

Outlook special

Over-the-top Television

July 2015

‘Is OTT TV the digital turning point for the TV industry?’





Over-the-top TV, Netflix and the impact on the TV industry

Perspectives for the Netherlands

Introduction

Cable companies have been offering subscription video-on-demand (SVOD) for a long time. But these SVOD services were never very successful. What then makes the Netflix SVOD service so popular? Why is it not following the same fate as the SVOD service of cable companies? This article sheds light on what sets the Netflix SVOD apart and what this means for the TV industry.

The rise of Netflix and over-the-top (OTT) TV services triggers many questions:

- Does OTT TV change linear or live TV viewing habits? Does it supplement or cannibalize linear TV?
- Do changes in TV viewing habits have an impact on the TV advertising market?
- To what extent has OTT TV led to changes in the pay-TV industry¹? Does it lead people to cancel their pay-TV subscription ('cord cutting')?
- How is the content creation industry affected by the rise of OTT TV?

To answer these questions we will turn to the US because the US are about four years ahead of the Netherlands in terms of use of OTT services and competitive dynamics.

Findings from the US, however, cannot be blindly extrapolated to the Netherlands. There are important differences, for instance in TV programming, pricing levels of pay-TV packages and advertising load on linear TV.

Many industries have gone or are going through a digital transformation process. Print, music, travel, retail are all industries that had a digital turning point and were thoroughly reshaped by the internet. It looks like OTT TV is the digital turning point for the TV industry. It affects business models and success factors along all the steps of the value chain of the TV industry from content creation to distribution. All the players in the TV industry therefore need to determine their strategy to deal with this transformation. Speed and agility in reshaping the strategy will be key success factors because the pace of the transformation is picking up and many players are taking new positions. There remains substantial uncertainty about how this transformation is going to unfold. Agility will therefore be key.

Netflix – a success story

Netflix launched its streaming subscription video-on-demand (SVOD) service in 2007 and currently has 41 million subscribers in the US. This means that in less than seven years Netflix managed to have more than a third of all American households subscribe to its SVOD service. The speed with which the service has conquered the US market is comparable with that of mobile telephony.

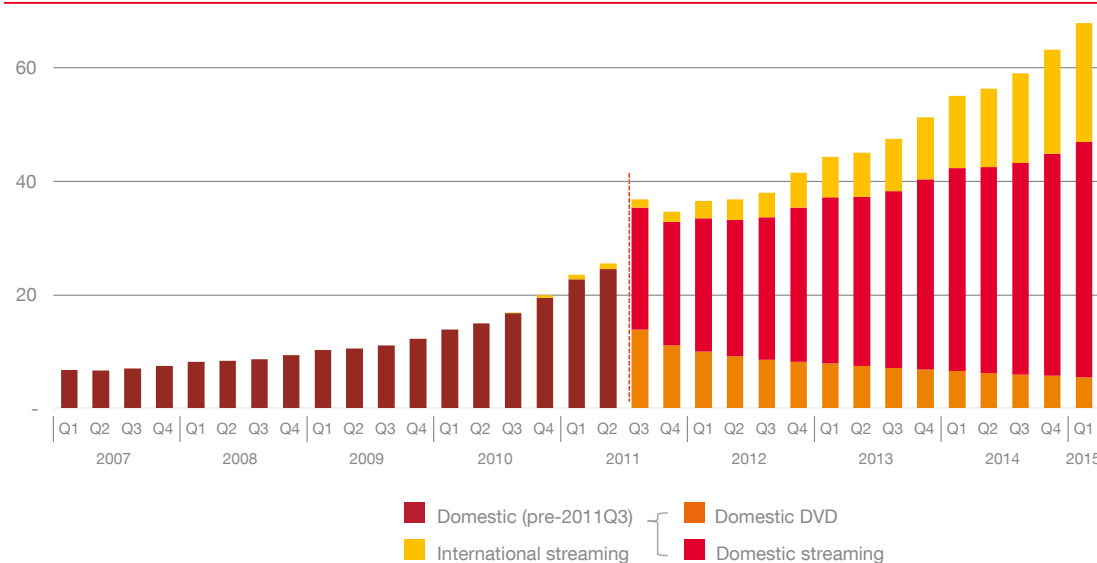
Driven by the success in its home market, Netflix started its international expansion in 2011. The company started close to home (Canada and several Latin American countries). In 2012 it expanded into Europe, first in the UK and Scandinavia and then in the Netherlands (October 2013). Last year Netflix entered the market in Belgium, France and Germany. Outside the US it currently has 21 million subscribers. The company has big international ambitions, as it aims to be available in 200 countries by 2017.

One in three households in the US now has a Netflix streaming SVOD subscription

¹ The term 'pay-TV industry' has different meanings across countries. We use it here to refer to the cable, IPTV or satellite subscription industry.



Figure 1 Number of Netflix subscribers (million, end of period)



Source: Netflix

With its current subscriber base (62 million subscribers worldwide to its streaming service plus 6 million subscribers in the US to its DVD rental service), Netflix has annual revenue of \$6 billion and streamed 10 billion hours in the first quarter of 2015.

The success of Netflix and its rapid expansion are particularly impressive as the company ‘reinvented’ its business model. Until 2007 Netflix was an internet ‘rentailer’ offering a rental subscription service for DVDs through the mail. It converted this semi-digital business model into the current digital streaming model.

2 A small but increasing number of pay-TV distributors integrates Netflix into the set-top box.

The service offered is often referred to as ‘over-the-top (OTT) television’ as Netflix bypasses the traditional TV distributors (cable, satellite etc.). A subscriber gets Netflix content over the internet instead of through a set-top box (the digicorder supplied by cable providers for instance)². We distinguish OTT from TV Everywhere (TVE). TVE is complementary to the ‘regular’ cable and telco pay-TV subscription and allows the subscribers to stream TV content over the internet (usually live TV, catch up TV and some VOD). TVE generally requires authentication to ascertain that the user is a subscriber to the regular pay-TV service.

Netflix in the Netherlands

Netflix does not share its subscriber numbers in the Netherlands (or in any country abroad).

Various organizations in the Netherlands have conducted market surveys to estimate the number of Netflix subscribers in the Netherlands. One of these surveys indicates there were ca. 100,000 subscribers three months after market introduction. A year after the launch, the subscriber figure had increased to approximately 700,000. Surveys at the end of 2014 by IHS and Telecompaper indicate Netflix had close to 1 million subscribers. Extrapolating these survey results, some estimate the current subscriber number at 1.4 million. This means that a year and a half after introduction one in five or six households in the Netherlands has a Netflix subscription.

We will look into Netflix and its success in more detail. We focus on Netflix because it is by far the largest player in the OTT TV area (ahead of players like Amazon Prime, Hulu, Vimeo etc.)

Why is Netflix so successful?

What drives the success of Netflix? Is it the vision and foresight of its management? Is it the long-term orientation of the company? Is it the timing of the roll-out? Branding?

The success of Netflix is undoubtedly linked to all these factors, but the key to its success is above all the service it offers its subscribers.



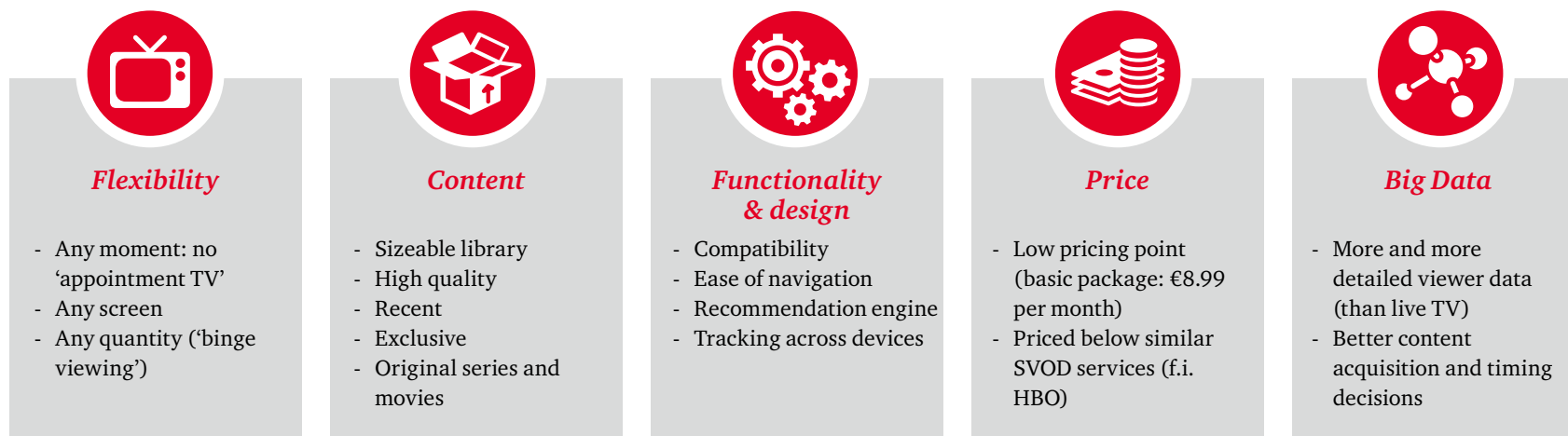
- **Flexibility** - Netflix allows subscribers to watch programmes on any screen and when or where it suits them. As a general rule there is no ‘appointment TV’ on Netflix. The subscriber decides when he watches an episode. If the subscriber wants to watch several episodes in one go (‘binge viewing’), he can – there is no need to wait until next Tuesday 7:45 p.m. to see the next episode. To many people this flexibility and convenience is important.
- **‘Content is King’** – Netflix has a sizeable library of movies and TV series in the US (9,000 titles). The library varies substantially in size across countries because of pre-existing licensing agreements with pay-TV providers and broadcasters. In all countries where Netflix

operates (for instance in the Netherlands), its library exceeds 2,000 titles. At least as important as the size of the library is its quality. Netflix offers appealing content, particularly its TV series are of high quality and recent. Many of these series are exclusively available on Netflix. This increases the appeal of the library. With its revenue base, Netflix can afford to outbid premium movie channels or cable channels and even re-shuffle the windowing practices for movies. The size of Netflix also allows to create original content and spend substantial amounts to create top notch series. Examples include *House of Cards* and *Orange is The New Black*. Some of these series even won Emmy awards. This original content is (by and large) exclusively available on Netflix. The Netflix library is also

continuously expanded and refreshed: new (original) series and films are added and some content gets delisted. Netflix announced its ambition to launch 20 to 25 new series every year – at a drum beat of one new serie every two weeks. This of course fosters loyalty among (long-time) subscribers.

- **Functionality and design** – Netflix is hassle free, the platform is well designed and is easy to navigate. Without a great deal of knowledge and expertise, the service can be connected to over 400 types of devices. Netflix also tracks a subscriber as he uses different devices. If he watches an episode on a tablet, Netflix will ‘automagically’ stream where he left off on television. The company spends \$350 million

Figure 2 Success factors of Netflix





annually on improving its platform. This includes improvements in design, ease of navigation, compression algorithms, compatibility etc. The kids section, for instance, showcases how much thought has gone into the Netflix service. The section is designed so that without any help from adults children can easily navigate the site and find the content they want by clicking on icons. Paramount in the Netflix success story is the recommendation engine. Netflix indicates it spends around \$150 million annually on this engine. The recommendation engine helps subscribers to discover new content and directs them to content they will likely appreciate. This increases the use of Netflix and subscriber satisfaction and in turn fosters subscriber retention.

- **The right price** – The success of Netflix also hinges on the price of its service. In the Netherlands a basic subscription is just €8.99 per month. In most countries the price Netflix charges, is well below the price of (more or less) similar SVOD services from pay-TV providers. Netflix streams its content over the internet. Internet neutrality rules in the US and the EU prohibit internet service providers (ISPs) from demanding compensation or payment from web publishers for traffic they generate on the ISP's network or for preferential treatment of the traffic. This means Netflix has a free ride on

During peak hours Netflix already accounts for about a third of all internet traffic in the US



the internet infrastructure. In the US it already accounts for a third or more of all internet traffic during peak hours. As a result of the internet neutrality rules Netflix can offer its service at a lower price than, for example, a cable provider asks for a similar SVOD service (e.g. HBO) if the cable provider wants to cover part of the infrastructure cost from the SVOD service.

- **Clever content acquisition and use of big data** Internet or OTT TV distribution has several benefits over distribution over coax cable. OTT TV enables the collection of increasingly precise data about individual viewers. These OTT TV viewer data are much more accurate than the viewer data collected from, for instance, viewer panels and allows for much more detailed segmentation. These more accurate and detailed viewer data allow for better estimates of the

audience size when a new programme is to be produced or licensed. Viewer data give Netflix an important information advantage in negotiations with content owners and they also support improved timing of new programme launches.

Netflix has a robust product concept and it implements this concept very effectively. That helps explain the company's success. It also helps explain why other comparable services are (or have been) less successful: they offer less content or lower quality content, content discovery or navigation is more difficult, there are no or fewer (personalized) recommendations, prices are higher, there are issues with device compatibility etc.

The success of Netflix is not entirely of its own making. Like most successful companies, Netflix had a healthy dose of luck. Content owners



‘Will Netflix be as successful in the Netherlands as in the US?’

initially greatly underestimated the potential of streaming SVOD services. As a result Netflix got great licensing deals with low fees. This enabled it to offer subscribers access to an appealing library and to quickly build its subscriber base right from the start. Access to content and licensing are often the reason why initiatives in the OTT TV area fail to meet expectations or have a slow start (e.g. GoogleTV).

Netflix is the dominant player in the OTT TV area in the US and in many countries outside the US. It will be difficult to dislodge Netflix from that position. The company is ahead of many players in key areas: quantity and quality of viewer data, dynamic design of its platform, recommendation algorithms, brand name, content access etc. Companies offering similar services, both new entrants and industry incumbents, may find it hard to overcome Netflix’s lead in these areas. The company’s growing position in the viewer market strengthens its position in the content market. As the Netflix subscriber base and its library grow in size, its bargaining power increases. That bargaining power is further strengthened by Netflix’s exclusive original content and its recommendation engine which guides content discovery and viewing patterns.

Limits to the Netflix success story?

Will Netflix be as successful in the Netherlands as in the US? Maybe not entirely. There are a number of relevant differences between the Netherlands and the US.

- There is no advertising on Netflix. In the US advertising on linear TV accounts for around a third of the broadcast time. The absence of advertising is one of the reasons why services as Netflix and premium channels like HBO have had such broad appeal. In the Netherlands advertising on TV is less prominent and cumbersome. Netflix’s ‘ad-free advantage’ may therefore not be as significant in the Netherlands.
- Pay-TV subscription in the US are much more expensive than in the Netherlands. The average price of a cable subscription in the US (excluding broadband) is about \$75 per month. A Netflix subscription costs about a tenth of a pay-TV subscription. Netflix is relatively more expensive in the Netherlands than in the US. This might limit the growth of Netflix. Also, the willingness to pay for TV content in the Netherlands is low. For instance, sports pay-TV channels had a rather slow start in the Netherlands.
- Although Netflix offers some local or Dutch content, it does not offer original Dutch content. The majority of the series and movies in the library are of Anglo-Saxon (American) origin. When Netflix enters a new territory, typically only 20% of its library will consist of local content. Viewers in the Netherlands and in Scandinavia generally appear to be open to Anglo-Saxon content. This probably explains why the Netflix subscriber base is

growing much faster in these countries than in France or Germany for instance. Yet, even in the Netherlands the demand for local programmes is substantial. Two thirds of what people watch on linear TV is usually local content. A lack of local content, particularly in small markets, may limit the success of Netflix.

- The smaller size of the Netflix library in markets outside the US may also limit its success abroad. Netflix, however, says it intends to expand the libraries abroad.

On the other hand, broadband penetration in the Netherlands is higher than in the US. This could be favourable for the penetration of Netflix.

Piracy too may hamper Netflix and OTT services. Netflix itself refers to Popcorn Time as one of its main competitors. Use of Popcorn Time is particularly high in the Netherlands.

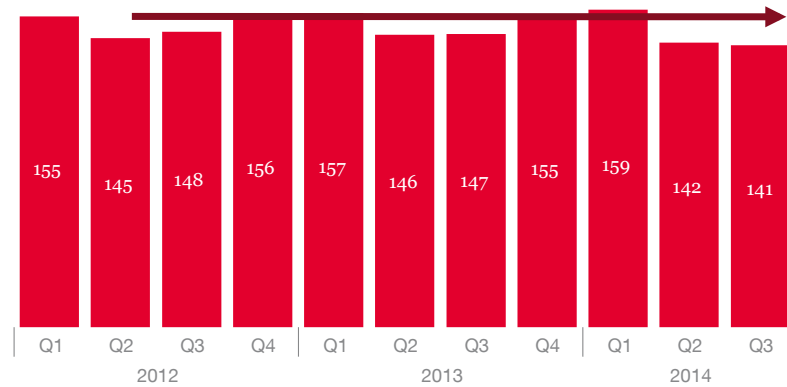
Netflix and linear TV - Cannibalistic or additive?

Netflix streamed 10 billion hours in the first quarter of 2015. The key question to all players in the TV industry is whether those 10 billion hours have changed TV watching habits. The data in the US may give some indications.

In the first quarter of 2015 Netflix streamed 10 billion hours worldwide

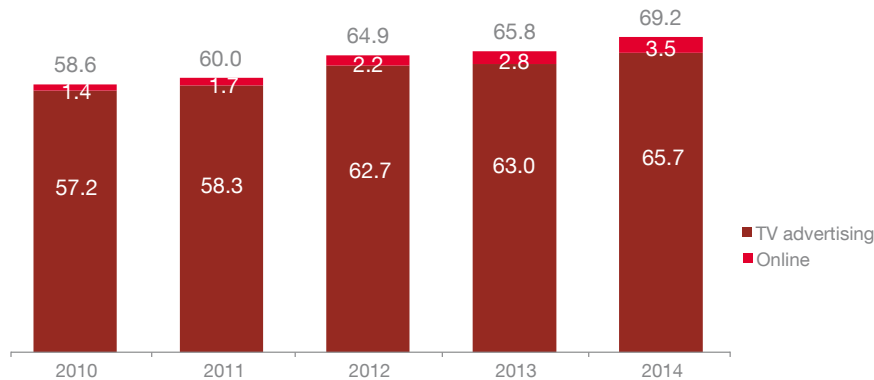


Figure 3 Linear TV watching in the US - P 2+ (hours per month)



Source: Nielsen

Figure 4 TV Advertising expenditure US (\$ billion per year)



Note: Online advertising revenue refers to ad revenue from sites operated/owned by the broadcast and cable networks, Source: PwC, Global Entertainment & Media Outlook, 2015-2019.

The Netflix OTT service has been available longer in the US than in the Netherlands and the household penetration is also higher in the US. In general, the US is about four years ahead of the Netherlands in terms of OTT TV user penetration and competitive dynamics.

Once we have assessed the impact of Netflix on TV viewing habits, we can evaluate if Netflix affects TV advertising. If Netflix indeed changes TV viewing habits, it will likely also affect the value of a pay-TV package to its subscriber. The analysis of TV viewing habits therefore allows us also to better understand if and why Netflix causes pay-TV subscribers to cancel their subscription ('cord cutting') or to take a less expensive package ('cord shaving') or causes (younger) households to never take a pay-TV subscription ('cord-nevers').

Linear TV watching in the US among the population at large (P 2+) has remained fairly stable over the past four years (at around 145 hours per month per viewer). Over the same period, Netflix almost tripled its subscriber numbers and streaming hours in the US. Some might deduct from this that Netflix supplements linear TV watching and does not cannibalize it.

Some find further corroboration of this in the US TV advertising figures. The US TV advertising market has been growing over the past four years – in spite of the tripling of Netflix's subscriber base.

In addition, over the past four years the number of pay-TV subscribers in the US has been fairly stable (at round 100 million). This too signals to some that Netflix is largely additive.

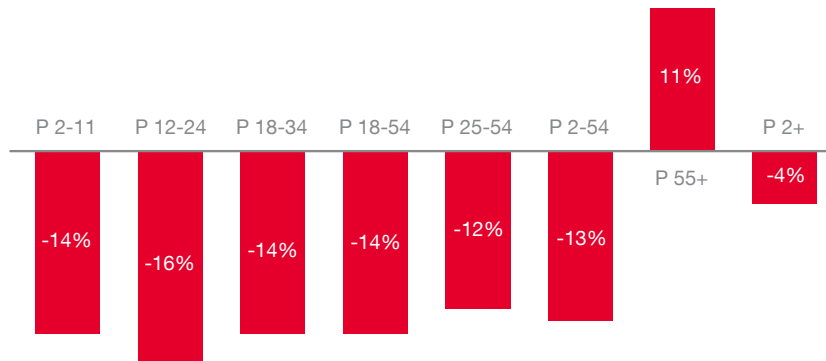
However, about a year ago, ratings for many network and cable channels unexpectedly started to fall, for some channels even steeply.

Time spent watching TV may indeed have stayed stable across the population at large (P 2+) during the last three years, but figure 5 shows that across age groups TV consumption has evolved differently. Older viewers (55+ year old) watch more (linear) TV. Younger viewers (2-54 year old), on the other hand, watch much less TV, a decline of almost 15% over the past four years. Subscribers to Netflix and other OTT TV services can mostly be found in the younger age groups. Their decreasing TV consumption is therefore linked to Netflix, the other OTT services and to TV Everywhere platforms.

As TV consumption among youngsters decreases, TV stations with a focus on younger viewers start to see major declines in their audience. For example, in the first quarter of 2015 MTV and Comedy Central both had about 20 to 25% less viewers compared to the same period last year. In general, the younger the audience of a TV channel, the bigger the decrease in TV ratings.

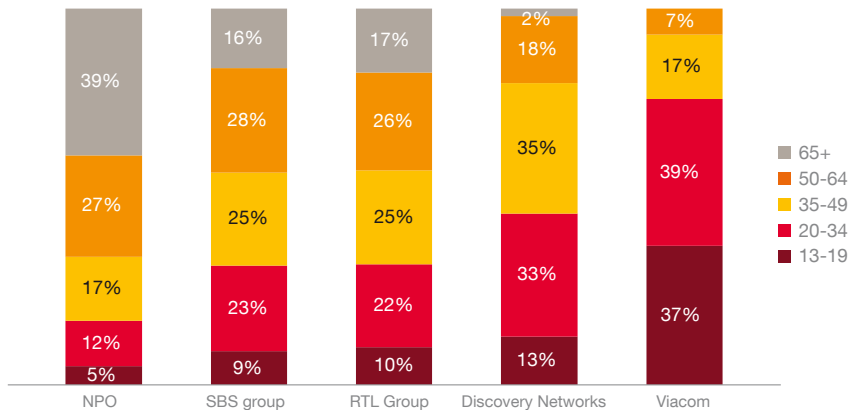


Figures 5 Aggregate prime time viewing, Live +7, 2013/14 versus 2009/10



Source: Nielsen, MoffettNathanson

Figure 6 Audience of TV networks in Netherlands – Break down by age group (2013)



Sources: PwC Analysis; SPOT Jaarrapport 2013.

In the Netherlands this implies that the impact of Netflix and other OTT TV services will likely differ across networks depending on the age profile of the audience.

The increasing linear TV consumption among older age groups is of little value to the TV stations as many older viewers (primarily above the age of 54) barely generate advertising income.

There are more data that show that Netflix is cannibalistic of linear TV watching. Panel data show that US households with a Netflix subscription watch almost 20% less linear TV than households without a Netflix subscription. The same panel data also show that after a household subscribes to Netflix, linear TV watching falls by almost 20%.

If TV watching is decreasing among younger age groups i.e., the age groups that generate advertising revenue for TV stations, why then has the total US advertising market grown over the past four years? Why has it not shrunk in line with declining TV ratings?

There are several factors that explain this conundrum. The US economy has seen growth rates of 2 to 3 % p.a. over the last four years. Historically, a 1% increase in GDP generally resulted in a 1.5% increase in TV advertising expenditure as TV advertising by and large maintained its strengths in terms of reach, richness of the message and frequency it offers. In addition, TV stations in the US (and in the Netherlands) have increased the advertising clutter (more and longer ad breaks)

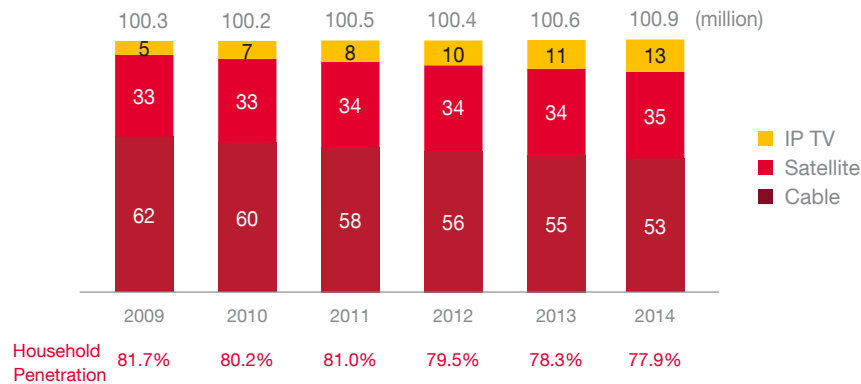
and are promoting shorter ads (15 second vs 30 second spots). This has increased both the quantity and the pricing of the spots. Lastly, both in the US and the Netherlands the number of TV channels has kept growing. This channel proliferation resulted in more fragmentation of the TV audience. Consequently, there are fewer programmes with big live audiences such as major sport events and blockbuster shows. Advertising space during these major programmes is getting scarcer and prices (CPMs) are increasing. Therefore, channel proliferation is thought to increase average price levels for TV advertising. Channel proliferation is one of the reasons why the major US broadcast networks keep having big markets shares in the TV advertising market despite the continuous decline in their ratings. The major broadcast networks now account for about 30% of the TV ratings but still account for approximately 60% of the US TV advertising market, because they still attract by and large the bigger audiences.

In short, Netflix has a deep impact on the TV advertising market from spot availability to pricing and ratings.

If Netflix does indeed lead to less (linear) TV watching, does it also affect the value of a pay-TV subscription to its subscribers? Are pay-TV subscribers cutting or shaving the cord? Are new households increasingly deciding not to subscribe to a pay-TV package?

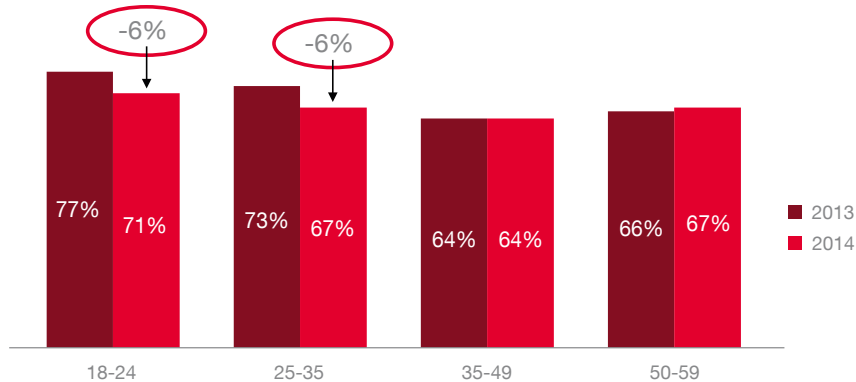


Figure 7 Number and penetration of pay-TV subscriptions US (million)



Source: PwC, Global Entertainment & Media Outlook 2014-2018

Figure 8 Pay-TV penetration by age groups - US Sept 2013 vs Sept 2014



Source: PwC, Feeling the effects of the Videoquake. Changes in how we consume video content (Oct-14)

The number of pay-TV subscriptions has indeed remained stable in the US in recent years (at around 100 million). The number of pay-TV subscription has, however, not moved in lockstep with the growth in households in the US (about 3% per year). TV penetration therefore has been decreasing from 82% to 78% over the last five years.

This decrease too, has been triggered primarily by younger viewers. PwC market research shows that in just one year (from 2013 to 2014) the penetration of pay-TV among viewers in the age group 18 to 35 decreased by about 6% (from ca. 75% to 69%).

The impact of OTT TV and Netflix is not limited to viewing patterns, the TV advertising market and pay-TV subscriptions. OTT TV providers, particularly Netflix, have become major competitors in the market for content. Netflix, for instance, outbid HBO for the rights to *House of Cards*. As a result of the growing demand for content from OTT players, prices in the content market (talent, scripts, etc.) have been steadily increasing.

Also, TV stations are improving the quality of their programmes and are raising content investments to defend their viewership against OTT TV and the binge watching phenomenon. SNL Kagan estimates that in the past four years programming costs for US cable TV networks have increased by 9% percent per year. Netflix and OTT is not the sole driver of this increase. There are other factors at play too, for instance channel proliferation.

Strategic implications of OTT TV and Netflix

OTT TV and Netflix in particular change the key dynamics in the TV industry: what people watch on (linear) TV and how much they watch, what they are prepared to pay for it, what TV advertisers are willing to pay for audiences, which content is in demand on which platform etc. As with many other changes in market dynamics it is important to resist the tendency to over-estimate the short-term effect and to under-estimate the long-term effect or, in other words, to find ad-hoc solutions for short-term problems without establishing a longer-term strategy.

Some fifteen years ago this tendency proved to be detrimental in the US when Netflix became successful with its DVD rental subscription by mail. This business model changed the dynamics in the home video market: what people were willing to pay for a rental or a purchase, which content was in demand etc. Short term quick fixes by the brick-and-mortar ‘rentailers’ were not adequate to escape bankruptcy (most notably of Blockbuster) and the lack of a long-term coherent strategy of content owners ultimately led to the collapse of the DVD sell through market, which was in the past the most important market for moviemakers.

With its streaming OTT TV services Netflix may yet again change the market dynamics – this time in the much bigger TV industry which has many more players and a more complex industry structure.

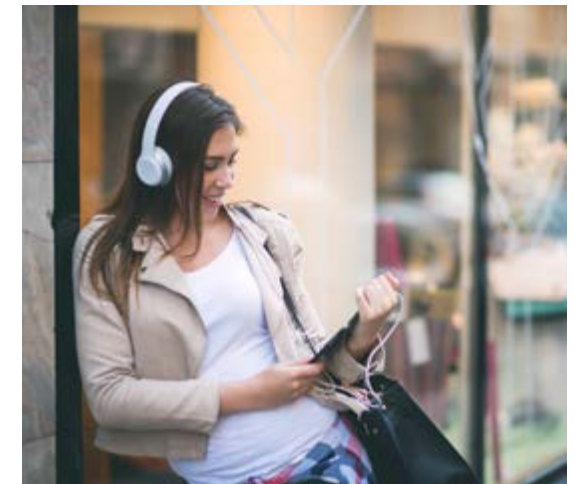


It is therefore crucial that players in the TV industry now formulate a strategic response to OTT TV. This touches all parties: TV stations, pay-TV providers, content makers (and their suppliers), advertisers, etc.

- **TV stations** face difficult choices. Should they develop an OTT TV platform? If so, should they act alone or in collaboration with other stations? Which programmes should they include in the OTT TV package: live broadcasts, catch-up TV (programmes from the past week, month or season) or catalogue? Should the OTT package include original and/or exclusive content? How much original content can the platform sustain on a longer term basis? Should the OTT service be subscription-based (paid for), advertising sponsored (free) or a mix of the two models? What consequences will the launch by a TV station of an OTT platform have on its relationship with its distributors and the fees it receives from the distributors (transmission fees)? Which content should a TV station license to other players (like Netflix) and which content does it keep for itself? Which rights should the TV station acquire to the programmes it airs? Which programmes should it acquire for linear or live TV and how should the programme mix evolve? Is the target group large enough in the long term to keep the TV station afloat?
- **Pay-TV companies** face similar questions. Should a pay-TV provider launch an OTT TV platform or package next to the TV Everywhere platforms? If so, how many and which TV stations should be included in the OTT TV package? At which price is

the OTT package attractive enough yet limits the risk of too much cannibalisation among its existing customer base? What is the likelihood of external players (retailers for instance) taking the initiative to launch OTT packages if pay-TV companies fail to do so? How should attrition among youngsters be managed: by price reductions, smaller packages, new combi-packages, targeted price reductions using big data?

- **Content makers** have to assess which types of programme will benefit or suffer from OTT TV and adjust their programme offering accordingly. Which content will experience the bigger decreases in live audience? How do audiences differ across platforms and which content has the higher potential across platforms? How will content budgets therefore evolve? What should content makers do with their libraries? Do they create their own OTT platform or do they license their content to Netflix, YouTube and the other OTT players? Which model had the higher yield (per dollar invested)? Can third party platforms (like YouTube) be used as testing ground and marketing vehicle for an 'owned and operated' OTT platform? Does broad distribution (through licensing with a player like Netflix) yield more revenue than a narrow niche distribution which may have higher yields?
- For **advertisers and their agency** it is important to consider which channels allow them to best reach their target groups now and in the future. If live TV watching (among youngsters) is decreasing, which channels will they use to



communicate with their target audience? TV advertising has been immensely popular and effective because of its reach and frequency as well as the richness of spot advertising. How should advertisers deal with the fall in frequency, reach and richness? Which platforms will be most suitable in the future for brand building, promotional activities, new introductions or events? Does the organization have the right skills to be successful on these new platforms? What price premium can target advertising or dynamically inserted advertising carry compared to linear TV?

The time has come to address these questions and to formulate a strategic response to the developments in OTT TV. In the US many players in the TV industry (TV stations, content



producers, pay-TV operators, etc.) have already made important moves and are taking major new initiatives. TV stations are making their content available to affiliated and third party OTT platforms. Some TV stations create new OTT platforms. Investments in (exclusive) content for OTT platforms which are affiliated with the TV stations (Hulu for instance) are increasing rapidly. Satellite operators are launching OTT packages. Makers of game consoles (Sony) and TV sets (Samsung) are entering the market. Google and Apple are rumoured to get into the industry. Retailers, Amazon for instance, are increasing their investments in OTT platforms and even creating original content. Premium cable channels (HBO, Starz etc.) are going OTT. There is a flurry of OTT

TV initiatives in the US. Also in the Netherlands we start to see the first major initiatives. Videoland has launched an OTT subscription service and invests in original content (*Black Tulip*). KPN is launching an OTT platform and also invests in original and exclusive content (*Brussels*)

Formulating a strategic response will involve a great deal of uncertainty and therefore trial and error. This is why flexibility will also be required. The new strategy will likely involve major changes in the business model and its success factors. This is why many new skills will need to be developed. There is not much time to formulate a strategic answer, as many players in the industry are already rolling out new initiatives. Not all initiatives will be successful.

But doing nothing and staying behind will for sure not be successful as those who stay behind will have to select from the less attractive left-overs.

Paramount in the formulation of a strategic response will be the development of OTT TV scenarios, a thorough analysis of the key strengths and assets of each player and an assessment of how the key strengths and assets can be leveraged in the various scenarios. Different players have different strengths and assets they can leverage and this will enable them to launch distinctive OTT TV propositions and meet the wants and needs of viewers in differing ways. ■

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