# INDEPENDENTS' DAY

## 6 questions facing today's independent producers and some thoughts on potential answers

OC&C Strategy Consultants

# INTRODUCTION

Content producers face rising rights and talent costs as they try to acquire a distinctive edge in a world of over-supplied "me too" vanilla content.

Independent TV producers specifically have a big challenge controlling these costs given their revenues are constrained by the well documented issues facing their broadcast clients.

In this paper OC&C considers six key questions facing the management and shareholders of our independent production companies. Responding to these questions should help position producers favourably for the journey ahead.

3 questions on strategy for producers...

1 Should we acquire / build a 'short-form' content producer?
The market is plagued with highly inflated valuations with an unproven long term profit model

2 What is our response to increased international competition?
International studios and broadcasters continue to move into content production. Are there benefits to be gained from launching a channel and if so, what?

3 What is the **real** (tangible or intangible) value in direct-to-consumer?
While syndication to digital "channels" can drive real value, direct-to-consumer remains digital pennies, relying predominantly on the unproven value of data to somehow drive value

...and 3 questions on operations

4 What is the blueprint for my business?
Indies require a clear strategic plan for their portfolios with robust rationale for their positions across geographies, genres and value chain

5 Can we reconfigure the operating model and make costs more variable in the face of soft revenues?
The independent production company of the future should focus on what has to be owned within the business vs contracted / shared

6 Are there alternatives to the traditional M&A model?
Offering creative talent access to back / mid office services without outright takeover is becoming more commonplace. The benefits for talent are clear, although investors need to be careful given thin operational synergies

# SUMMARY PERSPECTIVES

Developing a clear strategic and operational plan to drive bottom line growth in a challenging market is imperative for management and shareholders alike:

- Management need to be honest about the challenges they face and realistic about the expectations they set. Action on portfolio and cost could free up capital to invest into areas of growth which, although small today, could become important revenue streams in the future
- Shareholders need to buy into a 3-5 year journey to extract value, since the traditional international roll-up model is running out of steam for many global indies. Tough decisions may be required to drive value creation

Some initial perspectives for management and shareholders to consider:

- Strategic investments in direct-to-consumer, data and short form content will only deliver minor medium term financial impact. Some investments for 'strategic' reasons will undoubtedly lose money so the strategic case needs to be watertight
- Meaningful bottom line improvement will require intervention for many large indies – positive market trends have certainly calmed. Aside from developing the next hit, profit growth will require portfolio clean-up, organisational simplification, delayering and more 'aggressive' operational discipline
- How to retain talent remains the key question for management – alternative models for collaboration may be part of the solution

# 1.
# SHOULD WE ACQUIRE / BUILD A SHORT-FORM CONTENT PRODUCER?
## The market is plagued with highly inflated valuations with an unproven long term profit model

There are logical synergies between long-form and short- form content producers in terms of capabilities and customers, despite a lower price point and production values. The clamour for traditional long-form indies to launch or acquire short-form business is loud, with executives under pressure from shareholders and management alike to get into 'the next phase of growth'. However, exercising an element of caution is advisable.

### The Case for Investment
The usage of the world's top short-form companies has grown fast, fuelled to a large extent by YouTube. YouTube has tried a series of strategies to drive usage of, and value in, the platform. This began with offering very attractive revenue shares to free to air broadcasters, and developed into funding smaller content channels to 'prove' the value of the platform and, most recently, offering a platform for smaller subscription channels. The biggest recipients of YouTube's generosity have been the indies – Fremantle Media for example has over 100 channels and 4.5bn annual views (4 of these channels receive direct funding).

YouTube statistics suggest the programme is delivering some success – estimates of its global advertising revenues are now over $1.5bn. In particular, the strategy is leading to significant volume gains, with the top 25 channels receiving of an average of 1m+ views per week and partners in 2012 reaching the 100,000 subscriber level five times faster than 2 years ago.

### A Note of Caution
This usage has swollen pre money valuations of these players, however, a series of factors makes these valuations appear very inflated:

- 60% of these contracts have not been renewed. The view from many (funded) short-form producers is that that this is a short term 'gift' from Google
- Valuation based on viewers neglects the importance of engagement – subscribers are more valuable long term
- Valuations for these businesses are still based on users and subscribers and have not yet settled to a clear set of meaningful parameters

### Examples – Poorly Defined Valuation Metrics

| Name | Valuation[1] ($m) | # Annual Video Views (m) | Price per Annual Video View ($) | # Subscribers (m) | Price per Subscriber ($) |
|---|---|---|---|---|---|
| Machinima | 190 | 20,400 | 0.01 | 187 | 1.0 |
| Break Media | 51 | 564 | 0.09 | 2 | 23.2 |
| Next New Network | 50 | 2,400 | 0.02 | 7 | 7.7 |
| Clevver Media | 10 | 960 | 0.01 | 1 | 7.7 |
| Revision3 | 30 | 960 | 0.03 | 8 | 3.7 |
| Mind Candy | 200 | n/a | n/a | 60 | 3.3 |
| **Average** | | | **0.03** | | **8.5** |

1. Implied valuation from payment for part or whole of the business – press reports

# 2.
# WHAT IS OUR RESPONSE TO INCREASED INTERNATIONAL COMPETITION?
## International studios and broadcasters continue to move into content production. Are there benefits to be gained from launching a channel and if so, what?

### The Case for Avoiding Channels
To date, few independent production companies have made moves further down the value chain into the channels market – driven by a combination of factors including:

- Lower return on capital
- Concerns about competing with their broadcast customers
- Moving towards a more volatile (commonly advertising funded) revenue mix

There are examples of producers that have invested in international channels (for example, BBC Worldwide, Fox), however these are leveraging existing in-house channel operation capabilities.

### An Alternative View – Pro Channels
The most clear example of an independent content producer's foray into channels is that of Talpa, which first moved into the channels market in 2005 with Talpa / Tien. After disappointing results and a sale to RTL in 2007, Talpa acquired of 1/3 of SBS Netherlands in combination with Sanoma in 2011.

### So What is the Rationale?
Part of the logic is undoubtedly defensive, as other businesses move into the production space. Free to air broadcasters (such as ITV, P7) continue to invest in domestic and international producers, US studios (such as Warner Bros) are investing in international production assets to fit with their US film and TV production skills and multi-channel broadcasters (eg Discovery) are investing to create local content for channels in key genres.

However, there is also an important **strategic opportunity** – if an indie can produce (or reuse where it has rights) sufficient volumes of content, the benefits could include:

- Access to a greater part of the value chain
- The ability to create a better known consumer brand
- A deeper relationship with consumers, with the ability to drive consumers to other properties (eg archives, pay channels)
- Greater levels of consumer insight and data

# 3.
# WHAT IS THE REAL (TANGIBLE OR INTANGIBLE) VALUE IN DIRECT-TO-CONSUMER?

## While syndication to digital "channels" can drive real value, direct-to-consumer remains digital pennies, relying predominantly on the unproven value of data to somehow drive value

### The Sceptical View

Online and digital capabilities have rapidly created the potential for content owners to go direct to consumers, bypassing the traditional platforms and channels. However, there appears to be little short or medium financial value in pursuing this approach.

At present, anticipated value from these direct-to-consumer propositions is small – although direct-to-consumer provides incremental margin, it is generally tied to very low volume of sales and increased internal support and IT costs.

The challenges faced in 'going direct' for a content owner include having a corporate brand that is unknown to consumers – each channel / content brand needs its own marketing and web presence. Secondly, walking away from a lucrative, guaranteed sales revenue stream from an online platform to takes courage.

**Although the benefit of consumer insight and data to production companies is clear in theory, the tangible bottom line benefits are harder to prove. Pragmatically, they may reside more in gathering data and evidence to support a favourable linear deal, than from making money in their own right online.**

To date, there is limited evidence of successful direct-to-consumer propositions launched by content and IP owners across all consumer media (where success is defined as contribution to cash and / or profits). Whilst propositions such as Universal Picturebox and Sony Crackle exist, the metrics to declare success are not clear.

The most successful media examples tend to be in sport where leagues and franchises go online, although these audiences are often accessed indirectly (eg, via YouTube, Perform, etc) so aren't true direct-to-consumer.

### On a More Positive Note

There is cause for optimism with more positive examples outside of media. For example, leading FMCG propositions are delivering high levels of brand engagement coupled with tangible bottom line impact:

- Nespresso uses a strong service and e-commerce proposition to bypass supermarkets and build intimacy with the consumer achieving strong sales growth
- NIKEiD is a successful online direct channel that achieved sales growth 10% higher than traditional sales in 2012 by offering a personalised proposition and greater brand engagement

These suggest that for a strong enough proposition, sufficiently backed by marketing, direct-to-consumer could be an opportunity **for truly world class properties**.

## CASE STUDY

**Direct-to-Consumer Propositions**

### MUSIC LABELS

**The type of content offered plays a key role in success of direct-to-consumer music propositions and has driven varied success by labels**

- Universal Music's "Hip-O Select" has been successful and has become "the premier reissue label" in the US since launching in 2004
- Sony's Entertainment Network attempts to replicate the itunes download experience for a smaller catalogue
  - Failed to gain any significant scale with just 1m subscribers in the US (many on a free trial) versus Spotify (15m, 4m paying) and 54m for Pandora Radio

### GLOBAL STUDIOS

**Lower volumes and quality of service in comparison to non direct-to-consumer competitors**

- Studio propositions more limited than non-vertically integrated competitors
  - Sony's Crackle offers 250 movies to Netflix's 100,000+
- Results in lower volumes and traffic
- Lack of volume may limit investments in quality, creating a less compelling consumer service
  - Sony's Crackle and HBO Go historically marred by lower quality video play (lacking HD service)

### SPORT RIGHTS OWNERS

**Sports rights owners primarily look to extend reach – as opposed to other direct-to-consumer propositions that typically look to maximise margin**

- **US Sports:** Major sports franchises (NFL, NHL, NBA) offer comprehensive online direct-to-consumer packages for a seasonal fee of c.$100-200
  - Blackouts where games are available on TV (NFL Game Pass is not available in the US)
  - Designed to extend reach of sport (does not compete with TV broadcasting proposition)
- **IPL Cricket:** India Times Channel shows live action via YouTube to extend reach, but still a fraction of TV rights value
  - Global YouTube contract with India Times is worth c.$5m (105k subscribers and 41m video views)
  - TV licensing for the IPL is worth c.$100m pa in India alone

# 4.
# WHAT IS THE BLUEPRINT FOR MY BUSINESS?

## Indies require a clear strategic plan for their portfolios with robust rationale for their positions across geographies, genres and the value chain

Managers and shareholders pursuing M&A should be highly targeted in their approach, developing a strategic blueprint for the company. This blueprint of countries, genres and skills should clearly highlight areas of strength and weakness – strengths should be built on, weaknesses should be bolstered, divested or sold to release capital for investment.

The blueprint should clearly identify holes in geography, genre and skill that acquisitions should fill and agree this **before** looking for targets. Different geographies have different roles in a portfolio and as such, different rules should be used by which investments are evaluated. These rules may reflect a number of different characteristics of a given territory such as legal, regulatory and commercial environments. For example, territories frequently differ in their "terms of trade" and level of content imports vs exports. An example of this can be seen in three countries which would play different roles in a portfolio:

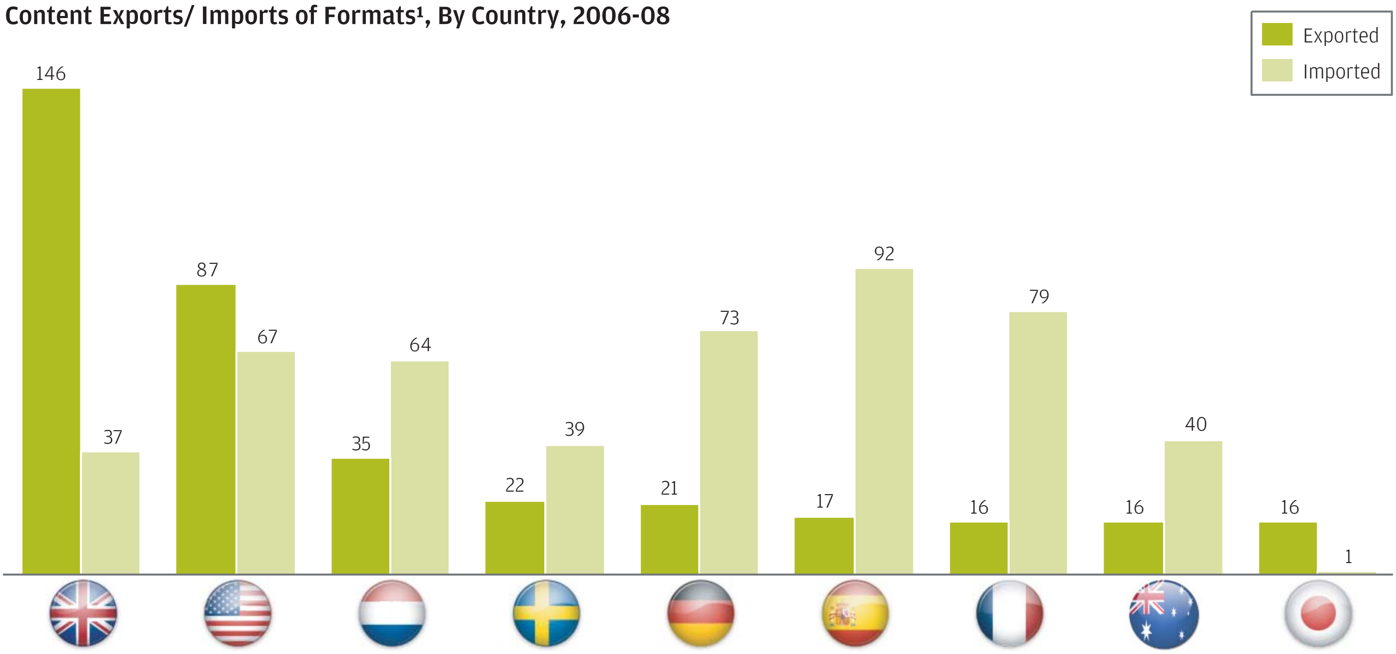
- The Netherlands is the second biggest exporter of content (ahead of the USA), has terms of trade that favour the producer (>50% quota for Dutch language content) and has a large stable of creative talent – this drives **high innovation**
- The UK has attractive terms of trade for a producer and is therefore a good place to build on an idea allowing **commercialisation** – having a large, English speaking free-to-air broadcaster fund the content but retaining the secondary rights is commercially very attractive
- The USA is a net importer of formats and has a role as a market where format / IP **returns can be maximised**

Warner Brothers' acquisitions in the UK and Benelux to fit their US business appear highly logical in this context.

In additional to territorial expansion, content producers looking to enhance their capabilities in online and digital should think carefully before purchasing specialist businesses. Managers should ensure the potential acquisition is fulfilling a clear requirement, need or function for the group.

All3Media acquired Illumina Digital specifically with a view to expanding its multimedia offering to adapt to the rise of online TV propositions. This is a good example of a targeted acquisition.

**Content Exports/ Imports of Formats[1], By Country, 2006-08**




1. Press releases, OC&C analysis

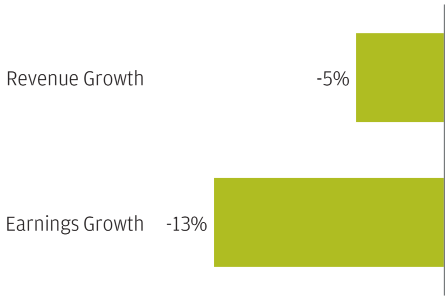
# 5.

# CAN WE RECONFIGURE THE OPERATING MODEL AND 'VARIABLISE' COSTS IN THE FACE OF SOFT REVENUES?

## The independent production company of the future should focus on what has to be owned within the business vs contracted / shared

In a hit driven business, prone to a variable top line, indies should ensure their organisational configuration is as flexible as possible. This will become ever more important as cyclical pressures hit broadcast customers (especially in Southern Europe) and slow structural migration continues. Thinking back to the recent global economic slowdown, the earnings of the majority of indies fell faster than their revenues as cost bases were too fixed.

**Average Fall in Revenues vs Earnings, 2008-09, for Global Indie Peer Group[1]**




1. For players with available data

The organisational configuration of the future should be:

- **Flexible**, allowing the proportion of variable to fixed cost base to increase. Use of outsourcing is a core method to allow the organisational structure to breathe
- **Networked**, drawing on specialised support on an adhoc basis. Other creative businesses are based on the use of freelancers who compete for design briefs. This approach provides the dual effect of ensuring best quality product without the cost of a large fixed staff roster
- **Responsive**, to changes in market conditions. For a content producer this may take the form of the ability to switch between the creation of local content versus provision of exploitable formats
- **Distributed**, with resource placed as locally as possible and focused on revenue generating activities
- **Lean**, with as many resources consumed on an 'on demand' basis as possible

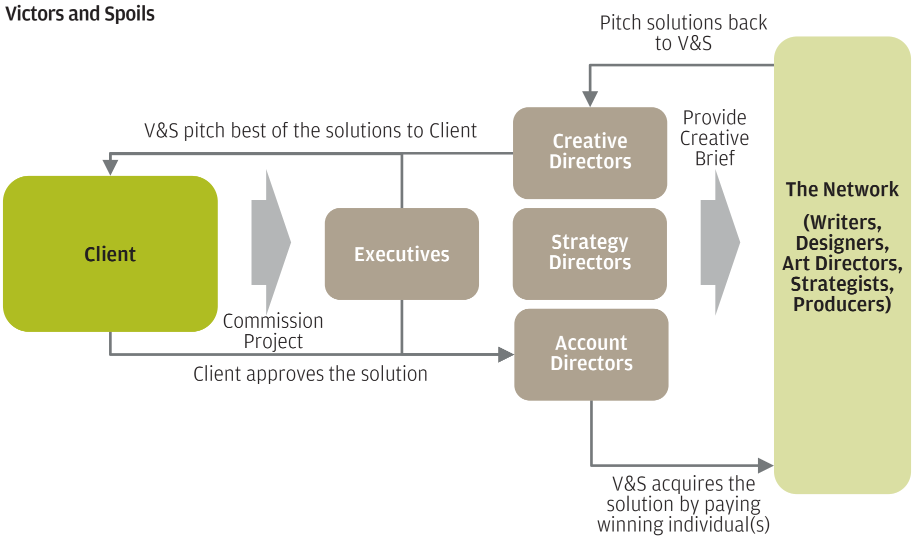
Management should be focused on evaluating those capabilities that are core to the business. The focus should be on reducing and potentially outsourcing any costs that are not true front-office activities.

Whilst independent production businesses have relatively high variable cost bases (predominantly reflecting the industries thin support layer and cost-plus based approach to commissioning), there is additional opportunity to "variabalise" fixed support and distribution costs.

Examples of more collaborative operating models exist outside of production – such as Victors and Spoils in advertising.

## CASE STUDY

**Victors and Spoils**




- Victors & Spoils is an advertising agency with a business model based on the use of a network of creative professionals
- When commissioning a project V&S Directors draw up a creative brief which is presented to its network
- This network is a growing pool of talent composed of c.6000 designers, writers etc, who pitch their solutions to V&S. The talent is either paid for all their work or they are only paid for ideas which the Client buys
- This model benefits from having a very large and diverse creative team delivering varying solutions at a lower cost than could be achieved in house
- Some of these cost savings can then be transferred to the client – however the client experience is similar to dealing with any other ad agency

# 6.
# ARE THERE ALTERNATIVES TO THE TRADITIONAL M&A MODEL?

## Offering creative talent access to back / mid office services without outright takeover is becoming more commonplace. The benefits for talent are clear, although investors need to be careful given thin synergies on operations (what are you actually buying?)

Managers of traditional "super indies" need to strike a trade-off between delivery of commercial returns and the retention of creative freedom. Too much focus on nurturing creativity may affect the business's ability to make astute commercial decisions, drive down costs and avoid pursuing value destructive opportunities. On the other hand, an overly commercial approach may leave little space to achieve creative "hits". A series of well known examples exist of the pitfalls of putting creativity before returns, or vice versa.

Managers have traditionally tried to create an environment where ideas are shared as much as possible between constituent businesses, creative autonomy is retained and hit ratios are maximised. However, this is notoriously hard.

As a result, a series of new models are emerging to try to better respond to the conflict.

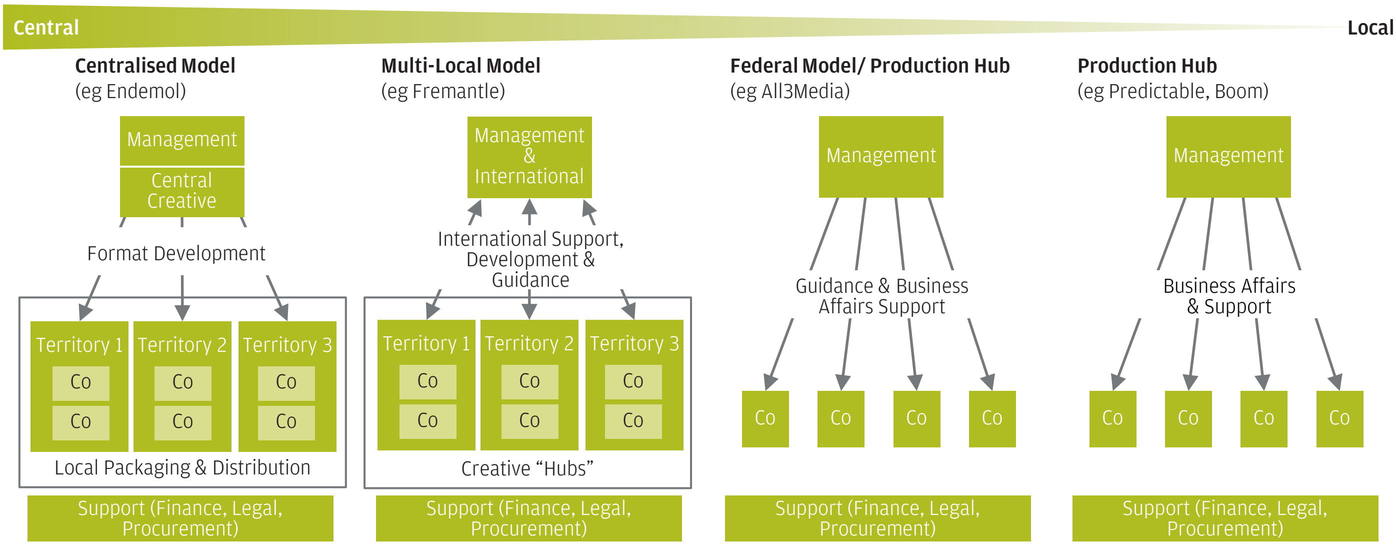
**Production groups are increasingly looking to incubate local talent rather than purchasing mature companies.**
This provides the opportunity to work with creative talent at a grass-roots level, ensuring the creative influence can be leveraged across the broader organisation and in line with the business's commercial goals.

Talent can be brought in-house at a later date if in the interests of both parties.

From the perspective of the creative talent, the provision of back and middle office services (such as finance, legal, procurement, licensing) without interfering (too much) with their creative process / creative autonomy can be highly attractive.

**Trend to looser commercial structures**
Overall there is a trend towards less centralisation and control and more flexibility. "Production hubs" are the most recent development in this area, offering talent specific back office support. These hubs (businesses such as Boom, Predictable Media, Greenbird and even BBC Worldwide's historical partial investments into indies) offer support services directly aimed at indie start-ups. The one notable issue of these looser structures is for investors who face a business less tied together for the long term.

### Alternative Group Models




| Centralised Model | Multi-Local Model | Federal Model/ Production Hub | Production Hub |
|---|---|---|---|
| ✓ Highly commercial approach to international formats drives financial performance<br>✓ Thin local teams package and deliver format to local market<br>✓ Efficient commercial model and economies of scale (procurement etc) | ✓ Can exploit own ideas or partner with creative businesses to produce their ideas<br>✓ Leverage local teams to ensure success in local markets<br>✓ High level of idea-sharing, driving more innovative output | ✓ High level of creative autonomy for group companies<br>✓ Structured for retention of key creative talent<br>✓ Competition between companies may drive performance | ✓ Lack of full takeover retains 'skin in the game' and creativity<br>✓ Attractive to smaller indies and early stage indies |
| ✗ Reliance on core format hits (in comparison to other operating models)<br>✗ Higher operational gearing due to fixed cost levels for format development<br>✗ Needs a diet of hits to feed the machine | ✗ Hit formats may be less successful internationally than in a centralised model<br>✗ "Thick" local operations make cost synergies difficult<br>✗ Higher operational gearing due to high fixed costs to maintain local presence | ✗ Questionable central synergies eg scale buying / procurement etc<br>✗ Lack of direct idea-sharing may stifle overall group performance<br>✗ Fragmented model may make more susceptible to break up | |

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