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Declining profits here to stay for TV networks

ROGER MONTGOMERY THE AUSTRALIAN NOVEMBER 08, 2014 12:00AM

FOR many years, I've held the view that the free-to-air television networks in Australia resemble a group of poker players locked in a room with no doors or windows, playing for a fixed quantity of chips (viewers and advertising dollars).

In any given year, one of the players would be dealt a superior hand (suite of programs) and all the chips would be won by that player. The following year, another player was dealt the best hand and, lo and behold, won all the chips. As the population never really grew, the total pool of revenue didn't either — the chips were simply passed around.

With takeover target Ten Network commanding 40 per cent of the advertising market, Nine 35 per cent and Seven 24.2 per cent, the allegory offered a robust description of free-to-air TV in Australia — until now.

A drain in the corner of the room, however, has been quietly collecting fallen chips.

With each passing year, the total quantity of chips in the room diminishes as alternative options for TV viewing attract a growing number of younger fans.

This trickle of chips down the drain is about to become a damaging and profit-destroying torrent. Investors considering buying shares in our local TV operators may want to think again.

For TV operators in the US, the game changed last month and the influence is bound to reach our shores shortly.

US network broadcasters HBO and CBS have just announced they have begun streaming content on the internet. Think of it as "all you can eat" TV — and it's going to destroy the virtual monopoly that cable, satellite and telcos have held over TV programming.

The internet is replacing traditional television, apps are replacing channels, remote controls are fast becoming extinct and screens are carried with you everywhere and anywhere.

The US cable TV industry earns about $US70 billion ($82bn) in revenue annually. Operators need only to look to the savaging of revenue experienced by the music industry to forecast the disruptive impact of this decision on their own.

For decades, the music industry profited from charging for a package of songs wrapped around one or two hits.

In Australia, $20 was not unheard of for a vinyl album and even $40 for a compact disc. Then along came Napster, iTunes, Spotify and Pandora.

Each of these operators served to unbundle the album and allow consumers to pay for and listen only to those songs they really wanted.

The result? Between 2003 and 2013, music industry revenue from music sales fell more than 50 per cent, from nearly $16bn to $7bn; and the number of major record labels fell to three from five previously.

The growth of subscriptions to cable and satellite services has stalled, falling to 101.4 million in 2013, from 101.9 million in 2012, according to SNL Kagan.

Tellingly, and according to comScore, one in six 18- to 34-year-olds did not watch an original television series on a traditional television set in the past 30 days.

For now, HBO will continue to sell its programs through cable and satellite providers, offering its new internet product to an estimated 80 million households that do not subscribe to HBO.

But HBO will not escape the obvious cannibalisation.

CBS has taken a different tack because, unlike HBO, its major source of revenue is not distribution fees but advertising. CBS has become the first US broadcaster to offer a live stream of local TV stations over the internet, without the need for a pay-TV subscription.

CBS's All Access product was launched in mid-October, for $US5.99 a month.

Subscribers are able to watch more than 5000 episodes of old TV shows, live-stream local stations in 14 markets and view 15 current prime-time shows the day after they air.

In a classic move to protect legacy business revenue, the new CBS service does not include National Football League games. Live sports programming represents the last guard for networks that pay billions to sports codes for the rights to broadcast games.

Yet if advertisers want to reach the growing number of people who aren't subscribing, CBS will need to submit to a world of lower revenue and lower profits.

And it's not only CBS and HBO that will be impacted. Reinforcing the trend to internet viewing, Sony is expected to launch an internet service with programming from Viacom that will include content from its Comedy Central, MTV and Nickelodeon networks.

Proof cable TV businesses must evolve and become broadband internet companies was evident in Comcast's third-quarter results, which revealed the company had lost 81,000 cable TV subscribers — but increased the number of internet broadband subscribers by 315,000. Downward pressure on revenues and profits will follow the decline in monthly subscriber fees for cable and ultimately there will be more competition for Netflix.

Prices will then take another leg lower and the wave will eventually reach Australia's shores, leaving Australia's free-to-air and cable TV operators poker-faced.

Roger Montgomery is the founder of Montgomery Asset Management.

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