SVOD SERVICES: THE FIFTH BILLION IS THE HARDEST

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Key takeaways:

- SVOD streaming services could easily spend $30B on content annually in the U.S. by 2024, and tens of billions more globally. At such levels in the US, SVOD services could capture 30% of TV consumption (and higher for some audiences)
- However, this depends on SVOD owners' tolerance for heightened profit margin erosion, probably to a degree exceeding current expectations
- In this world, traditional TV ad inventory with reach to scaled audiences that advertisers want is likely scarcer. Audiences will be reached on some ad-supported streaming services, reducing the negative impact.

Apple's TV streaming service has launched and this week Disney will launch Disney+ in the US, Canada and The Netherlands. AT&T has also now announced details of its new HBO Max SVOD service. While expanding SVOD services will increase consumers' choices, , the already negative trajectory of traditional television will not necessarily accelerate. In the short-term, the constraint is probably not consumers' willingness to access these services. Subsidies such as Disney's arrangement with Verizon give subscribers on its unlimited wireless plan access for free for the first year. Apple's bundling of access for its hardware consumers will help ensure that subscriber numbers are high from the start. Instead, limitations of their impact on traditional TV will be a function of the pace at which SVOD services increase spending on programming.

Some of the new SVOD services are launched by traditional TV owners, so accelerating investment in SVOD content will partially depend on overcoming the friction tied to cannibalizing their existing revenue streams. These are hard decisions. Taking risks and making investments will help future-proof their businesses, but not every company will do all they need to in the short-term in order to ensure long-term health.

Within several years, SVOD owners could spend $30 billion on exclusive streaming content in the US alone – and multiples of this figure globally – if each one seeks parity with the current largest players in the space. Consider the following:

- Domestically, Netflix is spending around $3.5 billion this year on an accrual basis, or probably closer to $5 billion in cash terms (assuming one third of the global $15 billion in expected spending this year is attributable to the US). This amounts to around 5% of the ~$75-80 billion spent by all MVPDs and streaming services in the US. This spending is arguably reasonable considering how much viewing Netflix generates. The company accounted for 37% of all streaming consumption on televisions in the US, and streaming accounts for around 14% of TV consumption, according to our analysis of Nielsen data. Their spending share is roughly in proportion to the share of consumer time their platform. Over the next several years, costs will undoubtedly rise as Netflix looks to maintain its audience share, and so it is not unreasonable to think in terms of $5 billion in spending on an accrual basis or more than $6 billion on a cash basis by 2024.

- Disney expects to be spending $5 billion annually on content by 2024, with one third of subscribers inside of the US, and presumably a proportional amount of spending on content assigned to their US content expenses. Paired with spending on Hulu which last year amounted to around $2.5 billion and which will presumably rise. Even backing out costs associated with Hulu's vMVPD service, we could expect a $4+ billion streaming content bill for Disney's domestic operations in 2024.

- Similarly, AT&T has indicated that by 2024 it will be spending an incremental $3 billion on domestic programming for its HBO Max service, above and beyond what it already spends on HBO today.

- According to the *Financial Times*, Apple has committed $6 billion to spending on original shows and movies for its TV service, presumably globally, over an unclear time horizon.

- Comcast's spending plans for Peacock, set to launch around the same time as HBO Max, have not yet been disclosed.

Assuming each of these services aim for viewing parity, it is not hard to imagine each of the six services spending $4 billion per year, on average. Additional services will also undoubtedly be significant buyers of content, especially CBS and Viacom which will presumably invest more heavily in their initiatives after the two companies formally come together.

All of this new spending would be consistent with recent increases in industry-wide programming costs. If the non-streaming world were able to hold the line on their content spending at around $70 billion, the $30 billion referenced above would represent an incremental $20 billion on spending (as streaming services spend around $10 billion on content annually at the present time). This would equate to a roughly 5% increase in spending annually over the next five years on programming by the services consumers receive in the US, a lower figure than the +7% increase in spending on programming we saw from cable and satellite operators over the past five years, between 2013 and 2018.

However, the economics of streaming services are very different than the traditional MVPD business. They are less favorable on a stand-alone basis and usually need to be considered in context of other services with which they are bundled. Assuming that advertising attributable to streaming services will not be incremental (only a limited relationship between changes in supply or improvements in targeting and changes in total spending), direct revenues probably won't fully offset costs by much, if at all. If consumers continue to increase their spending on all forms of video (services, cinema, and DVDs: $140 billion last year) through to 2024, there would only be an incremental $20 billion in consumer spending available for new services. This is roughly equal to the amount of new spending on content we estimate above. This suggests there is no positive financial contribution to the industry from new services, even if we only considered content costs. Favorably for Disney, Comcast, AT&T and Netflix, the money will mostly go to these companies as Amazon and Apple appear to primarily look at streaming services as a value-added product and are not likely to attempt to recoup all of their costs directly. The overall economics of these services can be viewed more favorably if we consider their contribution to other business, including reduced churn reduction or pricing premia for services they are bundled with.

Of course, content spending is only one cost item for SVOD services. Other costs can be substantial as well. For example, AT&T has indicated it will spend around $1 billion per year on what it is categorizing as customer acquisition. Netflix is currently spending around $1 billion annually on marketing expenses domestically (and more than double that figure internationally), which is likely the most similar comparable expense. Altogether, each SVOD service could very well spend incremental billions on advertising every year. Partnerships with hardware companies, call centers and subscriber management, streaming delivery and other costs will add billions more. And then there are the costs of cannibalization. New services may cause cord-cutting to accelerate or cause consumers to actually reduce what they are spending on video services. For example, greater numbers of consumers might decide that traditional free-to-air broadcast channels paired with a collection of SVOD services are a more than sufficient replacement for traditional cable, at a much lower cost. With all of these new costs, profit margins across the industry likely fall.

For the media industry, the question is what their tolerance for margin erosion will be? This will drive the pace of change in the years ahead. Some owners of streaming services will be more tolerant than others and position themselves more favorably for the future than others. But it's also possible that every one of them agrees this kind of business reinvention ultimately leads to a better business in the long-run. For consumers this world arguably looks more favorable: more industry-wide spending on content and the opportunity to purchase content packages more granularly. For advertisers, some elements of television will worsen because ad inventory is likely scarcer and reach is likely harder to come by. On the other hand, where advertising does exist in this new world – and many streaming services will embrace it – it will likely reach more engaged consumers, in potentially more valuable environments than those which have come before.