services at a time. Moreover, for many services, many providers offer similar types of content, and cost differentiation is the competitive weapon in the playing field (price pressure is tremendous, also due to Online Piracy). Finally, the bulk of the costs are represented by ex-ante fixed cost of content production/acquisition and the distribution infrastructure. Furthermore, today the vast majority of the products are delivered to the final consumer digitally, making the marginal cost of an additional user null. In this competitive environment, thus, the advantage is closely related to the volume of consumers and for this reason the price competition is tough. In this framework, across the industry, a collaboration strategy is often implemented: aimed at gaining a larger market share and competitive advantage than other competitors in the shortest time span possible (even if such entails becoming a loss leader in the expansionary phases). Technology, and user engagement can also be deployed to retain customers, generate switching costs and overall build entry barriers.

Threat of Substitutes

Substitution represents a relevant threat for the entertainment industry. Innovation, in particular, is what can affect incumbent's revenue the most. Substitution takes place both in terms of products and in terms of distribution channels. Technology giants such as Amazon, Google and Apple plan to continue to increase their pressure on the entertainment and media industry. Many tech players have become pioneers and market leaders in video distribution particularly for what concerns online streaming video. Amazon in particular has expanded its operations in basically every field of the entertainment industry, offering an online movie platform, books distribution both through e-book reader and through audible (recorded audiobooks) and a music streaming service as well. The music industry is also making moves toward online media expansion and increasing services offered to customers. Essentially, what these companies are doing is creating one-stop-shops for the consumer who no longer have to visit multiple sites for their entertainment and media needs.

Threat of New Entrants

The threat of new entrants into any industry depends on the strength of the barriers to entry, on the capital intensity required and on the ease of new companies to enter the market. The threat of new entrants to the entertainment industry is relatively low, especially in the content production activity. The high and prolonged financial commitment needed, for example, for movie production or for TV series production constitute an extremely high sunk cost and consequently a heavy entry barrier. Although the evolution of internet and online platforms are making the distribution activity a lot easier to access for new potential entrants, this industry is characterized by established companies and conglomerates with a significant presence in media networks and filmmaking and it would be difficult for a new entrant to overcome the big pressures market leaders against new comers.

Bargaining Power of Buyers (Consumers)

With the wide diffusion of wireless connection, mobile devices and online media platform it is clear that the consumer of entertainment content has more power and more flexibility. Consumers have complete control and can choose amongst a vast variety of options, with the possibility to view content wherever and whenever they wish to. For the abovementioned reasons, the entertainment industry features high bargaining power of consumers. This bargaining power is due in part to the attractiveness of low cost alternatives: if cheaper alternatives are available, consumers are likely to choose them. With this regard, differentiation and exclusiveness of contents is determinant. Consumers have a very wide selection of content to choose from and ease of access through increased online programming and sources of entertainment.

Bargaining Power of Suppliers

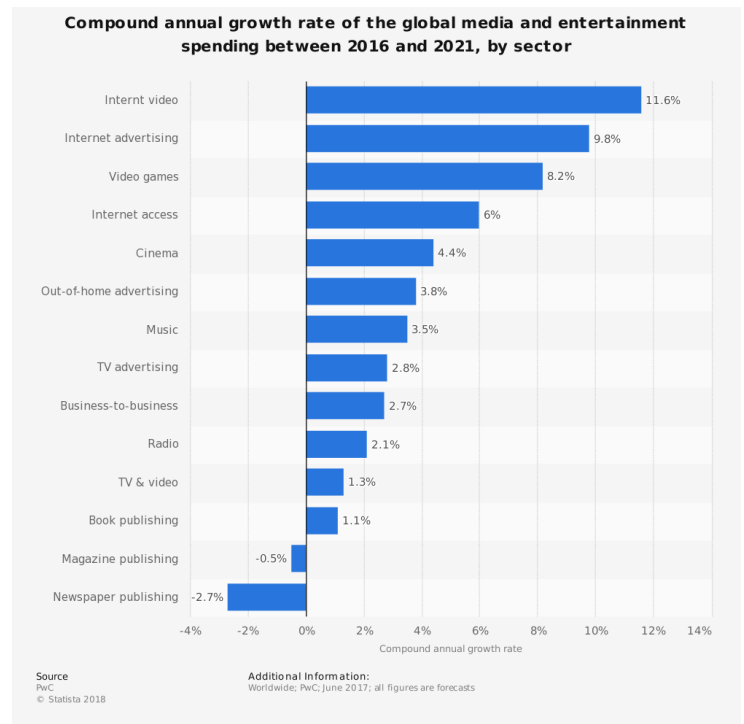
The bargaining power of suppliers in the entertainment industry is generally quite high, as most of the production comes from few and established players. As an example, we can refer to the music industry, in which the very vast majority of artists are signed to a small number of large record labels. Such labels own the rights to such content and cede such rights to distributors such as Spotify or Apple Music, in exchange for royalties and fees. A parallel example can be made in the film-making industry. Overall, the general level of supplier's bargaining power mostly depends on the chain of production-distribution and can vary by sub-industry. A common move of some of the larger players was to vertically integrate, to incorporate as many links as possible in their value chain. Large players seem to prefer a highly vertically integrated structure, but still, more and more companies are outsourcing parts of their business to cut costs and maximize efficiency in order to gain a competitive advantage.

All the same, the recent and general scenario of increasing competition and margin shrinking is diminishing supplier's overall clout on the entertainment industry's main players.

It is also important to add the influence of one particular stakeholder, not included in the Porter's framework: the government. The media and entertainment industry is a highly regulated sector: the government usually steps into corporate managerial practices, with particular reference to mergers and acquisitions. Due to its relevance in the society, the regulation concerning media and entertainment aims mainly at maintaining conditions for free markets, competition and protection of consumers; promoting efficiency and the development of technical standards; preventing excessive concentration of powers. Having such goals in mind, competent national authorities monitor content, as well as anti-trust and concentration violations.

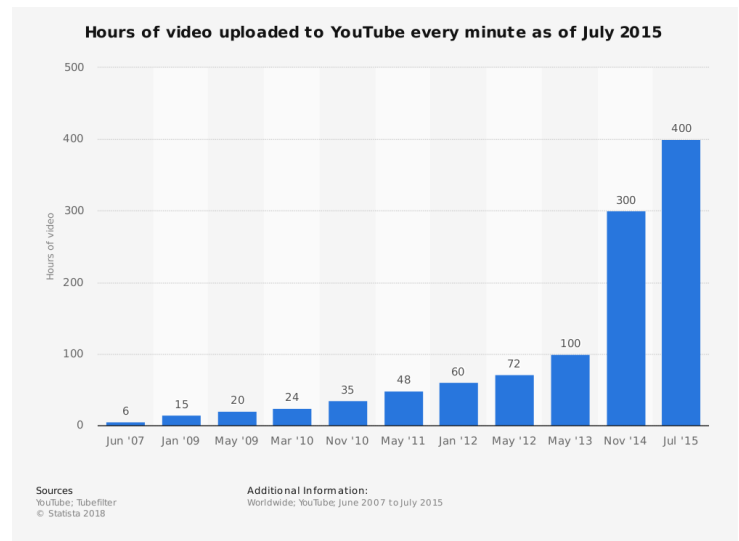
Industry Trend

The ongoing digitization of content and the substantial innovations in technology and in the distribution channels will continue to support growth and force changes in the entertainment industry. Distributors in particular will experiment with new revenue streams, particularly to reap the benefits from digital subscriptions and online advertisements. Consumption through mobile devices will continue experiencing growth and expanding market shares with respect to traditional channels. For this reason, mobile advertising is expected to grow by roughly 65% in the next few years. The publishing industry continues to experience a decline in advertising revenue and drop in readership due to the increased availability of free online content. A research from IBISWorld states that the life cycle of the newspaper industry is in the decline stage and predicts the continued contraction through 2021. The book publishing industry had slow growth between 2011 and 2016. It also suffers competition from online textbook subscriptions and download as well as from E-books, that are also expected to continue growing. However, the book industry is expected to do well in the coming years mainly thanks to college enrolments and especially in developing countries. Broadcast television will continue to experience significant changes. The trend toward online viewership of TV is expected to continue, yet advertisers will continue to spend on TV advertising due to its ongoing effectiveness. The film industry will have moderate growth in the next few years. An increase in distribution channels for motion pictures and an expanding global market will be the key contributors to growth.



Production companies are also experimenting with various methods for content delivery, such as online television and with mobile devices.

The clear winner is the subsector of internet video: it is expected to experience a double digit compounded growth rate over the next 4 years. In particular, data show that millennials are the main target of online video, with almost 26% of them watching more than 10 hours of video per week. Consumption of online video content takes place mainly in few platforms, namely YouTube, Netflix, Hulu and Facebook. Data witness that the hours of video uploaded on YouTube has skyrocketed in the last decade, featuring an exponential growth. Also, Facebook has shifted completely in the last 4 years toward video content: video, indeed, can keep the user more online on the platform and allow for more online advertising income.



Finally, we are and will witness an increasingly degree of “customization”, both in term of content and in term of advertising. Entertainment companies are figuring out how to provide an experience that each customer feels is tailor-made specifically for her or his preferences. Fortunately, users will continue to provide more data about themselves and companies can take advantage of this information and customize their content and advertising maximizing customer experience. Indeed, it is no longer enough solely to develop attracting content. Now, market leaders need to create fans: active users with common interests and experiences, who will daily return to the platform. Who will succeed in the creation of an army of fans, will enjoy substantial advantages.

The Change in Business Models

Content consumption has shifted drastically since the last decade. Today’s consumers are radically different than their older counterparts, and beyond requiring wireless access to their content (on the go), they have proven to be insufferable to both programmed shows (they want it on-demand) and traditional commercials.

In particular, the refusals of commercials by millennials has undermined traditional entertainments primary revenue base: advertisers. As advertisers come amiss in entertainment, subscription services have provided to be a viable alternative, with consumers providing an upfront periodical payment (mostly monthly), in exchange for a wide variety of content they can choose from. Advertisers will need to become more creative in the current landscape, and resort to alternative ways of marketing their products, with other alternatives such as product placements and sponsorships. In any case, it is clear that the drastic changes in the entertainment industry will force the next generation of player to fight with new strategic layouts. Entertainment’s Old Business Model is Dead.

With the advances in video, mobile, Internet of Things and other wireless technologies, there is now an overabundance of entertainment options readily available to customers. Because of that, streaming services such as Netflix continue to rapidly gain popularity. In 2016, about 50% of US households had an active subscription to at least one content service while millennials had an average of four subscription services active.

This trend has led media companies to adapt and go directly to the consumer with their own streaming service, and such is the case with Disney, which is scrambling to start-off its own streaming platform and catch up with

competition. Their acquisition of 21st Century Fox will help them launch their own online service and end their distribution agreement with Netflix. Similarly, fans of the popular show Game of Thrones have the option to watch it on HBO's platform by signing up for a subscription.

With the rapid innovation in technologies, we can expect customer demand to remain high in the foreseeable future. Streaming service providers should aim to remain on the cutting edge by improving the quality of their content whilst also finding ways to get the most value out of it. Traditional cable has proven slow to catch up with the increasing media encoding standards and has failed to provide the highest quality product to customers. Media aficionados with expensive gear used to rent Blue-Ray discs to get the most out of a movie. Now, with high speed broadband and advances in computer science one can stream the best quality content without having to wait for a physical copy of the disc.

One of the major pitfalls is the potential exclusivity of content. If every media company were to offer a paid media service and have exclusive rights over their productions, customers may feel forced to pay for multiple subscriptions, with the likely alternative that we will have few, but very large players, which become "worth their subscription".

Ads Based vs Subscription Based

We are on the incipit of a possible macro disruption: consumer habits have changed and are moving away from advertising to subscription-supported models. The reason for this shift relies both on the disadvantages embedded on advertising models and on the product enhancement of the subscription-based platforms.

Advertising is tedious for every user. As Scott Galloway, professor of marketing at NYU Stern and digital marketing guru said, "advertising is a tax on the poor, a tax on consumer attention". It has also become increasingly expensive. We are multi-tasking and keeping up with many things at once thus stopping to watch an ad is a speed bump in our lives and is perceived as extremely expensive. Moreover, streaming content has put more control in people's hands, control to watch what they want, when they want it, without the burden of the tax of attention. For these reasons, audience is migrating quickly away from traditional broadcast models and into subscription based non-ad supported platforms like Netflix. Advertising traditional model won't be gone overnight, but the signs of change are already extremely tangible. Traditional advertising forms are going to be forced to evolve or die. In this context, one of the strategies that is expected to keep ads from drowning is "product integration": which aims to understand the customer's preferences and find ways to effectively integrate ads within screen entertainment, rather than distracting users from it.

Subscriptions are in fact a useful tool to improve content. If the entertainment providers are willing to induce customers to pay for a product that they have enjoyed for free, they have to improve the service and the products get better. Again, Netflix should be recognised to be one of the pioneers of this strategy. The race is on to produce more quality content to keep subscribers happy, often using data from their direct relationships to learn about their preferences and continually improve. And this is what the popular online streaming company has implemented in the last years, with an undeniable success from the customers.

Information is Subscription Based Online content's second biggest weapon. As Providers come to know their customers better, they will progressively be in a better position to satisfy them and maintain their loyalty. When Apple Music was launched in the summer of 2015, most journalists gave Spotify for dead, as they thought Apple's wider access (and penetration potential) to consumers would trump Spotify's independent business. However, as time has passed, Apple Music was never able to surpass Spotify's expertise in the industry, and what history has taught us from that lesson is that access to customers is secondary to customer knowledge. Spotify had been

studying its customers for years, and had come to know them carefully over time, concretely, this translated in better playlists and curated content. Spotify's customers were satisfied with their existing product and few migrated to its competitor, furthermore, Apple Music struggled in understanding what content it should acquire, or advertise, and it became cost inefficient. Data Gathering will be a major battlefield in tomorrow's entertainment industry.

Repercussions in the M&A Industry

Recently, we have had two "shockwaves" in Entertainment which were initiated by the announcement of humongous M&A transactions: AT&T's bid for Time Warner and Disney's proposal to buy 21st Century Fox. Both of these transactions were caused by Entertainment's radical change in landscape and were attempts by large incumbents to remain relevant in a changing industry via M&A.

The Walt Disney Company and 21st Century Fox

On December 14, 2017, The Walt Disney Company announced that it would acquire several assets of 21st Century Fox in a \$52.4bn all-stock transaction. The deal would give The Walt Disney Company access to 21st Century Fox's world-renowned movie and television programs, thus allowing the company to create a "direct-to-consumer strategy" and to challenge the market position of the internet behemoths Netflix, Apple, Amazon, Google and Facebook. Additionally, Disney plans to implement its own streaming service in 2019.

Disney's bid can be interpreted as a desperate attempt on behalf of a traditional content producer to vertically integrate downwards and compete with the new providers such as Netflix on their own playing field and according to their own rules. Such ambitious move will be particularly interesting, and Disney's future and margins completely depend on it. While many see it as a belated response to an already disrupted industry, others view it as an impending challenge to today's newer players, where Disney may even have the upper hand in the future if it plays its cards right (due to the superior library of content it is acquiring and will have at its disposal).

The horizontal merger is currently awaiting regulatory approval, as the Justice Department takes time to evaluate the combined entity's ability to force cable companies and other distributors to pay higher rates. An analyst from the research firm MoffettNathanson stated: "Given the exclusion of the Fox network and TV stations, the big questions would probably be around the combination of the studios and the combined girth in sports affiliate fees".

AT&T Inc. and Time Warner Inc.

On October 22, 2016, AT&T Inc. announced its intention to acquire Time Warner Inc. in a stock and cash transaction valued at approximately \$85.4bn. The deal is expected to create large revenue synergies, through the creation of new and more efficient distribution channels. However, the Justice Department attempted to stop the transaction in November 2017, as the blockbuster acquisition could harm consumers, by putting upward pressure on prices, stopping innovation and reducing competition in the media and telecommunications industry. The Justice Department noted that "both AT&T/DirecTV's video distribution services and Time Warner's TV networks are available nationwide, so the harm would occur throughout the country". The combined entity would possess an unparalleled ability to reach customers through various news and entertainment programs, including CNN, TNT and Game of Thrones.

AT&T Inc.'s Chief Executive Officer, Randall L. Stephenson, stated that the Justice Department's decision to intervene in the deal was unfounded, as the two firms are not in direct competition with each other. Stephenson also refused to agree to a sale of company assets, in case the transaction would ultimately be approved and instead explained that in order for A&T Inc. to remain competitive in today's digital environment and to not fall behind

the large internet firms, effective media content would be a necessity. A major disadvantage of AT&T Inc. and Time Warner Inc. in the last years has been their lack of behavioural advertising and marketing. At last, the Justice Department may consider restricting the firm's scope and nature of operations, in order to mitigate any undesirable impacts on society.