Telecom and Media – how to ride the OTT wave

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Content

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Executive summary

The telecom and media space is going through significant changes as the way we consume media evolves. In 2014, the move to content digitalization accelerated and we received confirmation of the emergence of key players in the video and music distribution industry. In this report, which draws from more than 110 interviews with executives from the telecom, media and Internet sector, we focus on the evolution of audio and video content delivery, and on the relationships between the major players in this ecosystem.

- The megatrend towards online nonlinear video usage will only accelerate in the coming years.
- New internet-based players compete with traditional ones in all segments of the value chain and are far too big to ignore.
- Content remains king. We expect the rise in OTT to drive further content cost inflation.
- Traditional media, both pay-TV and free-to-air, TV and radio, are threatened by pure OTT players. We explore three market scenarios with varying impacts on the different types of players, and we propose responses, including surfing the OTT wave, by launching their own OTT services.
- For telecom operators, we see the OTT wave first and foremost as a growth driver for superfast broadband usage – with monetization opportunities in access, but also in proposing value added services to traditional media players and medium-size pure OTT providers.
- We believe that a return to growth in European telcos' revenues is finally in sight.

Significant shifts in media consumption – the beginning

The way we consume media – in particular, audiovisual content – is changing dramatically, with two concomitant trends: a strong increase in the number of digital devices such as smartphones and tablets, which are used more and more to watch videos and listen to music, and the rapid development in nonlinear usage.

Beyond the fall in physical sales, the impact of the "digital revolution" on traditional TV and radio is not evident – yet. A number of smaller channels have started to disappear and the profitability of large TV channels has suffered, but so far they seem to have been impacted more from audience fragmentation and economic recessions than from the rise of pure online players. In addition, pay-TV penetration and revenues are still growing, with no evident slowdown recently. Conversely, telcos' connectivity revenues have continued declining due to continued pressure on ARPU.

However, the generational gap between traditional TV viewers, radio listeners and digital natives is huge. We believe that in the coming years, these secular trends are likely to accelerate rather than slow down, creating massive opportunities and threats for all types of players in the value chain – the traditional ones as well as the emerging ones.

New players and new business models: too big to ignore

In all parts of the media delivery value chain – from content rights to distribution – a number of new actors have been emerging, leveraging new digital and online technologies to compete with traditional players. These new players include Internet giants such as Google (YouTube), as well as Amazon, Apple, Deezer, Spotify and Netflix.

Their scale is already an order of magnitude bigger than that of traditional players in the value chain, even compared to large pay-TV or telecom operators. This is true both in terms of operational metrics (e.g. geographic footprint and audience) and in financial terms (market capitalization, ability to finance themselves).

In each European country, many players have emerged and are competing in the online content distribution markets, with several business models (such as free-to-air, freemium, subscription based and transaction based). The largest and most successful players so far are global Internet leaders: Netflix, which is growing quickly on a global scale and accompanying its rise with large content investment; YouTube, owned by Google, looking beyond its free model; Apple, with further ambitions in streaming; and Amazon, which recently launched its Prime Instant Video service proposing S-VoD services.

Is content still king?

The evolutions of the ecosystem in the past few years have led to content producers capturing a growing share of value in the value chain. Will this trend continue with the rise of online services in the coming years?

Not all content is alike: we show the huge range of value attached to different types of video content, the real king remaining the global sporting events or national football championships. However, beyond premium sports and live news, exclusive series have an increasingly important role. This format is perfectly suited for OTT S-VoD providers, so we expect more along these lines.

Our analysis shows that unless one assumes Netflix's customer bases in European countries will rapidly triple – reaching penetration of c.50% – which seems unlikely, even the leader in the OTT space will not have the scale to compete with the pay-TV leaders (such as BSkyB) for the whole range of their content line-ups.

Still, our industry experts anticipate that overall content costs will continue rising in the coming years – and we agree. From a qualitative point of view, we expect the key words to be "exclusivity", "series" and "attractive". Finally, international content should continue to grow, even though the global-versus-local content battle remains undecided in Europe, with preferences varying by country.

Serious threats to traditional media

The rise of pure OTT players is a challenge for traditional TV players, both pay-TV and free-to-air – but not all are equally placed to face these challengers. We believe that the largest and most innovative pay-TV groups will be able to adjust, but with rising costs, and leading free-to-air TV channels will also keep high advertising revenues. The most challenged players are small TV channels and low-end pay-TV.

Traditional pay-TV is facing competition from pure OTT players on multiple content segments, mainly on price. Also, with the rise of on-demand programs, there is less value in aggregating a large number of channels. The long tail of channels is therefore losing interest from users. As a result, we believe that the long tail of large pay-TV bouquets will be under growing pressure. Pure OTT players also compete with premium series production – hence, pay-TV players will be able to maintain their leadership in content, but they will face pressures on both prices and costs.

Some Industry experts believe that there is a serious risk that pure OTT services may cannibalize traditional TV in the long-term – i.e. that pure online video players have the scale and potential to move up the ladder and become the new pay-TV.

Leading pay-TV groups should be able to adapt, fending off pure OTT competition by launching their own OTT services and leveraging their key assets, such as brand, relationships with content providers, technical skills, and last but not least, intimate and long-established relationships with their customer bases. However, this will require more costs (in content but also in new services) and probably some price adjustments.

Finally, on the advertising revenue side, the move to online consumption is a threat to broadcasters' advertising revenues. We believe that fee-to-air leaders should remain attractive to advertisers, and that innovative players will be able to capitalize on digital innovations, which can also enrich the advertising market. However, the new world will be a challenging one for smaller TV channels, which will not be able to amortize the growing cost of exclusive and attractive content for a sufficiently large viewer base.

Three possible market scenarios

The evolution of the TV market will depend on two main factors: 1) the level of virtualization in the edition and aggregation functions, versus the traditional programming function based on the manual analysis of audience; and 2) the share of the edition and aggregation market that the Internet players will capture – depending on the speed of change in behavior, Internet players' ability to capture premium content, and the brand power and adaptability of traditional players.

A strong parameter influencing the market's evolution will be the strength of the local content in terms of its availability and users' appetency for it in each country.

We therefore see three scenarios for the evolution of the competitive landscape:

- Scenario 1: local and premium content continues to "win", enabling a leading pay-TV operator to keep its leadership versus pure OTTs, limiting Internet players to a long tail of content with relatively lower value;
- Scenario 2: a few global pure OTTs manage to reach the scale necessary to compete with pay-TV on premium content;
- Scenario 3: global pure OTTs take over not only pay-TV, but the whole TV market, attractive massive audience and advertising revenues.

Growing strains on networks

A much-talked-about consequence of the growth in online video is the massive increase in data traffic carried over the Internet, and hence over telcos' networks. Ensuring that the quality of the viewing experience remains up to standards requires players to continuously upgrade their equipment. Key investment areas are the core networks, the interconnection between different players and content delivery servers.

Local-access operators (telcos, cable operators) are very vocal about the need for content providers (e.g. Google – the owner of YouTube – and Netflix) to contribute financially to the required investment. We expect continued jockeying on this subject – which is tightly linked to regulation (see Annex), but the situation has already evolved significantly. Indeed, we show that pure OTT providers are also investing a lot in their own delivery infrastructures (worldwide CDNs) and also that, in a growing number of cases, in the US as well as in Europe, they have struck financial agreements with local-access operators.

Opportunities for telcos: not a one-size-fits-all

The balance between risks and opportunities associated with the rise of online video appears much more favorable for telecom operators than for traditional TV players. Indeed, telcos have much smaller vested interests than traditional TV operators, and their network assets and advanced positions in the digital revolution are key assets that they can – and should – monetize.

First, all telcos can create value through an "enabler" role, monetizing their network assets – i.e. turning the growing strains on networks into an opportunity. Regardless of the market scenario for the development of pure OTTs and its impact on traditional TV players, telcos should benefit from the rise in online video usage in two core ways:

- Charging customers for faster speeds and/or data traffic. There is demand for this;
- Monetizing their network assets with global OTTs – basically charging them for a quality delivery.

In addition, in a market scenario in which pay-TV players and smaller OTTs succeed (closer to scenario 1), telcos have the opportunity to provide additional services beyond the pure network connectivity to these players, becoming their partners of choice in their migration to the new online video world. This is a value-added wholesale model.

Second, the revolution in the TV market can also be an opportunity for some telcos to generate revenues, not only as enablers, but also as direct players in online video and/or pay-TV. In our view, this is not for everyone. Our analysis shows that the opportunity for a telecom operator depends on two main factors:

- The operator's scale, local and global;
- The market context, including: who the established pay-TV operators are; how developed the market is; how successful the pure OTTs will be; the customers' appetite for local versus global content; the cost of content.

Overall, opportunities for Telcos to actually create value by investing in content and/or their own pay-

TV platforms will be the exception rather than the rule. Only the largest operators in specific market contexts can actually create value in such moves. For the majority, the preferred route should, in our view, be to partner with OTTs and local media players such as Pay-TV and FTA channels – sharing the risk and the upside with players that will have greater scale, both locally and globally.

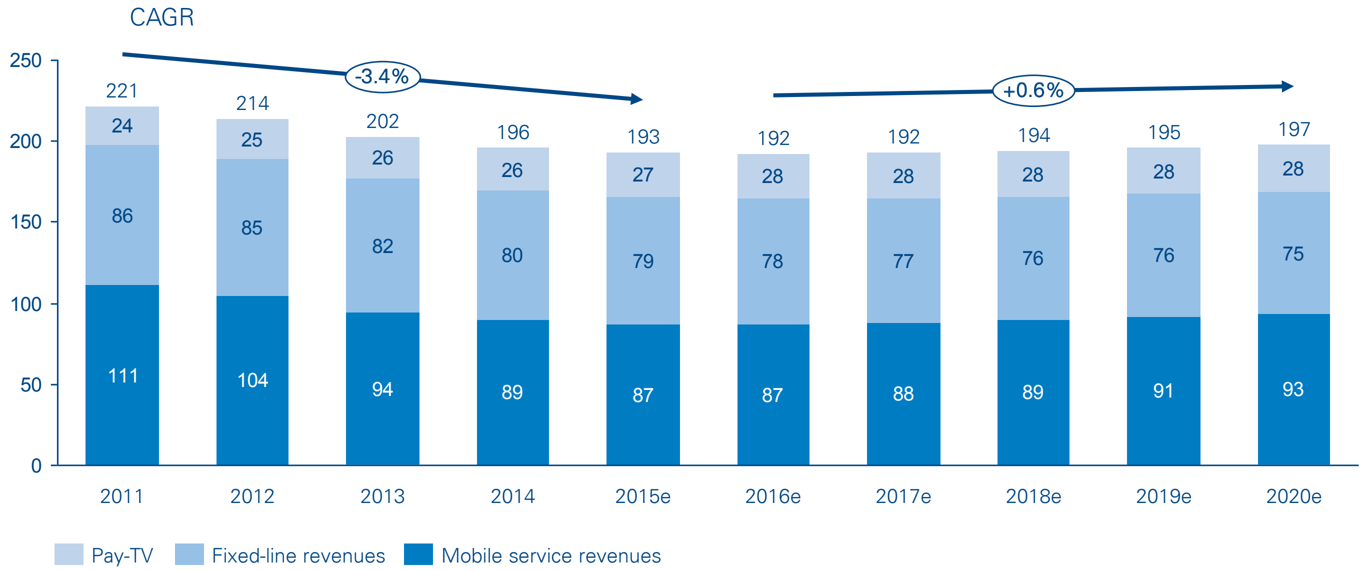
Telco revenues: a return to growth finally in sight

As we anticipated, the sector revenue trend remained negative in 2014 (-3%), but this was a milder decline than in 2013 (-5%), thanks to improvements in both mobile and broadband.

We have left our estimates for 2015–2016 virtually unchanged, with -1.5% in 2015e and stabilization in 2016e. Optimism has returned to executives across Europe, and we expect the sector to return to growth from 2017e, with 1% growth per year in the longer term and a +0.6% CAGR over the 2016e-2020e period.

Figure 1: Evolution of European telecom industry revenue in eight European countries[1)]

In EUR billions



Source: Arthur D. Little/Exane BNP Paribas note: 1) Germany, France, UK, Italy, Spain, Netherlands, Belgium, Portugal

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- Internet, software players and Over the top (OTTs): Deezer, Facebook, Google, Microsoft, Netflix, YETU
- Media groups: Bonnier Growth Media, Canal Digital, Canal+, Discovery, Hitfox, Maxdome, Mediahuis, Medialaan, Rai, RTL, SACEM, SF Anytime, TF1, Viacom, Voddler
- Regulators: ANFR, BIPT, ComCom, CSA, CTU, Hakom, NMHH, PTS, RTR
- Equipment manufacturers and others: Alcatel, Arqiva, Aurelius, Axos Capital, Ericsson, Gigaset, Nokia Networks, QSC, Qualcomm, Sagemcom, Technetix, Telenor Connexion, Teracom, TDF

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